



Community Banking | 2015 in the 21st Century

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Community Banking Research and Policy Conference

Community Banking in the 21st Century

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Alabama State Banking Department

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Letter from Lael Brainard

Community banks play a key role in supporting the economic vitality of communities all around America. Now in its third year, the *Community Banking in the 21st Century* research and policy conference has sharpened the Federal Reserve's understanding of the unique contributions and challenges of community banks. It's also given researchers an opportunity to help inform and influence discussions about the future of the community bank business model more broadly.

Past conferences have motivated the Federal Reserve to take a fresh look at the issues facing community banks, including the challenge of regulatory burden. Over the past year, the Federal Reserve has conducted an internal, comprehensive review of the regulations and regulatory processes impacting community banks and the extent to which modifications to these regulations or processes would have a meaningful effect on regulatory burden. The Federal Reserve Board of Governors has also acted on Congressional authority to raise the size threshold for a small bank holding company from \$500 million to \$1 billion. This action alone provided regulatory relief for more than 470 banking firms.

I would also note that the Federal Reserve is an active participant in a series of hearings offered this year under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGR-PRA) by the federal regulatory agencies. These hearings allow for a robust dialogue between banks and regulators. I am hopeful that they will lead to changes that better tailor our regulatory framework to the community bank business model, while continuing to ensure sound banking principles, appropriate consumer protection and fair access to credit and banking services.

Finally, I would like to congratulate the Conference of State Bank Supervisors and the state bank commissioners for their continued engagement in the State Commissioners' National Survey of Community Banks. The data gathered through the survey and anecdotal information gained through roundtable conversations inform the discussions here at this conference and promote continued interest by academics in the issues facing community banks.

I am very pleased to be a participant in this important event and look forward to deepening our knowledge of community bank issues and opportunities.

Lael Brainard

Governor

Federal Reserve Board of Governors

Chair, Committee on Consumer and Community Affairs

Letter from John W. Ryan

Alongside Conference of State Bank Supervisors Chairman David Cotney and Federal Reserve Gov. Lael Brainard, I am pleased to present this third annual report on the opportunities, challenges and perspectives of community banks.

I am very encouraged by the growing interest from researchers and academics regarding the *Community Banking in the 21st Century* research and policy conference. The work of these researchers has highlighted the unique value of community banks to local economies and small businesses. It has challenged certain regulatory dogma, such as the assumption that geographic diversity and business diversification is directly correlated to safety and soundness, and has highlighted the critical role that community banking plays in rural America.

As has been acknowledged in the past two conferences, regulatory complexity presents a clear and apparent challenge for community banks. Some have pointed to the current regulatory environment as the cause of industry consolidation and the lack of de novo charters. While only two banks have been approved for de novo charters since 2010, more than 1,500 institutions have closed their doors or merged with another bank. Understanding the extent of the relationship between regulatory complexity and industry consolidation is a pressing priority of regulators and is critical to ensuring the future of a strong, diverse dual-banking system.

Addressing these questions requires quantifiable data and sound analysis. It will also require practical, on-the-ground knowledge and feedback from community bankers, which is why state regulators once again organized town hall meetings and conducted a comprehensive nationwide survey of their community bankers.

I am pleased by the attention the research conference and this publication have garnered. Each year, more and more researchers, policymakers and industry stakeholders reference research from the conference to inform their daily work.

But research alone is not enough to solve these problems. As regulators, we must come together and put to good use all that we have learned. We are more than just administrators of the law; we must also provide leadership and vision. We cannot simply wait for a legislative solution. Congress alone won't solve the issue of regulatory complexity for us. Affecting change is also our responsibility.

I'm grateful for the work of state regulators, researchers and the thousands of community bankers who have put countless hours of work over the past three years into the *Community Banking in the 21st Century* research and policy conference and town hall publication. I am especially grateful for our valuable partnership with the Federal Reserve Board and the Federal Reserve Bank of St. Louis, without which we would be unable to hold this conference each year. Now that the foundation has been firmly established, I look forward to working together to produce meaningful, lasting solutions that ensure a financial system that best serves our economy, our citizens and our democracy.

John W. Ryan

President and CEO, Conference of State Bank Supervisors

Foreword from David J. Cotney

This is the third annual *Community Banking in the 21st Century* research and policy conference, designed to better understand the role community banks play in our financial system; the impact they have on local, state and national economies; and how financial and regulatory policy affects how they conduct business.

A unique and integral component of the research conference remains the direct input from community bankers. This year, state regulators once again held roundtable, town-hall-style meetings with their community bankers to gather first-hand accounts on the challenges and opportunities community banks face.

A few common themes emerged from these meetings. For instance, a lack of clear regulatory expectations and perceived aggressive examination tactics has led many banks to hire more compliance personnel and third-party auditors, both of which are in high demand and very expensive. Compliance costs have also led banks to abandon certain financial products, forcing consumers to nonbank financial services providers.

A CSBS and Federal Reserve survey of nearly 1,000 community bankers adds some quantifiable data to what we heard at the town hall meetings. For example, the survey revealed that regulatory compliance accounted for about 10 percent of all personnel expenses and 38 percent of accounting and auditing expenses for community banks.

A new component of this year's conference is the CSBS community bank case study competition, in which undergraduate student teams partnered with area community banks to showcase the local economic impact of community banks. This year's winning case study from the University of Utah and executive summaries of the finalists' reports are included in this publication. This combination of quantitative data and qualitative anecdotes, along with the academic research, are what make this conference so unique and innovative.

I am pleased to report that our approach is paying dividends. Over the past few years, I have observed bicameral, bipartisan recognition in Congress of the regulatory challenges and obstacles facing community banks. However, policymakers have been unable to agree on what type of institution constitutes a community bank. Using only asset thresholds to define institutions, while useful in certain contexts, has not been productive when it comes to determining whether an institution is a community bank for purposes of developing regulatory relief proposals.

As the findings of this research conference have shown, community banks are best identified by looking at asset size and at qualitative factors that allow for flexibility in interpretation and application. While testifying before Congress, CSBS and state regulators have taken these findings and advocated for a definitional approach to identifying community banks. This approach could be used as a basis for a broad range of regulatory right-size initiatives.

Ongoing research and dialogue on the role of community banks is vital to ensure we continue to enjoy a diverse, competitive and vibrant banking industry in the United States. I am proud of the work we have achieved to date and look forward to making strides together.

David J. Cotney

Chairman, Conference of State Bank Supervisors

Commissioner, Massachusetts Division of Banks

2015 National Survey

Introduction

This year's report on community banking is based, in part, on results of a second annual survey conducted by the Conference of State Bank Supervisors (CSBS) and state regulators. The goal of the survey is to provide a comprehensive view of what bankers are thinking about key issues facing the industry and how they are responding to changes in their markets. Its findings are supplemented by a summary, in narrative form, of town hall meetings and associated roundtable discussions among bankers and regulators held across the country.

Both parts of the report reflect the world as seen by community bankers. It is not intended to be all-inclusive; different perspectives yield different views. But it offers valuable insights that can be used to better understand and further the development of the community banking industry.

The report strives for topicality. What we noticed in last year's survey and in state-by-state discussions was a heavy focus on regulatory burden. This subsequently has been underscored by intensifying discussions devoted to compliance that have been heard in the hallways of banks, in the news media, at bankers' conventions, at research centers and within regulatory and political circles. This year, we expanded the number of questions concerning regulatory costs.

Community banks are generally regarded as having two key characteristics: They are small in size, and they do most of their business in the community in which they are located.¹ Since passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), common practice has been to define them as having less than \$10 billion in assets. For the purposes of this survey, we adopt the Dodd-Frank standard. Definitions, however, go beyond size. We note that community bankers often define their role in terms of "customer service" rather than size. They see themselves as complementing large banks by specializing in relationship banking and providing credit to small businesses.

Key Findings from the Survey

Respondents to the 2015 survey reported that regulatory compliance accounted for 11 percent of personnel expenses, 16 percent of data processing expenses, 20 percent of legal expenses, 38 percent of accounting and auditing expenses and 48 percent of consulting expenses. To the extent that these percentages are accurate and representative of the community banking industry, they imply a hypothetical compliance cost to community banks, in these areas alone, of \$4.5 billion annually. This would represent 22 percent of their net income.

It is beyond the scope of this year's study to determine the extent to which these potential costs are appropriately balanced against their benefits—in terms, for example, of bank safety and consumer protection—or even whether, in an objective sense, they are "high" or "low." But the collective interpretation of the survey results and discussion panels leads to a clear conclusion: They are sufficient to frustrate bankers.

Another important finding is a narrowing of the breadth of mortgage lending activities. One- to four-family mortgages were named as primary product lines by 69 percent of respondent banks, compared to 75 percent last year, which is a proportionate drop of 8 percent. Retrenchment encompasses nonqualified mortgages (non-QMs) that, under rules implemented last year by the Consumer Financial Protection Bureau (CFPB), are considered to be riskier than qualified mortgages (QMs). Bankers listed regulations governing them as among the most confusing and burdensome.

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How the Survey Was Conducted

To develop the survey, staff members of CSBS met with representatives from several Federal Reserve banks, the Federal Reserve Board of Governors and the academic community. Together, they developed questions that were refined by the Survey Research Institute (SRI) at Cornell University. The survey was distributed by state banking regulatory agencies in early 2015.

The questions were designed to highlight current issues of relevance to the community banking industry. Many, but not all, of the questions were similar to those asked in the 2014 survey, thereby offering an opportunity to compare responses over time. The questions involved lines of business, mortgage market participation, technological innovation, regulatory compliance, competition and consolidation. As mentioned earlier, new questions this year focused on specific regulatory costs.

SRI constructed the web interface used by the respondents, handled the technical aspects of data collection and forwarded the data for analysis. Unlike last year, respondents were given the option of providing their unique Federal Deposit Insurance Corp. (FDIC) certificate numbers. This allowed for an association of responses for a particular bank with its publicly available information.

The final sample consists of 974 responses from commercial banks with assets less than \$10 billion in 39 states.

TABLE 1
Bank Asset Categories

What was the asset size of your bank as of Dec. 31, 2014?	Banks in Survey		All State-Chartered Community Banks	
	Number	Percentage	Number	Percentage
Up to \$50 Million	54	6.19%	579	11.92%
\$50 Million to \$100 Million	136	15.58%	870	17.91%
\$100 Million to \$300 Million	340	38.95%	1,883	38.77%
\$300 Million to \$1 Billion	260	29.78%	1,117	23.00%
\$1 Billion to \$2 Billion	43	4.93%	221	4.55%
\$2 Billion to \$10 Billion	35	4.01%	187	3.85%
Greater than \$10 Billion	5	0.57%	0	0.00%

TABLE 2
Branching

How many branches does your institution currently have?	Banks in Survey		All State-Chartered Community Banks	
	Number	Percentage	Number	Percentage
0 (Headquarters Only)	170	19.45%	1,044	21.49%
1-5	435	49.77%	2,558	52.67%
6-10	147	16.82%	665	13.69%
More than 10	122	13.96%	590	12.15%

TABLE 3
Geographic Diversification

In how many states does your bank operate?	Banks in Survey		All State-Chartered Community Banks	
	Number	Percentage	Number	Percentage
1 State	822	86.44%	4,436	91.33%
2 States	79	8.31%	323	6.65%
3 States	22	2.31%	64	1.32%
4 States	6	0.63%	14	0.29%
5 States	1	0.11%	10	0.21%
6 or More States	21	2.21%	10	0.21%

Participation varied (Figure 1). Texas alone was home to more than 20 percent of all respondents.

The imperfect response rates and their unequal geographic distribution raise potential issues with respect to survey bias—that is, with how “representative” the respondent banks may be of the community banking industry overall. To address these issues, we compared characteristics of respondent banks with characteristics of the universe of all banks for which information

is available in the Reports of Condition and Income (Call Reports). We limited comparisons to state-chartered banks with less than \$10 billion in assets. (All but a handful of the 974 survey responses came from banks with state charters.)

Tables 1 through 3 provide information on asset size, branches and geographic diversification, respectively, for respondent banks and for the industry in general. Banks in the smallest size categories

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that participated in the survey tended to be underrepresented relative to the industry as a whole. In this regard, banks with less than \$100 million in assets represented 22 percent of those in the survey but 30 percent of all community banks. Surveyed banks had a greater number of branches and operated in a greater number of states.

More detailed statistical testing would be required to definitively quantify the extent to which surveyed banks were representative. Observed differences, however, do not appear to be conspicuous.

Results

The Customers of Community Banks

The role of community banks often is described in terms of customer service. These services, of course, are numerous and varied. One way to summarize them is by looking at banks' self-described customer categorizations.

Banks were asked to identify their primary lines of business and, within those lines, specific products and services offered. On average,

respondents listed four primary lines of business and eight products and services.

Lines of Business

Commercial real estate lending, the most common line of business, was named by 74 percent of respondent banks (Figure 2).² It is interesting to compare this exposure to data obtained from Call Reports, and presented in Table 4, which show that commercial real estate lending constituted about 43 percent of the loan portfolios of state-chartered community banks. This suggests that commercial real estate lending is a heavily weighted line of business—i.e., it is prominent in loan volume as well as by line of business. It also is heavily weighted relative to larger banks (with assets greater than \$10 billion), for which commercial real estate loans accounted for less than 10 percent of all loans.³

One- to-four-family mortgage lending also features prominently as a primary line of business. It was named by 69 percent of respondent banks. This is lower than last year (see later sections for discussion). Like commercial real estate, residential lending is a heavily weighted line of business, accounting for 23 percent of community bank lending.

Agricultural lending was named as a primary product line by 43 percent of respondent banks. Note that agricultural loans represented 3 percent of the total loans of community banks industry-wide. The latter level, while suggesting an underweighted line of business, is nevertheless

FIGURE 2
Lines of Business

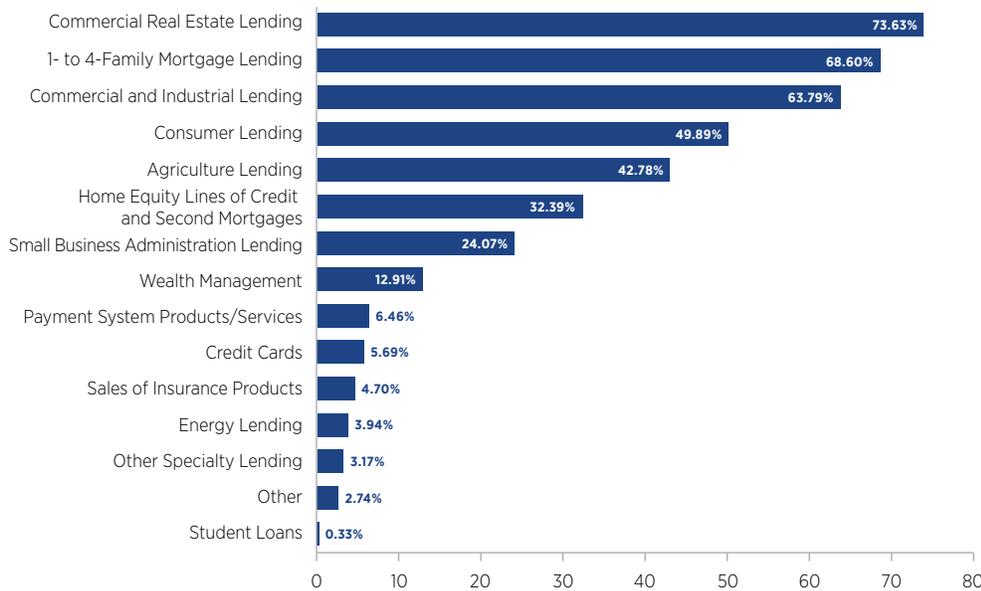


TABLE 4
Lending Concentration of the Community Banking Industry

Loan Product	Percent of Total Loans
Commercial Real Estate	42.75%
1- to 4-Family Mortgages	22.65%
Home Equity Lines of Credit	3.87%
Commercial and Industrial	15.05%
Consumer	6.08%
Agricultural Production	3.20%
All Other Loans	6.40%

NOTE: Data are obtained from Call Reports, Dec. 31, 2014.

high relative to the scant percentage of loans accounted for by agriculture in the portfolios of larger banks.⁴

Wealth management was a small but fast-growing activity. It was named as a primary line of business by 13 percent of banks this year (Figure 2), which is a proportionate increase of 18 percent (compared to last year's 11 percent level). Interest in offering these services intensified as banks sought new ways to generate profit in a low-interest rate environment.⁵ Retirement services, in particular, have been identified as a promising point of expansion.

Products and Services

With respect to specific products and services that banks currently offered and planned to offer in the future, categories varied significantly in relative importance (Figure 3). As was the case in last year's survey, automobile loans were the most prevalent. Nearly 90 percent of all banks offered them.

Very few respondent banks indicated that they offered payroll cards, student loans or reverse mortgages. The scarcity of offerings for the latter two services appears likely to persist, as they ranked first and second in the categories that bankers plan to continue to avoid in the future (Figure 4).

Mortgage lending products also were prominent, but in relative decline. This year, home equity lines of credit (HELOCs) and second mortgages (other than HELOCs) were offered by 60 percent and 65 percent, respectively, of respondent banks (Figure

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FIGURE 3
Products and Services Offered

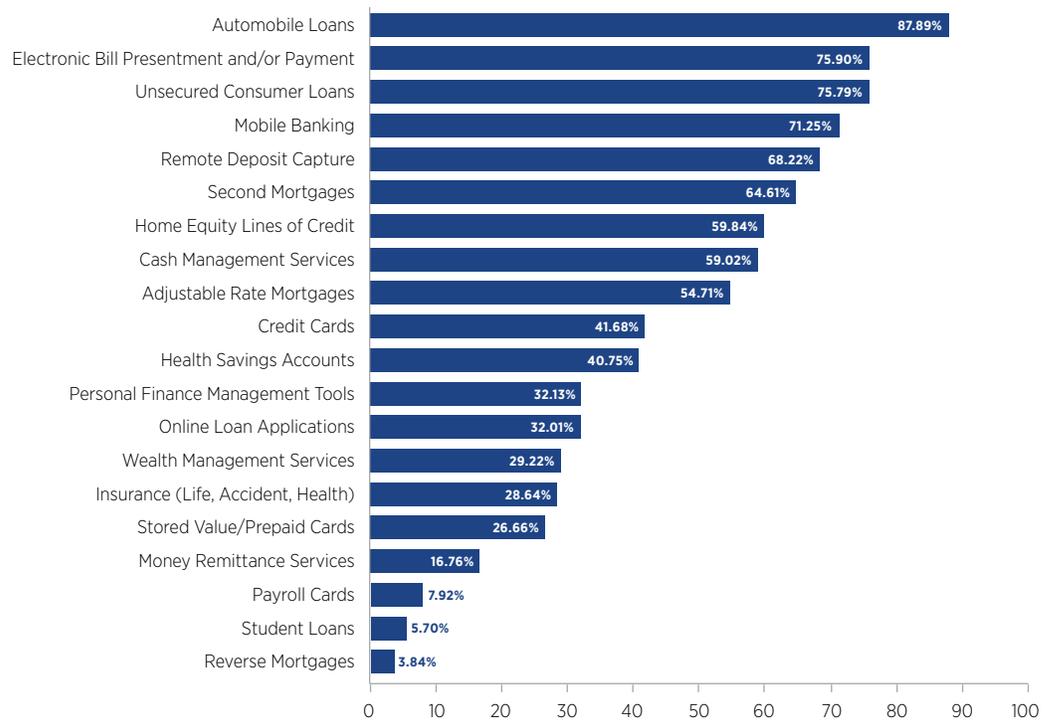


FIGURE 4
Products and Services Not Offered and Not Planned to Be Offered

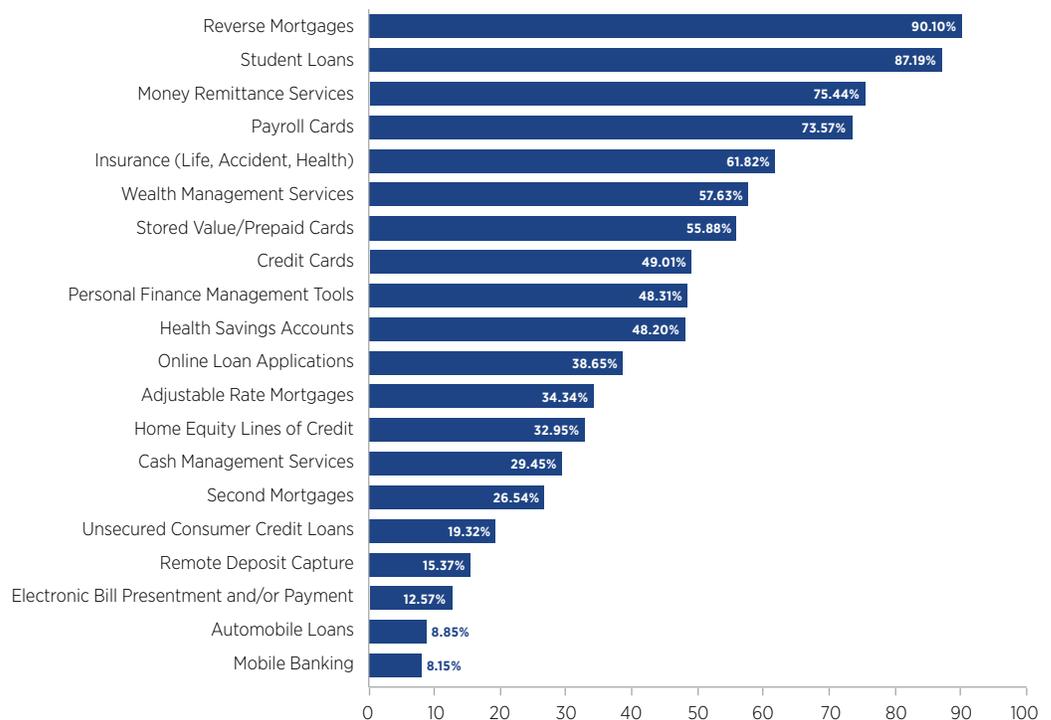


FIGURE 5

Products and Services to Be Discontinued

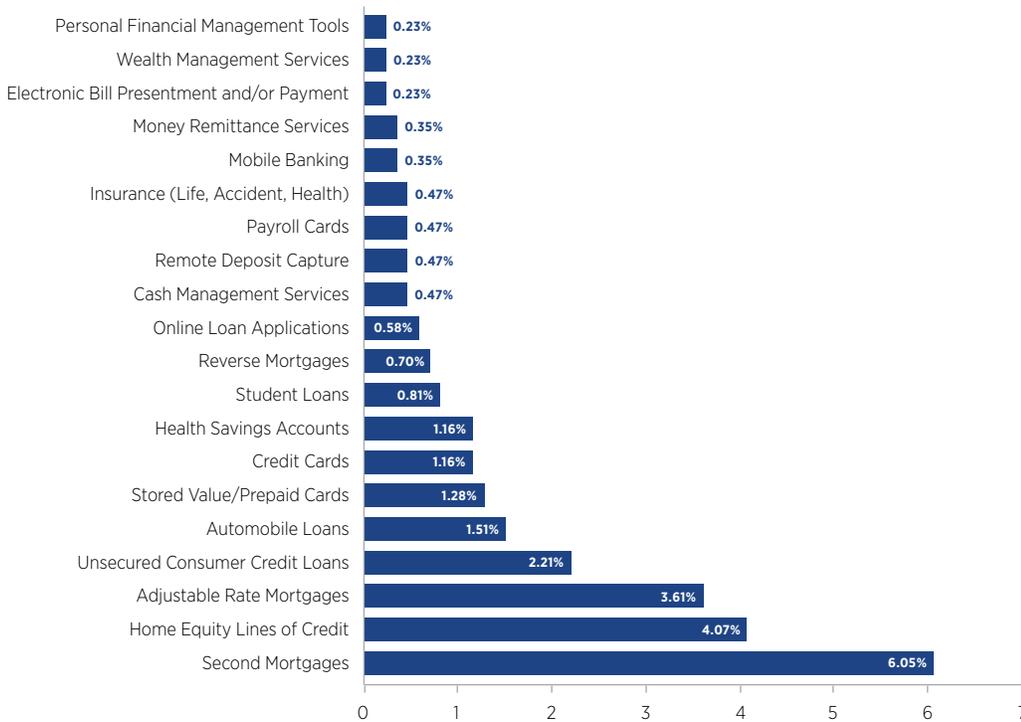
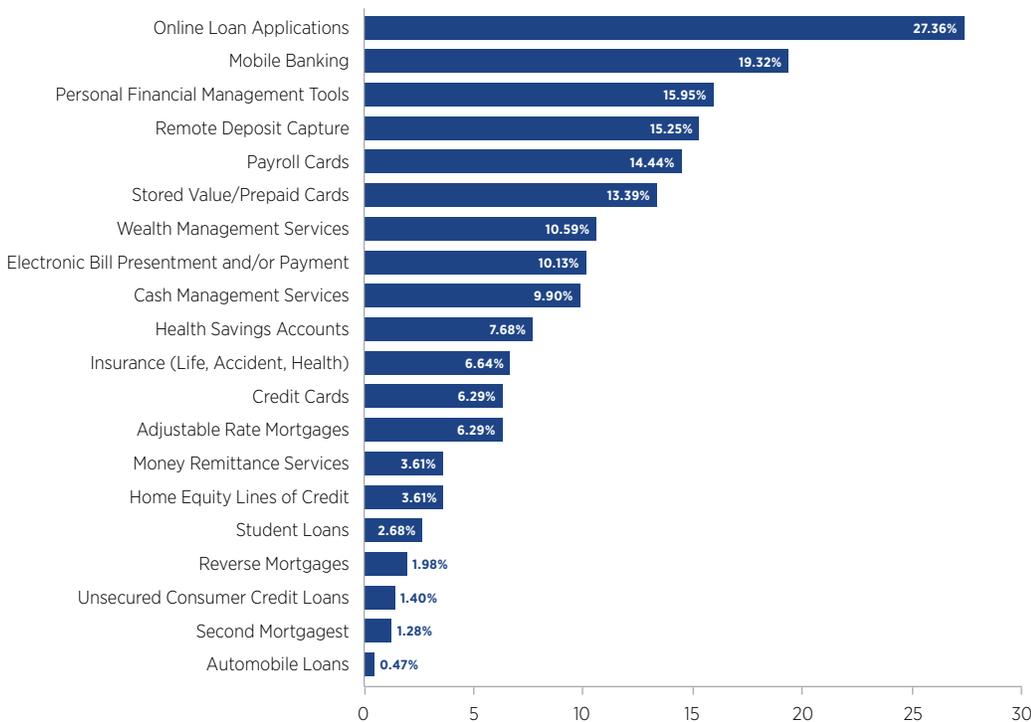


FIGURE 6

Products and Services to Be Introduced



3). This was down considerably compared to last year's levels of 66 percent and 73 percent. It is interesting to note that the decline in second mortgages was anticipated. In last year's survey, 26 banks expected to contract such lending, while only six banks expected to expand.

