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Community Bankers' 2014 Top 10 Challenges: The Regulatory Climate Continues To Be #1

Over the last four years community bankers have ranked the Regulatory Climate as their #1 challenge. However, the 2014 data reflects an increase in the weight of the voting (see Distribution of #1 Votes on page 2). Overall, when reviewing the comments, there is an uptick in optimism, and surprisingly, this year's results had little mention of Mergers & Acquisitions as a solution to bankers' challenges.

COMMUNITY BANK 2014 TOP 10 CHALLENGES

1. **Regulatory Climate**
2. **Interest Rate Environment**
3. **Loan Growth**
4. **The Economy**
5. **Earnings**
6. **Asset Quality**
7. **The Competition**
8. **Non-Interest Income**
9. **Deposit Growth**
10. **Technology**

THE SURVEY

CB Resource, Inc. partnered with Finance 500, a leader in Fixed Income products, in conducting this year's survey. The survey was held during the period of January 21, 2014 through February 7, 2014. We polled senior community bank executives to determine what they viewed as their top 10 challenges for 2014. In addition to ranking their challenges, we also asked our participants to discuss:

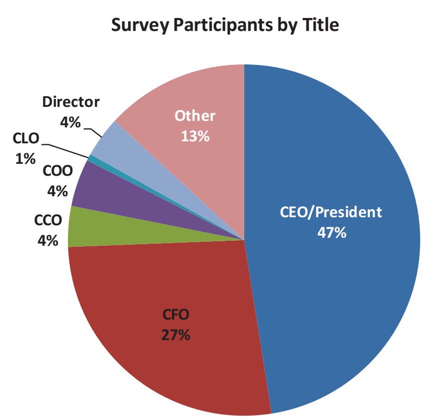
1. Their greatest challenges.
2. How they intend to overcome their challenges.
3. What their top strategic priorities are and what steps they are taking to implement these priorities.
4. What they are most optimistic about in 2014.

The purpose of the survey was to gain a clear understanding of what community bankers view as impediments to running their business, how they are addressing these impediments, and also to determine what they are focusing on to build value within their franchise.

WHO PARTICIPATED IN THE SURVEY?

162 community bankers responded to the survey throughout the United States. The following chart summarizes the distribution of respondents.

The largest groups of participants were community bank presidents/CEOs at 47% and CFOs at 27%, the balance of participants included Directors, CCOs, CLOs and other senior executives.



TOP 10 CHALLENGES TRENDS

	2011	2012	2013	2014
Regulatory	1	1	1	**1**
Interest Rates	5	5	3	**2**
Loan Growth	NA	6	2	**3**
Economy	2	2	4	**4**
Earnings	4	4	5	**5**
Asset Quality	3	3	6	**6**
Competition	NA	9	9	**7**
Non-Interest Income	NA	10	10	**8**
Deposit Growth	NA	NA	NA	**9**
Technology	NA	NA	NA	**10**
Capital	6	7	7	**NA**
Operating Expense	NA	8	8	**NA**

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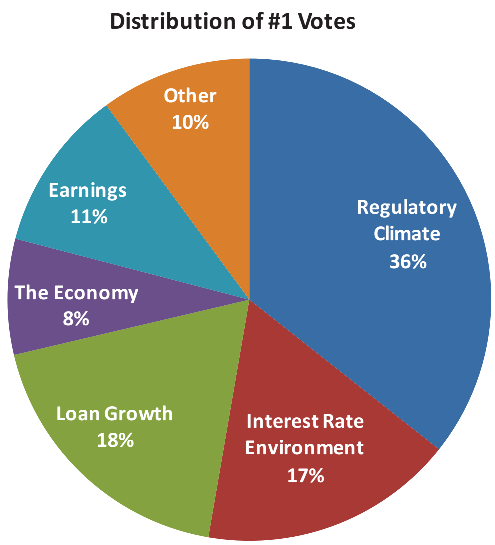
Trends over the last four years have been relatively stable. The top five challenges have consistently been Regulatory, Interest Rates, Loan Growth, the Economy and Earnings. Asset quality dropped out of the top five for the first time in four years, "Technology" has entered into the ranking. It is also interesting with all the discussions around Capital Adequacy, that for the first time in the history of the survey, Capital did not make the top ten list.



