FDIC Community Banking Conference: *Strategies for Long-Term Success*

Transcript

Panel 1: The Community Banking Model

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MS. ELMQUIST: Well, good morning, everybody. My name is Kristie Elmquist, and I'm the FDIC's Dallas Regional Director. I'm honored to moderate our first panel this morning because I have the opportunity and privilege to introduce you to four very experienced bankers, and one distinguished educator and researcher.

I've had a great time in the last couple of weeks getting an opportunity to talk to them about a variety of community bank issues, and I think you're going to find their comments this morning interesting and informative, and I hope that you will see the passion for community banks that I have seen from them.

So please, let me introduce our panel.

To my immediate left is Dave Hanrahan Sr. He's the President and CEO of Capital Bank of New Jersey in Vineland, New Jersey.

Next to Dave is Rebeca Romero Rainey who is the Chairman of the Board and Chief Executive Officer of Centinel Bank of Taos, New Mexico.

Next to Rebeca is Bruce Jay, President and Chief Executive Officer of Valley Republic Bank in Bakersfield, California.

Next to Bruce is Alden McDonald Jr., President and CEO of Liberty Bank and Trust in New Orleans, Louisiana.

And finally, Dr. Scott Hein, the Robert C. Brown Chair of Finance at Texas Tech University and faculty at three different graduate schools of banking: the Graduate School of Banking in Colorado, the Southwest Graduate School of Banking at SMU, and the Texas Tech University School of Banking.

So please, join me in welcoming our panel.

MS. ELMQUIST: This morning, Dave, Rebeca, Bruce, and Alden will share insights about their banks' business models, strategies they have used to overcome various challenges, and practices they have implemented to manage key risks. And Dr. Hein will provide an academic perspective to each of our discussion topics.

So let's get started by having our bank panelists provide an overview of their institution's business model to provide a context for this morning's discussion. Dave, why don't you get us started.

MR. HANRAHAN: Good morning, everybody. Capital Bank of New Jersey was chartered in 2007. We're located in Southern New Jersey, southeast of Philadelphia, Pennsylvania. Today we're about $380 million in size with four locations.

We follow a classic community banking model, bringing in (as my CFO likes to say) local, loyal, low-cost deposits, and lending them back out to small and medium-sized businesses in our immediate area. I'm very proud of our growth and success. I'm proud of my team.

One thing I could not have predicted when we opened for business in 2007 was the coming crisis, nor could I have predicted how good it would be for us. As counterintuitive as it may sound, 2008, 2009, and 2010 was a great time to be a brand new, well-capitalized bank without any bad loans in its portfolio (because we hadn't been around in time to make any), lending money at a time when many of our peers wouldn't or couldn't. That crisis gave our growth a huge shot in the arm.

We've also been the beneficiary of a lot of merger and acquisition consolidation in our market, starting with the 90-year-old community bank in our market that was sold to a regional right before we opened. Our little parochial Vineland didn't like that so much. We benefitted from that change and have continued to benefit from similar changes over the last nine years.

MS. RAINEY: Good morning. Centinel Bank of Taos is located in Taos, New Mexico, in the northern part of the state in a high mountain desert at about 7,500 feet. I say this because it's important—Taos is a tourism-driven market. Hopefully my comments today engage you enough that you want to come visit us in Taos.

Chamber of Commerce speak out of the way, the bank was founded in 1969 by my grandfather. I'm the third generation to run the bank in our geographic footprint of Taos County. The town of Taos is about 7,000 people. The county itself is about 35,000 and is very rural, very spread out, and our single market industry is tourism. The largest employer is government. We run about a 9 percent unemployment rate. The local economy is very challenged.

We have a main office and two drive-through facilities. We're a one-bank holding company, Subchapter S corporation, and we have six owners. We are very much a relationship-based organization. Over the bank's 47 years of history, we've had the opportunity to work with multiple generations of businesses and work with the local economy with the incredible spirit of entrepreneurship. We have more artists and nonprofits in Taos than I think anywhere in the nation, which makes running a community bank all the more interesting; there's a need for a creative approach to dealing with that type of population. The approach is very much relationship-based. We have averaged 5 percent growth year after year. Slow and steady wins the race, as I like to say.

MS. ELMQUIST: Thank you. Bruce?

MR. JAY: Well, good morning. I think I'm on the panel today because we're the poster child for de novo banks in this economy. We're certainly the newest bank in the western region. We opened in February of 2009, and to my knowledge, are probably one of the newest four or five banks in the United States since the recession. It's been a very interesting journey for us … been very, very successful, and I'm honored to be here today.

We're located in Bakersfield, California. For many of you on the East Coast, we're in a different part of California than what you've probably read about in the press. We're kind of the Texas of California. We're located about a hundred miles north of Los Angeles at the south end of the San Joaquin Valley.

Our county is the number one oil-producing county in the United States. If our county were a state, it would be the third-largest oil producer in the nation, and we're the third-largest agricultural producing county in the United States. So, oil and agriculture are very important economic drivers to us.

I appreciate Chairman Gruenberg's comments about reducing the de novo period to three years. Two months ago we graduated from the seven-year de novo period, so timing is everything. We are a C corporation. We organized the bank initially with $25 million in capital, and we're about $500 million in assets today. Our current return on equity is around 9 to 9.5 percent.

We have about 300 local shareholders, all very distributed. The largest shareholders—we have a couple that I think have about 6 percent. But other than that, we are a very traditional, very vanilla community bank.

We just opened our third branch about a month ago, so there are about $450 million in deposits spread among two branches. We have a very low-cost overhead structure. Our total overhead is about 100 basis points lower than our peer group. When we opened in 2009 with interest rates the way they were and margins as compressed as they were, we knew we had to be very efficient to be competitive.

We are very traditional, very vanilla. Our focus is commercial real estate, commercial and industrial, and agricultural lending, and our average account balance is about $400—or $150,000, which is kind of unusual. Probably one of the most interesting statistics about our bank is that in seven years we've never had a single 30-day payment delinquency or a nonperforming asset.

MS. ELMQUIST: Thank you, Bruce. Alden?

MR. MCDONALD: That's a tough act to follow. My name is Alden McDonald, president and CEO of Liberty Bank in New Orleans. That's where we're headquartered. Our bank is presently in eight states. We have approximately 23 branches, 30-plus ATMs, and we're celebrating our 44th year in community banking.

