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A matter of momentum

2016 Regional and Community Banking Industry Outlook Survey

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Contents

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John Depman is KPMG LLP's (KPMG) national leader for Regional and Community Banking. With over 25 years of experience in the banking industry, John has extensive experience working with public companies in an audit and advisory capacity, and has assisted several clients to successfully complete debt offerings, initial public offerings, and mergers and acquisitions.

Message from the author

Optimism, tempered by caution

I am often asked about the future of regional and community banking. I answer that I think the future is strong. Middle-market and small business enterprises are the back bone of our great country, and regional and community banking is the engine that keeps that business going. There will always be a need for regional and community banking in our country; however, we may not need all 6,200 Federal Deposit Insurance Corporation institutions we currently have now. Indeed, Canada, Mexico, and Japan seem to get by with vastly fewer banks. Japan, for example, has 6 national institutions, while the other two countries don't have many more. According to the results of our survey, only 8 percent of respondents believe a bank smaller than $1 billion in assets can survive. That size may vary depending on geography, but almost 5,400 of today's banks fall below that asset size. In fact, there are still about 1,700 banks below $100 million in assets. Fully 47 percent of our respondents indicated that their regulatory compliance costs represent between 11 and 20 percent of their total operating costs. The need to absorb these costs over a larger asset base is undoubtedly a driving factor in the interest in mergers and acquisitions (M&A) that we have seen. Twenty-nine percent of respondents indicated they were somewhat likely to be involved in M&A in the next year as a seller, a significant increase from the previous year of 7 percent.

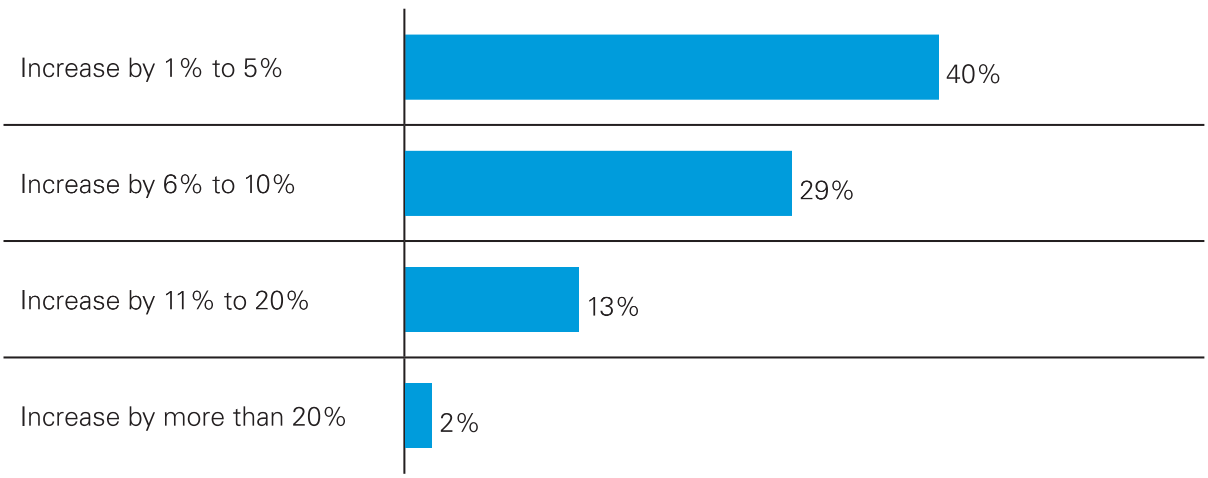
Another question I frequently get is regarding the future of the branch. Reports of the branch's death have been greatly exaggerated. While the number of branches has been declining in recent years, so has the number of banks, with the result that the average number of branches at each bank has increased. Our survey indicates the respondents are working hard at integrating technology and adapting staff to ensure the branch remains relevant and efficient. Regional and community banks have always used their branches and staff to develop strong relationships with their customers. Adapting them to the future will give them a leg up on fending off the Fintech companies and winning over the millennial generation.

Growth

A sizeable portion of regional and community bankers in our survey remain cautiously optimistic about maintaining moderate revenue and income growth in the next few years. Slightly more than 40 percent say they expect revenue growth of up to 5 percent in 2016, while almost 3 in 10 are even more optimistic, saying the growth rate will expand between 6 percent and 10 percent. A smaller portion (13 percent) even suggest a jump of 11 to 20 percent.

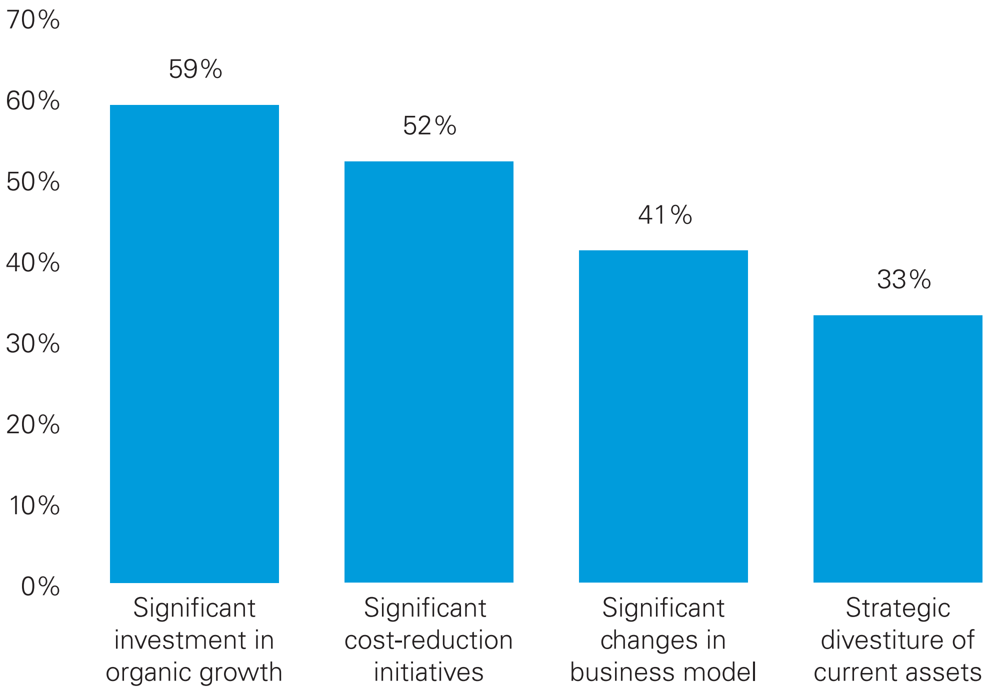
What are the reasons behind these expectations? For the most part, the banks we polled—those with assets of $1 billion to $20 billion—say they are upbeat about the headway they are making in transforming operations, making inroads with new customer segments, and in developing new products and services.

