90 Day Note

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When a Stock Valuation Can Add Value

By: Martina Dowidchuk, Senior Consultant

The stock market continues to remind us of its inefficiencies. Most banks saw their stock values decline last year despite the industry's record levels of earnings, continuing growth, and strong asset quality levels. In fact, the month of December 2018 recorded the greatest monthly stock decline since 1931. The broad market index, the Nasdaq Composite Index, was down 9.5% for the month of December and the banks were impacted even more than the overall market with the Nasdaq Bank Index falling 14.1%. For the year 2018, bank prices declined by 17.9% as measured by the Nasdaq Bank Index. This market correction was caused by a combination of economic and political factors, as well as the market's perception of their impact on the industry. The Nasdaq Bank Index has showed a considerable improvement since the end of 2018, but as of July 30, 2019, it continues to be more than 9% below the level it reached 12 months ago.

While there will always be external factors outside of any bank's control affecting the market pricing, the intuitive fundamental relationships tend to remain true among broadly-traded stocks. Regardless of the overall market's ups and downs, the market values of banks with a higher profitability, stronger growth prospects, and other positive fundamentals are typically higher when compared to banks with weaker performance. However, this is not always true for banks with a limited stock trading activity. **To ensure that the improvements in the bank's performance translate into the shareholder value, the earnings prospects and financial strength need to be proactively communicated to the proper audience so that investors realize the value of a community bank stock and the bank gets a proper credit for its performance.**

One of the easiest and fastest proactive measures available is to obtain an independent third-party valuation of the bank's stock. Professional appraisers use multiple valuation techniques that encompass both sound financial theory and the latest market realities. Different considerations are made depending on the type and purpose of the valuation. Some valuations may require a minority interest value (i.e., a trading value), while others may call for a controlling interest value (i.e., change of control value). A valuation report evaluates the bank's performance from different perspectives and provides an immediate stock value estimate that can then be communicated to shareholders and potential investors, providing a base point for future trades, stock repurchases, employee stock ownership programs, etc. Furthermore, if the bank has not previously had a valuation of its stock completed, the result in many cases could be a significant, immediate increase in shareholder value as the bank and its shareholders realize the true value and potential of the stock.

For community banks, understanding and proactively managing the shareholder value can be vital for many reasons. Young & Associates, Inc. has been providing valuation services and advice encompassing a variety of transactions and valuation purposes for over 40 years. Our experience in merger and acquisition activities, bank formations, and other capital market transactions gives us the expertise to help our clients understand their market value and make informed decisions as they implement their strategic initiatives. For more information on how Young & Associates, Inc. can assist your bank in this area, give me a call at 330.422.3449 or send an email to mdowidchuk@younginc.com. ❑

Succession Planning – The Key to Remaining Independent

By: Bob Viering, Senior Consultant and Manager of Lending Services

For many community banks today, remaining independent is the number one strategic priority. There are many reasons boards believe remaining independent is important: the board believes that the shareholders' investment will be maximized over a longer time horizon; that the bank as an independent local bank can best serve the needs of the community; that the employees as a whole will be far better served (and have jobs) by remaining independent. These are all reasonable and sincere reasons.

So, if staying independent is important, why are an increasing number of banks selling today? One of the biggest reasons that banks sell is that the board is not confident that there is anyone ready to take over management of the bank. Developing a successor internally is a multi-year process to groom a talented individual to learn enough about the day-to-day responsibilities and skills needed to manage a bank successfully. Hiring a new CEO externally sounds easy, but to find that right person that not only has the skills and background to succeed and also can fit in the community and, most importantly, the bank's culture can be a very challenging process, especially if you are in a rural community. If something happens that the CEO role is suddenly open, or the CEO decides to retire in a year or less, all too often there is not enough time to find that right person, and the easier decision is to sell while the bank is still running smoothly.

It sounds like having a plan on how the CEO position will be filled is the answer. We've seen very simple plans that are a few short paragraphs that basically say, "Joe and Mary can run the bank in the interim. If one of them is not the right person, we'll just hire someone." Even for a very small bank, it's almost never this easy. Even if you believe one of the top managers has the "right stuff" to be the next leader, have you thought about what skills they may need to develop to be ready? Have they had any real experience leading a group or an important project that gives you confidence they can run the place? Can you picture that person standing up in front of your shareholders? Or representing your bank to regulators? Or allowing your other key employees to operate successfully? Can they run the bank when times get tough (and they always do)? If you answered positively to these questions, do you have a plan, with timeframes, to provide the types of training and experience so that they will be ready to take over?

Even if you are confident you have the right person to take over, or you start early enough to recruit your next leader, what about the next level of management? Are they ready to step up when Joe or Mary ascends to the top spot? Do you have a plan to develop that next level of management? As you step through the layers of your organization, it often becomes clear that there are other key employees that would impact your ability to run the bank smoothly if they leave. What do you do if your head of IT leaves? Is there a replacement? Can the functions be outsourced? Every organization has those key people; they may not even be mangers that are critical to the operation. What's your plan if they are gone one day?

