

Issues from government regulations to corporate governance to competition “pop up” daily at banks nationwide. Grant Thornton’s **Twelfth Annual Survey of Community Bank Executives...**

Grant Thornton 



...explores these and other issues that community bankers say are important to their institution's growth and success in 2005 and beyond.

Corporate governance has been brought to the forefront of banker's minds in 2005. While not all community banks are responsible for complying with Sarbanes-Oxley, many are — or already have — adopted some of the act's provisions. The media spotlight on governance has also put pressure on banks to tighten internal controls. And, bankers report that 2004 was an expensive year, with both the cost of audit and legal fees increasing.

In spite of these increased costs, community bankers have not lost sight of their future goals and are expanding service offerings for customers and planning to open new locations.

Regardless of the issues facing their industry, community bankers are armed with the resources and know-how to deal with whatever issues “pop up” next.

The “community bank” profile

“Community bank” has many definitions. Some studies base the distinction on asset size; some set a strict ownership definition; and others define it as a philosophy.

To gather information for this study, Grant Thornton mailed questionnaires to a national sample of 4,625 chief executive officers and senior officers of banks and savings institutions in mid-November 2004. A total of 442 completed questionnaires were returned for a response rate of 9.6%, yielding a margin of error of $\pm 4.6\%$.

In this analysis, “small” community banks (30% of respondents) are defined as those with assets of \$100 million or less; “medium” banks (48% of respondents) are those with more than \$100 million to

\$500 million in assets; and “large” are those with more than \$500 million in assets, also generally known as FDICIA banks (22% of respondents). Only three FDICIA banks had assets in excess of \$5 billion.

The executives defined the community they primarily serve as rural (45%), suburban (38%) and/or urban (17%). For classification by primary federal regulator, 12% indicated the Federal Reserve; another 12% specified the Office of Thrift Supervision; 21% the Office of the Comptroller of the Currency; and 56% the Federal Deposit Insurance Corporation¹.

Almost one-third (30%) are publicly held; 57% are private corporations; and 13% have mutual charters. One in five (18%) of the respondents is an S Corporation.

This year, Grant Thornton also sent a shorter questionnaire to 407 audit committee chairmen of public banks and received 118 completed surveys for a response rate of 29%. Details of the audit committee chairmen responses are published in a separate document available from Grant Thornton (www.GrantThornton.com/banksurvey).

Grant Thornton extends its sincere appreciation to the community bankers who generously gave of their time to respond to our *Twelfth Annual Survey of Community Bank Executives*.



¹Total may not equal 100% due to integer rounding.

Corporate governance

Corporate governance and related internal control issues are of top concern for community bank executives, not only for publicly held institutions, but also as best practices for privately owned institutions.

Since the enactment of the Sarbanes-Oxley Act (SOX) on July 30, 2002, which applies to publicly owned companies, there has been a constant flurry of discussion about the applicability of selected provisions of the law to all insured depository institutions. Many of the act's

provisions mirror the annual audit and reporting requirements of Section 36 of the Federal Deposit Insurance Act applicable to insured institutions with \$500 million or more in assets.

Just over half (52%) of all community bank executives indicate that corporate governance is important to their success; and more than two-thirds (69%) are very comfortable and confident in their particular bank's corporate governance performance.

The opinions of large vs. small and public vs. private institutions on this issue vary significantly. About two-thirds of both large (66%) and publicly held (63%) institutions say that corporate governance is very important to their continued success, compared to 38% of small and 45% of privately owned banks.

Constant publicity, detailed regulatory guidance, and an exhaustive focus on corporate governance by industry trade groups and service providers may be factors contributing to bankers' emphasis on confidence in dealing with the issue. In fact, 81% of executives at large banks and 76% of executives at publicly held banks are confident in their performance related to corporate governance.

Audit committee chairmen (84%) are even more likely than public bank executives (63%) to rate corporate governance as important to their banks' continued success. This may be due to increased regulatory and media attention to the board of directors' role.

Internal controls

The nature of the business requires the financial industry to be attentive to internal procedures and controls. Consequently, more than two in five (45%) banks report that they had comprehensive internal control documentation prior to SOX.

The bankers most directly affected by SOX did not rest on the laurels of past performance; 45% of large (FDICIA) banks increased their internal control documentation in response to SOX and another 6% have plans to do so in 2005. If these banks stay on schedule, by the end of 2005 virtually all (98%) banks with assets in excess of \$500 million will have comprehensive documentation of their internal controls.

One-third (34%) of the executives at small banks have either prepared internal control documentation since SOX was enacted or have plans to do so in 2005. By the end of 2005, almost eight in 10 (81%) small banks also plan to complete comprehensive documentation of their internal controls.

“The focus on corporate governance and government regulations is business as usual for community bankers, since we tend to these matters on a daily basis. However, there isn't a bank out there that hasn't been affected by the new accounting regulations.”

— **Anne Arvia**, CEO and president
Shore Bank, Chicago, Ill.



Costs of corporate governance



According to industry trade association executives' and accounting professionals' anecdotes, top on the list of bankers' complaints are the rising costs of audits and expensive SOX Section 404 (management reports on internal controls) related services.

The results of this year's survey support these claims.

Two-thirds (67%) of all community bank executives indicate that the cost of documenting internal controls has increased this year. Nine in 10 (88%) executives at large community banks reported cost increases versus two-thirds (65%) of small bank executives.

