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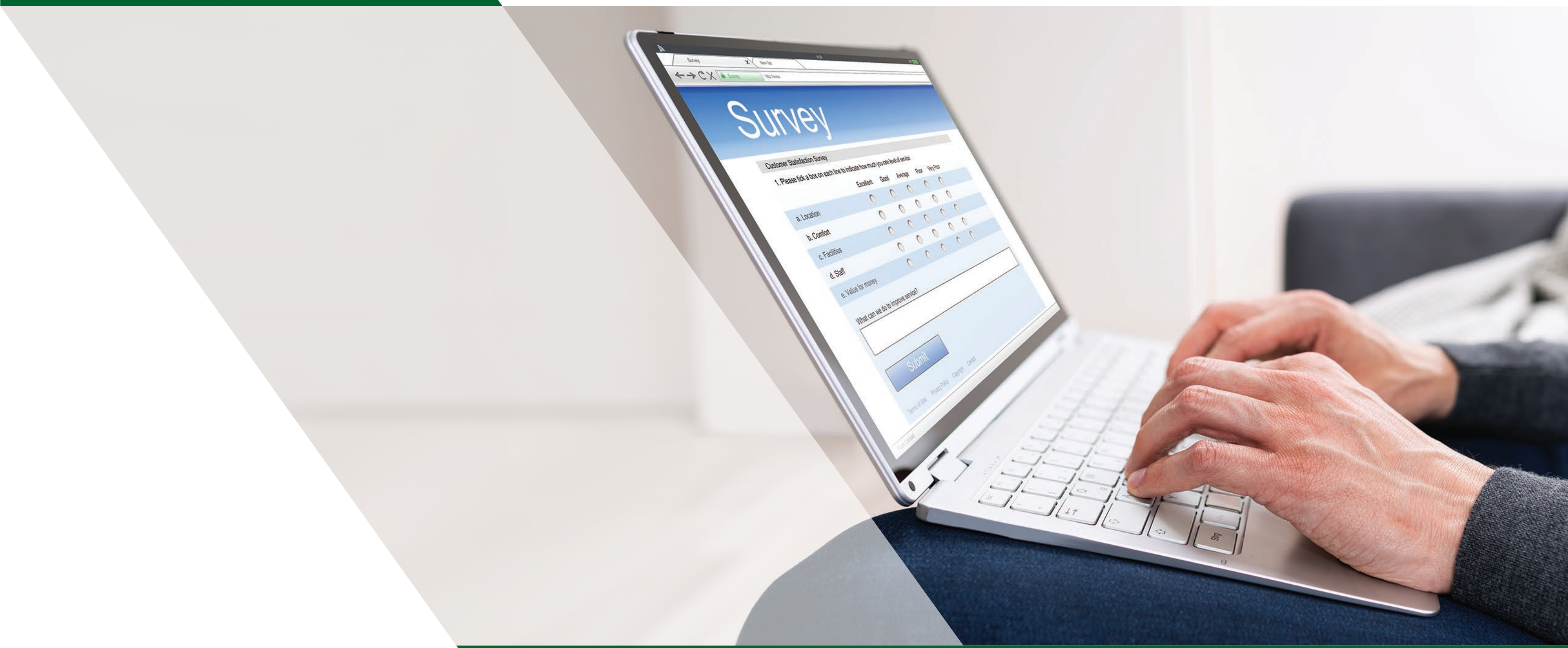
COMMUNITY BANKING ADVISOR



Challenges and opportunities in 2025
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Level the playing field with modern data analytics

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Challenges and opportunities in 2025

HIGHLIGHTS FROM RECENT COMMUNITY BANKING SURVEYS

Community banks face a rapidly evolving landscape. Two major surveys have recently been released, offering a road map for how community banks can thrive in 2025 and beyond. Whether it's adjusting lending strategies, enhancing marketing efforts or staying ahead of the tech curve, there are both risks and opportunities for bankers to address. Here are some key survey highlights.

INDEPENDENT BANKER SURVEY

Independent Banker published its 2025 Community Bank CEO Outlook survey in January 2025. One focal point of the survey was optimizing the balance between loans and deposits, which is essential for maximizing net interest income and effectively managing interest rate risk. Survey responses on this issue have varied significantly over time.

In its 2022 survey, conducted as the industry was recovering from COVID-related effects, 56% of respondents said their biggest challenge was "making more loans to offset a flood of deposits," while only 4% said their biggest challenge was increasing deposits. Three years later, the results are essentially reversed: 54% of bank CEOs say that growing deposits is their biggest challenge, while only 17% say making more loans is the biggest challenge. When asked what would drive profitability in 2025, the top answers were:

1. Small business lending,
2. Commercial real estate (CRE) lending,
3. Commercial and industrial (C&I) lending,
4. Residential mortgage lending, and
5. Agricultural lending.

