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The 2008 Survey of Community Banks in the Tenth Federal Reserve District

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INTRODUCTION

The Federal Reserve Bank of Kansas City last surveyed Tenth District community banks in 2004. At that time, banking conditions were very good, earnings were strong, asset problems few, and loan loss reserves and capital high. Interest rates were on the rise, coming off a nearly 55-year low. Survey banks were generally positive as they looked to the future.

Fast forward four years to the 2008 Survey of Community Banks, and expectations for the future are very different. After many years of favorable business conditions, banks are facing poor real estate markets—an area of concentration for many community banks—and greater competition on all fronts. Also, in the intervening years the banking environment has become less positive. At the time the survey was conducted in February 2008, asset problems were surfacing, charge-offs mounting, loan loss reserves falling, and earnings declining. Within this context, the 2008 Survey of Community Banks asked bankers about the challenges they see ahead and how their business strategies will address these challenges.

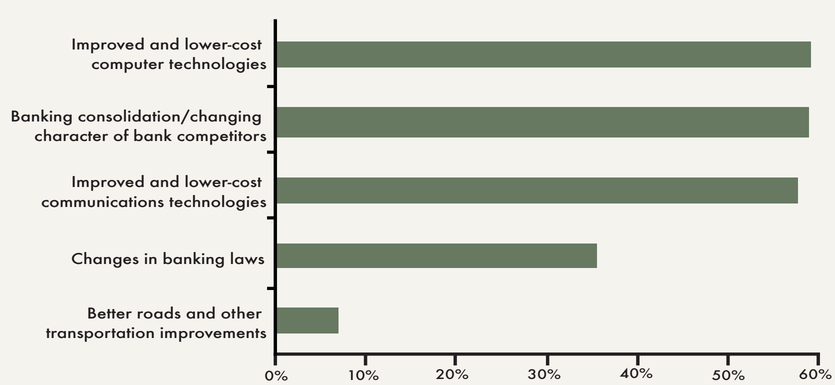
This article summarizes what bankers told us. The body of the article summarizes survey information, focusing on community banks, the challenges and competition they face, and their prospects. The Box (page 4) summarizes and reviews basic characteristics of the community banks that completed the survey.

COMPETITIVE ENVIRONMENT

Community banks face competition from many sources. In part, this competition is the result of changes to regulations that previously limited bank branching or the activities of other competitors, like thrifts and credit unions, or nonbanks, including government-sponsored enterprises (GSEs), such as Farm Credit Associations. Consolidation in the financial services industry has introduced added competition from larger financial institutions, while bank branching has reduced the distance between banks and potential customers.

Another factor that is increasing competition is continued technological innovation. As a result of services like online banking and remote deposit capture, consumers and businesses have access to a greater number of financial services providers for both loans and deposits. In fact, 90 percent of survey respondents said they experience greater competition from more distant competitors compared to ten years ago. Contributing to this increased competition is improved and lower-cost computer technologies (59 percent), and improved and lower-cost communications technologies (57.7 percent) (See Chart 1). Another strong factor is consolidation in the banking industry and the related change in the character of banks' competitors (58.7 percent). Fewer respondents attributed the increase in competition to changes in banking laws (35.4 percent).

Chart 1: What Factors are Contributing to Greater Competition?



Source: 2008 Survey of Community Banks in the Tenth District

Deposit Competition

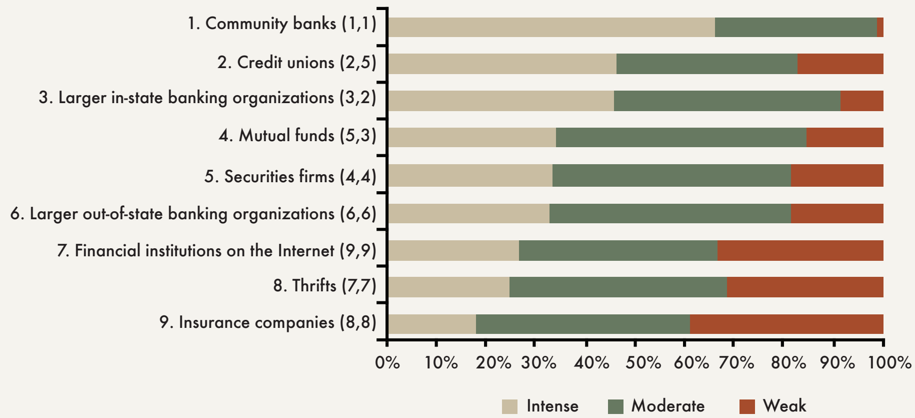
Although trends in the financial service industry wax and wane, consumer and business deposits remain a vital source of funding for community banks. Again in 2008, surveyed bankers said they expected other community bankers to be intense competitors for deposits over the next five years. Community banks have consistently ranked in first place among deposit competitors in the previous two surveys as well (Chart 2). Other significant deposit competitors are expected to include larger in-state banking organizations (40 percent), credit unions (46 percent), and securities firms and mutual funds (33.9 and 33.3 percent, respectively).

As noted earlier, technological innovations have increased consumers' choices of depository institutions. Several Internet-only banks were established during the tech boom of the 1990s and attempted to develop a retail banking customer base without brick-and-mortar branch networks. Many of these banks subsequently failed. However, some brick-and-mortar banks have successfully used the Internet to attract deposits. Notably, ING and Citibank have aggressively pursued deposits by offering favorable rates of return.[1] This trend may have caused community banks to alter their opinion of deposit competitors that are using the Internet. The 2008 survey shows that a larger percentage of community banks expect Internet financial institutions to be intense competitors for deposits in the future—moving these competitors to seventh place from last place on the 2004 and 2001 surveys.

