A Grant Thornton LLP study produced in association with

Bank Director®

BANK BOARD & EXECUTIVE SURVEY:

Cautious Optimism on the State of Banking

SEPTEMBER 2013

RESEARCH

Grant Thornton

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In June of this year, *Bank Director* magazine and Grant Thornton LLP conducted the 2013 Bank Board & Executive Survey, polling CEOs, senior executives, chairmen and audit committee members of the nation's banks on the current state of the banking industry—and their thoughts on the future.

Amid a slow-growth environment, last year's survey found respondents much less optimistic about the state of the U.S. economy. This year, as the housing market improves and interest rates finally seem to be rising, the leaders of the banking industry indicate a rosier view of economic affairs—although they remain wary of the impact of economic events on their institutions. Bank leaders indicate that lending will continue to drive plans for growth, while they strive for efficiencies that improve the bottom line in a continued low interest rate environment. Technology is also top of mind for respondents, who reveal what retail innovations they value and what cyber security risks keep them up at night.

As the Dodd-Frank Act closed in on its third anniversary, the banking industry saw a wave of activity from U.S. regulatory authorities. The U.S. Senate finally confirmed Richard Cordray as director of the Consumer Financial Protection Bureau (CFPB), and the Board of Governors of the Federal Reserve System issued final capital regulations to bring U.S. banks more in line with Basel III. "By the end of this year, the core elements of the Dodd-Frank Act will be in place," promised U.S. Treasury Secretary Jack Lew in July, to attendees of the CNBC/Institutional Investor Delivering Alpha Conference.

With less than half of the rules within Dodd-Frank finalized, it's not surprising that survey respondents remain deeply concerned about the implementation of regulations coming out of Washington. Nichole Jordan, national banking and securities sector leader for Grant Thornton LLP, says that bankers see that things are getting better, but remain wary of competitive and regulatory challenges. "There's still a great deal of uncertainty as a result of the evolving regulatory environment," she says. "Banks are increasingly concerned that they will be unable to meet onerous compliance requirements and still be profitable."

Key Findings

The results of the 2013 Bank Board & Executive Survey demonstrate a growing optimism among bank leaders, with 43 percent of executives and directors of the nation's banks expecting the U.S. economy to improve in the next six months, a rise of 30 percentage points since last year's survey.

- Financial institutions continue to worry about margin compression amid a continued low interest rate environment. Respondents overall cite persistent margin compression as their top concern, at 89 percent. The regulatory compliance burden, at 86 percent, and loan competition, at 78 percent, also rate highly.
- When asked about specific regulatory issues, respondents indicate greater concern about Dodd-Frank implementation and the regulatory and supervisory activities of the CFPB, and lessened concern about Basel III implementation and the Bank Secrecy Act. Perhaps not surprising to many in the banking industry, most respondents describe the CFPB's impact as more negative than positive, though they are split on whether the CFPB will affect their bank's business strategy going forward.
- Executives and directors express a lesser degree of concern on the issue of capital. Seventy-one percent of respondents indicate that their bank's capital levels are satisfactory, and they have no plans to raise capital over the next year. Only 8 percent indicate plans to raise capital to meet potential Basel III standards. Of those that do plan to raise capital, half plan to do so through a private offering to existing shareholders, while 47 percent plan a secondary offering on the public market.
- Cyber security risk is a growing concern for bankers, particularly for institutions with more than $10 billion in assets. When asked about specific aspects of cyber security risk, respondents worry most about online banking fraud, at 76 percent, and data theft, at 73 percent.
- Banks are willing to trim staff as a way to become more efficient. Forty percent of respondents indicate that their bank plans to reduce staff, and 34 percent plan to close branches.
- Banks remain wary of social media, with less than half of respondents indicating that their bank engages with customers via Facebook or Twitter.

Cautiously Optimistic About the Economy

Leaders in the banking industry often have a front row seat to economic ebbs and flows, and this year survey respondents indicate that things might be looking up for the U.S. economy. Forty-three percent indicate that the economy will improve by the end of 2013, with just 4 percent expecting the economy to worsen. What a difference a year makes: In last year's survey, just 13 percent expected the economy to improve. Just over half expect the economy to remain unchanged.

The economy has improved over the last year, but it's not booming either. "We still have issues with economic uncertainty," says Jordan.

