Bank Holding Company Association

Second Quarter, 2010

Newsletter

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Industry will feel pressure to re-orient away from real estate lending

Consultant Bill Conerly addresses bankers at the BHCA's Spring Seminar conducted May 3-4 in Bloomington, Minn.

Real estate concentration is the most crucial issue for bankers to address as they think about the future, commented Dr. Bill Conerly, an industry consultant from Oregon. "We have become an industry of real estate lenders," he said. "The biggest challenge coming is the effort to reduce our dependence on real estate."

Conerly is a senior fellow at the National Center for Policy Analysis and is a former senior vice president for First Interstate Bank. Conerly was a mid-day speaker at the Spring Seminar of the Bank Holding Company Association, conducted in Bloomington, Minn., May 4.

Diversification opportunities are limited, Conerly warned, noting that real estate deals are easier to find than good commercial and industrial loans. He said credit unions have more consumer loan business than banks. Successful banks will identify niches where they can excel. "So get the talent you need," he said, "and don't get into niches you don't know."

Earnings in the coming years will not be as attractive as they were in the 1990s, he said. Noting high average return-on-asset figures in 1995-96, Conerly said some bank earnings that were recorded as net income probably should have been set aside in loan loss reserves. Return-on-equity numbers that pushed 15.0 percent are not likely to be duplicated.

Junior examiners are being taught that "real estate is bad and capital is good," Conerly said. "These are the people who will be in charge in five years." He said their mindset will make it more difficult for banks to achieve the results they may have become used to a decade ago.

It will be important for bankers to condition their directors for realistic earnings expectations, he said. If directors hold onto unrealistic expectations, they become vulnerable to taking unproven methods and excessive risk "as they swing for home runs."

Community banks are going to need talented staff to succeed in a more competitive environment. Larger organizations are not providing the training they once did, so community banks cannot simply hire someone who used to work for a super-regional and expect they will have the skills they need. Community bankers are going to have to come up with new training methods.

In some cases, community banks can use technology to help their front-line employees be more effective. He said a teller, for example, should have the technology at their fingertips to differentiate customers according to how much business they do with the bank.

While large banks can have a variety of products and expertise, and can consistently deliver products at low cost, community bankers can compete by leveraging their flexibility, quick error correction, and high level of personal service, Conerly said.

Conerly warned, however, that as the population ages, it will become more difficult to find good employees. "You are going to have to steal them from

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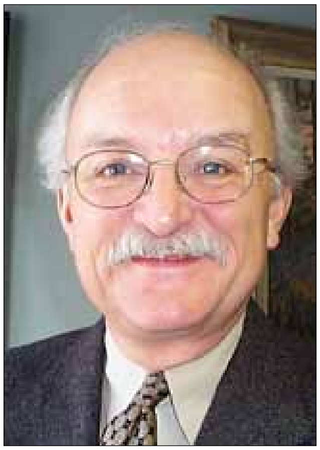
President's Column

Steven M. Wilcox
President, Wilcox Bancshares.
Grand Rapids, Minn.



By the time you read this column, it is quite likely that President Obama will have signed financial reform legislation into law. It looks like it could be the biggest set of changes for the banking industry since the Depression.

The prospect of another new banking law got me to thinking about all the major banking bills that Congress has passed in the last 30 years:

- ***The Monetary Control Act of 1980***
- ***Garn-St. Germain Act, 1982***
- ***Financial Institutions Reform, Recovery and Enforcement Act of 1989, known as FIRREA***
- ***FDIC Improvement Act, 1991***
- ***Riegle-Neal Interstate Banking and Branch Efficiency Act, 1994***
- ***Gramm-Leach-Bliley Act, 1999***

Each of these was an enormous bill, preceded by huge debates in Congress. They were all supposed to put us on a path of safety and soundness, efficiency, and social — if not economic — prosperity. Well, all this legislative activity failed to stop the housing bubble that led to the financial crisis of 2008; the industry and much of the economy is still healing and I am not sure whether this latest round of reform assures we'll never see anything like that again.

I read somewhere that experts now are saying that it is more important for bankers to be versed in federal and state law than in the intricacies of credit. Boy, there's a sad commentary. Compliance is important, but nobody gets into the banking business because they are interested in regulation. People get into banking because they like people, because they want to help others realize their dreams, and because they understand the power of effective credit allocation.

