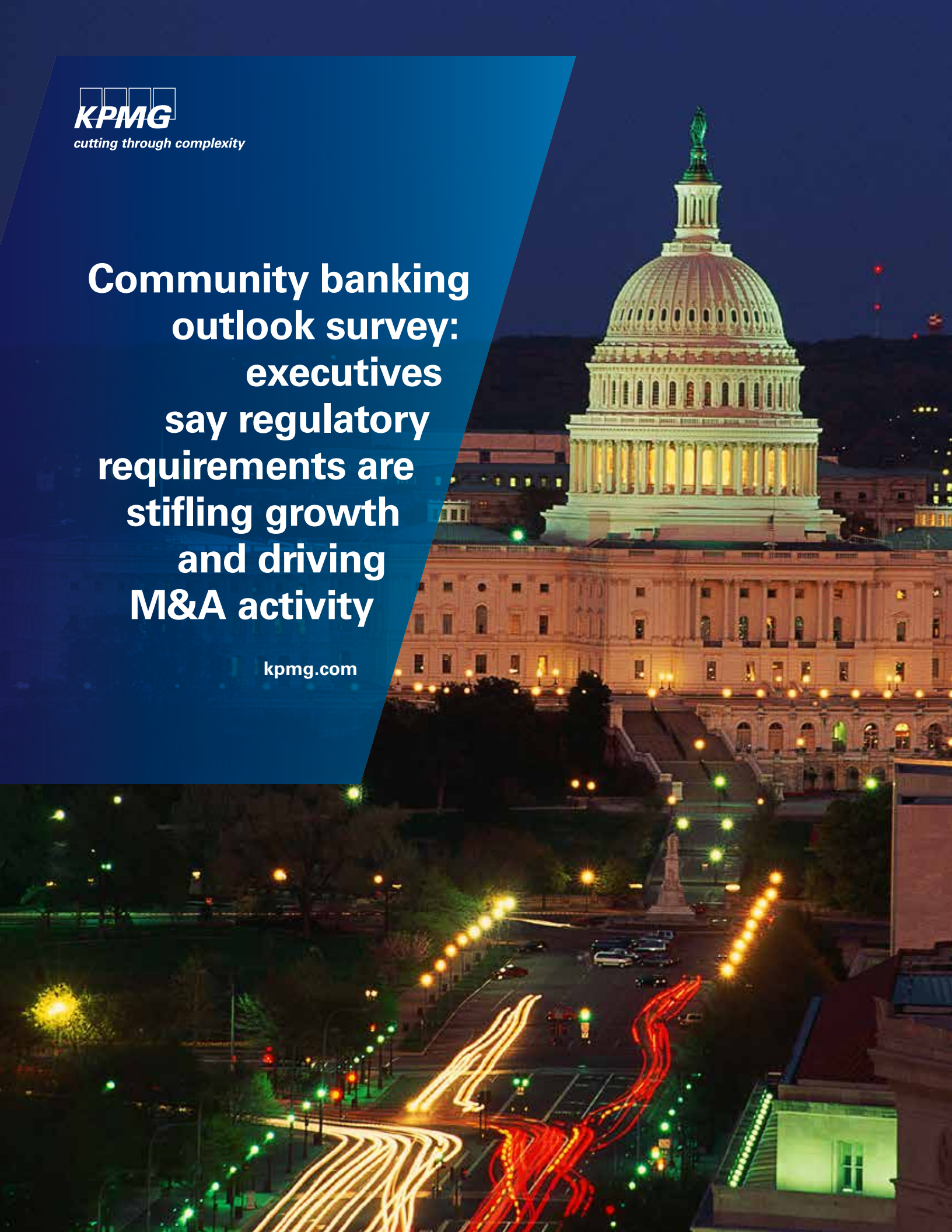




cutting through complexity

# Community banking outlook survey: executives say regulatory requirements are stifling growth and driving M&A activity

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**KPMG LLP, the audit, tax, and advisory firm, surveyed C-suite and other top-level executives at community banks with assets of \$1 billion to \$20 billion during September 2012. Participants were asked about business conditions in their sector, the most significant revenue growth opportunities, and any barriers to growth that may exist. They were also asked a variety of questions about the economy, including factors they perceive might impede or support their sector's recovery as well as the impact of regulatory reform on their businesses and potential areas of investment.**

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# Foreword

I am pleased to present KPMG LLP's 2012 Community Banking Outlook Survey, which provides candid perspectives and insights from more than 100 C-level and other top-level executives of community banks. This report includes both a snapshot of current conditions and impressions of what the near future may hold for this sector.

Community banks face profitability challenges in this difficult business environment. The U.S. Federal Reserve has held interest rates low, which has squeezed profit margins for loans and reduced yields on investment securities, while nonperforming loans continue to be a major problem. Meanwhile, the cost of regulatory compliance has increased significantly. Many banks are finding that a path for growth is through increased scale and efficiency through mergers and acquisitions (M&A).

The new regulatory environment in which community banks now operate is a game changer. Nearly half (47 percent) of executives in our survey said regulatory reform is the industry's biggest barrier to growth. The high cost of building the necessary compliance systems and processes is leading many community banking executives to reevaluate their business and operating models and growth strategies. What's more, banks anticipate more changes, as Dodd-Frank is only partially implemented and Basel III presents uncertainty.

The survey data shows that M&A is one of the options community banks have to stay competitive and grow in this environment. Well more than half (57 percent) of survey respondents said it was likely their bank would be involved in an M&A transaction in the next two years, and more than a third (38 percent) said "regulatory changes" were the most important M&A driver. These banks are finding that a successfully executed acquisition can provide access to new geographic markets, technologies, and products.

Perhaps most important, an acquisition can also generate sufficient scale to absorb regulatory compliance costs and meet regulatory capital requirements. Many banks will need to raise capital to meet new capital requirements, and those late to the game may find a much higher cost of capital. This could lead to more acquisitions that target over-capitalized banks, as buying capital at a slight premium is cheaper than raising it in the capital markets. Notably, community banks are the most likely acquisition targets.

In addition to M&A, regulatory requirements are also driving hiring. Based on our interactions with clients, we're seeing community banks hire more senior regulatory and compliance personnel as the time and expenditure dedicated to this area continue to escalate. A challenge for community banks is that experienced compliance professionals often come at a high price, contributing to the increasing cost of regulation. Our observation of the industry indicates that some banks have seen their regulatory costs quadruple as a result.

All this leaves the question of how community banks can find revenue growth. With an aging population, community banks are bolstering their asset and wealth management capabilities to serve customers nearing retirement. These customers also are more likely to visit bank branches and meet with a banker to discuss portfolio management and investment options. Some community banks are even hiring additional mortgage origination and wealth management professionals to capitalize on anticipated growth opportunities in these areas. In addition, community banks expect to increase spending for the development of new products to serve these clients. This strategy diverts strongly from larger banks, which are generally looking to the mass affluent and young professionals to find growth.

In the area of information technology (IT), community banks expect to update IT systems and invest in platform integration after acquisitions. While mobile banking could help to improve customer service and loyalty, many community banks face the challenge of earning an adequate return on this investment.

Overall, the survey confirms what our clients are telling us—that this new regulatory environment poses significant challenges. However, there were some surprises in the data. For example, the majority of community banking executives report that they are not overly concerned about cyber security despite recent, highly publicized cyber attacks. Banks of all sizes should ensure that their security systems and various processes are regularly updated to guard against this threat, which brings with it significant financial and reputational risks.