NOTEWORTHY #1 VOTE TRENDS

	2011	2012	2013	2014
Regulatory	45%	35%	23%	**36%**
Loan Growth	NA	17%	19%	**18%**
Interest Rates	NA	7%	11%	**17%**
Earnings	5%	8%	14%	**11%**
Economy	20%	15%	11%	**8%**
Other	NA	NA	NA	**10%**

When evaluating the percentage of #1 votes over the last four years, we found that the concerns over the Regulatory Climate reversed its downward trend and returned to 2012 levels, but not as high as 2011. Loan Growth has remained a significant challenge and most notably Interest Rate Environment has steadily increased as a challenge year-over-year.

TOP 10 CHALLENGES BY TITLE (POSITION)

TOP 10 CHALLENGES BY TITLE (POSITION), *continue*

	CEO / Pres.	CFO
Regulatory Climate	1	1
Interest Rate Environment	4	2
Loan Growth	5	3
The Economy	3	4
Earnings	2	5
Asset Quality	6	7
The Competition	8	10
Non-Interest Income	9	9
Deposit Growth	NA	6
Technology	7	NA
Capital	10	NA
Sales Effectiveness	NA	8

When reviewing top challenge differences between President/CEOs and CFOs, they both shared the top five challenges; however the ranking mix was different. They both viewed the Regulatory Climate as their top challenge, but differed on the others. The number two challenge for the Pres/CEOs was Earnings, while CFOs placed the Interest Rate Environment as number two (not surprising).

TOP 10 CHALLENGES BY ASSET SIZE

We also sorted the responses by bank asset size to get a better understanding of how size might influence challenges and priorities. The largest group of participants were banks with assets between

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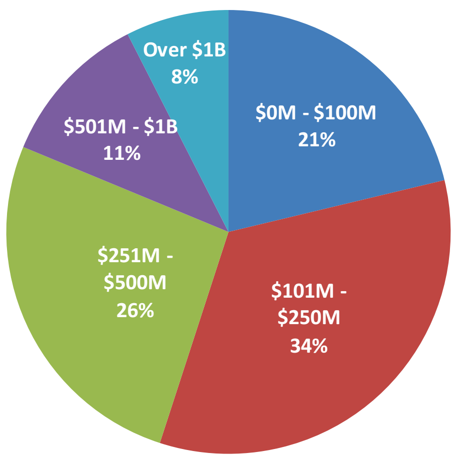
$101M - $250M, followed by $251M - $500M, and the third largest group was banks with assets under $100M.

Survey participants by Asset Size



	>$1B	$501M- $1B	S251M- $500M	$101M- $250M	$0M- $100M
Regulatory Climate	3	1	1	1	1
Interest Rate Environment	1	2	4	2	6
Loan Growth	4	6	2	3	3
Economy	2	3	3	5	4
Earnings	5	10	5	4	2
Asset Quality	NA	NA	7	7	5
Competition	NA	8	9	6	10
Non-Interest Income	NA	4	6	10	NA
Deposit Growth	NA	9	8	9	8
Technology	8	5	NA	NA	9
Capital	NA	NA	10	8	7
Operating Expenses	10	7	NA	NA	NA
Stock Value	6	NA	NA	NA	NA
Marketing Effectiveness	7	NA	NA	NA	NA
Other	9	NA	NA	NA	NA

Though there were no material differences among the respondents based on asset size, banks over $1B in assets rank the Regulatory Climate third on their list, with Interest Rate Environment as number one. Additionally, $1B plus banks were the only group to have "Stock Value" as a challenge on their top ten list. One additional observation we found of interest was that Earnings did not make the top five for banks with assets between $500M - $1B, it was ranked number ten.

OTHER KEY DEMOGRAPHICS

From a bank charter perspective the breakdown was as follows:

1. State Charted Banks: 71%
2. OCC Chartered Banks: 29%

TOP 10 CHALLENGES BY CHARTER TYPE

	STATE	OCC
Regulatory Climate	1	1
Interest Rate Environment	3	2
Loan Growth	2	5
The Economy	4	3
Earnings	5	4
Asset Quality	7	6
The Competition	6	9
Non-Interest Income	9	8
Deposit Growth	8	NA
Technology	NA	7
Capital	10	NA
Operating Expenses	NA	10

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This year's survey reflected no significant differences between State and OCC chartered banks. They shared the same top five, however with the exception of Regulatory Environment being rated number one, their ranking order was slightly different.