In 1972, a group of citizens in the New Orleans area came together to develop a bank to service the community that was somewhat ignored by the larger banks in mainstream banking. Today we still follow that same business model.

Our customer base is primarily low- and moderate-income, with a focus on the African-American community in all eight states that we're located in today. We have a high-volume, low-balance business model … sort of created an incentive for us to find different ways to run a community bank, because of our high overhead (not like Bruce's bank).

Our loan focus, for the most part, has been one-third consumer lending, one-third commercial lending, and one-third mortgage lending. We found that to be a pretty good balance that really carried us through many of the different business cycles that we've experienced in our economy. Today we have less than 100 shareholders, and over the last ten years our growth has been primarily through acquisition of small community banks, primarily outside of our community.

We learned back in 2005 when we experienced Hurricane Katrina that diversification was very important. Because we had already begun looking outside of our community for expansion, we took on the expansion mode of acquisitions in various communities.

Because of changes in banking, changes in opportunity for us to continue to survive with the type of customer base we serve, we also looked outside of the normal banking cycle and invested in a leasing company. Five small banks got together and formed a leasing company that today is still in existence. It's about 17 years old and it provides a pretty good source of revenue for the bank. I think throughout the morning you're going to find that community banks must change their business models or the way that they perform in different types of economies.

MS. ELMQUIST: Thank you, Alden. Scott, you do a lot of research in community banking. You do a lot of teaching for community bankers. Will you reflect on the community bank model from that perspective as well?

DR. HEIN: Sure. I think the reason that I've been invited is that I'm a friend of community banks, and that friendship, I think, has been developed primarily through my association with the bank schools that Kristie mentioned.

Banks get money in, get money out, and get money back—they all do that same thing. But I've noticed in teaching at these bank schools, that most of the attendees come from places we call

community banks that are different. They have, as just characterized here, very different takes on how they get money in, how they get money out, and how they get it back.

They have a unique approach. And I was just thinking, one thing I struggle with as an academician is, “What is a community bank?” I would applaud what the FDIC has done research-wise in identifying community banks. They go through and look at each bank and study in-depth aspects of the business model.

Academicians for many years have done the easy thing and said asset size is going to determine if a bank is a community bank. If it’s below $1 billion (or as Chairman Gruenberg was saying it might be now below $10 billion), it might fall into a community bank profile.

We have community banks that do things differently, and it’s hard to identify what’s unique about them. But I was just thinking—“community.” Why do we call it “community bank?” I think the answer is the word “community” says we look beyond ourselves. There is something beyond ourselves that is important, and I think that is what makes us focused in a unique way on our community beyond just ourselves.

Big banks get money in, get money out, and try to give back as well, but I think community banks do it in a different fashion. Academicians talk about a focus on relationship banking, and we try to translate that. In finance parlance, that’s what we call soft information. Trying to quantify and measure that is very difficult for academicians to do, but I think that is broadly capturing the uniqueness of what community banks do.

I really am a friend of community banks for the primary reason that Chairman Gruenberg said—they’re an important part of our financial system and they are a primary source of economic growth that I think this country thrives on.

So I appreciate this opportunity, and I applaud the FDIC for hosting this conference. Community banks are something that we need to continue to develop and foster going forward.

MS. ELMQUIST: Thank you. So thanks, everyone, for providing some background information. I think now that we have some context, let’s talk a little bit about some of the key marketplace changes or trends your bank has faced and the actions or strategies you and your team have implemented to ensure success.

Let’s try to limit it to one or two key marketplace trends so that each person will have an opportunity to share comments. Dave, will you lead us off again?

MR. HANRAHAN: I’d be happy to lead us off. I first have to say that Bruce claims that his bank has never had a 30-day-past-due account. I can assure you that I think Capital Bank of New Jersey was 31 days old when it had its first 30-day-past-due account.

(Laughter.)

MR. HANRAHAN: One of the biggest challenges I feel like we’ve faced over the last nine years is the low flat-yield environment. Ironically, the last and the only time I was in this room prior to today was in 2010 when I attended the Interest Rate Risk Symposium that the FDIC held here.

In preparation for my comments today, I went onto the FDIC’s website—which is a treasure trove of information by the way—and I managed to find not only the agenda for that day, but a

transcript of the event, the PowerPoint slides, et cetera.[1] And clearly we were all (bankers and regulators alike) worried about interest rates snapping back, not going out too long on our asset durations, et cetera. Boy, how wrong we were.

It's humbled me over the last nine years that whenever I try and predict rates, I'm usually wrong, so I try not to do that. The best thing I believe I can do is really lean into my interest rate risk models, testing all different scenarios. And I've got to tell you, the one scenario that I fear the most right now is that rates stay right where they are. That's worse for me than a 200-basis-point shock, or a 400-basis-point ramp, or any of the other scenarios that we run. Therefore, over the last nine years as we've dealt with an ever-increasing margin (as Chairman Gruenberg referenced earlier in his comments), we have continued to emphasize growth, but we've had to watch overhead like a hawk.

We have four branches. However, we haven't opened one since 2010. The last five-plus years we've leveraged the branches that we have, and we need to continue to do that growing, but managing the overhead. That's the only way that we're going to be able to continue to put money on the bottom line.

The amount of deposits I can get out of any one of my branches is finite, and I think at some point we're going to begin to use more noncore funding to augment our balance sheet. I know that there is some history between banks' use of brokered deposits and what regulators think of that. I think to a point it's a nice alternative funding source to use to continue to add to the growth of our bank without needlessly increasing the overhead that we have.

The interest rate risk in this environment has been the biggest challenge that we've faced for the last nine years, and I think it will continue to be that way as far as my eye can see.

MS. ELMQUIST: Thank you, Dave. Rebeca?

MS. RAINEY: So for us, the marketplace trend that really isn't anything new—we've always dealt with in the history of the organization—is the lack of market diversity and our local economic challenges. The strategy for us has been that the key is long-term relationships. And when I say relationships, it's interesting to try and define that. I appreciate Scott's comments around the academic approach.

For us, it goes beyond the financial information. It goes to knowing the individual and having that inside knowledge of whether it's a service that they're providing or a product that they're providing, knowing how they're surviving today, what's driven them in the past, but more importantly, how they will be able to thrive in the future.