Respondents from some regions indicate more optimism than others. Seventy-three percent of respondents from banks in the West expect to see the economy improve—significant-

ly higher than the overall response. Timothy Matz, an independent director at PacWest Bancorp, a $6.7-billion bank holding company headquartered in Los Angeles, says that the western economy has seen significant improvement over the last year. The Southern California real estate market is performing well, and "in Nevada and Arizona, where they were in the real deep recession, they've turned it around," he says.

FIG. 1

Concerns about the Economic Climate

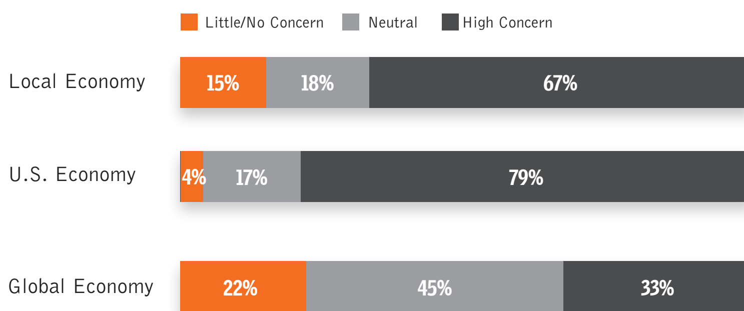
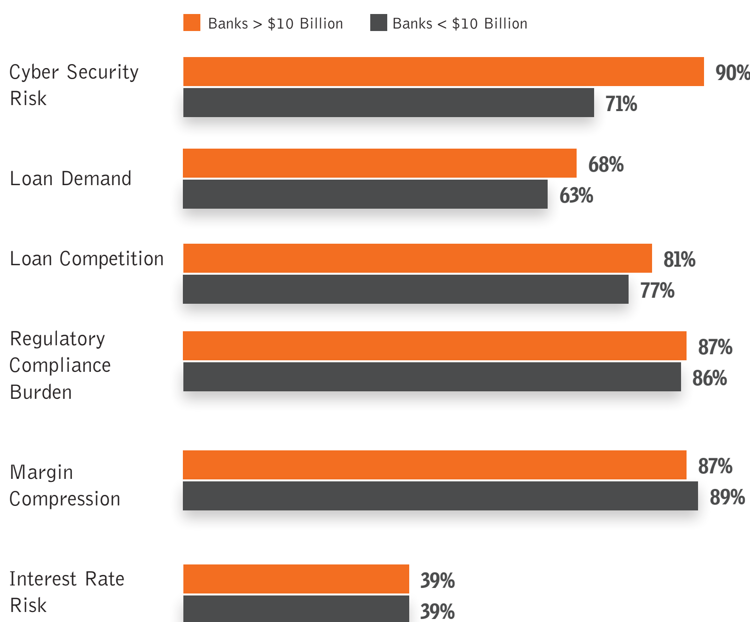


FIG. 2

Top Concerns Revealed



Respondents were asked to rate certain issues in regard to how they would impact the respondent's institutions, using a scale of 1 to 5. A rating of a 4 or 5 indicates a heightened level of concern, while a 1 or 2 indicates no or little concern. Seventy-nine percent indicate a high level of concern when it comes to the impact of the U.S. economy on their institution. Concerns about the bank's local economy are slightly lower, with 67 percent indicating heightened concern. The threat of events around the world, including the European community's ongoing economic struggles, does not warrant as much worry; just one-third indicate anxiety about the global economy.

Top of Mind for Bank Leaders

Concerns about the burden of regulatory compliance, for 86 percent of respondents, and continued margin compression, for 89 percent of respondents, remain top of mind for bank executives and directors. Other key concerns include loan competition, for 78 percent, and cyber security risk, for 76 percent.

Cyber Security Risk: Top Concern at Big Banks

Cyber security risk is a hot topic for respondents from the largest banks, with more than $10 billion in assets. Among respondents in this group, 90 percent cite cyber security risk as their top concern. Rona Pocker, national managing director of bank advisory and regulatory services at Grant Thornton, attributes this to the high profile of these institutions. "If you want to make a name for yourself as a hacker, that's where you would head," she says. While community banks, more reliant on outside vendors, share concerns about cyber security risk, the awareness is not as heightened.

Online banking fraud is the top cyber security concern for 76 percent of respondents, as well as data theft, at 73 percent. Denial-of-Service (DoS) attacks are a top concern for 57 percent of respondents overall, and the issue gains prevalence as the bank gets bigger. Fifty-two percent cite security

risks through mobile app usage as a key concern for their institution. As the number of customers using mobile channels grows, the risks could grow as well.

