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Survey of Community Banks in the Tenth Federal Reserve District

Community bankers in the region say their greatest challenges include the cost of regulatory burden and filling staff positions, according to a recent survey by the Kansas City Fed.

The goal of the 2008 Survey of Community Banks is to gauge how small commercial banks (those with assets less than $1 billion) respond to challenges, such as poor real estate markets, greater competition and regulatory changes, say Forest Myers and Eric Robbins, both policy economists at the Kansas City Fed. Myers and Robbins wrote the survey questions and subsequent research based on the responses.

The Kansas City Fed has conducted similar surveys for the last 20 years or so. The previous survey was in 2004 when banking conditions were good—earnings were strong, asset problems were few and bankers held a generally positive view for the future. This time is different, say Myers and Robbins.

With asset problems surfacing, charge-offs mounting, loan loss reserves falling and earnings declining, Myers says, "The banking environment has become less positive since our last survey. Our questions in 2008 were asked against a backdrop of more troubled times."

Overall, survey results show community bankers feel competitive pressure on deposit and lending business, driven in part by new and lower-cost technologies as well as changes in regulations that amplify this competition. Some of the areas emphasized by the respondents surprised Myers and Robbins. There were two main differences between the results of the '08 and '04 surveys:

- The cost of regulatory compliance (including the diversion of management's attention from business and what bankers perceive as an advantage given to less-regulated competitors such as credit unions) jumped from low on the 2004 list of challenges to the No. 1 spot in 2008.
- The second highest concern in 2008 was the ability to meet staffing needs because of the difficulty community banks say they have finding and compensating qualified personnel. In the 2004 survey responses, this was less of a concern, especially for larger banks.

"After years of favorable business conditions, ongoing competitive and economic changes present many challenges for community banks," Robbins says. "The environment they're working in isn't easy, but many have strategies to compensate."

Competition

Community banks face increasing competition from many sources. Several factors are contributing to this change, including:

- Legal constraints on financial institutions' locations and activities have relaxed;
- Larger banks expanded into new markets through acquisitions and growth;
- More bank branches mean more choices for customers;
- Technology allows banks to expand their reach at a low cost.

"Loan and deposit competition is intense, to say the least," Robbins says.

Deposits remain a vital source of funding for community banks, and bankers surveyed said they expect other community banks to be their most intense competitors for these deposits. However, they think intense deposit competition also will come from credit unions (46 percent) followed by larger in-state banks (40 percent).

The competitive environment for loans is similar; however, community bankers showed more concern regarding competition from farm credit associations. (The Tenth District includes large rural areas dependent on agriculture.) This competitive concern jumped from third to first from the '04 survey to the '08 survey. Other loan competitors include captive lending subsidiaries, such as John Deere Credit, and credit unions.

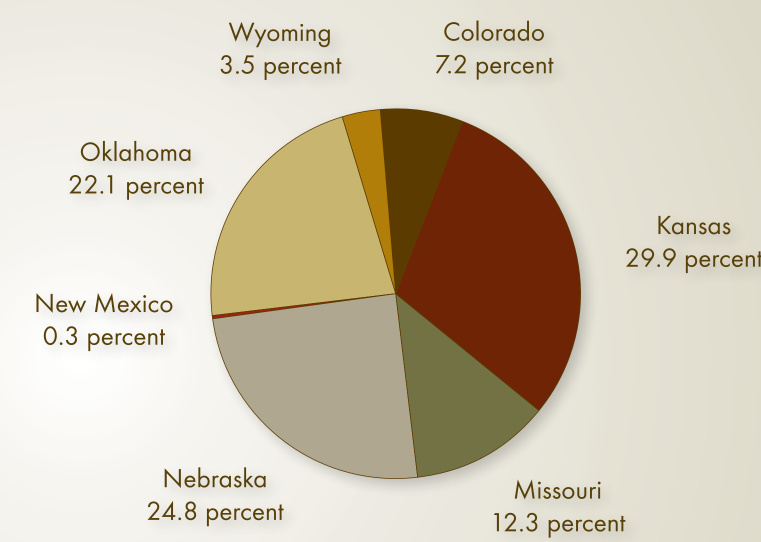
About the 2008 Survey of Community Banks

The Kansas City Fed created a 63-question survey that focused on four broad areas: general information about the bank; prospects and challenges; laws, regulations and guidance; and staffing practices and governance.

Surveys were mailed in February 2008 to all commercial banks with assets less than $1 billion in the Tenth Federal Reserve District. Of the 1,121 potential respondents, nearly 36 percent responded, which is high.

Similar surveys are conducted by the Kansas City Fed every three to four years. Responses are used for rural banking market analysis, policymaking discussions and for bankers to hear what their peers are saying. Bankers did not have to identify their organizations by name and could write comments at the end of the survey.

For a complete summary of the 2008 Survey of Community Banks in the Tenth Federal Reserve District, visit **KansasCityFed.org/TEN.**



Tenth Federal Reserve District survey respondents by state

In the open-ended portion of the survey, one respondent wrote, "Farm credit and credit unions combined will, and are, hurting our business. The tax advantage is huge and continues to make competing very difficult."

