

Federal Reserve System

Community Bank Study

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EXECUTIVE SUMMARY

This section provides Background and Research Methodology information, a Synopsis of Findings, and Results. It includes the major study findings, and can be used as a stand-alone document. For a comprehensive explanation of the information presented in this section, as well as other feedback gathered in this study, please see the Detailed Findings section.

Background

The Federal Reserve's Customer Relations and Support Office (CRSO)¹ formed a Research Steering Group in September 2000 to oversee and provide direction for a Federal Reserve study of community banks. Members of the Research Steering Group include community bankers, academics, and Reserve Bank economists². The primary purpose of this study is to examine the business strategies that community banks are undertaking to remain viable in a changing banking environment, identify what community banks require from the payments mechanism to survive in this environment, and suggest how the Federal Reserve might contribute to meeting those needs.

At the direction of the Research Steering Group, CRSO staff³ conducted one-on-one interviews with 10 community bankers from June through August 2001, and then collected additional information through follow-up communications. The discussion guide⁴ for these interviews includes questions related to findings from The Grant Thornton Annual Survey of Community Bank Executives, published in 1999. The Grant Thornton survey identifies five lines of business that community banks currently offer that are likely to double or triple during the next three years, including insurance/annuities, mutual funds, cash management for small businesses, 401(k) for businesses, and home banking via personal computer. These and other lines of business, along with current Federal Reserve services, were discussed with participants in this study.

The Research Steering Group commissioned the study to stimulate interest in, and to further public policy toward, the community bank sector. The aim of the study – using a qualitative methodology (one-on-one interviews) and a limited sample size – was to gain insight into community banks' business environment. The results are not statistically significant but, rather, should be seen as case studies.

¹ The Customer Relations and Support Office (CRSO) is a national support office responsible for managing sales and marketing initiatives, customer support, and electronic delivery of services to Federal Reserve customers nationwide.

² The Community Bank Research Steering Group is comprised of Edward Green, Research Steering Group Chairman, FRB-Chicago; Richard Anstee, FRB-Chicago; Marcus Alexis, Kellogg Graduate School of Management, Northwestern University; Carol Clark, FRB-Chicago; Camden Fine, Midwest Independent Bank; Geoffrey Gerdes, Board of Governors; Alton Gilbert, FRB-St. Louis; Richard Kolsky, Kolsky and Company; Alan Tubbs, Maquoketa State Bank and Ohnward Bancharas; and Stuart Weiner, FRB-Kansas City.

³ Staff from the Customer Relations and Support Office (CRSO) involved in this study include Carol Clark, Denise Duffy (note taker), Donna Hage (interviewer), and Chris Sink.

⁴ A copy of the discussion guide is provided in Appendix A.

Research Methodology

The Research Steering Group and CRSO determined that one-on-one interviews, rather than focus groups or a quantitative survey, were the appropriate research methodology for this study. One-on-one interviews afford interviewees the privacy and anonymity required for frank discussion of confidential and proprietary issues. In order to collect representative feedback from community banks nationwide, 10 institutions representing diverse asset tiers⁵, location types (urban, suburban, or rural/small town), and geographical locations were interviewed for this study. These criteria were combined as follows:

Asset Tier	Location Type	Geographical Location/Number of Branches
Large	Urban	Southeast/3 branches
Large	Urban	Northwest/4 branches
Large	Rural/Small Town	Midwest/1 branch*
Large	Rural/Small Town	Mid-South/19 branches
Medium	Urban	South/8 branches
Medium	Suburban	West Coast/4 branches**
Medium	Rural/Small Town	Midwest/3 branches
Small	Suburban	East Coast/1 branch
Small	Rural/Small Town	Midwest/1 branch***
Small	Rural/Small Town	Southwest/1 branch***

*Participant is a bankers' bank.

**Participant was chosen to represent the high tech sector, to help gauge future electronic banking activities.

***Participant is located in a remote area.

In addition to meeting the criteria listed in the table above, some respondents also represented the following institution types: de novo (Midwest and West Coast), minority owned and operated (South and Northwest), primarily commercial customer base (West Coast), bilingual/ethnic customer base (Southwest, Northwest, and Southeast), and higher-than-average use of Federal Reserve services (Mid-South). Three of the institutions service customers whose banking transactions sometimes involve foreign countries, including Canada, Mexico, and Pacific Rim countries (Midwest, Southwest, and Northwest, respectively).

⁵ For the purposes of this study, the asset tier ranges are defined as follows: small: less than \$50 million; medium: between \$50 million and \$200 million; and large: greater than \$200 million.

Key staff who were invited to participate in the interview sessions include the CEO, CFO, COO, cashier, branch manager, and lending officer. Federal Reserve participants included the interviewer and note-taker (both CRSO staff), and the local Reserve Bank's Account Manager for that institution.

Synopsis of Findings

Participants were asked a series of questions regarding their strategies, operations, usage of services in the last three years, and projected service usage within the next three years. Their responses are summarized below. Unless otherwise noted, items in most sections are listed according to the frequency with which they were mentioned (i.e., items that were mentioned most frequently are listed first and are followed by items that were mentioned by fewer participants). In addition, responses are grouped according to participant criteria (asset tier and location type) when the findings are particularly reflective of that group's responses.

Profitable Growth

- Participants named the following as initiatives that will position them for profitable growth within the next three years:
 - **Providing financial planning and other “non-traditional” services, such as brokerage, insurance, estate planning, and real estate:** Seven participants reported that their customers have asked them to begin offering these services; other participants have reported that they offer/will offer these services as a long-term customer retention strategy. Participants face certain challenges in offering financial planning and non-traditional services. One challenge is deciding whether to hire staff to implement and market the services or whether to form strategic alliances with third parties that will administer them. Two participants say it can be difficult to find qualified staff to implement the services and that they have long-standing competitors that also offer these services.
 - **Increasing fee income:** Five participants, particularly those in the **medium and small asset tiers**, intend to increase revenues through fee income, either from traditional core accounts (e.g., checking, savings and money market accounts) or from non-traditional services (e.g., brokerage and insurance services). Three participants mentioned that their fees are comparable to, if not lower than, their competitors' fees. They also say they have realized that chronically delinquent or overdraft customers are profitable, and they no longer seek to terminate these customer relationships.
 - **Opening branches and acquiring other institutions:** Five participants plan to open new branches or acquire other institutions. Two participants that acquire other institutions as a means of growth typically dispense with the acquired institutions' back-office systems, but retain the staff.

- **Increasing loan volume:** Four participants will increase loan volume by lowering interest rates, developing new loan products, or soliciting new customers (primarily local businesses).
- **Offering Internet banking:** Four of the five participants (in the **large and medium asset tiers**) that currently offer Internet banking to their customers do so as part of their strategy for profitable growth. They noted that their customers are requesting this service, and that several large competitors offer it. Seven participants do not view Internet banking as a revenue-generating service; rather, it is offered in order to attract new customers and retain current customers. Participants currently offering the service do so through a third-party vendor, although this arrangement is invisible to their customers. Two participants, on behalf of themselves or their customers, expressed concern over the security of Internet transmissions; one of these participants would like the Federal Reserve to establish an Internet banking structure that banks could use to offer this service.
- **Implementing technology:** Three participants said that technology affecting their back-office payments system operations changes rapidly, and they plan to install new systems. These systems primarily support Electronic Funds Transfer (ACH, debit cards, and wires), check imaging, and Internet customers. All participants form strategic alliances with third-party processors and/or vendors to offer these services. Five participants that do not have near-term plans to install new systems say that they find it difficult to keep pace with technology, because they do not have the volume of customer transactions needed to justify the cost of the new systems.
- **Promoting ACH:** Three participants are aggressively promoting ACH services as part of their plan for profitable growth. Additionally, two of these participants, as well as one other participant, would like the Federal Reserve to market ACH directly to businesses and consumers.
- **Other growth initiatives:** The following initiatives also were mentioned: one participant plans to obtain check processing contracts from large companies (e.g., insurance companies, government agencies); one participant will focus on customer service; one participant plans to increase the number of core accounts; and one participant will target services to middle-sector customers aged 30-50, including young families who eventually may acquire wealth.

Community Bank Product Offerings

The chart below lists participants' product offerings according to asset tier⁶. A summary of this information follows the chart, and is presented in alphabetical order, rather than according to frequency mentioned.

KEY⁷: Large asset tier
 Medium asset tier
 Small asset tier

Service	Currently Offer Service		Likely to Offer Within 3 Years		Currently Offer/Likely to Offer via the Internet		
	Is service an important source of revenue?		Is service anticipated to be an important source of revenue?		Yes, transactions and information	Yes, information only	No
	Yes	No	Yes	No			
ACH Origination							
ATM							
Cash Management for Businesses							
Check – Image Statements							
Checking Accounts – Business							
Checking Accounts – Individual							
Credit Cards							
Debit Cards (on-line and off-line)							
Financial Electronic Data Interchange (EDI)							
Financial Planning							
401(k) for Businesses							
Insurance – Life & Health							
Insurance – Property & Casualty							
Internet Banking							
Loans – Commercial							
Loans – Residential							
Mutual Funds							
Telephone Banking							

⁶ Information concerning Image Statements and Business and Individual Checking Accounts was collected through follow-up communications in November and December 2001.

⁷ If your copy of this table does not reflect the color-coded asset tiers, please see Appendix B for a representation of this table that depicts the different asset tiers with symbols rather than color.

- **ACH Origination:** Eight participants offer or plan to offer ACH origination. They say they expect usage of this service to increase due to marketing and customer demand. Additionally, six participants currently offer or plan to offer ACH origination to customers via the Internet. Four participants say it is challenging to offer this service because they find it difficult to train staff to learn the ACH system and to convince customers to accept an electronic deposit. Only one participant – a high tech institution with a largely commercial customer base – identified ACH origination as an important source of revenue. This participant aggressively markets the service, and processes over eight times more electronic payments per month than paper payments.
- **ATM:** All participants, with the exception of the bankers' bank, offer ATM cards to their customers, and the majority say that this service, while not an important source of revenue, is crucial to retaining customers and is easy to offer. Six participants expect ATM usage to increase. Two participants anticipate that usage will decrease due to an offsetting increase in the usage of debit cards.
- **Cash Management for Businesses:** Five participants offer some sort of cash management service. These participants say they would be likely to offer the services via the Internet. Participants that offer cash management say it is difficult to train staff to market it and learn the back-office systems that support it, and it can be difficult to find a strategic partner to help provide the service.
- **Check – Image Statements:** Six participants offer check statements to their customers using an image format. Four of these participants say that this offering is not an important source of revenue, but two noted that it contributes to cost savings. Two participants offer check images to their customers via the Internet. Four participants say it can be difficult to find a strategic partner to help provide the service. Two participants would like to lease back-office check imaging equipment (that would enable them to provide check images to their customers) from the Federal Reserve, because their expected volume does not justify the price of the equipment. One participant would like the Federal Reserve to provide statement rendering services for check images and one participant would like the check image product to be enhanced to enable electronic item return.
- **Checking Accounts – Business:** Nine participants offer business checking accounts (the one that does not is a bankers' bank), and most say that these accounts are an important source of revenue because of the service fees that they generate and the funding for loans that they provide. Eight participants expect the number of business checking accounts to increase due to new customer accounts and aggressive marketing efforts.
- **Checking Accounts – Individual:** Nine participants offer individual checking accounts (the one that does not is a bankers' bank). They say that this is an important service that is easy to offer. Eight participants expect the number of individual checking accounts to increase due to new customer accounts and aggressive marketing efforts.
- **Credit Cards:** Eight participants offer credit cards. Six of these participants say it is not an important source of revenue because of the number of competitors offering the service. Five participants say that usage of credit cards will increase as a function of customer

growth, but that the service can be difficult to offer due to complex regulations, administrative set-up procedures, and disclosure requirements.

