The 2004 Survey of Community Banks in the Tenth District

Forest Myers and Eric Robbins

Forest Myers and Eric Robbins are economists in the Division of Supervision and Risk Management of the Federal Reserve Bank of Kansas City. The authors would like to thank the many bankers who took the time to complete and return their survey questionnaire. They also would like to thank Matt Bassham in the Application Support Department of the Federal Reserve Bank of Kansas City for developing the online version of the survey questionnaire and the Administrative Services Department staff members for their help in data entry. The views expressed in this article are those of the authors and do not necessarily reflect those of the Federal Reserve Bank of Kansas City or the Federal Reserve System.

INTRODUCTION

Recent legislative changes, technological advances, and continued consolidation present significant challenges for community bankers. The USA PATRIOT Act, Sarbanes-Oxley Act, and Check Clearing for the 21st Century Act (Check 21) place new organizational, reporting, and operational requirements on financial organizations. Consolidation continues to change the competitive landscape and induces bankers to reconsider the best way to provide for their bank's future. This changing financial services landscape—including a low interest rate environment, evolving Internet banking practices, increasing electronic fraud and identity theft, and increased operational outsourcing—heightens risk and the need for strong risk management systems.

In order to gauge banking practices in this ever-changing environment, the Federal Reserve Bank of Kansas City periodically surveys District bankers on the current operational and regulatory issues facing community banks.[1] The information we gather is useful to us as a bank supervisor, and we believe that the publication of survey results meets the needs of many bankers who want to know what other bankers are thinking and doing.

The 2004 Community Bank Survey builds on information obtained in previous community bank surveys conducted in 2001 and 1994. This article introduces the 2004 survey—who was surveyed and the questions they were asked—and provides background information for articles that use survey information to explore specific banking questions included in this issue of *Financial Industry Perspectives*. The first section of the article summarizes and reviews basic characteristics of the community banks that completed the survey. The second section summarizes survey information, focusing on community banks, the challenges and competition they face, and their prospects.

THE SURVEY RESPONDENTS

The 2004 Community Bank Survey was distributed in February 2004 to all commercial banks in the Tenth Federal Reserve District[2] with year-end 2003 assets less than $1 billion (approximately 1,300 banks).[3] The survey instrument contained 86 questions. The questions focused on change confronting community banks and asked bankers for their thoughts on legal changes and their associated regulatory burden, market demographics and competitive challenges, and operational issues and technological advances.

Survey questions were arranged into seven broad topical areas.

1. General information about the bank
2. Governance and staffing practices
3. Vendor management practices
4. Competitive environment and prospects
5. Interest rate risk practices
6. Internet banking services
7. Payments system issues

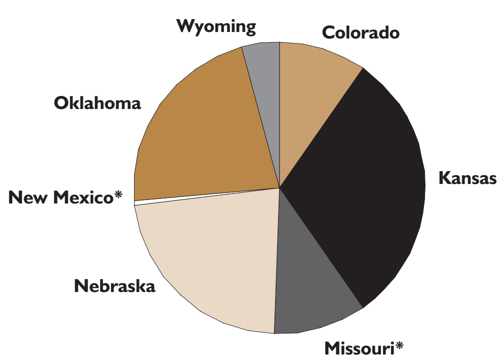
Not all topical areas are discussed in this publication. However, a complete summary of survey answers is available on the Federal Reserve Bank of Kansas City web site—*http://www.kansascityfed.org/Publicat/FIP/Fipmain.htm*.

Generally, the characteristics of the survey respondents are similar to those of all community banks in the Tenth District, making the respondents roughly representative of District community banks. In this regard, 75 percent of the survey responses are from banks headquartered in Kansas, Nebraska, and Oklahoma—reflecting somewhat the greater number of community banks with assets less than $1 billion in these states (Chart 1). By comparison, 71 percent of District banks with assets less than $1 billion are headquartered in these same states.

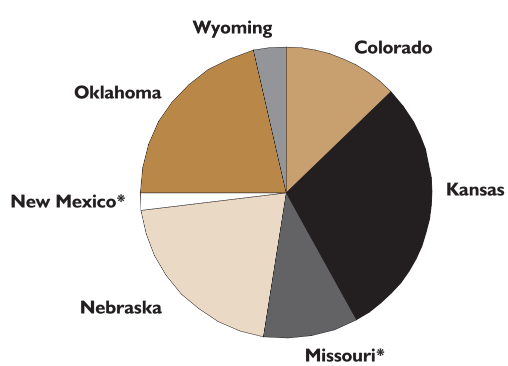
Asset size, charter class, ownership structure, parent company size, and federal tax election (S- or C-corp.) roughly parallel those of the District. However, survey respondents' recent earnings performance is slightly better compared to all District banks. In addition, respondents lean more toward multi-office operations than do District community banks as a whole (Table 1).