Respondents viewed nonlending services, such as wealth management, brokerage, credit and debit cards, payment services, and insurance, as minor contributors to profitability. They also predicted that loans would be the fastest growing revenue source in 2025, led by small business, CRE, residential mortgage and C&I loans.

Other priorities for community banks in 2025 include:

Traditional and digital marketing. Nearly 31% of bank CEOs said they'd spend more on marketing this year than last year, while more than 59% said

WHAT ABOUT TARIFFS?

Significant tariffs on imports from other countries present both challenges and opportunities for community banks. On one hand, tariffs may increase inflation, stifle growth and decrease employment, which could have a negative impact on many businesses.

On the other hand, community banks may also find opportunities to strengthen their relationships with customers affected by tariffs. For example, businesses may seek short-term financing to manage supply chain disruptions and increasing costs as they look for domestic suppliers for raw materials and goods (or suppliers in countries that have negotiated favorable trade agreements with the United States). Community banks also can offer support to businesses seeking to "reshore" manufacturing operations, expand domestic production capacity or pursue possible growth opportunities in countries that lower existing tariffs on U.S. imports.

they'd spend around the same amount. A majority (59%) plan to allocate more resources to digital marketing, such as digital advertising and social media.

Differentiation strategies. The vast majority of CEOs (77%) said their biggest opportunity this year is "differentiating their community bank from other financial services firms in their marketplace." Strategies for doing so include highlighting how they use deposits to help the community's homebuyers and small businesses, being more responsive than larger banks, providing great customer service, and investing in staffing to offer more person-to-person interactions.

Service offerings. More banks are expanding their offerings. Examples of new services are treasury management services, positive pay (to help combat check fraud) and instant debit card issuance.

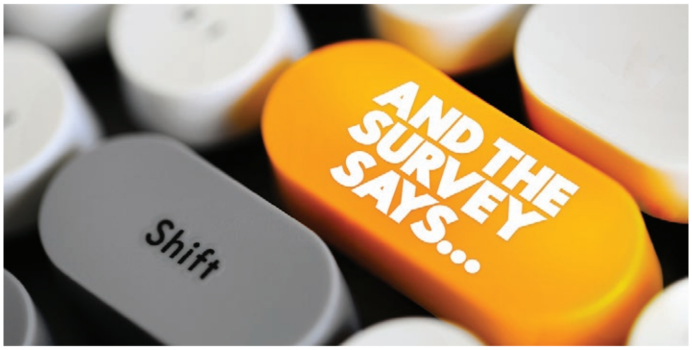
Technology. Many CEOs are considering adopting new technology in 2025, including loan origination software, online chat, updated websites, enhanced mobile banking, remote deposit capture, and electronic signature and payments software.

In addition, community banks are increasing efficiency to boost earnings. Over one-third of CEOs (35%) plan to tighten expenses, and around 10% plan to merge with another community bank.

CSBS SURVEY

Findings from the second survey were presented by the Conference of State Bank Supervisors (CSBS) at the 12th Annual Community Banking Research Conference in October 2024. The 2024 CSBS Annual Survey of Community Banks covered:

- Products and services,
- Technology,
- Digital platforms,



- Competition,
- Small business lending,
- Loan participations,
- Regulatory compliance, and
- Acquisition activity.

The CSBS survey was based on responses from nearly 370 community banks across 38 states. Notable findings included assessments of the following risks:

External. Respondents said the most significant external risks to community banks today are funding costs and regulation, followed by net interest margins and core deposit growth.

Internal. Community bankers continue to rate cybersecurity as the most important internal risk, followed by technology implementation and costs. Liquidity, the second most important risk in the 2023 survey, dropped to third place this year.

Inflation. A majority of respondents (55%) said that inflation risks were likely to persist but were manageable. Inflation's biggest impact, according to bankers, is on the cost of deposits, followed by personnel expenses, securities investment values and operating expenses.

There was also a significant shift from previous surveys in responses about funding. In 2024, 56% of bankers said they'd continue using brokered deposits at or near current levels, or planned to use them in the next 12 months (up 5% from 2023). Additionally, a majority of respondents predicted that, over the next 12 months, credit quality would be "much worse" or "somewhat worse" for loans to individuals, CRE loans, and C&I loans.

TOUGH TIME, SMARTER MOVES

In uncertain economic times, community banks need all the help they can get. Banking surveys can provide valuable insights into how other banks are handling the challenges and opportunities that lie ahead. ■

STAY ON TOP OF THIRD-PARTY RISK

Obtaining specific services and products from outside providers instead of generating them in-house can help to increase efficiency and control costs while ensuring your community bank stays competitive. However, third parties can also present risks that bank management must continuously assess and manage. Recent federal agency guidance can provide much-needed clarity.