Revenue-growth expectations: 2016



Looking ahead, banks say they are on the path of change to sustain growth, even in the face of technological advances that are altering how people and businesses are banking. Most (59 percent) say their primary strategic initiative in 2016 is significant investment in organic growth—new product development, new pricing strategies, and geographic expansion. We were struck by the largest percentage identifying organic growth this year; in the previous year's survey, only 9 percent of respondents identified organic growth as an area for strategic focus. In our view, such a significant jump indicates that these banks are listening to their customers and responding to demands for products and services they want from their local bank. For many (41 percent), a top strategic initiative will result in making changes to their business models—the design of their operations, the focus of their revenue sources, and how they deliver the products and services their customers seek.

Strategic initiatives that will consume most of senior management's time and energy

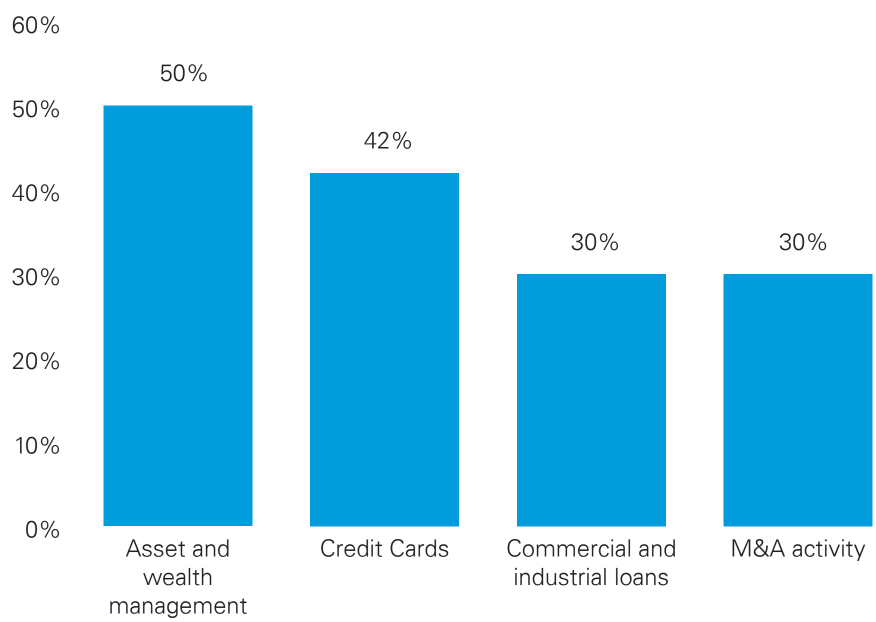


Key takeaways

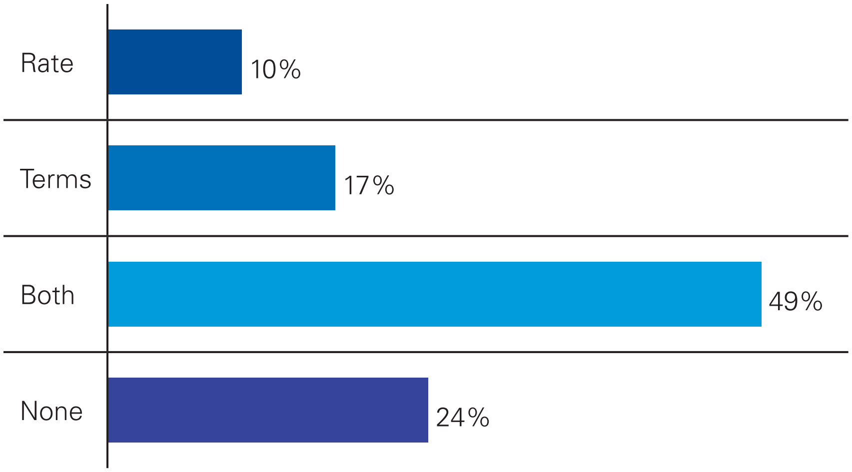
In pursuit of revenue and income growth management, banks will need to walk a fine line: be vigilant about the management of interest-rate risk as well as credit risk in lending. FDIC leadership recently expressed concern that some banks were skating too close to the edge of imprudent risk as they competed in making business and personal loans. In our survey we were surprised to learn that nearly half (49 percent) of the banks polled say they are relaxing *both rate and terms on commercial loans* in response to competitive pressures.

A large portion (50 percent) of respondents see strong drivers for revenue-growth potential in asset and wealth management, which is appealing to a broader spectrum of America including investors who run the gamut from the mass market to the coveted "high-net-worth" category. In addition to a reliance on their credit-card business, the respondents identify two other critical revenue drivers going forward: commercial and industrial (C&I) lending—an area of increasing competition among community banks—and mergers and acquisitions activity.