Loan Competition

The competitive environment for loans is expected to include many of the same competitors as for deposits. In 2004 and 2001, survey respondents said they expected other community banks to be the most significant sources of competition for loans (Chart 3). According to the 2008 survey, community banks continue to

Chart 2: Expected Deposit Competition for 2008–2013



Note: Numbers in parentheses represent rankings in the 2004 and 2001 surveys, respectively.
Source: 2008, 2004, and 2001 Surveys of Community Banks in the Tenth Federal Reserve District

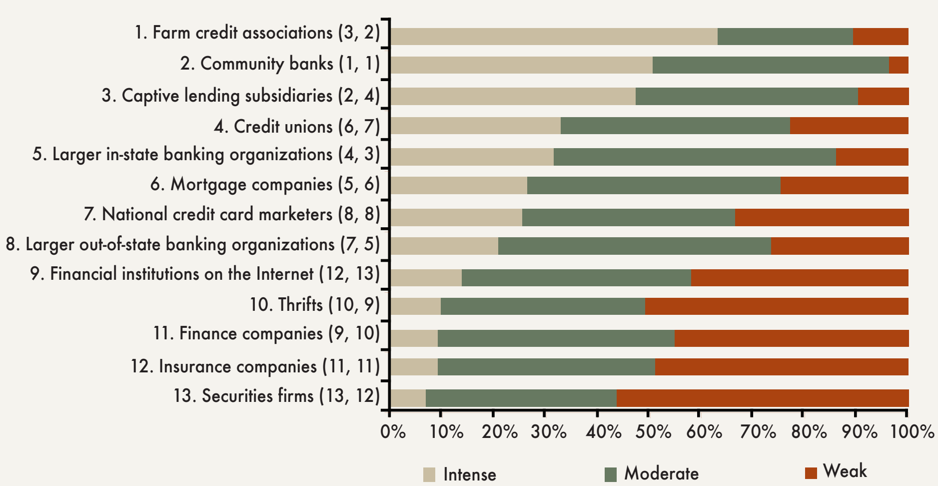
provide intense competition (51 percent). However, survey respondents showed greater concern regarding competition from Farm Credit Associations (63 percent).

The Tenth Federal Reserve District includes large rural areas that are dependent on agriculture as their primary economic activity; in fact, 64 percent of survey respondents indicated that the primary economic support of their community is agriculture. Many Tenth District banks are considered "ag" banks because the majority of their lending activity is related to agricultural lending. In the 2008 survey, competition from Farm Credit Associations for loans jumped to first place from third place in the 2004 survey. Bankers argue that as government-sponsored enterprises, Farm Credit Associations have a competitive advantage. One respondent noted, "Our largest problem is Farm Credit Services and their ability to loan money at below market rates."

Other competitors for loans included captive lending facilities such as John Deere Credit and GMAC. In past surveys, they have been viewed as strong competitors by community bankers and continue to be viewed as such in the current survey—placing third in the 2008 survey and second in the 2004 survey.

Credit unions are another competitor for loans to consumers and also increasingly to businesses. While credit unions have consistently ranked as intense competitors for deposits, they were fairly far down the list as significant competitors for loans. As noted in previous research from this Reserve Bank, credit unions are increasing the amount of business lending they conduct as a source of new income.[2] This may have led respondents to rank credit unions as stronger competitors for loans, moving them to fourth place from sixth place in the 2004 survey.

Chart 3: Expected Loan Competition for 2008–2013



Note: Numbers in parentheses represent rankings in the 2004 and 2001 surveys, respectively.
Source: 2008, 2004, and 2001 Survey of Community Banks in the Tenth Federal Reserve District

Small Business Lending

Community banks have traditionally been an important source of funding for entrepreneurial activity and small business lending. One reason for this was the opaque

THE SURVEY RESPONDENTS

The 2008 Survey of Community Banks in the Tenth Federal Reserve District was conducted from February 15, 2008, to March 30, 2008. Surveys were mailed to all commercial banks with assets less than $1 billion located in the Tenth Federal Reserve District.

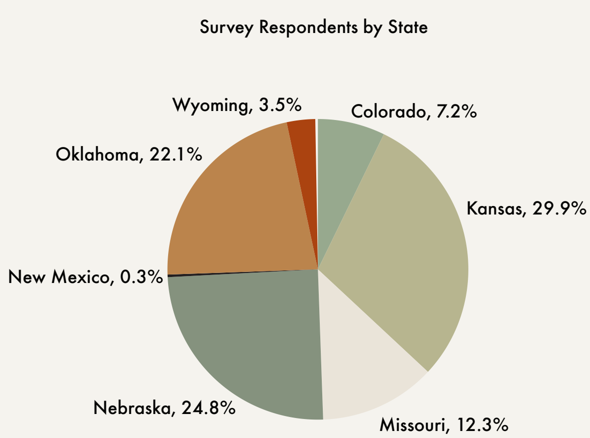
Of the 1,121 potential respondents, 401 banks completed the survey, resulting in a response rate of 35.8 percent. The characteristics of survey respondents are closely aligned with the characteristics of community banks located in the Tenth District, although the survey does not represent a random sample.[1] The survey instrument contained 63 questions. The questions focused on change confronting community banks, including market demographics and competitive challenges, operational issues and technological advances, and asked bankers for their thoughts on legal changes and their associated regulatory burden.

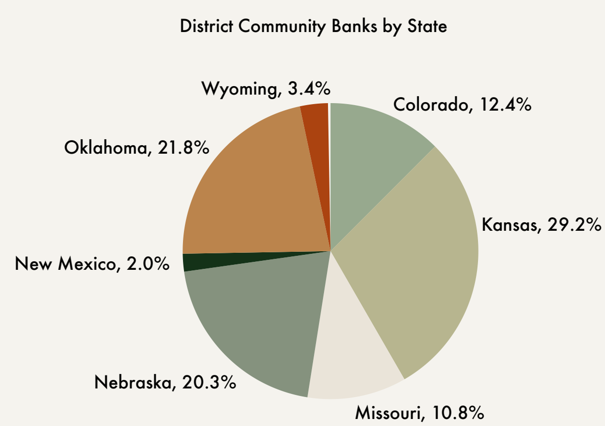
Survey questions were arranged into four broad topical areas:

1. General information about the bank
2. Prospects and challenges
3. Laws, regulations, and guidance
4. Staffing practices and governance

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, 77 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. By comparison, 71 percent of District banks with assets less than $1 billion are headquartered in these same states. Asset size, ownership structure, charter class, and parent company size roughly parallel that of the District. However, federal tax election was weighted more toward Subchapter S, and earnings performance was less than that of District community banks in general. In addition, respondents lean more toward multi-office operations than do District community banks as a whole (Table 1).

Demographically, the Tenth District is largely rural. It is populated mainly with small communities. Many of these communities have experienced population decline, some for a considerable period of time. Respondents reflect this demographic reality. A large majority of respondents (71 percent) are headquartered in cities located more than 30 miles from a metropolitan area (cities with a population of 100,000





or more). More than one-half of respondents are headquartered in cities with a population of 2,500 or less. A good number of these cities lost population (35 percent) or grew slowly, by less than two percent (23 percent) during the decade of the 1990s. Agriculture and agricultural-related activities provide the primary economic support for a substantial majority (64 percent) of them.

