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Impact of the Financial Crisis on U.S. Community Banks:

New Opportunities in Difficult Times

March 2009

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IMPACT POINTS

- The current financial crisis is impacting all financial institutions. Most community banks are well positioned to overcome new challenges, take advantage of new opportunities, and reclaim some of the deposits lost to larger institutions over the last decade.
- Of banks surveyed, 55% stated they have seen an increase in deposits as a result of new customer acquisition. Only 17% are challenged by customers withdrawing deposits from their institutions.
- Community banks are acquiring new customers at a faster rate than in the past. Of banks surveyed, 57% saw their level of new retail customer acquisition increase during Q3 and Q4 2008 compared to the first half of the year, while 47% saw an increased level of new business customers.
- Risk management is now a greater area of focus for 68% of community banks.
- The financial crisis is causing only 27% of community banks to shift their IT priorities. In fact, 41% of banks surveyed plan to invest more in IT during 2009 than they did in 2008.
- Community banks are still lending and 40% have seen an increase in loan origination volumes over the last year. Only 11% believe the crisis has “significantly” curtailed their institution’s ability to lend. Economic compression and mixed messages from the U.S. government are key factors driving down loan activity.
- Despite most community banks lack of participation in subprime lending, the implications of larger bank activities have begun to trickle down. Of community banks surveyed, 73% stated they have seen an increase in their traditionally low loan delinquencies and charge-offs since the start of the crisis. The significant growth in quarterly net charge-offs for the industry are being driven primarily by the largest banks.
- The information is this report is based on a February 2009 survey of 743 community bank respondents.

INTRODUCTION

The backbone of the U.S. financial system is comprised of community banks. Throughout their history, community banks have maintained relationship-based business models, which allow them to offer personalized service to their customers. Additionally, their local presence and knowledge of the community often enables them to make informed credit decisions based on more than simply boilerplate lending models. As a result, they provide crucial support to individuals and small businesses within their communities that may not otherwise be able to attain credit.

Despite their important role, community banks remain in the shadows of the largest institutions, which now control a disproportionately large percentage of U.S. bank deposits. Large institutions have significantly grown their geographic footprints, product portfolios and deposit bases over the last decade, due in part to mergers-and-acquisitions activities. Now many of those same banks are at the center of the financial crisis, needing financial assistance from the government, and struggling to stabilize their balance sheets and win back consumer trust. Over the last several months, the market has seen the ramifications of greed and unnecessary risk-taking, as banks strayed from traditional lending practices in favor of subprime mortgages and higher returns.

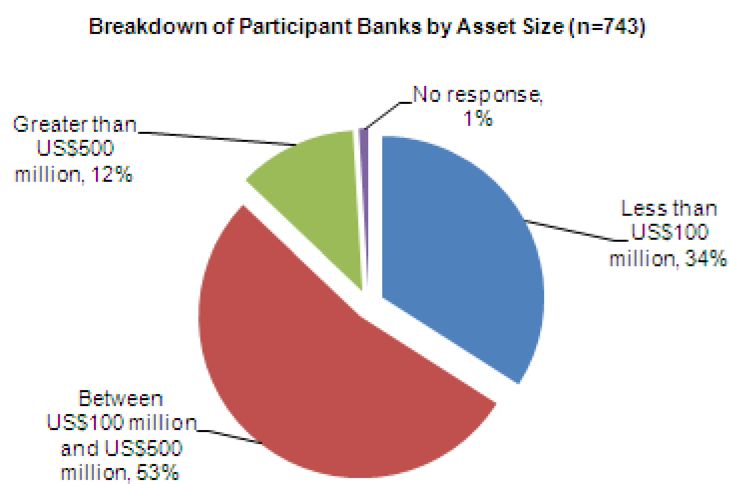
While primarily the largest U.S. financial institutions participated in subprime lending, all institutions, regardless of size, have been impacted by the current financial crisis. All banks are currently experiencing the trickle-down effect of increased delinquencies and charge-offs across their loan portfolios. Credit is largely frozen, impacting everyone from Wall Street to Main Street. Even most community banks, which chose to avoid subprime lending and thus maintain stable balance sheets, view the crisis as having a somewhat negative impact on their lending activities. While many are still lending and seeing increased loan origination volumes during these difficult times, 42% have seen a decrease in activity. Several of those banks experiencing decreased origination volumes have the funds to lend, but feel they are receiving mixed messages from the U.S. government. The government has been putting them through overzealous regulatory exams requiring tighter underwriting standards and criticizing existing loans on bank's books. Economic contraction has also led to fewer creditworthy customers and an overall worsening of existing credit quality. Additionally, community banks have been challenged by greater rate competition from larger banks trying to "buy" deposits from consumers. Customer concerns about the safety of their deposits have also been a challenge.

Some of the greatest opportunities often result from challenging times. This could not be more true for many community banks in the current financial environment.

While many struggle with these challenges and some risk failure (close to 43 banks failed from January 2008 to February 2009, according to the Federal Deposit Insurance Corporation), the current financial crisis also affords most of them the opportunity to grow their customer bases and win back some of the deposits they've lost over the last decade. It also enables them to increase their penetration into the highly desired small-business customer segment, and more effectively utilize technology to level the playing field, better serve customers, and better position themselves for future success. While all financial institutions are experiencing challenges in the current environment, community banks remain focused on their central mission of serving their local communities. In many cases, their futures are far brighter than those of many of their larger bank counterparts.

This report examines the impact of the current financial crisis on U.S. community banks, defined by the Independent Community Bankers of America (ICBA) as independent, locally owned and operated institutions ranging in size from less than US$10 million to some billions of dollars in assets. It analyzes the current challenges they face, as well as new opportunities resulting from the crisis. It also recommends areas for community banks to focus on in the coming months to maintain positive momentum beyond the crisis. The information in this report is based on the results of a February 2009 survey of 743 community bank respondents conducted by Aite Group with the assistance of Independent Community Bankers of America (ICBA). More than 50% of participating banks hold between US$100 million and US$500 million in assets (see Figure 1 on page 5).

FIGURE 1: SURVEY PARTICIPANTS

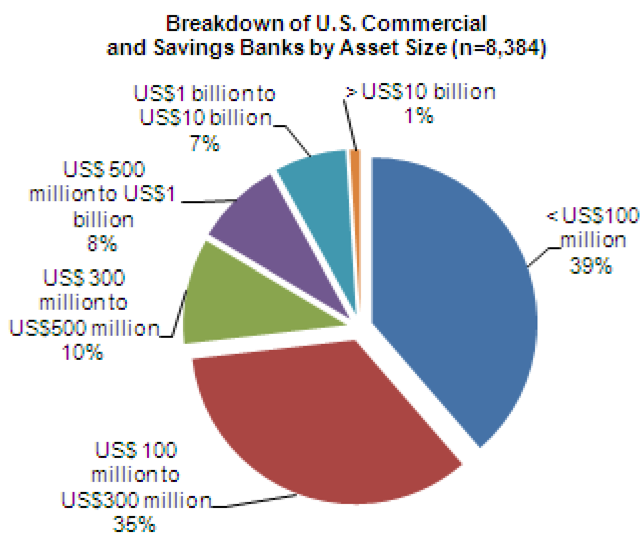


Source: Aite Group/ICBA February 2009 Survey of Community Banks

MARKETPLACE

According to the Federal Deposit Insurance Corporation (FDIC), 8,384 commercial banks and savings institutions existed in the United States as of September 30, 2008. Approximately 92% of those institutions are small banks, with less than US$1 billion in assets (see Figure 2).

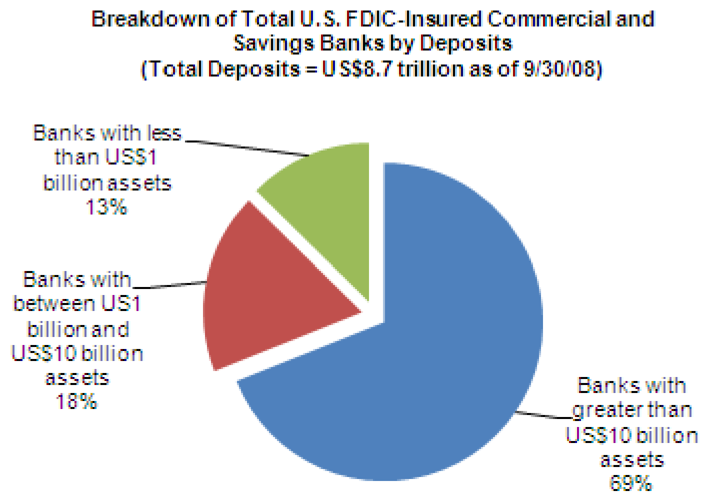
FIGURE 2: THE U.S. BANKING LANDSCAPE



Source: FDIC

While the number of small U.S. institutions is large, banks with less than US$1 billion in assets hold only approximately 13% of total bank deposits, a percentage that has decreased over the last 10 years (see Figure 3 on page 7).