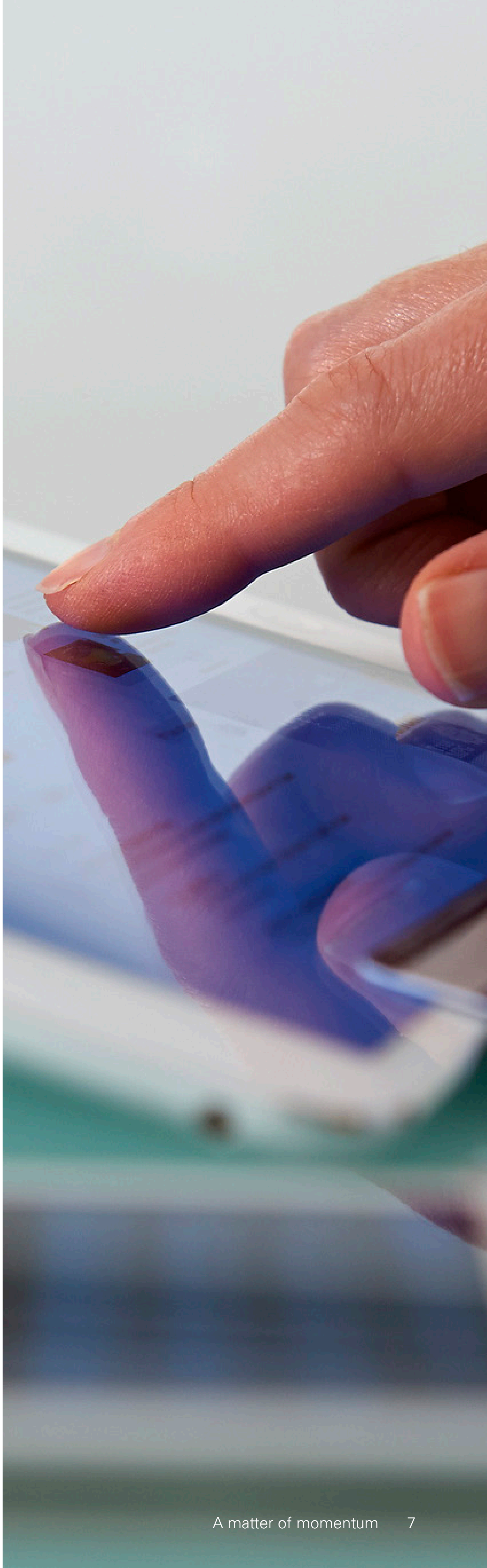
Biggest drivers of your company's revenue growth in the next 1–3 years?



Q. In response to increased competitive pressures, indicate which aspects of commercial loans you are relaxing.



We recognize banks must seize new opportunities, become innovators, and embrace transformative forces to remain relevant to customers who demand personal service, as well as mobile and online access. With banking in the midst of revolution, and the stakes being high, putting a premium on agility and bold actions is required, both for better user experiences and to hit growth targets.



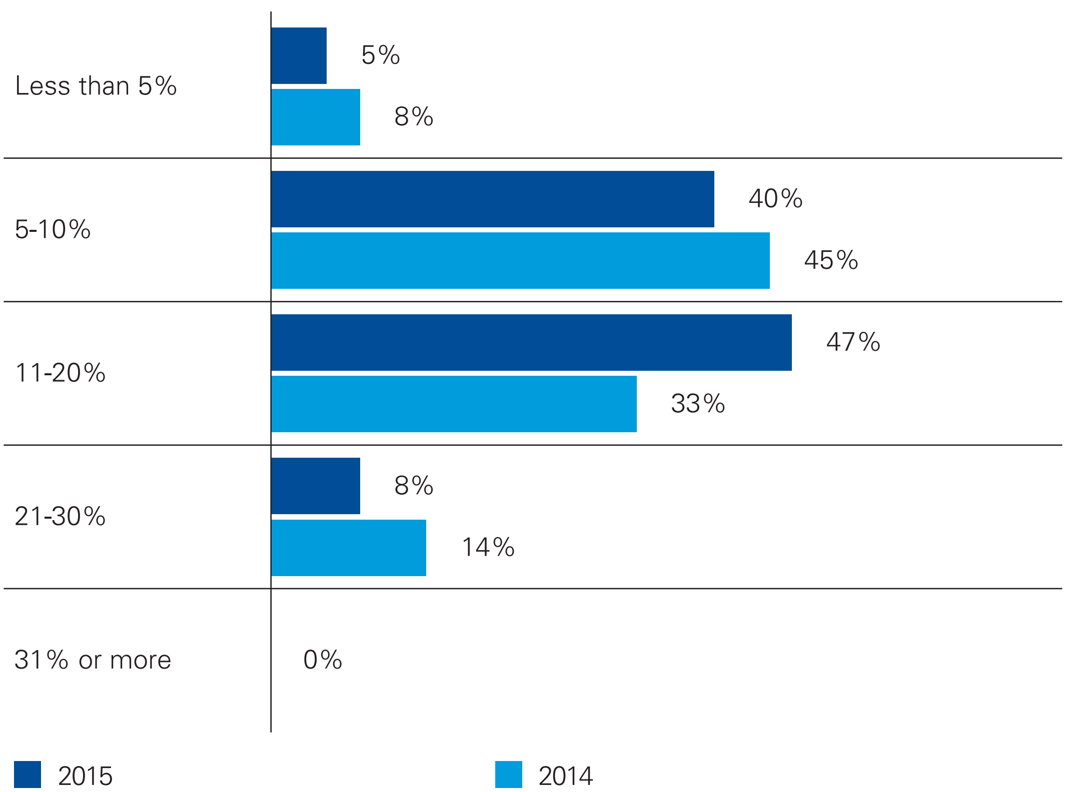
Regulatory compliance and costs

Early in 2016, the Dallas Reserve Bank warned of the negative impact that regulatory compliance costs were having on community banks, and suggested the need for adjustments to better match risk with the institution size. It may be a prudent action given the results we found in our survey.

There was a 14 percentage point jump from 33 percent in the preceding year's survey to 47 percent in this year's among respondents who said regulatory compliance requirements account for anywhere from 11 percent to 20 percent of their banks' total operating costs. The figure increases to 58 percent among banks with assets of between $10 billion and $20 billion, the largest of the segments of banks we polled in our regional and community bank survey.