A down market for adjustable rate mortgages (ARMs), on the other hand, was unanticipated. They were offered by 55 percent of respondent banks, down from 66 percent last year. In last year's survey, 55 banks said they expected to expand this offering, while 13 banks expected to contract it.

The extent to which slack mortgage lending may continue in the future can be inferred by looking at information on products and services that bankers expect to discontinue (Figure 5). Second mortgages, HELOCs and ARMs are prominent. They also ranked among the least likely to be considered by bankers as areas of expansion (Figure 6).

A surprise for bankers was in health savings accounts (HSAs). Last year, 27 banks said they expected to expand, and only two banks expected to contract, these accounts. Contrary to expectations, the representation among bank products and services was unchanged compared to last year. This also contrasts with an estimated increase of nearly 30 percent in the number of HSAs nationwide during the same approximate time period.⁶

Mobile banking services were increasingly mentioned this year as products and services (as well as primary lines of business, as indicated

previously). They were offered by 71 percent of respondents, which lifted it from the seventh-ranked category in 2014 to the fourth-ranked category this year (Figure 3). Other surveys have similarly documented the ubiquity of mobile phones in accessing financial services.⁷

The growth of mobile banking, along with cash management, which also moved up in relative ranking this year, confirmed prior forecasts of bankers. Last year, 285 banks expected to expand these activities, while only one bank expected to contract. The trend may continue. This year, 19 percent of bankers said they expected to introduce mobile banking services within the next three years (Figure 6).

Personal finance expanded significantly, more than doubling from last year's survey, albeit to a relatively low level of 32 percent (Figure 3). Unsecured consumer loans were offered by 76 percent of banks this year, down from last year's level of 80 percent. This category, along with second mortgages (as noted earlier), were the only ones that bankers last year expected to reduce more than they expected to expand. They were prescient on both.

Online loan applications were an enigma. Last year, 190 banks expected to expand within this category, while only three banks expected to contract. And this year, it is the product or service that bankers named as most likely to be introduced (Figure 6). But the survey this year shows that online loan applications were offered by only 32 percent of banks (Figure 3), a

percentage that barely changed from last year.

Mortgage Lending

The market for mortgage loans was buffeted last year by regulatory changes (particularly those affecting QM and non-QM mortgages) and intensified competitive pressures. Many banks curtailed mortgage activities.

One- to four-family mortgages were named as a primary line of businesses by 69 percent of surveyed banks (Figure 2), versus 75 percent the year before. This drop was anticipated, as last year's survey showed that the number of banks expected to decrease mortgage lending exceeded the number of banks expected to increase mortgage lending.

Considerable variation in mortgage market conditions was reported by geographic location, with bankers in some areas describing strong demand. More typically expressed, however, was a preference for retrenchment, often attributed to high regulatory costs, the complicated nature of the mortgage market and the large expenses incurred within it.

"Our mortgage operations operate at, or barely above, break-even volumes," one banker said.⁸ "It is a service we provide to our customers and is not profitable enough today to be a main source of our revenue. If volumes drop from these levels, then we will need to consider downsizing the mortgage department to service lower volumes without incurring losses to the company."

The de-emphasis on mortgage lending as a primary line of business and among

products and services appears to contrast with an inclination of banks to hold, rather than sell, the mortgages they make. In this regard, 45 percent of respondents said they held at least 90 percent of the loans they originated (Figure 7). On the other end of the spectrum, 12 percent of banks held less than 10 percent of the loans they originated.

The greater percentages of held mortgages has been *continued on the next page* ▶

FIGURE 7
Percentage of Mortgages Held

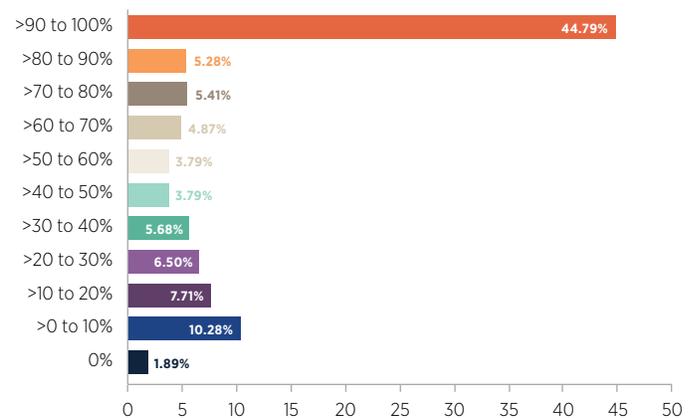
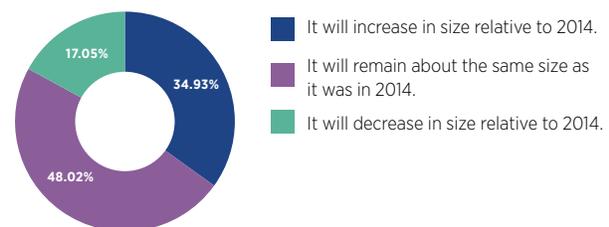


TABLE 5
Total Mortgages Held in Banks' Portfolios (in Billions)

Bank Type	2012	2013	2014
Community Banks	\$473.6	\$470.7	\$502.9
Large Banks	\$1,420.0	\$1,359.1	\$1,339.2
Total	\$1,893.6	\$1,829.8	\$1,842.1

FIGURE 8
Anticipated Mortgage Changes in 2015



attributed to low default rates and to the growth of jumbo loans (loans outside the lending limits of government-sponsored enterprises [GSEs]). Industrywide, the share of mortgages held by banks reached the highest level in a decade last year.⁹

We further examine this issue in Table 5. It is based on information from Call Reports for various years. The amount of mortgage loans in the portfolios of community banks increased from \$474 billion in 2012 to \$503 billion in 2014. Large banks, on the other hand, decreased mortgage loans held from \$1.4 trillion in 2012 to \$1.3 trillion in 2014. As a result, the relative

proportion held by community banks increased.

The decline observed last year in mortgages named as percentages of primary lines of business and products offered may be temporary, as twice as many bankers expected to increase, rather than decrease, mortgage lending in the future (Figure 8). However, almost 50 percent of them expected that the value of their mortgages will remain about the same size.

QM vs. Non-QM Lending

The observed declines in mortgage lending differed by categorization under rules implemented last year by the CFPB. QMs, which are more conservatively underwritten and therefore less likely to default, provide a measure of legal protection. Loans not meeting the QM requirements, on the other hand, may have borrowers or collateral that do not qualify to be sold through or insured by government agencies and GSEs. GSE-backed loans currently represent about 90 percent of the mortgage market.

Some community bankers saw opportunity in the new regulatory environment. In this regard, 8 percent of banks in the survey that made mortgages reported that more than 70 percent of them were in the non-QM category (Figure 9).¹⁰ But most bankers did not. Nearly 60 percent of respondent bankers stated that less than 10 percent of their mortgages were non-QMs, up from last year.

“The bank does not, nor does it have any intention of, accepting applications or originating any type of loans outside of the allowable exclusions

to the [qualified mortgage] provisions,” one banker said.

Bankers often complained about “confusing” regulations and what they believed to be the excessive focus on the risk posed by non-QM mortgage loans (see next section). This is underscored by information on forthcoming activity in non-QM mortgages presented in Figure 10. Less than 25 percent of banks said they expected to make non-QM mortgage loans in the future on anything other than an “exception” basis. More than 34 percent did not intend to make any such loans at all.

Mortgage Denials

Surveyed banks reported wide differences in denial rates on mortgage loan applications (Figure 11). Banks with denials at levels lower than 5 percent were the most prevalent. But a significant number (16 percent) had rates higher than 20 percent.

Many denials were attributed to a rule promulgated by the CFPB that requires assessment of a borrower’s “ability to repay” (Figure 12). But other factors also played a role. In this regard, 30 percent of respondent bankers said the rule failed to impact a single denial, and another 32 percent of respondents said the rule impacted less than 10 percent of their denials.

Regulatory Compliance

Longstanding debates concerning the costs of bank regulation became more pointed following the introduction of remedial policies after the most recent financial crisis. There was no other issue on which bankers in the survey were more vocal.

FIGURE 9
Non-QM Loans as a Percentage of Mortgage Loans

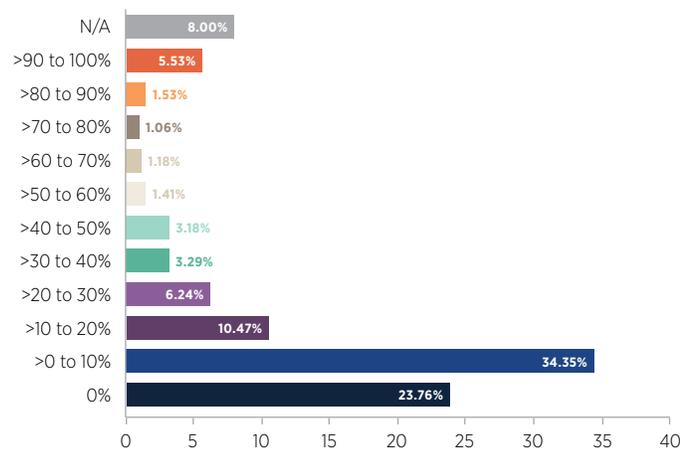
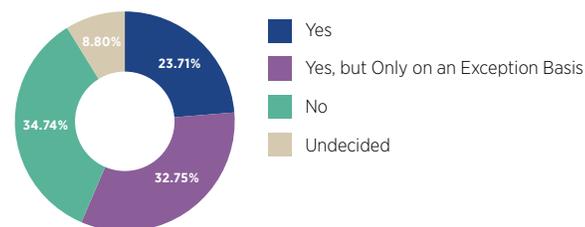


FIGURE 10
Non-QM Lending Plans

Will you make non-qualified mortgage (non-QM) loans in 2015?



The identification of compliance costs in the banking industry has proven to be an elusive objective.¹¹ Large-scale public data sets, such as Call Reports, provide only limited information that can be directly attributed to costs of particular regulations. As a result, attention has focused on alternative ways of trying to understand the volume, incidence and apportionment of regulatory burdens. Surveys have proven useful.

The questions this year concerning regulatory costs were chosen to extend and to expand on those asked last year. They also extend related research done recently by, among others, the CFPB,¹² the FDIC,¹³ the Federal Reserve Bank of Kansas City¹⁴ and SNL.¹⁵

Survey Responses

Bankers were asked to identify how much money was spent last year in five categories: personnel expenses, data processing expenses, legal fees, accounting and auditing expenses, and consulting and advisory expenses. Within a given category, they specified amounts spent specifically on compliance. The intent was to illustrate regulatory burden relative to various categories of operating expense. This information is presented in Table 6.

Surveyed banks stated that regulatory compliance accounted for 11 percent of their personnel expenses, 16 percent of data processing expenses, 20 percent of legal expenses, 38 percent of accounting and auditing expenses and 48 percent of consulting expenses. To better understand the levels of and changes in the estimated

compliance costs in the survey, we present data from Call Reports on expenditures by the community banking industry over the past seven years (Table 7).¹⁶ Note that these are overall expenses and are not limited to those accruing to compliance. But they offer a benchmark against which survey results can be compared.

Overall consulting costs were low, at less than \$800 million in 2014, but the percentage of them attributable to compliance was high, at 48 percent. They were noticeable to bankers:

“Because compliance exams are so daunting, community banks have been hiring consultants to help in the process,” one banker from Massachusetts said. “However, consultants both are costly and provide no guarantee of tangible benefit when it comes to the examination results.”

The compliance component of personnel costs, on the other hand, was relatively small, at 11 percent. But this category accounted for nearly \$32 billion across all community banks in 2014. To the extent that the allocation of expenses in the survey can be applied to the community banks generally, this would imply a dollar expenditure

continued on the next page ▶

TABLE 7
Industry-Wide Expenses across Categories

Expense Type	2008	2009	2010	2011	2012	2013	2014
Personnel	\$26,873.8	\$26,847.4	\$27,398.8	\$27,915.0	\$29,955.9	\$31,294.3	\$31,616.3
Data Processing	\$2,292.8	\$2,320.1	\$2,279.4	\$2,333.2	\$2,494.9	\$2,605.1	\$2,716.0
Legal	\$555.4	\$757.3	\$861.2	\$829.8	\$805.7	\$721.4	\$626.7
Accounting and Auditing	\$431.9	\$436.0	\$433.6	\$457.6	\$495.2	\$502.7	\$514.7
Consulting	\$438.4	\$437.5	\$577.3	\$578.9	\$623.4	\$715.9	\$795.8

SOURCE: Data on state-chartered community banks, Dec. 31, 2014. Dollar amounts are expressed in millions.

FIGURE 11
Mortgage Denials

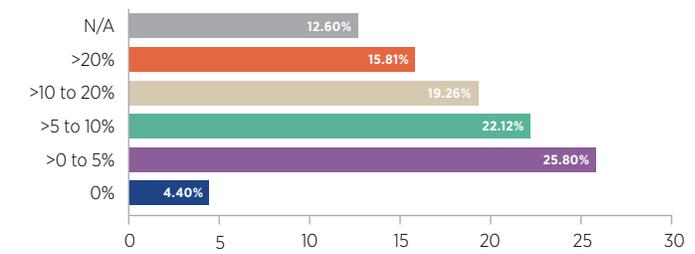


FIGURE 12
Mortgage Denials Based on “Ability to Repay”

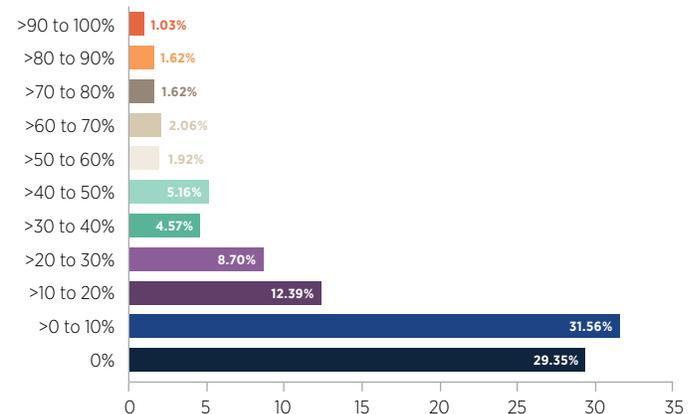


TABLE 6
Compliance Costs as a Percentage of Total Costs by Category

Expense Type	Mean	Median
Personnel (Salary and Benefits)	10.59%	5.82%
Data Processing	16.20%	10.00%
Legal Fees and Expenses	20.49%	10.62%
Accounting and Auditing	38.46%	30.60%
Consulting and Advisory	47.55%	40.00%

on compliance activities, in personnel alone, of more than \$3.4 billion (11 percent times \$32 billion).¹⁷

Personnel costs have been analyzed previously with respect to regulatory burden by, among others, the Federal Reserve Bank of Minneapolis (2014), which estimated that the hiring of a full-time employee at a bank with less than \$50 million in assets would reduce its return on assets by 23 basis points. Similarly, testimony before the U.S. Senate by the American Bankers Association cited the case of a particular bank with \$70 million in assets for which 15 percent of bank employees—the workload of three and a half

people—focused solely on regulatory compliance.¹⁸

Smaller banks bear a burden disproportionate to their size. A case study by the CFPB (2013) showed that two banks with less than \$1 billion in assets had compliance costs that represented as much as 6 percent of retail deposit operating expenses—more than double the percentage for banks with more than \$1 billion in assets. Bankers in the survey agreed:

“Small banks cannot afford to efficiently meet the same regulatory and compliance guidelines laid out for ‘big bank’ problems,” one banker said. “We are being forced to pay for all the same compliance as big banks without having ‘big bank’ income.”

To complete the discussion of hypothetical compliance costs, we summed the products of the percentages for each category in Table 6 and the community bank aggregates in Table 7. The estimated total dollar amount for compliance costs would be \$4.5 billion. This would represent 22 percent of community bank net income. It is worth noting that this estimated dollar amount is limited to community banks—in other words, it excludes the compliance costs at banks with assets greater than \$10 billion, which represent more than 80 percent of the assets of entire banking industry.

Over time and inclusive of compliance and noncompliance activities, consulting expenses have grown the fastest and most consistently, rising from \$438 million in 2008 to \$796 million in 2014 (Table 7). More generally, only a handful of banks in the survey

said compliance costs have decreased or stayed the same over the past three years (Figure 13). The most common rates of increase are in the range of 10 percent to 40 percent (Figure 14). More than 10 percent of banks reported increases of greater than 90 percent.¹⁹

Increasing compliance costs, in the opinions of some bankers, were driven not so much by new regulations as by changes to old regulations. According to one banker, the cost “is in the changes, not in the regulation...the pace of the changes is the issue.”

Discussion

We asked bankers to describe the impact of specific regulations and even particular aspects of those regulations. Responses varied widely, perhaps as a result of potentially uneven application of regulations across banks of differing size, product mix and geographic location. One bank’s headache over flood insurance regulation was another bank’s problem with overdraft regulation or the Community Reinvestment Act. But patterns emerge.

The Bank Secrecy Act (BSA), along with associated anti-money-laundering provisions, was named as the most costly regulation, particularly in the areas of training and reporting.²⁰

“The BSA requires specialized software, a team of people to manage changing—and, at times, unknown—expectations,” one banker said. “In addition to its many technical requirements, the process of surveillance of both customers and transactions is a very tedious and costly burden for the bank.”

FIGURE 13

Changes in Compliance Costs

Over the past three years (2012–2014), have your overall compliance costs increased, decreased or remained the same?

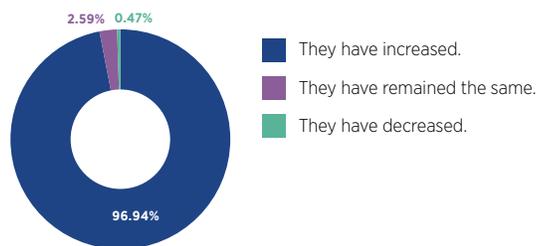
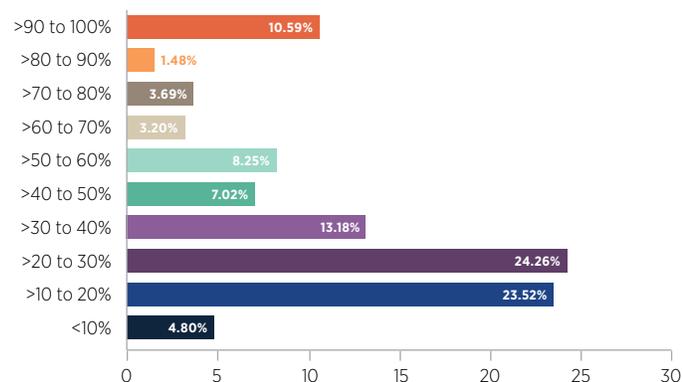


FIGURE 14

Percentage Changes in Compliance Costs (Last Three Years)



Its high perceived compliance cost, however, contrasts with a more tolerant attitude with respect to its enforcement. Relatively few bankers named it as the regulation they would most like to modify. Most bankers described it as easy to understand.

The regulations that bankers considered the most in need of modification and the most confusing to implement were associated with the “ability to repay” underwriting rules, QM rules and related rules under the Truth in Lending Act. These also were considered to be among the costliest to administer.²¹ They often were described as complex, technical, restrictive, counterintuitive, redundant and unhelpful to consumers.

“The existence of ability to repay and QM creates a higher risk of lender liability for banks, especially community banks,” one banker said. “Community banks have, for the most part, not had issues with high past due percentages and foreclosures on their consumer real estate loan portfolios. These banks have been able to be flexible in their lending practices and products they have offered, all with sound underwriting. The focus (now) is not so much on if proper underwriting was done on a loan but if that underwriting is properly documented as possible proof at a later date. ... Even if proper underwriting was done, and always has been done, the loan becomes more risky due to a possible miss in its documentation. The bank must either decide not to offer the product or put procedures in place to ensure that proper documentation is performed and then

retained adequately. Either decision is expensive. All for no increase in the strength of its underwriting or its loan portfolio.”

Bankers also expressed dissatisfaction with the Real Estate Settlement Procedures Act (RESPA), the Home Mortgage Disclosure Act (HMDA) and Dodd-Frank. HMDA was thought to be ambiguous. RESPA was criticized for its inconsistency and immediacy. Inconsistency also was mentioned often in the enforcement of Dodd-Frank, and bankers also faulted it for its complexity and inapplicability to small banks.

Overall, bankers feel inundated by new regulations, particularly those introduced after the most recent financial crisis.

“There has been so much coming at community banks, not only all the new regulations but constant changes and updates,” one banker said. “These changes have not only affected regulations but have changed entire processes and software. Banks are hung up on all the little technical details that are in the new regulations and there is very little, if any, benefit for the customer.”

Market Structure

The structure of the community banking industry is influenced over time by failures, new entrants and acquisitions. It is molded by technology. Within it, banks compete.

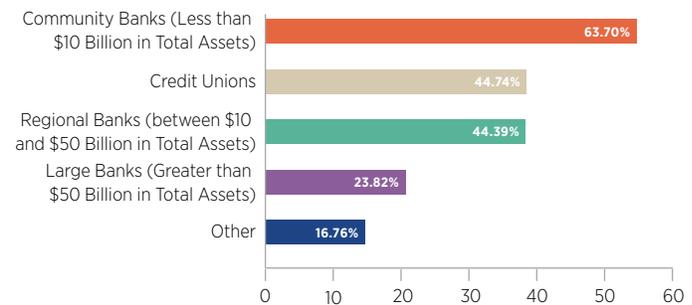
Competition

Community banks outperformed other categories of banks last year. Net income increased 28 percent to \$4.8 billion in the fourth quarter,

FIGURE 15
Anticipated Competitive Pressure



FIGURE 16
Likely Sources of Increased Future Competition



while net interest margins were 50 basis points higher than the industry average.²² This may have served to attract attention from their competitors. Last year, 60 percent of respondents foresaw more competition in the future. The same percentage foresees more competition today (Figure 15).

Community bankers consider themselves besieged: “Banks are scrambling to make the same money they made previously and are having difficulty doing so,” one banker said. “They will cut rates even more to generate the income they need to be equal or better than previous years.”

Many bankers expect stability within their competitive environment; nearly 40 percent of them estimated

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that their level of competition they face will remain constant. Only 1 percent of the bankers surveyed foresaw lesser competition in the future.

Many bankers described themselves as squeezed by regional banks (those with assets between \$10 billion and \$50 billion) and by credit unions. Information in Figure 16 confirms this belief, as more than 40 percent of surveyed banks anticipated both of these competitors to be more formidable in the future. Large banks (those with greater than \$50 billion in assets) also are seen to be a competitive threat. This was attributed by one banker to their “stepping down” into the community banking market.

Consistent with last year, however, community bankers view their greatest competitive threat to be from other community banks.

This demonstrates both the vibrancy of community banks and the potential cannibalization of the sector.

“Margin compression at larger institutions is driving large and regional banks to compete more with us for loans to small- and-medium-sized business,” one banker stated. “Such banks have not traditionally participated aggressively in this marketplace. ... We have seen them offering terms, conditions and pricing beyond the typical structure offered by community banks.”

The pressure from credit unions, on the other hand, is often described as arising from their inherent tax advantages and what is perceived to be a more lenient regulatory environment. It is evident in business lending—which one banker described as being treated as “consumer

transactions”—as well as in consumer lending itself.

“Credit unions have reduced the ability of community banks to diversify into consumer products,” one banker said. “They offer low rates at which we chose not to compete.”

Several bankers said they reduced levels of agricultural lending as a result of fewer borrowers and competition from “seed and chemical companies” that “carry” farmers’ debts and from the Farm Credit System. With regard to the latter, one banker stated that “Farm Credit continues to buy the best farm loans with lower rates and fees due to their lower funding costs.”

Consolidation

Across the industry, failures have declined sharply from peaks in 2009 and 2010, and the entry of new banks is virtually nonexistent. But acquisitions continue, as information in Figure 17 indicates.

Eleven percent of respondent banks said they received and seriously considered an acquisition offer. Bankers tended to overstate the possibility of receiving an acquisition offer; in last year’s survey, more than 20 percent of banks said they expected to receive an offer. A similar expectation is evident for the next year (Figure 18).

As for the other side of the deal, in this year’s survey, 20 percent of banks said they made an acquisition bid (Figure 19). A slightly higher percentage expected to make a bid this year (Figure 20). Of the bids made, less than half were completed (Figure 21). And of those completed, the

FIGURE 17

Have you received and seriously considered accepting an acquisition offer in the past 12 months?

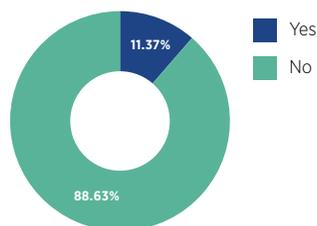


FIGURE 20

Do you expect to make an offer to a target institution in the next 12 months?

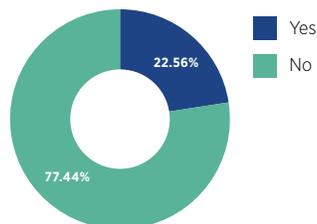


FIGURE 18

Do you expect to receive an acquisition offer in the next 12 months?

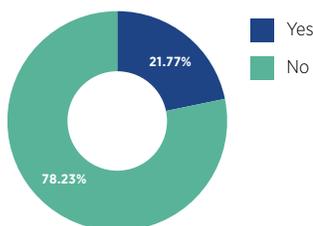


FIGURE 21

Was the offer to buy accepted?

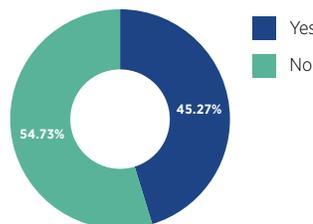


FIGURE 19

Have you made an offer to a target institution in the last 12 months?