- **Debit Cards:** Nine participants offer or will offer debit cards, and all participants that currently offer this service expect usage to increase, primarily as a function of customer growth, marketing efforts, and the demand from younger customers. Five participants say that debit cards, while not an important source of revenue, are an important service that is easy to offer.
- **Financial Electronic Data Interchange (EDI):** Only one participant currently offers Financial EDI. Three other participants plan to offer it within the next three years. (Three participants had not heard of the service.) Very few customers request this service, but the participant that currently provides it expects usage to increase as more customers become aware of its availability.
- **Financial Planning:** Six participants offer or will offer financial planning services, including trust and brokerage services. Only two participants foresee offering these services via the Internet. Five participants noted that it can be difficult to offer financial planning services because staff typically must be certified and/or licensed and dedicated to marketing the services.
- **401(k) for Businesses:** Only two participants currently offer a 401(k) service for businesses. Three other participants plan to offer it within the next three years. The participants that currently offer the service consider it to be an important source of revenue.
- **Insurance – Life and Health:** Five participants offer or plan to offer life and health insurance. Two of these participants expect to offer these types of insurance via the Internet. These participants typically enlist a third-party vendor (i.e., insurance agency) to offer these products on their behalf. Life and health insurance are not considered important sources of revenue, but are offered as a convenience to customers. An increase in usage is contingent upon marketing and local population growth.
- **Insurance – Property and Casualty:** Three participants offer property and casualty insurance. Four participants plan to offer these types of insurance within the next three years, and two participants say they plan to offer them via the Internet. As with life and health insurance, an increase in usage is contingent upon local population growth.
- **Internet Banking:** Five participants in the **large and medium asset tiers** currently offer Internet banking services to their customers. Further, within the next three years, all but one small asset tier participant will offer this service. These participants say that they expect demand for this service to grow due to customer acceptance of this channel and to population growth in the communities they serve. They also say Internet banking is not an important source of revenue and that, while it is an important service, it can be difficult to offer because of two challenges: 1) finding the right strategic partner to help offer the service, and 2) building the appropriate security into the system and convincing customers of the reliability of that security. Four participants would like to receive transaction information and notifications via the Internet and/or e-mail.

- **Loans – Commercial:** Nine participants said that commercial loans are an important source of revenue. Three participants said that they plan to allow customers to complete loan applications using the Internet. Seven participants expect the number of loans to grow in the near future, due to increased marketing efforts and local population growth. Three participants say commercial loans can be difficult to offer, primarily because of the amount of documentation required.
- **Loans – Residential:** All participants agree that residential loans are an important source of revenue. Four participants said that they plan to allow participants to complete loan applications using the Internet. As with commercial loans, these participants expect the number of loans to grow in the near future, due to increased marketing efforts and local population growth. Three participants say residential loans can be difficult to offer, primarily because of competition and the amount of documentation required.
- **Mutual Funds:** Three participants currently offer mutual funds, and two of the three indicated that this product is an important source of revenue. Three participants expect the usage of mutual funds to grow in the near future, due to increased marketing efforts, local population growth, and certificate of deposit (CD) rates. Two participants in **rural/small town** locations said that it can be difficult to find a strategic partner with which to offer mutual funds.
- **Telephone Banking:** Eight participants offer telephone banking transaction services, and they characterize this service as easy to offer but not an important source of revenue. Seven participants predicted that usage of the service will increase in the future.

Customer Segments

- Seven participants identified small and medium businesses as their customer niche, particularly for loan and ACH products. Four other participants identified senior citizens, community organizations (such as churches and non-profit organizations) and local ethnic/bilingual populations as substantial customer segments.
- Participants identified their profitable customers as small businesses, followed by businesses that use electronic payments, customers with multiple accounts, those that generate fee income (e.g., commercial customers who frequently overdraw their accounts), residential mortgage customers, and commercial real estate investors.
- Participants have lost few profitable customers in the last three years, but they nevertheless have lost some customers and prospective customers to regional and nationwide banks and the Farm Credit System, primarily because these organizations offered lower loan rates (specifically for long-term, fixed-rate mortgages). Two participants have lost customers because they did not offer electronic banking services such as Internet banking and ATM cards.

Customers' Business Concerns

- Participants discussed their customers' business concerns, particularly those that financial institutions in general are doing a poor job of meeting. These concerns include: being unable to fully meet small business customers' cash management needs and individual customers' financial planning needs; explaining which financial services entities offer which services; educating customers about various banking products that will meet their needs; explaining the risks associated with ACH origination; offering services such as account aggregation; handling customer service issues (particularly after an acquisition); targeting services to low-to-moderate-income customers; and ensuring that ACH payments are deposited when customers anticipate.

Competition

- Participants identified brokerage firms, regional and nationwide banks, credit unions, and mortgage companies as serious competitors. **Large and medium asset tier** participants also named insurance companies as serious competitors. Additional competitors include other community banks, retail or point-of-sale lenders, and the Farm Credit System.
- Participants expressed frustration that their non-bank competitors are regulated differently (i.e., usually with fewer lending conditions), and they said that they find the disparities to be unfair and restrictive.

Usage of Federal Reserve Services

- **ACH:** Seven participants said that their usage of ACH services has grown in the last three years, and that they expect it to grow in the future. The increase is due to customer awareness as a result of marketing efforts and government-mandated direct deposit.
- **Cash:** Four participants said that their usage of Cash services either increased or remained stable in the past three years. Only one saw a decline, due to direct deposit. Four participants expect their usage of Cash services to grow in the future due to new branches or new business customers. Two participants predicted that their usage of Cash services will decrease as customers increasingly use electronic payments mechanisms (e.g., ACH).
- **Check:** Six participants said that their usage of Check services increased in the last three years, primarily due to new individual and commercial customers. However, three participants predicted that their usage of Check services will decrease in the future, offset by an increase in customer usage of electronic payments methods such as Internet banking, ACH, and ATM cards.
- **Fedwire® Book-Entry Securities:** Five participants say that their usage of Fedwire Book-Entry Securities has been, and will continue to be, stable. One participant expects usage to grow due to their increasing purchases of Ginnie Mae securities, and another expects usage to grow as a result of more public sector deposits, which require securities as collateral.

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- **Fedwire Funds Transfer:** Six participants say that Fedwire Funds Transfer usage has increased in the last three years, and they expect it to continue to increase due to customer awareness. Only one participant predicted that usage would decrease because of its focus on ACH.

Correspondents, Third-Party Processors, and Vendors⁸

- Participants use correspondents, third-party processors, and vendors for the following products and services: ACH, check account posting, check image statements, check processing, Funds Transfer, Treasury securities, brokerage services for insurance, and brokerage services for stock.
- Nine participants said that they have several choices of correspondents, processors and vendors, and that these relationships provide services that are competitively priced.
- Participants sometimes base their choice of processor on service and convenience, rather than price.

Information Needs

- Overall, participants reported that they are satisfied with the amount and quality of information they receive, both from the Federal Reserve and other payments providers.
- Three participants registered complaints regarding the way that the information they receive from the Federal Reserve is delivered and organized. Specifically, they say that information arrives over the course of the day, and from multiple delivery methods (e.g., fax, courier, and FedLine[®]), rather than within a specific time frame. Also, two participants said information regarding regulations can be difficult to understand and should be summarized.

Impending Regulatory Changes

- Five participants mentioned that the privacy issues addressed by the Gramm-Leach-Bliley Act of 1999 will have an effect on their operations. One participant predicted that the Act is likely to “level the playing field” with non-banks if banks are allowed to offer more non-bank services (e.g., mutual funds, insurance).
- Individual participants also mentioned other impending regulatory changes and their respective impacts for the following products:
 - Interest-bearing checking accounts: Bill H.R. 1009, which will allow payment of interest on demand deposits, is likely to have a large impact on the cost of funds (but the participant could not predict if the impact would be positive or negative).

⁸ Please see Appendix C for a list of correspondents, third-party processors, and vendors used by study participants.

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- Commercial truncation: The Check Truncation Act is likely to have a large impact by providing the ability to offer more services electronically.
- Money market accounts: Bill H.R. 974, which will allow payment of interest on demand deposits, is likely to make operations more expensive if the number of monthly items increases from six to 24.

Sources of Information

- Participants obtain reliable information that helps them make business decisions from a variety of sources, including the American Bankers Association (ABA) and their state banking associations, conferences and conventions, colleagues, and professional advisors (e.g., accountants, lawyers, auditors). Additional sources of information are a directory and data services publication, local and regional financial services consultants, the Federal Reserve, external regulators, and the Bank Administration Institute (BAI).
- Two of the three **small asset tier participants** consider community bank associations – America’s Community Bankers (ACB), Independent Community Bankers of America (ICBA) and their state Community Bankers Association (CBA) – to be important sources of information.

Issues and Concerns

- Six participants say that regulatory restrictions occasionally prevent them from providing services to certain market segments. The restrictions named most frequently relate to loan services (e.g., those regulated by the FFIEC), particularly for farmers and low-income customers.
- Three participants view the Federal Reserve as uniquely positioned to assume a greater role in combating fraud, particularly for check, ACH, credit card and debit card transactions.
- Three participants find that the Federal Reserve’s Cash ordering services can be difficult or inconvenient to use, because frequent use of these services is sometimes discouraged.
- One participant is looking forward to offering an account aggregation service in order to satisfy customer demand for a product that gives them access to all of their financial statements in one place. Conversely, another participant believes that account aggregation will be a disadvantage to community banks. This participant said that account aggregation (which is likely to be brought to market first by large institutions) will allow an institution to have access to information about all of a customer’s accounts, thereby providing it with an opportunity to market services directly to other institutions’ customers.

Customer Service

- All participants say that community banks are better positioned than regional and nationwide banks to offer superior customer service.
- Five participants noted that their relatively small size allows them the flexibility to evaluate and respond to individual customer needs and revise their systems quickly.
- Three participants accommodate a variety of customer loan requests, such as deciding quickly whether to make a loan (e.g., in one day for residential customers), making loans to customers who lack complete income documentation (because they rely on funds from family members), and retaining the servicing on secondary market loans.
- Three participants provide consulting services to their customers at no charge, including financial counseling to individual customers and software recommendations to commercial customers.