While it is impossible to ignore what is going on in Washington, D.C., I try to focus on my own community. It isn't the rule-making process that puts people to work on Main Street; it's the decision-making process at the bank. Sure, I try to follow all the rules, but what's really important is figuring out when to make a loan and when to say no, when to fund the entire loan request or just a portion of it, when to ask for more details on a business plan, and when to take a closer look at the collateral. Lawmakers and regulators will always be changing the rules, but the basics about how to do banking really don't change that much. ■

Welcome New Members

The Bank Holding Company Association is pleased and honored to welcome the following new members who have joined our Association during 2010:

Bryan D. Bruns, President
Lake Central Financial, Inc., Annandale, Minn.

Nancy Skophammer, President
Hartland Bancshares, Inc., Hartland, Minn.

Trent Tarvestad, President, Scott Thompson, Secretary
Ramsey Financial Corporation, Devils Lake, N.D.

Marilyn Senty Ivers, President, Dennis R. Meyer, Vice President
Northern Financial Corp., Independence, Wis.

James C. Gray, President, Thomas R. Germann, Vice President
Superior National Banc Holding Company

In addition, the Association welcomes the following new associate members who have joined us in 2010:

Steve Davis, Regional Director, Tim Anderson, Business Development Advisor, Promontory Interfinancial Network, Des Moines, Iowa

Patrick Gaughan, President, Dan Hebert, VP of Commercial Accounts, Gaughan Companies, Forest Lake, Minn.
Specialize in commercial real estate brokerage services. Provide consulting and representation for clients buying, selling and leasing commercial real estate.

Timothy A. Naumann, Vice President, Bernstein Global Wealth Management, Minneapolis
Bernstein is a research driven investment management firm. Our high net worth clients entrust us with approximately $80 billion in assets because of our 40-year history meeting client objectives.

John Pope, Owner, John Pope Company, Minneapolis
Provide business consulting services to community banks and small business in the areas of strategic planning, annual planning, marketing and sales.

Stephanie Laitala, President, Jennifer Albrecht, Vice President, Marketing and Business Development, Owl Bookkeeping and CFO Services, Minneapolis
Owl believes two things to be true about a small business and its money. One, it should be stable and secure. And two, there should be more of it. Our team of bookkeepers, controllers, CFOs and turnaround experts bring their wealth of expertise and wisdom to accomplish these objectives for clients.

David R. Weir, Partner, Lenders Capital Resources, LLC, Wayzata, Minn.
Specialized Loan Recovery Strategies and Solutions for Lenders – Maximized Results for Complex Situations – CRE Loans, Commercial and Hotel Loans, Loan Participations and O.R.E.O.

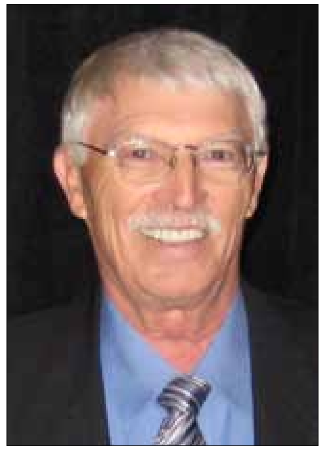
Gerry Hart, Account Executive, The Baker Group, Oklahoma City, Okla.
The Baker Group is a leader in the development of innovative asset/liability and investment portfolio management services for community banks. 1-800-937-2257, www.gobaker.com.

Cathy Berch, President, Kent Dunham, Director of Business Development, Center for Practical Mgmt., Boulder Junction, Wis.
Helping banks get better business results by giving managers the skills they need to build better relationships with their employees. We have decades of experience in the banking industry designing and deploying management systems, and coaching managers. We transform the way people manage. ■

The BHCA Newsletter is published quarterly by the Bank Holding Company Association for its members. To submit an article, please contact BHCA Executive Director Dennie Emmans at 763-784-3222 or 1-800-813-4754. FAX: 763-784-4546, e-mail: wdebhca@aol.com.

Director's Column

By W. Dennie Emmans
Executive Director



"This is my swan song"

These are the words that my predecessor, George Howes, used to begin his second-quarter 1993 Director's Column in the BHCA Newsletter. George had been diagnosed with colon cancer earlier in 1993 and was using the BHCA Newsletter forum to announce his retirement.