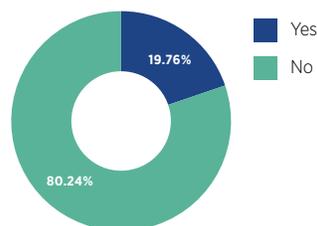
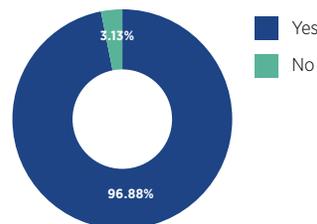


FIGURE 22

Are you pleased with the acquisition?



vast majority were deemed by bankers to have been successful (Figure 22). Blame for uncompleted deals was uniformly affixed to disagreements over price.²³

The reasons given by bankers for their continued interest in future acquisitions and their satisfaction with completed deals were often unique. They include managerial succession, aging owners, anticipation of lower price-earnings multiples and frustration with the pressures of increasing competition that were previously mentioned (including, specifically, the Farm Credit System). More generally, bankers appear to seek maximization of shareholder value, cultural value “fit” and geographic diversification.

Several bankers expressed an interest in acquisition as a way to achieve economies of scale in satisfying regulatory requirements. From this perspective, the previously identified increases can be spread more efficiently. Other bankers expressed a more general sense of frustration:

“I am tired and exhausted by trying to comply with ever changing and increasing regulations,” said one banker, in a typical comment.

Rendering the regulatory compliance motive even more poignant is a perception that more is involved in this issue than just cost. For some in the industry, their commitment to customer service has been compromised. One banker said, “Community banking has changed to the point of spending more time with compliance issues than providing service to our customers.”

Technology

An expanded role for technology was seen as driving increased expenses for banks. Banks are placing greater emphasis on online banking applications, mobile banking and other activities that may rely on technical or computational support. This is underscored by information on the technological expenses of banks (Figure 23).

In this year’s survey, technological expenses expanded, but only at the lower end of the spectrum. For instance, 30 percent of banks this year, compared to 40 percent of banks last year, reported minimal technological expenses of less than 5 basis points. More generally, 30 percent of banks reported expenses of about 15 basis points, which was similar to levels reported last year:

“We think that technology has evolved and will be more reasonable in price to allow a small bank like us to be able to do so,” one banker said.

Although the benefits of technological advance were voiced by many bankers, they sometimes were viewed as double-edged. In this regard, one banker said that “(t)he decision to let Apple Pay and others invade the payment system brings along with it inherent competition, tilting the banking universe toward players that can afford the fee structures of the providers.”

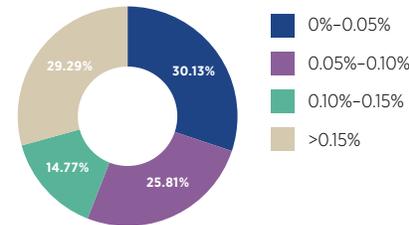
The Town Hall Meetings

The town hall meetings (and roundtable discussions) work hand-in-hand with the survey to provide a glimpse into the thinking of community bankers. The survey is national in scope but focused

FIGURE 23

Expenses on Technology

What was your total technology expense in 2014 as a percentage of assets?



on a relatively few preplanned issues. The meetings are complementary in encompassing perspectives that vary by geographic location and are expressed extemporaneously.

When creating the report, we recognized that industry engagement would be vital. Surveys alone, by definition, lack the immediacy that can only result from free-flowing discussions. State regulators were assigned to the task. They were well-positioned to lead this effort, given that they operate at the local level.

More than 500 bankers participated in more than three dozen events held between April and July. Some of the events were intimate with relatively few participants, while others had large audiences and, in some cases, facilitators. We refer to the former as “roundtable discussions” and the latter as “town hall meetings.”

Synopses of the town hall meetings and roundtable discussions are available in another section of this publication. By way of preview, however, we offer a few generalizations.

On many issues, bankers voiced consistent opinions across state lines. Unanimity,

continued on the next page ►

Overall, bankers feel inundated by new regulations, particularly those introduced after the most recent financial crisis.

Several bankers expressed an interest in acquisition as a way to achieve economies of scale in satisfying regulatory requirements.

in fact, was approached in discussions of regulatory burden. A comment from a banker in Arkansas is representative: “It is unbelievable the amount of money, time, energy and mental stress that goes into compliance. ... Instead of seeing the compliance examination as a tool to help manage the bank, it is viewed as a ‘gotcha’ process.”

Bankers typically considered safety and soundness exams to be helpful and meaningful in helping them to identify problem areas and to offer opportunities for resolution. Compliance exams, on the other hand, were seen as much less helpful.

Bank customers were said to be risk averse. In general, businesses were said to be shoring up adequate cushions in case of another crisis, were hesitant to re-enter lines of business where they lost money during the recession and were largely disinterested in taking large risks. Consumers were more hesitant to take out loans. They shopped around a lot longer for loans with the expectation that banks will saddle more risk.

Small banks said they struggled to maintain human capital. Some of these banks are in rural areas. Others faced difficulties because there were fewer training programs at small and regional banks. Younger employees were said to be hard to retain, with many of them leaving after training to work at larger banks with more promotion potential.

Several bankers pointed out that their customers were financially unsophisticated. This did not appear to be limited to the younger generation; both high school graduates

and retirees were said to be unable to maintain their own financial records, improve their credit score or manage their wealth. Several banks reported that retirees seemed ill-equipped to live within a budget that works for their retirement savings.

In contrast to the consistency of opinions expressed by bankers across state lines, concerns expressed by bankers within states vary widely. In some cases, they can be linked to economic characteristics that are shared by states. Community banks in oil-producing states, for instance, have struggled with the impacts of price declines on the quantity and quality of their energy lending portfolios. Bankers in rural states described challenges faced in acquiring quality staff from a limited pool of local applicants. In more urban states, employees at community banks were said to be easier to hire but harder to keep as competition from regional banks intensifies. In many rural states, community bankers said that they simply couldn’t compete with Farm Credit System lenders because of better tax rates, lower interest rates and application of those lower rates to financial products outside agriculture (such as housing).

In other cases, circumstances are unique. Finding board members seems to be more of a problem in Arkansas than Massachusetts. Bankers in New Mexico expressed appreciation for state regulators, who they consider to be more aware of the local economic environment: “Small banks feel that state regulators are best equipped to communicate to their federal counterparts

the value of community banks and the void that would be created if they were to be regulated out of existence.”

Conclusions

This second annual report has offered a window into the boardrooms of community banks, where decisions are made that individually affect their local economies and, from a collective perspective, the national economy as a whole. It depicts an overview of the community banking industry as described by the bankers themselves. It reflects their responses to survey questions as well as their verbal opinions.

A key component of the survey, which was introduced for the first time this year, asked bankers to estimate the percentages of various categories of expenses that were attributable to regulatory compliance. The goal was to quantify, to some extent, the burdens of regulations that bankers routinely criticized as excessive in the town hall meetings and roundtable discussions.

Surveyed banks stated that regulatory compliance accounted for 11 percent of their personnel expenses, 16 percent of data processing expenses, 20 percent of legal expenses, 38 percent of accounting and auditing expenses and 48 percent of consulting expenses. While the smallest percentage attributed to compliance costs was for personnel, this category had the largest overall expenses, making its contribution to compliance costs significant. It represented 75 percent of an imputed (hypothetical) compliance expenditure for the

community banking industry of \$4.5 billion. This \$4.5 billion represents 22 percent of community bank net income.

Other important findings concern a tumultuous mortgage market. The number of bankers describing mortgages as a primary product line or as an offered product or service declined relative to last year. More than half of all respondent bankers, moreover, said they planned to discontinue offering non-QMs entirely or to offer them only on an “exception” basis. At the same time, the percentage of mortgage loans held, rather than sold, increased. This may indicate that bankers are figuring out how to adapt to the new environment.

Bankers, overall, expressed frustration with compliance burdens. Not all respondent bankers, however, considered regulations to be unduly expensive or counterproductive. Many seemed resigned to them and some saw their benefits:

“As each exam takes place, another layer is added to comply, thus making compliance burdensome. I am not complaining, but each time an exam or a regulation adds another layer, we become so attuned to the regulation that the reasons, the customers, the real intent, gets lost. So, in a nutshell, it is expensive to comply, but I don’t see another way.”

We hope that this report, as well as others in the future, will serve as a podium on which bankers can express themselves. It is created in the spirit of an ongoing nationwide effort by researchers, policymakers and regulators to understand the nature of community banks.

With such an understanding, community bankers will be better able to fulfill their role as conduits through which flow their personal knowledge of customers’ creditworthiness and their keen understanding of business conditions in the communities they serve. For many of their services, there are few, if any, substitutes.

ENDNOTES

- 1 “The Role of Community Banks in the U.S. Economy,” Federal Reserve Bank of Kansas City *Economic Review*, 2003, Vol. 88, No. 2, pp. 15-43.
- 2 In all figures, percentages represent the number of responses in a given category relative to banks that answered the question.
- 3 Statistics on Depository Institutions, FDIC, Dec. 31, 2014.
- 4 Statistics on Banking, FDIC, various years.
- 5 Todd, Sarah. “Banks Prepare to Elbow in on Wealth Management,” *American Banker*, July 31, 2014.
- 6 Estimates were made by the Devenir Group.
- 7 “Consumers and Mobile Financial Services,” Federal Reserve Board of Governors, March 2015.
- 8 The narrative responses of bankers were solicited from specific questions asked in the survey.
- 9 Carney, John. “Banks Keep Loans Close to Home,” *Wall Street Journal*, March 22, 2015.
- 10 This reduction must be understood in the context, previously mentioned, of the increasing percentage of mortgage loans held by banks rather than sold.
- 11 Hoskins, Sean; and Labonte, Marc. “An Analysis of the Regulatory Burden on Small Banks,” *Congressional Research Service*, April 22, 2015.
- 12 “Understanding the Effects of Certain Deposit Regulations on Financial Institutions’ Operations,” Consumer Financial Protection Bureau, November 2013.
- 13 “FDIC Community Banking Study,” December 2012.
- 14 “Survey of Community Depository Institutions in the Tenth Federal Reserve District,” Federal Reserve Bank of Kansas City, August 2011.
- 15 Dobbs, Kevin. “SNL Survey Finds Soaring Compliance Costs Weigh Heavily on Small Banks,” *SNL Financial*, July 21, 2015.
- 16 All banks report personnel expenses regardless of amount. Other categories are reported only if they exceed \$25,000 and 3 percent of “other noninterest expense.”
- 17 We acknowledge limitations in matching data on a relatively small number of banks that responded to the survey with industry aggregates. We also recognize that survey data are subjectively reported. Our interpretations must be qualified accordingly.
- 18 Testimony of Jeff Plagge before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, Sept. 16, 2014.
- 19 Similar increases in compliance costs were cited in the previously cited survey by SNL, in which 35 percent of respondents said compliance costs have increased 30 percent or more over the past five years.
- 20 The related survey by the Federal Reserve Bank of Kansas City also ranked these areas as costly to implement.
- 21 See Finkle, Victoria. “Is Dodd-Frank Really Killing Community Banks?” *American Banker*, Aug. 18, 2015.
- 22 FDIC Quarterly Banking Profile: Fourth Quarter 2014.
- 23 As a caveat to the above data on acquisitions, note that it is impossible to relate them directly to actual data on recorded acquisitions because some may involve offers from multiple banks and because acquisition offers are often un consummated. The actual rate of acquisition among community banks is a fraction of these percentages.

2015 Town Hall Responses

State Commissioners Lead 2015 Town Hall Effort

Industry engagement is critical to better understanding the challenges and opportunities facing community banks today. Feedback from community bankers informs research and provides valuable on-the-ground insight. Industry engagement should be broad based, cover a range of issues and reach community bankers across the country. State regulators are well-positioned to lead this effort, given that they operate at the local level and know most, if not all, of the bankers in their states.

Twenty-seven states participated in this process in 2015 with events held between April and July. Events ranged from a series of small roundtables to large events with a facilitator.

The states were given seven areas to explore:

1. What are you seeing in the market around new business formation? Is activity increasing? Are new types of businesses or industries emerging?
2. What are you seeing with borrowing attitudes? Are borrowers willing to take more risk? How are present attitudes different from before the recession? How are local economic indicators better or worse than what is reported nationally?
3. What financial services needs exist at the local level that are not being met or could be better served?
4. What have you done to attract and develop human capital? What have you done or can you do as an industry in this state?
5. While the examination process is time consuming and disruptive, most banks find value from a safety and soundness examination. How do we remake the compliance examination so that it is more valuable to bank management?
6. How has regulatory burden impacted product availability or risk tolerance?
7. What emerging local, regional or national issues are of most concern to your bank and/or your community? What additional tools do you need, if any, to help you respond to these issues?

The questions were designed to complement the *Community Banking in the 21st Century* National Survey also presented in this publication. The results of the town hall meetings provide a unique opportunity to connect the quantitative data in the survey with the stories and experiences of bankers serving their communities.

The following provides an insightful look into these views as summarized by each state.



Market Condition and the Local Economy

Community bankers in Alabama reported mixed economic conditions. The Huntsville and Birmingham areas are improving at a slightly better rate than the national average, with northern Alabama seeing new business formation in the industrial sector, the technology sector, the defense industry and the housing market. In general, northern Alabama did not experience the same fluctuations in real estate values during the recent recession as the rest of the state, positioning it to recover more quickly.

In contrast, rural areas are growing slower than the national average. While existing manufacturing, automotive and industrial businesses have recovered and are growing, there is limited-to-no new business formation in these areas. The primary new business types that are emerging are service related, specializing in outsourcing for staffing and other services for pre-existing businesses.

Borrower Attitudes

Borrowers remain risk averse following the financial crisis. While borrower attitudes have improved somewhat, they still expect banks to take on more of the risk associated

with loans. Borrowers are also spending more time shopping for better interest rates before taking out loans. As one banker stated, “There is a slowly growing confidence level, which is very fragile compared to the attitude [before the crisis] that nothing can go wrong and risk is always worth taking.”

Business borrowers are also increasingly concerned about present and future regulatory decisions that could impact their business. Businesses seem hesitant to borrow in an environment of regulatory uncertainty.

Unmet Financial Services Needs

Community bankers in Alabama are still able to provide for most of the financial needs of their customers. However, payday lenders are expanding throughout the state, encroaching on the business of smaller banks and often providing products that are harmful for the consumer. Community bankers would like to see more guidance on how they could provide more traditional financial products to low- and middle-income households that are ultimately better for the consumer and the community.

There is also a growing concern that students graduating from Alabama schools are not receiving proper education on handling personal finances. As one banker noted, “Many of the students we see are graduating high school without an understanding of how to successfully manage basic financial skills required to operate a household.”

Attracting Human Capital

Finding local talent with the needed technical and business skills for issuing loans has been a major challenge for Alabama’s community banks. Despite being pressured by slim profit margins, several community banks have committed time and resources to hiring new talent and cultivating existing talent.

Community banks are working with trade schools, junior colleges and local communities to identify potential new hires. Some community banks will offer college students and recent graduates temporary or summer jobs before making a long-term hiring decision. When recruiting, banks highlight the workplace culture and the benefits of working in a strong, stable organization. Some community banks have expanded their benefits to attract new employees. Once hired, new staff often goes through internal training programs that are complemented by banking school curriculum.

Still, some community banks find it too costly to provide in-depth training programs. In the words of one banker, “Who has the time or the money to do this with compressed margins and larger regulatory compliance cost in the business model?”

Examination Feedback and Regulatory Burden

Community bankers find value in safety and soundness exams. Examiners will point out problem areas and talk through resolutions, giving banks the opportunity to

implement changes after an issue is identified.

In contrast, compliance examiners seem only interested in punishing banks, even if an error is clearly unintentional. It is also not uncommon for two different compliance examiners to view the same issue differently, leading to confusion and miscommunication between bankers and examiners.

The complex nature of compliance exams has substantially increased overhead costs for community banks. One community banker reported that seven employees now spend all or most of their time working on compliance issues, despite not needing a single full-time employee doing the same work before the recent recession.

The aggressive nature of compliance exams has led some community banks to abandon certain products, such as real estate loans. The risks and costs associated with making mistakes on the paperwork are too high compared to the financial gains from making the loan.

To help ease the regulatory burden associated with compliance supervision, examiners should be trained to approach a bank with a helpful attitude. In a rapidly changing regulatory environment, smaller banks need more time and guidance to learn and establish new processes. Examiners should be able to exercise discretion in favor of smaller banks when it is clear that an error by the bank is unintentional. Examiners should also complete exams in a specified time period, rather than breaking them up into smaller portions over several months.



Market Conditions and the Local Economy

Overall, the Arizona economy continues to improve at a pace slightly ahead of national results. However, unique challenges stemming from water rights and drought, as well as issues faced by businesses in close proximity to Mexico's border, are not reflected in these statistics.

Demand for loans has increased in Arizona's major metropolitan areas. Commercial and industrial loans, commercial real estate development, the health care industry, and the hospitality industry have all experienced steady growth, while the non-profit sector and international financing have shown signs of recovery.

Arizona's rural communities have seen only limited growth in new businesses. However, residential construction has rebounded significantly statewide. Existing residential customers and businesses have also been refinancing loans, regularly turning to community banks because of their competitive advantages through local market knowledge and relationship lending.

Borrower Attitudes

There is increased interest in local investment and in doing business with local community bankers throughout Arizona.

Loan growth in the smaller to midsize market has been robust, as many businesses' consumers now sense that the timing for loans is better while rates remain low. This is especially true for new retirees who have either just recently reached retirement age or postponed their retirement until the end of the recent recession.

Unmet Financial Services Needs

The banking industry as a whole is aging, and nonbank financial service providers offer greater mobility and are more nimble due to fewer regulatory requirements. Alternative funding sources, such as crowdfunding, are delivering alternatives to traditional financial services providers.

Some community bankers see this as an opportunity to begin developing crowdfunding within their own institution as a means for providing credit to borrowers who might not otherwise qualify for a bank loan. Arizona passed bipartisan legislation for crowdfunding in 2015.

Attracting Human Capital

Human capital is critical to community banks, and recruiting is especially difficult in rural areas. When turnover occurs in banks with smaller staffs, it is very disruptive

to the business. On-the-job training programs have proven effective for community banks looking to groom their talent pools. Professional recruiting has also been valuable, although some banks do not have the size to justify the cost.

Attracting skilled employees to rural areas has proven especially difficult. Some rural bankers have found success in leveraging technology to better develop talent without requiring permanent relocation to a more urban area.

Examination Feedback and Regulatory Burden

While recent compliance examinations have improved, they still pose an undue burden for Arizona's community banks. The exams seem to be all encompassing, require a large number of examiners and are too long and disruptive. At times, compliance examiners have expanded their review to business loans, despite the original goal of the exam being focused on consumer loans. This "mission creep," in combination with the costly nature of compliance exams, has led to significantly higher overhead costs related to compliance.

Mortgage loan disclosures have become so voluminous that many bankers don't believe consumers will ever have the time or capacity to

even read the information that is given to them. The entire mortgage disclosure process has become too onerous for consumers and bankers alike.

The exemptions for registering with the Securities and Exchange Commission contained in Regulation D seem irrelevant and outdated due to the withdrawal restrictions imposed on interest-bearing accounts as banks. An uneven competition has developed where nondepository financial service providers have been able to hold cash in money market accounts without any restrictions on the number of withdrawals.

Community bankers also believe that reciprocal deposits in the Certificate of Deposit Account Registry Service (CDARS) should be included in the calculation for liquidity. These deposits are not frequently traded or transferred.

The federal approach to Bank Secrecy Act inquiries makes bank customers feel like they are being treated like criminals when there is no evidence of criminal activity. This approach undermines customer trust in bankers, and regulators don't seem to appreciate the damage this can do to community banks.

To help ease the regulatory burden on community banks, policymakers should consider excluding them from more Dodd-Frank Act regulations.



Market Condition and the Local Economy

The overall economy in Arkansas has been fairly constant, with pockets of growth presented in recent months. The economy in larger markets is performing slightly better than the national average, and the economy in smaller markets is aligning with, if not slightly worse than, the national average. Areas not realizing significant levels of new emerging business have still seen expansion by their existing customer bases and by their existing businesses activity.

Specific areas of growth include the technology and international sectors and from venture capitalist activity. Arkansas has also experienced an expansion in multifamily residential mortgages and single-family rental property purchases.

Borrower Attitudes

Arkansas borrowers have shown a willingness to take on more risk, but are still acting more cautiously in today's environment than before the recent recession. Bankers indicate that borrowers are paying more attention to their finances and are trying to not repeat some of their previous mistakes. For example,

borrowers are keeping equipment longer and are trying to maintain some level of equity in their businesses.

Community bankers in Arkansas also report that borrowers now spend more time shopping for the best rates and terms. Many businesses have built up cash reserves and now use their own cash rather than financing new projects.

Unmet Financial Services Needs

Community bankers in Arkansas continue to operate in a regulatory and compliance environment that limits the types of services that can be offered. Nonbank competitors are able to provide certain financing to traditional bank customers because they do not have to operate under the same rules and guidelines that govern the banking industry. Bankers want to provide additional products or services similar to their nonbank competitors, but are fearful of unintended compliance violations.

Bankers also indicate succession planning has become a challenge for many of their customers as the owners of companies look to make ownership or business changes. Bankers want to assist their customers in these very

important shifts within their operations but have not been able to do so.

Financing rural housing also poses a significant challenge. Qualified mortgage (QM) rules have made it difficult for banks to extend housing credit to low- and middle-income families.

Lastly, bankers cited a need for more latitude in issuing small-dollar loans. These services are subject to heavier regulation than nonbank competitors, causing customers to seek financing outside the banks.

Attracting Human Capital

Community banks in Arkansas recognize that developing human capital is critical to the future of their institutions. Because of an anticipated large number of employees with substantial experience set to retire in the upcoming years, many institutions have focused on developing mentoring programs so new staff members can learn from more experienced bankers. One banker noted that growing and promoting from within was preferred to searching for trained staff from other institutions. Several bankers added that it is more challenging to attract quality staff in rural areas. Bankers acknowledged that they must

compensate at a higher rate to incentivize employees to begin their career away from a more urban area.

One banker noted success in attracting good talent by looking within their smaller community and identifying individuals that have high credibility and good business reputation. These people have strong working backgrounds and understand their communities, intangibles that are much harder to train than the specifics of the banking industry. Sourcing strong individuals from the community has especially helped with retention.

Finding board members has also been difficult in recent years. The increased regulatory landscape and the significant qualifications that board members need to possess, along with the increased risk to them as individuals, has become problematic when filling vacant positions.

Examination Feedback and Regulatory Burden

Collectively, Arkansas bankers agree that compliance exams are not useful tools for banks. Bankers would like to see compliance exams be more constructive versus critical. The exams are not transparent and are about how well the bank “checked the box.” As

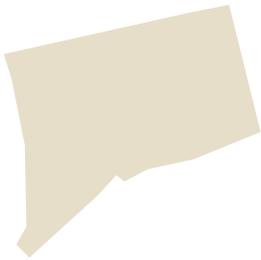
one banker noted, “It is unbelievable the amount of money, time, energy and mental stress that goes into the compliance function.” Instead of seeing the compliance exam as a tool to help manage the bank, it is viewed as a “gotcha” process.

Rules for the examinations are often unclear, and regulators do not always have full understanding of the newer regulations. Not clearly understanding ever-changing compliance regulations adds frustration and fear that a bank will be fined even if it is actively trying to comply. Also, as more off-site work is done regarding compliance exams, less opportunity exists for interaction with the regulators.

Arkansas community bankers stated that compliance is the fastest-growing area with regards to staff in many banks and the most costly function with no corresponding source of revenue. One banker noted that the compliance regulations are “killing” community banks and ruining consumer banking business instead of helping the consumers. All bankers agree that banks must be fair and should not take advantage of customers, but the current compliance environment is resulting in more hardships for consumers looking to obtain credit in a timely manner.

Emerging Issues

Arkansas community bankers specifically noted concerns regarding the ever-changing world of payment systems and the related increase in cybersecurity issues. Growing competition from nontraditional financial services also causes concern.



Market Conditions and the Local Economy

Connecticut's economy continues to lag behind the rest of the U.S., especially in the eastern part of the state. An uncertain business environment is creating a fear of job losses among major businesses and casinos, and the housing market is seen as unprofitable. Home construction is only slightly improving in most areas of the state, as the cost of construction far exceeds the cost of purchasing existing homes.

Commercial real estate is widely available. One banker estimated that there is as much retail space available today as there was seven years ago. Real estate prices in many markets have not rebounded to their prerecession levels and continue to fall in many market areas.

Wealthy, older customers are moving outside the state due to Connecticut's high taxes. Young people are also leaving the state. A significant talent drain is occurring as many college graduates choose to not return to the state.

The state is having trouble attracting startup businesses, and entrepreneurs are looking elsewhere for growth opportunities and a more friendly tax climate. Bankers noted that the state's Department

of Economic and Community Development competes directly with community banks by lending money to fully bankable customers. Community bankers commented that this is not a good use of state resources.

However, certain areas in the state have seen growth in various niche markets, such as partnerships with academic institutions, health care lending (specifically for nursing homes), medical marijuana, out-of-state multifamily housing, senior communities and import businesses.

Borrower Attitudes

Connecticut borrowers continue to be risk averse following the economic downturn. Most are looking to reduce overhead by refinancing existing loans. In addition to refinancing activity, community bankers are seeing an increase in owner-occupied commercial real estate financing.

Some companies are seeking financing for equipment purchases, but most are scaling back operations or expanding outside of the state. According to one community banker, a *Hartford Business Journal* article stated that 67 percent of Connecticut businesses did not intend to borrow money this year.

Unmet Financial Services Needs

Community bankers in Connecticut noted multiple areas in which their institutions experience difficulty in reaching new customers and retaining current ones. Community banks in the state are having trouble keeping up with rapid advances of the payment systems. Despite this difficulty, community bankers go to great lengths to safeguard customer data, and there are concerns that nonregulated payment systems data mine without customer awareness.

Bankers pointed to a critical lack of financial literacy among consumers and youth and suggested that the Connecticut State Department of Education encourage schools to integrate financial literacy programs into their curriculums. Community bankers also noted that reaching unbanked and underbanked customers is difficult due to recent regulatory requirements that conflict with providing credit to these customers.