Interestingly, officers demonstrate greater concern about certain cyber security issues than independent directors do, perhaps due to an executive's enhanced familiarity with these issues. Boards "don't feel like they always have their arms around [cyber security]," says Jordan, due in part to the increasing sophistication of cyber crime.

Regulatory Pressures

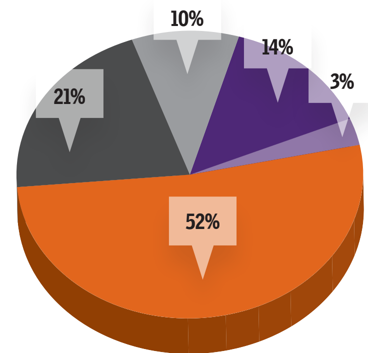
The regulatory compliance burden remains the top overall concern of banking leaders, and when asked about specific regulatory issues, implementation of the Dodd-Frank act rated the highest level of concern. Despite its passage three years ago, bank boards and executives remain burdened by outstanding sections of the legislation that have yet to be written, adopted or even proposed. The scope of work can be overwhelming for many institutions. "You've got more stringent capital and liquidity requirements," says Pocker. "Volcker hasn't been decided." Requirements from the CFPB are also costly to implement. Jordan says given all the other pressures, bankers are left to wonder: "How do we do all this and still make money?"

The Basel III final rules—which were not issued until after the survey had taken place–ranks lower on the list of regulatory concerns, as does the Bank Secrecy Act, with less than half indicating a high level of concern about either issue.

Sixty-five percent of respondents indicate heightened concern surrounding the regulatory and supervisory activities of the CFPB. When asked about the impact of the CFPB on the banking industry, 85 percent of respondents describe the agency as more negative than positive, and are almost evenly split regarding whether or not this will force a change to their institution's business strategy. In part, the business focus of a bank is a determining factor in gauging the agency's impact. Due to the CFPB's emphasis on the consumer, particularly residential mortgage borrowers, some banks are more affected than others.

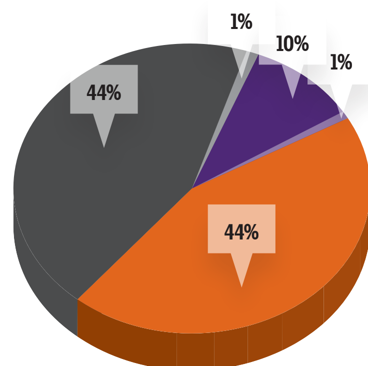
FIG. 3

Impact of the CFPB on the Banking Industry



Private Banks

- More positive than negative
- Negative, but won't impact bank
- Negative, and will force changes to business strategy
- No opinion
- Other



Public Banks

Interest Rate Risk May Be a Rising Concern in 2014

The survey results suggest that rising interest rates will become a larger concern heading into 2014. Seventy-five percent indicate that the impact of continued low interest rates on their institutions warrants a high degree of concern, a reflection of the intense pressure that declining margins have placed on their bank's profitability. Just 39 percent of respondents indicate that interest rate risk will be a concern for their institution over the next year—although that concern might rise now that interest rates are headed back up. As this survey came to a close, Federal Reserve Chairman Ben Bernanke's comments on possible reductions in

quantitative easing—comments he later said were misinterpreted— caused interest rates to jump. For consumers looking into a 30-year fixed rate mortgage, interest rates have risen by over 20 percent from a record-low 3.5 percent in May of this year. Pocker confirms that interest rate risk is a focus of the regulators. "The ongoing exams, which would have historically downplayed interest rate risk, are now much more intense," she says.

Rising rates will impact loan demand, as potential home buyers see their monthly house payment increase. The booming refinance market will also be impacted. "At some point the refinancing demand drops," says Pocker. "The retail mortgage market then relies on new loans, and that will be a very different environment for a number of these banks."

Capital Needs

The majority of respondents, at 71 percent, indicate that the capital levels at their institution are satisfactory. Of the 20 percent indicating plans to raise capital over the next 12 months, 42 percent plan to do so to support loan growth and/or to meet potential Basel III capital requirements, and half to support growth through mergers & acquisitions. While many banks may not seek to raise capital, Jordan says that preservation of capital is vitally important to community banks. Community banks in particular are working to "retain all their earnings and search for lower risk-weighted assets, as well as look for ways to increase earnings so they can increase capital," she says.