I have a couple of specific examples for you. As I mentioned, we have a lot of creative people in Taos. That has led to some creative and alternative approaches to building. Literally, we have a world-renowned architect who is building homes out of used tires and beer cans. We started lending on these homes about 30 years ago, and we had some interesting conversations. I remember I came into the bank trying to explain to examiners that "Yes, this is a sustainable home, and it makes sense, and there is resale value, and we've got this figured out."

[1] Symposium on Interest Rate Risk Management, FDIC, available online at https://www.fdic.gov/news/conferences/symposium_irr_meeting.html.

We had it figured out because we were on the ground and we understood what was going on. We also understood the market need and desire within our community for this type of product. So, over the years, not only have we been able to help this borrower survive, thrive, and create quite a development of these homes, we've also gotten them accepted on the secondary market. We've created an environment where this product can thrive because the financing has been provided and somebody was willing to take that risk.

We see that as well in a market driven by tourism and a lot of second homes, where discretionary income kind of fell out over the last several years. Those contractors needed something to do. We've had a mine reclamation project. We've had some infrastructure development going on up at the wonderful Taos Ski Valley, a significant $35 million project up there. Not a single contractor in Taos could tackle that project, but they could do it as a collective.

We were able to come to the table knowing their skill sets, whether it was the trenchers not being able to do all ten miles of the project by themselves, but three of them are able to split it up. They couldn't get the bonding to get that project done for the scale of the contractor they were working for. We provided the letters of credit to say, "Yes, not only do we know they have the financial capacity to do this, they have the skills and can get it done within the timeframe that they've been allocated," because of our knowledge of the borrowers and their ability to perform.

Put that all together, and today those folks have some significant capital infused within their business, they're back on their feet, and the project is done by local individuals. And that really, I think, is this key to our market strategy—being resilient and creative enough in the good times and the bad times to be able to respond to those unique needs within our community.

MS. ELMQUIST: Thank you, Rebeca. Bruce?

MR. JAY: I'd ask you to go back to 2009 and 2010 and remember some regulatory examinations that you had. Did anybody have a good experience during that period of time?

In our situation, we had just opened the bank. We had no peers. We were a safe haven, so we attracted a lot of core deposits very quickly. In our first year, we exceeded our business plan in terms of core deposit growth by about 400 percent.

So at the end of the first year, we were blessed with our first regulatory examination. I had 16 staff members. We had 20 examiners on-site for six weeks, and they didn't know what to do with us. The regulatory world was changing. A lot of pressure was coming out of Washington on regulators to tighten down the examination process, et cetera. It got a little unruly for a while; I'll be very candid about that.

The way we dealt with that is we were very intentional about developing a relationship with our primary regulator, the FDIC. I will say the regional director in the western region was receptive. I cornered him at a conference and said "we really need to talk." He was courteous enough to grant a face-to-face meeting with our Chairman and me a couple weeks later. So we went up, sat down, and just "eyeball-to-eyeball" shared what was going on in our marketplace, what was happening in our business, and worked through it.

And since that point in time I've made a conscious effort at least twice a year, either myself or the Chairman and myself, we drive to San Francisco and have about a two-hour meeting with

the regulators. That has been one of the most positive experiences that I've had in our seven-year history, and I would highly, highly encourage you to develop a close-working partnership with your regulators.

Secondly, I think one of the advantages we had when we opened was that our size allowed us to be very, very agile. Most of the larger banks and tenured banks were dealing with asset-quality issues. We were the only ones who figured out where the land mines were and where the opportunities were, and capitalized on those in a very quick fashion.

It wasn't a smooth road. I'd hired a chief credit officer who was very well known in the community. He was old school, 65 years old. He had been a chief credit officer for a long, long time. He was a shake-your-hand, collateral-based lender. Well, that didn't work in 2011, 2012, and 2013.

And after two years, it became obvious I needed to make a change. You have to recognize the environment, anticipate what's coming, and adjust your organization accordingly. I think the value of community banking, with our size, is that we can make those changes quickly and adapt to the environment.

MS. ELMQUIST: Thank you, Bruce. Alden?

MR. MCDONALD: I will share with you two examples of how we had to overcome changes and trends in the marketplace in banking.

As I mentioned earlier, our bank was basically servicing both the consumer community and the small business community in the banking space that the larger and the regional banks did not want as business customers. We had a pretty good niche in our beginnings of who we were servicing, and not too much competition.

Then some of the rules of the game changed, and a lot of the banks had to begin showing that they were lending to all parts of the community. The Community Reinvestment Act came into play. At that particular time, our target market became the target market for the large and regional banks.

They came into our market space and offered terms and conditions that made it very, very competitive for us. They reduced interest rates down below what would be competitive for us. They gave better terms and conditions for the better credits on our books, which left us with a void in dollars to lend and our interest rate spread. We had to really huddle and come together really quickly to offset this drain from the earning assets on our balance sheet.

Becoming creative, we again looked at the space that the larger banks did not want to participate in, in the banking industry.

So we began looking at—and became very creative and put together a school tuition program for the Catholic and private schools. We convinced the schools that it would be best for them to get out of the monthly tuition collection business, and have everyone to pay up front. So automatically we created some 300 to 400 new customers, as well as the commercial side of the school business. That was just one piece.

The second piece is at that particular time, the larger banks were not interested in mortgage lending, so we became robust in mortgage lending in our community. We became the number one FHA and VA lender in our community in order to put some new things in place.

I'd like to share a second story with you. I mentioned earlier that Hurricane Katrina hit in our community in 2005. Our bank lost 80 percent of our customer base, who had to evacuate from the community. Most of those individuals did not even begin coming back until one year afterwards.

Our institution lost all of our customers, all of our employees, and all of our records. So we literally had to find a way to restart the bank in a very short period of time, and to begin building our institution again.

The moral of that story is that we had to find a way to change. After the number of years that we'd been in business, all of a sudden we lost all of your customers. We had to become very creative again, which then put us on the road to Internet banking. A lot of our customers really jump-started the technology side of banking, where most people were a little bit reluctant in 2005.

That particular event (Hurricane Katrina) drove us to two things. Number one, I hired 15 young people to come work at the bank, because at that particular time I figured I had to change my customer base as well. I want you to think about that, because most bankers just go along with the customer base they have and nurture themselves on that. But it taught me and showed me that I had to begin thinking out of the box. We hired 15 young bankers and literally put them in positions of authority within the bank, because I had to create a new customer base, which then put me into the millennials.