Another surprise was that, contrary to the U.S. Federal Reserve's report, 37 percent of bankers surveyed found that they would need to raise capital as a result of the Dodd-Frank Act and Basel III, with another 29 percent reporting that they have not completed their analysis. This is troubling because the cost of capital is likely to increase as these banks tap the capital markets. With decreasing returns on equity and assets, capital will likely be more costly as investors demand more shares or a greater return for the same investment. Banks that are not assessing these requirements now might face difficulty raising capital in the future.

Despite these challenges, the majority of community bankers are optimistic about the economy despite the headwinds that they face. This likely indicates that most community banking executives believe the worst of the recession is behind them.

On behalf of KPMG, I would like to thank those who participated in this survey. I hope the findings are useful to you in addressing market challenges and opportunities. I also welcome the chance to discuss this survey and its implications for your business in the year ahead.

A handwritten signature in black ink, appearing to read 'John Depman', with a stylized flourish at the end.

**John Depman**

National Leader for Regional and Community Banking  
KPMG LLP

# Key findings from KPMG's Community Banking Outlook Survey

Some of the key findings from the 2012 Community Banking Outlook Survey include:

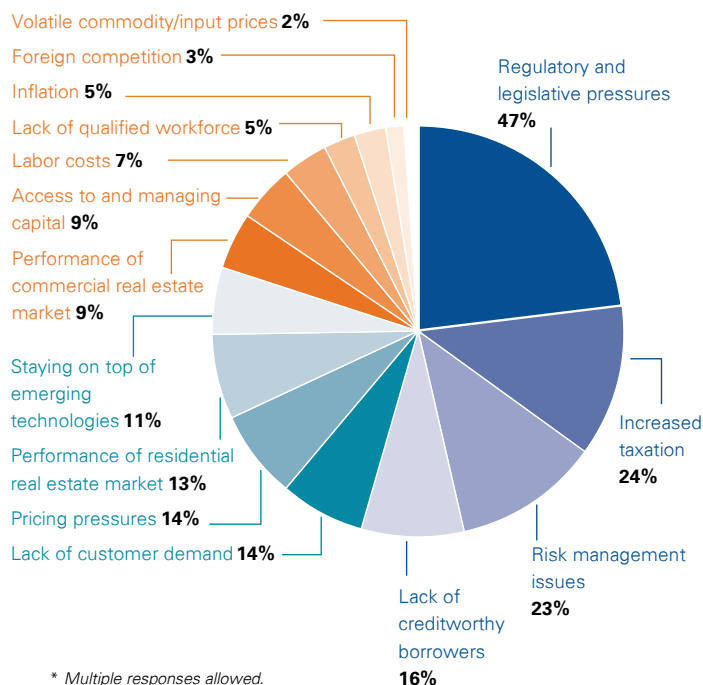
- Forty-seven percent of respondents identified regulatory and legislative pressures as the most significant barriers to growth over the next year, while 35 percent said regulatory compliance costs were having the greatest negative impact on financial performance.
- Fifty-seven percent of the respondents said it was likely that their bank would be involved in an M&A transaction in the next two years as a buyer (42 percent) or seller (15 percent); “regulatory changes” was selected most frequently (38 percent) as the most important driver of M&A.
- Community bank executives identified asset and wealth management (40 percent), cross-selling services (30 percent), and business model restructuring (23 percent) as the areas they believe will be the biggest revenue growth drivers in the next one to three years.
- Sixty percent of community banking executives said they would increase capital spending over the next year with information technology (50 percent), new products or services (34 percent), and acquisition of a business (23 percent) as the top areas of investment.
- Executives said troubled residential and commercial mortgages (37 percent) are having the greatest negative impacts on their bank’s revenue.
- Community banks are anticipating some headcount gains in the year ahead, with 55 percent adding to the payrolls, 27 percent expecting no changes, and 18 percent expecting a decrease.

KPMG’s 2012 Community Banking Outlook Survey reflects the responses of 105 senior executives from the community banking industry. Forty-nine percent of respondents work for institutions with \$1 billion to \$5 billion in assets, 31 percent with \$5 billion to \$10 billion in assets, and 20 percent with \$10 billion to \$20 billion in assets.

## Regulatory changes pose significant challenges

Community banking executives say new regulatory requirements are stifling growth, negatively impacting financial performance, and driving mergers and acquisitions (M&A) activity. In addition, troubled mortgages remain a problem and organic loan growth is slow. Overall, the costs of compliance and the increased capital requirements have weighed community banks down. This new regulatory environment is leading many community banks to reevaluate their operating models and growth strategies to stay competitive. As a result, community banks are looking to wealth management and cross-selling services to find revenue growth.

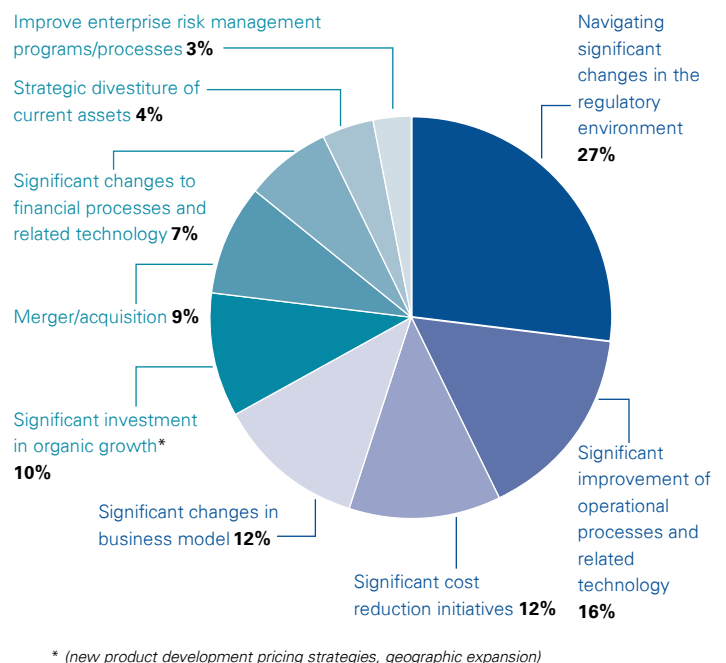
### Factors hampering growth\*



### Regulatory challenges

Respondents said the most significant growth barriers for their community banks over the next year are regulatory and legislative pressures (47 percent) and increased taxation (24 percent). As would be expected, the top initiative on the minds of management is navigating significant changes in the regulatory environment (27 percent). This is followed by the need for significant improvement of operational processes and related technology (16 percent), significant cost reduction initiatives (12 percent), significant changes in the business model (12 percent), significant investment in organic growth\* (10 percent), merger/acquisition (9 percent), significant changes to financial processes and related technology (7 percent), strategic divestiture of current assets (4 percent), and improve enterprise risk management programs/processes (3 percent).