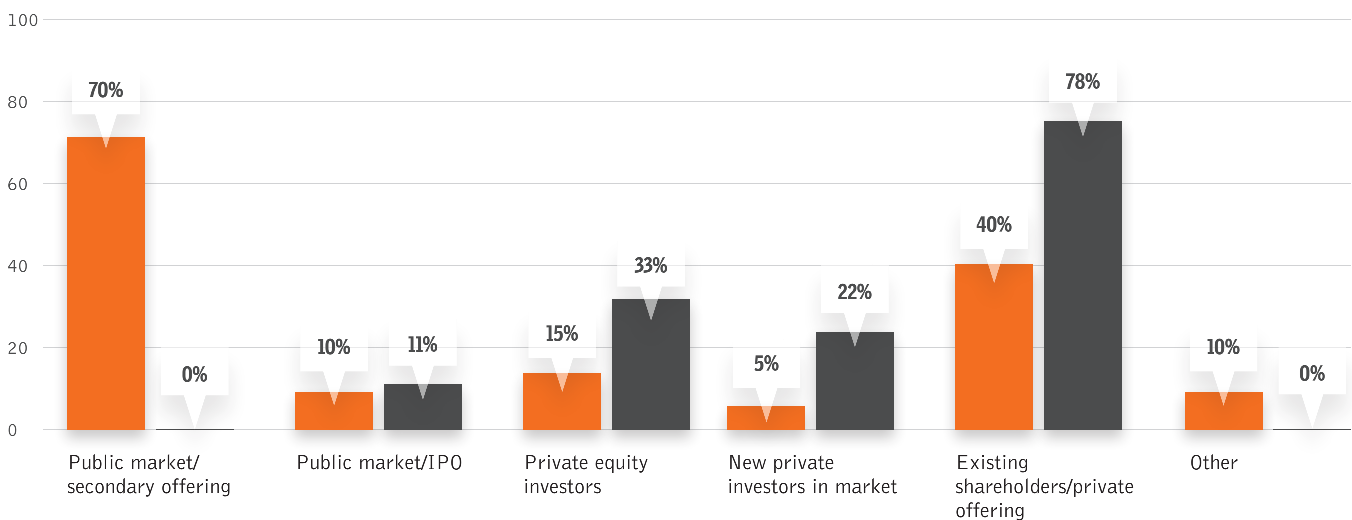
The largest banks, with more than $10 billion in assets, indicate a greater need for capital, with 29 percent voicing plans to raise capital. Nineteen percent of respondents from the largest banks cite Basel III standards as their reason to raise capital.

Many of those respondents whose banks plan to raise capital say they will tap multiple sources, with half planning a private offering to existing shareholders, and 47 percent planning a secondary offering through the public market. Only respondents from publicly traded banks indicate plans for a secondary offering, while the majority of those from privately held banks, at 78 percent, as well as 40 percent from public banks, plan a private offering. Only respondents from smaller banks with less than $5 billion in assets plan to tap another source of capital—private equity investors.

As capital sources are limited, Jordan says to expect continued consolidation among community banks. As directors of smaller institutions realize that

FIG. 4

Where do banks plan to access capital?



the stock price won't rise to the levels seen before the financial crisis, they may consider selling out.

Stress Testing: Continued Pressure from Regulators

In last year's survey, 86 percent of respondents indicated that they already conducted, or had plans to conduct, stress testing on a regular basis. Most respondents to the 2013 survey, at 73 percent, present stress test results to the board. Sixty-six percent use the results in liquidity analyses and/or asset-liability committee meetings. Just more than half use stress test results as part of the bank's strategic planning process.

Larger banks, required to conduct stress tests since the financial crisis, seem to make better use of the results. Eighty percent of respondents from banks with more than $10 billion in assets use the results from stress testing in liquidity analyses, 14 percentage points more than respondents overall. They're also much more likely to use the results to gain leverage with regulators. Smaller banks will have to catch up. "Regulators are putting increasing pressure on the community banks to do more with [stress testing]," says Jordan.