This pattern is repeated for general audit fees and general legal fees. This year, four in five (83%) of all bankers reported an increase in general audit fees, including almost one-third (29%) who said the increases were significant. The price of audits increased for practically all (95%) of large community banks, compared to 71% of small institutions. In addition, nearly two-thirds (60%) of all bankers cited increases in general legal fees.

Bankers noting increased cost of operations in 2004 (by asset size)

	small	medium	large
general audit fees	71%	85%	95%
documentation of internal controls	65%	59%	88%
D&O insurance	56%	66%	66%
general legal fees	48%	59%	78%
outsourcing or co-sourcing of internal audits	53%	60%	66%
attracting, retaining and educating board members	30%	39%	58%
compensation for audit committee chairman/members	14%	33%	53%

Bankers noting increased cost of operations in 2004 (by ownership)

	public	private	mutual
general audit fees	93%	79%	79%
documentation of internal controls	83%	60%	63%
D&O insurance	70%	59%	65%
general legal fees	76%	52%	60%
outsourcing or co-sourcing of internal audits	71%	52%	65%
attracting, retaining and educating board members	45%	37%	47%
compensation for audit committee chairman/members	41%	23%	49%

Bankers noting increased cost of operations in 2004 (FDICIA & public vs. all others)

	FDICIA & public	all others
general audit fees	93%	76%
documentation of internal controls	81%	58%
D&O insurance	68%	60%
general legal fees	75%	50%
outsourcing or co-sourcing of internal audits	68%	53%
attracting, retaining and educating board members	49%	35%
compensation for audit committee chairman/members	43%	24%

Concentration of services

The regulators do not require public companies to use different accounting firms for audit and *all* tax consulting services. In December 2004, however, the Public Company Accounting Oversight Board (PCAOB) proposed action to prohibit audit service providers from entering into contingent fee arrangements for tax services with their public company audit clients. The PCAOB decision confirmed and reinforced existing Securities & Exchange Commission (SEC) rules on contingent fees.

Even though not required, one-fourth (25%) of all community banks and almost one-third (31%) of large banks used different accounting firms for tax consulting and external audit services prior to the enactment of the PCAOB rule. On the other hand, more than half (56%) of all community banks, including 36% of large community banks, have no plans to engage different firms for tax consulting and external audits. Perhaps they do not fear conflicts, feel they have good control of these relationships, or simply value the relationships and see efficiencies and cost benefits in using one firm for both tax and audit services.

Other remedies

As far as other corporate governance procedures, even prior to SOX, one-third (34%) of all community banks met regularly with their accounting firms for planning, progress updates and final audit reports. In response to SOX, an additional one in five (22%) increased the number of these meetings.

Two-thirds (64%) of all community banks had audit committees composed solely of outside directors prior to the enactment of SOX; that number will

increase to eight in 10 (80%) by the end of 2005, if all planned actions are executed.

Executives at more than eight in 10 (84%) large banks report they had only outside directors on their audit committees even prior to 2002. By the end of 2005, this will be true for virtually all (98%) of the country’s largest community banks.

The same trend applies to including individuals with financial expertise on audit committees. Prior to SOX, almost three-quarters (72%) of large banks required their audit committees to include financial experts; another 13% did so specifically in response to SOX.

On a broad basis, executives at small banks are less likely than executives at large banks to make voluntary changes in response to SOX. These banks may need additional time to implement best practices because their resources are already stretched with mandatory compliance issues.

Looking for respite

Just how aggravated have public banks become with the complexity and cost of regulation or regulatory compliance? Enough to restructure their ownership? Today, 15% of public banks said, yes, they are likely to take their banks private in the next three years. This is a startling jump from 8% in the 2004 survey. Even more striking, one in five (21%) medium and small public banks are weighing the decision to go private in the next three years. In addition, 16% of bankers who say they may convert their banks to private ownership also say it is likely that their banks will be sold in the next three years.

Why public banks want to go private

burden of complying with regulations	90%
cost of complying with regulations	90%
reduce need to disclose activities if private	26%
more control if private	16%
means of utilizing excess capital	11%

The most often cited reasons for going private are the regulatory burden (90%) and the cost (90%) of compliance with regulations.

This is a further reflection of what regulators already know. Small- and medium-size depository institutions are bearing an inordinate regulatory burden. The banking regulatory agencies are committed to reducing regulatory burden on small and medium community banks. It remains to be seen if the results will come fast enough to preserve local bank stock as a viable investment option for community members.

Regardless of ownership structure, the price of attracting, retaining and educating board members has increased. Considerably fewer private community banks (23%), however, had to increase compensation paid to audit committee chairmen and members than public banks (41%) or mutual organizations (49%).

Regardless of perspective, the increased attention to internal controls and accounting issues generated by the corporate debacles in the early days of the 21st century have reached into the pockets of organizations, especially banks, of all sizes.

The effect of SOX and implementing regulations is to raise costs for all banks. All are paying the increased price.

Growing in the face of competition

The majority of bankers (53%) feel that the nation is “over banked.” An even greater majority (69%) say that their particular markets are over banked. When broken down by market served, bankers’ opinions follow general expectations. Fewer urban bankers think the nation (43%), or their markets (56%), have too many banks. More suburban bankers (77%), comparatively, say they could do with fewer banks in their markets.

Bankers are confident that they know exactly who their competitors are. Two-thirds (67%) of bank executives overall say they know their competitors. Even more executives at large banks (78%) and mutual banks (81%) are confident that they have identified all their competitors.