Another difference from the '04 survey is the increased competition stemming from advancements in technology, such as Internet banking, which allow online banks and brick-and-mortar banks to attract deposits.

These advancements are necessary to grow deposits, says John B. Schwartz, senior vice president, director and corporate secretary of State Bank of Blue Rapids in Kansas.

"Younger generations want and will demand more portable access to services," says Schwartz, who participated in the survey.

In response to these areas of heightened competition—and to increase customer deposits—survey respondents say they are utilizing a number of strategies, including acquiring other banks or branches, or adding new products and services.

> "The environment they're working in isn't easy, but many have strategies to compensate."

Regulatory burden

The level of frustration among bankers regarding regulatory compliance requirements has increased substantially.

"This message comes across loud and clear in bankers' responses to how they rate the level of future challenges," Robbins says. "Among 17 factors, meeting regulatory compliance requirements was the No. 1 factor, while in the 2004 and 2001 surveys, it was seventh and eighth, respectively."

Mark Blazek, president of Oak Creek Valley Bank in Valparaiso, Neb., said the survey was a chance for him to voice some of his concerns in regard to regulations.

"The biggest concern we have as a small town community bank is the one-size-fits-all approach," Blazek says. "The smaller the institution, the more disproportionately the regulations impact us."

A number of factors may have contributed to this reaction among many community bankers, Robbins says. Congress and regulatory agencies responded to post-9/11 national security and other issues with new legislation in an effort to combat money laundering, terrorist financing and other requirements for security programs and privacy notices. As a result, the amount of time banks' boards spend on compliance matters has jumped, say 96 percent of survey respondents.

The majority of survey respondents, including Blazek, expect compliance to continue to be a significant challenge.

"If substantial regulatory relief is not forthcoming soon for small community banks, there will be few, if any, left," Blazek says.

Others said the level of regulation was disproportionate to the size of their bank. One respondent wrote, "At $20 million (asset size), we are regulated as if we were $20 billion."

Economic challenges

Many banks in the District face slow-growing or declining populations and other challenges associated with being located in rural areas. Roughly 40 percent of survey respondents said lack of diversification opportunities to offset these challenges will be difficult.

One survey respondent wrote, "As the population ages, core deposits are going to move out of the banking system, and more expensive wholesale funding options will be necessary to maintain the balance sheet. Margins will compress and traditional banking services will become more expensive."

Bankers have responded to funding pressures in a variety of ways, such as using Internet posting services to obtain deposits, increasing their use of Federal Home Loan Bank advances and shortening the maturities of wholesale funding or CDs.

Regardless of recent market events and changes in funding costs, about 52 percent of banks surveyed believe their level of liquidity risk is low. Still, regulators urge banks to have contingency funding plans in place; about 67 percent of those surveyed do.

"Despite a downturn in economic conditions and increasing loan problems across the banking industry, survey respondents seem to be fairly positive about their ability to see things through to better times," Myers says. "Banks appear to be changing their lending strategies in response to these worsening economic conditions."

Staffing, governance

About 57 percent of community banks surveyed foresee problems hiring officers and about 43 percent predict challenges filling staff positions. The nature of community banks, which are often rural and in small towns, can complicate hiring. Survey results indicate larger financial institutions are more pessimistic, perhaps because they experience faster growth and are often located in larger areas where there's more hiring competition. Regardless of size, banks see filling teller positions as their biggest staffing challenge in the next five years, followed by loan administration and customer service positions.

"These are the highest percentages we have seen in our surveys," Myers says. "This may be, in part, reflective of the banking and economic conditions at the times the surveys were taken—for example, staffing concerns were higher during the poorer economic climates of 2001 and 2008."

In contrast, about 70 percent of community bankers don't think it will be difficult to fill board of director positions during the next five years. However, an increasing number say finding directors with the necessary skill set will be more difficult.

"The amount of staffing and training has become a major expense factor to the banking industry," says Dick Scarlett, chairman of United Bancorporation of Wyoming, which oversees Jackson State Bank in Jackson Hole.

Blazek, of Oak Creek Valley Bank in Nebraska, agrees that "there is always a demand for good, strong, experienced loan officers. That can be a challenge" for small, rural banks, although Oak Creek Valley's proximity to the Lincoln area and its job pool is beneficial.

Going forward

The responses of these surveys are valuable to both the Kansas City Fed and the community banks themselves.

"The aggregate results of such a survey should be very helpful in spotting trends in banking at the grassroots level," says Schwartz of State Bank of Blue Rapids in Kansas.

The high response rate for the survey can, in part, be attributed to community bankers wanting to speak directly to the Fed, say Myers and Robbins.

Says Scarlett, of United Bancorporation, "I feel the information I'm able to share from our market area will somehow be meaningful to the Fed in better understanding what is happening in the Tenth Federal Reserve District."

BY BRYE STEEVES, SENIOR WRITER

FURTHER RESOURCES

"THE 2008 SURVEY OF COMMUNITY BANKS IN THE TENTH FEDERAL RESERVE DISTRICT"
By Forest Myers and Eric Robbins
KansasCityFed.org/TEN

COMMENTS/QUESTIONS are welcome and should be sent to teneditors@kc.frb.org.