Additionally, the slow pace and operation of the Small Business Administration and other government programs impede community development lending by community banks.

Attracting Human Capital

Community bankers in Connecticut have pursued a variety of efforts to attract and develop human capital. Multiple financial institutions are offering internships to college students that can lead to employment opportunities following graduation. Banks are also creating internal training programs with mentors for specific career paths. In response to a changing workforce culture, banks are instituting flexible work policies, such as the ability to work from home and casual dress codes. A “General Education Development (GED) Test to Teller” program created in partnership with a local chamber of commerce is helping low- to moderate-income Connecticut residents earn their GEDs and receive training in skills needed to be a bank teller.

One banker noted that candidates are more likely to work for mutual institutions, where benefits are typically more lucrative. Some community banks in the state have had to scale back their benefit offerings, particularly health benefits.

Liability status, time commitment and education requirements have all created barriers in recruiting qualified

board members for the state’s community banks.

Bankers spoke positively of continuing education initiatives, including programs within the “Connecticut School of Finance and Management” that was established by the Connecticut Bankers Association.

Examination Feedback and Regulatory Burden

Community bankers in Connecticut find compliance exams to be antagonistic and aggressive, as opposed to safety and soundness exams, which are seen as more collaborative and cooperative. There is a perception that examiners nit-pick during compliance exams, rather than focus on addressing systemic problems. On a more positive note, several bankers indicated that recent compliance exams by Federal Deposit Insurance Corp. staff have noticeably improved since three years prior, with better communication and recognition that banks are trying to comply with the spirit of fair-lending laws.

Connecticut’s community banks are spending significantly more money on compliance and cybersecurity than they are spending on business development. Documentation requirements are hampering their ability to meet day-to-day business objectives, and

banks are spending increasing amounts of money on vendor management systems. Community bankers lack both the time and personnel necessary to deal with increasing regulatory burden, including heightened internal and external audit expectations.

Bank Secrecy Act exams also present significant difficulty. Recent exams have been confrontational, and there is a sense that regulators approach the exam with a predetermined outcome.

Community bankers in Connecticut seek consistency in exams, with ground rules that are clearly articulated and a risk-based approach. Bankers would also like to see more consistency among exam teams. Bankers are noticing that the state department is rotating examiners-in-charge (EICs) and suggested designating certain examiners as permanent EICs. Bankers noted that they are concerned by the loss of seasoned examiners, as many staff among the regulatory agencies reach retirement age.

Bankers continue to seek tailored and risk-based regulation that will provide a measure of relief from the one-size-fits all application of regulations designed for large, complex financial institutions.



Examination Feedback and Regulatory Burden

Compliance costs have risen significantly for Georgia community bankers over the past few years. More staff is required to handle compliance, and experienced compliance staff members are much harder to find and afford because of the high demand. For example, one community bank went from one part-time compliance staff member to having a full-time compliance staff member solely for real estate. Even small de novo banks are hiring full-time compliance staff. Combined with overall cost increases for education and training, outside consultants and auditing, compliance staff costs are becoming unduly burdensome.

Qualified mortgage (QM) standards and ability-to-repay rules are not having as much of a material impact on Georgia community banks as some had predicted. Bankers note they have passed on only a few select loans as a result of the new rules. That said, bankers still expressed concern over the longer processes created by new rules and worry about eventually being regulated out of lending. One banker did caution that the QM rules could have a significant impact on small businesses in rural Georgia since the bank may no

longer be able to take a mortgage on the business owner's home, the only asset that is typically available for collateral purposes.

Farm Credit Administration

The Farm Credit System (FCS) made a lot of sense when it was created by helping small, undercapitalized and unbanked farmers get the financing they needed to plant their crops. However, the FCS's mission has evolved significantly over the past 10 years. The FCS now focuses on servicing the top 10 percent of farmers to finance their purchases of land and irrigation.

These same farmers have traditionally been very good bank customers. However, since it has extremely low-cost funds and lower compliance costs, the FCS can undercut a community bank's interest rate by 1 percent from the outset. When factoring in the dividend that the FCS pays to borrowers as a patronage reward, the advantage in interest rate is closer to 1.5 percent.

Additionally, once a farmer is in the system, the FCS can meet any and all of the farmer's credit needs. One banker lost a deal to finance the acquisition of an apartment building because the farmer was able to get a better rate

from the FCS, despite the fact that there was nothing related to farming involved in the transaction.

Unfair competition from the FCS is having a much bigger impact on the community bank business model in Georgia than credit unions or even large banks.

Emerging Issues

Community bankers in Georgia see opportunity in technology, and many are investing in new technology to reach out to younger audiences. Products like smartphone apps generate more customers and revenue for cost than operating physical locations. In fact, some banks report plans to close in-store and traditional branches as a result of the success of their new digital services. While there is no disputing a need for physical locations, the appeal of digital solutions is apparent in both urban and rural areas. In some cases, the advantages of mobile banking in rural areas are even greater than in metro areas because of widespread availability of cell phone data coverage.

In line with this, some banks are also closing more traditional services like ATMs. Consumers are carrying less cash and are conducting more transactions electronically, so

it is much cheaper to allow customers to access other ATMs for no charge than for banks to pay for and maintain their own ATMs.

Market Conditions and the Local Economy

Real estate in Hawaii drives the economy, but many wonder how long this will be sustainable. Bankers question what will happen when the real estate market eventually slows. Developers have increased the amount of marketing they do by placing full-page sales advertisements in print newspapers, a visible sign of a slowing market and the need for a more diverse and robust economy.

The state also has a high cost of living that impacts business formation. Many times it is cheaper to start a business on the mainland. For potential employees, starting a career in Hawaii sometimes makes less sense because of high housing prices. This makes talent attraction and retention in all industries difficult for Hawaii as a whole, leading to muted business and economic growth.

Unmet Financial Services Needs

Hawaiian bankers have found that the most challenging competitors when serving smaller customers are from nonbank industries. Money service businesses, check cashers and payday lenders have increased in quantity over the years, directly competing with community banks' brick-and-mortar locations. To help gain understanding of how banks can meet customer demand, one banker suggested that a study needs to be performed to find out what services are needed and whether banks can actually offer the services in the current regulatory environment.

Banks have also noticed that services that used to be commonplace are no longer available. For example, a bank that used to cash checks for noncustomers cannot do so due to the Customer Identification Program. Underbanked and unbanked areas need regulatory relief so that banks can provide customers with a dynamic range of products.

Attracting Human Capital

Hawaii's status as an island presents its own unique challenges in attracting human capital. Local talent is incentivized to leave the islands for many reasons, including lucrative pay on the mainland and high property costs in Hawaii. Bankers identify specialty areas such as compliance and IT as hard to recruit for, with several banks outsourcing these tasks to other firms. Compliance officers tend to be in high demand and move from bank to bank, while teller positions are harder to fill when the economy is good.

The Internet has served as a helpful tool for recruiting and hiring for higher level positions. To fill entry-level skilled positions, community bankers believe that Hawaiian colleges need to provide more incentives for students to fill open positions in their own community.

Examination Feedback and Regulatory Burden

Banks in Hawaii take exams seriously and feel that the exam process is reasonable and fair. Bankers view themselves as running a franchise with exams being one of the associated costs of business.

Exams could be improved by increasing the level of consistency and collaboration between examiners. Conflicting viewpoints—such as one examiner accepting what another examiner criticized—cause frustration and confusion. To help reduce misunderstandings, bankers would like to have more of a partnership with their examiner. Increasing collaboration will reduce the likelihood or fear that bankers will inadvertently violate any laws. The way regulators handled the rollout of BASEL III was cited as a good example of the collaborative relationship desired between the industry and regulators.

The social media requirements regarding IT security concerns have all but restricted one bank from operating in these areas. Other banks restrict some social media. Bankers would like a preapproval process for some banking products, since examiners sometimes disagree about bank products that can be offered. For a well-run bank, there should be a “first strike” opportunity if something is found to be in noncompliance.

Fair lending in regard to disparate impact analysis needs to be more reasonable and relaxed, especially in Hawaii. Because of the diversity of the population and the reporting requirements, examiners should take time to better understand the population when there appears to be a fair lending concern.

Emerging Issues

Community bankers in Hawaii look at cybersecurity as a constant threat to



the industry. Even more so, however, Hawaii sees nonbank competitors as the largest threat to their business. They believe the same level of regulatory oversight needs to be in place for banks and nonbanks to compete fairly and for consumers to receive similar protections regardless of the financial service provider.

Credit unions also provide significant competition in Hawaii. By receiving a break on federal taxes, credit unions have an advantage that is recognizable. Further, credit unions pose a significant threat to the banking industry because they compete directly on physical locations. The island of Kauai is the most affected by this. The tax break caused one Hawaiian bank to lose two branch locations when going head-to-head with credit unions.

Banks cannot operate the same way in the future and be profitable. New emerging technologies now serve as inexpensive and efficient depository services and provide faster payment services. Banks will have to learn how to evolve and change to compete.

Disaster recovery and business continuity is also a threat. Cash delivery cannot occur in the time frame set by the Federal Reserve Bank. If there was a major disaster on Oahu, cash delivery likely cannot occur for seven to 10 days, when an air field is able to open.



Market Condition and the Local Economy

In general, business in Idaho is growing. Idaho is seeing resurgence in small businesses, in the establishment of retail businesses and in manufacturing expansion. As a result, residential construction and related trades are also increasing.

This economic growth has spurred higher demand for workers and decreased the pool of available labor. Wages have also increased as firms face difficulty finding and retaining qualified workers. Idaho's unemployment rate is better than the national unemployment rate.

Higher wages, in addition to educational offerings that provide high school students new technical skills that match with local job opportunities, have encouraged young adults to stay in-state and contribute to their local economies.

Borrower Attitudes

Borrowing attitudes in the state have improved since the financial crisis, with borrowers generally more optimistic about the future. Borrowers are increasingly asking for lines of credit. This is especially true in the medical community and with other young professionals looking to open their own practices. Borrowers in Idaho have shown a willingness to

take more calculated risks and are more willing to borrow.

Residential construction is also rebounding. While there are not as many real estate speculators, there is plenty of pre-sold building activity in the residential real estate market.

Agricultural lenders are seeing a shift in borrowing attitudes of farmers because of expectations of lower commodity prices. Farmers are reducing spending on capital purchases such as farm equipment, while cattle ranchers are expanding the size of their herds.

Unmet Financial Services Needs

While lending has grown in Idaho, bankers are still reluctant to extend credit to subprime borrowers because of burdensome regulations. This has forced some borrowers to use other sources of credit like payday lenders and credit unions.

Attracting Human Capital

It is becoming increasingly difficult to attract talented staff. Talented lenders have retired, and banks face an enormous challenge attracting new, younger generations to banking and finance. It seems as though many students are focused on shorter-term career goals and are not necessarily looking to stay at one institution long term, making

retention and skill training more difficult as well. Trying to meet the challenge of understanding what millennials respond to is critical to attracting the next generation of bankers.

Community banks are partnering with local universities by offering internships and conducting on-campus recruiting. Banks are also developing internal training programs supplemented with online courses. Being proactive on compensation and offering tuition reimbursement and other financial incentives are also possible avenues for increasing employee retention.

Regulatory Burden

Compliance examinations rely too heavily on the threat of punishment. There are no "technical exceptions" in compliance examinations like there are in safety and soundness examinations. The regulatory environment surrounding compliance examinations has resulted in most small banks adding new, non-income producing compliance staff. At some point, increased product overhead to meet compliance examination expectations will make certain financial products and services unprofitable.

As regulations rapidly change surrounding compliance, there is a greater need for federal regulators

to provide consistency and solid, practical guidance to community banks. Regulators should provide interpretation memorandums to the industry on technical regulations and establish a "help desk" system to answer bankers' questions.

The current regulatory environment has already forced community banks to avoid trying new products. From a customer service perspective, regulatory burden has slowed the delivery of banking products and services to the customer, particularly for mortgage products.

Emerging Issues

Nondepository financial service providers are expanding rapidly in Idaho, turning their relative lack of regulatory oversight into a competitive advantage. While this growth has impacted the entire banking industry, community banks are especially harmed by this change, as nondepository financial service providers encroach into a community bank's local relationships.



Market Conditions and the Local Economy

In general, bankers perceive that new business formation in Illinois is very limited. However, recent legislation has created a more profitable environment for the oil and gas industry and the medical marijuana industry. The agricultural sector remains strong, and agricultural-related businesses continue to be the leading industry in the central part of the state. Despite limited growth, economic conditions statewide remain stable. In central Illinois, the effects of the recession were not as severe as in the Chicago and St. Louis metro areas.

The homebuilding sector remains slow to recover statewide. Bankers noted that contractors are reluctant to engage in speculative building due to the excess supply of available housing and the lack of substantial population growth in the market area.

The foreclosure process poses local challenges in the Chicago area. The length of time required for a foreclosure in Illinois makes it difficult for banks to market and resell the properties in a timely fashion, leading to impacts on earnings. Property values in the Chicago market have been slow to rebound, and high property tax rates are causing some customers to leave the

community. New businesses are also wary to enter the market, and some businesses near the state's border have moved to other states to pursue a more attractive tax and regulatory environment.

Borrower Attitudes

Borrowers continue to be more conservative following the recession. The vast majority of borrowers are working to pay down debt as opposed to taking on additional debt.

On the other hand, some bankers have expressed concern with the agricultural sector, where some borrowers seem overly optimistic based on the past three years of agricultural operating profits.

Unmet Financial Services Needs

Illinois' community bankers remain successful at meeting most of the financial needs of their customers. Investment in technology services, including remote deposit capture and Internet banking, has allowed the state's community banks to keep up with the shifts in industry and consumer trends towards mobile banking.

Attracting Human Capital

Finding qualified individuals to work in community banks remains difficult. In particular, it is difficult to hire

and develop younger employees who would much rather live in larger cities. Most candidates are also seeking higher compensation than banks are willing to pay for entry-level positions.

In response, some bankers have started to recruit from local high schools and colleges. Summer jobs and part-time employment are being offered to encourage promising candidates to return to the bank full time after graduation. Providing temporary positions also allows banks to assess potential candidates' skills prior to making full offers of employment.

Examination Feedback and Regulatory Burden

It was felt that compliance exams are unduly burdensome and unnecessarily costly. The seemingly arbitrary application of fines, a lack of consistency among compliance examiners and the high cost of compliance staff all significantly contribute to the overhead cost of compliance exams. Community bankers in Illinois agreed that the majority of their time is being devoted to compliance with new, changing and existing regulations. This time would be much better spent working to attract new customers and strengthening relationships with existing customers.

Bankers are uneasy regarding the Consumer Financial Protection Bureau's new mortgage rules. Several bankers highlighted the challenges of satisfying appraisal requirements under the new rules. Many bankers felt that only a few banks and savings institutions are continuing to make mortgage loans. Community bankers agreed that the rules are too stringent and the risks too high to continue operating in the mortgage market.

The state's community bankers also feel that Bank Secrecy Act requirements are unnecessarily strict and time consuming for their staff.

Emerging Issues

Bankers expressed a desire to offer banking services to the emerging medical marijuana industry, but are concerned about federal regulators' response to providing these services.



Market Conditions and the Local Economy

Business development in Indiana is not robust, but modest improvement is noted. Most of the growth, particularly in business lending, has come from pre-existing businesses. Current customers are taking on new debt for expansion, but typically only within the same market. Businesses are willing to grow in their area of expertise or comfort, but they may not be willing to try something new.

Multifamily property financing is an emerging but unproven growth opportunity. The millennial generation now entering the workforce prefers mobility over home ownership. There is speculation occurring in the creation of new multifamily space, and loan growth in this segment of the market is not difficult to find.

Competition for growth is increasing. Many institutions are sacrificing either pricing or underwriting standards to gain a competitive advantage. Farm Credit System lenders are no exception, as institutions continue to offer product pricing that would be below a breakeven profitability point for most banks.

Indiana banks have enjoyed a competitive edge around the state border, particularly in more populated areas. The

state's campaign to pull businesses in from surrounding states has provided a market for new banking relationships. For example, business migration is noticeable in northwest Indiana, as some businesses migrated over the border from Chicago. That said, these businesses are not newly formed, nor were they growing into a new industry, rather they simply moved to a new geographic location.

Borrower Attitudes

Borrower attitudes about the future are optimistic. A strong stock market, stable-to-improving employment rates and moderate fuel prices all point toward prosperity. One exception would be the attitudes of agricultural borrowers, who are currently feeling margin and cash flow pressure. Farmland values are falling, but fortunately agricultural borrowers in Indiana have not highly leveraged their land equity.

Unmet Financial Services Needs

Bankers are discouraged when it comes to the development of new products and when trying to find ways to bank the unbanked population.

Qualified mortgage (QM) rules remain a concern. Institutions are unwilling to offer non-QM loans, which

is leaving many potential customers to look elsewhere for financing. Many of these potential homeowners struggle to find someone willing to provide financing, thus harming the overall housing market. Customers are being pushed outside of the traditional banking market into sectors that are much less customer friendly and much less regulated.

The Community Reinvestment Act (CRA) is well intended, but also has unintended consequences. Banks fight over a small segment of CRA-eligible business, leaving large segments of the local market without a financial institution solution. This is one of many reasons that families are forced to use higher-cost payday loans as opposed to more traditional banking solutions.

Local schools are not providing students with a sufficient financial management education. Many customers lack account-balancing and bill-paying skills and do not know how to manage their debt.

Financial literacy is not only a problem with recent graduates, however; older residents are also lacking the necessary skills to manage their finances. This is most evident with recently retired individuals who have been forced to

accept lower regular pension payments or take lump-sum pension payments. Many retirees anticipated the receipt of a comfortable pension check each month after retirement and struggle to live within their new budget.

Attracting Human Capital

Human capital remains a primary concern of community bankers. A strong need for the development of financial, leadership and organization skills exists within the banking workplace. Most new positions require a college degree. Many banks attempt to hire talent three to five years after graduating from college, after the employee has the opportunity to experience living in a larger metropolitan area and to have worked for a larger corporation. Many times talent can be acquired after an employee endures an unfavorable experience at larger firms.

However, regional banks are also paying more in an attempt to steal talent away from community banks, particularly when it comes to credit officers. When a community bank employee is perceived to have the ability to generate business, regional banks will offer salaries that community banks cannot match.

Compliance and human resources positions are in high demand. Community banks

have to develop these employees from within, but it is a long and hard process. It is expensive to find a qualified person for compliance, or any high-level position, in a small community. Talent in small town America is difficult to retain, as the population continues to shift toward larger urban areas.

The concept of shared services between community banks for some positions could be beneficial. However, it is hard to make the numbers work. Upwards of four banks may be needed, all of which would need a central geographic proximity, travel, support staff and other considerations. At the same time, many bank roles demand a full-time staff member, making it unfeasible to share an employee.

Management succession is also a substantial threat at the board level. Many successful business people do not want to take on the liability of being on a bank board. It is becoming increasingly difficult to expect that all directors remain knowledgeable of all areas inside the bank. The line between board responsibility and that of management is not as easily defined as it once was. Directors are not well compensated for what they are expected to know and do. Some good, young

director-level talent is being groomed in family-owned banks. However, there are fewer family-owned banks than ever before.

Examination Feedback and Regulatory Burden

Safety and soundness exams add value at all levels within a banking organization, including sales, operations, management and the board of directors. These examinations encourage elevated management performance and increase the chances of long-term institution survival.

However, compliance exams are not typically viewed in the same manner. Many of the compliance-based regulatory requirements provide no discernible benefit to the customer base or the bank. It is a challenge to get employees in an organization to get excited about an exam of items that add minimal value, even though compliance examinations are seen as incredibly important to the examiner.

There would be value in a dual compliance examination process, bringing in state regulators to complete joint state-federal compliance examinations. However, the desire to shrink state budgets would hinder the state regulators' ability to acquire the needed staff additions and expertise.

Examination material request lists should be reviewed for reasonableness. The safety and soundness request lists are robust and time consuming, yet mostly reasonable. On the other hand, compliance examination request lists are overwhelming. The amount of data being requested for compliance examinations is more than the examination team can expect to have the time to review.

It is frustrating that regulations designed to protect customers ultimately limit their financial options. Regulations are often designed to limit what a customer can do in an attempt to protect the small portion of customers who lack the aptitude to understand or make prudent decisions. Many regulations are lacking perspective. Bankers are currently spending more time trying to comply with onerous regulatory demands than they spend serving the community's needs.

The cost of regulatory compliance is absorbed by both bank shareholders and bank customers. While lower net income impacts shareholders, the customers also bear the burden of increased compliance costs that are directly or indirectly passed along to customers.



Market Condition and the Local Economy

Iowa is seeing slow-to-no growth throughout the state, with the rural areas having the most difficulty developing economically. Small manufacturing operations are showing signs of growth, but it is limited to small pockets within the state. The housing market is experiencing some limited growth as well. Many businesses in smaller communities would like to expand but are experiencing a shortage of workers.

Most community banks are heavily involved in the agricultural sector. However, the agriculture economy is generally cooling off statewide, with one exception being livestock operations. This could pose a challenge in the coming years as community banks look to diversify their customer base.

Borrower Attitudes

Agricultural lending is expected to decline over the course of the year and remain low for the next several years. Almost uniformly, it was expressed that farmers, especially those with more experience, are preparing for the forecasted down period and show little appetite for increased risk or expansion. Many seasoned farmers have also been working to help

less-experienced peers prepare to operate on a smaller budget. With this dreary forecast, it is expected that rent and prices on agricultural land will also fall in the coming years.

Residential borrowing is growing, but there is some concern that rental and commercial real estate may be overexpanding. Some bankers also noted an increase in lending to existing small businesses. Due to low net interest rate margins and stiff competition from credit unions for routine consumer loans, banks feel intense competition among themselves for loan customers and believe there is a concern for future growth in this area.

Attracting Human Capital

Iowa bankers are cultivating new employees by attending college career fairs, hiring college interns and hiring local community members. By focusing on the local talent pool, banks hope to reduce turnover. In addition, several banks have started to offer higher salaries to incentivize employees to stay longer.

Nevertheless, attracting and retaining employees in smaller communities is still incredibly challenging. Many bankers have opted to hire untrained and younger employees who are more likely to stay in the

community, since the costs associated with high turnover and the hiring process are more burdensome than in-house training.

Examination Feedback and Regulatory Burden

State and federal safety and soundness exams are seen as generally helpful and useful. Safety and soundness examiners take a collaborative, interactive and responsive approach to supervision.

Compliance exams, however, are unduly burdensome and put significant stress on community banks. Compliance examiners frequently make redundant and unnecessary information requests of the bank, are rarely collaborative or responsive to questions, and oftentimes give conflicting interpretation of rules. The cost of compliance auditing and examinations also imposes a significant burden on the banks.

In general, the burden of regulation has increased costs to banks and made mortgages and home equity loans less profitable. The difficulties posed by qualified mortgage standards and the length of time needed to process a loan have made mortgage lending unfeasible for many community banks.

Emerging Issues

Internet technology and emerging cybersecurity threats pose a significant challenge for Iowa's community banks. Keeping up with current cybersecurity issues, training employees to be aware of existing threats and keeping consumers protected against attacks are all areas of concern. Guidance from state and federal regulators on cybersecurity would go a long way to helping community banks manage these threats.

Iowa bankers also expressed concerns about the state's aging local population and the implications this poses for community banks.



Market Condition and the Local Economy

Kansas is experiencing limited business development in major metropolitan areas. The population of areas like Topeka has grown slowly, resulting in similarly slow growth in business activity, capital expenditures and acquisitions. For those businesses that are expanding, many are startups that lack the funding and reliable cash flow to develop any significant line of credit. The current credit availability for loans exceeds demand.

Slow population growth has also led to limited housing construction and development. However, in some areas, overall housing inventory is down, so there is some expectation of growth in the coming years.

Nevertheless, unemployment is low throughout the state. Because the state has a large agricultural sector, high cattle and crop prices largely insulated the state from the worst effects of the financial crisis. While most potential employees interested in work are able to find it, slow population growth also has made it difficult to attract new business into the state.

Borrowing Attitudes

Some of the most reliable long-term customers of community banks are still conservative when it comes to credit. Many of the largest customers for community banks are no longer willing to take big risks and are paying down their loans at a much faster rate than they once did. Having faced significant losses during the financial crisis, these businesses are hesitant to invest in any area in which they experienced loss.

As a result of limited business lending and increased credit availability, the pricing and structuring of loans has become more advantageous for borrowers. While consumers show a willingness to take advantage of these rates for mortgages, few businesses are seeking more credit.

Unmet Financial Services Needs

Consumers in need of small-dollar and short-term loans are unable to find them at community banks. The regulation on banks has been so onerous when it comes to small-dollar loans that banks have stopped offering them, leaving consumers to seek out credit from payday lenders.

Examination Feedback and Regulatory Burden

Community bankers find value in safety and soundness exams. Bankers indicated they learn from these exams and feel as though they are adequately able to prepare for them.

However, when it comes to compliance exams, some bankers feel as though they don't know what they will be tested on and are unable to prepare, despite the fact that many of these banks spend the most time preparing for compliance exams. Federal regulators could alleviate the challenges faced during compliance exams by improving their communication about expectations prior to the exam.

In general, examination reporting is getting more complex and costly. Additional requirements for the Home Mortgage Disclosure Act and for the Bank Secrecy Act are just some examples of where community banks are spending more time.

Some rural community banks are unable to obtain a rural or underserved exemption from the Consumer Financial Protection Bureau for the purpose of issuing balloon loans because their communities are adjacent to larger metropolitan areas.

Emerging Issues

Community banks in Kansas are losing more business to the Farm Credit System (FCS). Because of subsidies and fewer regulations, FCS institutions are able to lend at near-zero interest rates that are impossible for any bank to compete with.



Market Conditions and the Local Economy

Kentucky's community bankers are seeing little entrepreneurship or new business formation, but remain optimistic. Bourbon and automotive supplier industries are indirectly bringing new business into the state through tourism. In addition, personnel relocation provides opportunities for home mortgage and personal loans. Large companies are expressing interest in warehouse and manufacturing facilities, but they do not want to build or own the facility. Instead, they are only interested in purchasing or leasing existing space. At this time, community bankers are reluctant to originate construction loans or permanent financing for speculative commercial warehouse and manufacturing facilities.