Results

- Of the various characteristics of the participants in this study – asset tier, location type, geographic location, and number of branches – participants within the same asset tiers most frequently gave similar responses (e.g., large asset tier participants had the most in common with other large asset tier participants, etc.). These similarities did not extend to the other characteristics. For example, participant responses grouped according to location type rarely were similar, and responses grouped according to geographic location and number of branches were not at all similar.
- Several participants stated that they would like the Federal Reserve to ensure access to the payments system by providing the infrastructure for electronic payments services, such as ATM, debit and credit cards, and Internet banking. Using payments infrastructure provided by the Federal Reserve would allow these community bankers to offer payments services outside of their own market area (e.g., ATM), which is essential to remaining competitive with their larger bank counterparts.
- Access to payments system technology (e.g., ATM networks, EBT networks, Internet) is of paramount importance to several participants. These participants are concerned that emerging payments system infrastructure will not be accessible to smaller institutions.
- Participants offer some products not because they are important sources of revenue, but because these products help them retain existing customers and attract new ones.
- Where the study participants have third-party provider relationships established, the institutions are satisfied with those relationships. Most feel that the services they use are competitively priced, and that they are not tied to any specific provider. For newer banking

services such as financial planning, insurance and Internet banking, some institutions have difficulties finding the right partner.

- The study participants regard increased customer awareness as essential for maximizing ACH's growth potential. They would like the Federal Reserve to assume a greater role in marketing this service directly to consumers and businesses.
- The Internet is a very relevant channel for the community banks that participated in this study. The majority of participants plan either to offer traditional banking services such as ACH, loans, and cash management via the Internet, or to market those services via the Internet. Fewer banks, however, see a role for the Internet in offering non-traditional banking services such as insurance, financial planning and 401(k) services. Uncertainty surrounding Internet security prevents some banks from offering services through this channel. However, one de novo participant serving the high tech sector views the Internet as an integral piece of its corporate identity and plans to either offer or market all of its services via the Internet. In addition, this participant plans to expand to other regions nationwide using Internet technology.
- While participants in all asset tiers increasingly are offering traditionally non-bank services (e.g., brokerage, insurance, estate planning) as a strategy for profitable growth, community banks universally continue to rely most heavily on more traditional banking services. Only a minority of the participants currently offer insurance, 401(k)s, mutual funds, and Financial EDI. Of all the products and services discussed in this study, commercial and mortgage loans are the most important sources of revenue for participants.
- Several participants are concerned about complying with the Gramm-Leach-Bliley Act covering customer privacy as they form strategic partnerships to introduce new financial planning services.

DETAILED FINDINGS

This section presents a comprehensive discussion of all study feedback (including the information provided in the Executive Summary's Synopsis of Findings section) and further supports the items listed in the Results section. The items in each section below are listed according to the frequency with which they were mentioned (i.e., the items that were mentioned most frequently are listed first and are followed by items that were mentioned by fewer participants). In addition, responses are grouped according to participant criteria (asset tier and location type) when the findings are particularly reflective of that group's responses.

Profitable Growth

Study participants were asked what initiatives they plan to implement over the next three years to position themselves for profitable growth. They also were asked which customers they plan to target with these initiatives, the challenges they will face, whether they will need to form strategic alliances to implement the initiatives, and the nature of their competition. Their responses are provided in the sections below.

Providing Financial Planning and “Non-Traditional” Services

Seven participants indicated that they plan to generate non-interest revenue within the next three years by developing and/or increasing their offerings of one or more “non-traditional” services (e.g., brokerage, insurance, estate planning). The participants are targeting the non-traditional services primarily to their older customers, business owners, and those with high net worth. Participants say that they provide/will provide these services as a long-term customer retention strategy or because their customers have asked for them. One participant remarked, *“When they’re tied to us with that many services, it makes it harder to leave us.”*

Among the challenges that participants face in offering non-traditional services is deciding whether they should hire staff to implement the services or whether they will form strategic alliances with third parties⁹ to administer them. None of the participants mentioned any difficulties in finding strategic partners, and those that already have these partnerships in place generally are satisfied with the quality of service that their partners provide. However, two participants say that it is difficult to find qualified staff to implement financial planning and non-traditional services, and all participants say that they have long-standing competitors that currently offer the services, including regional and national banks, brokerage houses, insurance companies, and investment firms. Participants say that their local reputation and their strong customer relationships will help them differentiate their financial planning and non-traditional services from their competitors'. Their comments include the following:

⁹ Please see Appendix C for a list of correspondents, third-party processors and vendors with which survey participants have formed strategic alliances.

“We can’t out-research and development them, and we can’t out-produce them. But we can have more and better knowledge of the personal situations and financial problems that we’re trying to solve.”

“We’re known and we’re local. If you have the local connection, and I think a local bank has that better than anybody, then you have a foot up. You’re going to have more credibility with your local people.”

“We have established a good reputation in the community.”

Increasing Fee Income

Five participants, primarily those in the **medium and small asset tiers**, intend to increase revenues through fee income, either from traditional core accounts (e.g., checking, savings, and money market accounts) or from non-traditional services (e.g., brokerage and insurance services). These participants say that they frequently compare their account servicing and overdraft fees to those of their competitors and find that their own fees typically are lower, so they feel they will not lose customers by increasing their fees. Additionally, these participants say that they have begun realizing that chronically delinquent or overdraft customers are profitable. Comments concerning these issues are as follows:

“The irony is that 10 to 15 years ago you wanted to get rid of that (frequent overdraft) account. Now, all of a sudden, everyone woke up and figured out that these are the most profitable accounts.”

“The most lucrative product is the checking account with an NSF fee...we used to close those accounts, but now we’re letting those customers stay, and our fee income has doubled since last year.”

“A regulator told us, ‘You’ve got a few of these people who pay late, you need some more of them.’ You don’t want the guy who is 30 days late, but 15 days late is ok. You get a nice return on someone who pays late a few times.”

Opening Branches and Acquiring Other Institutions

Five study participants plan to grow profitably by either opening new branches or acquiring existing institutions. They evaluate the mix of personal and business accounts when considering where to locate a new branch. One participant is considering opening a branch in a small town where a nationwide bank is already established, because it feels that type of institution has not been successful at serving the area. Another participant that specializes in electronic banking intends to extend its Internet banking system to 50 metropolitan areas (through “virtual” branching). This participant said, *“This expansion is a goal by using technology. It has allowed us to bank people over larger geographic areas.”*

A study participant that has acquired several banks says that the challenges involved are facilitating the back-office system conversion and placing staff from the acquired institution. Participant comments include the following:

“...We acquire people...They are bankers that are high quality and have clients that have been with them for 10 years. If we acquire a bank, we’ll get their technology and acquire their people.”

“We have done the acquisition and the conversion in the same day, and that was tough. You have to marry the cultures, but I think to maintain customers, have as little change as possible and keep the HR (human resources) as smooth as possible.”

Increasing Loan Volume

Four participants, including all of those representing the **small asset tier**, say that they want to increase their loan volume and will do so either by lowering interest rates, developing new loan products, or soliciting new customers (primarily local businesses). These participants say that regulatory loan limits (based on asset size) prevent them from competing against larger banks and other lenders for larger loans.

Offering Internet Banking

Four of the five participants (in the **large and medium asset tiers**) currently offer or plan to offer Internet banking to their customers as part of their near-term strategic plan. Participants in the small asset size tier also are interested in offering Internet banking, however, none currently do so, nor do any identify it as a strategy for growth in the near term. Participants that identified Internet banking as a strategic growth initiative say that several large bank competitors already offer this service, and soon, most institutions will offer it. Participants say that their customers who are requesting and/or using Internet banking services tend to be seniors (in their 60s and older) and those in their 20s. According to one participant, *“The younger group was raised on computers, and those in the older group...have time on their hands.”* This participant also says that older customers would like to use the Internet to monitor their investments, while younger customers use it to get information.

Participants offering Internet banking say they use a vendor to provide this service, but that the vendor relationship is invisible to their customers (i.e., customers do not know that the service is offered in conjunction with another party). One participant that would like to introduce Internet banking says that the general public does not feel that vendor-provided systems are secure. Calling upon the Federal Reserve to establish an Internet banking structure that banks could use to offer this service, this participant commented:

“People today are looking at the Internet, but they hear about the security issues. It’s going to be very difficult for the marketplace to accept the (current level of) security. But when you say the Federal Reserve has a security wall, there’s a whole different type of credibility that goes with that. It’s the security piece that is going to bring customers into electronic banking, and that produces efficiencies for you guys as well.”

“You do a wonderful job with FedLine, and with all the other access points into the clearinghouse function. You have a tremendous amount of firewalls in place to prevent anyone from getting in. If you extended that to providing that sort of transactional clearinghouse for Internet services, then I think you could serve the

entire nation. It's a lot better than having us rely upon a series of different vendors who come and go."

Seven participants do not view Internet banking as a revenue-generating service; rather, it is offered to attract and retain customers.

Implementing Technology

Three participants noted that the technology that affects their back-office payments system operations changes rapidly, and they plan to install new systems. These systems primarily support Electronic Funds Transfer (ACH, debit cards, and wires), check imaging, and Internet customers. These participants have formed strategic alliances with third-party processors and/or vendors that help them offer their payments services, and they generally are satisfied with these relationships.

Five participants that do not have near-term plans to install new systems say that they find it difficult to keep pace with technology to the degree that their larger competitors do, because they do not have the volume of customer transactions needed to justify the cost of the new systems. Further, one participant noted that the community bank perspective routinely is excluded in the design of new payments technologies, so this sector relies on the Federal Reserve to represent it. Regarding the challenges that community banks face in adopting new technologies, participants say the following:

"We as a group, even though we account for 80 percent of the financial institutions in our country, have something substantially less than 80 percent of the influence in how the payments system ultimately looks. So we look to the functional side of the Fed for a certain degree of representation in those fundamental initiatives."

"When the management of a community bank sits down to plan their budget for the next operating year, or for a horizon of three years, they've got one shot to get the technology right. They might be investing \$300,000 or \$500,000, which for a community bank might be an entire year's earnings, or more. If they get it wrong, they've wiped out their bank for three years."

"Anything the Fed can do to increase the ease of payment is going to be critical. Part of the reason we look to (our processor) is the payment windows. It's rapidly becoming a 24-hour day, operationally. Specific products that would help us would be image clearing."

In addition to implementing technologies that facilitate operations, two institutions have installed strategic planning and/or profitability software designed to evaluate operational and staff efficiencies, and they will revise their systems and procedures accordingly. One participant said that the drive to become more cost efficient is related to non-bank competition, which has resulted in decreased interest margins.