Chart 1

Survey Respondents by State



District Community Banks by State



*Only the northern one-half of New Mexico and the western one-third of Missouri are located within the Tenth Federal Reserve District's boundaries.

Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

Table 1

Comparison of Survey and Tenth District Community Bank Characteristics

Measure/Attribute	Survey—Percent of Respondents Answering Question	Tenth District—Percent of Tenth District Institutions
Asset size (12/31/03)		
less than $150 million	82.21	81.60
$150-$300 million	10.43	11.02
$300 million-$1 billion	7.36	7.37
Charter class		
National	31.58	27.31
State	68.42	72.69
Bank ownership structure		
Independent bank	13.89	16.22
One-bank holding company subsidiary	68.21	61.80
Multibank holding company subsidiary	17.90	21.98
Parent bank holding company asset size		
less than $150 million	75.94	74.80
$150-$300 million	14.06	11.51
$300 million-$1 billion	6.88	7.54
greater than $1 billion	2.81	6.16
Office structure		
Single office	59.49	70.02
Multi-office, single state	35.37	27.15
Multistate	5.14	2.84
Federal tax filing status		
Subchapter S	42.72	38.33
C-corp.	57.28	61.67

Return on average assets (un-weighted average)	Survey Year	Survey C-corp	Survey S-corp	Tenth District Year	Tenth District C-corp	Tenth District S-corp
	2000	1.02	1.70	2000	1.07	2.06
	2001	0.88	1.64	2001	0.91	1.54
	2002	0.98	2.28	2002	0.79	1.54
	2003*	1.06	2.33	2003*	1.01	1.67

*Annualized Operating results through September 2003.
Source: Reports of Condition and Income and 2004 Community Bank Survey

A significant Tenth District demographic feature is the large number of small, slow-growing, rural communities. This feature is reflected in the characteristics of headquarters locations.

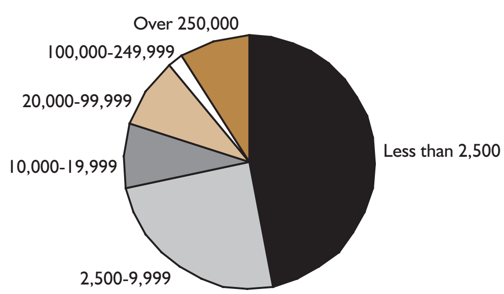
More than 46 percent of respondents are headquartered in communities with populations totaling less than 2,500. The headquarters for another 25 percent are in towns with populations between 2,500 and 10,000 (Chart 2).

Little or no population growth is an economic reality for many District communities, and many towns where survey banks are headquartered lost population or experienced weak growth between 1990 and 2000. More than 30 percent of respondents are headquartered in towns that lost population, and a similar percentage are in towns that grew between 0 and 2 percent over the decade.

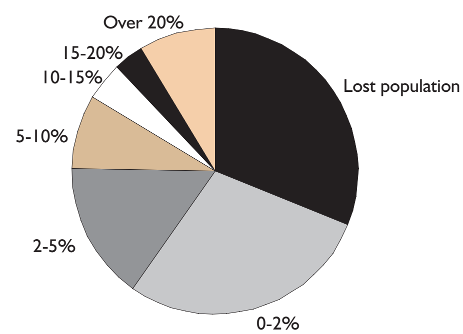
Many of the District's communities are distantly removed from its larger cities. Agriculture appears to be the primary economic support for many of these towns. This also is reflected in the demographic and economic characteristics of those answering the survey. More than 70 percent of respondents are headquartered in towns located more than 30 miles away from a metropolitan area (Chart 3). Sixty-two

Chart 2

Population of Places Where Survey Respondents are Headquartered



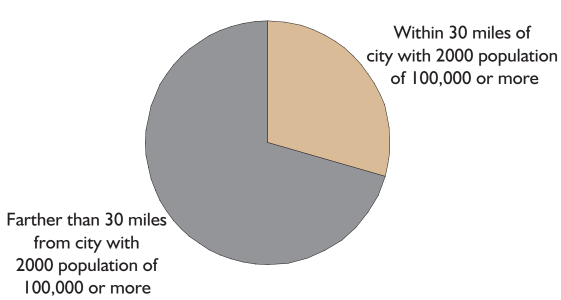
Population Change Where Survey Respondents Are Headquartered—1990 to 2000