Kentucky generally remains more insulated from the after-effects of the recent recession compared to many other states. Community banks in the state are performing better than national averages. Bigger cities have recovered and are reporting strong growth potential, while the smaller communities are experiencing reductions in population and continued concern over economic prospects.

Borrower Attitudes

Kentucky's borrowers are still hesitant and unwilling to take the risks that they were prior to the recession. Consumers are spending less and saving more, and they are using discretionary income to pay off debt. Student loans have negatively impacted borrowers' ability and willingness to take on additional debt, and many consumers are choosing to pay off student loans before borrowing money to buy a home.

Unmet Financial Services Needs

Competition for financial services is coming from a variety of nonbank sources, such as nontraditional service providers, credit unions, Farm Credit System lenders, peer-to-peer financing and companies financing their own products. This form of competition is different than it was before, as many financial services are now offered via the Internet. Since consumers can simply access services over the Internet, bankers cannot adequately measure competitive service providers because no physical buildings or businesses are moving into Kentucky communities.

Community bankers feel they are at a competitive disadvantage because they are

held to a higher standard than nonbank financial services providers. New regulations limit their flexibility when offering services or developing new products to meet customer demands.

Attracting Human Capital

Attracting human capital is a significant challenge. Many community banks operate in small insular communities, making it extremely difficult to attract talent to the community, or even entice college students to return after they obtain a degree.

Employing high school and college students as interns has served as an effective way to develop human capital in Kentucky. Bankers are hopeful that this process will create interest and motivate students to pursue a career in banking. Bankers also discussed that they are trying to offer more flexibility with schedules to accommodate and attract younger employees with families or other personal responsibilities or interests.

Examination Feedback and Regulatory Burden

Bankers believe exams, especially compliance exams, should be focused on systemic risks rather than one-time mistakes. Issues found during the process need to be

brought to bankers' attention, and discussions should take place before citing a violation. Open communication lines between bankers and regulators are critical.

Community bankers believe that regulatory burden affects their ability to provide services and has limited their ability to offer new products because of anxiety and expense. Some bankers have indicated that they are so nervous about making a mistake in the process that they choose not to offer a product or service in certain instances. The impact of regulatory burden on risk tolerance has been limited, but the biggest hindrance to the success of a community bank is flexibility, which has been largely taken away over the years because of the increase in regulatory burden.

Emerging Issues

Community bankers are greatly concerned about cybersecurity. Better information sharing between regulatory agencies and other community bankers would be helpful in alleviating emerging cyber-threats.

Market Condition and the Local Economy

Some bankers are seeing several startups emerge in their local communities. Large banks are aggressively reaching out to the startups in the area in an attempt to capitalize on future gains. Some community bankers see the startups' lack of experience in finances as too risky, while others have expressed concern about hiring staff experienced in analyzing new businesses.

The state is also experiencing a growth in restaurant and service industry ventures like salons, daycares and fitness centers. Restaurants in the area largely derive their funding from family members and are typically not well-capitalized.

Property values have rebounded considerably, so much so that high-income properties are often being sold for more than the asking price. Banks are also experiencing considerable development- and construction-lending demand.

Economic decline in certain areas, as well as unemployment, is forcing many loan modifications. Most delinquencies are from owner-occupied loans, making these types of loans risky for many banks. As a result, the delinquencies are causing foreclosures. Consumers are taking advantage of the grace periods provided on mortgages on a regular basis. Many banks feel that mortgage lending is no longer profitable in this sort of environment.

Unmet Financial Services Needs

Many banks are not providing basic money services

like ATMs. Banks that do provide money services often tell business customers that they may not house an ATM on their premises because it exposes the bank to Bank Secrecy Act (BSA) risk. Banks are also reluctant to provide small-dollar loans to consumers because of the high risk associated with these loans.

Many Massachusetts bankers also feel that their consumers lack the basic skills necessary to maintain their own financial records, improve their credit score and grow their own wealth. In response, banks have been providing financial literacy classes and programs using their marketing budgets.

Educating consumers has proven especially challenging when it comes to servicing undocumented immigrants. While there are more services helping immigrants who have a language barrier by providing multilingual services and financial education on how to buy a house or establish a business legally, there is still room for improvement.

Attracting Human Capital

Community banks have struggled to hold onto commercial lenders. Some larger banks are offering salaries far above market price to acquire a good lender. Salary is not the only thing causing community banks to lose staff, however, as midlevel managers seeking opportunities for growth are leaving community banks for larger banks after they have been trained.

Plans for a new casino in southeastern Massachusetts could also lead to more

employee departures as the casino seeks out staff with banking experience. To combat turnover and attract new staff, bankers have been working on improving their banks' internal culture and work environment.

Regulatory Burden

Compliance exams present a considerable burden to community banks. During exams, it seems as though examiners are actively seeking out ways to find the bank noncompliant. Even when banks want to comply, it seems as though examiners harbor an attitude that banks are actively trying to be noncompliant.

Bankers also feel there is a lot of unclarified "gray area" in compliance, especially with regards to Community Reinvestment Act (CRA) loans. Because CRA assessments rely so heavily on data, bankers are often making decisions based on CRA data requirements more than what will most benefit a community. These "gray areas" contribute to inconsistency between examiners, where each examiner has a different stance on how banks should be run.

This has resulted in many community bankers focusing more on compliance than on providing consumer services, often opting to provide small tweaks to already existing products rather than develop new financial services out of fear of new compliance burdens.

Because compliance exams are so daunting, community banks have been hiring consultants to help in the process. However, consultants are both costly and provide no



guarantee of tangible benefit when it comes to exam results.

Bankers suggest examiners offer insight on ideal methods and practices. Bank CEOs would also like the examiners to be more tactful when providing the exam results to board members. They feel that minor compliance issues are often exaggerated, making it look as though the CEOs are not doing their job. The banks would also prefer to have a rating system for compliance exams that better reflects the ambiguity of compliance, rather than being assessed on a "yes" or "no" basis.

Emerging Issues

Beyond the growing presence of larger banks, credit unions are increasingly competing with community banks throughout the state. In addition, the need to "know your customer's customer" is an emerging BSA risk for community banks. Lastly, community banks are struggling to appeal to younger consumers who put more reliance on technology than on in-person transactions and relationships.



Market Conditions and the Local Economy

Bankers indicated that Mississippi lags behind the rest of the country in economic development and education. However, new factories and industries are entering many parts of the state. Two car manufacturers have plants in Mississippi: Nissan in the central part of the state, and Toyota in the north. These plants continue to increase their production, and support businesses continue to open around the plants. Smaller industries are also experiencing growth. While bankers indicated that these developments were positive, enthusiasm is restrained. One banker noted that the recent improvements to the economy are “enough to notice, but not enough to brag about.”

Community bankers in Mississippi are generally optimistic about the housing market. Following the economic downturn, builders have been cautious to construct new homes, leading to increased demand for the limited housing supply. Despite increased demand, many bankers in the state operate in lower-income communities that are predominately renters’ markets. Having learned valuable lessons from the crisis, bankers continue to be wary

of increasing their concentrations in construction lending. In certain areas of the state, new construction is starting to increase, leading to gains for the local timber industry. Logging companies are experiencing significant growth.

The agricultural sector has seen five consecutive strong years, and the delta areas and its farming industries are seeing the benefits. Tourism in the delta is also generating additional income within local communities, but overall, the delta continues to struggle due to low household income and poor education.

Cities in the state are starting to see an increase in commercial and retail development, and lending activity is booming in the state’s three major college towns: Oxford, Starkville and Hattiesburg.

Overall, community bankers in Mississippi believe that the economy is improving, but they are not confident that positive growth will continue. Much of the new business in the area is stemming from large chain operations and not small businesses that are unique to the local area.

Borrower Attitudes

Lending opportunities are on the rise. Consumers remain cautious, but borrowing is starting to pick up, especially

among younger customers. Older borrowers were more affected by the recent downturn and are not willing to take on as much risk. While there was a broad consensus that lending is increasing, bankers from smaller communities continue to experience limited loan demand and a lack of qualified borrowers. One banker indicated that his core business customers have been hesitant to tap lines of credit.

Due to the tourist trade and increased income from the hotel and casino industries, borrower attitudes in coastal areas are improving. In the delta, agricultural lending is experiencing a dip due to several years of good crops and customer self-financing.

The level of acceptable risk for most borrowers is still substantially lower than before the recent recession. In addition, bankers have become more cautious in their underwriting processes.

Unmet Financial Services Needs

Community bankers in Mississippi continue to struggle with competition from larger commercial banks and less-regulated nonbanks. Community bankers in the state understand the needs of their customers and local communities. However, many are losing customers to less-regulated

industries, making it difficult to provide the services needed.

Specifically, opaque and confusing fair-lending exam processes are having a negative impact on mobile home lending. Legal fees stemming from fair-lending cases have made mobile home lending unattractive for banks. Few community bankers indicated that they are still willing to finance mobile home loans.

Challenges in Attracting Talent

As is the case in other states in the region, bankers are struggling to attract young talent to rural communities. Certain banks have considered moving their headquarters to larger cities and towns to more easily attract and retain talent. Community bankers indicated that the larger banks have a much easier time recruiting and retaining employees. To attract quality employees, banks will have to be flexible and allow their new hires to live in larger cities and commute.

Bankers agreed that conducting outreach with local colleges and universities has been helpful in recruiting young talent. Also, banks have made use of summer employment and internships, which often turn into full employment.

Examination Feedback and Regulatory Burden

Community bankers in Mississippi are concerned about increased regulatory burden, especially in the areas of compliance and Bank Secrecy Act (BSA) exams. Bankers commented that compliance examiners often appear to exhibit a “gotcha” attitude towards bankers. The long and drawn-out exam process causes fear and uncertainty at institutions, and bankers feel that there is no room for error.

Bankers see compliance exams as one-size-fits all and argue that small community banks are held to the same standards as large banks despite significantly less exposure. Overall, bankers want compliance examiners to consider the size, location and complexity of the institution. In addition, regulators should work to alleviate the time and expenses associated with the compliance exam process.

Community banks are also losing core business to land banks, credit unions and insurance companies. Insurance companies are able to provide better pricing due to their relative lack of regulations, and credit unions benefit from their tax status. The uneven playing field resulting from the cost of regulation has led to insurance companies

becoming the main competitor in the auto lending space. Nonbanks and major retailers compete with banks for fee income from check cashing and other consumer finance products. Bankers indicated that stringent BSA regulations are limiting their ability to operate in the consumer space, and customers are being driven towards less-regulated companies that do not prioritize consumer protection.



Market Condition and the Local Economy

New businesses are forming at a slow-to-moderate pace in Missouri.

While growth remains relatively flat, opportunities for business expansion and formation do exist. For example, Missouri has a large number of empty buildings available for commercial, retail and warehouse purposes. However, bankers noted that there is minimal new commercial business formation which, of course, causes these buildings to go unused. Two Missouri counties—Barton and Vernon—have had absolutely flat commercial sector growth. Bankers pointed to assisted-living commercial real estate as a specific area for opportunity in increasing business formation in the future.

Borrowing Attitudes

Borrowers who were in business prior to the recent recession are unsurprisingly more risk averse than new business ventures. In general, these businesses are borrowing less and saving more capital than before. New businesses, on the other hand, have shown more willingness to take on risk.

Introducing Students to Community Banking

Missouri bankers have focused on students in high school and college to help develop interest and an understanding about banking. In collaboration with high schools around the state, banks have developed a program in which a branch of the bank is located in the high school. Students gain real-world experience by assisting in banking operations, holding monthly meetings, and participating in mentoring opportunities. Local banks are already seeing an increased interest by students in banking and finance as a result of the program.

Bankers work with local colleges and offer internships for college juniors and seniors to be placed in banks around the state. This partnership helps students fulfill internship requirements while also attracting young talent to the banking industry.

Examination Feedback and Regulatory Burden

Due to the severe ramifications for mistakes and the long length of examinations, bankers have been forced to put compliance exam preparation ahead of customer service. A culture of fear exists where bankers feel like compliance examiners are actively seeking to find fault in their work.

Compliance exams lack the valuable discussion and

coaching that occurs during and between safety and soundness examinations. Developing the same type of relationship between bankers and compliance examiners would help improve the examination process. Additionally, the frequency of exams should be on a shorter interval. Three years between exams leaves an extended period where the bank does not have feedback on its work.

Emerging Issues

Missouri continues to struggle with increasing urbanization. Current trends show that small towns are dying out and more people strongly desire to live in metropolitan areas. There is a fight to keep economic vibrancy alive in small towns.

Missouri bankers worry about a national trend toward overregulation. Bankers trace these issues back to Washington, D.C., where they believe too much is being done to micromanage their business activity.

Missouri bankers also worry about the rapidly changing payment systems and online lending. As technology rapidly progresses, community bankers worry about being left out of new business opportunities.



Market Conditions and the Local Economy

While new business sectors like microbreweries and distilleries are emerging in Montana, most opportunities stem from existing markets such as restaurants, medical businesses, manufacturing, agriculture, logging, hospitality and tourism. Competition from large banks and nonbank lenders is aggressive on both price and terms.

Due to Montana's unique landscape, the economy is closely linked to the industries that exist in particular areas of the state. Falling oil prices are impacting eastern portions of the state, but these markets are holding relatively steady due to continued strength in the agricultural lending market. The western part of the state is experiencing some growth, but housing affordability continues to be an issue.

Borrower Attitudes

Community bankers in Montana indicate that borrowers are feeling increasingly positive and are more willing to take on risk. Despite this, community bankers continue to be conservative and are requiring borrowers to take on more of the risk associated with lending. Due to increased regulatory oversight, bankers are far more conscious of the

risks in concentrations and less interested in collateral-based borrowing.

Unmet Financial Services Needs

Montana's community bankers point to the Consumer Financial Protection Bureau's qualified mortgage (QM) rule as an example of a regulatory impediment. Loans that previously would have been kept in portfolio can no longer be extended to many individuals due to the regulatory risk of originating non-QM loans. Community bankers in the state are unwilling to shoulder the added regulatory risk associated with non-QM lending.

Attracting Human Capital

Montana's community bankers realize that they need to pay a premium to attract and retain qualified talent. The Montana Bankers Association is attempting to remedy a shortage of executive-level talent through an executive leadership training program and other initiatives.

Examination Feedback and Regulatory Burden

Scoping for risk continues to be discussed at the federal level, but there is a perception among the state's community bankers that compliance

exams are not focused on risk. Instead, compliance exams at community banks seem to be focused on identifying things that the bank may be doing less than perfectly.

The state's community banks are less likely to offer new products and services due to the fear that a small compliance issue will land them in significant trouble. Competitors that operate in niche, less-regulated sectors are able to innovate and gain customers, while bankers feel constrained due to the regulatory risks involved. This ultimately hurts consumers by pushing them towards less regulated and more risky options outside of the traditional banking sector.

Community bankers ultimately desire an approach that takes into account the size, business model and complexity of their institutions. They are concerned about continued viability due to the effects of "trickle-down regulation."

New Hampshire



Market Conditions and the Local Economy

Economic conditions in New Hampshire vary greatly by region.

In northern New Hampshire, the real estate market has a high inventory of available properties. Unemployment is relatively high, with hospitality personnel and the self-employed struggling the most to find work. Many have lost jobs. For those who do have jobs, hours have been cut and many are working part time. Bankers feel there is still considerable “slack” in the North’s labor market that remains unaccounted for.

In contrast, southern New Hampshire has substantially lower unemployment and significant business activity. A tighter housing market has created an advantage for home sellers, with buyers often bidding above asking price for a home.

Central New Hampshire represents a mix of economic conditions from the North and the South. In general, bankers report decent growth in manufacturing and tourism, while most industrial growth outside of manufacturing remains stagnant. All industries in central New Hampshire struggle to find qualified employees.

Bankers noted that western New Hampshire has low

unemployment rates, but those employed earn lower wages compared to other parts of the state.

Attracting Human Capital

Despite efforts to attend college career days and industry job fairs, young bank employees are harder to recruit and retain than ever before. Bankers desire interns, but finding candidates for internships and other positions has only worked for a few banks.

New Hampshire community bankers believe young employees entering the workforce employ a mindset that jobs need accelerated advancement and attractive location. Because of this, folks who are interested in working in banking are not attracted to living in certain areas of the state. Banks spend money on education for employees to try and keep them in the area, including internal courses, online courses and university classes. Despite this, banks still experience considerable turnover. Some community banks have resigned themselves to the fact that young employees are not interested in a long-term career at one place.

As good employees become harder to retain, salaries have skyrocketed as larger banks attempt to poach more qualified employees from small banks. High turnover,

high pay and costs of training and development have led to unprecedented overhead costs.

Examination Feedback and Regulatory Burden

Community bankers find value in safety and soundness exams. Strong, productive relationships with regulators cause safety and soundness exams to feel more cooperative.

Compliance exams, however, feel more like attacks on institutions. These exams are not productive and are very complex. Employees live in fear because an innocent mistake or a misinterpretation of the rules and regulations is put in the report. These findings can have a significant impact on the bank and have long-term consequences, as the exams only occur once every three years. Regulators should find a way to make compliance exams more cooperative and more beneficial to banks.

Market Conditions and the Local Economy

Community bankers in New Mexico are not optimistic about their ability to attract new business in the current economic and regulatory environment. Community banks in the state face unique challenges posed by serving primarily rural communities.

A wide variety of industries associated with agriculture and water resources call New Mexico home, and agriculture lending has historically been an area of opportunity for New Mexico's community banks. However, due to increased regulatory requirements, community banks are finding it more difficult to serve and generate new business within this niche market. Community banks that typically financed agricultural loans are finding that their customers no longer meet the necessary criteria that the banks are required to satisfy.

A sharp decline in oil and gas prices has posed significant difficulty for community banks that serve the industry. Other banks and their communities have also faced hardships due to the closure of military bases or mineral mines. Despite these challenges, net interest margins for the first quarter of 2015 show that community banks in the state are continuing to persevere.

The television program *Breaking Bad* provided benefits to the state economy via tax credits, but it left the rest of the nation with a negative perception of New Mexico. This negative perception has ultimately led to fewer business

opportunities for industries in the state, including financial services and community banking.

Borrower Attitudes

New Mexico's community bank customers are still reluctant to borrow. Older customers continue to purchase or construct homes, but they are often paying cash to purchase or building real estate on land that they already own. In addition, many customers who are qualified for financing are willing to pay higher interest rates to avoid the increased scrutiny that community banks are required to subject them to during the application process. Emerging businesses within the state that cater to the financial needs of the aging population are thriving.

Unmet Financial Services Needs

Community bankers are finding that the personal attention that was a valuable commodity of the past is no longer important to their younger customers. As such, community banks feel growing pressure to keep pace with technology as their customers increasingly look online for their banking needs. With resources taxed to the limit by new regulations, however, community banks are currently unable to devote the time and money necessary to invest in new technology.

Higher overhead costs and increased reliance on technology has led to banks exploring how to decrease their physical footprint while maintaining customer relationships. Overall, there is a consensus that

community banks have too many locations for the current volume of in-branch services.

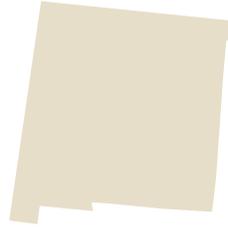
Examination Feedback and Regulatory Burden

New Mexico's community bankers are struggling under the weight of growing regulatory burden that is applied to the industry. Bankers want to be regulated based on the risk posed by their individual institution, not on the risk of a nationwide industry.

Community bankers in the state note that the consumer protection that the Dodd-Frank Act was intended to provide actually harms many consumers. For example, it is now virtually impossible for a self-employed small-business owner to qualify for a mortgage.

Bankers were in agreement that regulation has made mortgage lending almost extinct in community banks. One banker described the current situation by saying, "When consumers are unable to qualify for a loan, the U.S. Department of Agriculture comes out with a program with no down payment, or the government steps in and makes the loans under their own rules, but blames the community banks for the reason they had to step in." Even if one bank in a rural community is forced to cease residential lending, consumers are disproportionately harmed.

Compliance burden has caused tangible increases in overhead costs for community banks, many of which struggle to afford new staff that generate no profit. Given that many requirements are new and

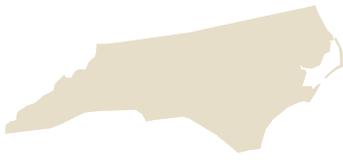


confusing, regulators should expect that mistakes will occur.

Systemic regulations such as the capital requirements imposed under Basel III are also having an impact on community banks. Due to risk weighting, community banks are now less competitive in commercial loans. Other nonbank lenders are entering the market.

Despite the overwhelming impact of new and changing regulation, New Mexico's community bankers expressed appreciation for state regulators. Small banks feel that state regulators are well-equipped to communicate the value of community banks and the void that would be created if they were to be regulated out of existence.

North Carolina



Market Conditions and the Local Economy

Market conditions are improving in North Carolina. While borrowers are still cautious and real estate lending has rebounded, the North Carolina market has not reached prerecession levels.

The Value of Community Banks in North Carolina

North Carolina community banks play a pivotal role in their communities. Local bank leaders participate in community civic groups, make donations in the community and provide jobs and career development to local citizens.

More importantly, community banks employ local decision-making and focus on extending credit within the community. De novo entrants in particular communities have significantly impacted the loan-to-deposit ratio of existing institutions, causing regional banks to make more local loans to remain competitive.

Attracting Human Capital

Hiring and retention at local banks has become more challenging. Despite rapid change in the industry, large banks are no longer providing extensive training to new staff. It has become especially difficult to find compliance staff. Even finding a good consultant for

compliance has proven difficult and costly.

Community bankers have had to change their approaches to hiring and retaining new staff. One community bank in North Carolina is hiring new college graduates based on GPA and compensating for higher GPAs, which has improved retention. While new college hires are often more technologically savvy, they lack competencies in lending and underwriting. Spending more time developing young hires is expected to improve long-term retention for small community banks.

Examination Feedback

Eliminating duplicative processes and improving efficiency of bank exams would be a welcome first step to improving the current regulatory environment. Facing more stringent regulations, community banks are increasingly turning to third-party reviews prior to their exams. Despite the availability of these independent reviews, examiners will duplicate the review. The community bank pays for both the third-party review and the examiner's time. Examiners are also requesting information from a bank that has already been provided through off-site data uploads.

Thus, despite the increased information being shared with and submitted to regulators, examiners are not using collected data to make exams more efficient. Providing a method for independent verification and validation, where regulators approve third-party auditors and rely on their assessment, could

help eliminate duplicative processes.

In addition, bankers are finding that they are spending considerable time training examiners on community bank matters.

Regulatory Burden

Regulatory burden is an increasing problem for community banks. Action will be needed both by Congress and by state and federal regulators to improve the regulatory environment for community banks.

Several local real estate firms have exited the closing business because of the Consumer Financial Protection Bureau's (CFPB) requirement to re-disclose during the settlement process, making it more difficult for North Carolina community banks to identify closing attorneys. The CFPB has also made it more difficult for community banks to give advantageous pricing to long-term customers, causing concerns about losing these customers to larger institutions. Fair lending implications have also led to several community banks exiting the indirect auto finance market.

North Carolina bankers are concerned about entering banking relationships with industries that are seen as politically unpopular, such as microbreweries, tobacco or shooting ranges. There is a growing concern about the potential regulatory consequences for engaging these industries.

Policymakers and legislators should work to better identify community banks in need of regulatory relief. Community banks cannot be

defined solely by asset size: Local leadership, locally driven lending decisions, a dedication to small business lending and a focus on Main Street are all factors that better define a community bank. Once community banks are clearly defined, policymakers and legislators should provide regulatory relief that reflects the relationship-lending business model used by these banks.

Many banks in need of capital are also forced to wait extended periods of time before closing on favorable transactions because of the additional review involved in applications. The extensive federal review of applications is inconsistent with a troubled institution's heightened need for flexibility and efficiency.

Emerging Issues

There is a growing concern that small bankers are being left out of the emerging payments loop. Small banks are increasingly taking the brunt of online card fraud while simultaneously losing business to mobile banking options. Relationship lending is difficult in an environment where branches are closing and being replaced by technology. As one banker put it: "Banking is something people do, not a place people go." Nevertheless, North Carolina's community bankers agree that community banks can still remain interactive with their customers through the use of emerging technologies like videochats and mobile banking.



Examination Feedback and Regulatory Burden

The Dodd-Frank Act, although originally intended to address the risk posed by the nation's largest financial institutions, has created a one-size-fits-all regulatory approach and has saddled community banks with new and unduly burdensome regulations. New regulations disproportionately impact smaller institutions that lack the personnel and financial resources of larger banks. As a result, community banks have seen a decline in market share and a trend toward consolidation.

Current use of "disparate impact" to identify fair-lending violations in banks has had the negative effect of eliminating certain lines of

credit available to consumers. Community banks, often operating in an environment of uncertainty when it comes to compliance, regularly choose to stop offering a product altogether when regulatory and litigation risks are too high.

Legislators should make a concerted effort to better define and identify community banks in need of regulatory relief. Once community banks are better identified, policymakers should pass legislation that tailors regulations to the size, complexity and overall risk profile of institutions. Policymakers should also be open to feedback from community banks and include community bank representation on federal regulatory boards.

Emerging Issues

Oklahoma bankers have expressed concern about data security in a world of increasing cybersecurity threats. State and federal regulators should provide more tools and guidance to community banks about how to adequately prepare for cyberattacks.



Market Condition and the Local Economy

The market conditions of Oregon vary by region. The populous Willamette Valley and the metropolitan-area Bend are seeing significant economic growth, while the coast and eastern Oregon are growing at a slower pace. The general consensus is that Oregon lags national economic indicators for growth, especially in rural areas.

The bulk of economic development is coming from technology and hospitality businesses as well as state and municipal government. While there are not many new businesses opening, existing businesses are expanding. At least some of this expansion can be explained by the rising population, a trend that is expected to cause an increase in multifamily developments in the more populous regions.

Borrower Attitudes

Appetite for borrowing is increasing but still lukewarm. Many homeowners are refinancing in an attempt to lock in longer-term fixed rates, signaling that borrowers are concerned about rising interest rates. Developers are beginning to seek land purchases and construction loans again, but not at precession levels.

As the population has grown, the inventory for residential single and multifamily homes has tightened considerably, and the market seems ready for new construction.

