Bank Holding Company Association

Third Quarter, 2010

Newsletter

Volume 25, No. 3

The New Risk Landscape

By Jeff Judy

One of the advantages of having banks in several markets is that it spreads out risk. Where a bank with just one or two locations, close together, can do little to manage concentrations in their credit portfolios, and are tightly tied to the ups and downs of a very local economy, larger organizations can even things out a bit. Concentrations in certain types of businesses in some banks can be balanced with a focus on different industries in others. Different economies will have slightly different drivers and cycles, at the local level, meaning that at the aggregate level, these cycles are flattened a bit.

That hardly eliminates the need for holding companies to manage risk. If anything, it is all the more important to pay explicit attention to sources and patterns of risk throughout the organization. If the advantages of spreading risk throughout the holding company lead to complacency, ugly surprises can result.

That is particularly true in today's banking environment. If holding companies have enjoyed some "buffering" of risk in years past, those advantages may be much reduced under current conditions. It is time to review and re-tune your risk management practices, because today's risks:

- Are greater in magnitude, in the sense that problems at an individual bank have a greater impact on the entire company than they did in that past; and
- Are broader in scope, as sources of risk are expanding significantly as the economy, and our industry, both evolve.

Trickle up risk

In a normal economy, struggles in a few locations or at a particular bank can be supported by the strength of the entire organization. Rarely did these fairly local troubles bubble up to impact the company as a whole.

But the risks of that kind of impact have risen enormously in the last couple of years.

The economic downturn is so broad that the differences between your best performers and your worst performers are much smaller than they were in past cycles. There is less surplus from the better markets to be applied to carry the weaker banks in the company.

Regulators are moving strongly to an enterprise-wide view of risk, and problems encountered within a particular bank are more likely to invite them to scrutinize the performance of related business entities.

The perception of our industry in the general media, and among the public, is at a low point. Problems with any of your business operations can quickly tar even the best performers with the same brush.

This heightened probability that local problems will become company-wide problems is sufficient reason, in itself, for a thorough review of your risk landscape. But even more important is the way that sources of risk are expanding.

In other words, not only are individual bank problems having a greater impact "upstream," there are more ways for those banks to get in trouble than ever before.

The Expanding Risk Spectrum

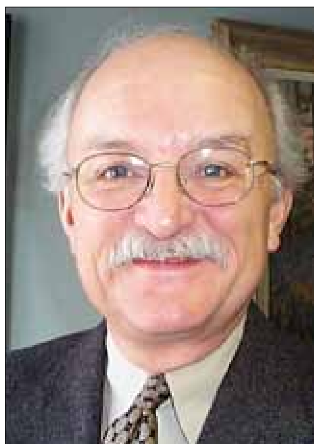
A weaker economy directly increases credit risk. But the recession has changed expectations among customers, the public, and our regulators in ways that greatly expand sources of risk.

Customer expectations are shifting. They not only favor safety and savings

Continued on page 6

President's Column

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



Fall is an exciting time, with football getting underway and baseball moving into the playoffs. The cool weather makes it enjoyable to be outside. And fall means the Bank Holding Company Association is putting on another seminar. I hope you will plan to join me Oct. 4-5 in Bloomington for this year's autumn meeting, entitled: "Banking Revelations for the New Environment."

I know it's not easy to set aside two days to attend a seminar, especially in today's environment when everyone is watching expenses. But I assure you that if you come to the seminar, you will be happy you made the effort. I have been attending seminars for years and have always found them to be very worth my time.

At our spring seminar, for example, I learned something about entrepreneurship from Dileep Rao, our lunchtime speaker. He explained the importance of supporting entrepreneurs, and why it is important for entrepreneurs to succeed. Sure, I have worked with entrepreneurs for years but the perspective of this professor and author gave me additional insight. The other speakers were great, too; if you were there, you know what I mean. If you weren't there, I invite you to attend the Fall Seminar so you can find out.

My school days ingrained it in me that September is also the start of a new year. It's a time when activity picks up after a rest in August. Congress is back in session, and the political season kicks into high gear before the November elections. We bankers have come through a tumultuous period the last 24 months. It was two years ago this month that the financial crisis shifted into high gear with the failure of Fannie and Freddie, not to mention Lehman Brothers. Things are calmer now; we have a massive new banking law, and we will see how this all works out in the coming months and years.