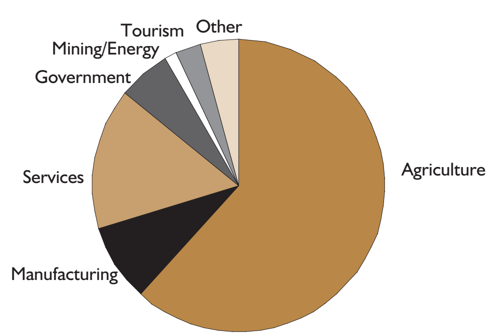
Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

Chart 3

Location of Places Where Survey Respondents Are Headquartered



Primary Economic Support for Communities Where Survey Respondents Are Located



Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

percent of survey respondents reported that agriculture provided primary economic support for their communities (Chart 3).[4]

CHALLENGES, COMPETITION, REGULATORY BURDEN, AND PROSPECTS

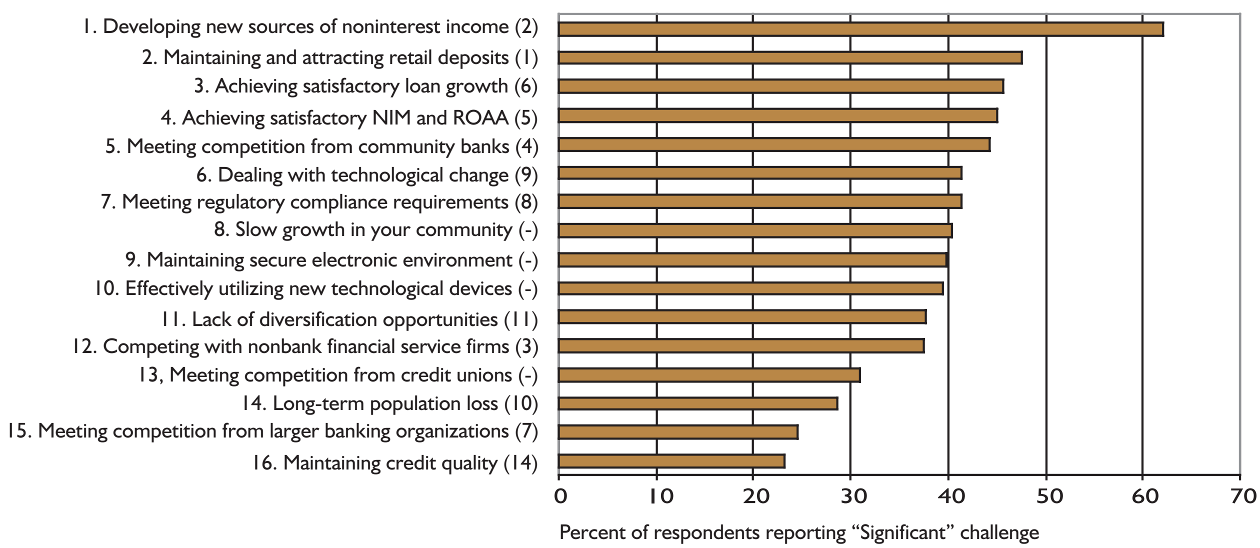
New laws and regulations, improved communication and computer technologies, and new financial instruments bring operational challenges. Enhanced transportation modes, aggressive competitors, and faster business pace bring added challenges. In some instances, a less-than-vibrant local economy tests the ability of District community banks to maintain profitability and provide competitive shareholder returns, ultimately determining their continued role as financial service providers. Within the context of change and its consequences, the 2004 Community Bank Survey asked bankers to evaluate the challenges they see ahead and their prospects for the next five years, 2004 to 2009.

Challenges Ahead

The survey asked bankers to rank the performance, competitive, organizational, and economic challenges they expect to encounter during the next five years as significant, moderate, slight, or no challenge. Chart 4 summarizes their responses, focusing on significant challenges. The numbers in parentheses represent the rankings from the 2001 Survey of Community Banks in the Tenth Federal Reserve District. With one notable exception, there was little difference in the top five ranking of future challenges for respondents. Developing new sources of noninterest income ranked highest as a significant challenge by bankers (62 percent). Maintaining and attracting retail deposits ranked second as a significant challenge (48 percent). Compared to the 2001

