BANKS SHOWING SIGNS OF OPTIMISM
As banks enter year seven of economic recovery.
INTRODUCTION

As we head into the homestretch of 2015 and banks go through their annual planning processes, we look at how industry thinking has shifted since the beginning of the year and what the banking sector is preparing for in 2016.

Just as it has been throughout this year, increasing CRE lending in 2016 remains the top priority for most respondents to this quarter’s survey. While 2015 has been a mixed bag for many banks, there have been a few bright spots in lending. Over 60% of respondents indicated that they have experienced growth in loan demand over the past 12 months. Fewer banks expect this rate of growth to continue into 2016, but the majority of respondents still expect to see positive growth in loan demand over the next year.

This expected moderation in loan demand may be related to bank concerns about the rise of nonbank lenders. Respondents reported growth in nonbank lending as the market event they expect to have the most negative impact on their institutions in 2016.

Even as lending remains a top priority, attention may be shifting towards the deposit side of the balance sheet. Respondents increased their prioritization of deposit gathering as they look towards a year in which interest rates are expected to rise and deposit competition is expected to become more intense.

If you have thoughts or questions about the results, please contact Steve Kinner, Senior Managing Director, Sales, at (866) 776-6426, x3445 or Phil Battey, Senior Vice President, External Affairs, at (866) 776-6426, x3357.

Sincerely,

Mark Jacobsen
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EXECUTIVE SUMMARY

As potential rate increase looms, banks express mix of optimism and anxiety

As momentum picks up for an expected rate increase at the end of 2015 or early 2016, bankers appear to be largely optimistic about the impact a potential increase might have on their institutions.

In the Q3 2015 Bank Executive Business Outlook Survey, which includes the responses of 207 CEOs, presidents, and CFOs of banks across the country, over 50% of respondents indicated that they expect a rate increase to have a positive impact on their banks. Another 21% of respondents expect a rate increase to have no impact.

This optimism about a rate increase comes even as bankers, on the whole, recognize that a rate increase will likely increase their short-term cost of funds. Nearly 70% of respondents expect their funding costs to increase over the next 12 months. The majority (58%) of those who expect an increase in funding costs expect it to be either moderately or significantly attributable to an increase in interest rates.

In past surveys, many respondents indicated that they welcome a rate increase since they expect to be able to reprice lending, adding to the overall revenue. However, general enthusiasm about a potential rate increase may mask some other areas of anxiety for banks as they plan for 2016.

**Rise of nonbank lenders seen as significant threat.** The growth of nonbank lenders over the last couple of years is an area of significant concern for community banks. More than 80% of respondents indicated that the growth of nonbank lenders would have a negative impact on their institutions, and 26% expect the impact to be very negative. This concern comes even as nonbank lenders have concentrated on lending areas that community banks have deprioritized as growth drivers, such as residential and consumer lending.

**Deposit gathering efforts grow in priority.** Respondents indicated that they are placing a higher priority on deposit gathering in 2016 compared to 2015. Attracting retail and corporate deposits ranked second and third, respectively, trailing only CRE lending on respondents’ list of lending and funding priorities.

**Smaller community banks concerned about ability to attract desired deposits.** Community banks with fewer than $1 billion in assets reported some concern about their ability to attract retail deposits, the primary source of funding for these institutions. Only 11% of respondents from these smaller institutions indicated that they expect to be extremely or significantly strong at attracting retail deposits, given the new environment they will be facing in 2016, including regulation and increased competition.

**CRE lending seen as priority and greatest strength.** Respondents indicated that they see increasing CRE lending as their greatest strength and top priority for 2016.

**Technology adoption seen positively.** Respondents report that they believe customer adoption of digital and mobile banking technology will have a largely positive impact on their business. This follows the results from the second quarter edition of this survey that showed the vast majority of respondents committing additional resources to digital banking technology.

**Implementation of big bank rules are a small concern for community banks.** Two-thirds of respondents do not believe Basel III liquidity coverage rules will have any impact on their business.
As a Federal Reserve rate hike seems increasingly likely for the end of 2015, banks appear encouraged by the potential impact of a rate increase for their institutions.

When asked to evaluate the potential impact of several predicted market events, over 50% of respondents indicated that they expect an interest rate increase to have a positive impact on their institutions, with 7% expecting the impact to be significantly positive. Twenty-one percent indicated that they don’t expect a rate increase to have a notable impact on their institutions.

A little over a quarter of banks expect interest rates to have a negative impact on their institutions, with less than 1% expecting the impact to be significantly negative.

This general optimism about an interest rate increase comes even as banks recognize that the increase could impact profit margins, at least in the short term. Nearly 70% of respondents indicated that they expect their funding costs to increase in the next 12 months. And, the majority (58%) of those expecting an increase, see it as moderately or significantly attributable to an increase in rates from the Federal Reserve.