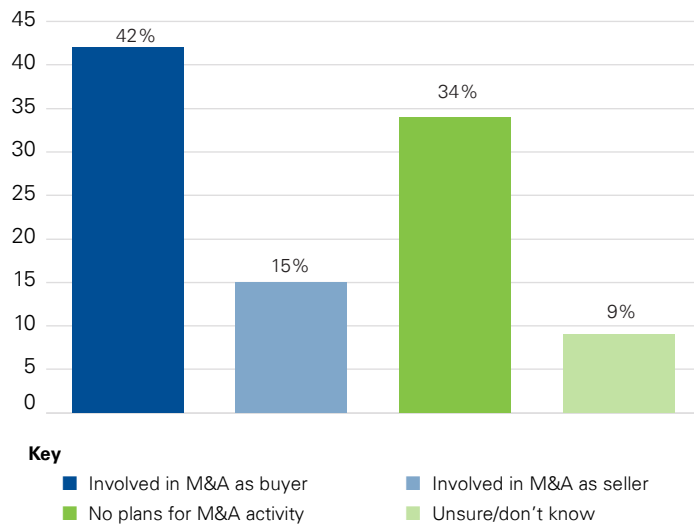
### Top initiatives on the minds of management



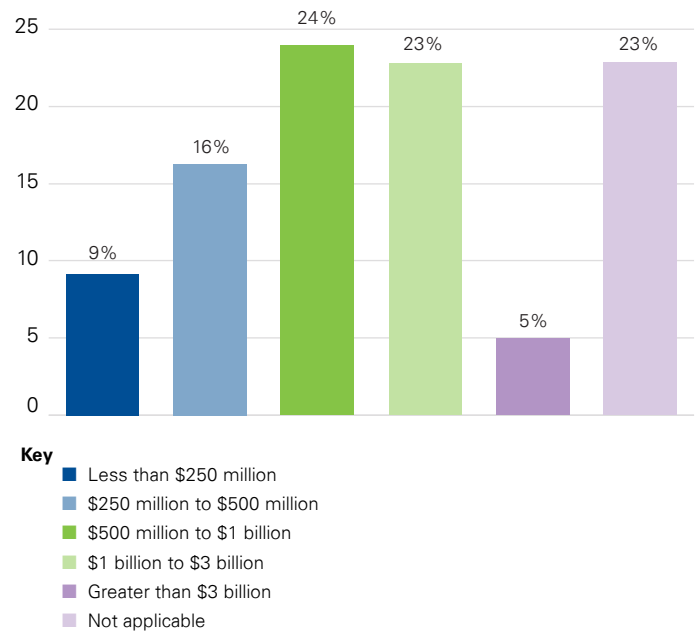
## M&A activity likely to increase

Regulatory reform is the top driver of M&A for community banks. Notably, 57 percent of the respondents said it was likely that their bank would be involved in a merger or acquisition in the next two years as a buyer (42 percent) or seller (15 percent). For community banks with M&A as part of their growth strategy, 47 percent said they would target a bank with \$500 million to \$3 billion in assets, while 16 percent said they would target a bank in the \$250 million to \$500 million asset range, and 9 percent said they would target a bank with less than \$250 million in assets.

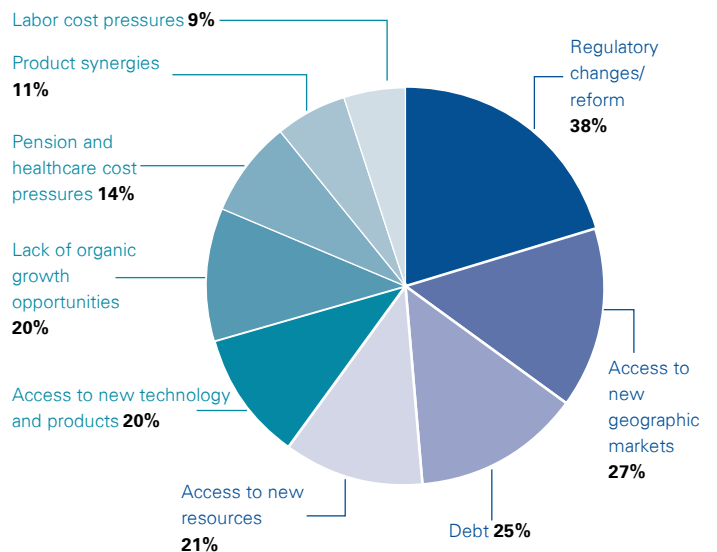
### Likelihood of M&A activity over the next two years



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



### Drivers of alliances, mergers, and acquisitions in the industry\*

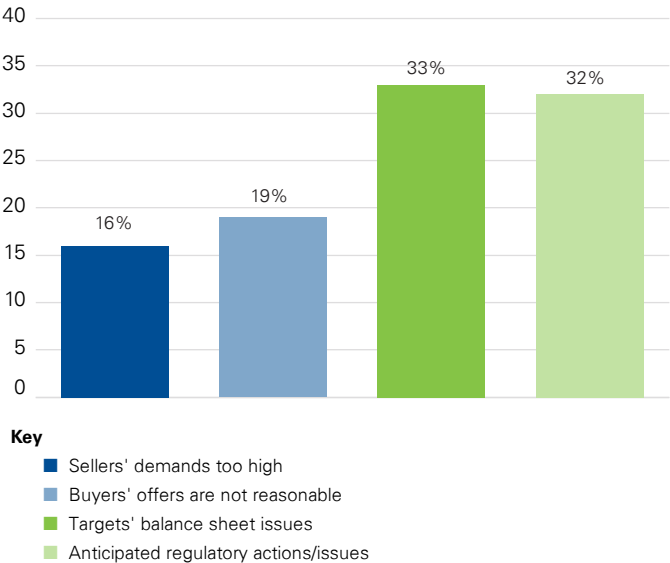


\* Multiple responses allowed.

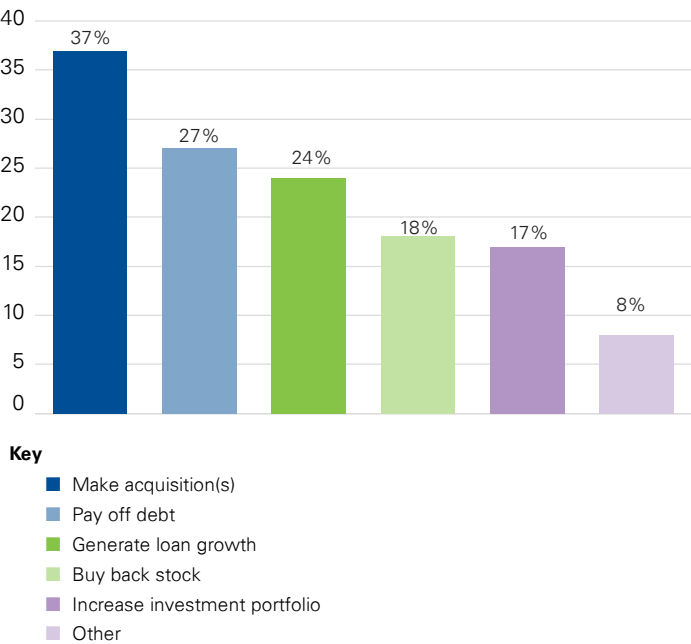
**Banks have the cash to pursue acquisitions**

The vast majority of respondents (74 percent) said their bank has significant cash on its balance sheet. Compared to a year ago, almost half (47 percent) of community bank executives surveyed note that their cash position has increased, while 46 percent say it has stayed the same and only 7 percent said it has declined. Notably, among the 74 percent of executives who indicated their bank had a significant amount of cash on its balance sheet, 37 percent said they planned to deploy it by making an acquisition.