Ironically, 17 years later, I am using the same medium to announce my retirement. Back in 2005, I was diagnosed with colon cancer. Through a series of surgical operations, chemotherapy and radiation treatments I have been able to cope with this disease for the past five years and still maintain a somewhat reasonable quality lifestyle and work schedule. A recent PET scan has indicated that the cancer has now spread to other organs of my body and therefore I am now classified as a Stage IV cancer patient requiring a more extensive regime of treatment.

It has been an honor and genuine privilege to work with and on behalf of Upper Midwest bankers through this superb organization. While I continue to be energized by my work here, I have reached the stage where I need to devote my interests to other priorities and turn over my position to a new leader. An executive search committee has been formed and employment ads will appear in the various media with a new hire coming on board on or before January 1, 2011.

I shall be eternally grateful for the opportunity to serve our membership and the financial services industry. From the board of directors who had the confidence to hire me 17 years ago, the directors who constantly amaze me with their passion and dedication to the organization and the industry, the members who solidify my belief that BHCA is one of the finest educational resources available, the associate members who are the backbone of the organization, my very capable assistant Sue Lien and our subcontract vendors, all of whom have made my job an enjoyable event. I truly have been blessed.

2010 Spring Seminar

A warm and grateful "Thank You" goes out to the 220-plus members and guests who attended the Bank Holding Company Association's Spring Seminar on May 3 and 4, 2010 at the Minneapolis Airport Marriott Hotel in Bloomington, Minn. The follow-up communications I have received, both written and oral, indicate that this seminar was very successful in most aspects of our mission to provide quality educational programs to our members.

While I won't go into specific detail regarding the Spring Seminar, as it is covered elsewhere in this edition of the Newsletter, I do want to thank all of the speakers who made this seminar a success. Their professional presentations of timely topics and issues were informative and most appreciated.

Regulatory meeting

Back by popular demand, the second annual Regulatory Meeting and

***Director's Column**, Continued on page 5*

Bankers should help entrepreneurs, speaker says

The United States economy is struggling because it is exporting too much of its wealth, says Dileep Rao, an adjunct professor of entrepreneurship at the University of Minnesota. Rao, author of "Bootstrap to Billions: Proven rules from entrepreneurs who built great companies from scratch," spoke to bankers at the Bank Holding Company Association's Spring Seminar, May 4 in Bloomington, Minn.

At the Spring Seminar, Dileep Rao (right) shared stories about famous Minnesota entrepreneurs, including Earl Bakken who founded Medtronic. Earl's son, Brad, (left) is president of Citizens Independent Bank in St. Louis Park, Minn.

"How much wealth has the United States shipped out of the country in the last 20 years? The answer is $7 trillion, and that is in a $14 trillion economy. Collectively, we have been selling our country abroad," Rao said to the lunchtime audience.

Rao said people commonly say small businesses create most of the jobs in this country, but he said that is a myth. "Most small businesses sell locally, and they don't export out of the region. Those that export are usually mid-size or larger. Unless they bring in wealth, small businesses can't create jobs unless they borrow.

"In the 1990s, we had a business phase based on debt. We know how that ended," he said. "In the 2000s, we had a consumer boom based on debt. We know how that ended. Now we have a government boom based on debt.

"In my opinion, to have a sustainable recovery, we have to export more or import less. If we keep importing from China, the jobs will be in China, the payroll taxes will be in China, the growth will be in China. The shiny new buildings will be in China. And the budget deficits will be in Minnesota and the United States," Rao said. "If we keep importing more than we export, the dollar will crash, inflation will rise, interest rates will rise, and there will be even more defaults. We become like Greece, Spain, Argentina and Portugal."

Rao said we need to encourage entrepreneurs who can sell to the rest of the world. "We need more sophisticated entrepreneurs," he said. "This means you need companies that can export from your area to bring wealth in, to make your area richer."

Rao encouraged bankers to help entrepreneurs in their communities. He laid out a five-point plan:

Lobby politicians to level the playing field. "We need a mutually beneficial relationship with our trading partners," so all the new jobs, technology and buildings don't end up in China, he said.

Train entrepreneurs to be capital efficient. He said entrepreneurs need to learn to use their capital wisely, which simply means they need to be careful how they spend their money.