Responses are not separated by asset size because of similarity in responses across all asset-size bands.
GROWTH OF NONBANK LENDERS MAJOR CONCERN FOR BANKS IN 2016

Of the predicted market events that were presented to respondents, the growth in nonbank lenders in the coming year was seen, by far, as having the greatest potential for negatively impacting banks.

Over 80% of respondents indicated that the continued growth of nonbank lenders in 2016 would have a negative impact on their institutions, with more than a quarter of all respondents indicating that the impact would be very negative.

This concern about nonbank lenders comes as community banks continue to focus their efforts heavily on commercial real estate lending, a field that has yet to experience significant inroads from nonbank lenders. Community banks rated growing commercial real estate lending as the top priority for 2016 among a list of nine potential choices, which included both lending and deposit gathering priorities.

So far, nonbank lenders have focused primarily on consumer lending and residential real estate, areas that banks are, for the most part, deprioritizing. Respondents ranked residential lending and consumer lending third and fourth, respectively, out of four lending priorities for the coming year. However, with nonbank lenders evaluating new markets, CRE lending in particular, banks are expressing concern that nonbank lenders will further disrupt bank revenue.

Expected Impact of the Growth of Nonbank Lenders

- 55% Somewhat Negative
- 25% Very Negative
- 17% No Impact
- 1% Somewhat Positive
- .5% Very Positive

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Priority Ranking of Lending Categories for 2016

- Increasing Commercial Real Estate Loans (HIGH PRIORITY)
- Increasing C&I Loans (HIGH PRIORITY)
- Increasing Residential Real Estate Loans (LOW PRIORITY)
- Increasing Consumer Loans (LOW PRIORITY)

Responses are not separated by asset size because of similarity in responses across all asset-size bands.
EXPECTATIONS FOR LENDING GROWTH MODERATES

Fewer expect to see growth in loan demand in upcoming year than experienced it in prior year.

The majority of Q3 respondents remain optimistic about growth in loan demand over the next year, with 56% of respondents reporting that they expect loan demand to increase over the next 12 months.

However, compared to the last two quarters, there’s evidence that enthusiasm about future loan growth isn’t what it was earlier this year.

For the first time this year, the percentage of respondents that are expecting loan demand to increase over the next year has fallen below the number that have experienced growth in loan demand over the past 12 months.

Additionally, expectation for future growth in loan demand fell to its lowest level for 2015. In the first quarter of 2015, 74% of respondents indicated that they expect loan demand to increase over the next 12 months. That number fell to 56% for this most recent survey.

This doesn’t mean that banks are expecting to see a decrease in loan demand, just that expectations are leveling off. Only 10% of banks reported that they expect to see a decrease in loan demand over the next 12 months.

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While respondents identified attracting retail deposits as their highest funding-related priority for the next year, there are concerns among banks with less than $1 billion in assets about their abilities to attract these deposits.

Asked to rank nine balance sheet priorities, which included both lending and funding priorities, banks identified retail deposits as their highest-ranking funding goal, with 23% of all respondents rating attracting retail deposits as their top priority overall.

However, many respondents seem unsure about their bank’s ability to meet this priority. Asked to rate their organization’s strength on a number of key factors, only 13% of respondents indicated that they were significantly or extremely strong at attracting retail deposits.

The concern was particularly clear among banks with less than $1 billion in assets. Only 11% of respondents from smaller institutions indicated they expect their banks to be extremely or significantly strong at attracting retail deposits, while 30% indicated that they do not expect to be strong in this area.

Responses from banks with assets of more than $10 billion are not displayed because of a lack of statistical representation within that asset-size band. See methodology on page 11 for details.
In our second quarter survey, banks indicated that they were making significant investments in new technology. Now, as they look forward to 2016, there’s a lot of optimism that those investments will pay off.

Of the seven potential market factors presented as options, respondents were most positive about the increased adoption of mobile and online banking technology by customers.

Over two-thirds of respondents indicated that technological adoption would have a somewhat positive or significantly positive impact on their institutions. Less than 9% of respondents expect the impact of technology to have a negative impact on their banks.

This response seems to put to rest some of the concerns that have been discussed about whether banks will adapt to a changing technological environment. With 97% of banks indicating some level of investment in mobile technology earlier this year, banks seem to feel that they are prepared to handle changes in consumer behavior.

### Q2 Survey Response: Investment Intentions Related to Online and Mobile Banking Technology

![Graph showing investment intentions](image)

Responses from banks with assets of more than $10 billion are not displayed because of a lack of statistical representation within that asset-size band. See methodology on page 11 for details.

### Expected Impact of Increased Adoption of Mobile and Online Technology by Customers

![Graph showing expected impact](image)

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COMMUNITY BANKS UNCONCERNED ABOUT MAJOR REGULATION ROLLOUTS IN 2016

The upcoming year will be a big year in banking regulation rollouts. Some more sweeping changes will go into effect, the two biggest being the next-stage implementation of the liquidity coverage ratio (LCR) and the implementation of changes to the rules governing money market mutual funds (MMMFs).