**What do you believe is the greatest impediment to M&A in the banking industry?**



**How do you plan to deploy it?**

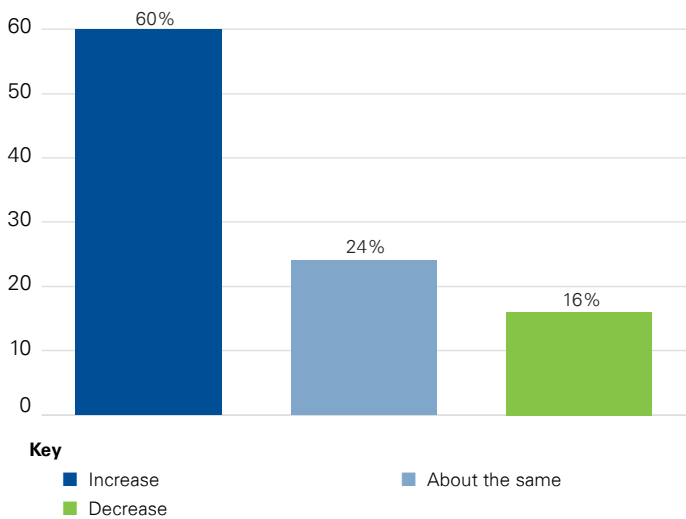




# Capital spending

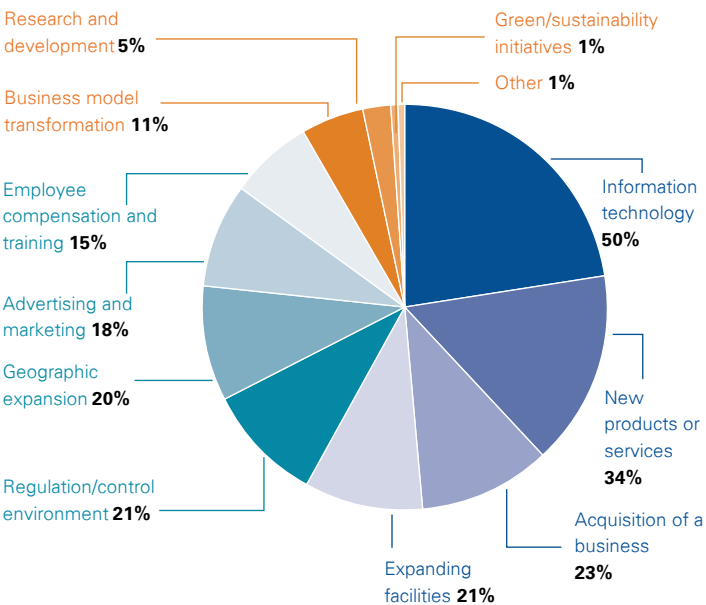
Sixty percent of survey respondents predict that their bank’s capital spending will increase over the next year, while 24 percent expect it to stay the same. A significant amount of this spending will be in information technology, cited by 50 percent of the executives as a top investment priority, followed by new products or services (34 percent), and acquisition of a business (23 percent).

Outlook for capital spending by your company over the next year



The planned increase in IT spending is likely to come in the form of updating systems and integrating platforms after acquisitions. The increase in spending on new products or services is likely to come from community banks’ focus on wealth management services and other service expansions.

Increased areas of capital spending over the next year\*

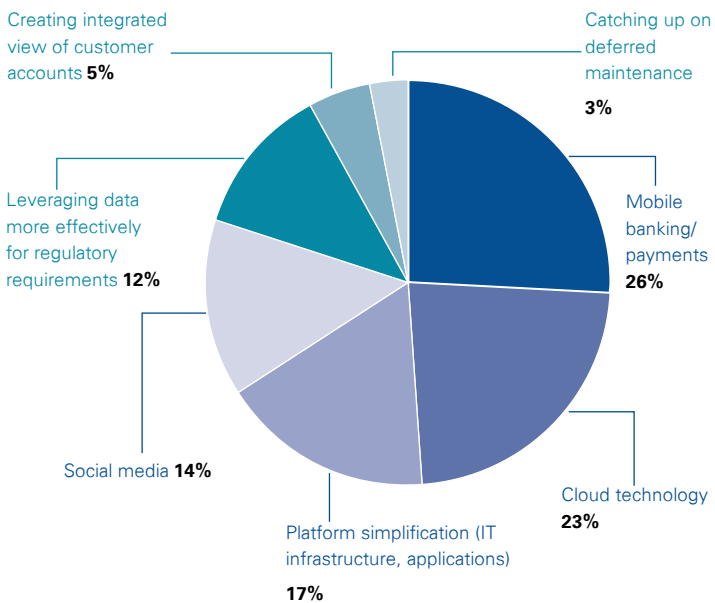


\* Multiple responses allowed.

## IT investment

Mobile banking and payments (26 percent) and cloud technology (23 percent) were identified as the most important IT-related projects for community banks in the next year. Community banks are investing in mobile banking as its utilization by consumers continues to become more mainstream, and they are also examining cloud technology as a means to increase efficiency and reduce IT costs.

### Most important IT-related projects in the next year\*

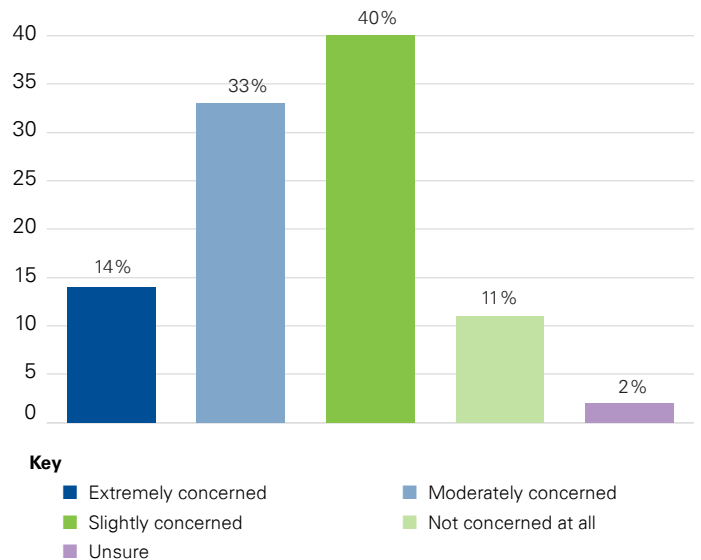


\* Multiple responses allowed.

### Cyber security

Community banking executives are not overly concerned about cyber security despite highly publicized recent cyber attacks. Fifty-one percent of community banking leaders said they were slightly concerned or not concerned at all that their bank may be vulnerable to a cyber attack, while only 14 percent were extremely concerned and 33 percent were moderately concerned.

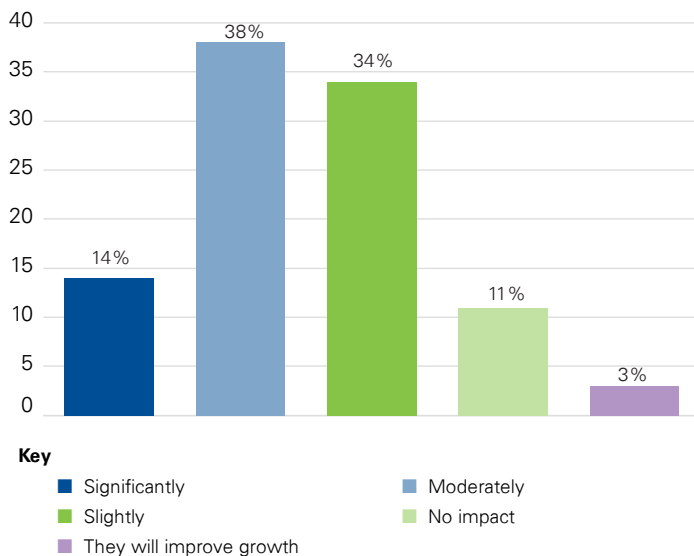
### How concerned are you that your bank may be vulnerable to a cyber attack?



