THE COMMUNITY BANK SENTIMENT INDEX

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A Look at the Future from Community Bankers

Banks are projecting an overall positive outlook for the future, according to first findings of the Conference of State Bank Supervisors (CSBS) Community Bank Sentiment Index. This sentiment is stronger for larger community banks than smaller and for banks in the South than in the Midwest and Great Plains, the Index shows.

Overall, 69% of banks surveyed by the CSBS stated they believe business conditions will be the same or better in the future, while 80% said they believe profits will be the same or better in the future.

The new Sentiment Index provides an important perspective on economic activity from those serving a critical role at the local level – community banks. Banks are central to the effective performance of the business sector. Bankers' attitudes reflect conditions in capital markets and conditions in the economy, primarily the local economy served by each bank. These insights have the potential to inform the market and policy makers on the overall health of the economy, opportunities and risk.

To capture these views in a consistent and sustainable way, CSBS incorporated a targeted set of questions into its annual national survey of community banks. The survey results will be released in October at the Community Bank Research and Policy Conference, which is sponsored by CSBS, the Federal Reserve System and the Federal Deposit Insurance Corporation. Building on last fall's initial report on community bank sentiment, the 2019 survey contained a new set of questions that will form the basis for a new CSBS Community Bank Sentiment Index.

The survey was distributed early in the second quarter of 2019. Beginning in September, the targeted set of questions will be sent to the industry quarterly and will form the basis for the CSBS Community Bank Sentiment Index. The Index will provide "real time" reports on conditions as the economy and economic policy change, providing a "bottom up" perspective.

Construction of the Index

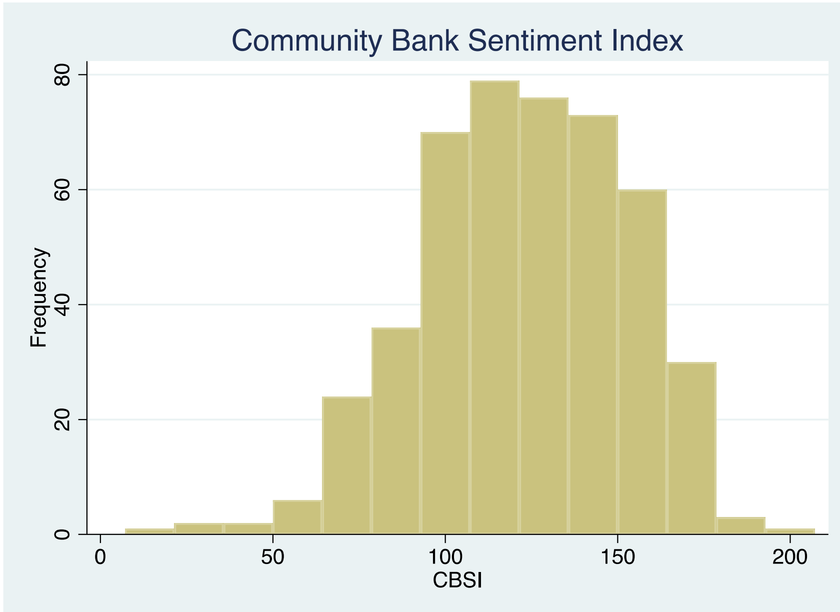
The Index collects bank views on seven dimensions that are mostly forward looking and combines them into the Index. A detailed distribution of each question is reported in the Appendix. These questions include:

1) How do you expect business conditions in your market to change over the next 12 months?
2) Where do you anticipate Federal Reserve monetary policy will be in 12 months from now?
3) How do you expect the regulatory burden on your bank to change over the next 12 months?
4) Is the current period a good time to expand your operations?
5) How do you expect your bank's capital expenditures on facilities or operations to change over the next 12 months?
6) How do you expect your profitability to change over the next 12 months?
7) How do you expect the franchise value of your bank to change over the next 12 months?