Again this year, bankers most often identify other community banks (76%) as a major source of competition. Ironically, over banking may very well stem from too many community banks vying for community customers.

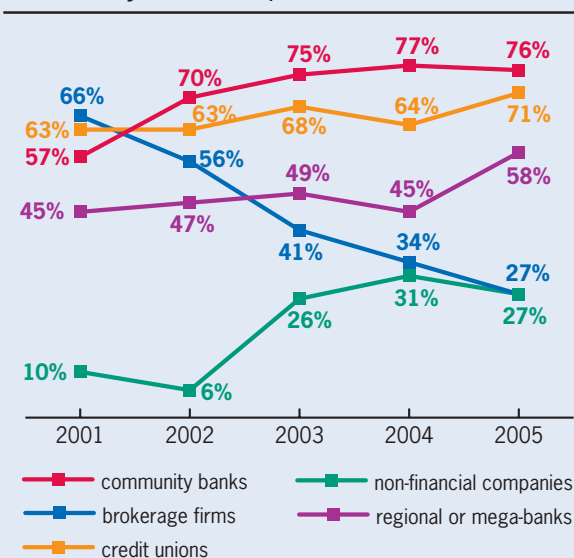
Other community banks are seen as a competitive threat more often by the executives at suburban banks (84%) than the executives at urban banks (69%) or at rural banks (71%).

Credit unions — a perennial threat to community banks — are named as major competitors by even more bankers this year (71%) than last (64%). This is likely due to various efforts to expand credit unions’ commercial lending authorities or relax common bond limitations. Bankers are especially wary of the growth of “mega-credit unions” with assets in excess of \$1 billion. Regardless of size, community served or ownership structure, bankers agree that credit unions are a significant source of competition.

Also this year, more community bankers (58%) identified regional or mega-banks as significant threats than last year (45%). This jump may be because regional banks are making acquisitions in markets previously “owned” by community banks.

Non-financial companies (e.g., Wal-Mart, 7 Eleven, Western Union) and brokerage firms are now on par, with 27% of bankers identifying each as a competitor. Although fewer bankers cite non-financial companies as threats this year, down from 31% in 2004; these competitors remain threatening to more small banks (40%) and to rural banks (35%) than their counterparts.

Community bank competition



Sources of competition

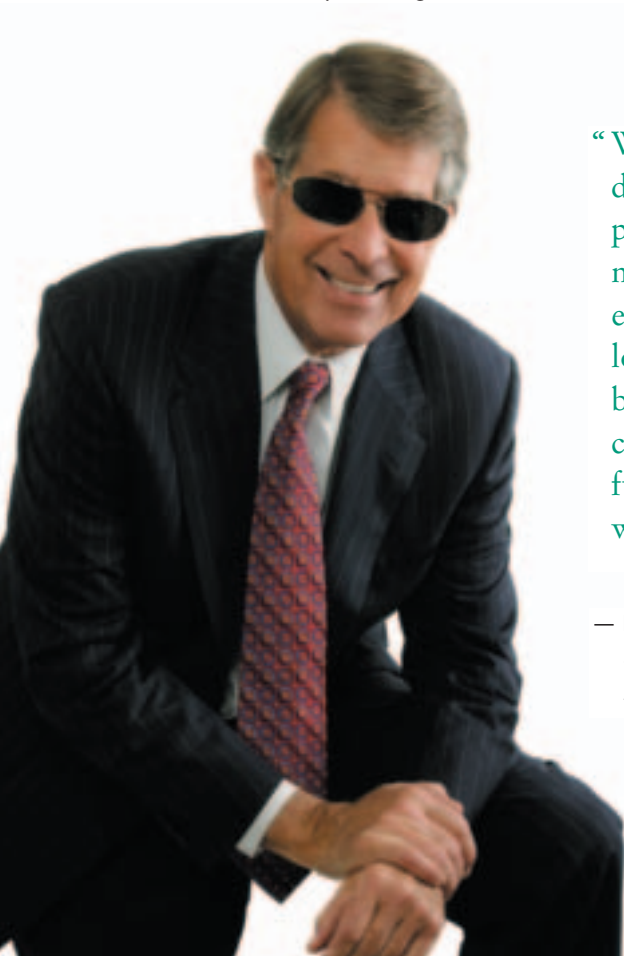
	2005	2001
community banks	76%	57%
credit unions	71%	63%
regional or mega-banks	58%	45%
mortgage companies	45%	36%
brokerage firms	27%	66%
non-financial companies (Wal-Mart, 7 Eleven, Western Union)	27%	10%
farm credit banks	21%	17%
mutual fund companies	19%	49%
insurance companies	17%	31%
government sponsored entities (Freddie Mac, Fannie Mae, FHLB)	11%	16%
industrial banks	8%	-
finance companies	7%	8%

The future looks bright

“The sun’ll come out tomorrow,” as the song goes, is community bankers’ opinion for 2005.

More than two-thirds (68%) of bank executives have an optimistic outlook for the state of the national economy and seven in 10 (70%) have an optimistic outlook for the business of community banking in 2005.

With this positive outlook, it is not surprising that three in five (62%) community bankers also think the country is moving in the right direction. Three-fourths (74%) of community bankers who are optimistic about the future of community banking are also optimistic about the general direction in which the country is heading, compared to only one-third (35%) of those bankers who have a more pessimistic outlook for community banking.