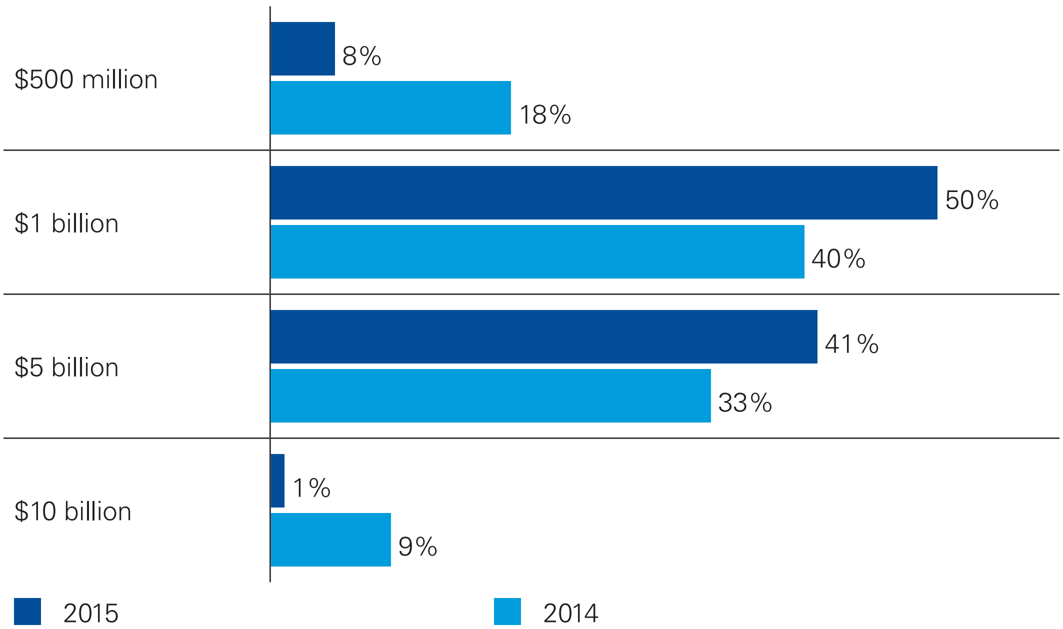
Operating Costs Driven By Regulatory Compliance Requirements

Q. Approximately what percentage of your total operating costs is driven by regulatory compliance requirements?



A key finding in the survey deals with the size a community bank needs in order to remain independent: a full 50 percent say community banks must hold assets of at least $1 billion, a jump of 10 percentage points from the previous year. Further, 41 percent say they believe the minimum is $5 billion, 8 points more than the previous year. And, it appears the cost of regulatory expenses is directly correlated.

Minimum asset level a community bank needs to remain independent



> *Regulatory compliance costs continue to create a drag on regional and community banks, and we do not expect that burden to ease up any time soon. In order to reduce these costs, we suggest banks reengineer compliance and reporting processes, using digital solutions.*
>
> **– John P. Depman**
> *National Leader for Regional and Community Banking, KPMG*

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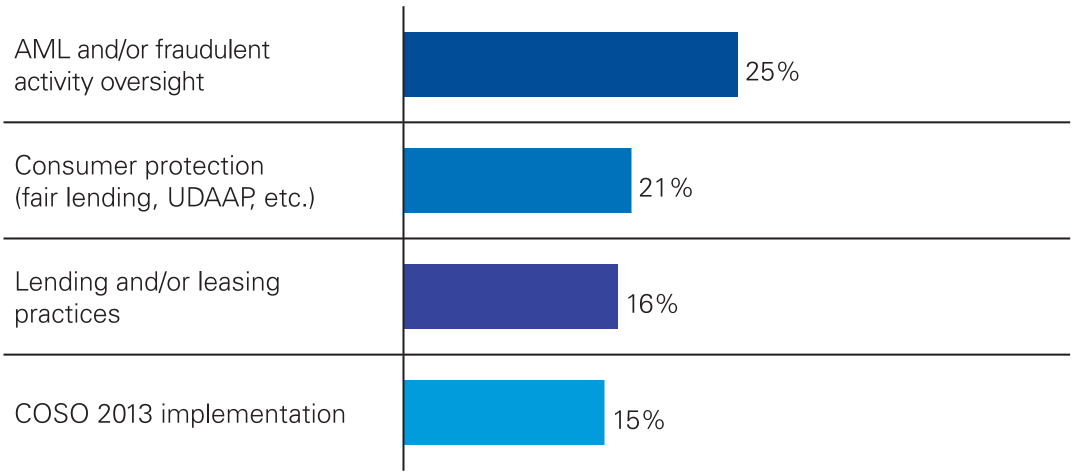
There is no single compliance area that is having a much larger impact than another area on operating costs. Instead, there is an array of regulatory requirements that push the overall cost of regulatory compliance higher, and raise the risk of noncompliance.

Compliance and reporting costs are most burdensome among the banks we polled in the areas of anti-money laundering (AML), consumer protection (fair-lending laws), lending and leasing practices, and the COSO 2013 implementation mandate.

When asked about where spending would be most significant in the next few years, the bankers in the survey said they expected regulatory compliance costs to be second in the rankings, behind spending on information technology upgrades and new products and services, which were tied for the top areas. A full 60 percent also say their primary challenge in meeting heightened regulatory expectations is enhancing their program to proactively deal with the pace of regulatory change and anticipating the focus of regulators and enforcement action.

Compliance areas having the most negative impact on operating costs



Further, bankers in the survey say the key components to help with compliance and risk prevention, detection, and response include: written policies and procedures that are accessible to all, the use of technology—particularly the power of data and analytics tools that are now available in the marketplace, and having the right people with the right skills driving the program.

Key components to drive compliance and risk prevention, detection

Key takeaways

In the more than five years since the Dodd-Frank consumer protection legislation was passed, many regional and community banks have struggled to boost top and bottom-line results because so much focus has been pulled away from developing new services and products, and instead, has been focused on compliance measures. As staff has been cut in some areas, banks have added compliance personnel. That one-two punch has hit these institutions hard.