The construction of the Index sums the percentage of "positive" answers on each question and subtracts the percentage of "negative" responses, creating the "net" percent providing a positive response on each of the seven questions. The net percentages of positive responses are summed over the seven questions, divided by seven and added to 100 to ensure the Index is always a positive number for interpretative purposes. For example, if 45% expected profits to increase and 30% expected a decrease (meaning 25% expected no change), the net percent providing a positive response is 15 (45-30). If the reverse were true, 30% expected gains and 45% expected declines, the net percent would be -15. If the Index goes below 100, it means that a higher percentage of bank respondents gave a negative response to the seven questions than gave a positive one.

Changes in the Index over time will reflect the balance between positive and negative responses. The Appendix provides a detailed discussion of how the Index is computed. The current average value of the Index is 122, showing on balance significantly more positive responses to the seven questions than negative ones. That balance can change as the economic and regulatory outlook changes over time, and the Index will reflect those shifts in expectations.

The graph below shows the frequency distribution of the Index, with one bank scoring the lowest Index value of 14 and one with the highest value of 200.



The Index showed some variation by CSBS District (Table 1). Banks in the Midwest and Great Plains were more likely to report an Index value below 90, while banks in the South were more likely to report Index values above 145. There was no association between urban/rural location and sentiment as measured by the Index.

Table 1: Sentiment by CSBS District

Sentiment>	**<=90**	**90-100**	**100-130**	**130-145**	**>=145**	**All Banks**
New England	12	12	43	10	22	11%
Midwest	17	20	29	15	19	34%
South	6	14	28	22	29	21%
Great Plains	23	10	38	14	16	25%
West	8	18	36	16	16	10%
All Banks	15%	15%	33%	16%	20%	100%

Sentiment was strongly correlated with merger and acquisition offers (Table 2). Banks expressing strong sentiment (Index values above 145) were more likely to report making an offer to buy or merge with another bank (29% versus 20% overall). This outcome is consistent with the idea that a more positive outlook for the future would give banks an incentive to expand through acquisition to enter new markets or consolidate their position in existing markets.

Conversely, banks expressing weak sentiment (Index below 90) were much less likely to have made such offers (5% versus 20% overall). Banks that received offers to sell were more likely (19% versus 15% overall) to express less confidence about the future (Index value below 90) and less likely (0% versus 20% overall) to express high confidence (Index value above 145).

Table 2: Sentiment by Merge/Acquire

Sentiment>	<= 90	90-100	100-130	130-145	>=145	All Banks
Offer to buy	5	13	38	14	29	24%
Offer to sell	19	24	34	8	15	15%
All Banks	15%	15%	33%	16%	20%	

Sentiment showed little association with importance of adopting new technology or the importance of being a leader in adopting new technology. Table 3 reports the responses for only those banks that reported "very important" for each question, with 26% responding "very important" to the importance of adopting new technology to meet customer needs, while only 5% reported leadership in adoption to be "very important." These results are not too surprising if technology investment is required to maintain core deposits regardless of a bank's market outlook.

Table 3: Sentiment by Technology Importance/Leadership

Sentiment>	<= 90	90-100	100-130	130-145	>=145	All Banks
Tech Importance	13	21	28	17	22	26%
Tech Leadership	4	26	35	17	17	5%
All Banks	15%	15%	33%	16%	20%	

CBSI and Financial Performance

The Index was positively correlated with both size represented by assets as of March 31, 2019 and year over year asset growth during 2018 (Table 4).[1] The smallest banks (under $75 million) more frequently reported Index values below 90 (46% versus 15% overall) and less frequently above 145 (7% versus 20% overall). Sentiment expressed by banks with assets between $225 million and $1.5 billion was less likely to be below 90 (about 8% versus 15% overall). Large bank sentiment tended to be higher than average for Index values above 145 but not for the largest bank with assets above $1.5 billion.

[1] The sample size for the tables was reduced to 463 because 27 banks submitted invalid FDIC certificate numbers.