2005 looks better to many more community bankers than last year² (2004) did. At the beginning of 2004, only one in 10 (10%) executives had an equally positive outlook for the economy and only two in 10 (18%) were equally optimistic about the business of community banking.

At the beginning of 2004, 40% of bank executives had a fair or poor (“pessimistic”) outlook on the economy; 26% had a dreary (fair or poor) outlook for the business of community banking. Now, in 2005, only 6% exhibit negative expectations for the national economy and a mere 4% have a gloomy outlook for the business of community banking.

“With deposits up and delinquencies down, a positive outlook on the job market and loan demand expected to increase, 2005 looks to be a good year for bankers. For the nation and community banking, ‘the future’s so bright, I gotta wear shades.’”

— **Richard Cupp**, chief executive officer and president
1st Century Bank, Century City, Calif.

By asset size, however, fewer executives at small banks (62%) than large (78%) or medium (72%) banks are optimistic about the business of community banking in 2005. Last year, optimism was consistent across asset sizes.

Today’s experience sets tomorrow’s expectations

Community bankers may have such a good outlook for 2005 because 2004 turned out to be better than expected. Many saw an upswing in loan demand, a decline in delinquencies, and relative stability of core deposits.

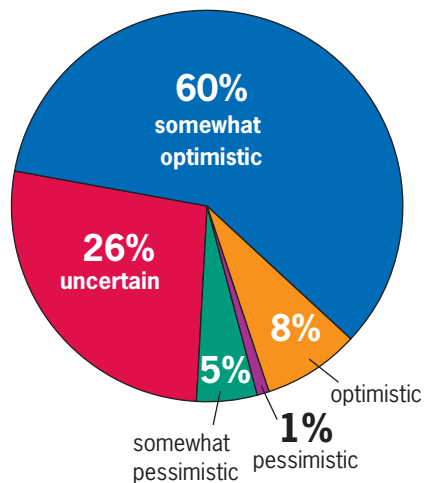
At the end of 2003, one-quarter (27%) of all executives expected delinquencies to increase and only 14% thought delinquencies would decrease in 2004. Instead, they reported quite different results at the end of 2004. Only one in five (18%) said delinquencies actually increased and a quarter (26%) reported that delinquencies declined.

Regarding core deposits, bankers’ expectations were right on track. In last year’s survey, almost one-half (45%) of the bankers anticipated deposits would continue to rise. In this year’s survey half (49%) of the bankers reported increased deposits. At the end of 2003, 14% expected a drop in core deposits for 2004. This was confirmed by 14% of bankers in the 2004 survey. Fewer community banks may have enjoyed growth in core deposits, but they seem to have experienced more stability.

² Note the national economy and business of community banking questions were modified from “poor, fair, good, very good, excellent” in the 2004 survey to a number gradation from 1 to 5. Nevertheless, Grant Thornton believes the comparisons are valid with significantly more bankers exhibiting a positive outlook.

Bankers outlook for 2005

State of national economy

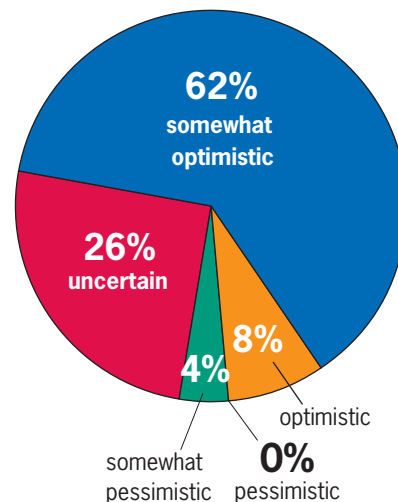


Large banks had a better year than small banks. They were more likely to report increased loan demand (64% versus 44%) and core deposits (61% versus 39%); and were also more likely than small banks to report a decrease in delinquencies (37% versus 21%).

In general, community bankers expect 2005 to parallel 2004. They are cautious about predicting modifications in customer behavior. Half (53%) anticipate loan demand to increase in 2005. Bankers are only somewhat more guarded as far as core deposits; four in 10 (41%) are willing to say they expect deposit growth to continue in 2005.

Only 14% are willing to predict fewer delinquencies in the coming year. Nevertheless, no matter how cautious, the bankers' optimism tempers their delinquency concerns. Generally, they do not expect delinquencies to increase; rather, considerably more bankers think rates will remain the same: 65% this year, up from the

State of community banking



55% who saw no change in delinquencies from 2003 to 2004.

More confidence

Despite (or perhaps because of) industry warnings and media stories or because they already have well-documented internal controls³, insider fraud and mortgage fraud are not issues of particular concern at most community banks.

Only one in 10 (11%) bankers is worried about insider fraud at their banks. Even fewer executives (5%) are concerned about mortgage fraud. Community bankers clearly know their customers and are confident that they know their employees. As noted by the FDIC in its Future of Banking Study⁴, community banks have the "...ability to assess the creditworthiness of borrowers without long credit histories..." The famous "six degrees of separation" may be even fewer in the hometowns of community banks.

Elements essential to successful community banking

For the fourth year in a row (2002-2005) the most often identified element in community banks' continued success remains "retaining key employees" (93%), tying this year with the first time survey option of "retaining deposits."

Human element. Almost three-quarters (73%) of all bankers are comfortable in their accomplishments with regards to their employee retention records. Confidence is high regardless of bank size. Executives at mutual organizations (83%), however, are more confident about their ability to keep employees than executives at private (70%) institutions.