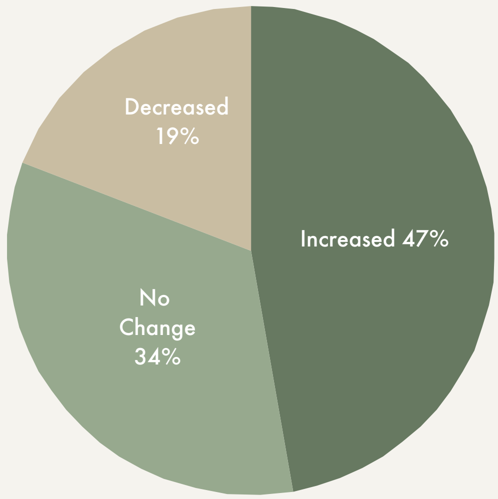
Not all topical areas or the questions included in the survey are discussed in this article. However, a **complete summary of survey answers** is available on the Federal Reserve Bank of Kansas City's website, **found here.**

Table: 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 (12/31/07)						
Less than $150 million	77.01			71.70		
$150-$300 million	12.83			13.98		
$300 million-$1 billion	10.16			14.32		
Chart class						
National	29.39			24.87		
State	70.61			75.13		
Bank ownership structure						
Independent bank	17.18			14.07		
One-bank holding company subsidiary	69.07			65.35		
Multibank holding company subsidiary	13.75			20.58		
Parent bank holding company asset size						
Less than $150 million	66.81			62.95		
$150-$300 million	18.49			16.30		
$300 million-$1 billion	11.34			11.58		
Greater than $1 billion	3.36			9.18		
Office structure						
Single-county	58.60			62.67		
Multi-county, single state	37.90			34.27		
Multi-state	3.49			3.06		
Federal tax filing status						
Subchapter S	55.17			47.83		
C-corporation	44.83			52.17		
Return on average assets (unweighted avg.)	Year	C-corp	S-corp	Year	C-corp	S-corp
	2007	0.80	1.19	2007	0.88	1.49

Source: Reports of Condition and Income and 2008 Community Bank Survey

Chart 4: Change in Small Business Lending Previous 5 Years

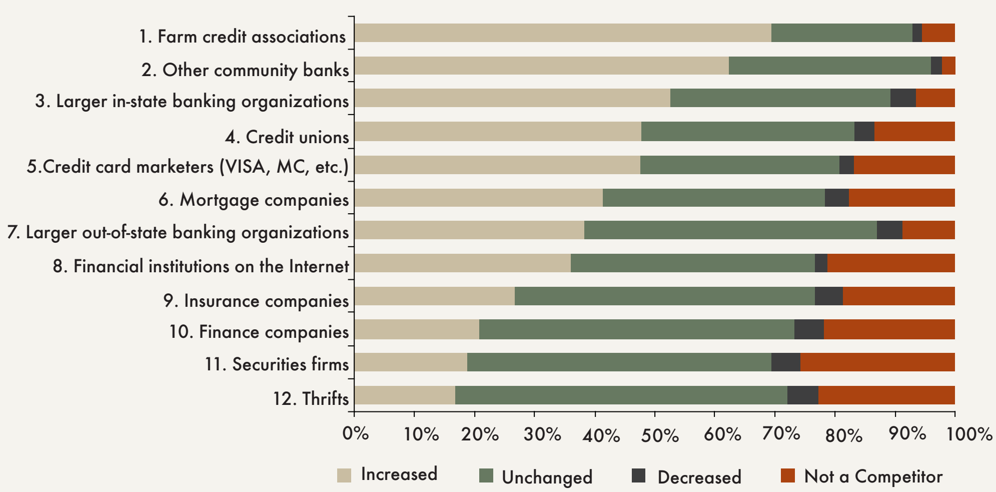


2008 Survey of Community Banks in the Tenth District

(continued from page 3)
nature of small business finances, which required close relationships with banks in order to gauge credit worthiness. Almost half of survey respondents said small business lending increased at their banks over the last five years, while 33.7 percent said their small business lending stayed the same. Among those banks that noted some change, the majority attributed increased small business lending to a change in the number of small businesses in the market. And, 47 percent believe a change in their bank's lending strategy was also a factor. Only 13.8 percent of respondents said changes in small business lending were associated with new lending technologies, such as online loan applications and the use of credit scores. More than half of respondents indicated that they are using credit scores when reviewing small business loan applications. Most use at least the consumer credit score of the business owner(s), and 28 percent have used a small business credit score, including owner and firm credit histories.

At first glance, the competitive landscape for small business loans appears to be similar to that for all lending (Compare Charts 3 and 5). Again, when asked to describe the nature of competition for small business loans over the last five years, respondents rated Farm Credit Associations as having increased small business lending competition more so than any other competitor. Competition from other community banks followed in second place. Among several differences, larger in-state banking organizations are ranked third in small business lending compared to fifth place for overall lending. Interestingly, national credit card marketers are also a more prominent competitor for small business lenders.

Chart 5: Change in Small Business Lending Competition During the Previous 5 Years



2008 Survey of Community Banks in the Tenth District

Revenue Enhancement Strategies

In the face of intense competition for loans and deposits from a wide variety of financial service providers, community banks are utilizing a number of strategies. These strategies include acquiring other banks or additional branches, seeking a buyer for the bank, or adding new prod-

Chart 6: Expected Ownership Changes, 2008-2013

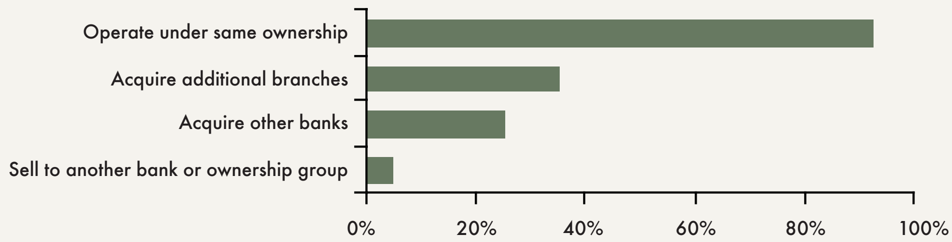
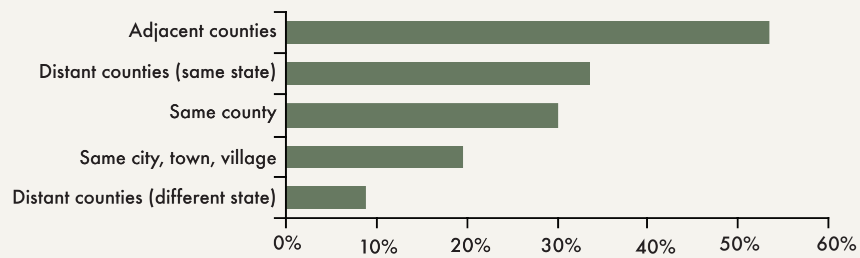


Chart 7: New Branch Office Locations



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ucts and services to maintain existing relationships and build customer base.