LCR rules generally apply to banks with over $50 billion in assets, although they also cover smaller banks in certain circumstances. And the money market mutual fund rule changes largely impact fund providers, although banks that use these investment vehicles for their own funds will be affected.

Most respondents to the survey, primarily community banks with less than $10 billion in assets, reported that regulatory changes will have a negligible impact. Over 66% of respondents indicated that LCR will have no impact, and 58% of respondents reported that they expect no impact from MMMF rule changes.

However, it’s been reported that the largest banks have begun prioritizing retail deposits as a result of these rule changes. On one hand, this may compound some of the challenges smaller banks expect in attracting these deposits. On the other hand, the changes could open up new opportunities for community banks to attract deposits from other sources, like public entities.
EVEN AS RATE INCREASE EXPECTED, TIME DEPOSITS LOW PRIORITY

Time deposits generally not seen as a strength or priority in 2016

As banks consider the possible consequences of a rising rate environment, one of the options to improve net interest margins has been to extend the duration of funding through the use of time deposits.

However, as we face the prospect of the end of zero-percent interest rates, banks appear relatively ambivalent about the use of time deposits as a core strategy.

Respondents ranked time deposits relatively low in priority among a set of nine potential priorities that included both lending and funding activities. Fewer than 10% of banks ranked the attraction of time deposits within their top three priorities.

It’s possible that banks have deprioritized time deposits because of a perceived weakness in attracting them. Two-thirds of respondents reported that they were not strong or only somewhat strong in attracting time deposits, while less than 10% reported that they consider their banks to be significantly or extremely strong.
BANKS CONTINUE TO PRIORITIZE CRE LENDING, BUT FOCUS STARTING TO SHIFT TOWARDS DEPOSITS

Out of nine possible lending and funding activities, banks ranked their capabilities and priorities in the area of CRE lending highest. Thirty-seven percent of respondents indicated that their banks are significantly or extremely strong in increasing CRE lending, while less than 10% did not consider themselves strong in this area.

As banks look towards 2016, they continue to prioritize increasing their CRE lending above all other activities. However, there’s a notable move towards increasing the focus on deposit gathering compared to 2015.

When comparing their 2016 priorities to this year, there was a significant increase in the number of banks that placed deposit gathering at the top of their list. In 2015, less than a quarter of banks ranked deposit gathering activity highest. In 2016, a third of banks now rank deposit gathering activity as their top priority.

This increased focus on deposit gathering comes as banks begin to face the prospect of a tightening funding environment. In the second quarter of 2015, the volume of deposits in the banking industry declined for the first time since the financial crisis. While this tightening has primarily affected the largest banks so far, there appears to be concern that smaller banks will be impacted.

### Ranking of Deposit and Lending Priorities in 2016

<table>
<thead>
<tr>
<th>Priority</th>
<th>Change in Average Ranking from 2015</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Increasing Commercial Real Estate Loans</td>
</tr>
<tr>
<td>2</td>
<td>Attracting Retail Deposits</td>
</tr>
<tr>
<td>3</td>
<td>Attracting Corporate Deposits</td>
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<tr>
<td>4</td>
<td>Increasing C&amp;I Loans</td>
</tr>
<tr>
<td>5</td>
<td>Increasing Residential Real Estate Loans</td>
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<tr>
<td>6</td>
<td>Attracting Time Deposits</td>
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<tr>
<td>7</td>
<td>Attracting Public Funds</td>
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<tr>
<td>8</td>
<td>Managing Wholesale Funding</td>
</tr>
<tr>
<td>9</td>
<td>Increasing Consumer Loans</td>
</tr>
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Promontory’s Bank Executive Business Outlook Survey was conducted online over the course of two weeks from October 19 – 29, 2015. The survey was delivered via email to bank CEOs, CFOs, and presidents at 4,912 banks throughout the United States and garnered a 4.2% response rate, with leaders from 207 banks completing the survey. Of these 207 respondents, 112 were CEOs and/or presidents (54%) and 95 were CFOs (46%).

As a representation of the overall banking industry, the sample of respondents skews slightly towards larger community banks, banks with assets between $1 billion and $10 billion.

Due to the small number of responses received from banks with more than $10 billion in assets, when asset-size segments are represented graphically in the charts in this report, responses from banks with more than $10 billion in assets are not included as a distinct segment. However, the responses of these larger banks are included in analyses related to the banking industry as a whole and in charts that do not segment by asset size.

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Promontory Interfinancial Network offers unique services that bring banks and other institutions together in a way that helps each to benefit from “the power of many”—enabling them to offer services that otherwise might be too difficult or costly to offer on their own and providing them with new tools for growth, efficiency, stability, and flexibility in the management of their balance sheets.

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