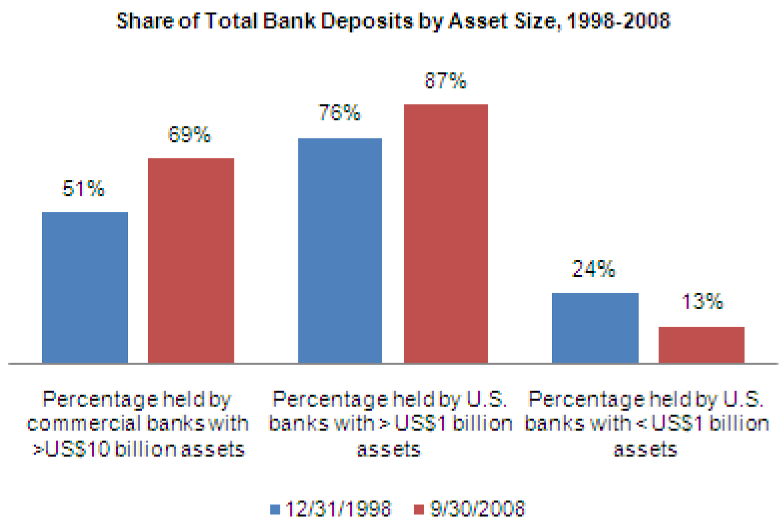
FIGURE 3: LARGE BANKS HOLD MOST U.S. DEPOSITS



Source: FDIC

According to FDIC data, as the number of U.S. banking institutions decreased from 10,464 in December 1998 to 8,384 in September 2008, total U.S. bank deposits grew from US$4.39 trillion to US$8.7 trillion. Despite the large increase in total deposits, banks with less than US$1 billion in assets grew by only 12%, while deposits held by the largest commercial banks (those with more than US$10 billion in assets), grew theirs by approximately 169% from 1998 to 2008. Additionally, the 18% increase in total bank deposit market share of large banks over the last 10 years has occurred largely at the expense of small institutions, which lost approximately 11% market share during that period (see Figure 4 on page 8). The four largest U.S. banks now control appriximately 50% of total U.S. bank assets.

FIGURE 4: THE LARGEST BANKS HAVE BEEN GROWING THEIR SHARE OF DEPOSITS AT THE EXPENSE OF THE SMALLEST BANKS



Source: FDIC, Aite Group

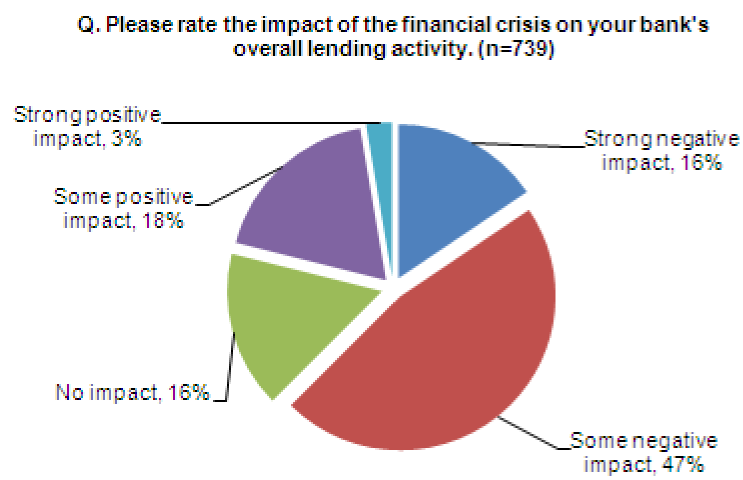
While the financial crisis is impacting all financial institutions from the largest banks to the smallest institutions, community banks are well positioned for future success in the market, and are seeing new opportunities to acquire customers, grow deposits and penetrate new markets. For some, there may be an opportunity to win back deposit market share lost to larger institutions over the last decade, as many large institutions are currently distracted by efforts to stabilize their balance sheets and win back consumer trust.

The next two sections of this report analyze the data from the Aite Group/ICBA joint community bank survey conducted in February 2009, and identify key challenges and opportunities arising for community banks as a result of the current financial crisis.

NEW MARKET CHALLENGES

All U.S. financial institutions, regardless of size, are being impacted by the current financial crisis, though the crisis is having a mixed impact on community banks. Similar to other banks, their lending business is being largely affected. Most community banks (63%) believe the crisis is having a negative impact on their overall lending activities (see Figure 5).

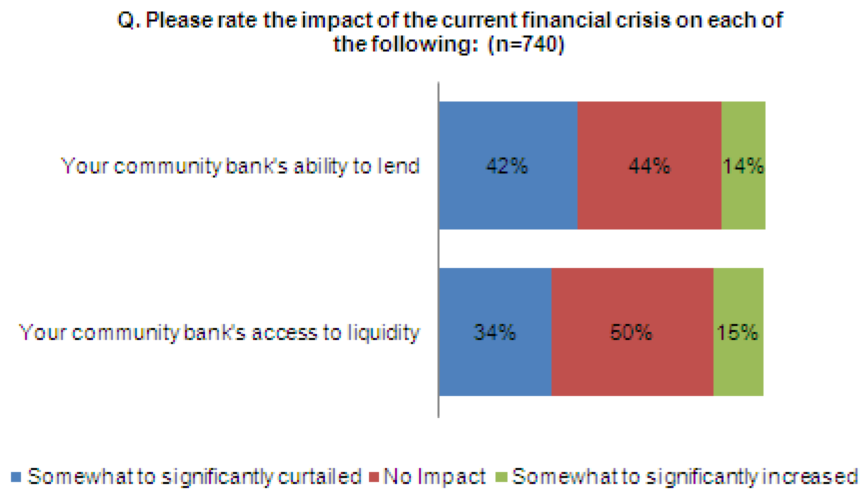
FIGURE 5: THE FINANCIAL CRISIS AND LENDING



Source: Aite Group/ICBA February 2009 Survey of Community Banks

While many community banks are still lending and 40% have seen an increase in loan origination volumes over the last year, 31% believe the crisis has "somewhat curtailed" their institution's ability to lend, while 11% believe it has "significantly curtailed" their ability (see Figure 6 on page 10). In several cases, decreases in community bank lending activity is not the result of a lack of funds or financial instability, but rather part of a reaction to mixed messages coming from the U.S. government: While these banks hear the government's requests for them to lend money, they also feel the government is dissuading them to lend by putting them through overzealous regulatory exams. Moreover, an economic contraction, by definition, means fewer loans will be originated, further leading to bank's curtailed ability to lend.

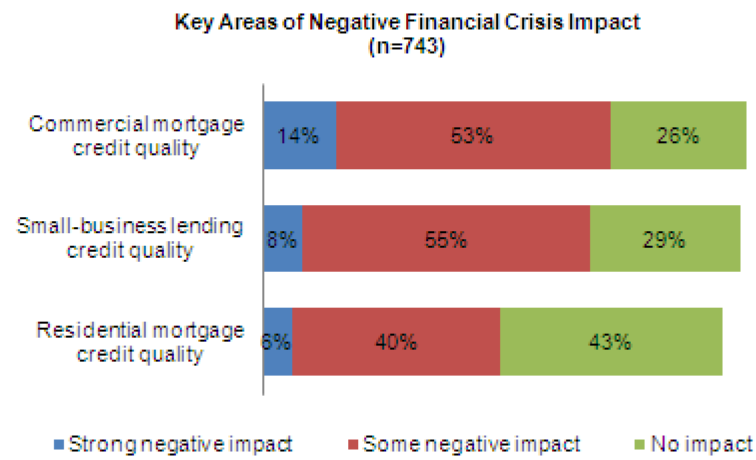
FIGURE 6: IMPLICATIONS ON BANKS' ABILITY TO LEND AND ACCESS LIQUIDITY



Source: Aite Group/ICBA February 2009 Survey of Community Banks

Overall credit quality has also been negatively impacted by the crisis, especially the quality of commercial mortgages and small-business loans (see Figure 7 on page 11). The commercial mortgages community banks are likely referring to are commercial real estate as opposed to land development loans. Banks with more than US$500 million in assets are the most likely to see a negative impact on the credit quality of commercial mortgages (82%), compared with smaller institutions with less than US$100 million in assets (59%), due to their greater penetration in the market. Interestingly, fewer banks are seeing a deterioration in residential mortgage credit quality, and 43% are seeing no impact at all. Overall, less than 15% of community banks feel the impact has been significant for any type of loan; the crisis is certainly having a negative impact on credit quality.