Then I had to begin thinking differently, so now we think technology banking. The technology banking has driven us to the point now—we have been in the process of creating a virtual bank over the last three and a half years. Keeping in mind our business model, we have to now compete with the nonbanks that are coming into the community and offering virtual services to the consumers, as well as small businesses. We've been about three and a half years now ahead of working in what we call the virtual bank space.

Last year we kicked off account-opening on the Internet, which we've been very, very carefully thinking about over the last five years. We also have online lending, and we did a three-year pilot project on that. Our losses came out to be less than our credit card losses.

So I would like to encourage you to think out of the box when you have all of these changes that are taking place in the banking community. If you've been in banking as long as I have, you've been through a lot of ups and downs. The key to our success over the years that we've been in business is our ability to change when we see change.

MS. ELMQUIST: Thank you, Alden. Scott, will you please share some insights from an academic perspective on this topic?

DR. HEIN: Well, I would just call your attention to the stories that we just heard. One theme I heard was that we were all challenged in many different ways. The economy challenged us. We were in a different environment that was more creative; we had to deal with hurricanes. All of us, and all of the stories that were relayed are examples of resilience in community banks. I think

this speaks to the uniqueness of community banks in a lot of ways. They are adaptable and do adopt creative responses to very difficult challenges that face them.

As a former Federal Reserve economist, I can't pass on the opportunity to talk about the economic challenge. I would say I've been a little disappointed in community bankers for not voicing more opposition to the low-interest-rate policy that we've had thrust on us for many years. I don't think this is the way that we should be trying to strengthen our economy. We do have significant economic challenges facing the economy, and low interest rates, I think, have proven unsuccessful in changing that tide.

I think we should move more quickly to normalize interest rates. I agree with Dave, that keeping interest rates where they are doesn't make sense to me. We should understand that our depositors are being harmed in a real sense when we can't pay them the damage done from inflation.

So again, I think community banks adapt to challenges. We have made it through this environment. Hopefully it will be changing going forward, and we will have more economic wind behind us than economic wind in our face. But I'm still encouraged that community banks have risen to these challenges in a variety of ways.

MS. ELMQUIST: Thank you. So now that we've looked back in time, let's switch gears and talk a little bit about the strategies you are putting in place now to prepare for the changes that you see in our marketplace that are just beginning to take hold, or that you foresee emerging. So Dave, want to get us started again?

MR. HANRAHAN: I'd be happy to. I realized when I gave my introduction on Capital Bank, I failed to tell you about our ownership structure, and that's going to play into what I say next. We are privately held. We're a non-SEC registrant, and we have about 450 stockholders, almost all of whom are local to our communities … I'm sure a lot like most of the banks in the crowd.

Chairman Gruenberg made reference earlier to the FDIC study showing that banks are able to achieve most of their economies of scale when they reach $200 to $300 million, and that is exactly the case with us. We've managed to post a double-digit return on equity the last couple of years, and I feel like we've now hit our stride in our ability to generate returns for stockholders.

That said, the lack of the liquidity in our stock is an issue for our stockholders. When we did our initial local capital raise, we told everybody, "This is a long-term investment; don't plan on getting your money back any time soon." They listened to that and believed that, but life happens. Stockholders die, they get divorced, they have to put their kids through college, and increasingly as time has gone on, they've needed to liquefy their stock. There hasn't been a good means for our stockholders to do that.

So last year we conducted our first ever stock repurchase offer with our stockholder base, and in about five weeks' time we bought back approximately 2.5 percent of our stock. It was elegant in that it provided a relief valve for those stockholders who needed or wanted liquidity, along with an ability to leverage my capital a little better.

I'll harken back to the comments I made in response to Kristie's first question. As we are challenged with an increasingly shrinking margin, one way for me to drive earnings per share and return on equity is to leverage my capital and shrink the number of shares I have

outstanding. This voluntary program was a very good way for me to give certain stockholders what they wanted, while making it better for everybody else who stayed in.

I hope the 2015 stock repurchase program is just the beginning of what we can continue to do over time to continue that liquidity option and leverage our capital more quickly.

MS. ELMQUIST: Thank you. Rebeca?

MS. RAINEY: Well, Alden touched on this a bit, but I think as we, as a smaller rural community bank, continue to think about our delivery channels in the future, one of the things we're really honing in on is the ability to leverage technology.

You can never be all things to all people, but how can—from a service perspective—you offer a variety of options? For us, that point-of-service experience in the lobby has to be as perfect as the online experience with our customers.

For me, a key piece of that has been our employee knowledge. You know, it dawned on me as we were launching mobile banking that not all my employees had smartphones, or would think of the ability to service customers using smartphones. We got iPads for every employee, and as we launched this product, we had a test phase where every employee used it themselves.

It seems very basic, but from a service experience as we think about changing delivery channels and we think about informing our customer base, we employees have to be able to use this technology and really appreciate it to be able to sell it. So for us, that's been a key piece with technology.

I think another key piece—again, in the rural areas—is who are our future customer is going to be. Whether it's the next generation of businesses or the new entrepreneurs, what brings them into Centinel Bank, and what encourages them to think about us as a resource?

Telling our story has become a lot more important as we think about these online channels, whether it's social media or the school systems, all things that we've always done. We are getting more creative about what those channels are and how we tell that story, so that we are not only (in my opinion) branding Centinel Bank and what we can offer, but getting them—a key point, especially with younger students—to think about the distinction of financial services. Whether they're opening their small business in Taos, New Mexico, or anywhere else, that they're seeking out a community bank and they understand those differences in financial services. That's been an important piece.

Through those channels, some of the specific things that we're doing are not just telling that story, but making it hands-on. We all offer various financial literacy programs. I'm going into the classroom and talking about some of these things, as do all of our employees. We do a "learn and earn" program and scholarship programs—all pieces that try not to just lecture to students, but do it in a way that they have that hands-on ability to understand what we offer… whether it's a younger person or somebody starting off, whether it's a future customer relationship or a future employee (another key piece for us). Again, when you don't have a large incoming new influx population, your future employees are those current students … so how do we develop those relationships in the future? It's by doing it now.

MS. ELMQUIST: Thank you. Bruce?