Promoting ACH

Three participants, including both **suburban** institutions, are aggressively promoting ACH services as part of their plan for profitable growth. One urban participant is marketing ACH to a diverse range of businesses, including churches, prisons, and non-profit organizations, saying that potential competitors (e.g., large banks) typically do not target the small business sector. This participant, who would like to see an ACH campaign targeted to small businesses, says, *“Traditionally, you’d offer ACH only to larger customers, but when you look at the paper coming through the system, you could eliminate a lot of it by having a lot of these smaller agencies and businesses using ACH.”*

Another participant that serves a largely commercial customer base is marketing the ACH service to big companies, particularly large accounting firms and insurance companies. This participant said, *“We’re finding the insurance industry is dying under paper.”* This participant mentioned that it has experienced problems with the ACH reconciliation information they receive from the Federal Reserve because it is not automated. Specifically, it said, *“Charge-backs and exception items flow through the statement in a way that they don’t match up with each other. They get grouped in different groups so you have to research the items.”* This participant would like to have tracer numbers on ACH origination items that are analogous to the tracer numbers on checks, so that if an item they originate is returned, the item can automatically be matched up.

Other Growth Initiatives

Other initiatives that participants will undertake to help them grow profitably include the following:

- Focusing on customer service: Although only one participant named customer service as a near-term growth strategy, all participants indicated that offering the “personal touch” is a crucial aspect of their customer relationships.
- Obtaining check processing contracts from large companies (e.g., insurance companies and government agencies): One participant acknowledged that even though large companies increasingly process payments electronically, *“They’re still stuck with a bunch of paper... They need those processed by someone.”*
- Increasing the number of core accounts: One participant described checking, savings, and money market accounts as low cost accounts that can be used to increase the customer base, which leads to an increase in fee income.
- Targeting services to middle-sector customers aged 30-50: One participant is developing services and customer appreciation activities for younger families that they predict will eventually acquire wealth.

Community Bank Product Offerings

Study participants discussed at length the following list of offerings (see table in the “Community Bank Product Offerings” section of the Executive Summary for overview)¹⁰.

- ACH Origination
- ATM
- Cash Management for Businesses
- Check – Image Statements
- Checking Accounts – Business
- Checking Accounts – Individual
- Credit Cards
- Debit Cards (on-line and off-line)
- Financial Electronic Data Interchange (EDI)
- Financial Planning
- 401(k) for Businesses
- Insurance – Life and Health
- Insurance – Property and Casualty
- Internet Banking
- Loans – Commercial
- Loans – Residential
- Mutual Funds
- Telephone Banking

Participants classified the offerings on the list as follows:

1. Currently offer/importance as a source of revenue.
2. Likely to offer within three years/anticipated importance as a source of revenue.
3. Currently offer or likely to offer via the Internet/whether customers can use this access method for transactions and information, or for information only.

Additionally, participants were asked the importance of each service to their future, the level of difficulty in offering each service, and whether they expect usage of the service to increase within the next three years¹¹. Participants’ responses for each offering are presented in the sections below.

¹⁰ Check – Image Statements, Checking Accounts – Business, and Checking Accounts – Individual were not included in the original interviews. Participants were asked about these services in follow-up communications. Also, Annuities initially appeared on this list of services. However, it was discovered during survey pre-tests that most community banks do not offer Annuities, so this service was not discussed in the subsequent interviews.

¹¹ Among the study participants were two de novo institutions that predicted that usage of all services they offer will increase, because, as new institutions, they still are actively marketing all of their services.

ACH Origination

Six participants (across all asset tiers) currently offer ACH origination to their customers, and two others plan to offer this service within the next three years. Additionally, six participants currently offer or are likely to offer this service via the Internet for both information and transactions, and they say they expect usage of the service to increase, due to marketing and customer demand. Four participants say they find it challenging to offer the service because it is difficult to train staff to learn the ACH system and sell the product, and it is difficult to convince customers to accept an electronic deposit instead of a paper check.

Only one participant – a high tech institution with a largely commercial customer base – identified ACH origination as an important source of revenue. This participant aggressively markets the service, and processes over eight times more electronic payments per month than paper payments. Six participants say ACH origination is not an important source of revenue, mostly due to lack of volume and relatively low service fees. These participants say they offer ACH origination as a means of retaining customer relationships. One participant called it an “attraction piece” for new customers, saying, *“The revenue isn’t important, but the service is.”*

In fact, participants named many other services in addition to ACH origination that they continue to offer, even though the services are not important sources of revenue, because these services (identified in the appropriate sections below) help participants retain existing customers and attract new ones. Participants called this practice, “defensive,” “reactionary,” and “strategic,” and explained why it sometimes is necessary to offer services that are not important sources of revenue, as follows:

“The most profitable customers are the ones with whom we have multiple relationships. We not only have his residential loan, but his snowmobile, his automobile. We have his checking account, his money market account, his ATM card and his debit card. Our objective is to get four relationships with each customer.”

“If we didn’t have it, you might ask, ‘What revenues would we lose?’...You’re talking about losing millions of dollars of deposits. It’s not just the revenues that are associated with the service that you’d lose, you’d lose the relationship.”

ATM

Nine participants offer an ATM service, either through their own institution or through a strategic partner. One participant (in the small asset tier) does not own an ATM, so it offers a card that customers can use at a regional convenience store chain for no-fee transactions. Six participants say that the ATM service is not an important source of revenue, but that it is crucial to retaining customers. (One participant said this service is important for generating revenues from foreign, i.e., non-customer, card usage.) Six participants said that they expect usage of the ATM service to grow within the next three years, but two predicted that it

would not, primarily due to an offsetting increase in debit card use. Seven participants characterized the ATM service as important and easy to offer.

Cash Management for Businesses

Five participants (representing all asset tiers) offer some sort of cash management service to their business customers, and two other participants plan to offer it within the next three years. Six of these participants said that they would be likely to offer cash management transaction services via the Internet. Five participants said they find it challenging to offer this service because it is difficult to train staff to market it and learn the back-office systems that support it. Also, it can be difficult to find a strategic partner to help provide the service. One participant said, *“To do what larger banks are doing – integrating more of their proprietary funds, their trust and brokerage areas where they’re sweeping to non-insured products – we haven’t got that figured out, but we need to.”*

All participants offering cash management services predict that usage will increase within the next three years based on increased customer understanding of the services.

Check – Image Statements

Six participants offer check statements to their customers using an image format, and they expect their check image volume to grow in the future as more customers accept this paperless option. Only one participant expects the volume of image statements to decrease, as a result of an overall decrease in check usage. Four of these participants say that this offering is not an important source of revenue, but two noted that it contributes to cost savings. Two participants that currently offer image statements say it can be difficult to find a strategic partner to help provide the service. Only two participants offer check images to their customers via the Internet.

Two **small asset tier** participants would like to offer check images to their customers but have determined through cost-benefit analyses that customer volume does not justify the price of the equipment. These participants would like to lease back-office check imaging equipment from the Federal Reserve that would enable them to provide check images to their own customers. One participant would like the Federal Reserve to provide statement-rendering services for check images. This participant currently deposits checks through a national bank, but says that they “definitely” would consider depositing their checks at the Federal Reserve if a statement rendering service were offered. One participant would like the check image product to be enhanced to enable electronic item return.

Checking Accounts – Business

All participants except the bankers’ bank offer business checking accounts, and the majority of them say that this type of account is an important source of revenue because of the service fees that they generate and the loan funds that they provide. Eight participants say that business checking accounts are easy to offer, although one participant noted that

business checking accounts are more difficult to offer than individual checking accounts because they have more complex requirements, such as obtaining corporate resolutions and signing authorities. Eight participants expect the number of business checking account customers to increase due to new customer accounts and aggressive marketing efforts.

Checking Accounts – Individual

All participants except the bankers' bank offer individual checking accounts, but only half of the participants say that these accounts are an important source of revenue, because they do not generate as much in fee income as business checking accounts. Eight participants say that individual checking accounts are easy to offer. As with business checking accounts, participants expect the number of accounts to increase due to new customer accounts and aggressive marketing efforts.

Credit Cards

Eight participants offer credit cards to their customers, and six of these participants say that this service is not an important source of revenue. One participant, noting that there is a great deal of competition for credit card customers, said, *“Everyone is getting multiple credit card solicitations these days.”*

Five participants expect the number of customers who use this service to increase, primarily as a result of acquiring new customers through other services. Some of the participants indicated that it can be difficult to offer the credit card service as a result of the complex regulations, administrative set-up procedures, and disclosure requirements.

Debit Cards (on-line and off-line)

Six participants offer debit cards to their customers, including all in the **large asset tier** except the bankers' bank, and three others plan to offer this service within the next three years. All participants that currently offer this service expect the number of customers who use these cards to increase, primarily due to new customer accounts, marketing efforts, and demand from younger customers (who are seen as proponents of this payments vehicle). Five participants say that debit cards are not an important source of revenue, even though they characterized them as an important service that is easy to offer. However, one participant said that debit cards can be difficult to offer if the strategic partner that provides the service does not meet the institution's and its customers' needs.

Financial Electronic Data Interchange (EDI)

Only one participant currently offers Financial EDI, and three others plan to offer it within the next three years. (Three participants had not heard of the service.) The participant that currently offers Financial EDI reported that only two of its customers use it, and although it is an important service that is easy to offer, it is not an important source of revenue. The

participant expects usage to increase as more customers become aware of its availability. However, this participant does not expect to offer Internet access to this service.

Financial Planning

Four participants representing all asset tiers currently offer some sort of financial planning services, and two others plan to offer these services within the next three years. The services offered range from traditional services, such as trust, annuities, and brokerage, to non-traditional services, such as budget counseling, which one small asset tier institution offers to customers who do not qualify for loans. Only two participants foresee offering the ability to transact financial planning via the Internet.

Five participants noted that it can be difficult to offer financial planning services, because staff typically must be certified and/or licensed. Also, in order for usage of financial planning services to grow in the future, staff must be dedicated to marketing them. Some participant comments regarding this service are as follows:

“I think that the general public really prefers the stereotype of the financial planners of the names like (national brokerage firms). We have a person who is just as capable, but he focuses on things that are more profitable. Most financial planning is not profitable. There are software packages now that for \$40 can do what 80 percent of the people want.”

“It’s difficult to offer these services and make money through a third-party (strategic partner). You have to contract because you need brokerage licenses, and most banks don’t have staff that are licensed. So, you have to have a partner that can do it, and the (profit) margins aren’t very good.”

401(k) for Businesses

Two participants currently offer a 401(k) service for businesses, and three others plan to offer it within the next three years. Only one participant says that this service is an important source of revenue. One participant expects usage to increase in the future because of good financial performance. This participant said it retains three investment managers whose portfolios have averaged 45 percent annual returns over the past several years.