FIGURE 7: IMPACT OF CRISIS ON CREDIT QUALITY



Source: Aite Group/ICBA February 2009 Survey of Community Banks

While some community banks are faced with new lending challenges, as mentioned previously, they are still lending, especially when compared to larger banks. In fact, while the largest banks saw a 3.23% decrease in 2008 net loans and leases, institutions with less than US$1 billion in assets experienced 5.53% growth (see Figure 8).

FIGURE 8: CHANGE TO NET LOANS AND LEASES

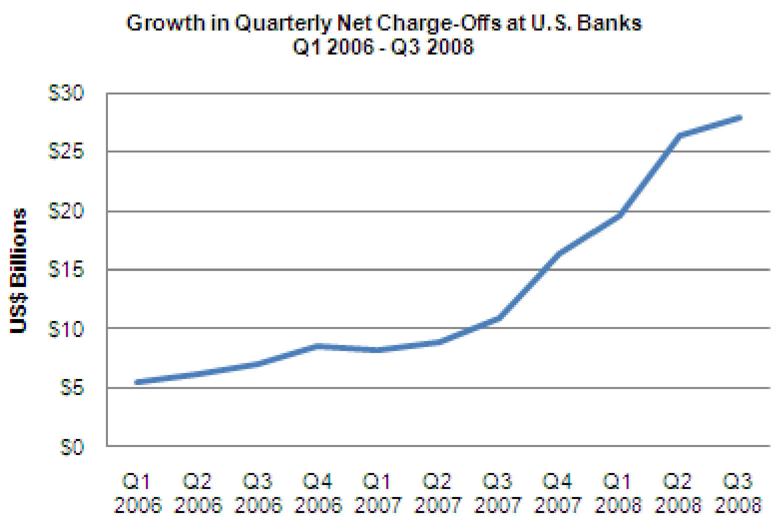
Asset Size	2008 Annual Growth	Annualized Quarterly Growth Rates			
		Q4	Q3	Q2	Q1
Total	-1.30%	-6.52%	-0.56%	-0.08%	2.19%
Greater than US$100B	-3.23%	-8.10%	-3.69%	-4.09%	3.30%
US$10B-US$100B	-3.21%	-12.08%	-0.46%	0.90%	-0.59%
US$1B-US$10B	3.14%	0.20%	6.77%	5.19%	0.57%
Less than $1B	5.53%	2.90%	4.98%	10.20%	4.17%

Source: FDIC, ICBA Data as of 12/31/08

While a large percentage of community banks view the current crisis as having a negative impact on overall lending activity and credit quality, many also attribute the rise in delinquencies and charge-offs to the crisis. Most community banks were not active participants in subprime lending. Despite this, many of their customers entered into such loans at other institutions, and the resulting loan delinquencies are now trickling down to the other institutions with which they have relationships.

As a result, 73% of community banks surveyed stated they have seen an increase in their traditionally low loan delinquencies and charge-off rates since the start of the crisis. The overall rise in charge-off rates is not surprising since the U.S. banking industry as a whole experienced an increase in quarterly net charge-offs greater than 400% from Q1 2006 to Q3 2008, driven primarily by some of the largest institutions (see Figure 9). According to the FDIC, the U.S. banking industry is experiencing its highest quarterly net charge-off rates since 1991. "Troubled assets" are eating away at the earnings of many banks. In fact, according to the FDIC, the median return on assets at institutions with greater than US$1 billion in assets fell from 1.03% to .56% from Q3 2007 to Q3 2008, while institutions with less than US$1 billion in assets saw their return on assets decline from .97% to .72%. Profitability erosion over this time period has therefore been greatest at the largest banks.

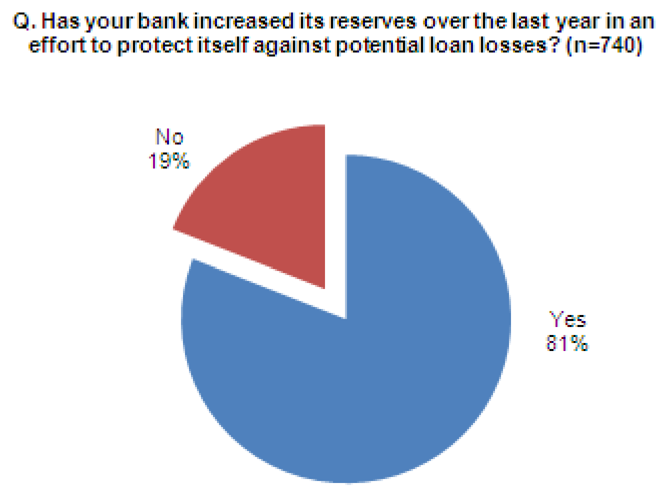
FIGURE 9: QUARTERLY NET CHARGE-OFFS AT U.S. BANKS CONTINUE TO RISE



Source: FDIC

Economic weakness, increased credit weakness, pressure from regulators and banks' desire to protect themselves against future potential loan losses, led approximately 81% of community banks to increase their reserves over the last year (see Figure 10 on page 13). Community banks with more than US$500 million in assets were the most likely to do so, with 94% taking part in this action. More than 10% of banks surveyed increased their reserves by more than a full percentage point over the last year.

FIGURE 10: OF BANKS SURVEYED, 81% HAVE INCREASED RESERVES OVER THE LAST YEAR

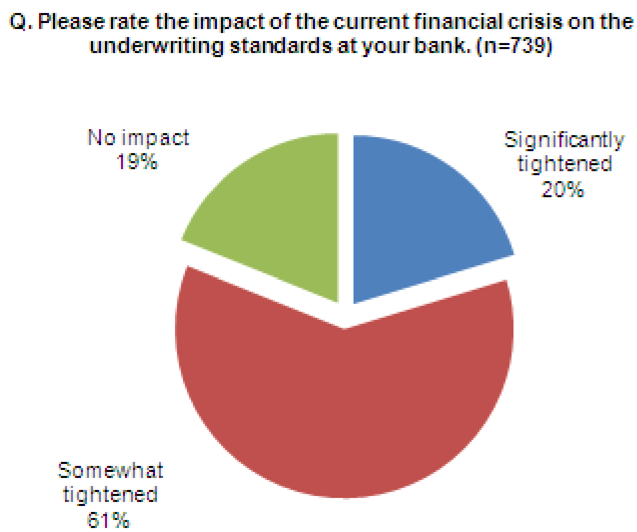


Source: Aite Group/ICBA February 2009 Survey of Community Banks

The financial crisis and new documentation requirements are also causing some banks to change processes and re-evaluate their credit evaluation practices. While most community banks have not strayed from traditional prudent lending and underwriting practices, 81% have tightened their credit standards since the start of the crisis. Of banks surveyed, 20% described this tightening as significant (see Figure 11 on page 14). Banks with more than US$100 million in assets have been the most likely to tighten their credit standards, while only 15% of banks with less than US$100 million in assets have done so. In most cases, tighter standards often means focusing greater attention on risk management and requiring more borrower information prior to making lending decisions (see Figure 12 on page 14).