I am grateful to you, my colleagues in the industry. I have had the privilege over the years of getting to know many of you across the state and the Upper Midwest. I am glad we can get together at least twice a year at the BHCA seminars. We need to stick together in this industry. Although many parts of the economy have gotten off track, the fundamentals of banking remain strong, regardless of how the media portrays it. We have a lot to look forward too and I hope you will join me in making the most of it. Let's start at the Fall Seminar. ■

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. ■

2010
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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

The Bank Holding Company Association's 2010 Fall Seminar will be held on Monday and Tuesday, Oct. 4-5, 2010 at the Minneapolis Airport Marriott Hotel in Bloomington, Minn.

The theme for our 59th semi-annual conference is entitled "Banking Revelations for the New Environment" and should once again prove to be one of those "must attend" events for bank owners, executive officers and bank directors who wish to become informed on current regulatory, legislative, ownership and strategic planning issues within the financial services industry.

The Monday, Oct. 4 after-dinner program will feature Phil Smith, President of the consulting and law firm of Gerrish McCreary Smith, Memphis, Tenn., whose presentation entitled "The Truth About Your Bank: What Directors and CEOs Need to Know" will take an interesting and informative senior level look at what is really going on at your organization. By revealing the truth about community banks, Smith will help you to improve the performance of your organization. Topics to be covered include why your strategic plan is not working, why your organization cannot make money, why your structure is ineffective and why your capital base is not what it used to be.

Our invited noon luncheon speaker on Tuesday, Oct. 5 for this seminar is Ron Feldman, Senior Vice President, Federal Reserve Bank of Minneapolis, who will discuss current organizational and regulatory issues within the Fed as well as proposed BASEL guidelines and their trickle down effect on community banks.

An additional noon luncheon presentation will be made by economist Dr. Eugenio J. Alemán, Director and Senior Economist, Wells Fargo, Minneapolis, who will provide an economic outlook for the nation, our region and key industries.

Phil Smith returns to give our Tuesday general session keynote presentation entitled "Banking Revelations for a New Environment: It's Going to be Different." To say that the financial services industry is changing rapidly is an understatement. This session will look at key changes that are taking place and how community banks can respond to be successful. These topics include capital raising, strategic planning, the regulatory environment, dealing with stockholders and board and management.

An additional Tuesday general session presentation entitled "Coping with the Widening Range of Risk" will be made by Jeff Judy of Jeff Judy & Associates, Minneapolis, and will address when community banks come out of the "hunker down and survive" mode and start planning for profitable futures. The risks they factor into those plans are broadening because of regulator action and media coverage/public perception. This session will discuss how to cope with these major impacts for the banking industry.

In addition, several workshop sessions will be held on a variety of timely topics within the financial services industry including:

- The New Wall Street Reform Act
- Managing the Loan Review Process

***Director's Column**, Continued on page 6*

Employment is toughest part of economic outlook, Fed president says

Editor's note: These are excerpts from a Sept. 8 speech delivered by Federal Reserve Bank of Minneapolis President Narayana Kocherlakota in Missoula, Mont.

The typical FOMC meeting features two so-called go-rounds, in which every president and every governor has a chance to speak without interruption. The first go-round is referred to as the economics go-round. The meeting participants describe their views on current economic conditions and their outlook for future economic conditions. The presidents' remarks will typically include references to their own local economies, as well as the national and global situation.

As part of my contributions to the economics go-round in August, I discussed my outlook for GDP, inflation and unemployment. In terms of GDP, I believe that a modest recovery is under way and is likely to continue. In terms of inflation, I expect a slight but welcome uptick over the next 18 months. Finally, in terms of unemployment, I see current and future problems in labor markets that may be difficult to combat using the tools of monetary policy.

Real GDP growth has been positive in each of the past four quarters, and the government's second estimate is 1.6 percent for the second quarter of this year. Based on estimates from our Minneapolis forecasting model, I expect GDP growth to be around 2.5 percent in the second half of 2010 and close to 3.0 percent in 2011. Together over 2010 and 2011, I'm now predicting that GDP will grow around 2.8 percent per year. In contrast, in my first speech about seven months ago, I predicted that GDP would grow around 3.0 percent per year over 2010 and 2011. There is a recovery under way in the United States. But, as expected, it is a modest one.

Let me turn now to inflation. From the fourth quarter of 2009 through the second quarter of 2010, the change in the PCE price level was just over 0.5 percent, which works out to an annual rate of just over 1 percent. The Fed's price stability mandate is generally interpreted as maintaining an inflation rate of 2 percent, and 1 percent inflation is often considered to be too low relative to this stricture. I expect inflation to remain at about this level during the rest of this year. However, our Minneapolis forecasting model predicts that it will rise back into the more desirable 1.5 percent to 2 percent range in 2011.