Regional and community bankers that intend to remain relevant and avoid the limits placed on growth and profitability that go arm-in-arm with increased regulatory spending, must up their game on the digital level in regulatory compliance and risk mitigation matters. In addition to the digitization of daily tasks, we believe risk and compliance executives must play a larger role in building a bank's strategy, including which products and services to offer.

What's more, we believe compliance cannot solely be viewed as a "top-of-the-house" job. Instead, the job of reducing costs related to regulatory mandates must permeate the entire organization—and that message about risk management and compliance efforts must be unambiguously and frequently stated at the top of the house so that the entire organization understands its importance to the survival and profitability of the bank. To that end, we suggest banks:

- Empower compliance and risk executives while securing company-wide sponsorship for consideration of regulatory issues. The tone from the top should guide every single person in the organization to be conscious of risk management for both compliance and business purposes.
- Establish a system to track applicable regulations and gather data for compliance, and gain an understanding of how to turn regulations into a competitive advantage.
- Create governance, regulatory, and compliance (GRC) tools that use automated data feeds to update institution policies as regulations change.

Mergers and acquisitions

One of the most interesting shifts in attitudes between this year's survey and last year's relates to mergers and acquisitions (M&A). Many fewer executives this year say they would "very likely'' be a buyer than did last year. Instead, many more say they are "somewhat likely'' sellers than said so last year. Furthermore, this year only 11 percent said they had no plans for M&A activity, which is half the rate of last year, when 23 percent said they had no M&A plans.

So, why the shift in focus? Is it a signal of a wait-and-see attitude relating to volatile equity and credit markets as well as unsettled global economic conditions? Are banks concerned that buying a competitor would push their institution above a certain threshold, requiring much more regulatory compliance reporting work? At this point, the answers are elusive; only time will tell why the executives chose their answers.

Q. What is the likelihood that your bank will be involved in a merger/acquisition in the next year?

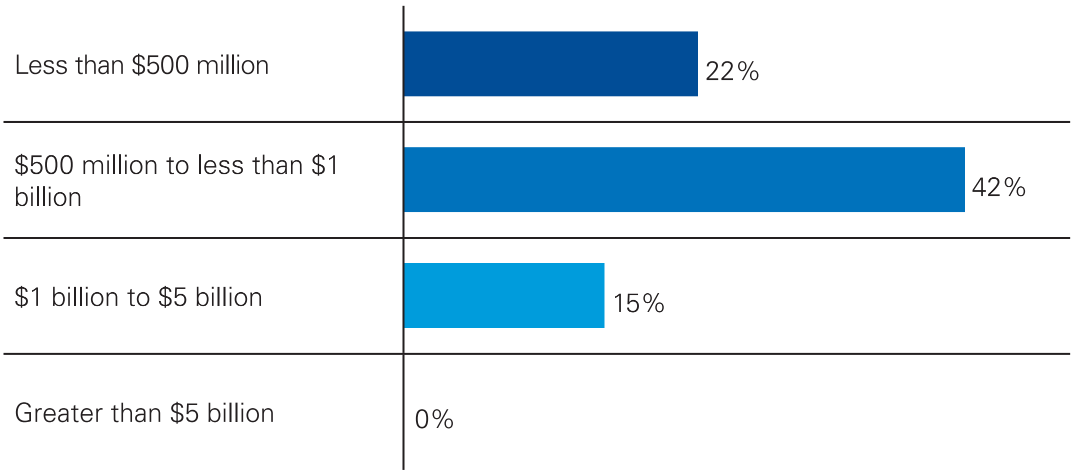
	2015	2014
Very likely – as a buyer	8%	23%
Somewhat likely – as a buyer	32%	26%
Very likely – as a seller	14%	14%
Somewhat likely – as a seller	29%	7%
No plans for M&A activity	11%	23%

For the 40 percent who say they either are a very likely or somewhat likely buyer, their criteria for doing the transactions seem clear: They are after a certain type of customer base that bolsters growth plans, they are focused on increased scale, and they see the purchases as a chance for cost savings.

For some time now, the total number of banks insured by the FDIC in the United States has been on a steady decline. Today, there are roughly 3,000 fewer banks in the United States than there were 10 years ago, and fewer than half the number of 20 years ago.

Nearly all of the decline in the past decade has been among the ranks of institutions with assets of less than $100 million. Among the segments where there has been an increase, there are 10 percent more banks today in the $1 billion to $10 billion range than 10 years ago. But, there are 10 percent fewer banks today with assets of $250 billion or more.