Insurance – Life and Health

Three participants offer life and health insurance, and two others plan to offer these types of insurance within three years. These participants typically enlist a third-party vendor (i.e., insurance agency) to offer these products on their behalf. Two participants expect to offer these products via the Internet. Two participants say they expect to see this service increase due to a growing local population and marketing. Only one participant sees these products as an important source of revenue. Rather, they are offered as a convenience to customers, and participants say it can be difficult to offer them if they cannot find the appropriate third-party vendor. One participant that serves a low-to-moderate-income community specifically

markets its credit life insurance product to its loan customers. This participant said, *“If someone has an eight, nine, or ten thousand dollar loan on a vehicle and the husband dies, then that’s a major impact on their economic situation, so having this insurance in place will pay that off.”*

One participant that does not plan to offer insurance products remarked that it would not be difficult to find a strategic partner to offer the service, but that the service is best provided by insurance companies. This participant said, *“I think if we stuck with what we are best at, we would be a lot better off. If bankers stuck with banking, and let the insurance guys stick with insurance instead of them trying to write car loans, do IRAs and write residential mortgages that they know squat about, and us trying to write homeowner’s and life insurance and write trusts, we’d all live a better life.”*

Insurance – Property and Casualty

Three participants offer property and casualty insurance products, and two of those noted that they consider these products an important source of revenue. One of these participants actually owns the agency that offers the products. Four participants say they plan to offer property and casualty insurance products within the next three years, and two participants say they plan to offer them via the Internet. Three participants say they expect to see this service increase due to a growing local population, but one said it is difficult to find licensed staff who are available to market the product to the community.

Internet Banking

Five participants in the **large and medium asset tiers** currently offer Internet banking services to their customers. Further, within the next three years, all but one small asset tier participant will offer this service. These participants say they expect demand for this service to grow due to customer acceptance of this vehicle and to population growth in the communities they serve. Seven participants across all asset tiers either currently offer or plan to offer transaction capabilities with their Internet banking systems, in addition to using this channel as a means of providing information. Four participants say that while Internet banking is an important service, it can be difficult to offer for two reasons: 1) finding the right strategic partner to help offer the service, and 2) building the appropriate security into the system, and convincing customers of the reliability of that security. One problem unique to a remotely-located participant is that the toll call required to access the only Internet Service Provider that services its market area discourages many customers from requesting Internet banking.

As noted above in the “Profitable Growth – Internet Banking” section, seven participants generally do not view the Internet banking service as an important source of revenue. Rather, it is offered as a means of retaining existing customers and attracting new ones. Participants commented:

“I think it would make us vulnerable (against the competition) if we didn’t have it.”

“You’re not going to get us to be the first bank in the country to claim that it’s going to be a significant profit generator...It will be a means to protect the Gen X’ers and Gen Y’ers and the Net generation, instead of finding another bank because their father’s or grandfather’s bank doesn’t do anything.”

“The biggest challenge is going to be convincing (customers) that it’s safe and secure. That is the number one question a lot of people still have.”

Regarding accessing and/or receiving information using Internet technology, seven participants say that they are looking forward to using this access method, and they also are particularly interested in learning what capabilities FedLine for the Web will offer. One participant is a pilot for FedLine for the Web.

In addition to receiving basic information and notifications, two participants mentioned various ways the Internet could help them with check processing. One participant that would like to use FedLine for the Web to review return item status said, *“I can review return item status, where right now you have to just call someone or wait for the item to come back.”*

Another participant said that the Internet could be used as a vehicle for check clearing, but couldn’t foresee exactly how. This participant said, *“We would look to you (the Federal Reserve) to give us the possibilities (regarding check clearing). We don’t know what the possibilities are, and we don’t know enough about the security, which is paramount.”*

One participant would like to receive information concerning procedural changes and regulations via e-mail, but would not use the Internet for transaction information. This participant said, *“I hate to do anything transaction related over the Internet or e-mail because we don’t have a secure system in place, and we’re not ready to make that investment.”*

Loans – Commercial

Nine participants said that commercial loans are an important source of revenue, and three participants said that they plan to allow customers to complete loan applications using the Internet. Seven participants noted that they expect the number of loans to grow in the near future, due to increased marketing efforts and population growth in the communities they serve.

Although loans are a fundamental community bank product, three participants remarked that they can be difficult to offer, primarily because of the amount of documentation required. One participant said, *“...We’ve been arguing with Congress forever. The documentation required for real estate lending is burdensome. If you’ve done a re-fi or new mortgage lately, when you see all the paperwork you need to sign, I think you’d say it’s difficult.”*

Loans – Residential

All participants offer residential (i.e., non-commercial) loans, and they say that these loans are an important source of revenue. As with commercial loan products, these participants say that they expect the number of loans to grow in the near future, due to increased marketing efforts and population growth in the communities they serve. As with commercial loan products, three participants noted that they sometimes find it difficult to offer residential loans because of the amount of documentation required, but also because of competition. Participants commented as follows:

“If you roll out all the documentation that’s required to put out a mortgage loan, it’s difficult. Once you get the processes down, and have a platform system that can spit out those forms and keep you in compliance, then it’s not so hard.”

“It’s a volume driven business, and we can’t compete with the larger banks and mortgage companies, because volume drives the rates down. We offer it as a customer service...but loans aren’t a big part of our portfolio.”

Mutual Funds

Three participants currently offer mutual funds, a service that they say is part of their financial planning offerings, and two of the three indicated that this service is an important source of revenue. One of these participants plans to offer mutual funds via the Internet. Three others plan to begin offering this service within the next three years, and two of these three expect it to be an important source of revenue. Three participants say that they expect usage of mutual funds to grow in the near future, due to marketing efforts, an expanding customer base resulting from population growth in the communities they serve, and certificate of deposit (CD) rates. Two participants in **rural/small town** locations said that it can be difficult to offer mutual funds, primarily due to challenges in finding the right strategic partner. One participant commented, *“Selecting the right strategic partner (to offer the service) is the critical step. If you asked us 10 years ago, we’d say it was difficult. Now we have a track record with this strategic partner that’s working well, but we had one false start before.”*

Telephone Banking

Eight participants currently offer telephone banking transaction services, and one participant plans to offer the service within the next three years. All participants that offer telephone banking agree that this service is not an important source of revenue. However, they noted that it is relatively easy to offer and it meets customers’ needs for an automated, easily accessible system, and that the offsetting reduction in calls to staff has resulted in some cost and time savings. One said, *“We used to average 225 transactions per teller per day, and that average is down to 180.”*

Seven participants predict that usage of the service will increase in the near future, because of the 24-hour-a-day convenience it offers. One participant expects usage of the service to

grow in the future because customers will use it in lieu of Internet banking (a service that customers want, but that this participant does not offer). In contrast, another participant expects usage of telephone banking to decrease, as it is offset by Internet banking.

Three participants have a substantial immigrant and/or bilingual customer base, and they noted that one of the challenges they faced in choosing a telephone banking system was ensuring that the bilingual version of their system offered the appropriate dialect for their customers. Two of these participants have found and implemented a system that meets their customers' language needs, but one participant is still searching for such a system. This participant commented, *"We weren't really happy with the Hispanic version of the package... the dialect wasn't very refined."*

Other

In addition to the services listed above, participants were asked if they have begun using or offering other services within the past three years. Only one participant offers an additional service, an accounts receivable program that helps small businesses bill and collect from their customers in a more timely fashion. However, the participant characterized this program as *"not as successful as we would have hoped,"* and believes that it could be more successful if their out-of-state strategic partner that administers the service would become more active in marketing it locally.

Customer Segments

Study participants discussed their customer niches – that is, the customer segment to which they market their services, or those customers who make up a significant percentage of their customer base. They also discussed the profiles of their most profitable customers and the reasons that they occasionally lose profitable customers.

Customer Niches

Seven participants across all asset tiers and location types said that small and/or medium businesses are their customer niche, particularly with regard to loan and ACH products. Types of small business customers include farms, local merchants, and service industry businesses, such as hotels and restaurants. Three participants characterized their typical customer as blue collar, and/or in the low-to-moderate-income range. One of these participants also serves a large middle class customer base. Two participants say that senior citizens are a substantial customer niche. Two others say that they actively target community organizations, such as churches and non-profit organizations. One participant mentioned that it targets an ethnic/bilingual population by facilitating local as well as foreign (e.g., international wire) payments. Another participant targets commercial customers that are technology savvy.

Profitable Customers

Participants were asked to identify their most profitable customers. Their responses encompassed several customer segments and service areas. Five participants said that small businesses are their most profitable customers. One of these participants specified that small and medium businesses that use electronic payments, especially ACH, are most profitable. Two participants said that customers (both commercial and individual) who have multiple accounts are profitable. One of these participants said, *“If I can get your residential loan, that’s a very important key element, and your main checking account. Now I’m starting to tie you down because I have two of your most basic needs met.”*

Two **small asset tier** participants identified profitable customers as those that generate fee income (e.g., commercial customers who frequently overdraw their accounts). One participant that deals primarily in electronic payments named insurance and property management companies (who collect recurring payments) as profitable, as well as residential mortgage customers. Another participant noted that its most profitable customers are commercial real estate investors.

Profitable Customers Lost

Overall, participants said that they have lost few profitable customers in the past few years. However, they distinguished between customers that they actually lost and prospective new customers whose business they could not acquire.

Participants across all asset tiers mentioned losing actual customers and prospective customers to regional and nationwide banks and the Farm Credit System, primarily because these organizations offered lower loan rates on long-term, fixed-rate mortgages. Two participants said that non-bank competitors such as brokerage firms, retail banks, and point-of-sale lenders, have captured a prospective customer market by offering banking services such as loans directly to their customers.

Two participants noted that they have lost prospective customers because they did not offer electronic banking services, specifically, Internet banking and ATM cards. One participant loses a small number of customers simply because the customers move out of the area. Another participant lost an existing customer when it did not offer the customer a loan to build a hotel in another market with which the participant was unfamiliar (i.e., in another part of the state). The participant noted that this customer not only got a loan from another institution, but moved his existing loan with the participant there as well.

Customers’ Business Concerns

Participants discussed the business concerns of their customers, particularly those concerns that financial institutions in general are doing a poor job of meeting. Those concerns are as follows:

- One participant said that community banks generally are not adept at meeting small business cash management needs, particularly in offering sweep accounts (although this participant said that the availability of Internet banking should address many of these needs).
- One participant said that banks generally are not adept at meeting individual customers' needs for financial planning services.
- One participant said that customers are confused about which financial services entities offer which services, because many banks now offer traditionally non-bank services (e.g., insurance, brokerage), and non-banks now offer traditional bank services (e.g., loans, money market accounts).
- One participant said that customers are unaware of the range of products that community banks offer, so more aggressive marketing is needed.
- One participant said that banks do not adequately educate business customers about the risks associated with ACH origination, and how to mitigate those risks.
- One participant said that customers want account information aggregation, but this service is not yet available.
- One participant said that banks concentrate on pricing issues (e.g., setting interest rates, adjusting service fees) at the expense of customer service.
- One participant said that customer service often suffers after an out-of-state bank acquires a local bank.
- One participant said that low-to-moderate-income customers are not well served by the financial services industry because marketing efforts and product development are targeted toward wealthier customers. The participant noted that this customer segment must resort to payday loan services, check cashing businesses, and pawnshops for services.
- One participant said that ACH deposits are not always available on the date that customers expect them.

Some of the participant comments regarding customer concerns are as follows:

“Community banks aren’t doing a good job at small business cash management. We try to work with these people on sweep accounts, but sweep accounts are clumsy. You get all kinds of confirmations that you have to send out. We don’t have the proprietary fund to sweep that in to that some of the larger banks may have.”