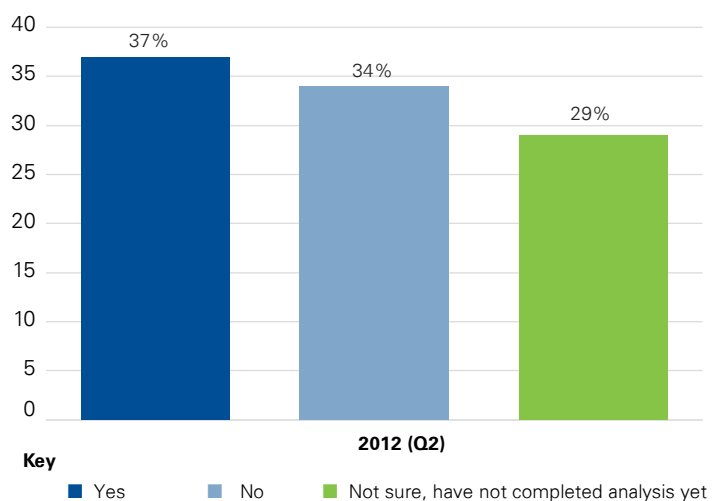
## New regulatory capital requirements

The vast majority of respondents (86 percent) believe that capital requirements from various regulatory initiatives will hinder growth. Thirty-seven percent of respondents said their community bank would need to raise more capital to meet these requirements, while 34 percent said they would not. A surprising 29 percent said they had not yet completed the analysis.

**Will new regulatory capital requirements hinder growth?**



**Do you believe the Dodd-Frank Act and Basel III will require you to raise more capital?**



### Rising compliance costs

Capital and liquidity requirements from various regulatory initiatives such as the Dodd-Frank Act and Basel III were identified as the biggest drivers of compliance costs.

#### Which will have the most impact on compliance costs?



1. Capital and liquidity requirements from regulatory reform



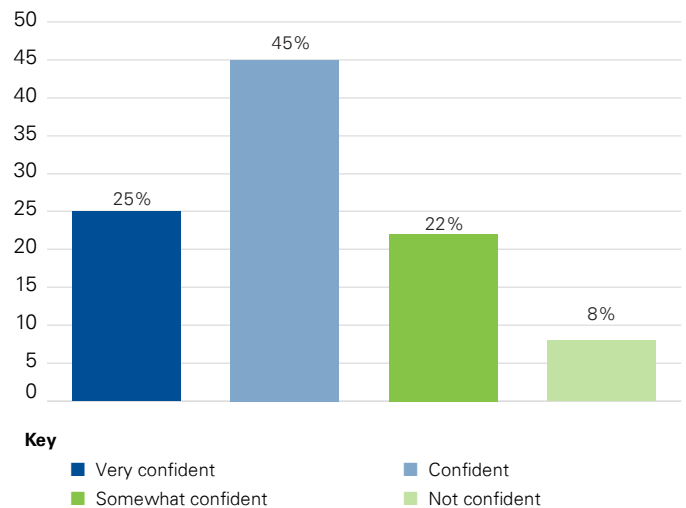
2. Federal supervisory changes



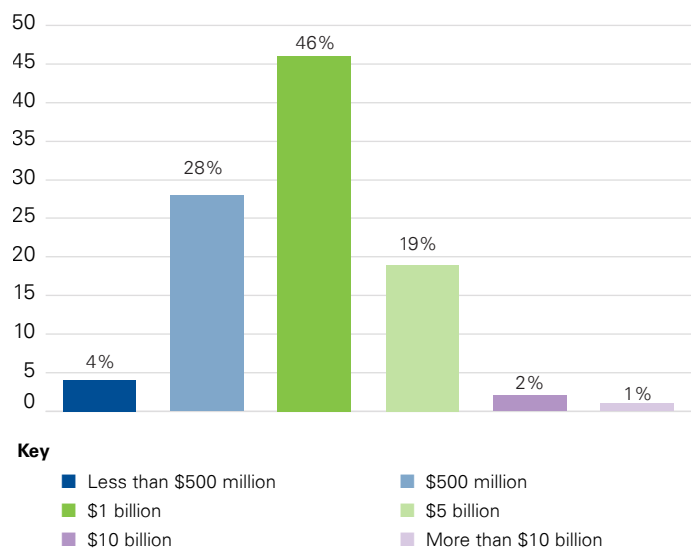
3. Consumer protection

Despite these rising compliance costs and capital requirements, most community banks (70 percent) are still confident that they will be able to remain independent.

#### With rising regulatory compliance costs and new capital requirements, are you confident that your bank will be able to remain independent?



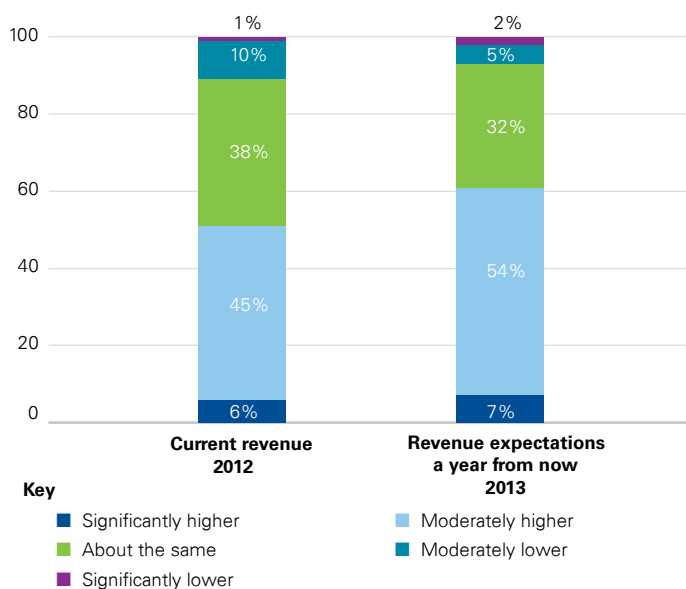
#### What is the minimum asset level a community bank needs to remain independent?



## Revenue

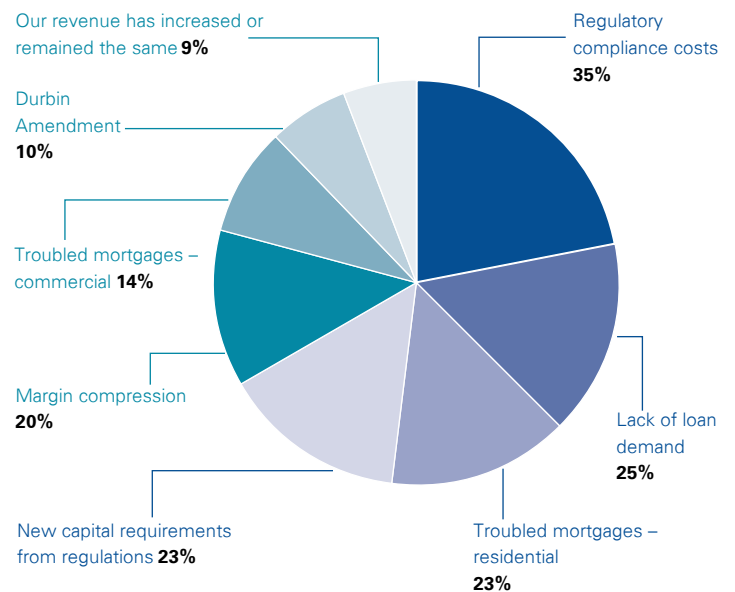
More than half of respondents (51 percent) reported an increase in revenue over the past year, and only 11 percent reported a decrease. When asked to describe their revenue expectations a year from now, 61 percent of community bank executives predict that revenue will increase, and 32 percent expect revenue to be about the same.