MR. JAY: I started my career as a CPA, so I'm kind of a numbers guy. I think in our business, being publicly held, we owe a return to our shareholders. Consistently, our growth rates have far exceeded our earnings rate, so later this year we're looking at an additional capital infusion for the bank. We've been planning for this for about a year.

Coincidentally, almost exactly a year ago, the Federal Reserve Bank changed their holding company rules.[2] It was Regulation A+ which moved a lot of the thresholds up to $1 billion (from $500 million), so we're currently in the process of forming a holding company.[3] And the express purpose of that (at least one of them) is to use debt as a way to manage the capital level at the bank going forward.

One of the benefits of a low-interest-rate environment is you can borrow money cheaply. We're seeing offers of debt at the holding company level anywhere from 4.5 to 6.5 percent pretax, which is a fairly inexpensive form of capital.

Conversely, if you're doing a capital raise, we think (probably) a $10 million block is the minimum level we can raise in one offering. Not only would we have the cost of the offering, but we have about $50 million in capital, so we would have an immediate 20 percent dilution to our shareholders on a return basis. We can manage that capital in smaller increments at a cheaper cost, we believe, through debt. Projecting our numbers out to $1 billion, we don't see debt becoming more than 15 to 20 percent of our total capital structure. We think that's a very healthy ratio.

There is a secondary potential benefit, and it'll take a different solution or a different path than what Dave had mentioned. Liquidating the stock, I think, is a problem for every community bank, certainly one for us. We have those shareholders who love what we're doing, and they realize that it's a long-term hold. But as Dave mentioned, circumstances happen, so you have people who want to sell stock. They have 500 shares that linger out there for sale, and somebody will low-ball the price. Then the stock goes down a quarter, then two months later goes down another quarter, and all of a sudden you can't figure out why your stock is trading at the price that it is.

With a bank holding company, we will at least have the flexibility of offering a stock buyback program. We can set those prices at wherever we deem appropriate and substitute debt for any stock repurchases. Based on our internal projections, I'm fairly confident we can increase our return on equity by 10 to 20 percent over the next three years by using the debt avenue versus a capital raise. So, we're excited about that.

I'm a flexibility guy. I like to have options in solving issues, especially capital management issues. We don't see a huge downside to forming a bank holding company. The cost of formation is fairly inexpensive. There is the possibility of adding an additional regulator, but with a shareholding company, most of those exams are done off-site and are fairly inexpensive.

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[2] Board of Governors of the Federal Reserve System, press release*,* April 9, 2015 (available online at http://www.federalreserve.gov/newsevents/press/bcreg/20150409a.htm).

[3] On March 25, 2015, the Securities and Exchange Commission adopted final rules, often referred to as Regulation A+, to facilitate smaller companies' access to capital. The new rules update and expand Regulation A, an existing exemption from registration for smaller issuers of securities, and were mandated by Title IV of the Jumpstart Our Business Startups (JOBS) Act. The updated exemption will enable smaller companies to offer and sell up to $50 million of securities in a 12-month period, subject to eligibility, disclosure, and reporting requirements. For details, see https://www.sec.gov/news/pressrelease/2015-49.html.

MS. ELMQUIST: Thank you. Alden?

MR. MCDONALD: We were asked to give some examples about forward-looking trends of banking and the economy itself. In my previous remarks I mentioned that things were changing, and that we had to begin doing things differently for a number of different reasons.

We talked about the different delivery channels that are before us. We have not only the different channels before us, but we have new competition coming into the marketplace. That new competition is unknown at this particular point, but it is approaching us fast and furious.

As I mentioned (I'll continue to give you the theme), we consistently look in the marketplace for banking opportunities that the larger banks and the regional banks don't want. We still today continue to do that 43 years later. It has worked for us. Our bank has been in business 43 years, 44 years later this year. We've been profitable every year with the exception of five years in the business, so our business model has worked for us.

But there are a couple of things that we have begun to change within our institution. We do know for a fact that fewer and fewer people are coming into the bank to conduct their banking business. So one thing we have begun doing is downsizing our banking facilities. We are about to open a new facility within the next couple of weeks, and that new facility has 1,800 square feet with two teller stations.

We have driven a lot of our customers to the technology side of banking. We basically encourage them to bank from their home, bank from their office, and things of that nature. The delivery channels, and also the way people are using financial institutions today, are changing very rapidly.

We had to change our behavior in our institution. We had to begin changing all of our employees to become sales-oriented, which is a very, very difficult thing to do. So, we have developed sales teams in all of our markets and began looking at, "Now, how do we do this thing going forward?" This is the future, so I'm challenging you in the audience to look at how you are going to deliver your message.

Digital marketing is one space that we have been working in for some time. We don't have it down yet, but we're getting there. We think the only way we're going to be able to compete in the marketplace is through digital marketing. We can't afford the other typical and traditional types of marketing through the media space. So digital marketing is a direct link with the market niche that we want to do business with. So we're going to be very, very heavy in digital marketing.

Not only digital marketing—but to emphasize to our sales team—we've identified a niche for small business. There's a niche of small business owners out there that are being left behind by the larger institutions, and it's very good business … it includes owner-occupied real estate. To lend to those individuals who own their building, and want to expand and buy new facilities—it's a great market niche that we're looking at. So along with the virtual banking, we're looking at new ways of lending, receiving, and creating customers.

We also see the small and medium-sized business loan program as an opportunity, because bank consolidation is taking place and a lot of small businesses are really looking for a new home. So we see all of this as opportunity. And one thing that we have practiced in our institution is whenever we see an obstacle, that "O" for obstacle also means opportunity.

MS. ELMQUIST: Thank you. Scott?

DR. HEIN: When I listened to the forward-looking comments, I was struck by the theme of technology. It reminded me of my students, whose iPhones or smartphones are attached to their hands 90 percent of the time. They're a different generation, obviously.

One thing that I have a concern about going forward is that community banks, as I emphasized, do relationship banking (which exploits soft information). Soft information is gathered face-to-face many times. I'm not sure how that's going to translate in a new environment where technology is the communication vehicle.

I think community bankers need to think about this changing world. It's going to be a challenge for us, I believe. Although I think we will still be able to communicate, it seems like face-to-face communication and using technology to communicate is not a natural combination. Millennials use technology to communicate, and I think we need to recognize that and work with that. But I have faith that we will be able do that and face that challenge.