Overall, only 5 percent of respondents indicated that they plan to sell their bank to another ownership group or banking organization (Chart 6). A much larger number indicated that they plan to acquire other banks (25 percent) or acquire additional branches (35 percent) over the next five years. Of those planning to acquire or open branches, 53.4 percent said these offices will be located in adjacent counties (Chart 7).

Although opening or acquiring additional branches poses potential risk, banks may benefit from a larger footprint. Among several factors that may lead community banks to pursue such a strategy, increasing customer deposits was the most important reason. Sixty-three percent of respondents cited this as an inducement to establishing or buying branches. Taking advantage of growth opportunities in more vibrant markets was noted by 59 percent of respondents.

In addition to reaching new loan and deposit customers by branching, banks may also increase profitability and customer retention by offering new or improved products. Many of these products allow banks to increase their customer base without expanding their physical footprint. For example, online banking and electronic bill payment provide a convenient method for bank customers to access their accounts and pay bills without visiting a bank or writing checks. This also reduces banks' operating costs.

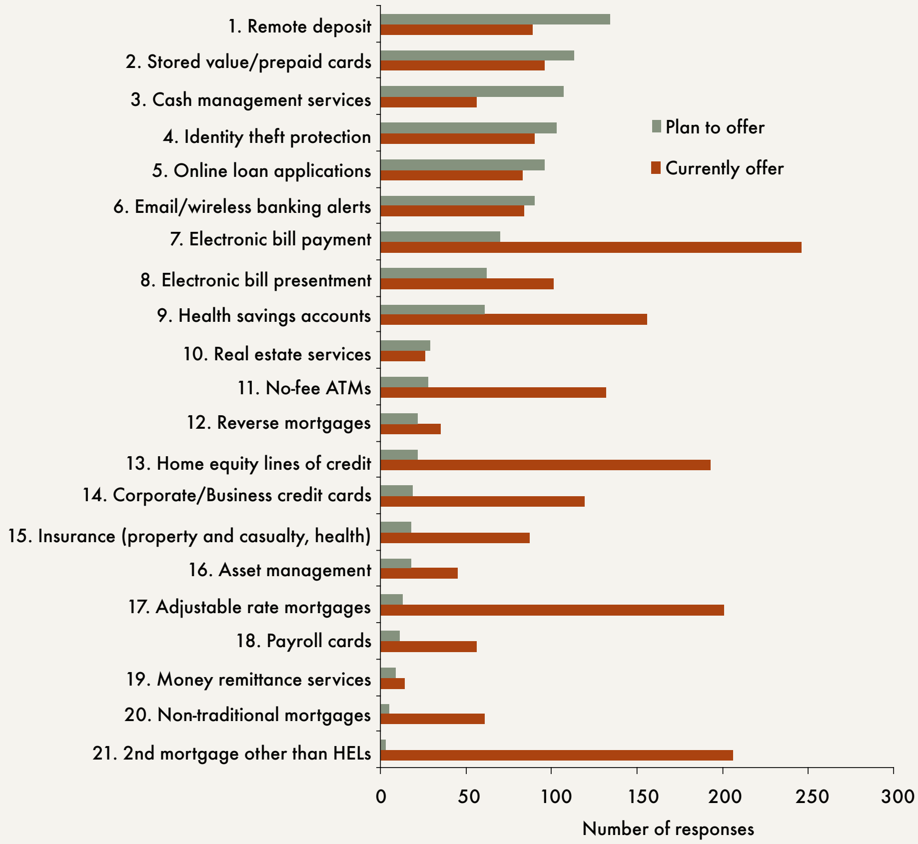
Electronic bill payment was one of the payment products offered by a predominant group of respondents and also a service many additional banks plan to offer within the next three years (Chart 8). Additional products and services that seemed to attract attention from bankers for future offerings included remote deposit, online loan applications, identity theft protection, and email/wireless banking alerts. Health savings accounts are offered by a substantial number of respondents (38.9 percent) and are also included in a good number of banks' future plans (15.2 percent). Many of these services allow banks to solidify customer relationships as well as potentially increasing non-interest income.

ECONOMIC CHALLENGES

Demographic

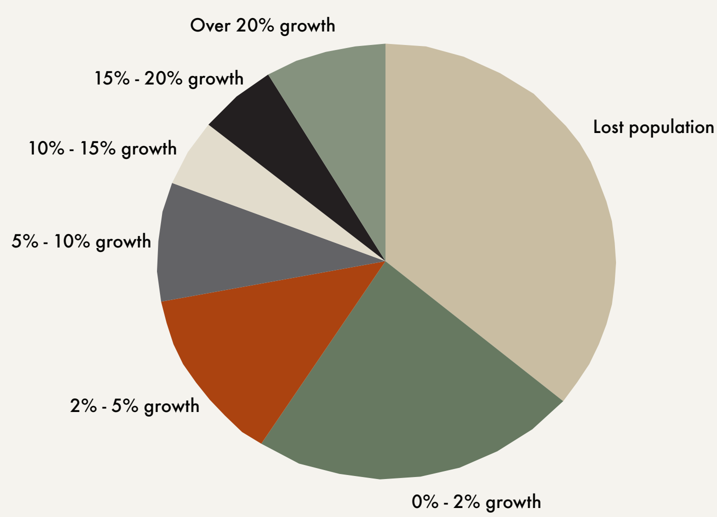
After years of favorable banking conditions, the economic environment in which Tenth District community banks compete for loans and deposits is now less positive. Many Tenth District banks are also challenged by longer-term demographic conditions associated with being located in rural areas that may be experiencing population decline. Half