But, bankers are divided on how difficult is it to find and keep the employees that mean so much to the success of their banks. Only one quarter (27%) of the bankers agree that it is difficult to attract and retain qualified employees. Rural bankers (32%) are more likely to agree that they have had difficulty in this task than suburban bankers (23%).

On the flip side, 44% of bankers say they do not have difficulty attracting and retaining qualified employees. Half of the executives at large banks (51%) hold this position, compared to 40% of the executives at small banks. Mutual bank executives (54%) were also more likely than private bank executives (41%) to say they have no trouble finding the employees they need.

³Currently, 67% of all community bankers report that they have developed comprehensive documentation of internal controls either before or since SOX was enacted.

⁴FDIC, "Community Bankers: Their Recent Past, Current Performance, and Future Prospects," Future of Banking Study, FOB-2004-03.1, www.fdic.gov.

Business issues for continued success

	important*	confident**
retaining key employees	93%	71%
retaining deposits	93%	62%
attracting new business customers	92%	53%
developing new sources of revenue	85%	33%
enhancing use of technology to improve productivity	80%	57%
offering Internet banking services	71%	73%
finding adequate funding resources	71%	64%
updating/expanding technology to better track customer needs	64%	33%
planning for management succession	63%	55%
measuring customer profitability	60%	29%
corporate governance	52%	69%
offering non-traditional financial services (insurance, broker/dealer, mutual funds, real estate)	39%	26%

*percent of bankers who say the issue is important to their bank's success.

**percent of bankers who say they are confident in their bank's performance in this area.

Furthermore, it would appear that one's outlook for community banking⁵ may have some impact since 48% of the "optimists," compared to only one-third (35%) of the "pessimists," have a sunny perspective on the availability of labor in their markets.

In line with their generally optimistic outlook for the economy, the nation and their own banks, half (51%) of all bankers plan to add staff, while only four in 100 are likely to reduce staff in 2005.

In contrast to their attitude regarding retaining key employees, bankers are not nearly as confident when it comes to retaining deposits. Just under two-thirds

(62%) of bankers are confident in their ability to do so.

Service element. Retaining deposits, understandably, connects with two other elements identified as important to community banks' continued success: developing new sources of revenue and finding adequate funding resources. Overall, 85% of community bankers say that developing new sources of revenue is an important element of success, but only one-third (33%) have confidence in their efforts.

Only two in five (39%) community bankers think offering non-traditional financial services such as insurance, broker/dealer, mutual fund, or real estate services is important to their success. Fewer executives at small banks (27%) think these

services are more important than those of medium (39%) or large (55%) banks.

Technology element. Technology is of widespread importance to community bankers. Four in five (80%) of all bankers say that enhancing their use of technology to improve productivity is important; but fewer than three in five (57%) are comfortable with their performance in this area. This may be because the executives who are the focus of this survey are not the "techno-gurus" of their banks.

Even more of the audit committee chairmen (87%) than the executives of public banks (72%) cite the importance of using technology to improve productivity. This may be because audit committee chairmen frequently work in businesses outside of banking and may make greater use of and have a greater appreciation of technology in their primary industry.

For the first time in three years, there was a dip in the number of bankers that value customer profitability measurement. In this year's survey, only six in 10 (60%) bankers say measuring customer profitability is important to their continued success, compared to about seven in 10 bankers in the three previous years' surveys. Relatively few bankers overall (29%) have confidence in their ability to measure customer profitability.

Because the success of community banking is so thoroughly intertwined in the success of the community it serves, these bankers may have a different perspective on customer profitability than what can be provided by modeling or other analytical software and techniques.

⁵"Optimists" are those bankers that indicated they have a positive outlook for community banking in 2005. Conversely, "pessimists" are those bankers who indicated they have a more negative outlook for community banking in 2005.

Spotlight on the business of banking

Recent laws and regulations have turned the spotlight on how banks conduct their business, what services they offer and the delivery mechanisms they use.

The Basel Committee on Banking Supervision⁶ seeks to develop internationally consistent capital adequacy supervisory regulations. Even though community banks are not generally subject to Basel II, the deliberations highlight key operating risk issues that are important for all banks, without regard to size or international activities.

The Sarbanes-Oxley Act (SOX) of 2002 not only focused on accounting and reporting but also emphasized internal controls and procedure documentation.

Additionally, the Gramm-Leach-Bliley Act (GLBA) of 1999 not only opened new doors on products and services for banks and other financial services companies, but also added new requirements to assure consumer privacy.

Bankers' performance

Probably because of the increased scrutiny of financial reporting in recent years, even more bankers (87%) acknowledge the importance of quality financial reporting to their success than last year (78%). In addition, more bankers (86% compared to 78% in 2004) express confidence in the quality of their financial reports.

Although 84% of bankers say that government regulations are the source of their biggest increase in time and manpower costs, nine in 10 (86%) agree that complying with regulations such as GLBA, Bank Secrecy, and the USA Patriot Act is important to their success. Three-quarters (73%) are confident in their compliance, leaving one-quarter of all banks somewhat less confident.

When asked if laws and regulations such as the Bank Secrecy Act and the USA Patriot Act were effective in fighting terrorism, almost one in five (18%) bankers agreed; but more than two in five (43%) disagreed.