WHAT'S THE PURPOSE?

The Federal Reserve, Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) finalized interagency guidance in June 2023 on managing third-party risks. The guidance aimed to promote consistent policies among the three agencies.

The final interagency guidance doesn't have the force of law and doesn't impose any new requirements on banks. Rather, it was intended to help banks develop and implement appropriate third-party risk-management strategies for their specific needs and situations.

WHAT'S CRITICAL?

A bank's third-party risk-management program should be appropriate for its size, complexity, risk profile and risk level. It should focus on significant bank functions or other activities that:

- Could cause a bank to face significant risk if the third party fails to meet expectations,
- Could have significant customer impacts,
- Require significant investment in resources to implement the third-party relationship and manage the risk, or
- Could have a major impact on bank operations if the bank has to find an alternate provider or bring the outsourced activity in-house.

A significant bank function is determined based on whether failure would result in a material loss of revenue, profit or franchise value.

WHAT'S THE RISK-MANAGEMENT LIFE CYCLE?

Effective third-party risk management follows these six continuous stages:

1. Planning,
2. Due diligence and third-party selection,
3. Contract negotiation,

4. Oversight and accountability,
5. Ongoing monitoring, and
6. Termination.

A bank should evaluate several factors at each stage of the life cycle. For example, when conducting due diligence on a potential vendor or partner, consider such factors as the third party's overall business strategy and goals, ownership structure, regulatory compliance capabilities, financial condition, resources, prior business experience, and fee structure and incentives. Other factors include, but aren't limited to, the qualifications of its principals and the effectiveness of its risk management, information security program, and physical security and environmental controls.

Factors to consider when negotiating third-party contracts include the nature and scope of the arrangement, measures used to assess performance, and responsibility for providing, receiving and retaining information. You also need to take into account the bank's rights to audit and monitor performance, compliance responsibility, confidentiality and integrity of the bank's information, and responsibility for responding to customer complaints, among other factors.

Throughout the life cycle, a bank should follow three principles: 1) oversight and accountability, 2) documentation and reporting, and 3) independent reviews. The guidance outlines regulatory expectations regarding the responsibilities of a bank's board of directors and management to oversee the risk-management process, as well as documentation and reporting requirements. It also emphasizes the importance of independent reviews of the risk-management process by a bank's internal auditor or an independent third party.

These reviews assess the adequacy of a bank's processes for ensuring that third-party relationships align with its business strategy. They also examine how the bank identifies, measures, monitors and controls third-party risk. In addition, the reviews evaluate the bank's understanding of and monitoring of concentration risks and its responses to material breaches, service disruptions or other material issues. Finally, the reviews assess how the bank confirms oversight and accountability for managing third-party relationships.

WHAT ARE BEST PRACTICES?

By rigorously managing third-party risk in light of the federal guidance, community banks can create long-term, mutually beneficial relationships with outside providers. These suggested best practices can serve as a template to help your community bank develop and strengthen its risk-management approach. ■

SMALL BANKS, BIG DATA

Level the playing field with modern data analytics

The idea of analyzing data is nothing new. Banks have always collected data about their operations and customers and used it to make informed decisions. What *is* new about modern data analytics is that advanced technologies now make it possible to quickly collect and analyze huge amounts of data from both internal and external sources. This capability enables banks to enhance the customer experience, streamline operations and improve risk management.

ENHANCING CUSTOMER SATISFACTION

Data analytics allow banks to collect comprehensive information about their customers in a centralized location and analyze customers' product usage, transaction histories, behaviors, demographics and preferences. Banks can leverage these insights to anticipate customers' needs and tailor their products and services, improving customer satisfaction and loyalty.

Analytics also can help banks predict which triggers might cause customers to leave. This advance warning can ensure the bank has an opportunity to take steps to retain them.

COMBATING FRAUD

Traditionally, banks have relied on audit-based methods or employee tips to detect fraud, but these methods have limited efficacy. For one thing, while they detect fraud after the fact, they do little to anticipate or prevent it. Plus, they're not always effective. Audits, for example, often rely on random sampling, leaving significant amounts of unexamined data.

Today's data analytics tools, on the other hand, can examine vast amounts of data — both internal and external — to reveal patterns, anomalies and trends that signal potentially fraudulent activities, often in real time. According to the Association of Certified Fraud Examiners' survey, "Occupational Fraud 2024: A Report to the Nations," organizations that use proactive data monitoring/analysis enjoy a 50% reduction in both fraud losses and fraud duration.

One example of a financial services company using data analytics to detect fraud is PayPal. Its system analyzes historical payment data to identify factors closely associated with fraud, including device types, countries of origin and user profile information. This data is used to generate machine-learning algorithms that evaluate transactions for signs of potential fraud.