Chart 8: Current and Planned Product Offerings



Source: 2008 Survey of Community Banks in the Tenth District

Chart 9: Population Change of Respondent Locations, 1990 to 2000



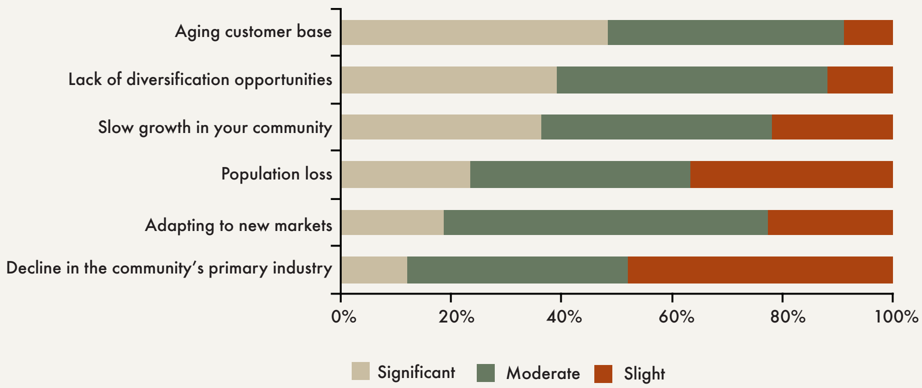
Source: 2008 Survey of Community Banks in the Tenth District

of the survey respondents' home offices are located in towns with fewer than 2500 residents. Also, a significant percentage of these communities experienced slow population growth or actually lost population during the decade between the 1990 and 2000 censuses. For example, 36 percent of survey respondents are located in towns that lost population, and 23 percent had population growth of less than 2 percent (Chart 9).

These factors are certainly reflected in how bankers reacted to challenges that lie ahead. Almost half anticipate an aging customer base as a significant challenge during the next five years (48.5 percent), while 36 percent expect slow growth in their community to be a significant challenge (Chart 10). The location of these institutions may also pose challenges as the banks are constrained in their ability to diversify, concentrating their lending mainly in a single industry. Indeed, 40 percent of respondents said lack of diversification opportunities will be a significant challenge in the future.

Despite a downturn in economic conditions generally, 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. Among seven performance factors, maintaining

Chart 10: Level of Future Demographic Challenges, 2008-2013



Source: 2008 Survey of Community Banks in the Tenth District

in consumer finance, credit card, and auto lending as a result of increased competition from large national competitors. In addition, banks are fighting for core deposits with competitors on the Internet. One response to lending competition is increased lending in commercial real estate, resulting in a concentration in these loans by some banks.

Recently, residential and commercial real estate markets have weakened, and loan delinquencies related to residential construction and land development loans are growing. Banks appear to be changing their lending strategies in response to these worsening economic conditions. The 2008 survey asked bankers how they changed their lending strategies with respect to residential mortgage lending and commercial real estate lending (Table 1). Almost half of bankers are giving greater consideration to the suitability between borrowers and the mortgage products they offer potential customers (44.6 percent). A smaller percentage of respondents (30 percent) reported offering new residential mortgage products, such as new types of adjustable rate mortgages and home equity loans, while 30 percent cited greater use of mortgage brokers or third parties.

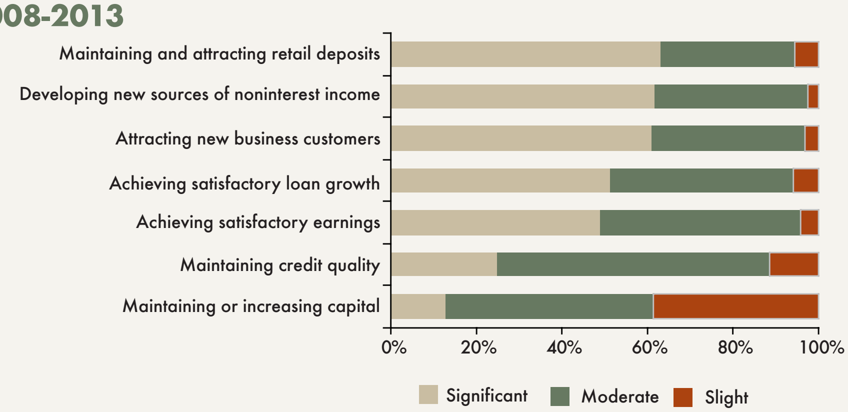
credit quality was a significant concern for only 25 percent of respondents—placing sixth among seven performance factors (Chart 11). And maintaining or increasing capital, a critical cushion during deteriorating banking conditions, came in last place. Only 13 percent of respondents expect this issue to be a significant challenge in the next five years. Community banks appear to show much greater concern about growing deposits, finding new noninterest income sources, attracting business customers, and achieving satisfactory loan growth.

Lending and Funding

The survey results point to changes in the types of lending and funding available to banks. For instance, community banks are far less active

For most community banks, residential mortgages are underwritten in a manner that allows them to securitize and sell the mortgage. In contrast, they often maintain a larger percentage of commercial loans on their books, such as commercial real estate loans. As economic conditions have deteriorated, bankers are focusing on their exposure to commer-

Chart 11: Level of Future Performance Challenges, 2008-2013



Source: 2008 Survey of Community Banks in the Tenth District

Table 1: Changes in Residential Mortgage Lending Practices

Greater consideration of 'suitability' between borrower and mortgage product	45%
Offering new products (reverse mortgages, new types of ARMs or home equity loans (HELs))	30%
Greater use of mortgage brokers /third parties	30%
Increased securitization	23%

Source: 2008 Survey of Community Banks in the Tenth District

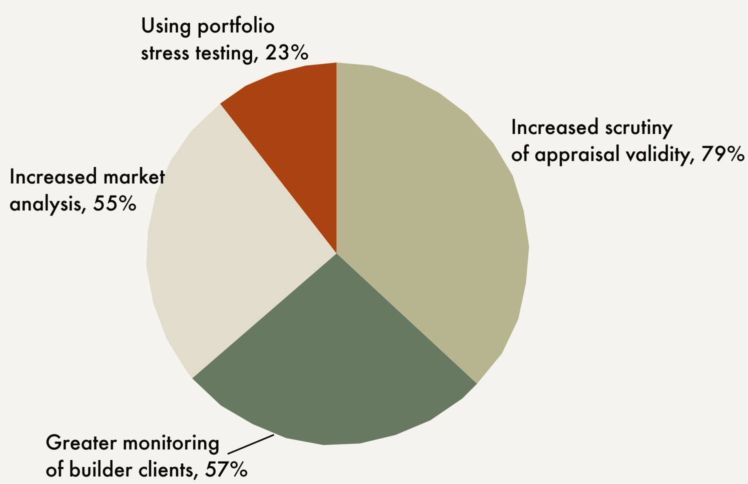
cial real estate (CRE). One way to ensure that the bank is protected in the event of CRE problems is to maintain adequate collateral. The reliability of appraisal information is critical in this regard. The majority of survey respondents have increased scrutiny of the validity of appraisals (79 percent–Chart 12). Many bankers are also increasing monitoring of their residential builder clients (57 percent) and increasing their analysis of market conditions (55 percent). Fewer respondents are utilizing stress testing tools on their portfolios of CRE loans.