With continued reminders of terrorist threats, regular newscasts of natural disasters including the devastating hurricanes that ripped through Florida and other parts of the South and the floods and landslides that inundated California in 2004, more bankers (74%) embrace the

“To exceed customer expectations, banks have gone to greater and greater lengths — from offering online bill payments to having ATMs on every corner. At Woodforest National Bank we even have ‘round the clock’ branches inside Wal-Marts that are open 24 hours a day to accommodate our customers.”

— **Robert Marling, Jr.**, chief executive officer
Woodforest National Bank, The Woodlands, Tex.



⁶For more information on the Basel Committee on Banking Supervision, go to the Bank for International Settlements Web site www.bis.org.

Operational issues for continued success

	important 2005	confident 2005
protecting customers' privacy	92%	81%
assuring quality of financial reporting	87%	86%
verifying systems operations and controlling technology risks	86%	58%
complying with regulations (GLBA, Bank Secrecy Act, USA Patriot Act)	86%	73%
assuring security of Internet services	86%	60%
confidence in third-party service providers	79%	58%
managing investments	79%	76%
planning for business continuation after a physical, economic and/or business disaster	74%	66%
developing appropriate written business procedures	65%	64%
implementing Check21	64%	73%
structuring secondary market activities	35%	38%

importance of business continuity planning, up from two years ago (64%). In addition, bankers' confidence in their planning has improved steadily. Today, two-thirds (66%) of bankers are confident in their business continuity plans, up from half (48%) in 2003.

Well-documented business procedures are part and parcel of well-documented internal controls and are key elements of quick recoveries after business disruptions. Well-documented business procedures can also enhance the bank brand and promote delivery of the brand promise by guaranteeing consistent, timely and secure delivery of services.

The perspective of bank executives on the importance of written business procedures is trending upward. In the Grant Thornton survey just two years ago (2003), only half (50%) of all bankers

thought written business procedures were important to their success, and less than three in five (56%) were confident in their written procedures.

Today, two-thirds of bankers say documenting business procedures is important (65%), and that they are confident in their performance (64%).



This change in perspective surely is due, at least in part, to the internal control emphasis of SOX and maybe even to recent Basel II discussions of operations risk that are so widely reported in industry press.

Nine in 10 (92%) community bankers believe that protecting customers' privacy is very important to their banks' continued success. This is an increase over last year and a continuation of the upward trend since 2002. Eight in 10 (81%) bankers are confident in their ability to protect their customers' privacy, about the same as previous years.

Although 86% of bankers acknowledge the importance of assuring Internet security, their comfort with their performance wanes, with only 60% expressing confidence.

Planned efforts to make the bank grow

	total	small	medium	large
increase cross-selling efforts to current customers	81%	76%	81%	91%
conduct promotions to attract new customers to existing products and services	70%	59%	74%	77%
offer new products and services	67%	56%	71%	71%
expand market area by opening new branches in new geographic area	49%	29%	53%	70%
open new branches in existing market area	39%	17%	41%	64%
acquire another bank or financial services organization	30%	17%	27%	55%
add ATMs	24%	18%	24%	35%
enter joint venture/affiliation (insurance, real estate, broker dealer)	23%	22%	21%	28%
expand market area by purchasing branches from another bank	18%	5%	23%	26%
purchase branches from another bank in my current market area	12%	5%	12%	24%
sell or close branch(es)	6%	4%	4%	11%

The picture is comparable for bankers' confidence in third-party service providers, which most community bankers rely on for some of the most important aspects of their operations. Four in five (79%) recognize how important their third-party partners are to their success and, yet, only three in five (58%) are comfortable in these relationships.

Verifying systems operations and controlling technology risks are important elements of daily operations. If the bank's computers go down, banking services may not halt completely, but operations certainly would be not only more difficult, but also riskier. Nearly nine in 10 (86%) community bankers recognize the importance of testing and verifying systems; however, fewer than six in 10 (58%) are confident in their banks' testing capabilities.

Taking these last four items together — privacy, Internet security, confidence in third-parties, and technology risk — we see a startling picture.

Although community bankers express widespread concern about protecting customers' privacy, they generally are not confident in their performance in these key areas that are essential to privacy protection. Customer privacy cannot be considered sufficiently protected until all bankers are confident in their third-party service providers, their systems and their Internet security. As always, there can be security without privacy, but there is no privacy without security.

The best defense is a good offense

For 81% of banks, the first defense against competitive forces and a catalyst for growth in the next three years is to increase cross-selling efforts to current customers. Although cross-selling is important to banks regardless of size, community served or ownership structure, large banks are particularly likely (91%) to cite cross-selling as a strategy for growth.

In spite of this emphasis on cross-selling, only one-third of community bankers (34%) report currently having specific cross-selling goals for management-level employees; even fewer (28%) have cross-selling goals for all employees. The bright side is that these are both increases over 2004 when only one-quarter (24%) had cross-selling goals for management and one-fifth (21%) had set them for all employees.

Outlook on outsourcing

Unequivocally, community bankers do not outsource customer service, loan processing or other job functions to companies outside the United States, nor do they have any plans to do so in the next three years.

Nine in 10 (88%) community bankers say their third-party service providers do not outsource to subcontractors outside of the United States. However, 11% do not know whether or not their service providers use foreign contractors.

Bankers' opinions of third-party providers that use foreign contractors are mixed. More than one-third of all community banks (34%) say they would probably change third-party providers if they found out that they were outsourcing outside of the United States; while the same percentage say they would not consider changing service providers under these same circumstances.