Chart 4

Significant Challenge Areas 2004-2009



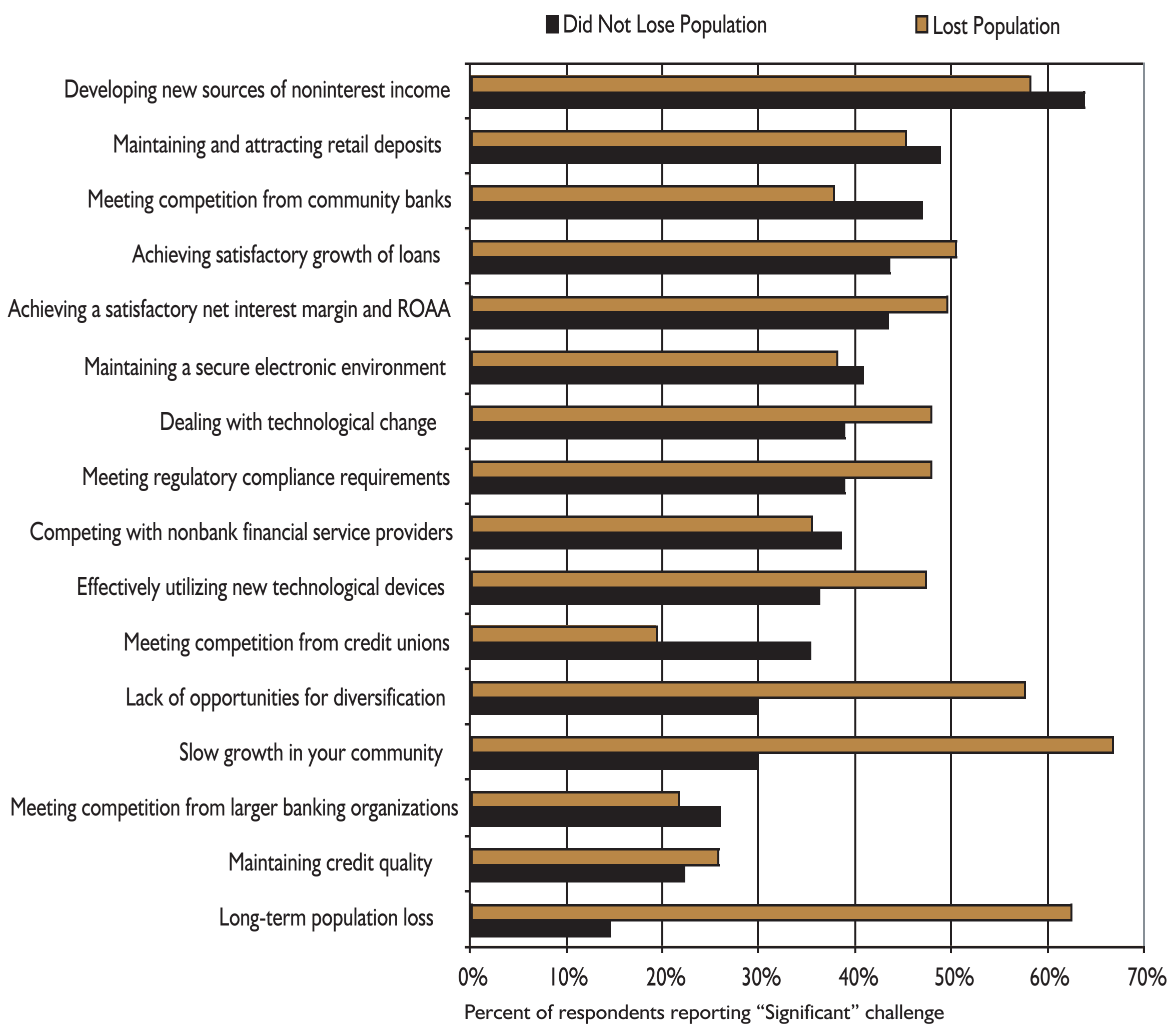
Note: Numbers in parentheses are rankings from the 2001 Community Bank Survey. A "-" indicates that the response option was not included on the 2001 survey.
Sources: 2004 and 2001 Surveys of Community Banks in the Tenth Federal Reserve District

survey, respondents to the 2004 survey seem to be more concerned about achieving satisfactory loan growth (46 percent), displacing competition with nonbank financial services as the third highest challenge. The latter dropped to 12th on the list of challenges (38 percent). Achieving a satisfactory net interest margin and return on average assets ranked fourth (45 percent) and meeting competition from community banks ranked fifth (44 percent). Interestingly, competition from larger banking organizations dropped considerably compared to its seventh place ranking in the 2001 Community Bank Survey.