Table 4: Sentiment by Asset Size (3/31/2019)

Sentiment>	<=90	90-100	100-130	130-145	>=145	Total
<= $75M	46	13	26	9	7	10%
$75M-$125M	28	22	27	13	11	14%
$125M - $225M	12	16	33	18	22	21%
$225M - $500M	8	14	37	18	23	26%
$500M - $1500M	6	14	37	14	29	18%
>$1500M	12	12	37	20	20	11%
Total	15%	15%	33%	16%	20%	100%

Asset growth was also positively related to sentiment (Table 5). Banks with the highest growth rate in 2018 (above 15%) more frequently reported Index values above 145 (40% versus 20% overall) and less frequently reported Index values below 90 (2% versus 15% overall). Banks experiencing negative growth were more likely to report Index values below 100. Although not shown, sentiment was weakly associated with deposit growth. Faster growth could be the result of a number of success factors such as core deposit acquisition or local market growth.

Neither profitability (ROA) nor capital (equity/assets) showed any association with the Index. These results are consistent with the need for scale to absorb increased regulatory costs as well as maintain a technology footprint to attract millennial customers and grow core deposits regardless of the outlook for the future.

Table 5: Sentiment by Asset Growth (YOY 2018)

Sentiment>	<=90	90-100	100-130	130-145	>=145	Total
<= -3%	20	16	27	18	20	10%
-3% to 0%	23	23	31	15	10	13%
0% to 4%	20	15	34	11	20	27%
4% to 8%	15	13	38	14	21	24%
8% to 15%	8	17	38	21	16	15%
>15%	2	8	26	24	40	11%
Total	15%	15%	33%	16%	20%	100%

Several questions related to the importance of core deposits were added to the 2019 Survey, and one showed a strong correlation with the CBSI: the impact of depopulation. Banks that reported depopulation as “important” or “very important” more frequently reported lower Index values, i.e., had a more pessimistic outlook over the next 12 months (Table 6). This outcome is not surprising when local market customers are the primary source of core deposits.

Table 6: Sentiment by Depopulation Importance for Core Deposits

Sentiment>	<=90	90-100	100-130	130-145	>=145	Total
Not important	8	14	31	21	26	33%
Slightly important	14	17	34	10	24	19%
Moderately important	9	13	38	20	21	18%
Important	29	15	35	12	9	18%
Very important	25	20	30	9	16	12%
Total	15%	16%	34%	14%	21%	100%

Real Time Analysis: The Trump Tariff Announcement on May 6, 2019

The returns from this first survey permit a real time evaluation of the breakdown in trade talks with China on the economic outlook for community bankers. Using May 6, 2019 as the cutoff date, sentiment was compared based on the 98 surveys received before May 6 and surveys received approximately two weeks afterwards (surveys received through May 17 totaling 89) and those received approximately six weeks after the announcement (363 surveys received through July 5).

Table 7: Sentiment by Surveys Received Through May 17

Sentiment>	<=90	90-100	100-130	130-145	>=145	All Banks
Received on/before May 6	13	12	34	18	22	55%
Received after May 6	27	19	35	6	13	45%
Total	20	15	34	12	18	

In the two weeks after the tariff announcement, community banks showed a significant deterioration in sentiment (Table 7), most likely the result of the heavy concentration of respondents in the Midwest and Great Plains where agricultural lending is very important. Respondents more frequently reported Index values below 90 (27%) versus before the tariff (13%) and less frequently reported Index values above 145 with 22% reporting Index values below 90 before the announcement and 13% thereafter. By July 5, the difference narrowed with those reporting below 90 falling to 16% and those above 145 rising to 20% (Table 8).

Table 8: Sentiment by Surveys Received Through July 5

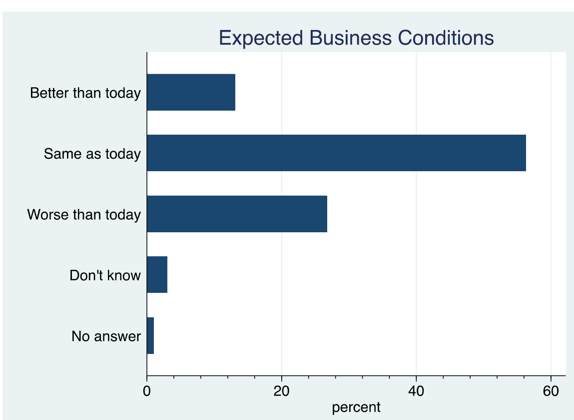
Sentiment>	<=90	90-100	100-130	130-145	>=145	All Banks
Received on/ before May 6	13	12	34	18	22	28%
Received after May 6	16	16	33	15	20	72%
Total	16	18	35	14	18	100%