Several of the economic factors (e.g., increased competition, technological innovations, etc.) discussed earlier are influencing banks' funding costs. As one respondent said, "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." In fact, most survey respondents noted an increase in the cost of deposit funding (82 percent) over the last two years (Chart 13). Funding costs are also affected when retail and commercial customers move deposits in order to achieve higher returns. Thirty-six percent of bankers indicated that their commercial customers had reduced checking account balances and increased their use of CD accounts (22 percent), sweep accounts and repurchase agreements (34 percent) during the prior two years. Retail customers have also moved balances from checking accounts to money market deposit accounts (46.2 percent).

Bankers have responded to funding pressures in varying ways (Chart 14). For example, some bankers are using Internet posting services or brokered deposits to obtain deposits (8 and 18.4 percent, respectively). A much larger percentage of bankers increased their use of Federal Home Loan Bank advances (46.5 percent). Banks also reported shortening the maturities of wholesale funding or CDs (19.7 percent).

Despite recent market events and changes in funding costs, most banks believe their level of liquidity risk is low (52 percent). However, banks have nonetheless been urged by regulators to have contingency funding plans in place in order to address funding and liquidity problems. One banker noted that their "holding company invested a significant amount of resources to address liquidity…stress tests have been placed and contingent sources of funding have been obtained and tested." Overall, 67 percent of banks surveyed have a formally documented contingency funding plan. Of those with contingency funding plans, almost half of their plans include estimates of funding that needs to be replaced in stress situations.

Chart 12: Changes in Commercial Real Estate Lending Practices



Source: 2008 Survey of Community Banks in the Tenth District

Chart 13: Factors Influencing Core Deposit Strategies

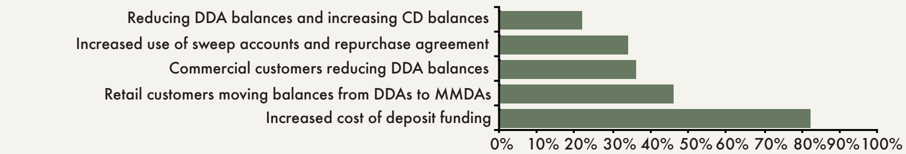
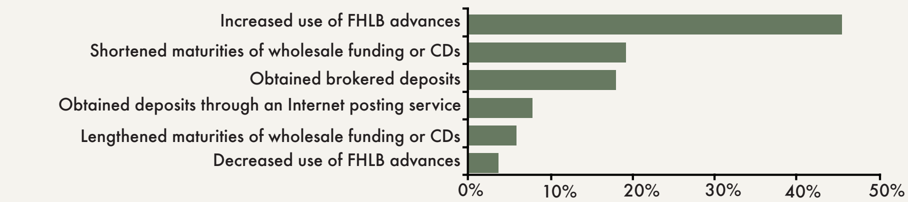


Chart 14: Bankers' Response to Market Changes for Funding



Source: 2008 Survey of Community Banks in the Tenth District

REGULATORY BURDEN

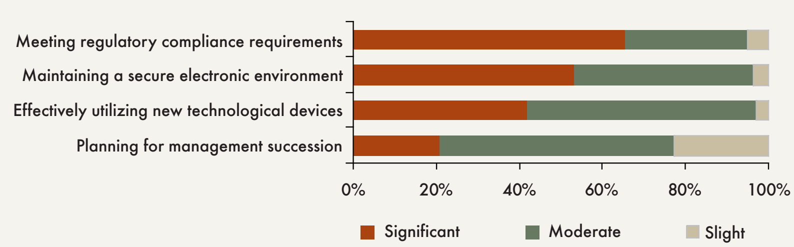
As noted earlier, the 2008 survey indicates that community banks are grappling with intense competition for loans and deposits and doing so in a worsening economic environment. At the same time, banks must comply with a number of safety and soundness and compliance regulations while some of their competitors operate without similar regulatory burdens.

The level of frustration among bankers regarding regulatory compliance requirements has increased substantially compared to prior surveys. This message comes across loud and clear in bankers' response to how they rate the level of future challenges they expect in the next five years. Among 17 factors, meeting regulatory compliance requirements was the No. 1 factor. In the 2004 and 2001 surveys, this factor was in seventh and eighth place respectively. Sixty-six percent of bankers classified regulatory compliance requirements as a significant future challenge (Chart 15) in the 2008 survey.

A number of factors may have played a role in the large jump in bankers' concerns regarding regulatory compliance. In recent years, Congress and regulatory agencies responded to national security and other issues by passing new legislation, regulations and guidance. These requirements include new or amended rules such as: changes to the Bank Secrecy Act and currency transaction reports (CTRs) meant to identify money laundering and terrorist financing; the USA Patriot Act rules and "Know Your Customer" requirements, which added new requirements for customer identification programs; and, the Gramm-Leach-Bliley Act provisions that require banks to implement formal information security programs as well as new rules on privacy notices.

More recently, regulators issued new authentication guidelines and rules promulgated by the Fair and Accurate Credit Transactions Act, which amended the Fair Credit Reporting Act to require financial institutions to develop identity theft prevention programs that identify customer behavior or transactions that may be related to identity theft and require them to respond to these so-called "red flags" to prevent identity theft. In addition, regulators amended the regulations that implement the Truth in Lending Act to require the verification of income and assets and place certain additional restrictions on "higher-priced" mortgage loans. Many of these new regulations

Chart 15: Level of Future Challenges, 2008-2013



Source: 2008 Survey of Community Banks in the Tenth District

require banks to conduct independent risk assessments specific to each issue. For example, banks are now required to conduct independent risk assessments when developing their information security program, BSA program, and ID Theft Red Flags program. In addition, these programs normally require approval by banks' boards of directors. Thus, the amount of time banks' boards spend on compliance matters has increased, according to 96 percent of respondents. Table 2 shows how survey respondents ranked the relative burden of various laws or regulations.