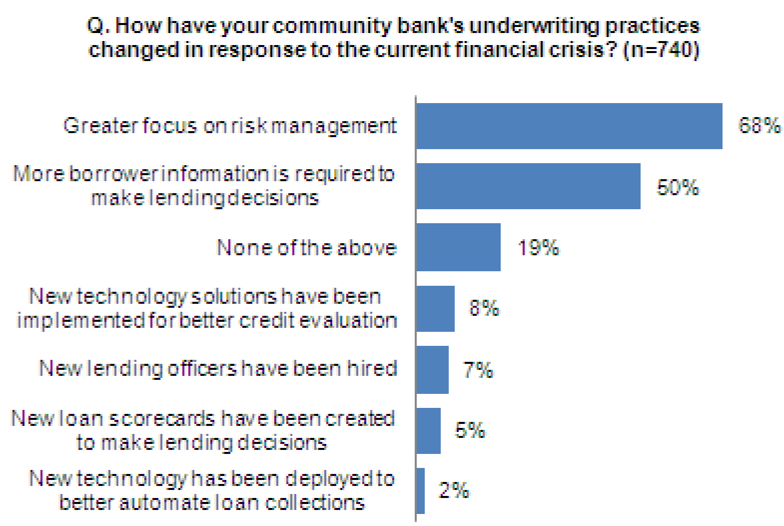
Of banks surveyed, 27% have also removed some loan products from accessibility to new borrowers. Thirty-seven percent of banks with more than US$500 million in assets did so as well, while only 19% of banks with less than US$100 million removed loan products from availability. Very few community banks are developing new credit risk scorecards or deploying new technologies to help better evaluate risk, as most feel they already have strong processes in place.

FIGURE 11: BANKS ARE TIGHTENING THEIR UNDERWRITING STANDARDS



Source: Aite Group/ICBA February 2009 Survey of Community Banks

FIGURE 12: OF BANKS SURVEYED, MORE THAN HALF ARE FOCUSING ON RISK MANAGEMENT AND REQUIRING ADDITIONAL BORROWER INFORMATION

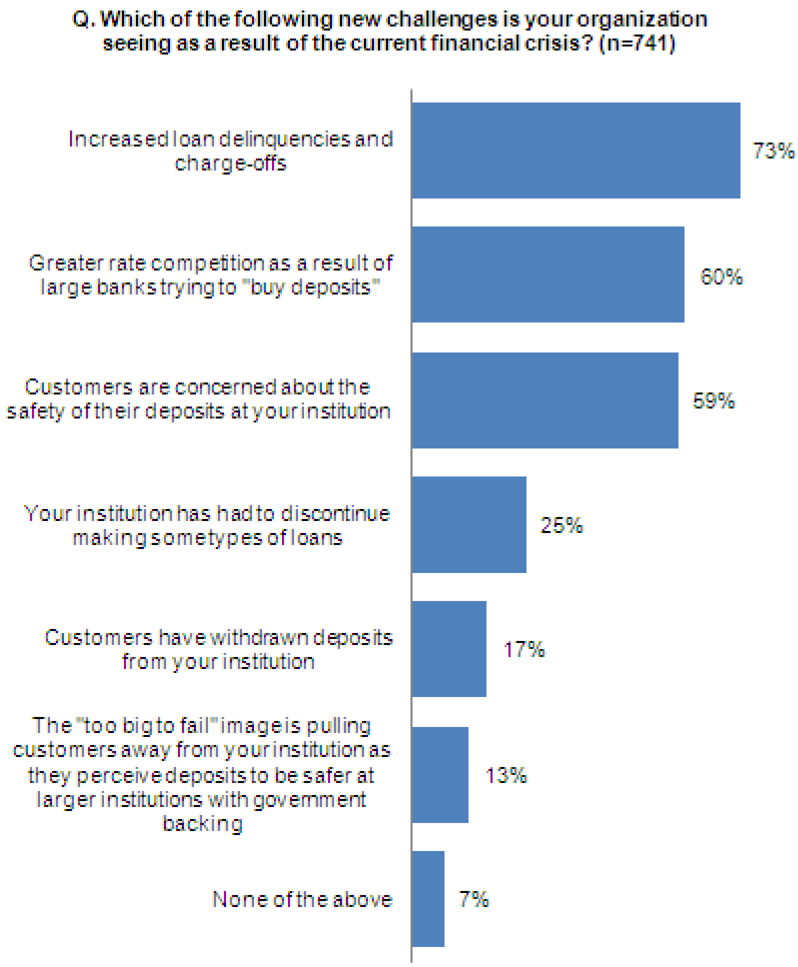


Source: Aite Group/ICBA February 2009 Survey of Community Banks

In addition to deteriorating credit quality and an increase in loan delinquencies and charge-offs, the financial crisis is bringing with it other challenges for banks (see Figure 13 on page 16). For example, by leading to increased competition in the marketplace, especially for deposits. Of community banks surveyed, 60% are experiencing increased competition from large banks looking to win deposits at any cost, and offering higher-than-usual interest rates for them. This forces other institutions to match those rates, and cuts into margins for the entire industry.

Nearly 60% of community banks surveyed are also challenged by customer concerns about the safety of deposits at their institutions. This has begun to subside given the higher amount of deposits now being insured by the FDIC, as well as bank efforts to educate customers and relieve their fears. Even so, many banks feel these fears were exacerbated by government actions demonstrating a belief that some institutions are "too big to fail." While only 13% of community banks say they are experiencing customer attrition as a result of "too big to fail" perceptions, 43% believe the perception is creating challenges for their institutions. Twenty-four percent disagree, however, and believe that receipt of Troubled Assets Relief Program (TARP) funds is having a negative effect on the way consumers look at large institutions instead, helping community banks win customers. The community bank market obviously has mixed feelings in this area.

FIGURE 13: NEW BANK CHALLENGES RESULTING FROM THE FINANCIAL CRISIS

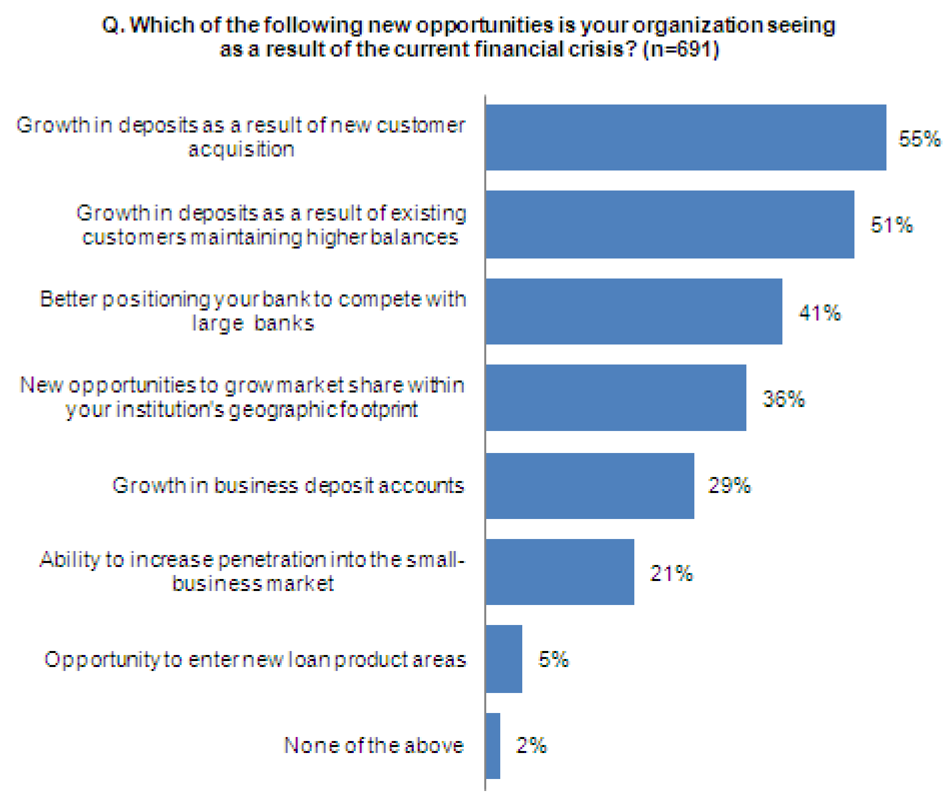


Source: Aite Group/ICBA February 2009 Survey of Community Banks

EXCITING NEW OPPORTUNITIES

Some of the greatest opportunities are created during challenging times, and this certainly holds true for community banks in the current financial services environment. While they are experiencing some new challenges as a result of the current crisis (as described in the previous section), many also see new opportunities. Figure 14 summarizes some of the key new opportunities for community banks.