### Compared with this time last year, how would you describe your company's current revenue?



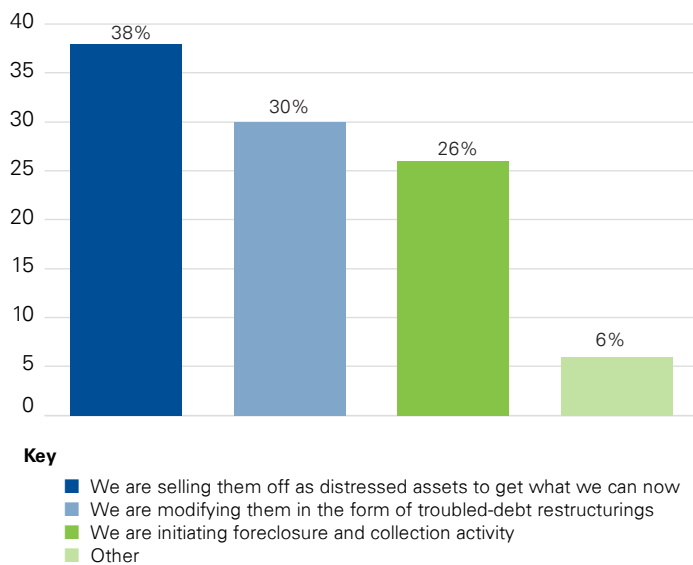
### Greatest negative impact on your bank's revenue \*

Troubled loans continue to impact the industry, as 37 percent of community banking executives said either troubled residential mortgages (23 percent) or commercial mortgages (14 percent) are having the greatest negative impact on their bank's revenue. Notably, more community banks are selling these loans off as distressed assets or modifying them in troubled-debt restructurings than are initiating foreclosure and collection activity.



\* Multiple responses allowed.

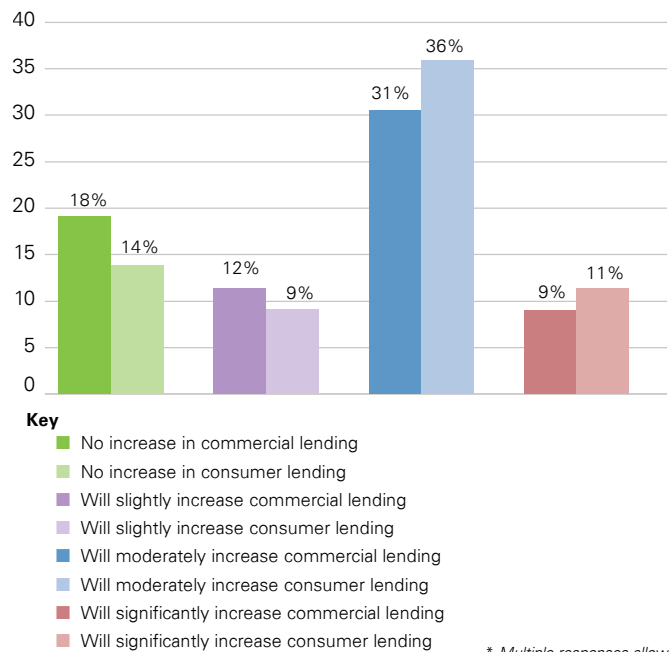
### What is your strategy for handling nonperforming loans currently on your books?



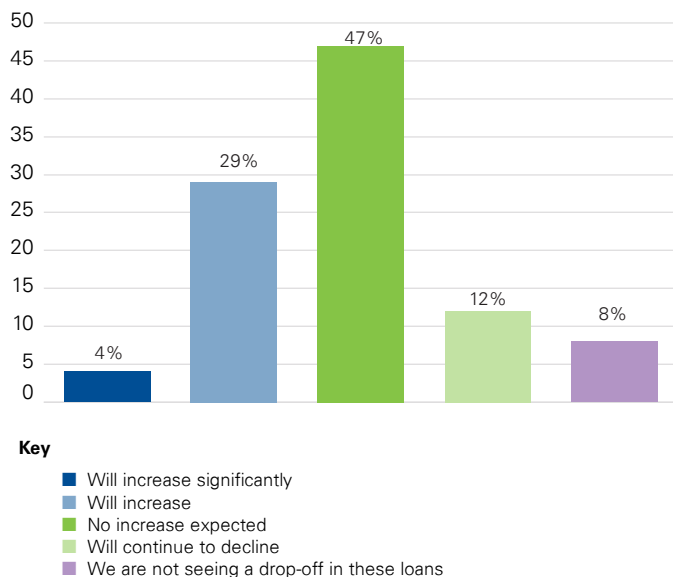
### A difficult lending environment

Slightly more than a third (36 percent) said they anticipate that their bank will moderately increase consumer lending, and slightly less than a third (31 percent) said they anticipate that their bank will moderately increase commercial lending. However, nearly half (47 percent) do not expect an increase in construction loans. These results reflect the difficulty community banks are having in developing organic loan growth.

### Do you anticipate that your bank will increase lending in the coming year?\*

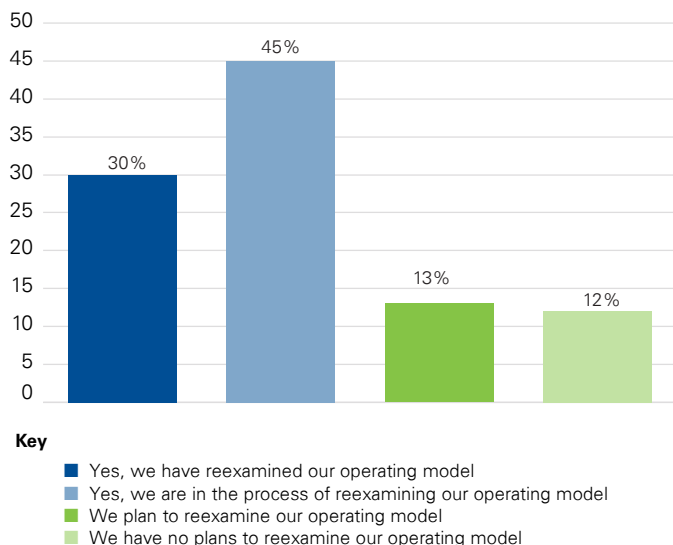


### What is your outlook for construction loans in the coming year?



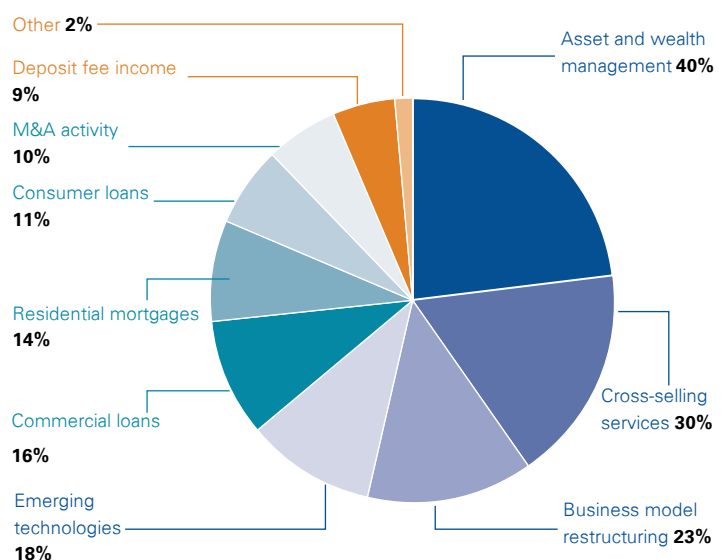
In response to new regulations and the difficult lending environment, community banks have reexamined or are in the process of reexamining their operating model.