The other challenge that hasn't been mentioned that I see in West Texas in particular, is urbanization (moving out of rural communities). That's very common in West Texas. I live in Lubbock, and a lot of individuals from rural communities are moving to Lubbock as part of the urbanization that is going on. This is going to influence community banks in many locations as their communities are shrinking.

So when we count community banks, we need to recognize that there's maybe a force going on there … this urbanization that we're observing in our economy broadly. That's going to be a challenge for community banks to deal with. We need to recognize there are people still there (in rural communities) who need to be served and deal with that.

MS. ELMQUIST: Thank you for sharing both your past and prospective challenges and the strategies you've utilized to ensure your long-term success. I think there are some really good lessons learned in your comments for all of us. Before we entertain questions from the audience, let's wrap up with a few comments on best practices you utilize to manage risks. So Dave, if you could lead us off again.

MR. HANRAHAN: I think we community bankers have been dealt a great hand. The Chairman recounted the statistics on a declining number of us. While I think that's bad public policy for our country, I have to admit, competitively, I like having fewer competitors in this business. I think if I stay true to what I'm best at—that is, providing flexible, friendly service to my depositors, and providing access to decision makers for small and medium-sized businesses—that's something the big banks can't beat me at. They can outspend me on technology. They can have more branches than I do. They can have broader product offerings. But they can't do that personal customer service well.

I think the best risk management practice I can have is to stay true to what I am, not worry so much about what the big banks are doing, to play the really good hand that I've been dealt, and to play that hand well.

There was also a lot of talk about the need to get to a certain dollar size, and this false dilemma is preached of having to either acquire or be acquired. I was recently in the company of Lee Burrows, an investment banker with Banks Street Partners. With remarkable candor for an

investment banker, he said to me, "Why would you buy somebody else at 1.5 times book when you could by yourself at book?" This was in the context of our stock repurchase discussion.

I think if we simply manage our organization to our strengths, we've got a great future.

MS. ELMQUIST: Thank you. Rebeca?

MS. RAINEY: As I think about risk management, we have so many different tools and reports and pieces that we've implemented into our organization these days. The thought that came to mind for me is a culture around risk management, and that's where we've really focused within our organization these days, asking, "How do we approach the gray area?" A lot of what we do in some cases is black and white, and we have procedures, policies, and checklists that sometimes help us work through that. As we create a customer experience, tackle loan decisions, and work through a difficult situation, how are we as an organization developing the thought process around risk and critical thinking to understand how we evaluate those decisions that we make, as they become potentially more complex and we deal with more gray area? That really, for us, is where the opportunity is—is where the pieces aren't so clear.

Within our organization, we're doing things within our committee structure where we're bringing in more individuals that aren't necessarily me or our bank president, but folks that are hands-on, thinking about their day-to-day operations processes, as we write policy and do risk assessments. That really makes folks think about not just what the problem or solution is, but what's the risk, how are we going to mitigate it, and how comfortable are we making that decision moving forward?

That's been a fun cultural shift within our organization that really has helped to empower what I hope to be continued strong leadership development, as well as thinking outside the box in terms of how we take care of our customers in our community.

MS. ELMQUIST: Thank you. Bruce?

MR. JAY: Well, we can't control interest rates. We can't control the economy. We can't control regulatory compliance rules coming down the pike. But there are knobs that we can control within our organizations. We spend, at our bank, time focusing on what those knobs are, and we keep our hands on them all the time. It begins with people—this is still a people business. We focus on hiring the best of the breed. There's no substitute for having great people in our organization. Our hiring process, as an example, includes at least six interviews before we will bring a new person on board. We're very, very diligent in our hiring practices, and this has proved to be our greatest asset.

You can control underwriting. You can control the cost of your organization. We spend a lot of time focusing on those things and we think that it's a great future for community banking. Pay attention to the basics and do them very, very well.

MR. MCDONALD: Scott mentioned something that made me remember some of the things that we're doing to make certain that the younger people with the machines in their hand are real people. One thing that's very, very important (it's a management practice as well a risk-management tool) is that we are very, very, very involved in the community. When I say very involved in the community, I mean we have practically all of our offices in some type of community activity. Sometimes they're out of the bank more than they're in the bank dealing

with community activity. Those are the people-to-people pieces that we have at play in conjunction with our technology.

One key I'd like to share with you (I think I only have one person in here from my marketplace) that we see as a way of keeping in touch with this new generation and our customer base, is our focus on home ownership in a lot of different ways.

You have an opportunity to deal with these individuals on a very regular basis. Trust me. That's how you stay in touch with people, but you use your technology in order to deliver the services. So I want you to keep in mind that your people-to-people piece is very much part of where we have to go in the future. That's a delivery channel, number one, and number two, that is the best way for you to get additional business.

I mentioned earlier that we have a high-volume, low-balance business model, so we have to find different ways of mitigating our risk in a number of different areas. The customer base we lend to has very low, in most places, credit scores. About 20 percent of our customers have credit scores above 700.

So in our lending practice, we have centralized underwriting and centralized collections. And as a result of that, we also have a couple of committees that review our reports on a very, very regular basis. Our collections department supplies top management with a trend in 0 to 15 days, 15 to 29 days, et cetera.

We can tell from an early-warning signal that we receive through these reports what is about to go bad, and we jump on it very, very early (both for small businesses and consumers) to help mitigate whatever those challenges are.

Monitoring all areas of our bank is a very strong suit for us, and we train all of our management team to monitor, monitor, monitor. We develop dashboards for every area of the bank. We monitor the dashboards on a monthly basis, and everyone is tied to their goals and objectives. The monitoring piece for mitigating risk in our bank is very important.

Second, we developed years ago a budget modeling tool that we've used probably over the last 30 years, and we call it "the one-day look." It's a one-page report, we could literally take all of our crew numbers (for the most part) and predict where we're going to end up for the month, for the quarter, or for the year. The reason that's important to us is that we're monitoring the risk factors that we have, and any changes in the marketplace will show up in this monitoring tool that we have.

Two basic things that we use … we're very, very much on top of the budgeting process, monitoring of the budget process, and monitoring of the budget on a monthly basis. The second piece is that we manage risk by having a ton of different management reports that tell us the story before it becomes a fire. Again, thank you very much.

MS. ELMQUIST: Thank you, Alden. Scott, how about from an academic perspective?