“I’m always surprised to hear of customers who don’t know we have certain products. Somehow or other, they haven’t gotten the message.”

“With all these mergers, the personal service level isn’t what people in small towns are used to. Big banks (from out of state) buy small banks and then sell them off, because bankers in Minnesota don’t know what the economy is like in Texas.”

“Our industry hasn’t addressed the blue collar segment of the market. One of the most profitable segments (due to fee income) is the blue-collar worker who goes from paycheck to paycheck. Those individuals are left

behind by the industry. We tend to focus our marketing efforts, our product development, toward the wealthier customer.”

Competition

Study participants identified the various types of competition they face. They also identified the effects of, and their strategies for, dealing with these competitors.

Serious Competitors

Participants were asked to identify organizations that they consider to be serious competitors for their business. Eight participants said that **brokerage firms** are serious competitors, as are **regional and nationwide banks**, primarily because of their ability to offer long-term, fixed-rate loans. Six participants named **credit unions** as serious competitors, especially because credit unions no longer are required to have a commonality in their customer base. Five participants named **mortgage companies** as serious competitors, but only four participants named other **community banks**. One commented, *“Community banks aren’t necessarily stealing customers from each other, larger banks are stealing customers from community banks.”*

Three participants in the **large and medium asset tiers** said that **insurance companies** are serious competitors. One participant named **lenders that have access to customers at the point of service or sale**. Another participant named **retailers that now operate banks**. One participant based in a rural location said that **Farm Credit System** agencies are serious competitors. However, another rural-based participant remarked that not only are Farm Credit System agencies not competitors, the participant actually refers customers to these agencies. This participant does so because regulators now consider loans to certain farmers, e.g., those having \$1 million in assets but no cash flow, to be “classified and criticized assets.” The participant said that regulators encourage banks to forego making such loans.

Only one participant said that they have no serious competition because they are remotely located and because their low-to-moderate-income clientele makes the area an “unattractive” market.

Participant comments concerning their competitors include the following:

“The competition isn’t commercial banks anymore, it’s brokerage companies. You have (national insurance company) offering car loans. Your broker is giving you the investments, selling you credit cards, giving you a second mortgage on your house, giving you a line of credit, giving you interest on your checking account, on your idle funds.”

“Regional banks came in and priced about 150 basis points below our market for a 15-year fixed-term – we did lose about \$10 million for that. Our strategy as a bank is not to fix for 15 years. Five years is our threshold. We still remember the 1970s when the rates went up and banks got in trouble with fixed rates.”

Competitors Regulated Differently

Participants across all asset tiers and location types expressed frustration that their non-bank competitors often are regulated differently, usually with fewer lending conditions, and many said that they find the disparities to be unfair and restrictive. Participant comments on this issue are as follows:

“Payday loan companies are driving bankers crazy because they’re totally unregulated.”

“It’s not a fair playing field. Credit unions are not subject to taxation, so they can loan their money out at 38 percent less. Second, they don’t have to spend their time on CRA (Community Reinvestment Act) and other regulations.”

“...Credit unions...I won’t get started on that! We get hammered on rates that we’re able to pay on our deposits, whereas credit unions can offer lower rates on vehicles and higher rates on deposits, and they’re not subject to tax.”

“Farm Credit has an advantage in that they have no requirement to live up to CRA rules. They can cherry-pick. They don’t have to provide funding to low and moderate groups.”

“We shouldn’t minimize the significance of competition from our large bank counterparts, but at least they play by the same rules.”

“The new state laws tie our hands because of all the regulations that come with it. Out-of-state banks open branches here but are regulated by their own state’s laws, while we are subject to the laws of this state, which mandate a lower loan-to-value ratio. It hurts us in our ability to do loans that they might be able to do.”

Usage of Federal Reserve Services

Study participants evaluated how their usage of Federal Reserve services has changed in the past three years, and predicted how usage might change in the future. The services they discussed are ACH, Cash, Check (including payor bank services), Fedwire Book-Entry Securities and Fedwire Funds Transfer. Two **de novo** institutions participated in this study, and one of these participants said that usage of all services has increased since they opened 18 months ago and will continue to increase as a function of their growth. The other **de novo** participant said that usage of only payments services (i.e., ACH, Check, and Fedwire Funds Transfer) will grow because their focus is on payments mechanisms. The sections below report the discussion of past and future usage of Federal Reserve services.

ACH

Seven participants said that their usage of ACH services has grown in the last three years, and nine expect it to grow in the future. The increase is due to customer awareness as a result of marketing efforts and government-mandated direct deposit.

Cash

Four participants said that their usage of Cash services increased in the past three years and four others said their usage remained stable. Only one saw it decline, due to direct deposit. Four participants expect their usage of Cash services to grow in the future due to new branches or new business customers. (The remaining study participant has not used Cash services and does not plan to do so.) Two participants predicted that their usage of Cash services will decrease as customers increasingly use electronic payments mechanisms (e.g., ACH). Three participants mentioned that they sometimes find it difficult or inconvenient to use the Federal Reserve's Cash services. Their comments include the following:

“One of the reasons we didn’t go through the Fed was because the branches like to order twice per week¹².”

“The biggest issue for us is the Fed’s standard bundles. We’re looking for an intermediary like (armored truck service) to be our cash vault because we want to order and ship too often.”

“(The Federal Reserve’s cash ordering policy) is causing community banks in this (rural) area a lot of discomfort and inconvenience because they can’t find operators that will give them currency and coin. How is an armored truck service going to get out to the rural part of the state in anything like a cost competitive rate? I know one armored car service was going to charge a bank \$600 per month just to bring currency and coin. The bank can’t afford that – it’s a significant percentage of monthly income.”

Check

Six participants said that their usage of Check services increased in the last three years, primarily due to new individual and commercial customers, and two participants said it remained stable. However, three participants predicted that their usage of Check services will decrease in the future, offset by an increase in customer usage of electronic payments methods, such as Internet banking, ACH, ATM, and debit cards. Four participants predicted that usage of Check services would increase in the future; one specified that the increase will be the result of their customers’ dislike of debit cards.

Fedwire Book-Entry Securities

Five participants say that their usage of Fedwire Book-Entry Securities has been and will continue to be stable. However, two participants expect their usage of this service to grow

¹² Under certain conditions, the Federal Reserve may impose a service charge on branches ordering cash more than once per week.

in the future. One of these participants said that the increase is due to increasing purchases of Ginnie Mae securities and the other said that the increase will be a result of more public sector deposits, which require securities as collateral. Only one participant said that usage has decreased, and they expect it to continue to decrease in the future as a result of their strategy to move their funds from investments to loans.

Fedwire Funds Transfer

Six participants say that usage of Fedwire Funds Transfer increased in the last three years, and they expect usage to continue to increase. They say that customers have become more aware of its availability and they like its convenience. Two participants say that they expect usage of Fedwire Funds Transfer to remain stable. The high tech participant predicted that its usage would decrease because of their focus on ACH.

Correspondents, Third-Party Processors, and Vendors¹³

Survey participants identified the correspondents, third-party processors, and vendors they use for the following products and services: ACH, check account posting, check image statements, check processing, Funds Transfer, Treasury securities, brokerage services for insurance, and brokerage services for stock. Further, they discussed whether these relationships offer competitively priced services or whether they maintain these relationships because they have no other options. Nine participants said that they have several choices of correspondents, processors and vendors, and that these relationships provide services that are competitively priced. Participants sometimes base their choice of processor on service and convenience, rather than price. Some of their comments include the following:

“Our ATM processor – it’s a matter of convenience. They’re overpriced, but they are convenient.”

“It would probably be too cumbersome to change. When we were looking for an on-line processor, we had trouble finding someone who was willing to take us on.” (Noted by a small asset tier institution.)

“We have an expensive form of check processing, but they do a really good job for us. It’s the Cadillac with the Cadillac price.”

Of all services and processing relationships, only one participant mentioned using a high-priced processor because there are no other options. This participant is charged for Treasury securities per account transaction at prices the participant believes are not competitive.

¹³ Please see Appendix C for a list of correspondents, third-party processors, and vendors used by study participants.

Information Needs

Participants were asked whether their payments services providers give them enough information to perform their business effectively, and whether Internet technology provides an opportunity for accessing and/or receiving such information. Overall, participants reported that they are satisfied with the amount and quality of information that they receive from the Federal Reserve and other payments services providers. Additionally, four participants would like to receive transaction information and notifications via the Internet and/or e-mail. However, three participant institutions registered complaints regarding the way that the Federal Reserve organizes and delivers information. Their comments are as follows:

“I liked the way it was a few years ago, where everything from the Fed came at one time...you got it all at one time each day. Now, I get a fax for one thing, a courier brings return items in an envelope, and we get our reserve account statements from FedLine. When the statements are available on the Internet, we’ll be able to click on them and get the ones we want on demand.”

“I think we get enough information (through FedLine), but it’s often disjointed. We’ve got notices and things coming in all different directions. It’s hard to keep track of things, and the amount of communications can be overwhelming.”

“If we could get it through the Internet, we could save it and eliminate the need for a paper file.”

“A lot of times, operating circular memos come out and, frankly, they’re confusing to read. You’re referring back and forth from this operating manual to this operating circular, instead of having things written clearly.”

“I would recommend the example of (consulting firm). They take this horrendous regulation and they digest it down to understandable, easily read, easily implemented key points. So I don’t have to spend 85 hours reading something, then 12 thinking about it, and then another 24 trying to implement it.”

Impending Regulatory Changes

Study participants discussed which foreseeable, impending regulatory changes are likely to affect the range of products that they offer to their customers. Five participants mentioned that the privacy issues addressed by the Gramm-Leach-Bliley Act of 1999 will have an effect on their operations. One participant predicted that the Act is likely to “level the playing field” with non-banks if banks are allowed to offer more non-bank services (e.g., mutual funds, insurance). Participant comments regarding this Act are as follows:

“As Gramm-Leach-Bliley defines itself, we’ll probably have issues.”

“We can’t have a clear idea of where we want to go with financial planning and real estate services until Gramm-Leach-Bliley is settled.”

“Privacy issues that affect Internet banking are changing so quickly. We’ve just started offering transactional Internet-based products, and we may have to change that.”

“The privacy regulations that have come into place have certainly placed an extra onus on the financial institutions and their dealings with third-party vendors. All of a sudden, now you have to be documenting everything these other people are doing with the information you’re providing. In today’s world, to be honest, I’m confused as to how far I need to go with that. As it is, we’re so regulated today that sometimes we feel like we’re being strangled.”

Participants also mentioned other recent and impending regulatory changes and their impact, as follows:

- Interest-bearing checking accounts: Bill H.R. 1009, which will allow payment of interest on demand deposits, is likely to have a large impact on the cost of funds (but the participant could not predict if the impact would be positive or negative).
- Commercial truncation: The Check Truncation Act is likely to have a large impact by providing the ability to offer more services electronically.
- Money market accounts: Bill H.R. 974, which will allow payment of interest on demand deposits, is likely to make operations more expensive if the number of monthly items increases from six to 24.