Large banks are ahead by far: two-thirds (65%) have cross-selling goals for management and half (52%) have them for all employees. Even though three in four (76%) small banks say they intend to grow through increased cross-selling, only 14% have established cross-selling goals for either management or other employees.

Basic incentives, sales training, leadership development, coaching, and feedback are key ingredients of successful cross-selling. Individual, fairly based goals

More rural bankers (44%) say they would withdraw their business from service providers who use foreign outsourcers than suburban (25%) or urban (27%) bankers. Perhaps these bankers are more sensitive because rural communities have been hard hit by outsourcing in the manufacturing industry.

Community bankers are also divided when it comes to the issue of U.S. government controls on foreign outsourcing. Half (52%) of the bankers say that they are against such regulations, while one in five (18%) agree that governmental regulatory intervention is appropriate to control foreign outsourcing. Once again, rural bankers are more likely than their counterparts to support government controls, with one-quarter (26%) agreeing they are appropriate.

can be powerful tools to spark life into cross-selling programs and can be used effectively in a bank of any size.

Seven in 10 (70%) of all community banks are defending their turf by going after new customers that may have a need for existing products. Again, large banks (77%) are more likely to aggressively promote existing products than small banks (59%); and suburban banks (78%) are more likely to use this tactic than rural (65%) or urban (64%) banks.



Bankers are also going on the offensive. Even though 53% of all community bankers say the nation is over banked, 49% still plan to expand their market areas by opening new branches in new geographic areas. One-fifth (18%) of all bankers report these branches will be purchased from other banks. Large banks (70%) and urban banks (68%) are especially likely to move beyond their current market areas to open new branches, find new customers and grow.

In addition, while more than two-thirds (69%) of community bankers believe their particular market areas are over banked; 42% of these same bankers plan to open new branches in their existing market areas within the next three years. Evidently, these bankers believe there may be too many different bank choices in their areas, however, at the same time, still not enough convenient access points to their own banks.

Improving convenience is certainly one method to promote growth. One in four (24%) bankers, including almost one-third (31%) of bankers that serve suburban markets, contend that they will increase ATM access, either by adding proprietary units or by joining networks.

Some community bankers are trying to thin out competition in their market areas. Thirteen percent of those bankers who say their markets are over banked plan to buy branches from another bank in their market space. In general, the executives at large banks (24%) and public banks (20%) are even more likely to say they are on the hunt in their own market area.

Notwithstanding the popular notion of over banking, only 6% of all community bankers, including 11% of large banks, indicate they will sell or close branches in the next three years.

Furthermore, 10% of public and private bank executives indicate that it is likely their banks will be sold within the next three years.

Funding bank growth

	used in 2004	plan to use 2005	will use in 3 years
earnings	88%	89%	86%
FHLB advances	56%	63%	61%
brokered deposits	22%	25%	26%
issue trust preferred securities	12%	9%	14%
issue common equity	8%	7%	10%
securitizations	4%	5%	5%
issue preferred stock	1%	1%	1%

Funding feeds growth

Seven in 10 (71%) bank executives identify finding adequate funding resources as important to their banks' continued success and 64% are comfortable with their banks' ability in this area. Although somewhat fewer (62%) executives at small banks name funding as particularly important to continued success, fewer (56%) also exhibit confidence in their performance. Executives at three-quarters of large (75%) and medium (74%) banks rate adequate funding sources as very important to their continued success and about two-thirds say they are confident in their banks' performance.

Earnings consistently are by far the most popularly cited funding resource for growth. Nine in 10 (88%) community bankers reinvested earnings in 2004; nine in 10 (89%) expect to fund growth with earnings in 2005; and almost nine in 10 (86%) anticipate reinvesting earnings to fuel bank growth over the next three years.

The flexibility of Federal Home Loan Bank (FHLB) loans also helps bankers fund growth. More than half (56%) of all bankers used FHLB advances for funding last year, more than the 46% who said they expected to use them. Even more bankers (63%) expect to rely on FHLB advances to fund growth in 2005. It does not appear that this usage rate will abate over the next three years, when three in five (61%) bankers expect to rely on FHLB advances.

More than one in five (22%) bankers reported funding 2004 growth by using brokered deposits; up from 16% in 2003. Future use is expected to level off with one-quarter of community bankers planning to broker deposits in 2005 (25%) or over the next three years (26%).

To feed growth, private banks have the option of going public. Eight percent of the executives at all privately held banks said they are somewhat or very likely to take their banks public in the next three years. Half of these (50%) said that if they did so, it would be to fuel growth; six in 10 (60%) said it would be to seek more capital.

Nurturing the customer relationship

In the past two years, banks enjoyed vigorous deposit growth. Two-thirds (66%) of community banks saw deposits increase in 2002; 65% reported increases in 2003; half (49%) enjoyed increased deposits in 2004; and 41% expect continued growth in 2005. Core deposits continue to be the most basic resource for community banks.

That is probably why seven in 10 (70%) community bankers believe that their bank is doing a great job in delivering what customers want and need. Executives at large banks (75%) are more likely to express such satisfaction than executives at small banks (64%). This may reflect larger banks' abilities to offer more services due to economies of scale. Nevertheless, the majority of community bankers are confident in their ability to meet their customers' needs.

Community bankers not only know their competitors, they also recognize that they are in head-to-head competition for their customers' loyalty. On average, community bankers estimate that almost half (46%) of their customers have demand deposits or loan accounts at other institutions. Therefore, they have made concerted efforts to retain and attract new deposits and to win more of their customers' business. Their plans indicate these efforts will extend into 2005.