FIGURE 14: NEW OPPORTUNITIES FOR COMMUNITY BANKS

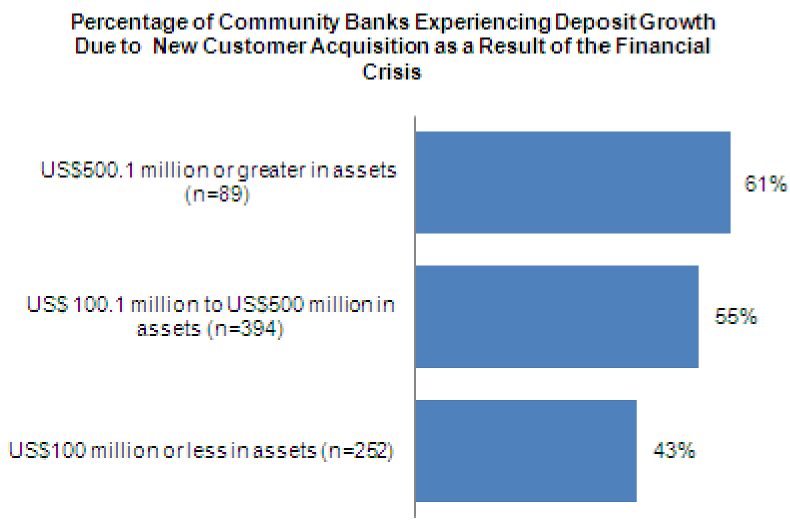


Source: Aite Group/ICBA February 2009 Survey of Community Banks

DEPOSIT GROWTH

One of the most exciting results of the financial crisis for community banks is the opportunity for them to reclaim some of the deposits they have lost to larger institutions over the last decade. In fact, 55% of community banks surveyed stated that they have seen an increase in deposits as a result of new customer acquisition, while 51% have seen it as a result of existing customers maintaining higher deposits (likely the result of them removing it from the stock market). (See Figure 14 on page 17.) Community banks with more than US$500 million in assets have been the most likely to see deposit growth as a result of new customer acquisition, while the smallest institutions — those with less than US$100 million in assets — have been the least likely (See Figure 15).

FIGURE 15: DEPOSIT GROWTH BY SEGMENT

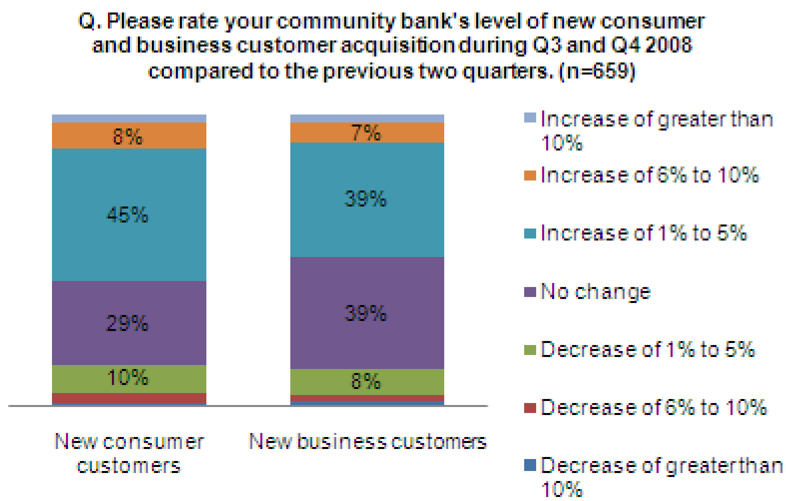


Source: Aite Group/ICBA February 2009 Survey of Community Banks

NEW CUSTOMER ACQUISITIONS

While the volume of new customer acquisitions has been modest, most community banks have seen an increase in the level of new customer acquisitions over the last year. Most saw their greatest growth Q3 and Q4 2008. During that time, 57% of community banks saw their level of new consumer customer acquisition increase, while 49% saw an increased level of new business customers over the previous two quarters. In fact, 45% and 39% saw an increase between one and five percent for consumer and business customers respectively during those two quarters compared to the previous two. More than 9% of community banks saw an increase of greater than 6% among both customer segments during the period (see Figure 16 on page 19).

FIGURE 16: NEW CUSTOMER ACQUISITION



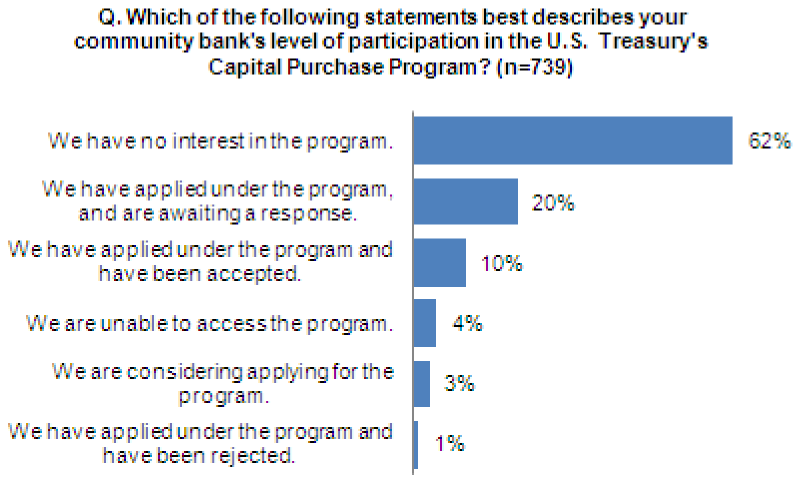
Source: Aite Group/ICBA February 2009 Survey of Community Banks

BETTER POSITIONING AGAINST LARGE BANKS

New customer acquisitions achieved over the last year have been due in part to mistrust of, and in some cases disappointment with, the greed displayed by some large institutions participating in subprime lending. Additionally, some large banks have also become distracted by their efforts to stabilize their balance sheets, resulting in lower levels of customer service. Customers looking for greater familiarity in their financial institution relationships and better customer service are attracted to the more personal lending standards of smaller institutions, which often take into account knowledge of the customer as opposed to the boilerplate methods of many larger institutions. In some ways, the market is seeing a "flight to quality," whereby consumers are shifting their allegiance to institutions providing the highest levels of quality service.

Finally, almost a quarter of community banks believe that receipt of TARP funds has hurt the way consumers and businesses view large banks. Many community banks do not want to be viewed in the same light as larger institutions, and also do not want to be subject to greater government control of their activities. For those reasons and others, 62% of community banks have no interest in participating in the U.S. Treasury's Capital Purchase Program. The smallest institutions — those with less than US$100 million in assets — are the least likely to participate, with 74% stating they have no interest in the program. Of community banks, 41% feel the financial crisis has better positioned their institutions to compete against larger bank players (see Figure 14 on page 17).

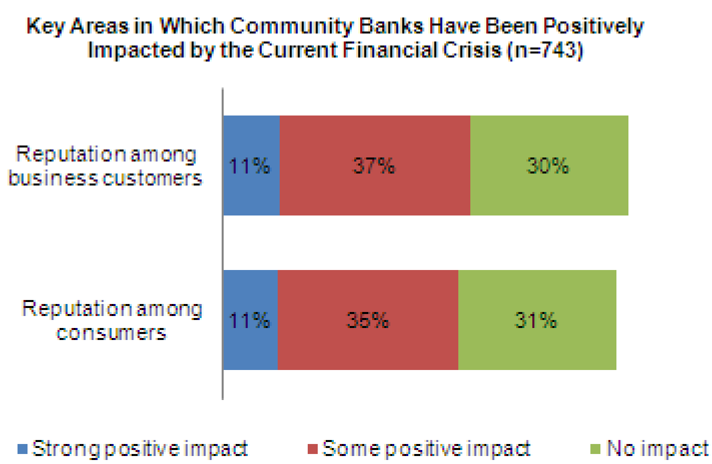
FIGURE 17: MOST COMMUNITY BANKS HAVE NO INTEREST IN THE CPP PROGRAM



Source: Aite Group/ICBA February 2009 Survey of Community Banks

In fact, 48% also believe the crisis has improved their reputation among business customers, while 46% believe it has improved their reputation among consumers (see Figure 18).