STREAMLINING BANK OPERATIONS

Data analytics can help banks identify and address inefficiencies, providing cost-saving opportunities. For example, centralizing customer data minimizes the need for manual data entry and reduces the potential for errors. With the help of data analytics, banks can:

- Automate document processing and other routine tasks,
- Enhance credit risk assessments by incorporating factors like credit scores, income, debt-to-income ratios, employment history, cash flow, repayment history and social media activity,
- Leverage predictive modeling and machine learning to assess the likelihood of loan defaults, and
- Conduct stress testing and scenario analysis to predict loan portfolio performance and evaluate associated risks.

Additionally, banks can drive strategic decisions by analyzing customer, market and economic data. These insights are invaluable for shaping product development, expansion plans, targeted marketing efforts and other key strategies.

PUTTING DATA ANALYTICS TO WORK FOR YOUR BANK

Harnessing the power of data to automate processes and improve efficiency frees up bank personnel to focus on personalized service and local expertise. That's what differentiates community banks from regional and national competitors. Embracing this innovative technology will help your bank stay ahead of the curve in today's competitive banking landscape. ■

BANK WIRE

CECL: BACKTESTING IS CRITICAL

All banks are now subject to the Current Expected Credit Loss (CECL) model, requiring them to recognize an immediate allowance for expected credit losses over an asset's life. First introduced by the Financial Accounting Standards Board in 2016, CECL represents a shift from the old incurred-loss model to a forward-looking approach, under which banks recognize an immediate allowance for all expected credit losses over an asset's life.

The CECL rules allow banks significant flexibility in selecting an appropriate, practical model for estimating credit losses. Federal regulators don't expect smaller institutions to implement complex modeling techniques. However, after a bank implements a model, it must be validated regularly to ensure accuracy. One validation method many banks use is "backtesting." This involves comparing a bank's predicted credit losses against its actual loss experience over time. Armed with the results, a bank can revisit its CECL model and make necessary adjustments. ■

FINASTRA BREACH HIGHLIGHTS IMPORTANCE OF THIRD-PARTY RISK MANAGEMENT

In late 2024, Finastra, a financial technology firm that serves more than 8,000 financial institutions worldwide, including 45 of the world's top 50 banks, experienced a major data breach. The hacker stole around 400 gigabytes of client data and internal documents and then offered them for sale online.

The breach serves as a timely reminder of the importance of managing the risks associated with vendors and other third parties with access to sensitive client data and confidential information. Federal regulators expect banks to develop a formal third-party risk-management plan. Among other things, banks should conduct thorough due diligence on prospective providers (including their security practices), negotiate contracts that clearly spell out security requirements and expectations, continuously monitor third-party relationships, develop and test incident response plans that include third parties, and conduct periodic independent reviews of their third-party risk-management process. ■

OCC CLARIFIES BANKS' AUTHORITY TO ENGAGE IN CRYPTOCURRENCY ACTIVITIES

In a recent Interpretive Letter, the Office of the Comptroller of the Currency (OCC) reaffirmed that banks can engage in the following cryptocurrency activities:

- Providing crypto-asset custody services,
- Maintaining stablecoin reserves, and
- Verifying blockchain-based payments.

The letter also rescinds the requirement that OCC-supervised institutions receive supervisory nonobjection and demonstrate adequate controls before engaging in these activities.

COMMUNITY BANKS EMBRACING DIGITAL TRANSFORMATION, AI

According to a recent survey by BNY Mellon, more than 90% of community banks "are prepared to initiate digital transformations," but less than 20% "see themselves as experts in data analytics." In addition, around 40% of community banks say they're incorporating artificial intelligence (AI) and machine learning into their strategic visions, with an eye toward "helping address everything from customer service to risk assessment." ■

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Community Banks

Andrews Hooper Pavlik PLC provides a broad range of accounting, audit, tax, and consulting services to the community banking industry. Our services are customized to meet your needs and include collaboration with your management teams.

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- Independent Loan Review
- Internal Audit
- Model Validation
- Quality Control Review
- Regulatory Compliance Audit
- Risk Assessment Assistance
- Sarbanes-Oxley (SOX) Assistance and Testing
- System and Organization Control (SOC) Examination
- Trust Administration Internal Audit

IT Consulting

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- GLBA Compliance Audit
- Penetration Testing
- Social Engineering
- Vulnerability Assessments

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- Due Diligence Review of Deposits and Human Resources
- Interim Period Financial Statement Audit
- Pro-Forma Financial Statement Assistance
- Regulatory Compliance Consulting
- Tax and Accounting Assistance

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- IRS Examinations
- Tax Planning
- Tax Research
- Tax Return Preparation

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