Studies have shown that customers who use Internet banking maintain higher balances, use more services and stay with the bank longer than non-Internet users. In keeping with this, the most often cited technique bankers use to attract and retain deposits is to promote Internet banking services.

Even though fewer bankers acknowledge the importance of Internet banking to their future success this year (71%) than last year (79%), in general, they are committed to using Internet banking to help them retain deposits. In 2004, seven in 10 (69%) promoted electronic bill payment and Internet banking specifically for this reason; six in 10 (63%) indicate that this is their plan for 2005.

Bankers are on target with consumers' desires. In a recent study by Keystone Systems, based in California, 56% of consumers said that online banking and electronic bill payment were more important than physical location when they selected their banks.

Community bankers meet their competitors head-on when it comes to keeping their customers. Three in five (57%) say they offered to match or exceed competitors' rates to retain or attract new customers in 2004. Almost half (46%) say they would be willing to do so in 2005.

More than two in five (44%) banks offered new savings products in 2004. And, while only 9% offered new Health Savings Accounts (HSA), almost one-third (31%) expect to offer HSAs in 2005.

In 2004, many banks tried to make physical access more convenient. About one-third (31%) said they opened branches to attract and retain customers; more than two in five (44%) say they will open branches in 2005 for the same reason. One in seven offered expanded service hours or will do so this year.

Less traditional tactics bankers use include "open house" events (43%), financial planning seminars (31%) and banking services for children (23%).



Commercial service offerings

	total	small	medium	large
average % commercial clients	32%	27%	33%	37%
percent of banks offering:				
cash management	50%	17%	56%	83%
payroll services	24%	17%	27%	28%
equipment leasing	20%	11%	18%	39%
none of these	37%	63%	32%	12%

Tending to the most valuable customers

Community bankers are trying to learn more about their best customers and target those that are most profitable. Two in five (40%) bankers say they identified and targeted these customers in 2004 and almost three in five (58%) say they will in 2005. Yet, when asked if they have procedures for identifying and tracking their most valuable customers, only one-third (33%) said they did in 2004. However, almost three-quarters (71%) say they will three years from now. Comparatively, three years ago (in the 2002 survey), 79% said they intended to be able to identify and track their most valuable customers by now.

Despite two-thirds (64%) of bankers saying that updating and expanding technology to better track customer needs is important to their continued success, they have not been able to do so, by and large.

In the 2002 survey, three in five community bankers said they expected that they would be using customer relationship management (CRM) software in three years (2005). But, today, just 27% — no change from last year — actually do. Adoption of technology-based solutions is apparently much more feasible for large banks than for small. More than half (52%) of large banks use CRM software, with four in five (83%) saying they expect to have it in place within the next three years. Only one in 10 (11%) small banks currently have CRM software; although three in 10 (30%) hope to have it by 2008.

Unfortunately, bankers' intentions for three years from now still may be wishful thinking. Prices still may be too high; applications, too complicated; and implementation, too labor-intensive. In addition, bankers' resources are strapped as they focus on regulatory issues and invest in compliance programs related to corporate governance, the USA Patriot Act and the consumer privacy provisions of the Gramm-Leach-Bliley Act, among others.

Cultivating business customers

Community banks traditionally have been important business allies for community-based businesses. In turn, these businesses are important customers for community banks.

The banks responding to this year's survey, on average, report that 32% of their customer bases are commercial customers. Mutual banks report that 16% of their customers are commercial entities.

Almost all (92%) executives say attracting new business customers is important to their continued success. Unfortunately, however, just over half (53%) are confident in their performance.

In addition to deposit and loan accounts, some banks offer their business customers more specialized commercial products. Half (50%) of all community banks offer a cash management product. Large banks (83%) and public banks (68%), however, are more likely to offer services, such as cash concentration and/or cash disbursement arrangements and sweep accounts.

Software packages designed to help community banks tailor services to the needs of their commercial customers have become more prevalent and, in many cases, more cost effective. But, to meet community banks' needs and expectations, these improvements apparently have not been enough.

Conclusion: Bankers' optimism reflects a bright future

In 2005, community bankers are optimistic and self-assured, maybe even somewhat content. In spite of intensifying competition, they are committed to growth. Bankers are very confident that they are meeting their customers' needs, but they have not stopped looking for new products and services or ways to enhance convenience and productivity.

Community bankers are confident in their corporate governance policies and procedures. Because complying with government regulations is widely seen as a key element in bringing them business success, community banks are working to beef up procedures to implement best practices as well as conform to regulatory mandates.

Nonetheless, meeting government regulations is a major source of expense for community banks — both in terms of time and manpower. Medium and small publicly owned community banks are even considering conversion to private ownership to ease their regulatory burden. Consolidation in the banking industry is not over; community bankers are still in the market to buy and sell as they look to find new economies of scale.

Investments to assure regulatory compliance may be interfering with community bankers' ability to introduce new technology to help them better understand and meet their customers' needs. Although they have not been able to invest in customer relationship technology the way they intended to three years ago, they hold on to the hope that they will be able to add technology to help them determine customer profitability and better identify customer demand in the not-too-distant future.

Community bankers have faith in the future of the nation and are passionate about the business of community banking.

“Community bankers' commitment to strong corporate governance and to their communities makes me believe 2005 will be a great year for community banking.”

— **John Ziegelbauer**, managing partner
Grant Thornton's National Financial Institutions industry practice



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