FIGURE 18: COMMUNITY BANKS FEEL THEY ARE BEING VIEWED MORE POSITIVELY



Source: Aite Group/ICBA February 2009 Survey of Community Banks

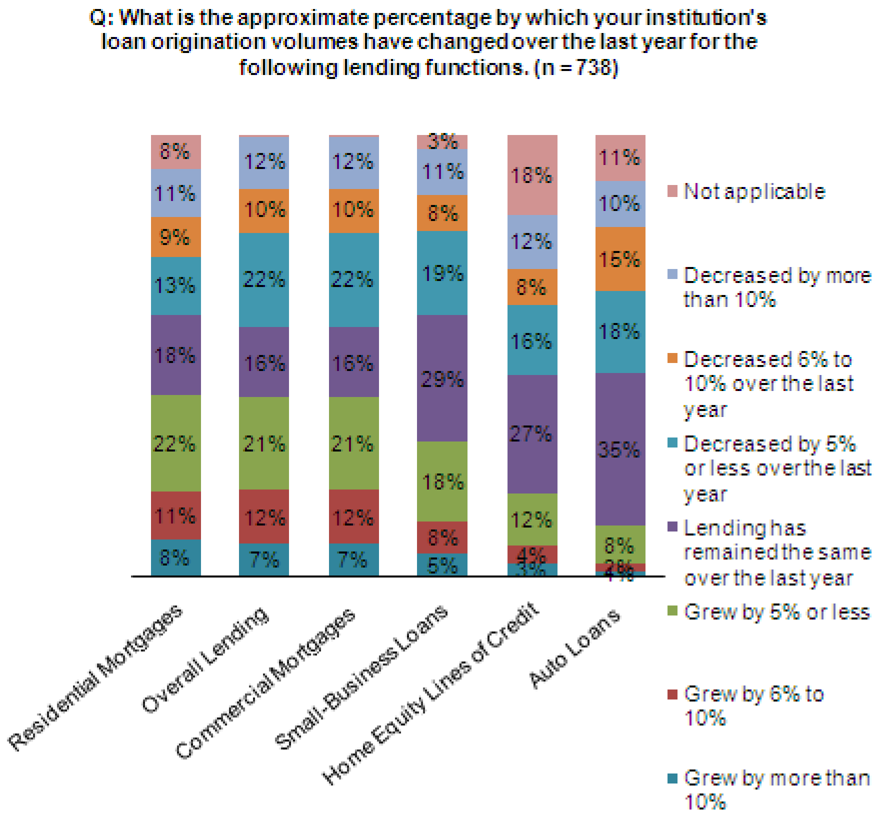
INCREASED PENETRATION AMONG SMALL BUSINESSES

An Aite Group survey of 303 small businesses concluded that community banks served as the primary financial institution to approximately 30% of U.S. small businesses at the end of 2007, compared to 33% served by the five largest banks at the time. Community banks are growing their market share among these customers at a faster rate than any other bank segment. The current environment is creating even more opportunities for community banks to continue to penetrate this customer segment, especially as some of the larger banks increasingly shut them out through higher interest rates on small-business credit cards and frozen credit for small-business loans. In fact, the crisis has resulted in a growth in business deposit accounts for 29% of community banks surveyed, while more than one-fifth of community banks believe the crisis has increased their ability to grow their penetration into the small-business market. This will likely result in greater revenues for community banks, as Aite Group forecasts small businesses will spend almost US$500 billion on financial products this year.

LOAN ORIGINATION GROWTH

Most community banks never swayed from traditional lending practices in search of greater returns, have responsibly managed their balance sheets, and have increased their capital adequacy ratios over the last year. Additionally, while more than half of community banks surveyed believe the financial crisis is having a negative impact on their overall lending activities and credit quality, many of them are stable and continue to lend. In fact, 40% of community banks have seen an increase in the volume of their overall lending. This is a real testament to the success of the community bank model, especially given the economic contraction and subsequent decrease in overall industry lending volumes. Most community banks have seen the greatest increase in residential and commercial mortgages (see Figure 19 on page 22). Little change has been seen among consumer and business card volumes over the last year.

FIGURE 19: CHANGE IN LOAN ORIGINATION VOLUMES BY PRODUCT



Source: Aite Group/ICBA February 2009 Survey of Community Banks

MAINTAINING MOMENTUM

While community banks are experiencing some new challenges, they are also seeing many new opportunities presented to them as a result of the current crisis. As described in the last section, many have enjoyed increased deposits over the last year, as well as new customer acquisitions, better positioning against larger banks, stable balance sheets and loan origination growth in some product areas. Community banks should not expect these benefits to continue indefinitely, however, without some additional effort on their part. In fact, with any luck, the crisis will come to an end soon. In preparation for that, this section highlights Aite Group's recommendations to community banks to ensure that they continue to enjoy some of these benefits and maintain positive momentum even after stability is returned to the financial markets. Technology must play a key role in their overall strategies.

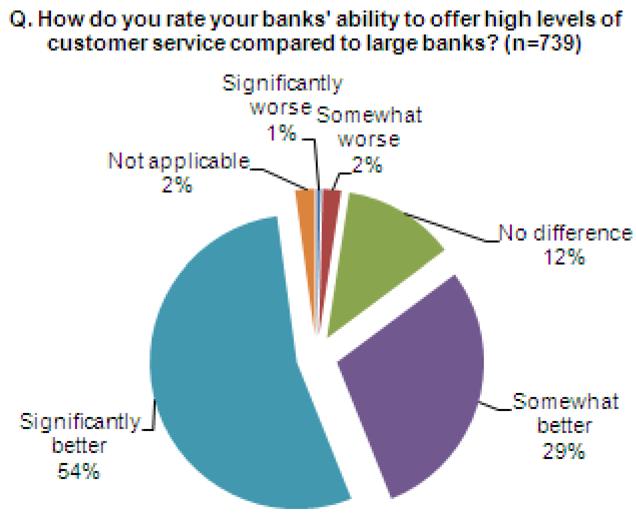
ENHANCE CURRENT STRENGTHS

Even prior to the financial crisis, community banks were winning-over new customers with their ability to offer high levels of customer service. Even in good times, it is difficult for large institutions to match a community bank's ability to know its customers on a personal level, answer questions without first directing customers to automated systems, and offer more intimate lending standards that take into account knowledge of the customer. Most community banks recognize their strength in this area. In fact, 54% of community banks surveyed believe the level of customer service they provide is significantly better than that offered by large banks, while 29% feel their level is somewhat better (see Figure 20 on page 24).

Community banks must continue to enhance their already high levels of service by better leveraging technology. The deployment of customer analytic technologies, for example, will enable them to better understand customer product usage, better predict customer needs, and more effectively cross-sell additional products to deepen relationships.

While continuing to focus on using the branch as an important sales channel, community banks must also implement more integrated multi-channel strategies not only to serve customers more effectively, but also to ensure a similar experience regardless of their preferred channel.

FIGURE 20: MOST COMMUNITY BANKS BELIEVE THEY EXCEL AT CUSTOMER SERVICE

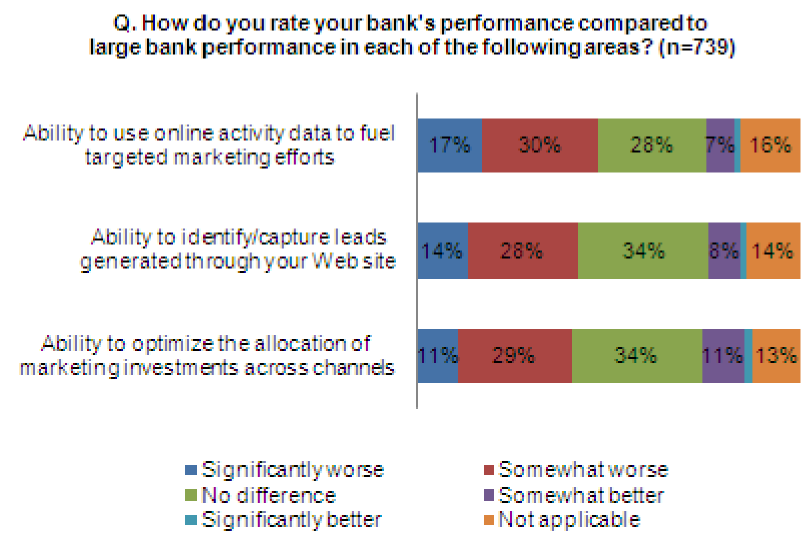


Source: Aite Group/ICBA February 2009 Survey of Community Banks

BETTER UTILIZE THE ONLINE CHANNEL FOR SALES AND MARKETING EFFORTS

In addition to using technology to better serve customers and better understand their needs, community banks should also leverage technology, especially within the online channel, to more proactively solicit new customers and market to existing ones. Doing so will enable community banks to continue to grow new customer acquisition volumes and more effectively cross-sell while generating new potential fee-based revenues from new services. Unfortunately, community banks have not been high adopters and/or effective users of online sales and marketing technologies to date. In fact, at least 40% of community banks admit that their ability to use online activity data to fuel targeted marketing efforts, identify leads generated through their Web sites, and optimize allocation of marketing investments across channels is worse than that of large institutions (see Figure 21 on page 25). While their ability to acquire new customers is a strength, attracting new customers is often more expensive than cross-selling to existing customers. Community banks must therefore be able to do both. Better utilization of technology to perform these activities will not only improve their effectiveness, but also help them to do so more cost-effectively.