Q. If M&A is part of your growth strategy, what asset level bank would you target?

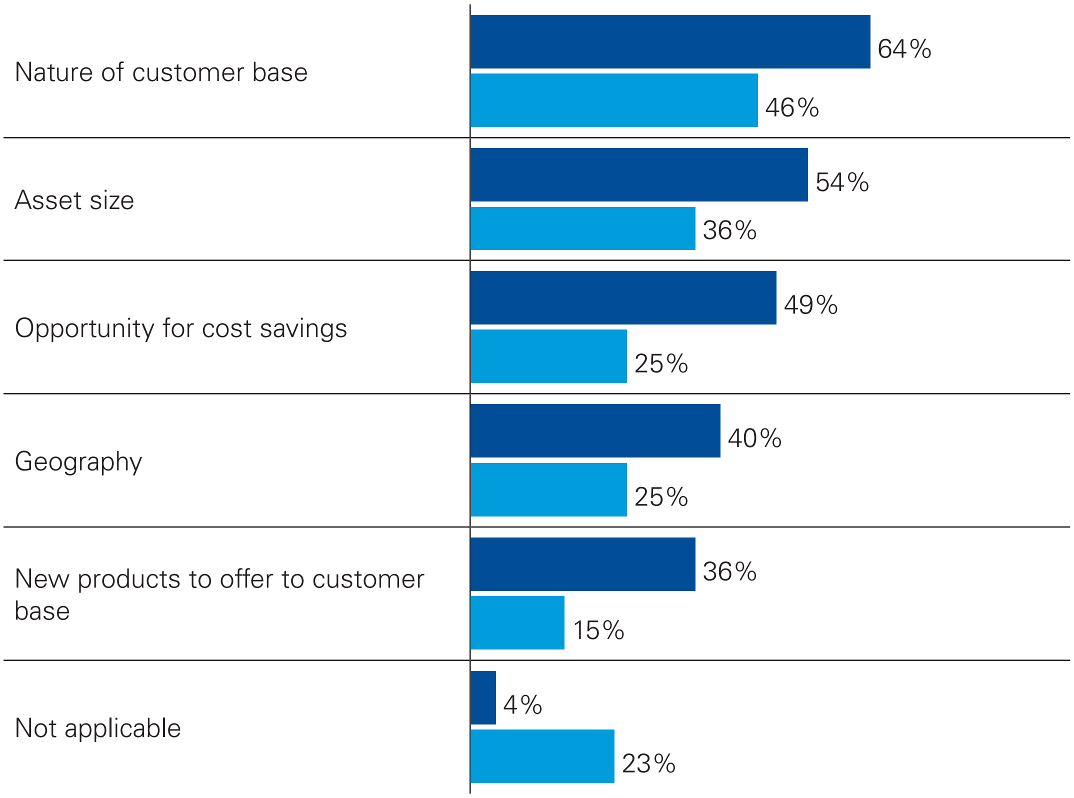


Although there is no way to be certain regarding the common motivations underlying the merger wave of the past two decades, it is probably safe to suggest that many buyers acted in order to cherry pick certain customers by choosing valuable locations. They might also have been interested in creating scale through more assets and personnel, and there is the possibility they wanted to leverage systems and processes for costs savings.

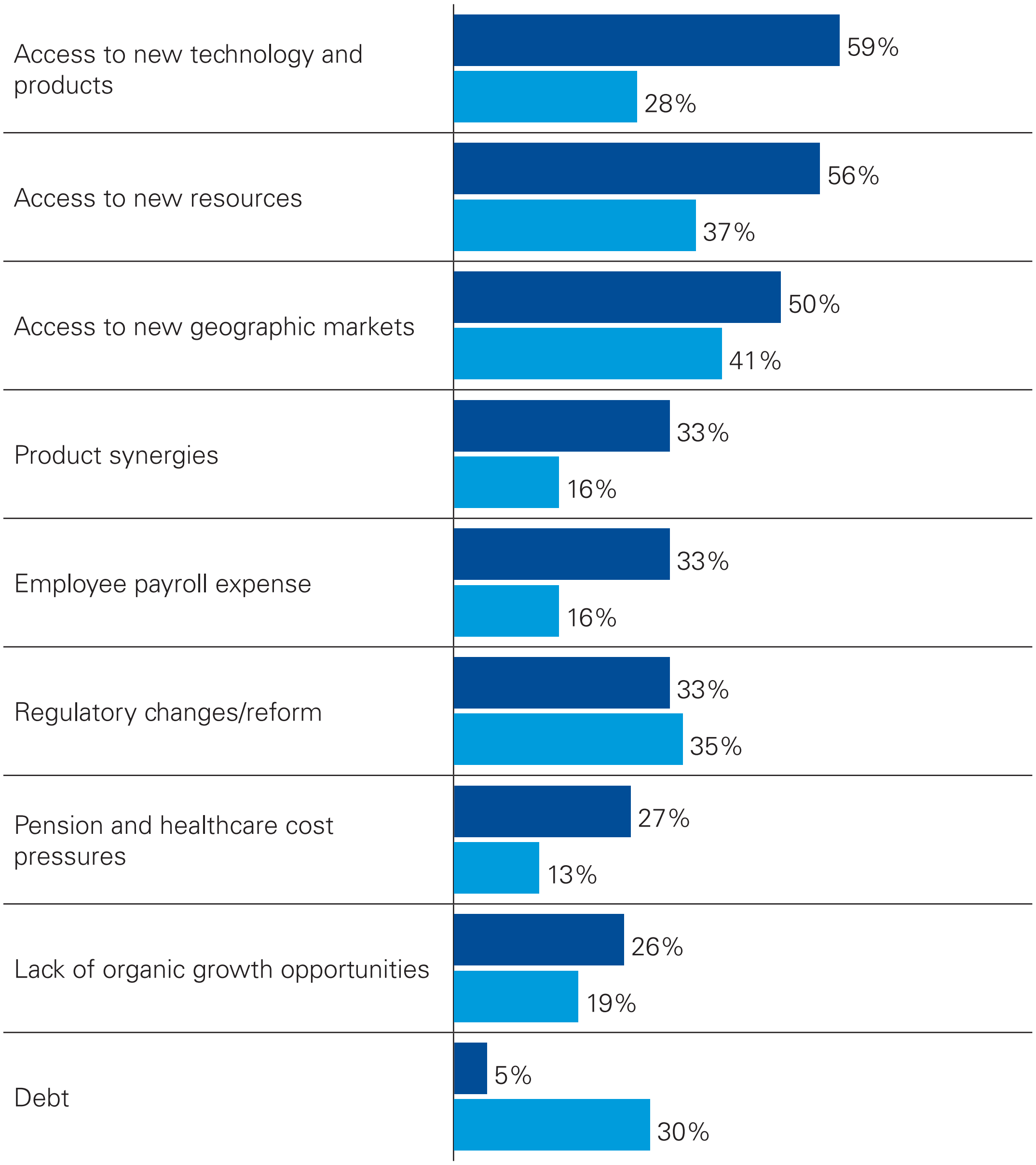
Some of the unanswered questions will center on an institution's capabilities and preparation to do a deal, whether the merger will be based on geography or on creating scale. Regardless of the intent, we expect more investors and regulators to ratchet up the pressure on buyers and sellers to get things right. However, if history has taught us anything in mergers and acquisitions, it is that they often are fickle undertakings, where many of them simply do not work out as planned.