A recent study conducted by the Federal Reserve Bank of Kansas City noted that the growth characteristics of the communities in which banks operate play an important role in their performance and the challenges they face.[5] The survey responses reflect this notion. Survey respondents located in communities with a declining population put greater weight on issues related to this decline. Chart 5 shows the

Chart 5

Significant Challenge Areas 2004-2009 As Related to Population Growth



Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

difference in response pattern between banks headquartered in towns losing population and those experiencing population growth. Overall, respondents located in towns with declining populations expect significant challenges related to the slow growth in their communities (67 percent), long-term population loss (62 percent), and lack of opportunities for diversification (58 percent). In addition, a greater percentage of bankers in communities facing decline also anticipate significant challenges with regards to achieving satisfactory growth of loans (51 percent), compared to bankers in growing communities (41 percent).

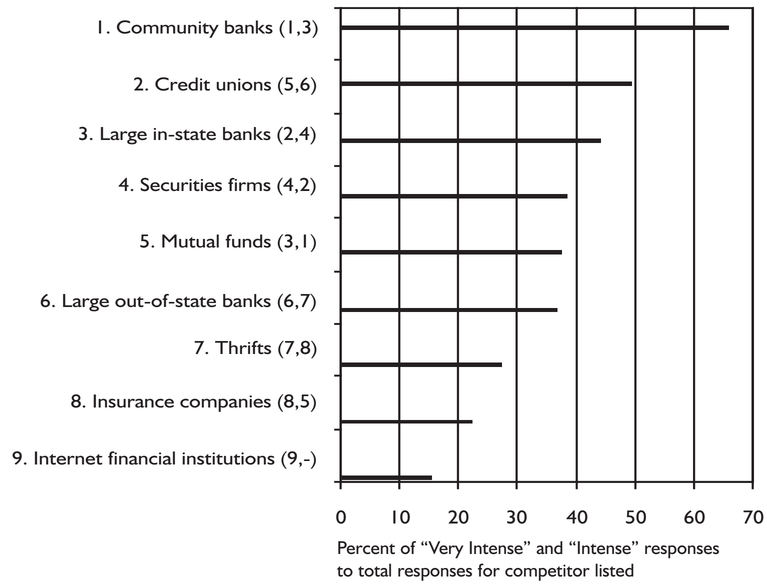
Future Deposit and Loan Competition

Deposit and loan competition rank high on the list of challenges District community bankers see ahead, and the 2004 survey asked bankers for the source of this competition. Charts 6 and 7 summarize their responses. The numbers in parentheses reflect the ranking given to deposit and loan competitors in the 2001 and the 1994 Surveys of Community Banks in the Tenth District.[6] The two charts show that respondents expect other community banks to be the most important source of deposit and loan competition. This has been shown to be true over the years covered by the three surveys. Chart 6 shows the steady rise of credit unions as deposit competitors in the minds of bankers. In the 1994 survey, 32 percent of bankers expected intense to very intense deposit competition from credit unions; in the 2004 survey, the percentage was 49.

The chart also shows the decrease in expected deposit competition from mutual funds. In the 1994 survey, mutual funds topped the deposit competitor list. By the

Chart 6

Expected Deposit Competition for 2004-2009 Tenth District Community Banks

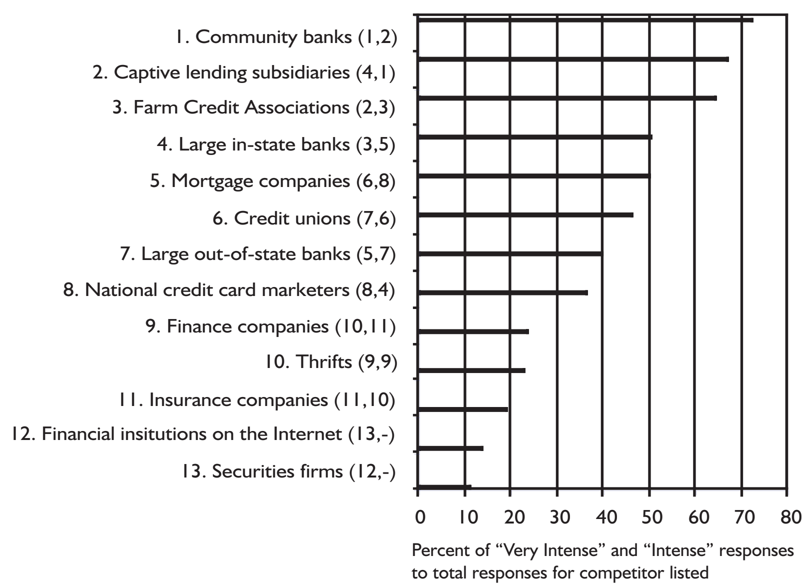


Note: Numbers in parentheses are competitive intensity rankings from the 2001 and 1994 Tenth District Community Bank Surveys, respectively. A"-" indicates the competitor was not broken out separately.