FIGURE 21: ONLINE SALES AND MARKETING PERFORMANCE



Source: Aite Group/ICBA February 2009 Survey of Community Banks

CONTINUE TO GO AFTER THE SMALL-BUSINESS SEGMENT

As mentioned previously, the small-business customer segment has become an important target market for many community banks due to its potential for establishing deep relationships and generating fee-based revenues. Level of customer service is a key decision criteria for approximately 45% of small businesses when selecting their primary financial institution, which places community banks in a strong position to win their business. While community banks have always had strong small-business lending relationships, prior to the last two years, most of them did not have many of the necessary cash management product offerings and online capabilities to sufficiently meet the increasingly sophisticated small-business needs. Many, for example, continued to serve small-business customers with retail banking solutions and consumer products. Since that time, many community banks have ramped-up their efforts to win the hearts and wallets of these customers by deploying new online solutions built specifically for small-business customers, attempting to better understand their specific needs and broadening their product portfolios. As a result, progress is being made as community banks increase their market share of this important customer segment at a faster rate than any other bank segment.

More can still be done, however. A recent Aite Group survey of 303 small businesses found that only 41% of small-business customers that consider a community bank to be their primary institution are extremely satisfied with the online banking capabilities their bank offers them. Additionally, only 25% of that same group stated they were extremely satisfied with their community bank's ability to offer a full product suite.

BROADEN YOUR PRODUCT PORTFOLIO

As mentioned, community banks need to broaden their product portfolios in order to better meet the needs of small-business customers and see greater success with those businesses generating more than US$1 million in annual revenues. Additionally, contrary to the quickly expanding small-business product portfolios of many of the largest banks, many community banks have moved at a slower pace. As a result, community banks are often seeing lower adoption rates in some product areas such as business savings/money market, small-business credit cards and debit/check cards, as well as payroll services and Health Savings Accounts.

While community banks are more competitive on the consumer banking side, they must continue to keep their eyes on the offerings of their larger bank competitors. As the crisis creates new opportunities for them to compete and win against the largest banks, the need to broaden their product offerings will intensify. Additionally, a broader product portfolio will enable community banks to attract much-needed deposits while also enabling them to shift away from more of a lending- focused business model.

LEVERAGE TECHNOLOGY TO THE FULLEST EXTENT

While community banks are seeing opportunities in the existing environment, they must also leverage technology to the fullest extent in order to fully reap the benefits and continue positive momentum. Technology not only helps to level the playing field, enabling community banks to better compete against larger banks in their geographic footprints, but also allows community banks to better serve existing customers and more effectively meet the demands of new customers — especially new customers that may be accustomed to the broader product portfolios and services of larger banks. While community banks have been evolving into more full-service institutions over the last few years, many still offer limited product offerings when compared to larger banks.

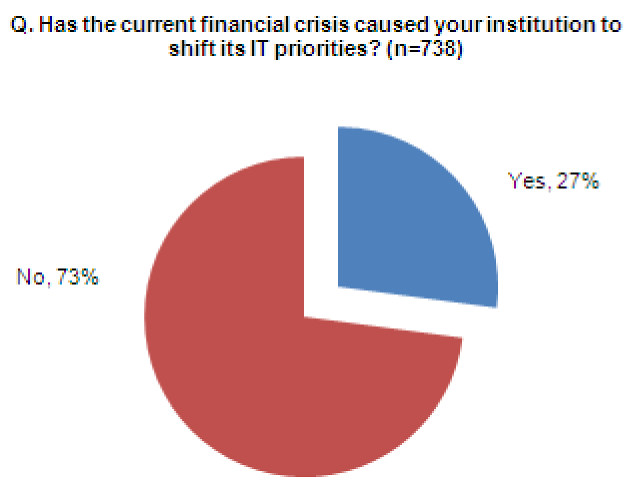
In the coming months, community banks must show a greater willingness to deploy the right technologies in order to better compete with larger banks. They must improve their online capabilities and deploy new small-business banking solutions if they haven't already done so. Finally, they must continue to deploy solutions such as remote deposit, which enable them to eliminate geographic boundaries and limited target markets while implementing mobile banking capabilities that enable them to attract younger customers and those that value greater convenience.

IT PRIORITIES

The previous section of this report recommended that community banks leverage technology to the fullest extent to better position themselves for continued growth once stability is returned to the market. This section describes the current IT priorities of community banks and where they are most likely to be spending their IT dollars over the next year.

While the financial crisis is having an impact on community banks, it is not resulting in a shift in IT priorities for most of them, at 73% (see Figure 22). This is especially true for the smallest institutions. Of those with US$100 million or less in assets, 80% responded "no" when asked whether the financial crisis has caused their institution to shift its IT priorities.

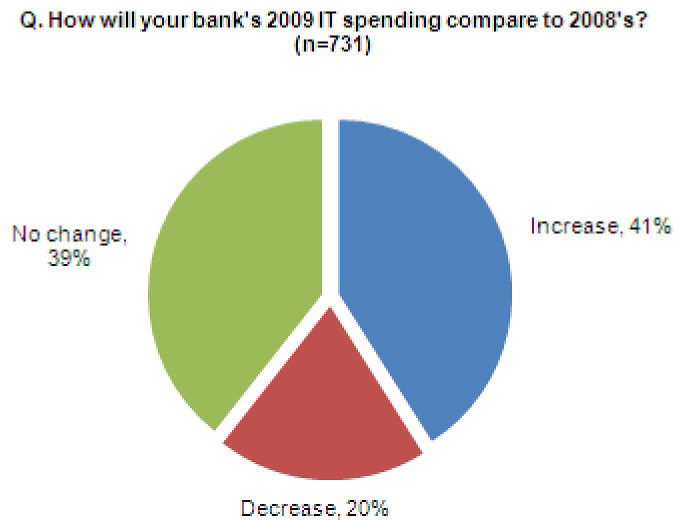
FIGURE 22: THE CRISIS IS NOT SHIFTING MOST BANK IT PRIORITIES



Source: Aite Group/ICBA February 2009 Survey of Community Banks

Interestingly, unlike many large banks, community banks are still actively pursuing new technology investments despite the financial crisis. In fact, 41% of community banks plan to spend more on technology during 2009 than they did in 2008 (see Figure 23 on page 29).

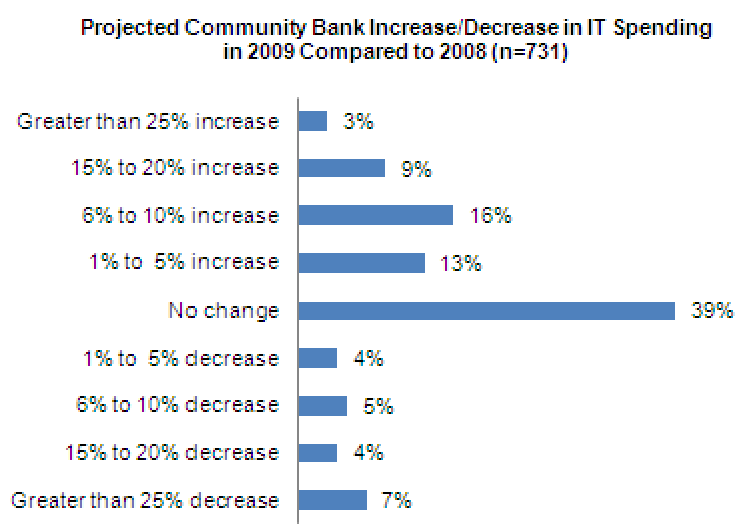
FIGURE 23: IT SPENDING WILL INCREASE DURING 2009



Source: Aite Group/ICBA February 2009 Survey of Community Banks

Of those banks expecting to increase their IT spending this year, 28% expect to increase spending by more than 5% (see Figure 24).