Unmet Financial Services Needs

Oregon is in need of banking services for the growing marijuana industry. Concerned with how federal agencies might react, banks are currently unwilling to provide services to marijuana businesses.

Attracting Human Capital

Most community banks are struggling to fully staff their front-line personnel. There is a limited market of employees who are qualified to be tellers or entry-level employees. There is also a lack of qualified loan officers: Not only are fewer loan officers entering the workforce, it is increasingly difficult to find experienced loan officers that have the right combination of skills in credit analysis and sales.

Currently, Oregon has no graduate-level banking program within the state. The Oregon Bankers Association is working with local colleges to develop a graduate banking program.

Examination Feedback and Regulatory Burden

There is consensus that the compliance exam process is out of alignment and that bank examiners are excessive in their reviews. The exam itself does not recognize that the level of scrutiny in compliance should reflect the size and overall risk posed by an institution. Community banks should not be held to the same level of scrutiny as the nation's largest banks.

Because of the excessive nature of compliance exams, many small banks in Oregon have avoided engaging in consumer and mortgage lending. The compliance requirements are too onerous and not worth the return on investments.

Emerging Issues

Several economic and local political developments have limited the growth of new and existing businesses. Lack of affordable housing due to land-use restrictions and curtailment of housing development and uncertain state government policies around health care, taxes and the minimum wage have caused uncertainty for businesses and banks in the state.

Other concerns include emerging cybersecurity threats and the challenges facing

a community bank to adequately address cyberthreats; the growth of underregulated third-party service providers and nontraditional financial services companies; and the desire to see Congress pass regulatory relief measures.



Borrower Attitudes

Tennessee businesses are looking to expand their operations and take on more risk and, thus, are more comfortable borrowing to expand. For example, consolidation in the Tennessee health care industry means many companies are looking to grow by buying out their competitors.

However, community bankers noted that meeting their business customers' credit needs is a longer and more complicated process in the postcrisis world. Tennessee bankers are willing to extend credit to business borrowers, but it is more difficult for businesses to qualify for loans now than it was before the crisis.

Unmet Financial Services Needs

Community bankers' ability to meet customer needs has been significantly hampered by new compliance regulations and the expansion of credit unions in their communities. For example, community bankers are interested in offering small-dollar loans and believe they could compete with payday lenders to offer a more consumer-friendly product. However, fair lending concerns, onerous paperwork and limits on fees and interest rates make small-dollar products unprofitable for the bank.

Attracting Human Capital

Tennessee community bankers believe efforts to develop younger executives' skills and mentor them for further leadership will help fill upcoming gaps at key positions. The Tennessee Bankers Association has established a young bankers initiative that provides education programs for the next generation of community bank leaders, and it plans to launch other banker education and training programs this year.

Some Tennessee bankers noted that developing connections and networking with local universities and colleges has helped them attract new hires. Tennessee community banks with internship programs for college students have seen plenty of interest from undergraduate students and have been able to regularly recruit talented students after graduation.

Compliance Examination Burden

Community bankers in Tennessee think that compliance examinations could be more beneficial if field examiners took a more measured approach to compliance problems. Examiners should help institutions comply with the law instead of being accusatory or punitive. Examiners who

provide banks with solutions to their compliance issues as well as examples of how other banks rectified similar issues would add value to the compliance exam process. Most importantly, after recommending changes based on a compliance examination, examiners need to have realistic expectations on how long it will take for banks to make those changes in their policies and practices.



Mortgage Lending

The reason for the qualified mortgage (QM) and ability-to-repay rules was to avoid systemic risk in the market in case of loan default. If community banks issue loans and keep them in their portfolios, they are fully incented to ensure that the loans do not enter default. A small bank that holds its loans in portfolio does not present a systemic risk to the system and should be allowed to grant QM status to its portfolio loans.

In addition, the licensing requirements for anyone who interacts with a mortgage loan, along with new requirements from the Truth in Lending Act, have led to community banks hiring mortgage specialists, a cost that is difficult to justify when making fewer than 500 loans per year. Community bankers in Texas feel that, beyond the asset-size exemption threshold, reporting under the Home Mortgage

Disclosure Act should be limited if an institution makes fewer than 500 loans per year.

Community banks are typically best suited to help borrowers who may need non-conforming loans. However, the Independent Bankers Association of Texas found that 48 percent of its member banks have been limited in making mortgage loans and 8 percent have stopped entirely.¹

Fair Lending

With fair lending, it feels as though regulators are trying to tell banks exactly how much they can charge their customers. This has caused community banks to abandon some types of loans as they are no longer profitable. Some long-term customers of community banks are no longer able to receive a loan at their bank and are turning to payday lenders, paying a higher interest rate than they were before. This is the same problem consumers

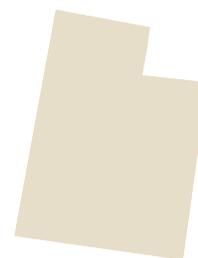
currently face with new insufficient fund rules; if consumers cannot easily access credit at their banks, they will turn to less regulated entities for help.

Bank Secrecy Act Compliance

Community banks in Texas also face undue reporting requirements through the Bank Secrecy Act. The threshold of \$10,000 for completing a suspicious activity report (SAR) has been the same for a long time, with no regard for inflation or changing circumstances. A change in the threshold or a simplified SAR form would go a long way in easing regulatory burden.

ENDNOTES

1. Independent Bankers Association of Texas. <http://www.ibat.org/PDFs/2014/02/07/2014-ibat-member-mortgage-survey>.



Market Condition and the Local Economy

Utah's economic growth is better, stronger and more broad based than in previous years. New businesses forming include technology startups, residential multifamily construction firms along public transit corridors, and retirement home businesses. The supply of vacant developed lots is decreasing, and home prices are increasing rapidly. The labor market has tightened considerably, with banks struggling to hire entry-level employees such as tellers.

Borrower Attitudes

Investment money is more available, and financiers are increasingly interested in investment properties. Borrowers are asking for longer fixed interest rates and to borrow with little or no down payment. Because of the growth in lending and rise in property values, bankers are seeing more nonbank competitors who are advertising faster closings on loans.

Attracting Human Capital

Attracting young, talented staff has proven a major challenge. Utah has a pool of talented college graduates, but needs to provide more

incentive to the younger generations to stay in banking and finance. The Utah Bankers Association intern program for college students seeks to assist member banks with the challenge of recruiting and hiring qualified employees.

Regulatory Burden

Community banks in Utah are experiencing some of the greatest regulatory burden during compliance exams. Compliance examiners seem to be actively trying to find violations and problems where there aren't any and do not come across as helpful or as a resource to bankers. Focusing on compliance issues relevant to bank size and complexity, providing an overview of common red flags and mistakes that are seen during compliance exams beforehand, and being more interactive with bankers during the examination process would all be helpful steps in improving the process for community banks.

Since community banks have been unable to operate with some flexibility, they have lost their competitive edge in industries where they were previously dominant. Mortgage lending is one example where community bankers no longer feel that they can profitably compete.

Emerging Issues

The younger generation of customers is tech-driven and looks more to alternative financing sources, such as crowdfunding or peer-to-peer funding. It is a challenge to successfully provide services and products to attract this customer base. The changing payment system is also a concern. As the payment environment rapidly evolves, it is becoming more difficult for community banks to keep up with their limited resources.



Market Conditions and the Local Economy

Washington as a whole is experiencing economic growth. However, much of this growth is focused in the Seattle metropolitan area, while the remainder of the state is only seeing modest gains. Seattle is benefiting from the growth of technology-related firms and their need for commercial real estate. The eastern part of the state benefits from the continued strength of the agricultural sector, though commodity pricing risks still loom. Other economic opportunities in eastern Washington are limited.

Borrower Attitudes

Bankers' assessments of borrower attitudes are mixed. While some believe lending activity continues to be curtailed by the deleveraging mentality caused by the financial crisis, others report a gradual return to borrowing. In general, the agricultural and technology sectors have increased their use of credit, while other industries remain cautious of borrowing.

Some banks that previously focused on real estate have shifted to a commercial and industrial focus where there are more business opportunities. From the community

bank perspective, it is challenging to benefit from this activity since much of the funding comes from large banks and private equity firms. Community banks do see some benefits from downstream activity.

In markets with new business formation, community bankers find significant competitive pressure from large banks that appear to be more willing to lend with less collateral and more liberal credit terms. Multifamily lending was specifically identified as an area in which lending terms and cap rates have become irrational and difficult to justify. The "highly volatile commercial real estate" designation has made many historically viable community bank deals difficult to book. Specifically, existing land equity does not count since a developer has to have 15 percent cash invested in the project.

Unmet Financial Services Needs

Aggressive competition is breaking down the relationship-based banking model. The overall regulatory approach of narrowing the road of acceptable risk with qualified mortgage (QM) and commercial real estate (CRE) limitations has dramatically increased the competition

for bankable single family residential and CRE deals, as well as for commercial and industrial loans, having the unintended effect of increasing risk in the system.

In terms of consumer lending, there are few opportunities for community banks with manufacturer financing, credit unions and credit card banks dominating the market. Community bankers cite specific examples of loans they do not feel comfortable making due to the ability-to-repay and QM rules. For example, bankers universally agreed that they are uncomfortable making mortgage loans to self-employed individuals and individuals with a change in employment. The ability-to-repay rule is impacting how self-employed people compensate themselves, requiring them to take more money out of their business and leaving less for capital support and expansion. Bankers remain very concerned about future litigation risk.

Attracting Human Capital

Attracting qualified employees continues to be a challenge for community banks. Staffing at the branch level is a consistent and long-term problem. The banking system still has not adjusted to the lack of robust credit training by large,

regional banks that previously fed the talent pool for community banks.

Training new bankers is a significant challenge and investment. This is especially difficult with a generation that has less interest in a long-term employment commitment. Bankers displaced through the financial crisis had to find new careers and haven't necessarily returned to banking. A significant portion of managers are within five years of retirement.

Human capital issues also extend to the board room. There is a push for independent board members and members with a broader range of expertise. It is difficult to attract board members who are willing to accept the position's risk.

The Pacific Coast Banking School recently launched an awards program for college professors who promote banking as a career for college graduates.

Examination Feedback and Regulatory Burden

Bankers continue to feel vulnerable to consumer compliance and Bank Secrecy Act violations. This vulnerability stems from what they see as a "no tolerance" stance by the federal regulators. The separation of safety and soundness and compliance exams leaves

compliance examiners with no context for overall risk. Bankers universally agreed that if the regulatory agencies altered their approach to focus on the bank's risk management and operational processes with more focused transaction testing, the bank would gain more value from the process and likely improve its ability to comply.

The sheer volume and complexity of regulations makes it very difficult to achieve 100 percent compliance, and it seems as though most exceptions do not amount to any consumer harm and do not represent a disregard for anti-money-laundering laws.

Community banks would like to see regulators offer more tools to address the rapidly changing regulatory landscape. For example, if interest-rate risk is a concern, offer a simplified model that community banks could utilize. Currently, each bank is developing its own solution. Bankers are concerned with the anticipated changes to the accounting standard for the Allowance for Loan and Lease Losses. This is an area that community banks would appreciate a solutions-oriented approach from the regulators.

Emerging Issues

With continued pressure

on the net interest margin, uneven economic activity and significant competitive pressure from large banks, credit unions and Farm Credit System lenders, Washington's bankers are concerned about the outlook for earnings over the next year. The profile of community banking in Washington could change significantly over the next few years.



Market Condition and the Local Economy

Recent mine closures and a reduction in the corresponding work force has put serious strain on West Virginia's southern region. As young families leave the area in search of new opportunities, community bankers in the area remain hopeful that rural marketplaces will develop as business activity diversifies.

Other communities in West Virginia see some stabilization in the marketplace as proposed pipeline projects and recent gas production leasing activity has increased local deposits. Community bankers in the eastern region also pointed to increased activity in the region's agricultural and natural resources sector as positive developments.

In north-central West Virginia, unemployment is low. Local banks have experienced an increase in new small business development, and the health care sector also continues to grow.

Statewide, labor force participation rates are among the lowest in the nation. Community bankers are closely monitoring changes in the number of local building permits issued in recent years for indication of increased construction activity, economic development and lending opportunities. Bankers are

hopeful that the elimination of the business franchise tax, which went into effect Jan. 1, will lead to entrepreneurship and position West Virginia to compete for new and expanding businesses.

Borrower Attitudes

Loan demand remains flat in West Virginia as both banks and borrowers remain cautious. Given the current interest rate environment, net interest margins remain very low for community institutions. Community banks face stiff competition from larger banks and regional institutions that are more able to relax pricing and terms on loans. Some community banks are experiencing loan growth in areas where larger institutions have vacated the market due to lack of business activity or interest.

Unmet Financial Services Needs

Mortgage lending in West Virginia was largely unaffected by the new qualified mortgage (QM) rules, as community banks were able to offer non-QM loans under different approval standards. The mortgage insurance market also continues to loosen up, further enabling stabilization in mortgage lending in the state.

Some bankers are concerned that new rules relating to

appraisals and flood insurance have increased costs to the consumer and delayed the loan closure process, impacting reputation and weakening a traditional strength of community banks: processing and closing loans in a timely manner.

Community bankers also identified a lack of high-tech infrastructure in the financial services marketplace in West Virginia. As new technology becomes available across the spectrum of financial services—including product sales and delivery, mobile banking, and the payment system—many community institutions lack the infrastructure to offer a full range of such services to their customers.

Attracting Human Capital

West Virginia bankers view education as the key to developing human capital. Community banks throughout the state have developed extensive training and education programs, including specialty off-campus training, job-specific cross training, broad spectrum multifunctional training, and bank culture training.

As the cost of health care continues to rise and wage pressure remains constant, banks are recruiting employees from local colleges, high schools and larger regional institutions. Community banks have implemented

innovative work scheduling programs to accommodate the familial responsibilities of their employees and to improve employee retention, which continues to be the single most challenging human capital issue for the state's community institutions.

Even still, community banks are plagued by the persistent exodus of the state's best and brightest talent to other regions of the country where economic opportunities are more varied.

Examination Feedback and Regulatory Burden

Recent changes in federal regulations have had a significant impact on risk tolerance of community banks in West Virginia. Community bankers have shied away from home equity line of credit loans and have been forced out of the mobile home lending markets. They likewise report a reduction in the number of construction and bridge loans as a function of risk management. The increased cost of compliance has priced both lenders and borrowers out of these markets. Community bankers are extremely sensitive to risk and highly wary of the potential for both regulatory enforcement actions and private litigation.

In light of the sheer volume of new federal regulations,

community bankers suggested that compliance exams be used as an opportunity to provide guidance and assistance with implementing new and emerging standards as opposed to an opportunity to unnecessarily punish community banks. Community bankers would welcome interim exams designed to assess ongoing efforts to implement guidelines and ensure that their institutions are on the right track with regards to compliance.

Regulators could also develop a periodic newsletter explaining frequent compliance issues found during exams and how to correct them. Current efforts—including quarterly publications, video series and conference calls—are useful. However, community banks seek even clearer, more concise and efficient methods for identifying common compliance issues and guidance for implementing measures to remedy their mistakes quickly and effectively.

Emerging Issues

Cybersecurity continues to present a unique set of concerns for community bankers striving to provide their customers with the best, most up-to-date financial services in the digital age. Costs associated with security upgrades

and fraud remediation are continually increasing.

Bankers are also frustrated by what they see as fundamental unfairness relating to the burden of loss between the banks and retailers. Compliance with new national labor standards presents a particular concern as banks question their status under new and emerging regulations.

However, community bankers in West Virginia stand ready to face these challenges and find new and innovative solutions for the perpetually changing marketplace.



Market Conditions and the Local Economy

In general, Wisconsin's economic indicators are in line with national indicators. Two pockets of variance are:

- Dane County and the state capital of Madison, where local indicators are generally above national figures
- The less-populated northern part of the state, where local indicators are lagging national data

New business formation is slow in most areas of the state. Business owners appear to have learned a lesson from the 2008 recession and are reluctant to spend on expanding their companies or adding more employees. Labor force shortages are holding back expansion plans for some businesses, primarily in manufacturing and construction. Businesses are finding it difficult to find new workers who have the proper skill sets or who can pass the necessary drug screening and background checks.

One possible exception is the agricultural sector. Farmers, especially younger, more eager ones, are willing to take on more risk and expand their operations. This is especially true for dairy farmers interested in investing in robotics to increase milk output. New

businesses are also forming around the sand fracking industry, a development driven by the oil extraction industry in North Dakota and elsewhere.

Borrower Attitudes

Businesses that survived the recession are still risk averse. Before the recession, there was more willingness to take risk and borrow more, but now borrowing businesses are more measured.

Unmet Financial Services Needs

Consumer mortgage rules are having a distinct chilling effect on banks' ability and willingness to write mortgages. The rules are preventing banks from offering products that customers want and that are mutually beneficial for both the institutions and the customers. As one bank CEO put it: "These rules are hurting the very people they were designed to protect."

Attracting Human Capital

Bank CEOs, especially those at smaller institutions, are finding it difficult to attract and retain qualified employees for their management teams. The pool of qualified employees has been reduced because many large, regional banks have cut back significantly on

their internal management training programs. In an attempt to remedy this, some banks have started internship programs with local colleges or high schools.

Said one bank CEO: "Community banking isn't sexy. It got a bad name during the recession. College grads aren't looking at us. They're looking for big bucks with investment banking firms."

Examination Feedback and Regulatory Burden

Compliance exams seem to treat banks as if they are intentionally trying to break the rules. Compliance exams need to be more collaborative and risk focused.

Regulators should do more sharing of common compliance findings so that institutions can more proactively address those issues ahead of their own exams. Bankers regularly look to examiners to help find solutions to their problems and give suggestions based on what the examiner has witnessed in other banks. Simply citing a violation without providing solutions isn't helpful to the bank.

Product availability is often determined not by what the institutions can and should be offering, but by limitations imposed by regulatory agencies. For example, balloon loans are a product that did

not cause any problems for banks or Wisconsin consumers, yet many banks are no longer able to offer balloon loans to consumers interested in them.

Emerging Issues

Regulatory burden on banks and businesses alike has been stifling and costly. The cost is being borne by consumers, because businesses are merely passing it along. The speed at which administrative law is evolving is creating a "what's next" attitude, where business borrowers must assess the current environment before expanding their business operations.

Competition is also a concern. Community banks deserve to have a level playing field. Competition from tax-advantaged institutions like credit unions and Farm Credit System lenders puts banks at a distinct disadvantage.

Community Bank Case Study Competition

The financial crisis and its aftermath have prompted policy makers to re-examine the diversity of financial institutions that make up the U.S. banking industry, as well as the regulatory framework that governs these institutions. Policymakers are rediscovering the important role community banks play in both local markets and the national economy. Embedded in thousands of local communities, their unique relationship-based approach to banking is crucial to the economic success of households and businesses across the country.

The Federal Reserve and the Conference of State Bank Supervisors (CSBS) have been at the forefront of exploring community banks' role in today's economy. Since 2013, the annual *Community Banking in the 21st Century* research and policy conference has brought together academic experts, federal and state policymakers, and community bankers to discuss how new research and data can be used to develop a better policy and regulatory framework for community banks.

The Community Bank Case Study Competition, facilitated by the CSBS, is part of this broader community bank research initiative, but it emphasizes the individual and unique stories of community banks and their impact on the economic life of local communities. In the spring of 2015, the CSBS held its inaugural Community Bank Case Study Competition. Undergraduate student teams from DePaul University, the University of Arkansas, the University of Missouri – Kansas City and the University of Utah partnered with local community banks to conduct original case studies evaluating the performance of the institutions and how the banks managed exposure to commercial real estate (CRE) assets during and after the financial crisis.

The students developed written briefs of up to 25 pages that covered the impacts that local businesses and the economy derive from the partner community bank, including:

- CRE lending
- The challenges the community bank faced during and after the financial crisis, including exposures from CRE lending
- The lessons learned and strategies adopted for reducing exposure to losses from CRE markets going forward

In addition to written briefs, the students submitted 10 to 15 minute video presentations detailing their case study findings.

Competition participants were judged based on how well their projects described the bank's market and market presence, its impact to the local community, and their analysis of the bank's CRE exposures, key financial indicators and management decisions during and after the financial crisis.

The CSBS announced the University of Utah student team as the winner of the inaugural Community Bank Case Study Competition in May 2015. The winning students were awarded scholarships and given an opportunity to present their research at the 2015 *Community Banking in the 21st Century* research and policy conference. Additionally, the team's full written brief is published in this report.

University of Utah

Bank of American Fork Was Successful During the Great Recession Because It Performed an Extensive Workout Process, Acted Early to Mitigate Loss, and Found New Sources of Capital

Students: Jenny Flatberg Lambson, Changsu Lee, Kurt Moore, Brett Welker

Advisor: Jack Brittain

Introduction

Utah County is forty-four miles south of Salt Lake City, Utah. It is known for some of Utah's best orchards, great boating on Utah Lake, and difficult but amazing hiking up Mount Nebo and Mount Timpanogos, the highest summits of the Wasatch Front. Utah County is home to the National Security Agency's Utah Data Center, Brigham Young University, an Adobe regional office, a large Cabela's, and American Fork, a city with an industrious history. Utah County is also home to 60 percent of Bank of American Fork's branches.

The Bank of American Fork, which currently has \$1.1 billion in assets, was founded in American Fork in 1913 and is still headquartered there. It was closed for nine months during the Great Depression and reopened when it met capital requirements. As a Utah state-chartered community bank, the Bank's relationships lie at the heart of its success. This case study is about how the Bank survived the Great Recession, despite its high concentration of commercial real estate (CRE) lending.

The Bank of American Fork sustained profitability throughout the Great Recession by performing an extensive workout process on troubled loans, acting early to mitigate loss, and finding new sources of capital. In doing so, proactive leadership leveraged the Bank's strong community and customer relationships to structure a turn around. The positive results have directly benefited the Bank's communities, the businesses and depositors who rely on the financial services the Bank provides, and the Bank's shareholders.

The Bank's execution during the crisis and lessons learned will contribute to its future success. First, the Bank learned it needs to limit geographic CRE concentrations and it needs diversified equity sources. Second, community banks are very important economic drivers on a local level. In turn the community's success contributes to the success of community banks. For the Bank of American Fork, the relationships it had established over decades were an asset that helped it navigate the Great Recession while continuing to finance businesses in the community. Finally, the Bank benefited from a strong management team and culture of collaboration among the Bank's leaders. This was strengthened by the Bank's experiences and subsequent success. It is an asset that will serve the Bank well in the future.

High CRE Concentrations Contributed to the Great Recession in Utah

The abundance of land in the west has historically served as solid collateral for banks in Utah. Regional banks finance large projects. Credit unions and industrial banks issue consumer loans. Community banks lend on commercial projects in the communities they serve.

There are three main commercial real estate (CRE) loan types: (1) Acquisition, Development, and Construction (ADC) Loans are issued for an initial land purchase and infrastructure build; (2) Construction Loans finance housing unit construction; and (3) financing for commercial and rental properties. By 2006 and 2007, community bank concentrations in commercial real estate loans were noticeably high.

In 2007, examiners started issuing warnings about dangerous CAMEL ratings to the banks with over 300 percent concentration in CRE loans or over 100 percent concentration in construction loans. Darryle Rude, Chief Bank Examiner at the Utah Department of Financial Institutions remembers realizing that “sooner or later someone was going to be left holding the construction loans. And that institution was going to own overpriced farmland.” That is exactly what happened. The ensuing glut of black acre on the market drove down prices.

By late 2009, land values had plummeted by up to 50 percent. Community banks

were engaging in what had historically been best practices, but the rising prices made it difficult to pass up opportunities. The large amount of land in the west means land is the main source of collateral for community bank CRE loans. When prices dropped, customers went bankrupt.

Community banks were left with the collateral: large amounts of land and buildings that had lost value. Banks are not landlords. The property values are written off from their assets over five years. The banks also have to pay fees, keep up security, and perform maintenance and repairs on buildings they own.

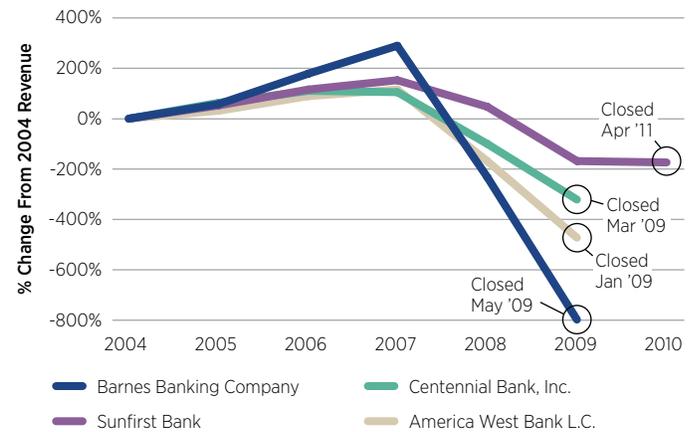
Community banks around the country with high commercial real estate concentration suffered extreme revenue losses. *Exhibit A, Closed Banks in Utah*, details the most extreme losses in revenue of Utah community banks. Between 2009 and 2011, 6 out of Utah’s 29 community banks closed. Barnes Banking Company and Centennial Bank were closed during the recession after not recovering from 500 percent and 700 percent respective concentrations in CRE.

High CRE concentrations reflect the historical reliance on land as the main source of equity in Utah. In fact, community banks in Utah still struggle to find sources of equity other than land. *Exhibit B, ADC Loan Growth By Fed Region*, shows that the San Francisco Fed Region had the highest growth in ADC Loans during the recession.

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EXHIBIT A

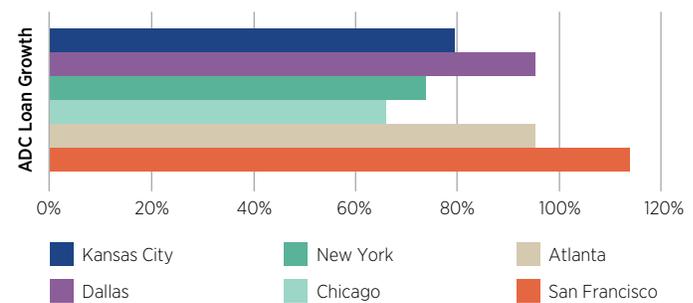
Closed Banks in Utah



Failed Utah community banks saw large increases in revenue leading up to 2007. These increases were followed by large declines once real estate prices began to fall.