So the news about inflation and GDP is in the "good, but certainly could be better" category. However, the lack of vitality in the U.S. labor market can only be termed disturbing. The national unemployment rate remains at 9.6 percent in August. Private sector job creation remains weak. I do not expect the unemployment rate to decline rapidly, and so I expect it to be above 8.0 percent into 2012.

If one digs deeper into the data, the situation seems even more troubling. Since December 2000, the Bureau of Labor Statistics has been keeping data on the job openings rate, which is defined as the number of job openings divided by the sum of job openings and employment. Not surprisingly, when job openings rise, the unemployed can find jobs more readily, and the unemployment rate typically falls. The inverse relationship between the unemployment rate and the job openings rate was extremely stable throughout the 2000-01 recession, the subsequent recovery, and on through the early part of this recession.

Beginning in June 2008, this stable relationship began to break down, as the unemployment rate rose much faster than could be rationalized by the fall in job openings. Over the past year, the relationship has completely shattered. The job openings rate has risen by about 20 percent between July 2009 and June 2010. Under this scenario, we would expect unemployment to fall because people find it easier to get jobs. However, the unemployment rate actually went up slightly over this period.

What does this change in the relationship between job openings and unemployment connote? The disincentive effects of extended unemployment insurance benefits are one possible cause for this change. However, I suspect that these effects are not all that large. I am comfortable with the San Francisco Fed's 2009 estimate, which finds that the extensions of benefits have boosted the unemployment rate by 0.4 percent.

The bigger issue is mismatch. Firms have jobs but can't find appropriate workers. The workers want to work, but can't find appropriate jobs. There are many possible sources of mismatch—geography, skills, demography—and they probably interact in nontrivial ways. For example, there may be jobs available in eastern Montana and western North Dakota because of the oil boom. But a household in Nevada that is underwater on its mortgage may find it difficult to move to those locations.

That was essentially my input into the economics go-round of the FOMC in August. GDP is growing, but more slowly than we would like. Inflation is a little low, but only temporarily. The behavior of unemployment is deeply troubling.

After the economics go-round, the FOMC meeting then transitions to its second phase, the policy go-round. Again, the meeting participants have a chance to speak in turn about what they perceive to be the appropriate policy choices for the committee. We all are committed to achieving the Fed's dual mandate to attain both price stability and maximum employment. The former objective is generally understood as keeping inflation in a tight range around 2 percent. The second part of the mandate is much more of a moving target. Employment is shaped by many determinants beyond the Fed's control: demographics, social custom, taxes, and so on. The Fed's job is to keep employment as high as possible, given these other factors.

Right now, the committee has to think about two quite distinct policy tools: short-term interest rates and balance sheet management.

The federal funds rate has been set at 0-25 basis points for over a year and a half. The FOMC's August statement contains the following key sentence:

"The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

As you would hope, there is an intimate connection between my economics summary and what's in this statement. The unemployment rate is 9.6 percent, and measured inflation is low (below 2 percent). Market and survey measures of expected inflation are also low (also below 2 percent). In its statement, the FOMC is saying: We're keeping interest rates low to keep unemployment from going any higher, and we feel safe in doing so because there seems to be little threat of inflation.

Let me turn next to the issue of the Fed's balance sheet. The Federal Reserve has $2.3 trillion of assets—over 2.5 times what it owned in September 2008. Over $2 trillion of those assets are in Treasuries, debt issued by Fannie Mae and Freddie Mac, or mortgage-backed securities issued by Fannie Mae and Freddie Mac. These MBSs are backed by the U.S. government—the Federal Reserve faces no credit risk in holding them. But they do have another kind of risk called prepayment risk. If long-term interest rates are low, then many people prepay the mortgages in the MBS. The owners of the MBS—in this case, the Fed—get a large coupon payment and the MBS's principal falls. However, if long-term interest rates are high, then few people make these prepayments.

This kind of fluctuation in prepayments is at the heart of the FOMC's new policy action in August. Long-term interest rates have declined surprisingly fast since April. But the fall in long-term rates led more people to prepay their mortgages. As a result, MBS principal balances were falling. In this sense, the Fed's holdings of long-term assets were shrinking, leaving a larger share of the long-term risk in the economy in the hands of the private sector. According to estimates in a recent paper, this extra risk in private hands could force up the risk premium on long-term bonds by around 20 basis points and be a drag on the recovery. The FOMC decided to arrest the decline in its holdings of long-term assets by reinvesting the principal payments from the MBSs into long-term Treasuries.