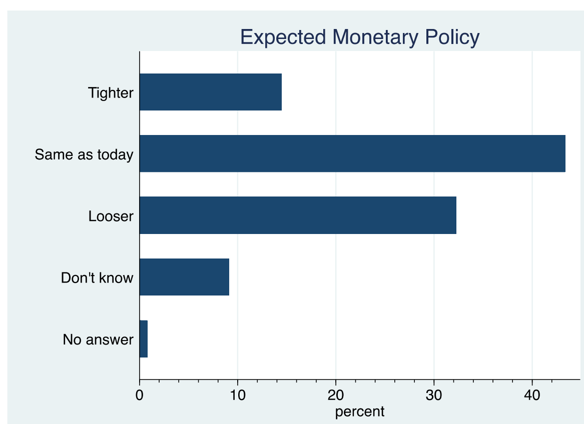
This methodology will permit an examination of the impact of economic, regulatory or political change that occurs during a survey period.

A Detailed Look at the Components

Future Business Conditions

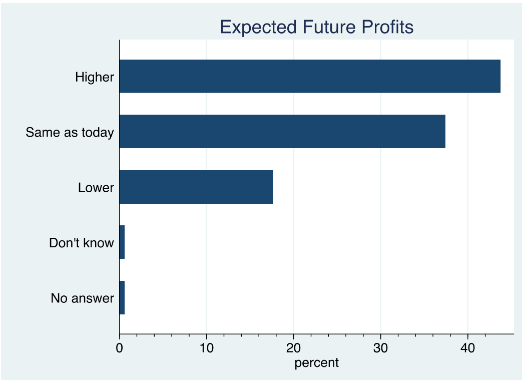
When asked about expected business conditions in 12 months, 13% of the bank managers reported they would be "better than today," but 27% expected a deterioration (the net favorable percent = -14), a concern for loan demand. These responses are consistent with their expectation about Federal Reserve policies, as 28% expect monetary policy to be looser (to offset economic expected weakness) while only 14% expect policy to tighten. If business conditions weaken as expected, the Fed is more likely to cut rates and make other policy changes that support private spending. This change would produce lower interest rates on new loans and existing lines of credit.



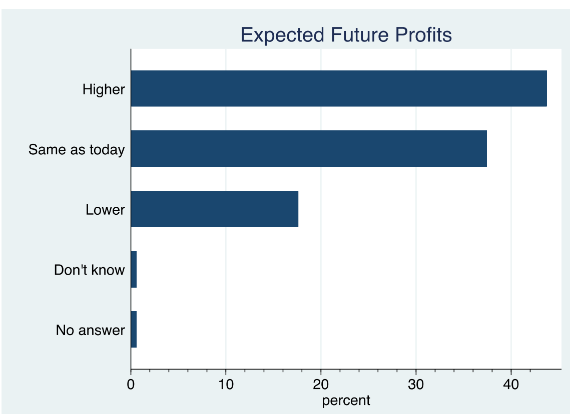


Profitability

Forty-three percent of the respondents to the survey expected profitability to increase over the next 12 months. Only 18% expected it to be lower despite some headwinds to the longest expansion in U.S. history and some uncertainty about where the Fed is headed with its policy rate (the "net" percent of favorable responses is 43-18 = 25). The economy and Fed policy are clearly on the mind of bankers when thinking about profitability over the next 12 months, with cost of funds (36%) and loan demand (32%) cited as the two most important factors influencing earnings (see Table 9 below).



When thinking about the biggest challenge to their business, the focus is less on the overall economy and more about the local market and regulation. Twenty-three percent report core deposit growth as their biggest challenge followed by regulation at 15% and competition at 15% (Table 11 below). The latter two are external factors not under the control of management. Core deposit growth is determined by bank policy decisions made in response to the economic environment, given the regulatory and competitive structure of the market in which they operate.