EXHIBIT B

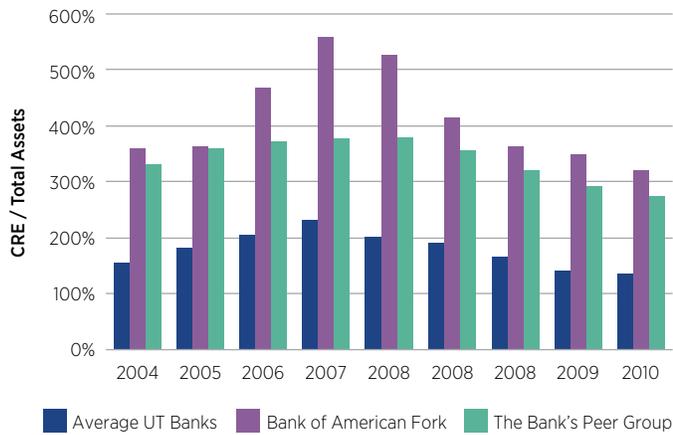
ADC Loan Growth by Fed Region



Acquisition, Development, and Construction loans grew the most over this period in the San Francisco Federal Reserve region. This is indicative of the more substantial role that real estate plays for banks in the West.

EXHIBIT C

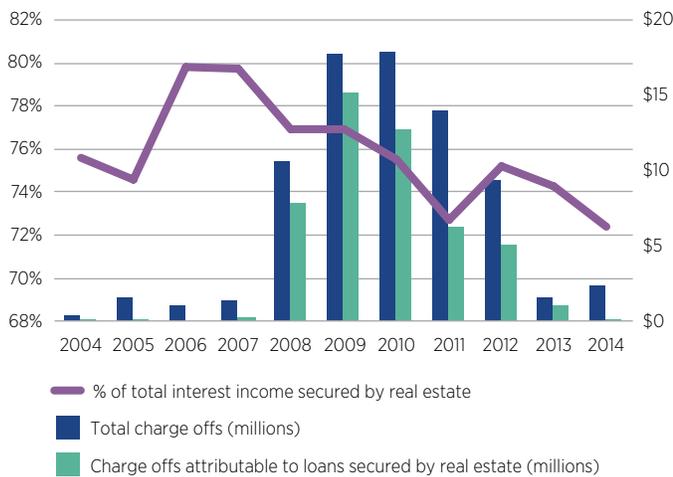
Bank of American Fork's High CRE Concentrations



The Bank of American Fork had above-normal concentration of CRE loans compared to Utah banks on average and the bank's peer group as identified for regulatory purposes.

EXHIBIT D

Charge Offs and Real Estate Concentration



Leading up to 2008, Bank of American Fork became increasingly concentrated in loans secured by real estate. Once prices began to fall and borrowers began to default, charge offs attributable to loans secured by real estate skyrocketed.

Bank of American Fork's Difficult Situation and Successful Strategies

Leading up to the crisis, Bank of American Fork had a 560 percent concentration in CRE loans. This is evident in *Exhibit C, Bank of American Fork's High CRE Concentration*. Out of a total \$724.4 million in loans in 2007, it had \$611.7 million in ADC loans. As a result, its concentration in ADC loans is where it took most of its losses. The bank lost about \$50 million during the recession.

Exhibit D, Charge Offs and Real Estate Concentration, show the Bank had increased charge offs due to the increased defaults during the recession. The Bank's management was prudent to heed regulator warnings about its concentration early. In July of 2008, it formed the Special Asset Department (SAD) Committee. Bank officers, board members, and loan officers met every other week for up to five or six hours and performed an extensive workout process on all the Bank's loans.

The Bank Performed an Extensive Workout Process

The SAD Committee's purpose was to summarize each loan over \$100,000, re-value the collateral, and create action plans for the Bank. Committee members used a collective approach to address each issue and gain a comprehensive understanding of the Bank's intricate situation. It decided to get rid of its non-performing assets mid 2010. The effect was the Bank's Other Real Estate Owned (OREO) account, which tracks properties owned by the

Bank, grew to unprecedented size. The large jump in OREO account size in 2010 is shown in *Exhibit E, OREO Make Up*.

Liquidating the OREO required a complex strategy. The Bank got stuck with some geographically concentrated lot holdings. Rick Anderson, Bank Senior Vice President-Northern Region, was central to the Bank's liquidation strategy. According to Rick Anderson, "We couldn't sell one lot at the lower property values without writing down the values of all the area's lots on the books. We couldn't dump properties on the market without driving down prices and hurting ourselves." Finding buyers was difficult and time consuming. Also, selling had to be done very deliberately. The strategy was very involved and as is explained later, the bank came up with an innovative solution to address this problem.

The SAD Committee worked out solutions to problem loans whenever possible. The Bank worked hard to land each of its customers and wanted to retain and even strengthen its relationships. Sometimes the collection strategy involved bi- or trifurcating loans. For instance, if a customer had an acquisition loan and a construction loan, and but could finish and pay for only the acquisition loan, SAD would separate them and deal with each loan individually. This made it possible for the bank to both salvage income sources and recognize losses.

It didn't take long for the committee to realize that when it downgraded an asset during this difficult period, it was better to write it off right away than hold onto it. The Bank

couldn't go to court to get a collection because the builders and developers had lost everything. There was no money to sue for.

The SAD Committee was able to assess the true value of the bank's assets because, as a community bank, it knows its customers and their businesses and it was able to determine fairly accurate expectations of repayment. Another positive result of the SAD Committee is that the decision makers all left each meeting knowing what they were going to do next, which lent consistency to the Bank's actions and unity during chaos. The SAD Committee's extensive workout process on troubled loans took a lot of time and effort. This time and effort really contributed to the Bank surviving the Great Recession.

The Bank Acted Early to Mitigate Loss

The Bank knew the longer that an account was past due, the less likely it would be able to collect. Consequently, it made a concerted effort to collect on loans before they were 90-days past due. After 90-days past due, a loan is allocated to nonaccrual and the Bank has to re-evaluate how much it actually anticipates it will collect on the loan. It immediately charges off the difference between that and the original amount.

The Allowance for Loan and Lease Losses (ALLL) account is the contra account that protects the balance sheet during asset value erosion. The Bank acted early and got a clear picture of the true values of its loans through the SAD Committee. Therefore, Wolfgang Muelleck, the Bank's

CFO, was able to boost the ALLL account in anticipation of the future charge offs.

Mr. Muelleck feels that his experience as a partner at Ernst and Young before joining the Bank taught him to be very conservative and guided him to protect the balance sheet of the bank. *Exhibit F, Effect of Loan Losses*, shows that taking the early loan losses supported the Bank moving forward. The Bank reallocated capital early in the downturn, while there was still capital to assign.

It was thus able to secure positive income streams in the future instead of holding losers or reeling from unexpected losses. When the economy started to improve around 2012, the Bank was in a good position because it had written down its bad loans. The tendency to hold on to losers hurt many banks during the crisis. Taking losses early allowed Bank of American Fork to reallocate funds toward more profitable areas.

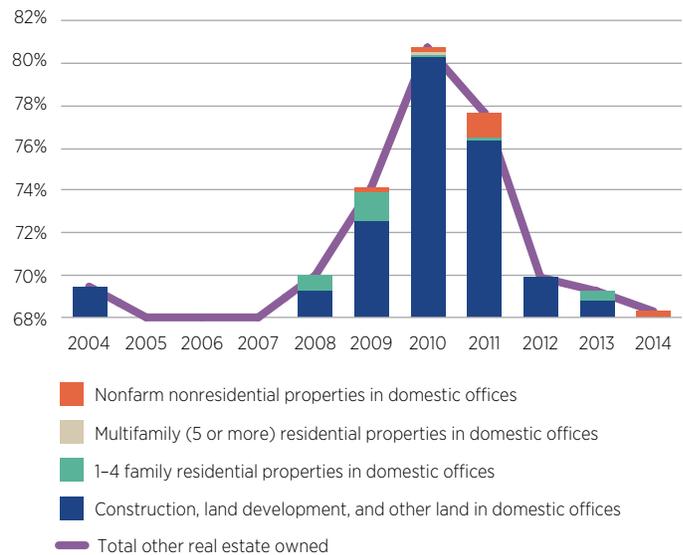
This allowed the Bank to remain capitalized, continue lending, and continue contributing to its local economy. Acting early to mitigate losses helped the Bank of American Fork help the city of American Fork survive the Great Recession.

The Bank Found New Sources of Capital

Another strategy that helped the Bank of American Fork during the financial downturn was innovating to grow its capital. In 2010, Bank officers anticipated real estate prices would eventually normalize post crisis. They found investors with a longer time horizon than the Bank to join

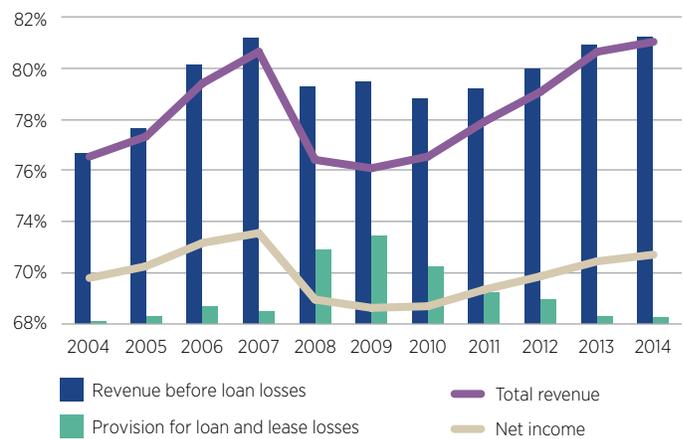
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EXHIBIT E
OREO Make Up



The Bank of American Fork's OREO portfolio grew to an unprecedented size as a result of the downturn; most of this portfolio was composed of construction, land development, and other land in domestic offices.

EXHIBIT F
Effect of Loan Losses



Increases to the bank's Allowance for Loan and Lease Losses have a direct effect on revenue and net income.

The Bank's loyalty to its community has created a community loyal to the Bank.

a fund called Bank of American Fork Foreclosed Property Fund (BAFFPF). The fund bought low valued assets from the bank's OREO account in anticipation of eventual increasing property and resale values. This allowed the Bank to move bad assets off its books and increase its capital.

It took some time for Bank officers to meet with the FDIC, the SEC, and all the regulators, and raise the money for the fund. The minimum investment to enter the fund was \$50K. Bank officers provided no forward guidance. J. Scott Lewis, CEO, manages the fund. He is not an employee of the Bank and BAFFPF is a separate Limited Liability Company (LLC) that is friendly to the Bank but not controlled by the Bank.

BAFFPF purchased property from the Bank totaling about \$4 million. This amount was a little disappointing because the officers felt strongly that they were offering a solid investment opportunity for community members. This fund was a really good idea even though it didn't have a larger net effect because OREO, as a percent of total assets, peaked the year it was established.

According to Wolfgang Muelleck, CFO, "The fund has averaged a nine to ten percent return. And there is approximately \$400,000 left to be liquidated." The insight of the Bank officers and their knowledge about economic cycles paid off for the investors and the Bank. They had the foresight to secure potential profits for members of the community who joined the fund while also reducing the OREO account. This was innovative and intelligent, and it helped

add capital while eliminating non-performing assets.

During the downturn, the Bank offered several innovative products also. These products included MyRate Checking[®] Accounts, Rehabilitation Loans, and CheckSmart[™] Senior. While none of these products were responsible for saving the Bank, they did help the Bank keep lending and they positively contributed to the community's perception of the Bank's health.

In 2008, the Bank launched MyRate Checking Accounts and initially paid up to 4.07 percent on deposits of up to \$25,000. Christopher Liechty, the Bank's Vice President of Communications, is proud of this and the other products at the bank. He said, "Since 2008, MyRate Checking Accounts have drawn \$80 million in deposits to the Bank. It has been a successful project." Because the Bank was relatively well capitalized going into the downturn and because it made smart decisions, it was able to afford the marketing campaign to launch and advertise the new products.

Rehabilitation loans are a product that contributed to the resurgence of dwindling communities and neighborhoods. They were two-step products that first financed the purchase of a foreclosed property and then gave a construction loan based on the post-construction forecasted appraisal. Whit and Monica McQueen, a husband and wife realtor team, along with one of the Bank's loan officers cooperated to create this product.

Whit McQueen said, "2008 was a time of crisis, but it was also a time of opportunity.

Deal flow for real estate agents dried up, but for investors prices were rock bottom, there was a lot of supply in good neighborhoods, and financing was cheap." This product helped realtors and investors purchase and improve foreclosed properties, thus putting occupants into empty houses and improving neighborhoods. It helped employ construction workers, appraisers, and many others, which helped the local economy recover.

The Bank received a state award for Age-Friendly banking for CheckSmart Senior, the first online banking program of its kind. It focuses on protecting senior citizens from predatory lending and fraud. The accounts come with products that seniors tend to use more, like cashiers checks, for little or no fee. While this did not generate much money for the Bank, it is an example of the way community banks can be invested in helping all members of the local community be fiscally responsible and protected from emerging threats.

Because the Bank put a lot of effort into anticipating troubled loans and acted early to protect its balance sheet, it was able to remain committed to meeting the needs of its community. It did this, in part by offering innovative products to its members and thus finding new sources for capital. This contributed to both the overall profitability of the community and the Bank.

The Bank has Strong and Proactive Leadership

The experienced management team did a great job of leading the Bank through the recession. One of the bank's

key strengths is the culture of teamwork they've built. David Anderson is the Chief Credit Officer. He has been with Bank of American Fork for 40 years and his father used to be the Bank's president. He talked with emotion about how there was never any finger pointing as far as who may have caused the problems. He said, "There was only the idea that we would all do what was needed to get the Bank through the downturn." This is exceptional and we feel the culture of teamwork really supported strategy execution.

Bank of American Fork entered the downturn well capitalized. In fact, as shown in *Exhibit G, Net Income and Dividends*, it continued to have positive net income every year during the downturn. This afforded it the ability to take losses when it had to, but also to take advantage of opportunities. It was able to deploy a marketing team of five employees that protected the Bank's image with a marketing crisis prevention plan. It could launch new products and commit the time and energy required to complete an extensive workout process. To keep net income positive, it cut budgets, cut its employee base for the first time in the history of the Bank, and cut bonuses.

There was never an indication that the Bank was reaching a liquidity crisis, but in 2008, for the first time since the Great Depression, it did not pay a dividend. The health of financial institutions is measured by the tier-1 capital ratio. It is essentially a comparison of a firm's core equity to its total risk-weighted assets. For Banks

to keep paying out dividends, this figure needs to be at least six percent. This is the benchmark for a Bank to be considered "well capitalized."

The Bank's lowest year for this measure was in fiscal year (FY) 2007 when it was 10.6 percent, well above the six percent minimum. Still, management understood it had to sacrifice during this time. This conservative management style has helped guard the Bank's strong and responsible reputation.

No shareholder owns more than a nine percent stake in the bank, but there are families who will team up and vote together. Family ownership benefits the Bank. For instance, family is not as likely to sell stock in tough times. One of the families with ownership traces its heritage back to 1958 when Orville Gunther became the sixth president of the Bank.

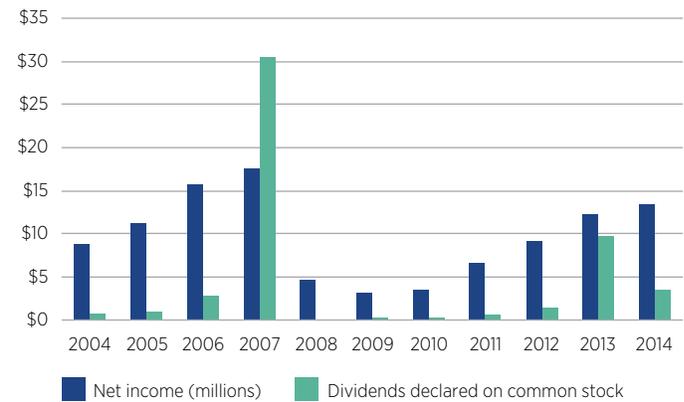
These families have common sense about commercial real estate investments in their community. Sometimes community banks move away from family governance to attract a good president, but according to Commissioner Leary, "When they do this, they lose a certain unwillingness to fail." For an institution like Bank of American Fork, family ownership provides an anchor in the community and this family ownership and involvement played a key role in the Bank's decisions throughout the Great Recession period.

The Bank Contributes Substantially to its Local Economy

The Bank's loyalty to its community has created a community loyal to the Bank. For instance, the city of American

EXHIBIT G

Net Income and Dividends



Even though the Bank of American Fork had high CRE concentration and suffered on the top and bottom line from loan losses, it maintained positive net income throughout the downturn and continued to pay a dividend in every year except 2008.

Fork does its daily banking with the Bank. The Bank of American Fork has also grown organically and increased its market share by expanding its branches and Utah territory in the last few years. In 2013, Bank of American Fork merged with Lewiston State Bank, a community bank chartered in 1905 in northern Utah, and which had approximately \$250 million in assets.

As part of its expansion, People's Utah Bancorp, which has about 400 shareholders and is the parent company of both banks, has just purchased a new building in American Fork for its headquarters. The building is on the historic registry and the Bank will restore the building and protect city heritage in doing so.

The Bank has a company wide policy about giving locally. The value of the Bank's community giving is discussed in an article in the Daily Herald in August of 2011. It states that in 2010 and 2011, the Bank donated over 2

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The foundation for the Bank's success was working closely with its borrowers, its regulators, and all its stakeholders.

percent of its profits to local charities. From 2008-2011 its employees donated more than 2,200 hours of community service. The Bank helped establish a public library in its county with a \$10,000 donation through a matching grant program.

Its most famous charity is *Project Teddy Bear*. Since its beginning in 2001, over 35,000 stuffed animals have been given to local kids in need. Mayor Hadfield said, "The bottom line is they invest heavily in our community. Not only the buildings and the real estate property taxes, but they keep their buildings up. It has a great presence in our community and they do so many good things for the community." This makes sense because the bankers know that the Bank's success depends on the communities' success.

The heart of the Bank's economic impact is lending. It has financed projects, subdivisions, and small businesses in its neighborhoods for over one hundred years. Bank of American Fork is a successful community bank that knows its economy. It takes such good care of its assets that it continued lending throughout the Great Recession. Many other institutions stopped all lending activities, either because they were not capitalized or because they were afraid. We spoke to three small business owners who all said that they actually could not find banks lending during the Recession until they worked with Bank of American Fork.

It is impossible for us to project the real value of the Bank's loan activity as we cannot accurately extrapolate all the wealth that was created

by the loans issued during the Great Recession. Chris Williams, owner of JCW's burger restaurant, received construction loans from the Bank to build two new stores. During the downturn his business hired over a hundred new employees. Because of those jobs, all of those local residents paid their bills, their mortgages, their kids' college tuitions, bought groceries and movies, got haircuts, and many other things.

Multiply this many fold and add in the circulation of the income of the construction workers, the developers, the appraisers, the realtors, the home builders, the farmers, the lawmakers and the local police officers and you have the impact of Bank of American Fork on its local community. Multiply this by 6,000 and you have the economic impact of community banks in the United States.

Ensuring The Bank's Success

Bank of American Fork made a lot of strategic, conservative, and wise community minded decisions during the Great Recession. Still, there are some issues moving forward that we think merit attention. Issues are presented for the bank level, the regional level, and the industry level.

The Bank Needs Discipline To Limit Geographic CRE Concentrations

The Bank spent millions of dollars and countless hours to learn that it needed to institute a self imposed maximum limit on geographic concentration of CRE. To remain competitive, it now finances projects larger than thirty lots

in phases. *Exhibit H, Bank of American Fork's Changing CRE Concentrations*, shows how the Bank has intentionally cut its Acquisition, Development and Construction Loans in half and doubled its concentration in Owner Occupied and Non-Owner Occupied Loans.

This is one of the main areas that hurt the Bank when the recession hit. Therefore, even when times are good, the Bank of American Fork should be disciplined about maintaining limited geographic exposures.

The Bank is also doing some other things to keep itself on track. Wolf Muelleck said the Bank has created and filled the new position of credit review officer to, "independently check loan grading." It has also cut its ADC lending by half and doubled its owner occupied CRE lending in a move toward diversification. Forward thinking strategies, like these that are based on lessons learned, should continue.

Regional Equity Sources Need to Be Diversified

The Great Recession tested western community banks and their reliance on commercial real estate as both collateral and as investment. Many unsuccessful community banks in Utah had high concentrations in commercial real estate. According to Commissioner Leary, "This was hard for banks to manage leading up to the crisis because they had no losses. There was no pressing reason to stop risky behavior." But now, the wisdom has changed. There is a reason to diversify and yet doing so presents significant innovation challenges.

The regulators have a responsibility to assess the

economy and communicate guidance. They are the key in providing the macro view to local institutions. Throughout the downturn the Utah DFI worked closely with both the industry and the legislature to strengthen fiscal responsibility in the state. Since the downturn, the Utah Department of Financial Institutions (DFI) is focusing on mastering long-term trend analysis. It is interested in strengthening community banking because of their positive contribution to local economic development.

The Bank's relationship with the regulators was likened by Richard T. Beard, Bank of American Fork CEO, to the relationship we have with our dentist. That is, we would rather have them than not have them, even though it is painful sometimes. All parties seemed to agree that Bank of American Fork keeps open and clear communication channels with its regulators. We feel this relationship allowed the Bank to realize its dangerous exposure, understand the depth of the crisis, and have clear support for its exit plans.

Because of the nature of this important relationship, the regulators will be of great help for regional and local banks as they establish new sources for equity. The regulators will make sure that the new sources are smart and efficient and regulated. Therefore continuing to protect the industry and the customers.

The Community Bank Is An Important Economic Driver In Communities

Participating in this case study taught us most community banks are the economic drivers of their communities

because they lend directly to the people in their communities. Richard Beard, CEO of Bank of American Fork said, "We finance the dreams of our community" when referring to the fundamentally personal nature of the Bank's role in society.

Yet, as shown in *Table 1, Decreasing Net Assets of Community Banks*, industry expansion has halted and net assets are decreasing. These are difficult conditions for an industry burdened by the costs of both cyber security and regulations. Community banks are a vital part of our economy but as an industry, we wonder if they might be becoming less competitive.

We don't know where this trend will lead. But we do feel that community bankers know their customers. They have the unique ability to assess the risk of a loan and they also have economic intelligence to decide what projects stand to be most successful in their communities. These roles seem to be unique to the community banker and vital to the deep economic success of any town, city, or rural area. We think community banks need special attention right now to truly value their role and protect them moving forward.

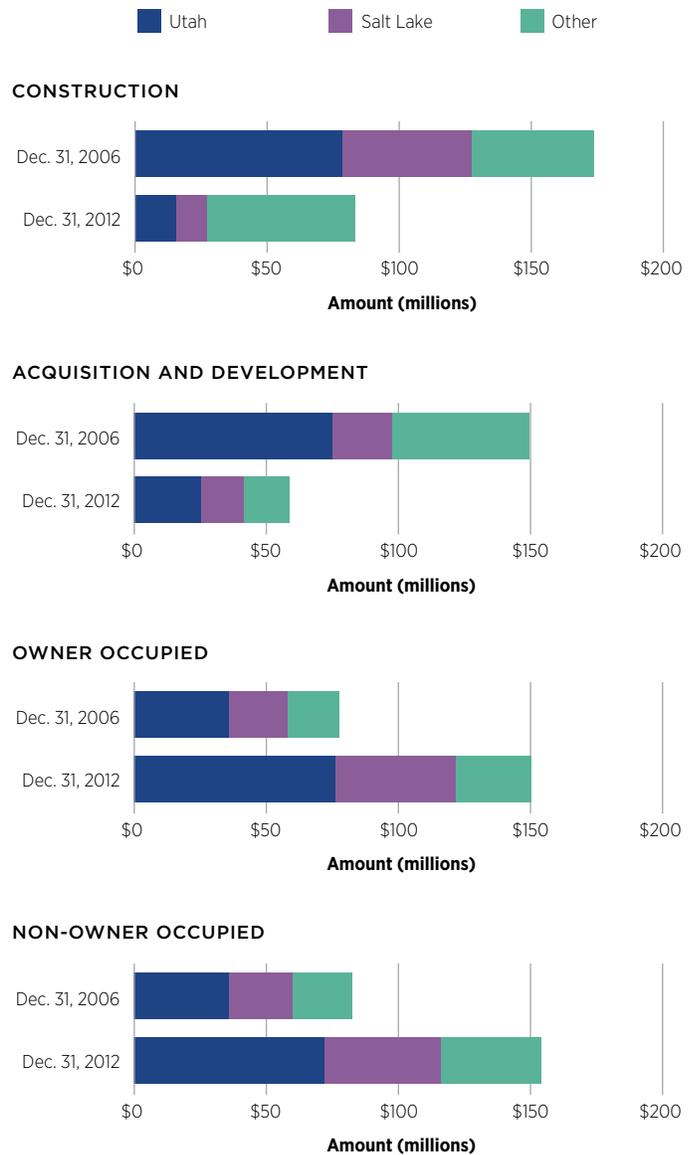
Summary of Important Qualitative Variables In Community Bank Valuation

The Bank of American Fork's recession era success depended on both quantitative and qualitative factors. We identified the most common qualities we heard about in our research that lead to successful community banks.

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EXHIBIT H

Bank of American Fork's Changing CRE Concentrations



Since the downturn, the Bank of American Fork has decreased its position in construction, acquisition, and development loans in order to diversify its loan portfolio and prevent extreme concentration like those experienced before the downturn.

Qualitatively, we conclude that successful community banks should rate high on: conservativeness of underwriting; preciseness of risk management; management knowledge; management ability to act; quality and commitment of ownership; quality of appraisals; diversification of business plans; spirit of cooperation with regulators; not growing for growth's sake alone; and perhaps most importantly, the intimacy of the relationships a bank has with its customers, shareholders, employees, and communities.

Increasing regulation and decreasing net asset size of the community bank industry puts extra pressure on this vital economic driver. Quantitative

valuation is not enough to demonstrate and protect the real value of community banking in our national economy. We suggest that including some of these qualitative variables in industry valuation could contribute greater accuracy to the model for the true value of a community bank's assets.