Plans for Growth

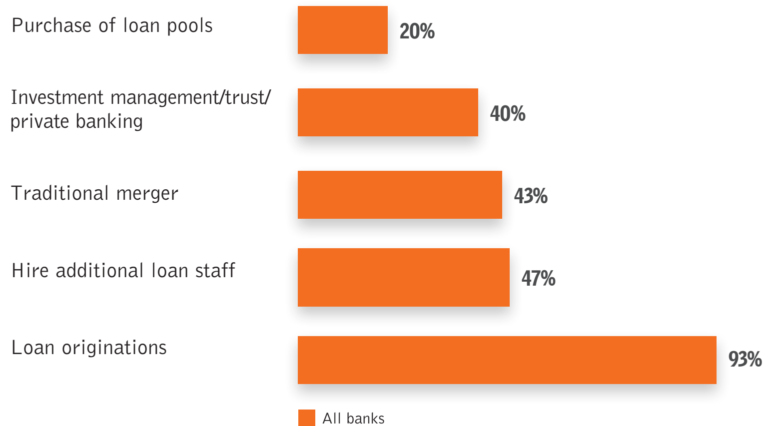
Organic loan origination remains the top choice for growth among survey respondents. Forty-seven percent also plan to hire additional loan staff—and many will 'steal' loan producers from competing banks, says Jordan. Given a competitive loan environment, "if [the bank] can look at a lending officer that has a good book of business that he or she can bring with them [to the bank]" that can be a fairly easy and efficient way to grow the bank, she adds.

More bank executives and boards plan to expand into investment management, according to 40 percent of respondents—up 15 percentage points since last year.

Forty-four percent of respondents plan to grow through an acquisition, a choice slightly more popular with respondents from banks with between $1 billion and $10 billion in assets. While it may be easier to grow quickly this way, "regulators are only going to allow the very strongest banks to

FIG. 5

How do banks plan to grow?



make acquisitions," says Jordan. "It's pretty well implied that unless you are a 1 or 2 [CAMELS] rated bank [then] don't come to [the regulators] with any request to acquire competitors."

Investment in Technology

In addition to growth plans, respondents were asked to reveal how their institutions plan to become more efficient, and 84 percent indicate plans to invest in new technologies to do so. With increased technology investment as well as reduced foot traffic in the branch, it isn't a surprise that 39 percent plan to reduce staff, with larger publicly-traded banks more inclined to make these cuts. Pocker says that some cuts will occur due to shifts in strategy or focus into areas where banks can better compete. However, she cautions that overzealous staff reductions can result in increased operational risks. If the staff is overworked, the bank might seem more efficient, but "it may or may not be more effective in providing its services," she says.

Some investments in technology that create efficiencies for banks can also meet consumer expectations. Most respondents to the survey indicate that they already offer, or plan to offer, online banking, at 88 percent; mobile banking, at 83 percent; and mobile remote deposit capture (RDC), at 74 percent.

Fifty-three percent report upgrades to ATMs.

One-third use, or plan to use, teller capture, while 11 percent have plans to use, or currently use, video tellers. As the industry evaluates what the branch of the future will look like, "certainly there's going to be less brick and mortar going forward, and some of the bigger banks are already experimenting with [video tellers]" as a way to provide service with less staff, says Jordan.

Forty-eight percent report that their bank engages with customers on Facebook or Twitter, although many banks continue to drag their feet due to the associated risks. "I think there are some concerns about reputational risk," that cause banks to take it slow on social media, says Jordan.

Surprisingly, respondents from smaller banks report higher social media engagement, with 71 percent from banks with less than $1 billion in assets reporting customer interaction via social media, while just 28 percent from the largest banks report usage of social media for customer engagement. "If you think about a large, complex bank, it does social media on a big picture basis and tries to reach customers—that's a pretty broad customer base," says Jordan, while a community bank serving a local population would have a more personalized touch to social media.

About the Survey

In June over 130 senior executives and directors of U.S. banks with more than $500 million in assets responded to the 2013 Bank Board & Executive Survey, conducted by Bank Director and Grant Thornton LLP. Twenty-nine percent of respondents serve on their bank's audit committee; CEOs account for 18 percent of responses. Some of the largest banks in the U.S. are well represented, with 24 percent of respondents from banks with more than $10 billion in assets. Thirty-eight percent of respondents represent banks with $1 billion to $5 billion in assets, 24 percent from banks with $500 million to $1 billion in assets and 13 percent from banks with between $5 billion and $10 billion in assets. Most, at 71 percent, work for or serve on the board of a publicly owned institution. Results of past surveys are available in the research section at BankDirector.com.

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