Sources: 2004, 2001, and 1994 Surveys of Community Banks in the Tenth Federal Reserve District

Chart 7

Expected Loan Competition for 2004-2009 Tenth District Community Banks



Note: Numbers in parentheses are competitive intensity rankings from the 2001 and 1994 Tenth District Community Bank Surveys, respectively. A"-" indicates the competitor was not broken out separately.

Sources: 2004, 2001, and 1994 Surveys of Community Banks in the Tenth Federal Reserve District

2001 survey, they had fallen to third. They ranked fifth in the 2004 survey.

Several survey respondents provided the following comments regarding competition from credit unions:

> "Untaxed credit unions are our biggest competitor—especially ones larger than $500 million..."

> "Credit unions are operating tax free, which is unfair competition."

With respect to lending competition, other community banks, captive finance subsidiaries, Farm Credit Associations, and large in-state banking organizations consistently have remained among the top five competitors for community banks from survey to survey.

Table 2

Do You Foresee Problems Filling...

	Foresee a Problem (Percent Answering Yes) Declining Population (Percentage)	Growing Population (Percentage)
Nonofficial staff positions	11.2	8.9
Official staff positions	30.6	24.9
Outside director positions	30.2	23.3

Do you have a written management succession plan?

	Declining Population	Growing Population
Percent answering yes	44.2	33.8

Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

Staffing Challenges

The 2004 Community Bank Survey asked banks in the Tenth District whether they anticipate difficulty in filling a variety of positions in the next five years. A large majority of respondents foresee no problems filling staff, officer, and outside director vacancies (90.4 percent, 73.4 percent, and 74.6 percent, respectively). However, those in declining markets do see a greater challenge, especially in filling officer and director positions (Table 2). The greater challenge in staffing and leadership is not lost on banks operating in areas of population decline. Banks headquartered in towns losing population are more likely than those in growing communities to have written management succession plans in place.

Table 3

Relative Burden of Selected Laws and Regulations

Rank	Law or Regulation
1	USA PATRIOT Act
2	Bank Secrecy Act
3	Other (describe)*
4	Truth in Lending
5	Privacy notices
6	Home Mortgage Disclosure Act (HMDA) and Regulation C
7	Expedited Funds Availability Act or Regulation CC
8	Community Reinvestment Act (CRA)
9	Regulation D and limits on transfers and withdrawals from money markets
10	Extensions of Credit to Insiders and Regulation O
11	Appraisal regulations
12	Deposit insurance coverage

*Other included Regulation W, Gramm-Leach-Bliley Act, and Real Estate Settlement Procedures Act.
Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

Regulatory Burden

Complexity and cost of complying with banking laws and regulations is an ongoing concern for many bankers. The 2004 survey asked bankers to rank selected banking regulations by the time devoted to them. Table 3 shows the ranking bankers gave each law and regulation, listed by most to least amount of time spent on each.

The survey provided bankers with the opportunity to add written comments to amplify and clarify their views. The Regulatory Burden section of the survey generated most of the written comments received on the survey. The following are representative of those received:

> "The future of banking must address the enormous regulation/compliance burden placed upon banks presently."

> "Increasing complexity of compliance is requiring a significant increase in the commitment of resources. Need to level the playing field—Farm Credit and credit unions have distinct pricing advantages due to regulations and laws."

"The regulatory burden on the financial industry is causing a huge shift in management priorities from developing new products and services for customers to documenting and abiding by regulations."

"With the unending avalanche of laws and regulations, we in small banking institutions find ourselves in an impossible situation. There are simply too many laws in existence for us to be able to fully understand and know them all as is expected. Time and time again, I find myself in a situation just trying to think of all the laws that might apply. Knowing the details of all the laws has long been impossible—it is now difficult just to know all of those which are applicable in a given situation."