Sources of Information

Study participants identified the sources from which they obtain reliable information that helps them make business decisions. Eight participants obtain information from the American Bankers Association (ABA) and seven participants obtain information from their state banking association. Seven participants consider conferences and conventions to be important sources of information, as are colleagues and professional advisors (e.g., accountants, lawyers, auditors). Two participants obtain information from a directory and data service publication. Other sources of information include local and regional financial services consultants, the Federal Reserve, external regulators, and the Bank Administration Institute (BAI). All participants access information both through hard-copy materials and the Internet. Two **small asset tier** participants consider community bank associations (i.e., America’s Community Bankers [ACB], Independent Community Bankers of America [ICBA]) to be an important source of information.

Issues and Concerns

Study participants mentioned a variety of issues and expressed several concerns regarding their operations. These issues and concerns are presented in the sections below.

Regulatory Restrictions

Four participants discussed how regulatory restrictions occasionally prevent them from providing services to certain market segments. The restrictions they named most frequently relate to loan services, particularly to farmers and low-income customers, and they noted that their unregulated competitors (e.g., the Farm Credit System, payday loan organizations) offer services that they would like to offer. Participants commented as follows:

“I’ll tell you, right now it’s extremely difficult for a bank to make loans to farmers. A farmer may have \$1 million in real estate that’s free and clear. But, if we make the farmer a loan and he doesn’t have the cash flow to repay the loan except for the sale of real estate, then that’s a “classified and criticized” asset of the bank. So, we’re really limited.” (As noted in the “Competition – Serious Competitors” section.)

“Underwriting guidelines have been developed by the FFIEC to the point where they are separating the haves and have nots, and they’re (implying) the have nots are undesirable. They would rather you not service a customer who has had credit problems in the past, who has a debt-to-income ratio above a certain number – it doesn’t mean they have a lot of debt, they just don’t have a lot of income. But the measure is the measure.”

Two participants said that payday loan organizations, because they are unregulated, are not under the same obligation as community banks to operate in the public interest.

Fraud Prevention

Three participants said they view the Federal Reserve as uniquely positioned to assume a greater role in combating fraud. One participant would like the Federal Reserve to develop a system for notifying institutions of unusual transactions. This participant described a Web site that is marketed as a bill payment service. For a nominal charge, users can create a check that then generates an ACH transaction. The participant explained, *“If I can find your account number, I can write a check on your account. The potential for fraud – we see the sophistication that’s out there. What are the Fed’s plans, if any, to help the community banks? It’s very scary. We are seeing a tremendous increase in scam artists using ACH.”*

Another participant mentioned a new policy whereby staff physically inspect checks over \$2,500, as a means of reducing the number of counterfeit checks. This participant, which lost almost \$4,000 on one account because of the easy access to counterfeit check systems, said, *“The crooks can buy computer programs and generate counterfeit checks.”*

Another participant suggested that the Federal Reserve, in its function as a clearinghouse, should oversee fraud prevention for credit and debit cards also. This participant said, *“When you look at the fraud, someone’s going to have to step in...the Fed is the transaction clearinghouse. Credit cards and debit cards are being used as checks – and you’ll have the whole American system not feeling secure.”*

Issues with Federal Reserve Services

The section above titled “Usage of Federal Reserve Services – Cash” discusses why some participants find the Cash service difficult or inconvenient to use. Additionally, one participant mentioned that a correspondent bank offers a safekeeping service that is more flexible and useful than the Federal Reserve’s.

Account Aggregation

Two participants mentioned account aggregation services, whereby customers can see information about their account relationships with a variety of entities. The information is presented in one place through an electronic connection hosted by one of the financial institutions with which the customer has an account. One of the participants said that they plan to offer the account aggregation service because customers are eager to use it. This participant said, *“Account aggregation is something customers are looking for. Having all the accounts shown on one statement. We become their financial portal and we can aggregate all their financial information (such as insurance and brokerage accounts) in one place.”*

In contrast, the other participant that mentioned account aggregation said that this service is likely to be advantageous to large institutions but detrimental to community banks. This participant said that the financial institutions that bring the service to market first (most likely large institutions) will be able to see information about all of a customer’s account relationships and then market services directly to other institutions’ customers. Although some institutions already offer the account aggregation service, this participant is not looking forward to the time when the service is widely available. This participant said, *“The rule is, he who aggregates first, wins. It’s going to kill the 700 community banks out there because the large banks are going to cherry pick the cream of the crop of your customers. They’ll see what accounts your customers have, then offer them their teaser rate and the customers will take it. So, who’s going to use the aggregation service? The wealthier clients who are on the road and want to see all of their accounts in one place.”*

Customer Service

All participants say that community banks are better positioned than regional and nationwide banks to offer superior customer service. Four participants said that when large institutions based elsewhere establish a local presence, they gain customers (described by one participant as “merger deserters”). One participant, echoing the opinion of several others, said, *“Most of our competitors are so big,— they’re offering their services in a different (impersonal) way. They’re driving their customers away, and we’re more than happy to take care of them.”*

Technology

Five participants noted that their relatively small size allows them the flexibility to evaluate and respond to individual customer needs and revise their existing systems quickly, as they see fit. Two say that this flexibility extends to their back-office technology systems as well as

to products and services. Participant comments regarding their back-office systems include the following:

“I don’t think community banks have a more difficult time or are less flexible in their ability to deploy technology. I think we’re more flexible than our larger competition. We’re able to roll out faster and more efficiently in a general sense. However, we don’t typically have a large say in the design structure itself of the technology that becomes deployed – it is typically engineered by larger institutions.”

“With our size and price, we’re not handicapped. We’ve got referrals from (a national bank) because they can’t touch certain types of deals because they’re too structured.”

Loans

Three participants described their ability to accommodate a variety of customer loan requests, such as deciding quickly whether to make a loan (e.g., one hour for residential customers), making loans to customers who lack complete income documentation (because they rely on funds from family members), and retaining the servicing on secondary market loans. Their comments include the following:

“A lot of our customers are financially credit worthy but don’t have a credit history and they don’t have documented income, so it’s very difficult for them to go elsewhere. We go by our personal knowledge of the customers. A lot of times we know they have resources, we know they have the income, it just doesn’t show up on paper. That’s how we do a lot of our banking, and that’s where we have an advantage, because a larger bank goes strictly by the documentation customers can produce.”

“...Offering the luxury of community banking and still having the right products. On consumer lending, there’s not a reason that we shouldn’t take less than one hour to make a decision. A lot of your regionals, their turn-around is not that flexible.”

“While we sell our loans on the secondary market, we’re retaining the servicing. Customers deal with us, not an 800 number for (a credit company) in Colorado or California.”

Consulting

Three participants mentioned that they provide consulting services to their customers at no charge. One small asset tier participant provides financial counseling to their customers to whom they have declined a loan. Another has assisted customers in understanding their local property tax charges. A participant that specializes in high tech banking provides advice to its corporate clients on which software packages to use (and is considering providing this type of advice as a consulting service). These participants commented as follows:

“When we have to turn someone down because of the income-to-expense ratio, that’s where it starts off, we help them with their budgeting. This town is low-to-moderate-income, and the education level is low. There’s a lack of understanding of financial responsibilities, and they depend on someone to help them.”

“We will help our customers unravel tax mistakes.”

“We had a major payroll company client that couldn’t figure out how to electronically pay its taxes. We went and looked at their accounts receivable. We went out and found software that would integrate with their software and lower their costs dramatically.”

Participants are proud of the level of service that they offer their customers and the personal relationships that they have with them. Several have a motto that represents their commitment to customer service. One participant remarked, *“The ability to make that determination (which services to offer) with sincerity is what separates community banks.”*

Results

- Of the various characteristics of the participants in this study – asset tier, location type, geographic location, and number of branches – participants within the same asset tiers most frequently gave similar responses (e.g., large asset tier participants had the most in common with other large asset tier participants, etc.). These similarities did not extend to the other characteristics. For example, participant responses grouped according to location type rarely were similar, and responses grouped according to geographic location and number of branches were not at all similar.
- Several participants look to the Federal Reserve to ensure access to the payments system by providing the infrastructure for electronic payments services, such as ATM, debit and credit cards, and Internet banking. Using payments infrastructure provided by the Federal Reserve would allow these community bankers to offer payments services outside of their own market area (e.g., ATM), which is essential to remaining competitive with their larger bank counterparts.
- Access to payments system technology (e.g., ATM networks, EBT networks, Internet) is of paramount importance to several participants. These participants are concerned that emerging payments system infrastructure will not be accessible to smaller institutions.
- Participants offer some products not because they are important sources of revenue, but because these products help them retain existing customers and attract new ones.
- Where the study participants have third-party provider relationships established, the institutions are satisfied with those relationships. Most feel that the services they use are competitively priced, and that they are not tied to any specific provider. For newer

banking services such as financial planning, insurance and Internet banking, some institutions have difficulties finding the right partner.

- The study participants regard increased customer awareness as essential for maximizing ACH's growth potential. They would like the Federal Reserve to assume a greater role in marketing this service directly to consumers and businesses.
- The Internet is a very relevant channel for the community banks that participated in this study. The majority of participants plan either to offer traditional banking services such as ACH, loans, and cash management via the Internet, or to market those services via the Internet. Fewer banks, however, see a role for the Internet in offering non-traditional banking services such as insurance, financial planning and 401(k) services. Uncertainty surrounding Internet security prevents some banks from offering services through this channel. However, one de novo participant serving the high tech sector views the Internet as an integral piece of its corporate identity and plans to either offer or market all of its services via the Internet. In addition, this participant plans to expand to other regions nationwide using Internet technology.
- While participants in all asset tiers increasingly are offering traditionally non-bank services (e.g., brokerage, insurance, estate planning) as a strategy for profitable growth, community banks universally continue to rely most heavily on more traditional banking services. Only a minority of the participants currently offer insurance, 401(k)s, mutual funds, and Financial EDI. Of all the products and services discussed in this study, commercial and mortgage loans are the most important sources of revenue for participants.
- Several participants are concerned about complying with the Gramm-Leach-Bliley Act covering customer privacy as they form strategic partnerships to introduce new financial planning services.

APPENDIX A: DISCUSSION GUIDE

COMMUNITY BANK SURVEY

A recent industry-wide survey of community banks indicates that there are five lines of business these institutions currently offer that are likely to double or triple during the next three years¹⁴. These lines of business are: insurance/annuities, mutual funds, cash management for small businesses, 401(k) services for businesses and home banking via personal computer. Although not mentioned in the survey, it is also possible that demands for Financial EDI may increase in the future.

The six lines of business identified above rely on the support of the payments system. As we develop payments system plans over the next few years, we want to do everything possible to ensure that the current Federal Reserve electronic payment offerings are adequate to support these growing business needs. It is also possible that community banks need third-party processors to fill the gaps between what the Federal Reserve can provide and what financial institutions want to offer. Based on the information obtained from community bankers, the Federal Reserve will be better positioned to make decisions on enhancing existing services or offering new ones. Concurrently, the Federal Reserve will need to make decisions regarding the extent that business partners are brought into this process.