DR. HEIN: I learned from talking to community bankers a great deal myself and as an academician teaching banking courses—I'm struck by the fact that in talking about risk management, we break that discussion into different components. We'll talk about credit risk and how you measure and manage that, and we talk about interest rate risk (ad nauseam, according to my students) and how you measure and manage that. But in talking to community

bankers, I'm struck by the recognition that these risks aren't in individual silos. We need to recognize some of these risks are interrelated.

I hear this notion of enterprise risk management. I think community bankers actually have a much better handle on their enterprise risks than the real big banks. Could you imagine trying to manage Bank of America with all of the various parcels and parts? Talk about the risk that they are exposed to. I think we have a fairly simple task, then, in comparison.

I do think it gives a strength, then, to the community banker. It is technology, the risk of technology. It's interest rate risk. It's credit risk. We need to look at all of the various components and recognize that they aren't separate, but they're intertwined. They can influence one another.

I see many community bankers (most, I would say, do it just by intuition) looking at risk from a global perspective instead of trying to measure individual components. It is a strength in the community bank business model.

MS. ELMQUIST: Thank you. I appreciate all of those best practices. Why don't we stop here and provide the audience with an opportunity to ask the panel questions? If you have a question, I'd encourage you to go to the microphone, which is in the middle of the room. Any questions?

PARTICIPANT: Don't give me a microphone, though. I never met one I didn't like. I'm curious as to what kind of loan-to-deposit ratios you're running at your banks, and how that has grown or shrunk over the last four or five years? Where do you see that going over the next four or five years, and the strategies you've discussed?

MR. HANRAHAN: Seventy-five percent. It's been very steady at that number. I would love it to be higher. I'm not sure it's going to be.

MS. RAINEY: We've declined over the last five years from 70, 75, right now we're at about 50. It's a huge challenge facing us. A lot of what we are continuing to do is think about those buckets that we haven't been active in, and think about what we're doing to promote some of the loan products that we're doing, and getting that message out there. We've been fortunate to have great core deposit growth, but our local market is not keeping up with that demand.

MR. JAY: Well, I agree with Rebeca. It's been a marathon to try to get a balance. Four or five years ago, we were a 30 percent loan deposit ratio, and it made earnings a little tough. Right now we're around 70. We think 70, 75 percent is a pretty good sweet spot for us.

MR. MCDONALD: We're in the same ballpark, between 70, 74 percent. We don't see our loan-to-deposit ratio getting much more than that. We're looking at bumping it up just a little, but with the credits in the marketplace right now, it's a little bit challenging. So we're trying to be a little careful.

MS. ELMQUIST: Thank you. Next?

MR. BUSH: My name is Mike Bush, I'm the president and CEO of Mississippi River Bank. I'm the guy Alden was talking about who's in his market share. He didn't want to give me that secret.

However, my business model for our bank is more in line with what David and Bruce do, and that's C&I lending and CRE lending.

How many people in here have that kind of business model, C&I? Are all of you all aware of the new FDIC deposit insurance assessments rule that's going to go in place?[4] There's going to be a look-back for premiums based upon where you have your loans, regardless of how your loans are performing. Do you all know that? If you don't yet, you need to know.

And the American Bankers Association has asked the FDIC that we be assessed just on what we're doing within our banks, using our CAMELS rating. I don't know if we're still in the comment period or not, but if we are I think it's very important. For the industry to be penalized by a look-back of what happened between 2008 and now and say that we have to pay additional premiums based on that would be a curtailment on our ability to be lenders, to keep making that 44 percent of the loans for small business. So I hope everybody's aware of that. If you're not, you need to have a position. And I don't know if you all were aware of it and if you have a position, either David or Bruce?

MR. JAY: Is there any asset size threshold?

MR. BUSH: Everybody $10 billion or less. This is going to be under the new deal under Dodd-Frank reform … every bank with $10 billion or less in total assets will be in that category.

MR. HANRAHAN: I can't recite chapter and verse on that new proposed rule. What I can tell you is that I'm very much looking forward to my premiums going down by about 30 percent in the third or fourth quarter of this year.

While I'm not a big fan of the Dodd-Frank Act, I will tell you, I'm grateful that the assessment base was changed to be total liabilities, not just deposits. That favors guys like me. I'm also grateful that the cost to get the Deposit Insurance Fund Reserve Ratio from 1.15 to 1.35 was on the backs of the big banks. I will stay attuned to what this gentleman is talking about, but I think we're going to get a nice reduction in premiums within the next couple of quarters.

MS. ELMQUIST: Are there any other questions?

MS. LEMIEUX: Hi, I'm Kathy Lemieux, and I'm from the Chicago Fed. You all mentioned technology, and certainly we read about the many different ways banks interface with some of these new fintech [financial technology] lenders. And so I would like to ask each of the panel members, do you consider these trends an opportunity or a threat?

MR. HANRAHAN: I think it's some of both, but mostly opportunity. When I heard that a certain big bank decided it's going to outsource all of its small business loans under $250,000 to a fintech company, I jumped and clicked my heels. While there's a slice of customers that's going to like that, there's a bigger slice of customers that it's going to drive nuts. The big banks might as well say, "Go to your local community bank instead, because it's just not something that we can do."

The small business owners that we lend to are invariably imperfect in some way. Maybe they have a strong debt coverage ratio but not the capital position we'd like. Maybe they have good

[4] 12 CFR Part 327 Assessments; Final Rule (Federal Register Vol. 81, No. 58, p. 16059-16074, March 25, 2016, available at https://www.gpo.gov/fdsys/pkg/FR-2016-03-25/pdf/2016-06770.pdf).

collateral but not quite the credit history we'd like to see. What we specialize in is lending to the imperfect, and I don't think that's well served by the fintech space. I think it an opportunity for people like us.

MS. RAINEY: I completely agree and I think another opportunity is the actual technologies that are being used, and we as community banks can leverage some of those models to create that "imperfect situation" and ability to deliver and compete for all borrowers regardless of their scenario. I think that's a fun piece of it as well.

MR. JAY: From what I read, Washington is starting to look at the fintech world and establish some regulatory boundaries at least to level the playing field to some degree with regard to regulation and oversight.

If I had a concern as a community bank, it's that so we're reliant on a single provider (service bureaus) for a lot of our technology. We've been leaning on our provider, and have had a whole new series of conversations about what they're doing in terms of monitoring fintech development and the partnerships that they might be able to embrace (which would then make technology available to us).