I believe that the apolitical nature of the FOMC's work hinges critically on another aspect of central bank structure, and that has to do with the Federal Reserve's relationship with the U.S. Congress. On the one hand, the Federal Reserve is a creation of Congress. It has the power to amend the Fed's responsibilities, as the recent financial reform legislation certainly attests. The Senate approves the presidential appointments to the Board of Governors. Both chambers receive regular reports from the Board of Governors on the conduct of monetary policy, financial supervision, and the payments system. In addition, the Federal Reserve undergoes regular audits of its finances and various operations.

On the other hand, Congress has intentionally removed itself from the direct conduct of monetary policy by granting the Federal Reserve the independence to perform this function on its own. In effect, Congress has said that it does not want monetary policy unduly affected by political considerations. This independence is not only a hallmark of this country's central bank, but is also a characteristic of developed economies worldwide. ■

Treasury to set up accounts for tax refunds

The U.S. Department of the Treasury announced Sept. 2 that it will launch a new pilot program to help capitalize on tax refund season as an opportunity to provide unbanked and under-banked Americans with access to safe, low-cost financial accounts. This pilot will deliver targeted offers to certain low and moderate income individuals to sign up for new accounts with debit card access at tax time in order to receive their refunds through direct deposit. It will also test offering accounts that can be used year-round in the future to deposit other sources of income, store money safely, make purchases, pay bills, withdraw cash, and build savings.

The pilot is expected to launch during next year's tax return filing season. Treasury will reach out to eligible taxpayers in early 2011 through direct mail and partnerships with private companies encouraging employees to direct deposit their payroll checks.

The offers to enroll in the pilot will include instructions on how to use the account. Treasury will evaluate the results of the pilot to inform future decisions about the viability, structure, and timing of offering similar accounts as an integrated part of the tax filing and refund process.

According to the Federal Deposit Insurance Corporation's 2009 National Survey of Unbanked and Under-banked Households, there are an estimated 9 million households without bank accounts. Another 21 million households are under-banked, meaning that they have a bank account, but these accounts do not fully meet their needs, and they still rely on high-cost check cashing services or other costly financial service providers.

The use of safe and appropriate financial services and products can help households maintain financial stability. Unbanked and under-banked individuals often face difficulties saving and planning for their financial futures, making them more vulnerable to medical or employment emergencies and threatening their ability to invest in continuing education, purchase a home, or send their children to college. The unbanked are disproportionally low and moderate income. According to the FDIC's 2009 National Survey, a person making $30,000 or less is more than seven times as likely to be unbanked as someone making $50,000 or more.

This pilot will build on the Obama Administration's continuing efforts to assist the unbanked and under-banked as well as empower Americans to make informed financial decisions. Social Security and Supplemental Security Income benefit recipients can currently receive their payments through the Direct Express Debit MasterCard card, a program established pursuant to terms approved by Treasury. By 2011, Direct Express is expected to expand to all individual federal benefit programs. Additionally, President Obama has requested $50 million in his FY 2011 Budget for a new "Bank On USA" initiative designed to bolster state and local efforts to help low and moderate income Americans obtain access to safe and appropriate financial services and products. ■

Risk landscape

Continued from page 1

over risk and debt, they are more suspicious of bank motives and practices, thanks to the highly publicized actions of some players in our industry.

Regulators are, of course, much more attentive to the least hint of problems, at the same time that legislation and agency rulings are tightening oversight.

Legal risk is enhanced, frankly, by the desperation of many customers. Foreclosures, bankruptcies, and legal challenges are all more likely as customers look for any way out of their obligations.

Operational costs associated with complying with new regulations, adapting products to new customer demands, and even dealing with the media and community and investor relations, will be reflected in changes to systems and processes, and staff time devoted to learning new practices.

A Brave New World

It is still true that doing business in a variety of markets affords some protection from risk. But without reassessing your sources of, and responses to, risk in your markets, you can easily give up some of that protection by overlooking new threats to your company.

We will face a slow economy for some time to come. If you hope to thrive in challenging conditions, take a fresh, new look at where new risks can threaten your banks, and how they can trickle up through the rest of your company. ■

Judy is principal of Jeff Judy & Associates, Minneapolis. Visit www.JeffJudy.com or email him at jeff@jeffjudy.com.