Table 2: Relative Burden of Selected Laws and Regulations

Rank	Law or Regulation
1	Bank Secrecy Act and Currency Transaction Reports (2)
2	USA PATRIOT Act and "Know your Customer" requirements (1)
3	Commercial Real Estate Concentration Guidance (-)
4	Home Mortgage Disclosure Act (HMDA) and Regulation C (5)
5	Community Reinvestment Act (CRA) (8)
6	Real Estate Settlement Procedures Act (RESPA) (-)
7	Truth in Lending Act (TILA) (4)
8	Information security/authentication guidelines (-)
9	Privacy notices (GLBA) (6)
10	Nontraditional Mortgage Product Risk Guidance (-)

Numbers in parentheses represent rankings in the 2004 survey.
Source: 2008 Survey of Community Banks in the Tenth District

What do bankers expect for the future? As noted earlier, more than 60 percent expect compliance to be a significant challenge in the next five years. And given that Congress and regulators are issuing new laws and regulations, this may be influencing bankers' expectations. As one banker observed, "we have no subprime paper, yet we expect to be burdened with additional onerous regulations governing mortgage lending to correct a problem we had no part in creating ... the existing mortgage lending regulations are almost incomprehensible. Unfortunately, we expect them to get worse."

STAFFING PRACTICES AND GOVERNANCE CHALLENGES

Staffing Practices

In order to remain competitive, banks must be able to hire and retain highly qualified officers and staff. This can be challenging as employee pools shrink in rural areas experiencing declining and aging populations. Even in more economically vibrant locations this can be difficult if the bank, because of low operating returns, cannot offer competitive pay and benefits. Because of this, we asked community bankers to look forward five years and comment on their ability to meet staffing needs in the future. Slightly more than 57 percent indicate they see problems hiring officers, and nearly 43 percent said hiring staff could be problematic (Table 3). Although a significant number see no hiring challenges, those seeing problems ahead are the highest we have seen in our surveys—especially when it comes to filling officer vacancies.

Table 3: Do you foresee problems meeting staffing needs during the next five years?

Survey year	Staff Positions	Officer Positions
2008	42.7%	57.4%
2004	9.6%	26.6%
2001	32.7%	22.4%

Source: 2001, 2004, 2008 Tenth District Community Bank Surveys

Despite being a look forward at filling personnel vacancies, the significant challenges seen by many may in part be reflective of banking and economic conditions at the time the surveys were taken. For example, bankers' concerns related to filling staff positions were higher in 2001, a recession year, and 2008, a period of bank performance challenges, compared to their responses in 2004. However, more secular forces may be at work as well.

Table 4: Respondents that See Challenges in Meeting Future Staffing Needs—by Bank Asset Size

	Assets less than $150 million (288)*	Assets $150-$300 million (48)	Assets over $300 million (38)
Non-official staff	40.21**	54.17	52.63
Official staff	53.87	64.58	76.31

* Number of respondents
** Percentage of "Yes" responses to total responses for asset size category

Source: 2008 Survey of Community Banks in the Tenth District

Table 5: Factors Making it Difficult to Meet Future Staffing Needs—by Bank Asset Size

Non-official staff			
Reason	LT $150 million	$150 to $300 million	GT $300 million
Qualified applicant unavailable	33.6*	31.3	42.1
Competing employment opportunities	25.2	37.5	50.0
Other	2.4	0.0	2.6
Official staff			
Reason	LT $150 million	$150 to $300 million	GT $300 million
Qualified applicant unavailable	47.2	52.1	52.6
Competing employment opportunities	15.8	20.8	39.5
Unable to offer career opportunities	14.8	4.2	10.5
Other	2.5	2.1	10.5

*Percent of observations by asset size
Source: 2008 Survey of Community Banks in the Tenth District

Table 6: Ranking of Staff Positions Expected to be Difficult to Fill—by Bank Asset Size

Assets LT $150 million	Assets $150-$300 million	Assets over $300 million
Teller (28.0)*	Teller (39.6)	Teller (42.1)
Loan Administration (24.8)	Loan Administration (31.3)	Customer service (36.8)
Customer service (19.6)	Customer service (31.3)	Auditing (31.6)
Accounting (16.0)	Loan review (27.1)	Loan administration (28.9)
Auditing (15.0)	Accounting (20.8)	Accounting (26.3)
Loan review (14.3)	Auditing (18.8)	Loan review (23.7)

*Percent of observations by asset size
Source: 2008 Survey of Community Banks in the Tenth District

With regards to these forces, it is tempting to think the large increase in concern pertaining to meeting future employee needs would be centered at smaller institutions. However, this is not case. Instead, it tends to be larger institutions that are more pessimistic about their ability to attract talented personnel in the future (Table 4).

A partial explanation for this may be that these institutions tend to experience faster growth than smaller institutions in rural areas, often resulting in greater hiring needs and increasing the challenge of finding qualified applicants to fill positions. Moreover, they are often located in larger, faster growing locations, where they may face greater competition for employees.

Looking forward at their staffing needs, we asked bankers to tell us the positions they see as the most difficult to fill. Regardless of size, they see filling teller positions as their biggest staffing challenge during the next five years (Table 6), possibly reflecting the higher turnover rate for tellers. Filling loan administration and customer service positions is also an important concern. While not as great a staffing challenge for smaller institutions, filling staff auditing slots is a concern for banks in the largest asset category. This undoubtedly reflects that large banks often have internal audit functions while smaller banks (especially the smallest asset category) do not, making audit staffing more of an issue for larger institutions. Also, the greater complexity of larger banks may make it harder to find qualified auditors to fill vacancies.