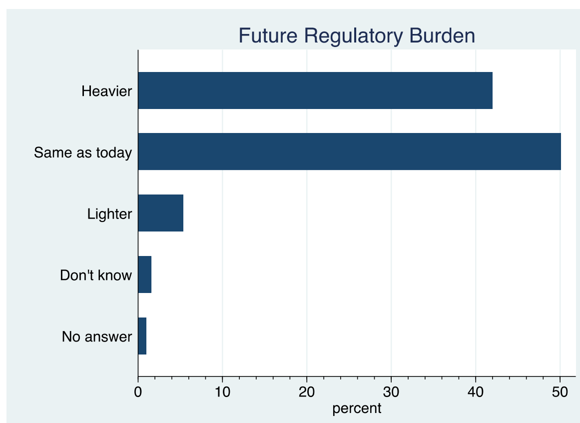


Table 9 shows that banks expecting higher profitability over the next 12 months more frequently reported loan demand (44% versus 32% overall) as a factor influencing future profitability and less frequently reported cost of funds (28% versus 36% overall). Those banks expecting lower profits more frequently reported cost of funds as the reason (44% versus 36% overall).

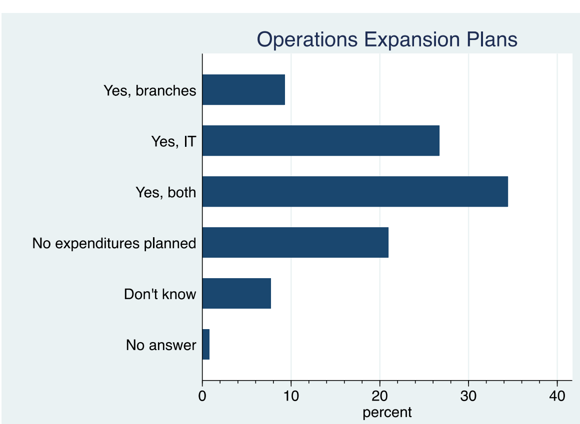
Table 9: Future Profitability Outlook by Factors Affecting Outlook

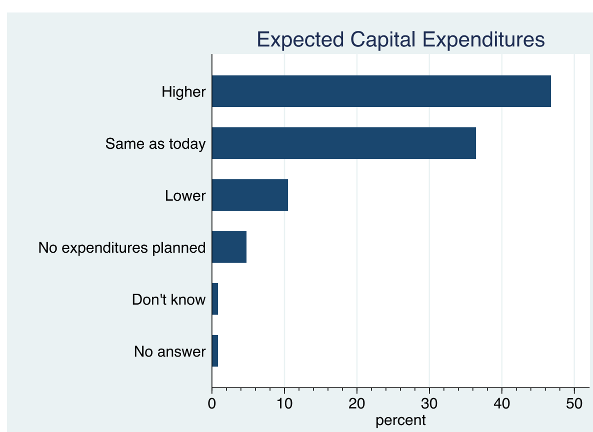
Future Profitability	Lower Rates	Operating Costs	Loan Demand	Regulatory Costs	Cost of Funds	Other	All Banks
Higher	10	11	44	2	28	4	43%
Same	10	17	22	7	42	3	38%
Lower	8	10	26	8	44	4	19%
Total	9	13	32	5	36	4	100%

Although regulatory cost was cited by few (5%) as a driver of lower profitability over the next 12 months, it still remains one of the most significant challenges community bankers see to their business model. When asked about future regulatory burden there was not much optimism: 41% expected it to become heavier while only 5% expected some relief.

Expansion plans

With a strong economy and a favorable profitability outlook, it is not surprising that 70% of the respondents think that now is a good time to expand in their market. Nine percent report that the current environment is a good time for branch expansion, 27% for IT/systems investment and 34% report for both. Looking ahead over the next 12 months, 47% planned higher capital spending, lower than the 70% thinking the current period was a good time for such spending, while 21% did not feel the current period is a good time for operations expansion. Only 11% report plans to lower capital expenditures, and 5% report no planned expenditures over the next 12 months.