Director's Column

Continued from page 3

- Profit Improvement Strategies
- Strategic Planning in Today's Environment
- Bank Compensation – The New Normal

By all indications, the BHCA Fall Seminar should once again prove to be "your best two days in banking." I look forward to seeing you on October 4 and 5, 2010. ■

BANK HOLDING COMPANY ASSOCIATION

Fall Seminar

October 4 & 5, 2010

BHCA PRESENTS

"Banking Revelations for the New Environment"

Make plans now to attend the 58th semi-annual seminar of the
Bank Holding Company Association at the
MINNEAPOLIS AIRPORT MARRIOTT HOTEL
2020 East American Boulevard, Bloomington, Minnesota

Monday, October 4, 2010
6:00 p.m. to 9:00 p.m.

RECEPTION, DINNER & PROGRAM:

"The Truth About Your Bank: What Directors and CEO's Need to Know"

Our after dinner program will feature Phil Smith, President of the consulting and law firms of Gerrish McCreary Smith, Memphis, TN. This presentation will take an informative look at what is really going on from a board and senior level at your organization and reveal the truth about community banks to help improve the performance of your organization.

MARK YOUR CALENDAR TODAY!
Don't miss any of these great speakers and much, much more!!

EVENING SESSION FEES:
BHCA members and guests........$75
Non-members..............................$125

GENERAL SESSION FEES:
BHCA members and guests $225
Non-members..............................$325

Tuesday, October 5, 2010
8:30 a.m. to 3:30 p.m.

Our invited noon luncheon speaker for this seminar is Ron Feldman, Senior Vice President, Federal Reserve Bank of Minneapolis who will discuss current organizational and regulatory issues within the FED as well as proposed BASEL guidelines and their trickle down effect on community banks.

A special noon luncheon presentation will be made by economist Dr. Eugenio J. Alemán, Wells Fargo, Minneapolis, MN who will provide an economic outlook for the nation, our region and key industries.

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Several workshop sessions will be held to discuss:

- *The New Wall Street Reform Act*
- *Managing The Loan Review Process*
- *Profit Improvement Strategies*
- *Strategic Planning in Today's Environment*
- Bank Compensation - *The New Normal*

To take advantage of the reduced hotel room rate contact the Minneapolis Airport Marriott Hotel at 952-854-7441 before September [illegible], 2010 and mention that you are reserving for the BHCA Fall Seminar

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Bank Holding Company News

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

✓ Notice filed by Shawn Paul Weinand and Linda Lou Weinand, both of Tonka Bay, Minn., to acquire Alliance Bank Shares Corporation, Andover, Minn., and thereby gain control of 1st Regents Bank, Andover.

✓ Kirkwood Bancorporation Co., Bismarck, N.D., and Kirkwood Bancorporation of Nevada Inc., Las Vegas, filed to acquire 94.89 percent of Eagle Valley Bank, N.A., St. Croix Falls, Wis.

✓ Sandra and Jule Jacobson, Plentywood, Mont.; Edward and Lois Angvick, Medicine Lake, Mont.; Walter Norbo, Plentywood; Julia Norbo Exemption Trust, Plentywood, and Patsy Morstad, Plentywood, filed to acquire a portion of Treasure Bancorp., Inc., Plentywood, and thereby gain control of Montana State Bank, Plentywood.

✓ Change in control notice filed by Margaret Morton, Eden Prairie, Minn., to acquire and retain Vision Bancshares, Inc., St. Louis Park, Minn., and thereby acquire and retain Vision Bank, St. Louis Park.

✓ Richard G. Anderson, Helena, Mont.; Dick and Margaret Anderson, Helena, and David L. Anderson, Los Altos Hills, Calif., filed to acquire and retain 10 percent or more of Mountain West Financial Corp., Helena and thereby acquire and maintain control of Mountain West Bank, N.A., Helena.

✓ First Holding Company of Park River, Inc., Park River, N.D., filed to acquire First Sharon Holding Company, Inc., Aneta, N.A., and thereby acquire First State Bank of Sharon, N.D., and Sheyenne Bancorp., Inc., Park River, N.D., filed to become a bank holding company by acquiring First Sharon Holding Company.

✓ Dairyland Bank Holding Corporation, La Crosse, Wis., proposed to engage *de novo* in lending activities.

✓ Change in control notice filed by Paul Bennett Lewis, Mendota Heights, Minn., to gain control of Fidelity Holding Company, Minnetonka, Minn., and thereby gain control of Fidelity Bank, Edina, Minn.

✓ Notice filed by Aaron Matthew Ness, Yankton, S.D., and others to acquire and retain 25 percent or more of First Dakota Financial Corporation, Yankton, and thereby acquire and retain control of First Dakota National Bank, Yankton. ■