Help them find the right financing. Help them find the most economical financing for their situation.

Understand the financing gaps in your community, and help out if you can.

Help them to become more self-sufficient. Some entrepreneurs are good at sales and some are good at financial management, but few are good at both. The ones who are good at both have the best chance of success, he said. ■

FDIC official offers look into current challenges

Banks should look closely at their portfolio of home equity lines of credit, advised Steve Flaten, field supervisor at the Minneapolis office of the FDIC. Flaten was a speaker at the Spring Seminar of the Bank Holding Company Association hosted May 4 in Bloomington, Minn.

Flaten said banks should "scrub" those portfolios looking for changes in employment status. With falling real estate values, he said, some of the credit lines likely exceed the value of the collateral. "Don't look for past-dues, look for cases where your customer has lost his or her job," he said.

Real estate loans continue to be the top problem for banks, Flaten said, although he said by now most of the problem credits have been identified. Conditions are tough though, he said, with about 25 percent of Minnesota's banks on the FDIC problem list. Last year, six of the nation's 145 bank failures were in Minnesota.

Flaten said he is concerned bankers are under-reserving for troubled loans. He noted that reserves for bad loans at the end of last September in Minnesota banks were about equal to reserves held by those banks in 2005. "Yet, problem loans to reserves have gone up significantly," he said.

Given the difficulty of raising capital in the current environment, Flaten encouraged bankers to develop a capital plan. A good plan should identify steps for raising capital today and a few years into the future. "Where would you get capital if you needed it, and if your only answer is to borrow it, then you might want to start over," he said.

Equally important is liquidity, he said. "Years ago, every institution had an investment portfolio as a secondary source of liquidity. We have a lot of institutions that haven't had them recently," he said. "Balance sheet liquidity is not the most profitable thing right now — Fed funds aren't earning you a lot of money, nor are short term investments, but the alternatives if you have to find funds are not good."

Finally, Flaten encouraged bankers to reconsider incentive-based compensation plans they may have in place. "In the past, we placed too much emphasis on growth and quantity in our compensation plans. We didn't counter-act that with quality," Flaten said. "There were a lot of bonuses paid for credits that brought us problems. Make sure your incentive compensation plans reward the positive and take back for the negatives." ■

Industry feels pressure

Continued from page 1

other firms," he said. Conerly predicted there will be a lot of capital from overseas that will be looking for a home in the United States, and he said, investors are generally interested in investment instruments that are easier to understand than they have been during the last few years. ■

Director's Column

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Golf Outing will be held on Tuesday, July 20, 2010 at the Legends Golf Club in Prior Lake, Minn.

This event is co-sponsored by the Independent Community Bankers of Minnesota and the Bank Holding Company Association. It will feature representatives from the State of Minnesota – Department of Commerce, FDIC, Federal Reserve Bank, OCC and OTS.

See Newsletter insert for registration information.

Fall Seminar

Make plans now to attend the Bank Holding Company Association's Fall Seminar on Monday and Tuesday, October 4 and 5, 2010 at the Minneapolis Airport Marriott Hotel in Bloomington, Minn. ■

Association Executive Director

The Bank Holding Company Association, a 200-plus member Upper Midwest organization, seeks a dynamic leader at its Minneapolis headquarters.

Successful candidates must possess a BA/BS degree, 10 plus years of proven business and financial management experience, association management and government relations/legislative experience in addition to strong administrative, communication and team building skills.

Banking experience is highly desirable.

Mail or fax resume to:
Executive Search Committee
Bank Holding Company Association
200 Coon Rapids Boulevard NW, Suite 305,
Minneapolis, MN 55433.
Fax: 763-784-4546.

BHCA speaker: Consider these 10 keys to future success

There has never been a more important time for bank owners and managers to consider their particular business model, discerning which characteristics of the model have contributed to success and which characteristics need to be changed. S. Scott MacDonald, president and CEO of the Southwest Graduate School of Banking Foundation, urged bankers at the May 3-4 Spring Seminar of the Bank Holding Company Association to evaluate their own business models. "Many of our normal business practices may be out of vogue," he said at the seminar conducted in Bloomington, Minn.

MacDonald offered 10 keys to for future success.