### Has your institution reexamined its operating model as part of your growth strategy?



### Biggest drivers of revenue growth in the next one to three years\*

Reflecting the difficulty in profitable lending and the need to reevaluate their business models, community bank executives identified asset and wealth management (40 percent), cross-selling services (30 percent), and business model restructuring (23 percent) as the biggest drivers of their bank's revenue growth in the next one to three years.

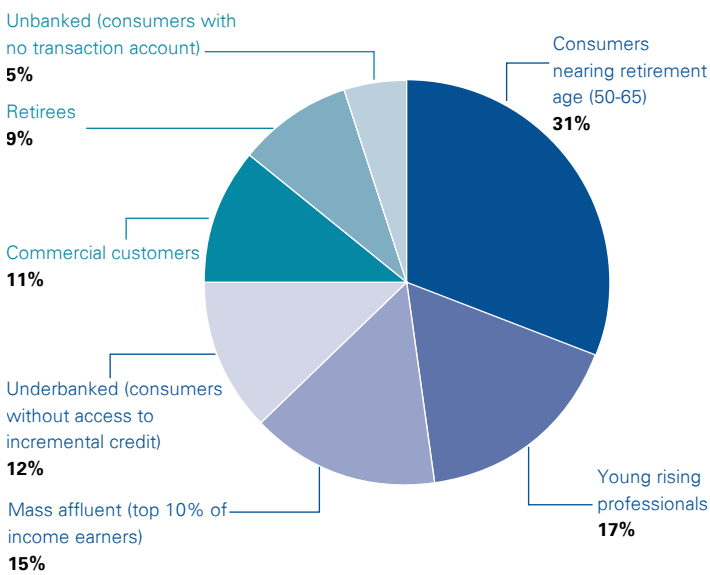


\* Multiple responses allowed.

Thirty-one percent of community banking leaders said consumers nearing retirement age was the customer segment that presents the greatest growth opportunity for their bank. These customers are more likely to visit the branch and meet with a banker to discuss their portfolio management and investment options.

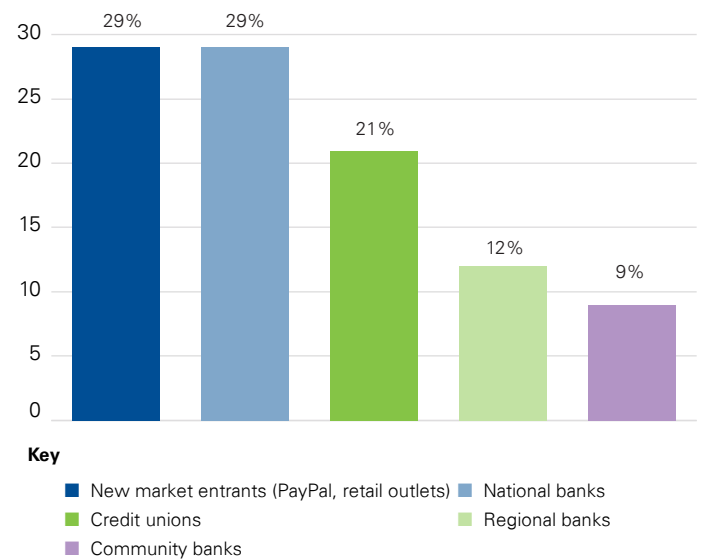
Community banks see a competitive threat not only from national banks, but also from PayPal and retail outlets.

#### Which segment presents the greatest growth opportunity for your bank?\*



\* Multiple responses allowed.

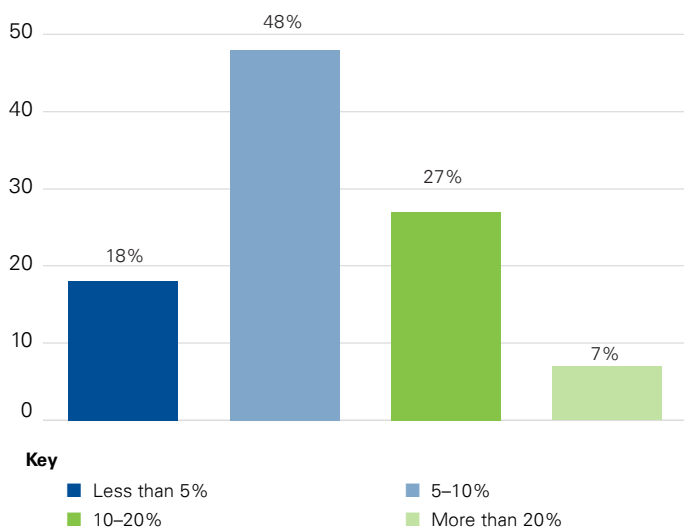
#### Which of the following represents the biggest competitive threat to your bank?



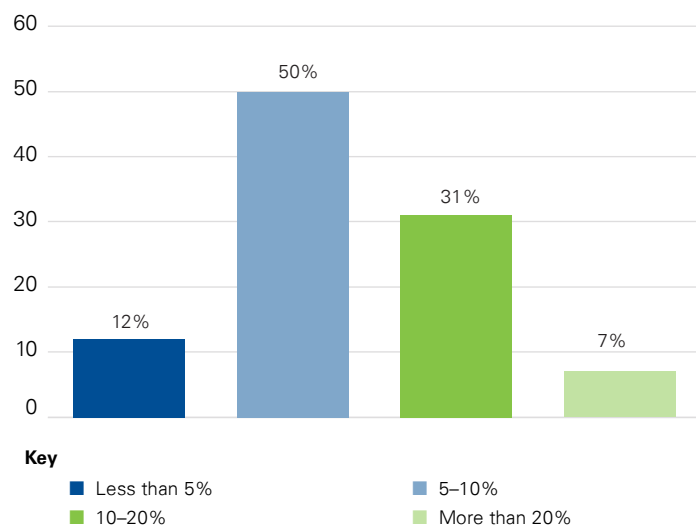
### Fee income

Ninety-three percent of respondents said fee income accounts for only 20 percent or less of their bank's total revenue, despite the decline in interest revenue. Almost half expect loan-related fees to provide the greatest potential to boost fee income.

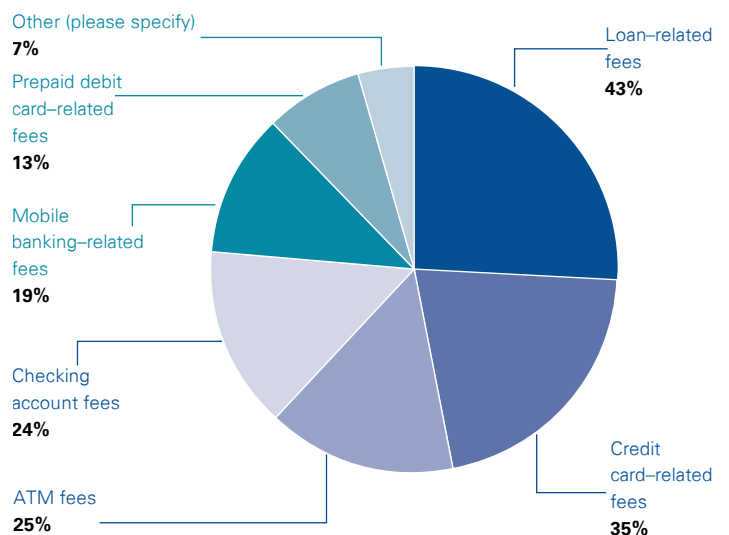
#### What percentage of your total revenue is currently derived from fee income?