TOP 10 CHALLENGES C CORP VS. SUB S

Understanding that there may be operating differences between C Corp banks and Sub Chapter S banks, we also reviewed the data from a corporate structure perspective:

1. C Corp: 66%
2. Sub Chapter S: 30%
3. Other: 4%

	C CORP	SUB S
Regulatory Climate	1	1
Interest Rate Environment	2	4
Loan Growth	3	2
The Economy	4	3
Earnings	5	5
Asset Quality	6	8
The Competition	7	10
Non-Interest Income	9	6
Deposit Growth	8	NA
Technology	NA	7
Capital	10	NA
Quality of Management	NA	9

When reviewing the data, we found no material differences between C Corp and Sub Chapter S banks. Some minor differences included, Technology and Quality of Management made the top ten list for Sub Chapter S banks, while Capital made the list for C Corps.

SPECIFIC COMMENTS FROM THE SURVEY

The Regulatory Climate, Interest Rate Environment and Loan Growth where ranked higher than the remaining challenges. Reviewing over 370 additional survey comments provides further insight about the sentiment community bankers currently hold for dealing with specific challenges and their solutions supporting value creation. One interesting observation related to the comments, for the first time in four years, Mergers and Acquisitions were all but absent from comments addressing "go forward" solutions.

Comments Related to the Top Challenges

Here is a sampling of specific comments relating to the top challenges. These comments are a fair representation of the larger number of opinions received from respondents:

- "**Regulatory** Burden. Almost impossible for community banks to stay on top of all the **regulatory** changes. We have added staff (3 experienced compliance officers) and plan to really focus on training our staff. Unfortunately, the pace of new **regulations** has even left the examiners in a state of confusion.....nobody can keep up. A very uncomfortable environment to be in."
- "Increased **regulation** has resulted in significant time being spent by loan officers on paperwork, in addition to the staff increases required to train, execute and audit compliance procedures. This all takes away from revenue generating positions."
- "Compliance with new **regulations** is currently the biggest challenge."
- "Obviously QM is a burden and QRM for us in our servicing business. Flat in **interest rate** yield curve will bring down margins. Have seen some loan growth so raising core deposits are once again a challenge. On out **interest rate risk** as it relates to duration could get to be a significant issue if not contained and matched."
- "Our biggest challenge is **interest rate risk**. With a portfolio stacked with step-ups it's hard to find a win/win. If rates move too high we could have long term low rates in the portfolio as these bonds do not get called."
- "The push for **earnings** and **loan growth** to counteract **shrinking margins** and ballooning **regulatory** costs will tempt some banks to lose focus on the fact that we are in an **interest rate environment** that virtually none of us have seen. Wrong steps in managing **interest rate risk** have the potential to compromise our future. Also, **IRR** can increase risk on the loan side and increase the risk of default if the possibility of rising rates is not incorporated into credit analysis and loan structure."

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- "Loan growth: lack of quality loans and poaching by competitors."
- "Our biggest challenge is finding high quality **Loans**. Also related is the pricing on **loans** from competition."
- "**Interest rates** and lack of **loan growth**, along with decline in **non-interest income** from mortgage refinancing activity will impact **earnings**."

Real or perceived, these comments reflect the challenges that many community bankers are facing every day. How they respond will likely be reflected in earnings and growth trends or with innovative solutions when addressing increased regulatory requirements.