For official staff, bankers see filling lender (loan officer and senior lender) and compliance officer positions as their biggest challenges (Table 7). As was the case with staff positions, bank size affects the challenge seen in filling specific

Table 7: Rank of Official Staff Positions Expected to be Difficult to Fill–by Asset Size

Assets LT $150 million	Assets $150-$300 million	Assets over $300 million
Loan officer (33.5)	Loan officer (45.8)	Loan officer (60.5)
Chief lending officer (30.3)	Compliance officer (33.3)	Chief lending officer (42.1)
Compliance officer (28.2)	Chief lending officer (25.0)	Chief IT officer (36.8)
Cashier/ops officer (21.8)	Auditor (20.8)	Loan review officer (31.6)
Chief IT officer (19.4)	Chief IT officer (16.7)	Chief financial officer (26.3)
CEO (16.2)	Loan review officer (16.7)	Compliance officer (26.3)
Loan review officer (8.8)	CEO (10.4)	Auditor (18.4)
Auditor (8.5)	Cashier/ops officer (6.3)	Cashier/ops officer (15.8)
Chief financial officer (8.1)	Chief financial officer (4.2)	CEO (10.4)

Source: 2008 Survey of Community Banks in the Tenth District

official positions. Most notable are the positions of chief financial officer and compliance officer. In larger institutions, these positions may be held by separate individuals, while at smaller banks these responsibilities may by carried by a single individual such as the cashier. Therefore, smaller banks may not have these positions to fill. Interestingly, filling chief executive officer (CEO) positions is well down the list of difficult positions to fill for all bank asset size categories.

Overall, meeting staffing needs over the near term appears to be more of an issue for community banks than it has in the past. This is especially true for officer positions.

Governance

Strong boards—consisting of active, independent, well-qualified, and knowledgeable individuals—as well as adherence to good governance practices, are important ingredients in a bank's success. With this mind, our surveys ask community bankers about their ability to obtain directors to meet future board membership needs. The surveys also include specific questions about their bank's governance. The 2008 survey is no exception.

Unlike many instances involving staffing, a strong majority (70 percent) of community bankers do not anticipate difficulty filling director positions during the next five years (Table 8). However, it is important to note that an increasing percentage of bankers are finding director recruitment more problematic; the percentage of bankers expecting greater problems meeting their director needs increased by more than 60 percent from the 2001 survey.[3]

Director liability has always been an important concern when it comes to director recruitment, and it still is today. Two-thirds of community bankers indicate that director liability makes it difficult to get individuals to serve on their banks' boards (Table 9). However, in both the 2004 and 2008 surveys, finding individuals with the necessary business expertise, background, or skill set was even more problematic.

Table 8: Percentage of Respondents that Foresee Problems Recruiting Outside Directors During the Next Five Years

Survey year	Percent of Respondents
2008	30.3
2004	25.3
2001	18.3

Source: 2001, 2004, 2008 Tenth District Community Bank Surveys

Table 9: Factors that Make it Difficult to Recruit Directors

Reason	Percent of Respondents
Director liability	66.7
Work and time involved	35.0
Knowledgeable individuals with necessary expertise unavailable	69.2
Inadequate compensation	22.5

Source: 2001, 2004, 2008 Tenth District Community Bank Surveys

Stakeholders in corporations and others have long advocated certain governance practices to help promote shareholder rights and better operating performance. Governance scandals (e.g., Enron, Worldcom, Adelphia) and the passage of the Sarbanes-Oxley Act of 2002 provide added impetus for improved governance. Consequently, we ask community bankers about their boards (size, meeting

Table 10: Governance Practices of Community Banks

Characteristic	2001	2004	2008
Median board size	7.0	NA	7.0
Median no. of outside directors	3.0	3.0	3.0
Median no. of board meetings	NA	12.0	12.0
Median annual board retainer	$3,500	$3,600	$3,600
Board chairman and CEO position held by separately (% Yes)	NA	NA	57.7
Outside directors constitute a board majority	NA	42.2	46.1
Retainer paid regardless of meeting attendance (%Yes)	NA	42.6	46.5
Director performance assessment done (%Yes)	9.0	27.7	30.3
Board has adopted code of ethics for bank (% Yes)	NA	65.7	75.8
Mandatory retirement age for directors (% Yes)	NA	8.1	5.3
Retired officers of bank serve on board (% No)	NA	NA	68.4
Directors participated in training during year (% Yes)	NA	48.9	59.4
Bank has written management succession plan (% Yes)	29.7	36.8	41.6

Source: 2001, 2004, 2008 Tenth District Community Bank Surveys

frequency, director retainers, etc.) and their governance practices to see what inroads recommended practices have made into their banks.[4] With respect to the board specific matters, there is little change in size, meeting frequency, or retainer (Table 10). Regarding governance practices, community banks for the most part continue to move toward practices advocated by proponents of good governance.

SUMMARY

In summary, the 2008 Survey was taken in the beginning stages of an unfriendly economic environment. Against this backdrop, community bankers feel continuing competitive pressure on their basic deposit and lending business as new and lower-cost technologies and changing laws lessened the influence of some competitors while amplifying the threat from others. Looking forward, community bankers see expanding the geographic footprint of their operations, adding new products, and building noninterest revenue sources as ways to address increased competition. In many ways these results are similar to findings from previous surveys. However, two things seem to set this survey apart from earlier surveys. The first is the intense concern over regulatory burden. The second is the difficulty seen meeting future staffing needs. With respect to the first, bankers—not just community bankers—have always expressed concern over regulatory burden, its dollar cost, the diversion of management attention from running the business, and the perceived advantage given to less-regulated competitors. In this survey, "meeting regulatory requirements," jumped from well down the list of future challenges to the No. 1 spot. Moreover, the bulk of written comments focused on regulatory burden. This may be a product of the times as suggested earlier in the discussion on burden or perhaps even the hardship associated with a less-positive economic environment. Regardless of cause, regulatory burden has risen to the top as an issue for community bankers as a future challenge.

Although regulatory burden has implications for community banks remaining effective competitors, the second concern, meeting future staffing needs, is more fundamental. As noted earlier, the ability to attract and retain highly qualified officers and staff is a key variable in being able to compete in the market place. In this regard, a much larger percentage of community banks see meeting their future staffing needs as a problem than in previous surveys. This is especially true of larger community banks that see difficulty in finding qualified candidates and being able to compete for those candidates.

Endnotes

[1]ING is a Dutch financial services company that owns ING Direct, the operating name of a federal savings bank that offers high interest savings and deposit accounts.

[2]Between 2004 and 2007, total credit union business lending increased by an annual compound rate of 23.4 percent. For more information on credit union growth see: Robbins, Eric, "Credit Union Growth in the Tenth Federal Reserve District: How Legal and Regulatory Changes Have Affected Credit Union Expansion," *Financial Industry Perspectives*, July 2005.

[3]The limited number of responses makes size break-out comparison not meaningful.

[4]A discussion of recommended governance practices and the basis for them can be found at "Corporate Governance Practices: Where do Tenth District Banks Stand?" *Financial Industry Perspectives*, Federal Reserve Bank of Kansas City, 2004. http://www.kansascityfed.org/banking/bankingpublications/prs04-5.pdf