Expectations May Have Contributed to the Success of the Region

In the end, perception probably played a key role in Utah's relatively rapid recovery and low unemployment rate. Utah kept building during the downturn and this created confidence in the community. A \$1.5 billion 700,000 square foot downtown mall was finished in 2012 and the University of Utah built ten new buildings during the downturn with a value of over \$1 billion. These two actors alone kept many construction companies in business and workers employed.

They also kept cranes in the air. Richard Stevenson, Vice President of the Real Estate Banking Division at Zion's Bank, felt that lenders and investors saw the construction projects as proof that the recession would be brief and that this allowed them to have positive expectations about the state of the State. Therefore, they kept doing deals, albeit at a much lower level than 2007, and positive expectations played a role in the depth of the recession in Utah.

The BAFFP Fund helped investors and the Bank. By 2012 housing was starting to bounce back and the BAF-PPF investors were realizing

significant profits from the property portfolio they had acquired from the Bank. These are relationships the Bank can turn to in the future. These are also customers who can turn to the bank in the future when they need financial products. This type of dynamic should strengthen the local economy especially in crises.

In fact American Fork is doing well. Over the last four years, the population of Utah County has grown twice as fast as the national average. According to the Mayor of American Fork's *2015 State of the City Address*, last year American Fork issued permits for 19 commercial projects, totaling \$23 million, and 200 business licenses. Over that same period, the Bank experienced a ten percent year over year increase in its development applications.

Expectations might be a diverse and underlying factor in economic recovery. Positive expectations from seeing continuing construction during the recession may have lent buoyancy to the Utah economy. Positive expectations from the Bank officers regarding the cyclical nature of crises may have given investors a reason to purchase properties at very low prices. And the positive expectations of a community like American Fork that works so seamlessly with its community banks may contribute to the region's future prosperity. Because community banks are so intimately involved in the community, they provide a strong base from which community members can form economic expectations.

TABLE 1
Decreasing Net Assets of
Community Banks

	2008	2013
Number of Community Banks	8,170	6,550
Amount of Community Bank Assets	\$3.02 trillion	\$2.8 trillion
Average Amount of Community Bank Loans	\$256.9 million	\$427.3 million
Share of U.S. Banking Assets Held by Community Banks	21 percent	18 percent
Total Community Bank Profit	\$236.6 million	\$28.8 billion
Percent of Community Banks That Reported at Least One Quarterly Loss	43 percent	20 percent
Percent of Community Banks That Raised Capital	67 percent	51 percent
Number of Community Bank Failures	19	24
Number of Community Bank Charters Issued	97	2
Number of Community Bank Mergers	285	230

SOURCES: FDIC, Bloomberg, LP

Industry expansion is halted and net assets are decreasing, even as the scale of the deals seems to be increasing. Without knowing the answer, we wonder if this trend will contribute positively to the community bank's ability to serve in its economies.

Conclusion

The Bank of American Fork's strong management team created three important strategies during the Great Recession. First, because it was relatively well capitalized, it was able to put tremendous energy and resources into its workout process on troubled loans. Through this process, the Bank relied on its close relationships with its borrowers to accurately anticipate increases in foreclosures and OREO.

Second, these accurate forecasts allowed the Bank to mitigate future loss by boosting ALLL early. This allowed the Bank to take advantage of new opportunities during the later years of the recession because it did not have capital tied up in losing endeavors. Third, the Bank was innovative in finding new capital sources. This allowed it to maintain positive net income, continue lending throughout the downturn, and support the continued economic success in its community.

To perform these strategies, Bank of American Fork relied on its relationships in its local economy. The foundation for the Bank's success was working closely with its borrowers, its regulators, and all its stakeholders. Relationships like these will also be the foundation of its future success.

SOURCES

For our case study, we had the pleasure of meeting with many of Utah's financial leaders. We began at Bank of American Fork where we learned the keys to its success during the downturn from Rick Anderson, SVP Northern Region; Dave Anderson, Chief Credit Officer; Kevin Johnson, SVP Central Region; Randall Benson, SVP and General Counsel; Richard Beard, CEO and President of People's Utah Bancorp and Bank of American Fork; and Wolfgang Muelleck, CFO of People's Utah Bancorp and Bank of American Fork.

We met with Chief Bank Examiner Darryle Rude and Deputy Commissioner Paul Allred at the Utah Department of Financial Institutions and learned about the role of community banks, the Great Recession, and the job of the regulator. To better understand the real estate and commercial real estate markets we met with Richard Stevenson Jr., Vice President, Real Estate Banking Group at Zion's Bank. Finally, we returned to DFI to discuss banking in Utah and the west with State Commissioner G. Edward Leary, Chief Examiner Rude, and Supervisor of Banks Tom Bay.

Next we conducted phone interviews with Bank officers Rick Anderson, SVP, and Dave Anderson, CCO, to learn about its liquidation strategy and geographic concentration. We also communicated with Wolf Muelleck regarding the bank's financials and met with the Bank's VP of Communications Christopher Liechty to make appointments to meet bank customers.

We conducted formal interviews on camera with government representatives Commissioner Leary, Chief Examiner Rude, and American Fork Mayor James H. Hadfield; Bank officers Rick Anderson, Wolfgang Muelleck, Richard Beard, Dave Anderson, and Chris Liechty; and Bank customers Andrew Smith, CEO of Four Foods Group and owner of Kneaders, Christopher Williams, co-owner of JCW's Burger Restaurant, and the McQueens, a husband and wife realtor team.

Everyone was extremely generous in sharing time and knowledge with us. We are grateful for their participation and for this opportunity.

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APPENDIX 1

Bank of American Fork's Balance Sheet

As of:	Dec. 31, 2007	Dec-31-2008	Dec-31-2009	Dec-31-2010	Dec-31-2011	Dec-31-2012	Dec-31-2013	Dec-31-2014
ASSETS								
Cash & Balances Due From Depository Institutions	25.3	21.5	52.0	36.4	30.5	101.1	82.0	33.0
Noninterest-Bearing	25.2	21.1	15.4	11.5	18.0	30.6	21.6	19.7
Interest-Bearing	0.1	0.4	36.6	24.9	12.5	70.4	60.4	13.3
Securities Held-To-Maturity	5.4	0.5	0.3	0.3	19.1	23.2	24.7	28.5
Securities Issued by States and Subdivisions	5.4	0.5	0.3	0.3	19.1	23.2	24.7	28.5
Available-For-Sale Securities	102.1	83.8	82.3	183.6	211.8	238.2	241.1	237.1
U.S. Treasury Securities	-	-	-	-	-	-	-	2.0
U.S. Government Agency Obligations	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
U.S. Government Sponsored Agency Obligations	61.6	47.9	50.3	76.3	14.5	69.8	36.9	42.2
Securities Issued by States and Subdivisions	33.6	29.6	27.0	36.1	56.9	51.9	44.3	34.9
Mortgage Pass-Throughs Guaranteed by GNMA	0.4	0.3	0.2	21.6	101.0	71.5	32.5	14.2
Mortgage Pass-Throughs Issued by FNMA and FHLMC	6.4	5.8	4.6	3.4	2.6	7.2	40.5	54.9
MBS Issued or Guaranteed by FNMA, FHLMC, GNMA	-	-	-	46.0	35.0	35.6	62.4	62.9
Commercial MBS Pass-Through Issued or Gtd. by FNMA, FHLMC, GNMA	-	-	-	-	-	-	0.5	0.6
Other Commercial MBS Issued or Gtd. by FNMA, FHLMC, GNMA	-	-	-	-	-	-	14.0	15.3
Other Domestic Debt Securities	-	-	-	-	1.6	1.0	9.7	9.9
Other Foreign Debt Securities	-	-	-	-	-	1.0	-	-
Investments in Mutual Funds & Equity Securities	-	0.1	0.2	0.1	0.2	0.2	0.3	0.3
Fed Funds Sold & Securities Purchased to Resell	-	-	0.0	0.9	0.9	0.8	0.6	0.6
Federal Funds Sold in Domestic Offices	-	-	0.0	0.9	0.9	0.8	0.6	0.6
Loans and Leases Held For Sale	-	-	4.0	6.3	8.5	25.6	13.6	12.1
Loans and Leases, Net of Unearned Income	724.4	752.0	647.7	585.6	590.4	581.0	648.3	749.0
Loan Loss Allowance	11.2	17.5	22.0	19.3	15.5	13.7	14.4	14.3
Net Loans and Leases	713.1	734.5	625.7	566.2	574.9	567.3	633.9	734.8
Fixed Assets, Including Capitalized Leases	17.4	19.6	17.3	16.2	15.5	16.2	17.2	16.8
Other Real Estate Owned	-	1.9	6.1	12.7	9.7	1.9	1.3	0.3
Construction, Land Development, and Other Land in Domestic Offices	-	1.3	4.5	12.4	8.3	1.9	0.8	-
1-4 Family Residential Properties in Domestic Offices	-	0.7	1.4	0.0	0.1	-	0.5	-
Multifamily (5 or More) Residential Properties in Domestic Offices	-	-	-	0.1	-	-	-	-
Nonfarm Nonresidential Properties in Domestic Offices	-	-	0.2	0.2	1.2	-	-	0.3

As of:	Dec. 31, 2007	Dec-31-2008	Dec-31-2009	Dec-31-2010	Dec-31-2011	Dec-31-2012	Dec-31-2013	Dec-31-2014
Other Intangible Assets	-	-	-	-	0.8	1.1	1.1	1.1
Mortgage Servicing Assets	-	-	-	-	0.8	1.1	1.1	1.1
Other Assets, Total	13.7	15.9	23.1	20.3	18.2	16.0	15.1	15.7
Accrued Interest Receivable	5.9	4.3	4.2	3.9	4.0	3.7	3.8	3.9
Net Deferred Tax Assets	5.2	6.5	7.3	7.4	6.3	4.4	6.1	5.9
Equity Securities Without Determinable Fair Values	1.4	2.3	2.3	2.3	2.3	2.2	2.1	2.0
Other Assets	1.2	2.8	9.3	6.7	5.7	5.7	3.0	3.8
Total Assets	877.0	877.8	810.9	842.8	889.9	991.4	1,030.4	1,080.0

LIABILITIES								
Total Deposits	693.8	724.3	710.3	740.4	781.2	870.7	907.7	948.1
Domestic Deposits	693.8	724.3	710.3	740.4	781.2	870.7	907.7	948.1
Noninterest-Bearing Deposits	197.1	145.6	152.5	161.8	176.1	236.0	253.6	280.2
Interest-Bearing Deposits	496.7	578.7	557.8	578.6	605.1	634.7	654.1	667.9
Fed Funds Purchased & Securities Sold to Repurchase	10.6	10.3	2.3	0.5	0.8	0.9	1.1	1.5
Federal Funds Purchased in Domestic Offices	7.0	8.0	-	-	-	-	-	-
Securities Sold Under Agreements to Repurchase	3.6	2.3	2.3	0.5	0.8	0.9	1.1	1.5
Other Borrowed Money	83.0	48.0	-	-	-	-	-	-
Other Borrowed Money, Short-Term	83.0	48.0	-	-	-	-	-	-
Other Liabilities, Total	2.8	2.9	2.7	3.4	2.8	5.6	7.5	5.0
Interest Accrued on Domestic Deposits	1.1	0.9	0.7	0.5	0.4	0.3	0.3	0.2
Allowance for Credit Losses	-	0.3	0.3	0.3	0.2	0.3	0.3	0.3
Other Liabilities	1.6	1.7	1.8	2.6	2.2	5.0	6.9	4.5
Total Liabilities	790.1	785.5	715.3	744.3	784.8	877.2	916.2	954.6
Common Stock	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Surplus	2.9	2.9	3.0	3.3	3.5	3.7	4.0	4.2
Retained Earnings	83.3	87.9	90.8	94.0	100.0	107.9	110.5	120.6
Accumulated Other Comprehensive Income	0.6	1.4	1.7	1.2	1.4	2.5	(0.4)	0.5
Total Equity Capital	86.9	92.3	95.6	98.5	105.0	114.2	114.2	125.4
Total Equity Capital, Including Minority Interest	86.9	92.3	95.6	98.5	105.0	114.2	114.2	125.4
Total Liabilities and Equity	877.0	877.8	810.9	842.8	889.9	991.4	1,030.4	1,080.0

SOURCE: S&P Capital IQ

APPENDIX 2

Bank of American Fork's Income Statement

As of:	Dec. 31, 2007	Dec-31-2008	Dec-31-2009	Dec-31-2010	Dec-31-2011	Dec-31-2012	Dec-31-2013	Dec-31-2014
CURRENCY								
Interest and Fee Income	64.5	51.3	45.1	38.8	36.9	38.2	38.5	40.4
Interest on Domestic Loans	64.5	51.3	45.1	38.8	36.9	38.2	38.5	40.4
Secured By Real Estate	55.8	-	-	-	-	-	-	-
1-4 Family Residential Properties	-	5.7	5.8	5.5	5.3	5.1	4.9	4.8
Other Real Estate	-	37.3	31.4	26.6	25.1	26.5	27.4	28.6
Loans to Finance Agriculture Production and Other Loans to Farmers	0.4	0.4	0.4	0.4	0.4	0.2	0.3	0.1
Commercial and Industrial Loans	7.1	6.7	6.5	5.5	5.3	5.6	5.3	6.2
Credit Cards	0.2	0.2	0.3	0.3	0.2	0.2	0.2	0.3
Other Loans to Individuals for household, family and Other Personal Expenditures	1.0	0.9	0.7	0.6	0.5	0.5	0.5	0.4
All Other Interest and Fee Income	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Income From Lease Financing Receivables	-	-	-	-	-	0.0	0.7	0.8
Interest From Depository Institutions	0.0	0.0	-	0.1	0.1	0.1	0.2	0.1
Other Interest on Securities	4.9	4.4	3.2	3.5	4.9	3.7	3.9	4.9
On U.S. Treasury & Agency Obligations	3.0	2.7	1.8	2.1	1.0	0.5	0.5	0.5
On Mortgage-Backed Securities	0.3	0.4	0.3	0.4	2.5	1.6	1.9	2.9
Other Interest and Dividend Income	1.5	1.4	1.1	1.1	1.4	1.5	1.5	1.5
Interest on Federal Funds Sold	0.5	0.2	0.1	0.0	0.0	0.0	0.0	0.0
Other Interest Income	0.0	0.1	-	-	-	-	0.0	0.0
Total Interest Income	69.9	56.0	48.4	42.5	41.9	42.0	43.4	46.2
Interest on Deposits	17.6	14.7	9.4	6.6	4.9	3.6	3.1	2.8
On Domestic Deposits	17.6	14.7	9.4	6.6	4.9	3.6	3.1	2.8
Interest on Transaction Accounts	0.1	0.1	0.1	0.2	0.2	0.3	0.2	0.1
Interest on Savings Deposits, Including MMDAs	7.4	6.9	4.4	3.1	2.4	1.5	1.5	1.5
On Time Deposits of More Than \$100,000	3.4	2.9	2.3	1.8	1.3	1.2	0.9	0.7
On Time Deposits of Less Than \$100,000	6.7	4.8	2.6	1.5	0.9	0.7	0.5	0.4
Interest on Federal Funds Purchased	1.7	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Interest on Trading Liabilities	2.1	2.0	0.2	-	0.0	-	-	-
Total Interest Expense	21.4	16.8	9.6	6.6	4.9	3.6	3.1	2.8
Net Interest Income	48.5	39.1	38.9	35.8	37.0	38.4	40.3	43.4
Service Charges on Dom. Deposit Accts.	3.2	3.6	3.4	2.9	2.6	2.4	2.5	2.5
Investment Banking and Brokerage Fees	0.1	0.1	0.0	-	-	-	-	-
Brokerage Fees and Commissions	0.0	0.1	0.0	-	-	-	-	-
Annuity Sales Commissions	0.0	0.0	0.0	-	-	-	-	-
Income From Other Insurance Activities	0.0	-	-	-	0.0	0.0	-	0.0
Net Servicing Fees	0.3	0.3	0.3	0.4	1.2	0.7	0.5	0.6
Net Gains on Sales of Loans and Leases	-	0.1	1.4	1.9	2.2	4.6	5.7	5.1
Net Gains on Sales of OREO	0.2	0.0	(0.2)	(0.1)	(0.6)	0.1	0.8	0.4
Net Gains on Sales of Other Assets	0.0	0.0	0.6	-	0.0	0.0	-	-

<i>As of:</i>	Dec. 31, 2007	Dec-31-2008	Dec-31-2009	Dec-31-2010	Dec-31-2011	Dec-31-2012	Dec-31-2013	Dec-31-2014
Other Noninterest Income	3.4	3.2	2.9	3.1	3.4	3.8	4.7	4.2
Total Noninterest Income	7.1	7.3	8.4	8.3	8.9	11.6	14.3	12.8
Revenue Before Loan Losses	55.7	46.5	47.3	44.1	45.9	49.9	54.6	56.2
Provision For Loan and Lease Losses	2.4	14.4	17.0	11.3	6.2	4.7	1.5	1.1
Total Revenue	53.3	32.1	30.3	32.8	39.7	45.2	53.1	55.1
Realized Gains on Securities Available-For-Sale	-	-	-	-	0.1	0.1	(0.3)	0.1
Total Realized Gains on Securities	-	-	-	-	0.1	0.1	(0.3)	0.1
Salaries and Employee Benefits	15.8	14.4	13.3	14.5	16.7	19.2	21.5	21.2
Expenses of Premises and Fixed Assets	2.7	3.0	2.7	2.6	2.6	2.7	3.1	3.2
Other Noninterest Expense	6.9	8.0	9.8	10.6	10.8	9.5	9.4	9.5
Total Noninterest Expense	25.3	25.4	25.8	27.7	30.0	31.4	34.0	33.9
Income Before Income Taxes	27.9	6.8	4.5	5.1	9.7	14.0	18.8	21.2
Applicable Income Taxes	10.2	2.1	1.3	1.6	3.1	4.7	6.5	7.7
Income Before Extraordinary Items	17.7	4.7	3.1	3.4	6.6	9.3	12.3	13.5
Net Income, Including Noncontrolling Interests	17.7	4.7	3.1	3.4	6.6	9.3	12.3	13.5
Net Income	17.7	4.7	3.1	3.4	6.6	9.3	12.3	13.5

SOURCE: S&P Capital IQ

DePaul University

Students: Joe Basa, Ted Jesionowski, Tatiana Lampley, Mike Palaguachi, Martin Wierzbicki

Advisor: Lamont Black

First Eagle Bank, headquartered in Chicago's West Loop, has proven to be a model of resilience and sound financial practices. Purchased in 1991 by President and CEO Andy Salk and his father Joe Salk, First Eagle grew from \$32 million when the bank was acquired to \$455 million in total assets in 2014. Even while 60 banks failed in Illinois since 2009, the majority of which were located in the Chicago Metropolitan area, First Eagle weathered the crisis and succeeded through excellent risk management, strong leadership and maintaining their relationship-lending business model.

First Eagle Bank's "community first" approach is apparent in its practices. First Eagle is a certified Community Development Financial Institution, a distinction held by only 11 banks in the Chicago area. First Eagle has also maintained an "Outstanding" rating for its Community Reinvestment Act (CRA) performance every year. Recently, First Eagle has sponsored housing developers from the Federal Home Loan Bank of Chicago's Affordable Housing Program.

This approach was instrumental to the survival of First Eagle during the financial crisis. Noticing emerging issues in the local community, First Eagle began tightening its underwriting standards. The bank leadership understood that sound investment during a downturn would require the bank to be heavily invested in customers' long-term success. While other banks suffered the onset of the financial crisis, First Eagle survived by restricting lending to businesses and community members with long-term relationships to the bank.

However, relying on their established business relationships alone was not sufficient in the wake of such an unprecedented economic downturn. Despite experiencing a negative net income during the crisis, First Eagle maintained a high capital ratio that protected the bank from default. The bank also maintained a sizeable allowance for loan and lease losses (ALLL) to account for expected bad debts.

Looking back on the crisis, staff at First Eagle had learned several valuable lessons. First, the bank needed to establish and maintain a more diverse portfolio of borrowers so it could avoid large CRE losses. Second, the bank needed to maintain rigorous standards for underwriting, making sure it knew its customers well before issuing credit.

University of Missouri—Kansas City

Students: Mark A. Devaney, Yuliana Onopriyenko, Garrett R. Pfau

Advisor: Bill Keeton

Johnson County, a suburb of Kansas City, is among the 100 most affluent counties in the country. The county is home to almost 600,000 residents, and it is the second largest county in the Kansas City metropolitan statistical area. While prosperous today, the county's economy was significantly affected by high concentrations of construction and CRE lending during the financial crisis and the fall of the housing market in 2008.

The Kansas City area has a relatively high number of community banks per capita. Both Kansas and Missouri were among the last states in the country to eliminate restrictions on intrastate banking and acquisitions by out-of-state, multibank holding companies, leading to the establishment of many community banks. This community bank presence created a strong relationship between residents and community banks in the Kansas City area.

Bob Regnier founded the Bank of Blue Valley in 1989. The bank experienced humble beginnings. But as the community and CRE market around the bank grew, so did the bank. Regnier established the Bank of Blue Valley as a locally owned, locally managed institution committed to serving the residents of Johnson County. Today, Bank of Blue Valley has \$630 million in assets and five locations around Kansas City.

Johnson County experienced rapid "in-migration," in the 1990s and early 2000s. This population increase created new demand for housing. As a result, Johnson County banks increasingly emphasized and began to specialize in construction lending.

Johnson County is unique because of its market for independent builders operating at lower margins rather than larger developers. Because of this, homebuilding in Kansas City heavily relies on community banks for financing and, as a result, residential construction and development loans make up a high percentage of loans at banks like the Bank of Blue Valley. Bank of Blue Valley residential construction loans were 13 percent of total loans in 2007, more than double the national average.

Construction loans at Bank of Blue Valley began performing poorly in 2007. The bank's noncurrent construction loans peaked in 2008 at 14.7 percent for residential construction loans and 19.9 percent for other construction loans. Other banks saw an increase in noncurrent constructions loans during this same time. However, Bank of Blue Valley's noncurrent loan rate was higher than others.

Three factors exacerbated construction loan failures in Johnson County during the crisis. First, banks had eased credit standards as a way to maintain lending. Second, a false sense of optimism had developed based on sustained population growth since the 1950s. Third, builders had been producing more expensive homes, which were harder to sell in the downturn.

To reduce potential losses, Bank of Blue Valley began outsourcing their borrowers' development of unfinished housing and selling the finished product to recoup their loans. This practice was unheard of in the area at the time. Ultimately, Bank of Blue Valley's solution to the problem proved successful. The bank also received \$21.75 million from the U.S. Treasury's Troubled Asset Relief Program in 2008 and raised \$5 million from existing shareholders in order to rebuild capital. These factors together helped save Bank of Blue Valley and allowed its return to profitability.

As the bank rebounded from the financial crisis, Bank of Blue Valley began adopting strategies for future success, including making greater use of statistical and external data to assist personnel with underwriting decisions, strengthening its internal controls and focusing on building up its customer deposits to reduce reliance on volatile funds. After the financial crisis, Bank of Blue Valley became more cautious in its lending practices, diversifying its loan portfolio, raising lending standards and lowering its concentrations in residential construction.

University of Arkansas

Students: Robert Ladtkow, Austin Washburn, Matthew Monaghan, Nicholas Lipscomb, Rifat Rasul

Advisor: Tim Yeager

Northwest Arkansas is home to many of the country's largest and most successful companies. The region has become the third fastest growing metropolitan statistical area in the nation and is currently home to more than 500,000 residents. According to the FDIC, 39 banks currently operate in Northwest Arkansas, the majority of which are local community banks. The intense competition among community banks in the region can be attributed to local CRE demands.

In the years prior to the 2008 financial crisis, there was an increase in corporations entering the region, which sparked a heightened real estate market and caused CRE lending to fuel community bank growth.

In 2005, Gene George, Dorothy Hanby, Bob Shaw and Don Gibson took advantage of the booming market and founded Legacy National Bank in Springdale, Ark. Legacy thrived during this peak in the economic boom, ending its first year with \$132 million in assets, surpassing its three-year projection in just a few months.

By mid-2007, due to the oversupply of CRE, Legacy began to suffer along with the rest of the economy. Being more vulnerable than a larger corporate bank, community banks had fewer resources to deal with the growing number of loan defaults and foreclosures. Legacy, in particular, suffered more than its peers because of its heightened concentration in 100 percent pre-financed CRE lending, a market identified as "the weakest performer" of the economic downturn.

Legacy's other real estate owned as a percent of total assets jumped from 0.48 percent to 3.97 percent in roughly two years, while other northwestern Arkansas community banks remained more stable on average, increasing from 0.28 percent to just 0.51 percent. In addition, capital ratios at Legacy were falling, and net write-offs surged. Legacy's net write-offs of commercial real estate loans surpassed 8 percent in 2009. The value of the loans written off exceeded \$6 million, more than \$4 million of which were in CRE. As a result, Legacy suffered significant losses. Compared to peer banks in Northwest Arkansas, return on assets for Legacy in 2009 was -3.16 percent versus 0.43 percent for peers.

Things began to turn around in May 2008 when Legacy began to regularly rate loans and report them to the OCC in an effort to improve credit quality. The bank researched and analyzed each potential new loan in detail in order to ensure repayment, and it avoided 100 percent financed speculative construction loans. Finally, Legacy agreed to maintain a Tier 1 capital ratio of 8 percent and a total risk based capital ratio of 12 percent. These restrictions caused Legacy's return on equity to decrease even more during the height of the crisis, but the bank's loyal investors aided its survival, and it ultimately succeeded.

Community banks in northwestern Arkansas—Legacy in particular—were hit harder by the Great Recession than the rest of the country, but recovered stronger and more prepared for future crises. Legacy produced a net profit in 2011 after three consecutive years of losses.

To reduce future CRE risk, Legacy lowered its percentage of construction and land development loans to 60 percent of its capital in an aim to diversify its commercial real estate portfolio. The bank also brought in independent advisors to aid in assessing loan risk in order to predict customers' ability to pay back loans, and it began to carefully assess potential borrowers' loan status with other banks. Collateral became one of three sources of repayment rather than the only one, and Legacy began to have all collateral appraised more carefully to ensure its value could properly be used for repayment.

Legacy has recovered full swing, with virtually no write-offs from 2011 through 2014.

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