Capital expenditures ("CAPX") are often positively correlated with profitability, and we might expect to see banks that have a positive (negative) outlook for profitability also report higher (lower) future capital expenditures. The Q1 2019 survey provides some evidence to support this behavior (Table 10).

Table 10: Future Profitability Outlook and Expected Capital Expenditures

	Expected Capital Expenditures				
Future Profitability	**Higher**	**Same**	**Lower**	**Nothing Planned**	**All Banks**
Higher	50	34	13	3	43%
Same	44	41	7	6	37%
Lower	44	35	13	8	18%
Total	47	36	11	5	100%

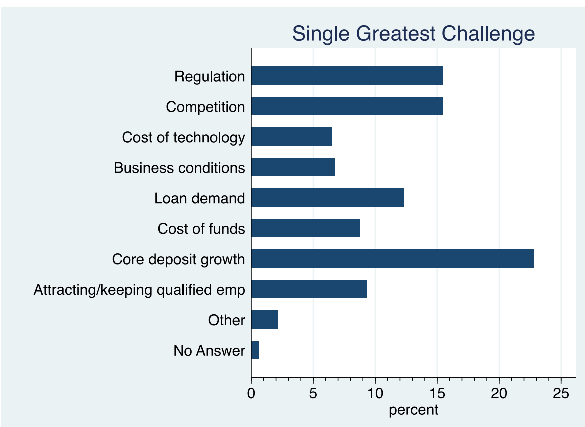
Of the 47% reporting higher future planned capital expenditures, those banks reporting higher future profitability are more likely to report higher capital expenditures compared to those expecting lower profitability (50% versus 44%). And banks expecting higher future profitability are less likely to have no planned capital expenditures.

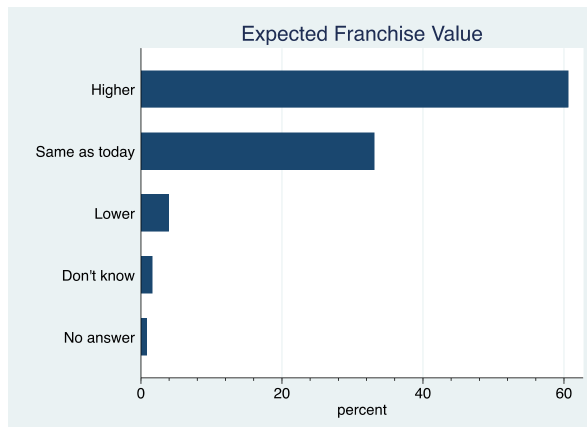
Greatest Challenge

The most frequently cited greatest challenge for the bankers was attracting core deposits in a market where short-term rates have been increasing for the past year, reported by 23% of the respondents (Table 11). Tied for second was dealing with the cost of regulations (15%) and competition from other banks and new types of lenders (15%). Although few cited business conditions as the greatest challenge, the fourth most frequently cited challenge was loan demand, which depends to a great extent on economic conditions. Banks were equally concerned, although at a much lower level, about finding qualified staff (9%) and the growing costs of new technology (9%). Building core deposits requires customer loyalty as well as paying well for deposits, and having a unique advantage (e.g. location, a focus on service and convenience etc.) creates an upward pressure on funds costs.

Table 11: Franchise Value by Greatest Challenge

Franchise Value	Core Deposits	Reg-ulations	Compe-tition	Loan Demand	Cost of Funds	Attracting Employees	Cost of Technology
Higher	22	16	14	14	10	9	6
Same as today	23	14	18	10	8	10	5
Lower	30	20	10	10	0	0	15
All Banks	23	15	15	12	9	9	7





Overall, bank managers appear to be quite optimistic about the near term outlook for the banking industry in an economy that is at full employment. But longer term, dealing with the cost of regulations will be a persistent problem, especially if the 2020 election brings a new cadre of policymakers to Washington, D.C. Although the number of competitors will likely decline through mergers and aquisitions, technology and the emergence of new nonbank competitors will intensify the competitive landscape. Loan demand will depend primarily on the course of the economy, now experiencing its longest expansion in history. Growth has been strong and all firms, large and small, are having trouble finding workers, a concern of many bank managers although a record low percentage of small businesses report any problem getting the credit they need and loan rates are historically low.[2] Policymakers will have a challenge keeping growth on an even keel with many risks to both the economy and community banking yet to be resolved.