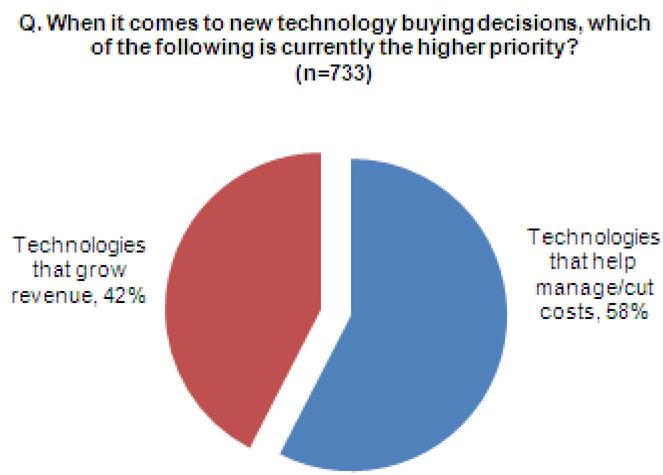
FIGURE 24: BREAKDOWN OF IT SPENDING INCREASES AND DECREASES



Source: Aite Group/ICBA February 2009 Survey of Community Banks

Over the last few years, most banks have been very focused on generating revenues, as well as on deploying technologies that better positioned them to do so. The current environment is resulting in a slight preference for technologies that will enable community banks to operate more efficiently and cut costs (see Figure 25).

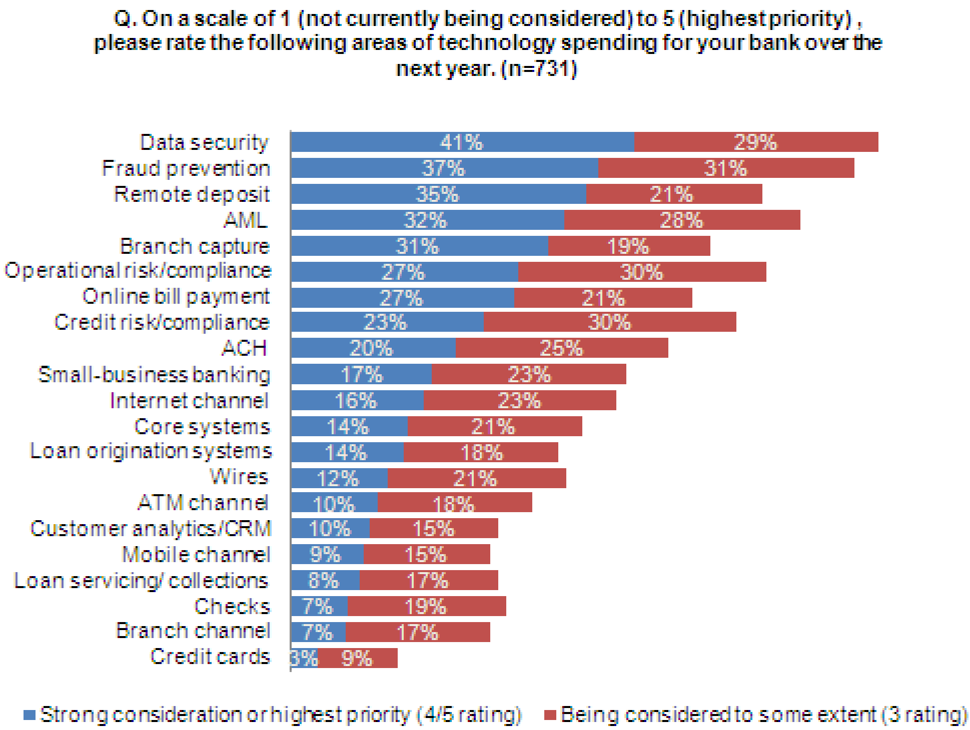
FIGURE 25: SLIGHT PREFERENCE FOR COST-CUTTING SOLUTIONS



Source: Aite Group/ICBA February 2009 Survey of Community Banks

Over the next year, the top IT priorities of community banks will be very focused on fraud/security, capture solutions, and operational risk management and compliance (see Figure 26 on page 31).

FIGURE 26: 2009 IT PRIORITIES OF COMMUNITY BANKS

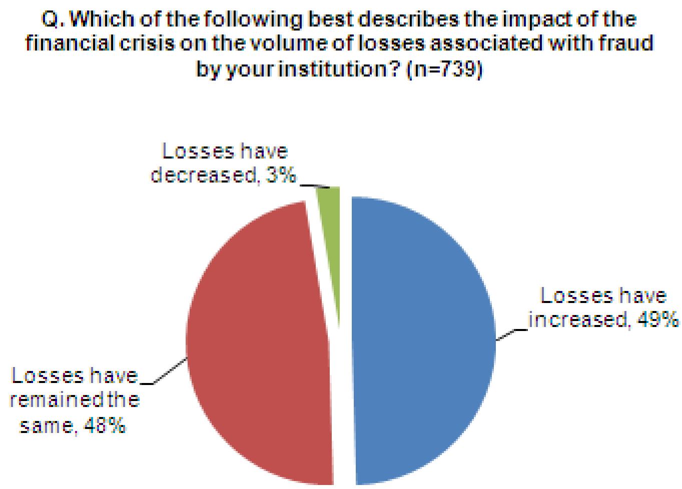


Source: Aite Group/ICBA February 2009 Survey of Community Banks

FRAUD/SECURITY

Of banks surveyed, 41% stated that data security is either a strong consideration or a top priority for their institution over the coming year. Additionally, 37% and 32% assigned similarly high rankings to fraud prevention and AML solutions respectively. Fraud/security was a high priority for community banks during 2008, and will continue to be this year. It is a high priority for all institutions, as maintaining data security is essential to maintaining customer trust — the lifeline of a bank's existence. Additionally, as fraudsters continue to grow more sophisticated, banks are in essence constantly going after a moving target. Finally, as individuals continue to struggle during the current financial crisis, the likelihood of fraud is increasing. In fact, of community banks surveyed, 49% stated that they have seen an increased volume of losses associated with fraud at their institution as a result of the financial crisis (see Figure 27 on page 32).

FIGURE 27: FRAUD IS ON THE RISE



Source: Aite Group/ICBA February 2009 Survey of Community Banks

CAPTURE SOLUTIONS

The large number of banks planning to deploy capture solutions such as remote deposit and branch capture over the next year is not surprising, given the many benefits these solutions offer, especially for banks with more than US$100 million in assets. In addition to providing greater efficiency and lower costs to banks, these solutions also enhance the customer experience and increase convenience. Technologies such as remote deposit are especially important to community banks because they break down geographic boundaries and enable banks to attract the business of new customers, regardless of where they are located. Many banks deploying this technology have experienced not only a rise in new customer acquisition, but also an increase in deposits.

OPERATIONAL RISK MANAGEMENT AND COMPLIANCE

Finally, the third area of great focus for community banks over the next year is operational risk management and compliance solutions. This too is no surprise given the intense regulatory pressure and need for greater transparency being placed on banks.

CONCLUSION

The current financial environment is a difficult one for all institutions, regardless of how conservative their strategies have been and how well capitalized they are. Community banks are no strangers to challenge, as they have been the backbone of the U.S. financial system through many good and bad times, and will continue to be for many years to come. The current recession has been especially difficult for a number of them, but it brings new opportunities for far more. By striving to serve their customer’s best interests without straying from traditional practices, most community banks have been able to grow deposits, acquire new customers, better position themselves in the eyes of customers, and maintain stable financial statements. Some community banks feel they are seeing more opportunities today than they have in the last several decades. In order to ensure that they can maintain this positive momentum, community banks must:

- Continue to build on their strengths;
- Utilize the online channel for sales and marketing efforts;
- Continue to go after the small-business segment;
- Broaden their product portfolios; and
- Leverage technology to the fullest extent.

Community banks do not have any easy road ahead of them, with uncertainty about upcoming regulations, and no clear vision of when the economy will begin to turn around. Until it does, community banks must continue to march forward, enjoy the benefits their risk-averse business models have given them, and do all that is necessary to position themselves for the greatest success not only in today’s environment but also in the next economic cycle.

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