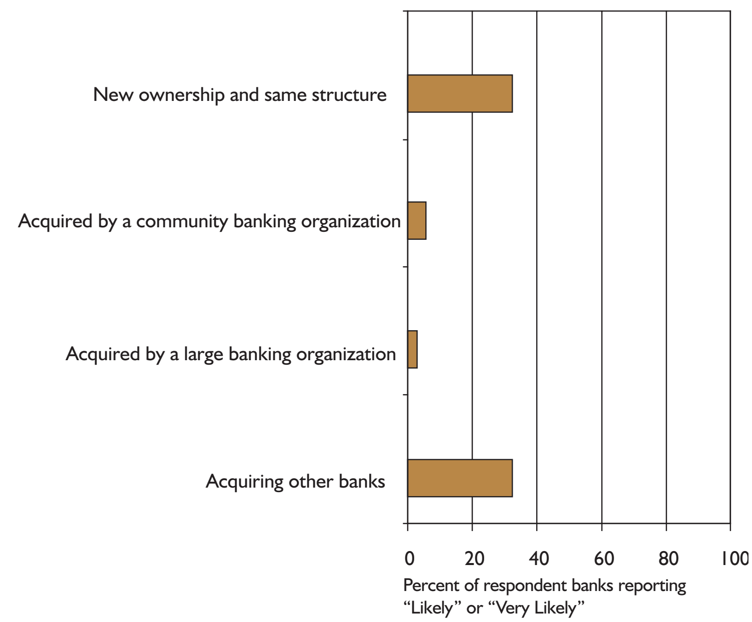
Prospects

Although their banks face many challenges, respondents to the 2004 survey maintain a positive near-term outlook. About 94 percent believe that it is "likely" or "very likely" their banks will operate under the same ownership and structure over the next five years (Chart 8). Of those that see change ahead, 32 percent see ownership changing but the same operating structure remaining in place. Expanded operations are on the minds of many survey respondents, further reinforcing the notion of a positive outlook. A good number of those forecasting change (32 percent) see themselves acquiring other banks (Chart 8).

A slight majority of all respondents (52 percent) say they will open or acquire additional branch offices (Chart 9) over the next five years. Most of these banks project that these offices will be in either adjacent counties or distant counties in the same state. The exact nature of branch expansion plans, however, depends heavily on bank size. For instance, larger banks are more likely to have branch expansion plans for the next five years. More than 86 percent of those banks with assets between $150 million and $1 billion answering the

Chart 8

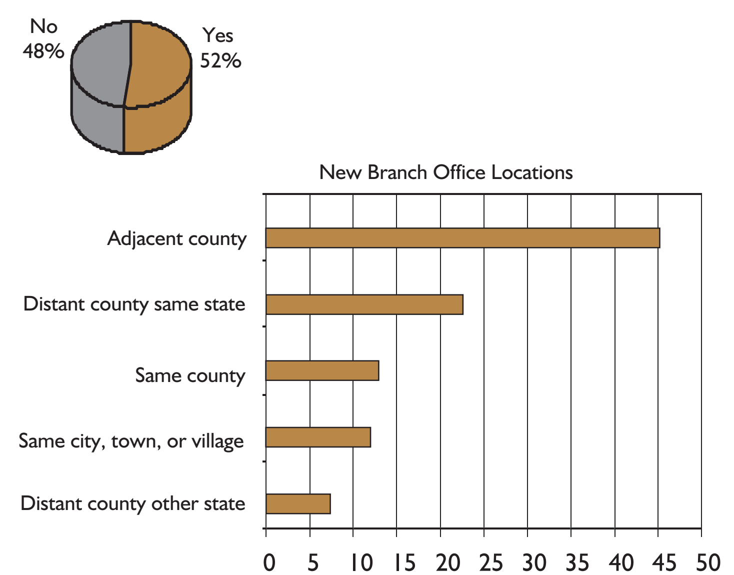
Expected Ownership Changes, 2004-2009



Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

Chart 9

Plan to Establish More Branches? If So, Where?



Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

Table 4

Proportion of Survey Banks Planning on New Branches

(By Respondent Asset Size)

Bank Size	Percent Yes
Assets less than $150MM	43.67
Assets between $150-300MM	86.21
Assets between $300MM-$1B	91.30

Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

survey plan to add branches during this period, compared to only 43 percent for banks with assets less than $150 million (Table 4).

Forecasts on the location of new branches also differ depending on bank asset size (Table 5). Respondents from very small banks, who plan on branching, are more likely to establish branches beyond the city or county in which they are headquartered. Very large banks (those with assets between $300 million and $1 billion), on the other hand, are equally likely to establish additional branches within their headquarters' cities and adjacent counties.

The difference in branching plans may reflect, in part, environmental differences that large and small banks face. Large community banks tend to operate in larger markets with growth opportunities to exploit. This tends to lessen the need to branch beyond their headquarters city. Tables 6 and 7 offer some support for this view. Table 6 shows that nearly 56 percent of survey responses from the smallest banks came from banks headquartered in towns with a 2000 population of less than 2,500, while 41 percent of the largest banks are headquartered in towns with a 2000 population greater than 250,000. Table 7 shows that larger community banks are also the ones more likely to report population growth in their communities over the decade of the 1990s.