Costly and sometimes fatal mistakes often are made right at the start in the planning, due diligence, and execution stages, just to name a few steps along the way. Those and other critical factors make it vital to issue a common reminder: Stick to the basics.

Q. Among the banks planning an M&A transaction in the next year, what criteria will be used to select a target?



Q. Which of the following do you think will be among the most important drivers of alliances, mergers, and acquisitions in the industry?



Key takeaways

Answering fundamental questions can help form a foundation for success. Buyers should ask whether the deal fits their bank's business model, culturally and strategically. We believe there needs to be a recognition that bank executives sometimes get so wrapped up in trying to make the deal, that they lose sight of whether it makes sense. ***There will be times when participants might not get the best price****, but when considerations are made about the other matters—long-term strategic objectives, the people you will acquire, the level of technological sophistication, the seller's culture of connecting with customers—the deal could be a very good one.*

Questions that should be considered are as follows:

Does the deal put me in a better place tomorrow than I am today? Does this make sense as it relates to our strategy?

What is the quality of earnings? *The balance sheet remains a prime area for deep review. When the issue of quality of earnings is raised, it is prudent to investigate whether there has been a flurry of reserve releases. Have costs been squeezed down so much that from an operational perspective there are some key processes that are untenable for a long-term period? Has the bank gone too far out on the rate curve in seeking yield on the bond portfolio?*

What is the current asset/liability management profile of the bank? *It would be useful to discover whether the target bank has been focused too much on short-term products. Another question: After rates rise, will the customers who are happy to be in a transaction product today (because they are not making much on CDs or money markets) walk out the door if another bank has a better product?*

Is the target bank up-to-date on their regulatory compliance efforts? *Beyond the numbers, there should be ample evidence that the target's regulatory profile is rock solid. Is there clear evidence that the bank has had professional assistance in determining any liability relating to anti-money-laundering or Bank Secrecy Act issues? If it has not engaged professional assistance, ask the board and management if they are comfortable that the proper level of diligence has been done.*

What are the data practices of the target bank? *Where and how is data stored? What security protocols have been instituted and followed? How often are those protocols reviewed and updated? Does the board and top management believe the data it receives after it orders a report?*

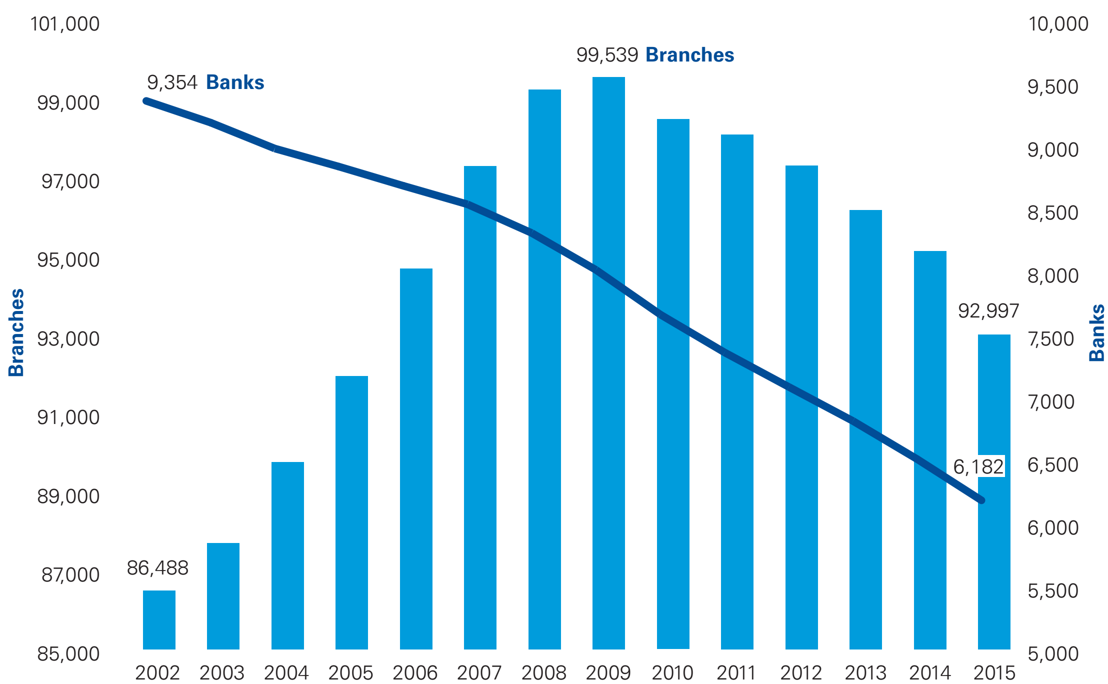
Branch of the future – transformation

Among the most-discussed topics in banking today is how mobile and online banking applications will affect customer behavior to the detriment or enhancement of bank branches.

While it is a fact that the number of branches has been on the decline since hitting a peak of 99,539 seven years ago (2009), it is also true that at the end of 2015 there were 6,500 more branches in the banking system than in 2002, when there were 3,000-plus more banks than are now operating in the country.

That increase in the average number of branches per bank means that branches remain a fundamental aspect of the banking experience. There is some evidence that customers may feel far more engaged with the bank when the bank can align with customers' preferences to be served both physically and digitally.[1]

Banks and Branches 2002–2015



Source: FDIC, March 2016

While banks report that foot traffic has declined in branches, bank customers also express appreciation "for face-to-face interaction when they have a problem they need help solving. Even if they visit a branch just a few times each year, there is a feeling of trust and security in knowing their bank is there when they need it.''[2]

[1] "Most Banks Would Trade Personal Banking for Digital Banking,'' *Gallup.com*, April 17, 2015

[2] "Is the Bank Branch Dead?'' *Texas Banking*, October, 2015

In our survey we learned that banks are creating new strategies and investing in technology as much for in-branch relationship building as for online or mobile reasons. We also learned that banks are creating flexible hours for employees to be in the branch when customers are most likely to visit.