No. 1: *Update your strategic capital plan.* Bankers need to have a contingency strategy for raising capital as capital levels across the board have begun to decline. Regulatory and strategic demands are driving capital needs. Banks with loan quality issues, concentrations in real estate, or dependence on borrowed funds will need more capital, he said.

No. 2: *Manage your growth*. "Faster growth," he said, "will require even more capital and a great business plan…Acceptable growth depends on where it comes from and how it is financed."

Growth is a good thing, but MacDonald said bankers should be careful about how they obtain it. "In the old days, double-digit growth was considered very risky," he said. "But in the years leading up to the crisis, double digit growth had become acceptable. Going forward, growth will be highly scrutinized by regulators and investors. This means we are going to have to be more selective about the business we put on our books."

Some of the deals banks took on to grow didn't make sense, MacDonald said, citing the fact that many bankers used to say they'd rather make $1.5 million on a $20 million investment, than $1 million on a $10 million investment. With twice the risk, the banker settled for only 50 percent more return.

MacDonald stressed the importance of differentiation. "It seems many banks are going after the same customers," he said. "Differentiate yourself from everyone else."

No. 3: *He urged bankers to re-evaluate their branching strategy*. "Do we need more branches to grow or should we grow the branches we have?" he asked. "Are the branches we have appropriately, strategically located, and productive?" Activity on online accounts is up 15 percent from a year ago and 50 percent of all deposits are now made at ATMs, up from about 33 percent in 2006.

"Your branching model should match you customer needs," he said.

No. 4: *Manage your concentration risk.* In the past, MacDonald said, banks grew their loan portfolio slowly and prided

Can we make the hard choices?

The Spring Seminar of the Bank Holding Company Association kicked off May 3 in Bloomington, Minn., with a presentation by S. Scott MacDonald, president/CEO of the South West Graduate School of Banking Foundation. MacDonald told the group that for the country to remain great it must be willing to make hard choices. The title of his presentation was: "The New Big Government: Can We Survive the Cure for What Ails Us?"

MacDonald reviewed some of the problems in our country, including growing debt. He noted that about half the people in the country earn 88 percent of the income and pay 97 percent of the taxes, leaving the other 50 percent of the population earning 12 percent of the income and paying 3 percent of the taxes. He also noted that the largest expenditures in the federal budget are for health and human services. Defense and interest on the debt are the only other major expenditures in the budget.

MacDonald said one of the great things about America is that in the United States, people still set great goals and believe they can achieve them. "Other countries don't even try to set goals anymore," he observed. "We can do anything," he said, "but we must figure out how to make the hard choices."

Regarding government spending, he noted that this year the Social Security system will pay out more money than it will take in. He asked for a show of hands from people who would be willing to give up their Social Security income. Few, if any, hands went up. ■

themselves on diversification. More recently, that model gave way to accelerated growth and concentrations in real estate lending. Today, he said, diversification is back in vogue, but it is difficult to obtain in many markets. In general, MacDonald said bankers are going to have to accept slower growth in their loan portfolio.

Concentration risk in the industry is growing, MacDonald noted. The 10 largest banks in the country now control 67 percent of the nation's assets, compared to only 23 percent in 1993. Banks with fewer than $100 million in assets control just over 1 percent of the nation's assets compared to 1993 when they controlled nearly 10 percent.

Members of the BHCA Board of Directors, from left, are: L. Lee Madetzke, North State Bancshares, Inc., Shakopee, Minn.; Charles Robasse, Wabasso Bancshares, Inc., Wabasso, Minn.; Gary Paulson, First Holding Company of Park River, Inc., Park River, N.D.; President Steven Wilcox, Wilcox Bancshares, Inc., Grand Rapids, Minn.; Douglas Farmer, Farmer Bancshares, Inc., Holmen, Wis.; Patrick Gates, Security Fin'l. Services, Inc., Hibbing, Minn.; James Kramer, SE Minnesota Bancshares, Inc., Altura; Bruce Ferden, Frandsen Financial Corp., Arden Hills, Minn.; and Exec. Director W. Dennie Emmans, Minneapolis. Not pictured: Douglas Jilek, Prairie Bancshares, Inc., Lester Prairie, Minn.

No. 5: *Maximize your core deposit sources and effectively manage your liquidity*. Banks used to fund themselves almost entirely with local deposits, but increasingly banks have turned to wholesale or borrowed funds. In the future, "our success will be defined by our ability to acquire core deposits and manage our borrowed funding risk and costs."