Smaller banks in slower growing markets, on the other hand, may have fewer local opportunities to exploit and may need to move beyond city boundaries to find additional customers to serve. Limited resources and staying close to a customer base they know also may lessen their willingness to go much beyond adjacent counties.

This does not mean that a good number of smaller institutions are not willing to branch more distantly to improve their business opportunities. For example,

Table 5

Where Survey Banks Will Locate New Branches (By Respondent Asset Size)

	Same City	Same County	Adjacent County	Distant County Same State	Distant County Other State
Assets less than $150MM	6.59	27.54	40.12	21.56	4.19
Assets between $150-300MM	10.87	26.09	41.30	15.22	6.52
Assets between $300MM-$1B	24.32	18.92	24.32	16.22	16.22

Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

Table 6

City Population Where Survey Respondents Were Headquartered (By Respondent Asset Size)

	Less than 2,500	2,500-9,999	10,000-19,999	20,000-99,999	100,000-249,999	Over 250,000
Assets less than $150MM	55.89	24.71	6.08	5.70	1.52	6.08
Assets between $150-300MM	6.06	33.33	24.24	24.24	0.00	12.12
Assets between $300MM-$1B	0.00	16.67	4.17	25.00	12.50	41.67

Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

Table 7

City Population Growth from 1990-2000 Where Survey Respondents Were Headquartered
(By Respondent Asset Size)

	Lost Population	0-2% Growth	2-5% Growth	5-10% Growth	10-15% Growth	15-20% Growth	Over 20% Growth
Assets less than $150MM	34.80	30.40	15.20	7.60	4.40	2.40	5.20
Assets between $150-300MM	27.27	15.15	15.15	12.12	3.03	12.12	15.15
Assets between $300MM-$1B	4.35	21.74	17.39	13.04	8.70	4.35	30.43

Source: 2004 Survey of Community Banks in the Tenth Federal Reserve District

anecdotal information from examiners indicates a willingness of some rural banks in slower-growing markets to establish branch offices in metropolitan areas to improve their growth opportunities. This strategy may help explain why approximately 25 percent of smaller bank survey respondents plan on branching into more distant counties over the next five years (Table 5).

SUMMARY

Most community banks in the Tenth Federal Reserve District are small, state-chartered banks operating with a single office. The environment in which these banks operate has changed in a number of ways in recent years. New and revised legal and regulatory requirements, changing technology practices, and continued competitive pressure present community banks with many challenges. Environmental factors, including declining or slow-growing populations and remoteness from larger cities with diverse economic support structures, add to the challenges faced by many of these banks.

Looking forward over the next five years, community banks expect continued challenges related to developing new sources of noninterest income; maintaining and attracting retail deposits; achieving satisfactory loan growth, net interest margin, and return on average assets; and competing with other community banks. Smaller community banks expect these challenges, as well as challenges related to demographic issues, such as population decline and lack of opportunities for diversification, to continue in the near term. In addition, community banks expect continued deposit and loan market competition from other community banks. They also see credit unions as serious deposit competitors and the Farm Credit Associations and captive finance companies as significant loan competitors.

Despite these many challenges, most community bank respondents maintain a positive outlook. A vast majority plan to operate under the same ownership and structure in the near term. In addition, more than half of all survey respondents expect to establish additional branches. Where these offices are located depends heavily on the size of the bank, with smaller banks tending to acquire or open offices near their existing offices.

ENDNOTES

[1] For the purposes of this article and the 2004 Survey of Community Banks in the Tenth Federal Reserve District, the term "community bank" refers to those banks with assets less than $1 billion.

[2] The Tenth Federal Reserve District consists of the states of Colorado, Kansas, Nebraska, Oklahoma, Wyoming, the western one-third of Missouri, and the northern one-half of New Mexico.

[3] We received 341 responses to the survey, equaling a response rate of 27 percent. About one-third of respondents submitted their answers online.

[4] Although a majority of survey respondents describe the primary economic support of their community as agriculture, data from the Bureau of Economic Analysis (BEA) suggests that agriculture may no longer be the pre-eminent economic activity in the Tenth District states. (See: "From the Mountains to the Prairies: The Banking Environment in the Tenth Federal Reserve District" in this edition of *Financial Industry Perspectives*.) Gross state product data from the BEA reflect that other industries are higher contributors to statewide output in the Tenth District states.

[5] Forest Myers and Kenneth Spong, "Community Bank Performance in Slower Growing Markets: Finding Sound Strategies for Success," *Financial Industry Perspectives*, 2003, Federal Reserve Bank of Kansas City, *http://www.kansascityfed.org/PUBLICAT/FIP/prs03-2.pdf.*

[6] The 1994 survey was limited to banks with assets of $150 million or less.