Q. What strategies is your bank considering or utilizing for your branch of the future?

When asked to describe a benefit of a "bank-of-the-future"—such as branches with virtual tellers, a concierge-style greeter to engage customers coming into the branch—25 percent of respondents say they hoped their branch would optimize a strategy to drive in-person business opportunities and create more customer business in the branch to strengthen the personal relationship that is the foundation of banking.

Q. What are your key priorities for transforming the branch experience?

Despite intentions to transform the branch, less than one-third say they completed the work. The reason for the slow pace may be that some bankers aren’t sold on the concept. For many bankers, branches are solidly viewed as vital for personalized interaction and enhancing the experience that many customers want when they seek information or advice on products such as mortgages, personal loans, and investments.

Q. When do you envision your branch-of-the-future concepts to be fully deployed?

Information technology: An across-the-board issue

Key takeaways

Clearly, the answer to faster, smarter responses to customer needs is not simply to throw money at the challenge. While a considerable segment of regional and community banks outsource a host of IT programs, many still face IT obstacles that could benefit from the addition of middleware and new generation front-end systems that could help manage hurdles involving data storage and retrieval that is so critical in enabling accurate and swift decision-making across the enterprise.

The goal is to create a flexible core platform that enables data sharing and integration, with a constant focus on creating a better user experience along with improved internal operations.

As much as that goal is easier said than achieved, the difficulty cannot stop bank executives from making that the "top" goal in the months ahead. It may take quite a bit of convincing, and a lot of agility, but it is an issue that cannot be put off.

Few topics elicit more concern among management and board members alike than plans for spending on information technology (IT) programs designed to reduce costs, boost profitability, and enhance operational procedures.

For many executives, the idea of such spending programs creates a vision of a black hole where money and staff resources are sucked into obscurity. Promises are bright; results too often tend to be less than stellar.

Still, banks today are, by and large, technology companies – at least that's how Lloyd Blankfein, Chief Executive Officer of Goldman Sachs Group, recently described his company[3] - and many others agree. Technology has become the primary engine running the business, and so-called Fintech (financial technology) companies increasingly are making their mark on banks' profitable products and services.

For their part, commercial and retail customers increasingly depend on—and demand—rapid, IT-enabled interaction with their banks, regardless of whether the banks are as big as Goldman, or a community bank tucked in a small town.

In our survey, this notion was reinforced when we analyzed answers to a series of questions. While responses differed based on the size of the institution surveyed, we found that IT was either the top or number two response on questions about:

- Factors most likely to affect spending budgets (number 1)
- Branch transformation plans (numbers 1 and 2)
- Key components that would drive compliance risk prevention, detection, and response (number 2)
- Most important drivers of alliances and mergers and acquisitions (number 1)
- IT operations (number 2)

Despite its essential nature in virtually every operation, the paradox involving IT, however, is that many banks, regardless of asset size, operate with older and often outdated IT systems.

[3] "Goldman in Ventureland,'' Bloomberg.com, July 28, 2015

Conclusion

Knowing that regional and community banks want to kick-start growth, better manage regulatory risk, decide whether they are going to be buyers or sellers in a fluid M&A market, and focus on the "branch of the future," 2016 may very well be known as the year of agility.

Accomplishing all—or even some—of those goals will require an overall shift in mind-set for many executives in the regional and community sector. Some may be very limited due to not having access to enough funding and new talent. But they must rely on creating ideas for change, because change is happening all around them at lightning speed.

To help reach these goals we offer a series of ideas that these executives may want to contemplate:

A need for speed relating to change management: How fast is fast enough? This is a question that only each organization can answer, depending on its business model, customer base, strategic plans, and level of agility. If getting bigger is a key to success, as suggested by the vast majority of respondents who say they believe community banks must hold a minimum of $1 billion to remain independent, then agility regarding change management will be essential. While much of the success of change rests on an acceptance across the organization that change is essential, we believe there is much pick-and-shovel work required. That work will be especially important for such jobs as re-engineering front-end systems to creating strategic review teams that meet quarterly instead of once or twice a year.

Think mobile: Understandably, many regional community banks may believe mobile connectivity is something only for the biggest banks, or something to think about a few years from now—but consider this data:[4]

- The amount of time Americans spend on their mobile devices daily has increased by seven times since 2010.
- There are now ***6 billion smartphones in use across the globe***, each one more powerful than the "supercomputers" of just a decade ago.
- With the rise of millennials, whose attachment to their phones is already legendary—over 75 percent of millennials spend more than two hours per day on their smartphone—it's clear that engagement levels will continue to rise.
- A mobile-first design philosophy can exponentially increase a customer base. Pinterest, at first, was a hugely successful Web site, and was the fastest site ever to reach 10 million unique visitors. And yet a year after it went mobile in 2012, it had 70 million users.

[4] "Becoming a Mobile Leader in a $600B Market," *cmswire.com*, February 2, 2016

A culture that accepts change: This recommendation comes as no revelation to anyone who has been in the banking industry or has closely observed it for a while. The fact remains, however, that a common critique of this industry is that it is a captive of inertia. Top executives often talk a good game about change and agility, but transformation generally has been slow and weak.

Place a laser-like focus on digitization: Like it or not, smaller banks will need to do a better job of everything from mobile offerings to virtual tellers to faster and less-manual onboarding. While there has been movement on these fronts, the movement has been slow and sporadic. Laggards will soon enough realize they are far behind the competition and imperil their organizations. Those who are not willing to create a core focus on the customer, and powered by digital tools, risk irrelevance.

Empowering talent to act as entrepreneurs: Banking organizations that encourage independent thinking and creation of ideas for new products and services have proven to be among high performers. A bank need not be among the top 10 in order to establish an innovation lab or an innovation team. Some banks have created contests among their employees to focus on ideas for growth, and the results in many cases have been successful. Banks of any size can no longer rely on one executive group to be innovators.

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