MR. MCDONALD: We see it as a huge opportunity, and that's why we have entered the technology space, especially digital marketing.

As was mentioned earlier, once these small businesses go to these technology lenders, they're going to find out that the community bank is the best space for them to begin with. So using technology and using digital marketing will help drive them to us. You can't just make a loan over the Internet or through some technology piece. I mean, that will work for a little while, but most of the consumers and businesses have certain types of issues that community banks specialize in. So we see it as an opportunity to drive business our way. That is how we will open ourselves up to a greater marketplace. We look at it as a real opportunity.

DR. HEIN: I would just add that I think it is mainly an opportunity, but there is a threat there. Tomorrow's small business owner is going to be more technology-oriented, so I think community banks need to make sure that they are still connecting with those individuals. So it is a threat from that perspective. On net, though, I would agree with the consensus, that it's more of an opportunity, and that the big banks are going to mess it up.

MS. LEMIEUX: Thank you.

MS. ELMQUIST: Are there any other questions? I think we have time for at least one more.

PARTICIPANT: If I can end maybe with the last question, or close to the last question. First, I want to thank the panelists. As community bankers, we don't really like to share our ideas or our thoughts, so we definitely appreciate that. Since you have discussed long-term strategies—what's your long-term personnel strategy to replace these people in the next ten years? What keeps you up at night about replacing those people? What part of your bank concerns you the most? What have you thought about, maybe an innovative strategy to replace those individuals in your bank? I know a number of you said your success is the people that work for you. How do we replace those and find that kind of talent over the next couple of years? That's my question. Thank you.

MR. HANRAHAN: It's a great question. We do have a talent crisis in our industry, partly because we have a big image problem, and also in part because there aren't the big bank training programs that there once were. I was, you know, one of the last to come through. Now thankfully I only have to hire three or four new people a year, so I don't have scores and scores to find. I am very pleased that we've been able to bring in some young college graduates over the last nine years of our existence that are smart, hungry, and that care and want to do a good job. Today my Bank Secrecy Act officer is somebody who we hired as an intern. My credit department manager, who's a Cracker Jack kid, was hired as an intern. We've had very good experience in carefully hiring young people and showing them there's a really good career path in commercial banking that they might not have known about. I hope that we're able to continue to do that to grow the next ranks of leaders.

MS. RAINEY: I'm facing a retirement in my compliance officer in the next five years, amongst a few other positions within the organization. That's one that does keep me up at night, just given this particular individual has been with the bank for 30-plus years. She's worked in all areas of the organization. You don't replace that kind of knowledge easily at all.

For us, it's been building that knowledge amongst several different individuals. Within our compliance committee, we've added four people within the last year. We pulled in those folks that are working in different areas of the organization and beefing up their compliance knowledge. They're now doing the compliance audits as opposed to the compliance officer, and really getting hands-on experience. It's also a great way for me to test out some of the different personalities and see who may be a best next fit. Compliance is a perfect example of something that is everybody's job, but there's so much information and knowledge—how do we get some of those specific technical skills spread out throughout the organization?

I think another piece to this (something that I take very personally) is that our industry as a whole hasn't been that exciting, sexy career that people think about. I think, for me, that's something very important. I think about how we as an industry tell our story to get more folks as they're coming through college into thinking, "I want to be a community banker." It sounds silly, but I think part of the way we stem this tide is by getting people to talk about it and think beyond banking schools, because those folks are already in this career.

So how do we back up a little bit younger and think about how we promote our industry for those future folks that bring the skills and talents back to their hometown or to another community and want to engage in what we get to do?

MR. JAY: It's a great question. You guys are probably out there looking this way thinking, "We've got a bunch of young people up here on the panel, but looking out that way, not so much." That's a very legitimate question. We talk about it a lot at our bank. It's not only staff, it's our directors. Our executive team probably averages 65, 66 years old. Our directors probably average 67, 68 years old. So you roll the clock forward five years, ten years, and there's going to be a wholesale replacement of some form that's got to take place.

We haven't solved it yet. I will say that some of these young kids coming out of school are very, very smart, and they know how to use technology to get a heck of a lot of work done. There are some real diamonds in the rough out there … you have to create a work environment that is conducive to what they're—I don't know where their heads are at—but if you can get them focused, they're quality people. They can do a good job for you. I think retaining them is probably the bigger challenge over the long haul. It is a problem.

MR. MCDONALD: We haven't found a solution to that one either, but we are constantly looking at the younger generation's atmosphere. One thing we started four years ago is a leadership training institute to build leadership for the community. We have classes between 20 and 25 individuals, tops. We've graduated 150 of those individuals, and we find that those individuals go out into the community and talk about what a great job we do at the bank. As a result of that, we get a lot of people who are interested not only in our institution from the banking side, but also from the employment side. That has been a very good lesson for us, and it's been a good piece for the community.

The 150 graduates that came out of the institute are presently on boards and commissions within the entire metropolitan area. Those individuals are sending us business and they're sending us employees. They have friends that want to relocate to New Orleans, and the first place they send them is to the bank. We get to see a lot of résumés, and we pick and choose from those résumés.

DR. HEIN: If you are looking for new talent, let me encourage you to reach out to your local higher-education institution. I would mention the Conference of State Bank Supervisors has started a very interesting program with regard to community banks—a national case study competition, where students then are encouraged to study a community bank. Last year they studied commercial real estate. I was a judge on that competition. There were six case studies that really showed that these students reached out and learned a great deal about community banks, commercial real estate exposure, and the problems that surfaced during the financial crisis.

This year, the case study is built around small business lending. I decided to form a team to study small business lending at a local community bank. I heard there are 30 teams that are organized this year. Hopefully this will be a growing thing that will get the next generation understanding firsthand what community banks do in very different ways.

MR. MCDONALD: Let me just add to that. You have a lot of young, bright people going to work for these large institutions and they're finding out that they don't want to be associated with a large organization, so we raid that talent pool as well. Normally they come with some good training. So that's been a very good source for us.

MS. ELMQUIST: Thank you, audience, for those questions. Before we conclude, please join me in thanking our panel for sharing. They did a tremendous job I think this morning, sharing their experiences, some of their best practices, and importantly, their strategies. And I also want to just thank you for serving your communities. You do a great job. Thank you.