[2] The National Federation of Independent Business (300,000 member firms) reported that only 3% of the owners said they did not get all the credit they needed (52% had no interest in a loan), and the average rate paid on shorter term loans was around 6%. (NFIB.org/research)

APPENDIX

The distribution of responses to the seven Index questions are shown below, along with the computation of the "net percent providing favorable responses," used to compute the Index. Note that some these are negative, meaning that a higher percentage of the respondents gave a negative response than gave a positive one. Below, the net percentages are added together divided by seven and added to 100 to ensure that the Index is always positive. An Index value under 100 means more respondents gave a negative response than gave positive one.

EBCD= 13-27=-14 EXPECTED BUSINESS CONDITIONS

Future business conditions

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	They will be better than today.	68	13.3	13.3	13.3
	They will be the same as today.	291	56.8	56.8	70.1
	They will be worse than today.	137	26.8	26.8	96.9
	I don't know.	16	3.1	3.1	100.0
	Total	512	100.0	100.0	

EMP=32-15=17 EXPECTED MONETARY POLICY: "LOOSER"-:"TIGHTER"

Future monetary policy

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	It will be tighter.	76	14.8	14.8	14.8
	It will be the same.	222	43.4	43.4	58.2
	It will be looser.	166	32.4	32.4	90.6
	I don't know.	48	9.4	9.4	100.0
	Total	512	100.0	100.0	

ERB=5-42= -37 EXPECTED REGULATORY BURDEN CHANGE

Future regulatory burden

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	It will get heavier.	216	42.2	42.3	42.3
	It will be the same.	260	50.8	50.9	93.2
	It will get lighter.	27	5.3	5.3	98.4
	I don't know.	8	1.6	1.6	100.0
	Total	511	99.8	100.0	
Missing	Refused/Not Answered	1	.2		
Total		512	100.0		

ECAPX=47-11= 36   EXPECTED CAPITAL SPENDING

Future facilities expenditures

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	They will be higher.	240	46.9	46.9	46.9
	They will be the same.	188	36.7	36.7	83.6
	They will be lower.	54	10.5	10.5	94.1
	No expenditure planned.	25	4.9	4.9	99.0
	I don't know.	5	1.0	1.0	100.0
	Total	512	100.0	100.0	

GTEX = 9+27+34= 70
(There are only two categories in this question, YES or NO, so there is no "negative" to subtract)

Operations expansion

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Yes, branches, ATMs, ITMs, etc.	48	9.4	9.4	9.4
	Yes, improved systems	140	27.3	27.3	36.7
	Yes, to both	176	34.4	34.4	71.1
	No	108	21.1	21.1	92.2
	I don't know	40	7.8	7.8	100.0
	Total	512	100.0	100.0	

EPR=44-17=27   EXPECTED PROFITABILITY CHANGE

Future profitability

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	It will be higher.	223	43.6	43.9	43.9
	It will be the same.	194	37.9	38.2	82.1
	It will be lower.	88	17.2	17.3	99.4
	I don't know.	3	.6	.6	100.0
	Total	508	99.2	100.0	
Missing	Refused/Not Answered	4	.8		
Total		512	100.0		

EFV= 60-4 = 56 EXPECTED CHANGE IN FRANCHISE VALUE

Future franchise value

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	It will be higher.	308	60.2	60.9	60.9
	It will be the same.	169	33.0	33.4	94.3
	It will be lower.	20	3.9	4.0	98.2
	I don't know.	9	1.8	1.8	100.0
	Total	506	98.8	100.0	
Missing	Refused/Not Answered	6	1.2		
Total		512	100.0		

Index Component	% positive	% negative	Net
EBCD	13	27	-14
EMP	32	15	17
ERB	5	42	-37
GTEX	70	0	70
ECAPX	47	11	36
EPR	44	17	27
EFV	60	4	56
			155
CBSI		146/7 + 100 =	122