In the past, core deposits were a natural governor on growth. MacDonald said that in the future, bankers should keep borrowings or brokered deposits to no more than 20 percent of assets. Bankers should avoid brokered money to fund long-term growth; better to use it for managing interest rate risk or to cover short-term weakness in deposits.

No. 6: *Bankers will need to be more selective in the loans/business they put on the books*. Low interest rates have allowed banks to maintain margins but that is going to change as rates rise. Success in the future will be defined by a bank's ability to maintain margins through strategic business selection and delivering value to customers. Net interest margin, the industry's historic primary source of income, continues to decline. Bankers should not accept more risk in order to make up the difference. "Zero profit is better than negative profit," MacDonald reminded the audience.

The key for bankers will be differentiating themselves from competitors. Banks that become less creative and less distinguishable from competitors will suffer.

No. 7: *Banks must find new sources of income*. Success will depend on creating value for the customer. New products will have to be developed for existing customers, new customers will have to be found for existing products, and new products will have to be developed for new customers. Bankers should think about earning profits by providing solutions more than by charging fees, MacDonald said.

No. 8: *Plan for the future today*. In the past, success was measured by a bank's ability to buy loan officers, new banks and branches. More recently, it was measured by cost control. In the future, success will be measured by a bank's ability to strategically control costs and retain the right people. "Good talent is hard to find," MacDonald reminded. "Think about growing your own talent rather than buying it from somebody else."

No. 9: *Cost control and service improvements must be a long term goal implemented effectively rather than in reaction to events you can't control*. Cost slashing reduces employee moral and sometimes results in customer backlash. Successful banks will reach out to potential clients to grow their business. Costs need to be continually evaluated because other costs, such as FDIC insurance premiums, are likely to rise.

No. 10*: Be willing to adapt*. Financial reform legislation and other "big government" initiatives are likely to significantly change the way banks operate. "Our future business environment may be out of our control," MacDonald said. "The world is different today than it was in the past. You can complain about it, but if you want to survive and thrive, then you need to adjust." ■

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INSIDE THIS ISSUE

Bank Holding Company News

Following is a partial report of recent bank holding company filings with the Federal Reserve Bank of Minneapolis:

✓ 215 Holding Company filed to acquire White Rock Bank, Cannon Falls, Minn.

✓ Notice filed by Aaron Matthew Ness and other members of the Ness extended family to acquire 25 percent or more of First Dakota Financial Corp., Yankton, S.D., and thereby acquire First Dakota National Bank, Yankton.

✓ Notice filed by Peter Paul Bell, Lake Forest, Ill., to acquire 10 percent or more of Lake Shore Wisconsin Corp., Kohler, Wis., and thereby gain control of Hiawatha National Bank, Hager City, Wis.

✓ Notice filed by the Hensley Family Limited Partnership of Kalispell, Mont., to retain control of Valley Bancshares, Inc., Kalispell, and thereby retain control of Valley Bank of Kalispell.

✓ Waumandee Bancshares, Ltd., Waumandee, Wis., requests retroactive approval to acquire Waumandee Insurance Services, Inc., and thereby engage in insurance agency activities in a town with a population of fewer than 5,000.

✓ Lake Central Financial, Inc., Annandale, Minn., filed to engage, *de novo*, in extending credit and servicing loans.

✓ Notice filed by Dennis and Terri Brazier, Greenbush, Minn., to gain control of Border Bancshares, Inc., Greenbush, and thereby gain control of Border State Bank, Greenbush.

✓ Stonebridge Bancorporation, Minneapolis, filed to acquire Shakopee Bancorp., Shakopee, Minn., and thereby indirectly acquire Citizens State Bank of Shakopee.

✓ Notice filed by Joyce J. Eickhoff Revocable Trust, Joyce J. Eickhoff, trustee, Adrian, Minn., to acquire 25 percent or more of Adrian Building Corporation, Adrian, Minn., and thereby gain control of Adrian State Bank.

✓ TCF National Bank, Wayzata, Minn., through TCF International, Wayzata, an edge corporation, is proposing to increase its investment in a foreign organization, TCF Commercial Financial Canada, Inc., Oakville, Canada, to $173,027,000. ■