Overcoming These Challenges

The following comments reflect a sample of the specific actions that many community bankers are taking to addressing current challenges and building franchise value:

- "Conduct **thorough research** of all new regulations and **develop plans for implementation**. Utilizing all **compliance resources** available."
- "**Niche lending** in **construction**, **jumbo residential ARM** and primarily by running higher loan volume to **offset the margin decline**."
- "**Hire staff** and get **processes in place** to please **regulators** then get back to **making money**."
- "Effectively manage our balance sheet as it relates to **maturing of loans and deposits**. **Increase variable rate loans**, lock in longer term **deposits during low rate environment**."
- "**Hire** additional loan officers, **streamline processes** and **increase marketing** efforts."
- "We're going to manage the growth of the bank through select **asset sales** and **participations**. By **keeping servicing** we hope to increase overall profitability. **Capital** will be raised in **small increments** and through retention of earnings."
- "More **staffing**, **training** and **outsourcing**."
- "**Acquisition** of another **bank** or **lending team** from a competitor."
- "Keep looking for the **right deal**."
- "**Drive growth** via **additional hires**, **new business lines** and **change in pricing** strategy."
- "**Multi-pronged approach** toward retail accounts via **reward checking** programs (including enhanced website and **online** account opening and **national marketing**), **attorney trust** accounts via attorney relationships, better penetration of existing business customers' owners and managers' personal accounts (into above-mentioned rewards checking accounts), leverage **non-profit relationships** for deposit accounts, other not yet identified."
- "Slowing deposit growth and expanding loan portfolio growth through the continued development of relationships."

Top Priorities for 2014

The comments related top priorities, though similar to overcoming the challenges, were framed more from a perspective of strategic performance and value creation.

- "Hit **loan growth** planned targets. Add **derivative capabilities** to aid in pricing competitiveness. Constant attention paid to front line pricing, with willingness to give up business if it doesn't **meet our profitability standards**."
- "Top priority is to maintain the **strong trajectory** of the bank while controlling the on-balance sheet growth rate. **Marketing** arms of the bank are still on **full throttle** while the back office is seeking channels and **developing systems** to sell and service loans."
- "**Reducing** Interest Rate Risk exposure and quality loan growth. We will be looking for opportunities to reduce the Investment portfolio's average life, duration and EVE ratios. Additionally, we will be targeting the **agricultural sector** for more **operating, equipment and real estate loans** in addition to C & I operating and equipment loans."
- "**Grow** net income for the **5th consecutive year** with increased net interest income and expanding mortgage production."
- "Creating and celebrating a **shared vision!** We are taking steps to "marry" the **marketing message** with actual product functionality, the outreach program, and **corporate goals**."
- "**Growth**- potential **acquisitions**, organic deposit and loan growth, 3rd party marketing partnership, **redeployment** of human resources to support growth initiative in key markets."

Optimistic Comments

On the other hand, the survey was not just a vehicle to express challenges or obstacles, the participants were asked to comment on "what they are optimistic about in 2014." Here are a few samples of positive sentiments from community bankers:

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- "I believe there are **loans to be had** and that the **economy is slowly improving**. I have a good team getting them to think about who is a potential customer no matter where they are, grocery store, church etc. This will be a **different kind of focus** for us but I believe we are ready for it...."
- **"Economy** appears to be **improving** slightly. The November elections should give the republicans a shot of controlling the Senate. Maybe then we can get **CFPB a little better under control**. Hopefully we can get our fiscal house in order so the country can achieve to the level it is capable of when the government gets out of the way."
- "Fortunately we have a **strong economy** and a **good working relationship** with our **regulators**."
- "**Earnings** should remain **strong** as pressure for lower rates from loan customers has shrunk. Existing commercial customers are **borrowing more** for business expansion and for replacement of obsolete equipment."
- "**Positive loan growth** and **increased** net operating **earnings**."
- "In spite of government interference and regulatory over-reach, small **business people want to succeed and will**."
- **"Change** in Gov't control to a more **business friendly party."**

CLOSING OBSERVATIONS

Though the ranking order has changed somewhat over the last four years, there has not been a significant shift in bankers' perspective of their top challenges. External forces (regulators, interest rates and the economy) were viewed as the top obstacles to creating value in the recent past. However, challenges that are more fundamental to the business like loan growth and earnings continue to garner the greatest focus. When reviewing comments related to overcoming these challenges, the majority of responses focus on those things that can be controlled versus expecting change in the uncontrollable areas.

It will be interesting to observe if improving core fundamentals and a slightly improved economy will shift the level of community banker optimism. Though consolidation trends have been part of the community bank landscape for over 20 years, this year's responses seem to indicate a commitment to remain independent and to play a significant role in their communities.