Objectives

1. Identify priority growth opportunities for community banks.
2. Understand community bank challenges and anxieties in competing for growth opportunities.
3. Explore avenues for the Federal Reserve to help community banks compete.

¹³ “Community Banks: A Competitive Force.” Grant Thornton. 1999 Sixth Annual Survey of Community Bank Executives.

Interview Questions

Number of Branches: _____

Urban _____ Suburban _____ Rural/Small town _____

1. What are the two or three initiatives over the next three years that will best position you for profitable growth?
2. What type of customers are you targeting with this initiative? Who, specifically, are these customers?
3. What are the biggest challenges you face in implementing this initiative? What are you doing to overcome these challenges?
4. Do you have competitors that could also provide this service? If so, who? How is your initiative different or better than your competition's? How are you vulnerable against your competition?
5. Are these alternatives new or were they always available to your customers?
6. Do you need strategic alliances to implement these initiatives? If yes, are these relationships in place? If so, who are you working with? If not, what are you doing to develop these alliances?
7. With which alliances do you feel you receive high quality service? With which do you feel the service needs improvement?
8. What would you like the Federal Reserve to do to help you meet your desired outcome?

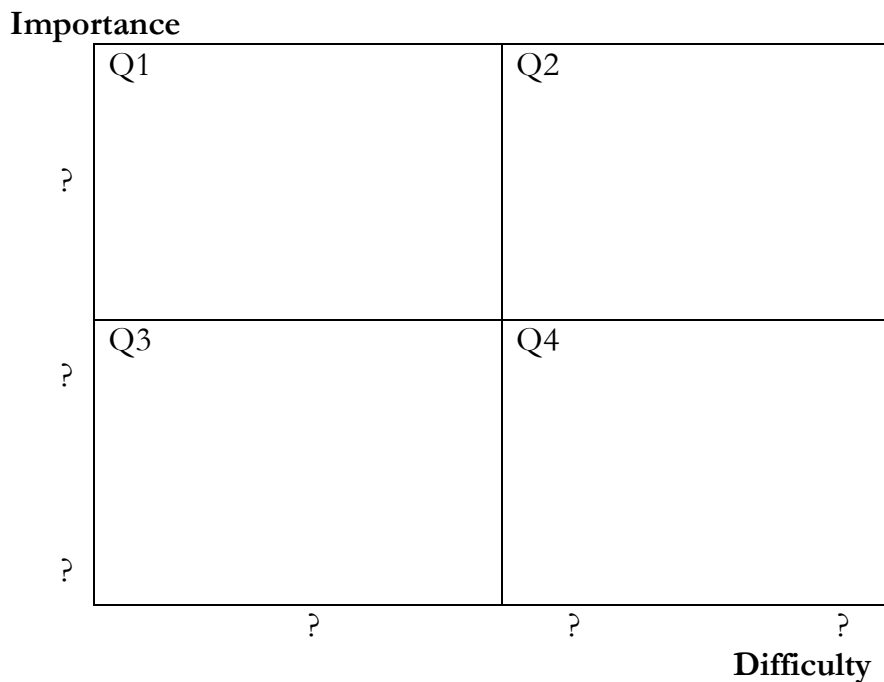
9. Please complete the table below to indicate:

- Which of the services you currently offer, the percentage of customers using these services, and whether the service is an important source of revenue.
- Which of the services you are likely to offer within the next three years, and whether you expect the service(s) to be an important revenue source.
- Which services you currently offer or plan to offer via the Internet.

Service	Currently Offer Service		Likely to Offer Within 3 Years	Currently Offer/Likely to Offer via the Internet (Choose one)		
	Percentage of Customers Using	Is service an important source of revenue? Yes/No	Is service anticipated to be an important source of revenue? Yes/No	Yes, transactions and information	Yes, information only	No
ACH Origination						
ATM						
Cash Management for Businesses						
Check – Individual Checking Accounts						
Check – Business Checking Accounts						
Check – Image Statements						
Credit Cards						
Debit Cards (on-line and off-line)						
Financial Electronic Data Interchange (EDI)						
Financial Planning						
401(k) for Businesses						
Insurance – Life & Health						
Insurance – Property & Casualty						
Internet Banking						
Mortgage Products – Commercial						
Mortgage Products – Residential						
Mutual Funds						
Telephone Banking						

Q10-11 for services Currently Offered:

10. How long have you been offering the service (new within last two years, longer than two years)?
11. Within the next three years, do you expect an increase in the number of customers who use these services? Why/why not?
12. Are your customers telling you that they need any of the services you do not currently offer? Will they take their business elsewhere if you don't offer it?
13. Are there any other services that are important to you and your customers that are not listed on this table? If so, what are they?
14. How important is each of these services to your future as a bank, and how difficult is it to offer these services? In the table below, Quadrant 1 indicates high importance and ease in offering; Quadrant 2 indicates high importance and difficulty in offering; Quadrant 3 indicates low importance and ease in offering; and Quadrant 4 indicates low importance and difficulty in offering. Plot each service into the appropriate quadrant to reflect its importance and difficulty in offering.



15. What do you regard as your customer niche (e.g., a particular industry or business, etc.)?
16. Who are your most profitable new customers? Have you obtained these customers in the last year?

17. For your most profitable customers, tell me about their top three business concerns that are critical to their future, but that financial institutions in general are doing a poor job of meeting. What are you doing to meet these concerns?
18. Do you have serious competitors for your business (e.g., other community banks, brokerage firms, credit unions, mortgage companies, regional or nationwide banks)? If so, who?
19. Tell me about profitable customers you've lost in the last few years. Why did you lose their business?
20. Do you use third-party processors? Do you use correspondent banks? If yes, which of the following services do you outsource to each: ACH processing, DDA account posting, Funds Transfer transactions, Treasury securities, brokerage services for insurance, brokerage services for stock? Any others?
21. For the services that you outsource, which do you feel are provided at competitive prices, and which do you purchase from a provider because you have no other options?

Service	Purchased at Competitive Prices	Purchased Because of No Other Options
ACH Processing		
Check Account Posting		
Check Image Statements		
Check Processing		
Funds Transfer Transactions		
Treasury Securities		
Brokerage Services for Insurance		
Brokerage Services for Stock		

22. How has your usage of Funds Transfer, Treasury Securities, ACH, Cash, and Check collection (including imaging, truncation, and Payor Bank Services) changed over the last three years? Why have your purchases changed? Do you think your usage will increase or decrease in the future? Why?
23. For the services we've just discussed, does the Federal Reserve provide you with enough information to perform your business effectively?
24. What additional information would be valuable to you?
25. What information should be consolidated? Integrated?

26. What information could be provided in a timelier manner?
27. How would you like to access information (e.g., hardcopy reports, e-mail, Windows®, the Web, other)?
28. What opportunities does Internet technology provide for accessing and/or receiving information from the Federal Reserve?
29. Regarding the information you receive from the Federal Reserve, are there any manual processes that you'd like to see automated?
30. Are there any other types of services that your institution has become involved in during the last three years that we have not already discussed? What prompted you to begin offering these services?
31. Are impending foreseeable regulatory changes likely to affect the range of products that you offer to your customers? If so, how?
32. From what sources do you obtain your most reliable information to help you make business decisions (e.g., state banking associations, national banking conferences/conventions, colleagues in the banking industry, professionals such as accountants that include professionals that provide formal consulting advice, correspondent bankers, other payment providers)?
33. Are there any other problems or issues that we have not discussed that you would like the Federal Reserve to know about?

APPENDIX B: COMMUNITY BANK PRODUCT OFFERINGS

KEY: Large Asset Tier: I
 Medium Asset Tier: *
 Small Asset Tier: #

Service	Currently Offer Service		Likely to Offer Within 3 Years		Currently Offer/Likely to Offer via the Internet		
	Is service an important source of revenue?		Is service anticipated to be an important source of revenue?		Yes, transactions and information	Yes, information only	No
	Yes	No	Yes	No			
ACH Origination	*	** #		#	** ##		*
ATM	*	**####				*	
Cash Management for Businesses	*	* #		*	** #		*
Check – Image Statements	* #	*		*	*	** #	##
Checking Accounts – Business	*** ##	#				** ##	#
Checking Accounts – Individual	** #	* ##				** ##	#
Credit Cards	*	** #			*	** #	
Debit Cards (on-line and off-line)		** #	* #		*	* #	* #
Financial Electronic Data Interchange (EDI)			**		*		*
Financial Planning		* #		*	*	*	* #
401(k) for Businesses		*	*	#	*	*	#
Insurance – Life & Health		* #	*		**		#
Insurance – Property & Casualty	* #	*	*		**	*	#
Internet Banking	*	*		* ##			
Loans – Commercial	*** ##	#			*	** #	##
Loans – Residential	*** ####				**	* #	##
Mutual Funds	*	*	* #		*		* #
Telephone Banking		***##	#			*** ##	

APPENDIX C: CORRESPONDENTS, THIRD-PARTY PROCESSORS, AND VENDORS

ACH

Federal Home Loan Bank
FISERV
Magic Writer

CHECK ACCOUNT POSTING

American Trust
Bank of America
Federal Home Loan Bank
Infotechnology
Lasco

CHECK IMAGE STATEMENTS

FMS
Lasco

CHECK PROCESSING

American Trust
FISERV
FMS

CORE DATA PROCESSING

Federal Home Loan Bank
Metavante
Spirac

CREDIT CARDS

Elan
Equifax
First Tennessee
M&I (Metavante)
MBNA

DEBIT AND ATM PROCESSING/NETWORK

Cirrus
EDS
MAC
Pulse
Shazam
VISA

FED FUNDS

Bankers' Bank
Federal Home Loan Bank
Wachovia

FUNDS TRANSFER

Bank One
Federal Home Loan Bank
First Union

INSURANCE SERVICES

ARTA
United Mercantile

STOCK BROKERAGE SERVICES/ASSET MANAGEMENT

DLJ
Prudential Bache
Sirach Capital
UBS Securities

TREASURY SECURITIES (SAFEKEEPING AND PROCESSING)

Bank One
Compass Bank
Fifth-Third Bank
Sun Trust

OTHER THIRD-PARTY VENDORS

Check Free – Bill Payment
Digital Insight – Internet Service Providers
Fannie Mae – Mortgage Processing
Federal Home Loan Banks – Liquidity
First Union – Cash
First Union – International Guarantees and Letters of Credit Certification
Harland – Loan Processing
ICBA – Mortgage Processing
InfoVisa – Trust Services
MOHELA – Student Loans
Option G/L – Profitability Software
S1 – Internet Banking
Sendero – Profitability Software
Thomas Cook – International Services
United Missouri – Bond Portfolio Processing

Atlanta

Boston

Chicago

Cleveland

Dallas

Kansas City

Minneapolis

New York

Philadelphia

Richmond

St. Louis

San Francisco