#### What do you expect the percentage of your total revenue derived from fee income to be three years from now?



#### Which of the following do you believe has the greatest potential to boost fee income?\*

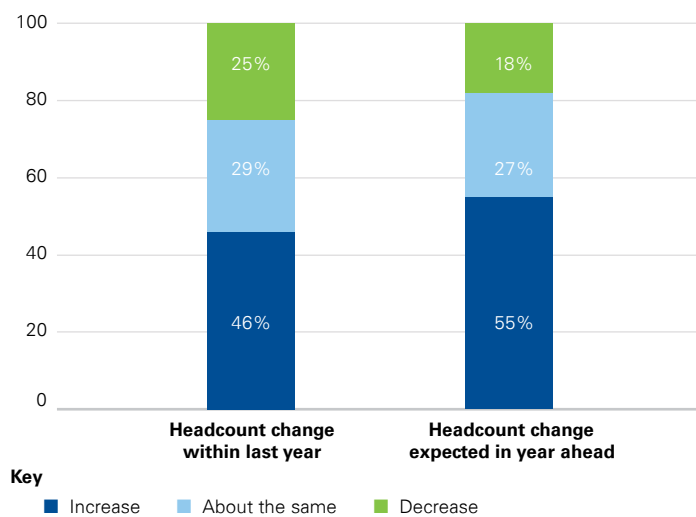


\* Multiple responses allowed.



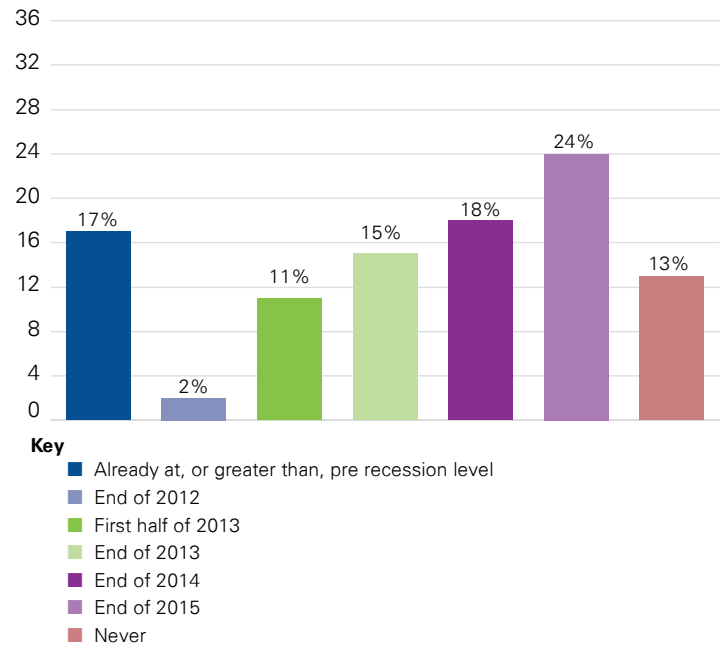
## Headcount

Almost half (46 percent) of survey respondents noted that they added personnel over the past year, and only 25 percent reported a decrease in headcount. Community banks are anticipating some headcount gains in the year ahead, with 55 percent adding to payrolls, 18 percent decreasing jobs, and 27 percent expecting no changes to their workforce. A large portion of the increase in headcount will likely come from adding compliance professionals. These hires are often experienced personnel with high salaries.



Only 17 percent of survey respondents said their U.S. headcount has returned to pre recession levels, while 24 percent do not anticipate it will return to such levels until the end of 2015 or later. Notably, 26 percent expect their U.S. headcount to return to pre recession levels during 2013. Moreover, 13 percent do not think it will ever return to pre recession levels.

### Headcount: Return to pre recession levels\*

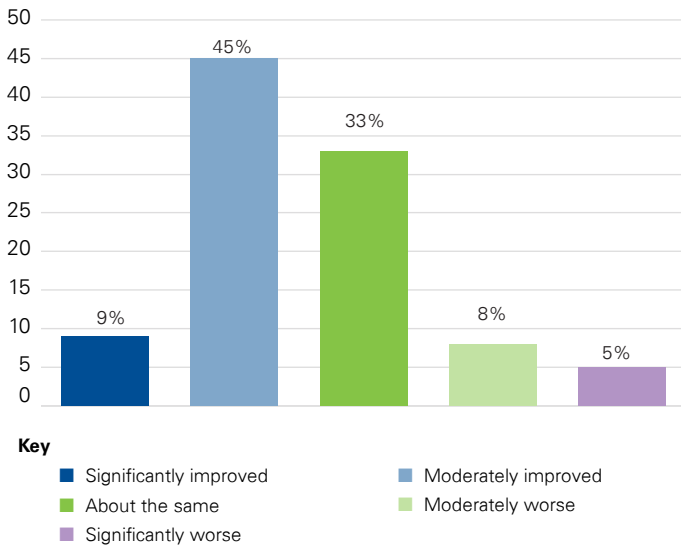


\* Multiple responses allowed.

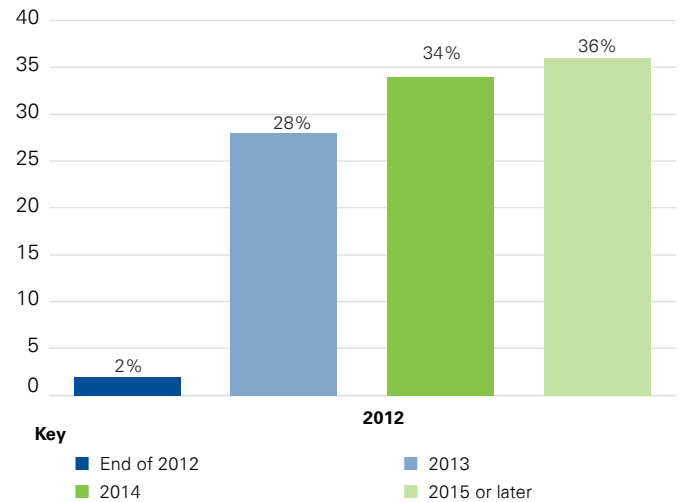
## Expectations for the economy

Despite the fact that community banks face significant challenges, more than half (54 percent) of executives expect the economy to be improved a year from now, while 33 percent expect it to be about the same. Notably, only 13 percent expect it to be worse. However, the majority (70 percent) believe an economic recovery will not actually occur until 2014–2015 or beyond.

### A year from now, what are your expectations for the U.S. economy?



### When do you think the U.S. economy as a whole will recover? Recovery will be substantially complete by...



# Conclusion

Community banking executives face significant challenges from regulatory compliance costs, capital requirements, and net interest margin compression. In addition, troubled mortgages remain a problem and organic loan growth is slow.

In response, many community banks are reevaluating their businesses and operating models to find growth strategies. Community bank executives say they are focusing on wealth management and cross-selling services to find revenue growth, and they are targeting consumers nearing retirement age.

Perhaps most significantly, many community banks are looking to M&A to find growth—which has been elusive organically—and cost savings through economies of scale. These banks are looking to M&A not only to access new markets, but also to help them generate scale to absorb increased regulatory compliance costs.

Notably, the regulatory environment brings significant challenges and uncertainty. Dodd-Frank is only partially implemented, and banks anticipate more regulatory changes to come, adding to a growing regulatory burden. Nonetheless, while they anticipate a slow recovery, the majority of community bank executives are cautiously optimistic about the economy, indicating that the worst of the recession is likely over.

For decades, KPMG's Banking & Capital Markets practice has been recognized for its presence in and commitment to the industry. Through our international network of member firms, we have the global reach and experience to serve clients anywhere in the world. Our regional and community banking practice includes professionals with the knowledge, experience, and skills to help our clients address their most pressing challenges, sort through today's complex business problems, and achieve their goals.

**KPMG: A Leader  
in Serving Regional  
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