If you may be facing the expected change at the CEO level and you have other key people that are in sight of retirement, selling can seem like a simple, expedient solution. The key to not being backed into a corner when retirements occur, or when a key person leaving is a threat to the successful operation of the organization, is having a well thought out succession plan. A successful plan has the following elements: it identifies those key individuals in the bank needed to run the organization successfully; it identifies the skills and training needs for those individuals that have the ability to be promoted to more responsible positons, even the CEO role; it has a written plan with timelines for preparing the individual for that next step; and it is updated at least annually to verify that the plan is still the best plan for the bank and that the individuals are progressing as expected.

If you truly want to remain independent, then you must take the time, and it will take time, to develop a meaningful succession plan. Well done, it will take months to develop and time to groom and coach that next level of talent, to review and update your plan as required.

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At Young & Associates, Inc. we are committed to the idea that we are all best served by having strong, well-run community banks. If you would like help in developing your succession plan or would like a critical eye to review your existing plan, reach out to us: we've got community banking's back. To contact me, give me a call at 330.422.3476 or send an email to bviering@younginc.com. ❑

Private Flood Insurance Update

By: Bill Elliott, CRCM, Senior Consultant and Manager of Compliance

As you are no doubt aware, the issue of flood insurance has been unsettled for the last 18 months, and the formal FEMA flood program is only approved until the fall. But, after a long wait, the regulators have published additional regulation for private flood insurance – which does not rely on Congress to do anything, and makes the presence or absence of the FEMA program less problematic for lenders.

Background

The Biggert-Waters Act (2012) amended federal flood insurance legislation to require the agencies to issue a rule directing regulated lending institutions to accept "private flood insurance," as defined by the act. In response to subsequent legislation and comments received regarding the private flood insurance provisions of the first proposed rule (2013), and the second proposed rule (November 2016), all prudential regulatory agencies finally issued the rule, effective July 1, 2019.

It remains to be seen how effective and efficient this will be, as it is a "work in process." But some have told me that some of their customers have found lower flood insurance rates privately (meaning these policies may become more popular). Others have told me that they have had customers declined for private flood insurance based on the riskiness of the property location.

Summary of the Rule

The rule requires regulated lending institutions to accept "private flood insurance" defined in accordance with the Biggert-Waters Act. There are essentially three categories of private flood insurance.

Category One – Private Flood Insurance with "Compliance Aid" Language

If the following language appears on the flood policy, the lender may accept the policy without any further review:

> "This policy meets the definition of private flood insurance contained in 42 U.S.C. 4012a(b)(7) and the corresponding regulation."

Although it remains to be seen how well this will work, we hope that most insurance companies will include this language, which will make it quite easy for lenders, as no additional effort will be required.

Category Two – Private Flood Insurance without "Compliance Aid" Language

The rule permits regulated lending institutions to exercise discretion to accept flood insurance policies issued by private insurers that do not meet the statutory and regulatory definition of private flood insurance. The conditions for acceptance include a requirement that the policy must provide sufficient protection of a designated loan, consistent with general safety and soundness principles, and the regulated lending institution must document its conclusion regarding sufficiency of the protection of the loan in writing.

The difficulty for lenders will be to determine whether these policies really meet these (and other) requirements. And although the regulation says "discretionary," it does not appear that the regulators will just allow lenders to summarily reject these policies.

Category Three - Mutual Aid Societies

The agencies will now allow the acceptance of plans providing flood coverage issued by mutual aid societies. The rule defines "mutual aid society" as an organization:

(1) whose members share a common religious, charitable, educational, or fraternal bond;

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(2) that covers losses caused by damage to members' property pursuant to an agreement, including damage caused by flooding, in accordance with this common bond; and

(3) that has a demonstrated history of fulfilling the terms of agreements to cover losses to members' property caused by flooding.

A regulated lending institution may accept a plan issued by a mutual aid society, as defined above, if the regulated lending institution's primary federal supervisory agency has determined that such plans qualify as flood insurance for purposes of the act.

Requirement to Purchase Flood Insurance

There is nothing in the rule that changes the amounts of insurance required, or anything else. This simply allows more options and hopefully, over time, will make everyone's life – lenders and borrowers – easier.

If you need any assistance in this area, especially private flood policies without the "compliance aid" language, please give us a call at 330.422.3450 or send an email to bille@younginc.com. We are always happy to help. ❑

Capital Market Commentary

By: Stephen Clinton, President, Capital Market Securities, Inc.

July Market Update

"The current expansion has continued, uninterrupted . . . While the annual economic growth has not been remarkable, it has been stable."

July marks the beginning of the 11th year of the U.S. economic recovery that began in June 2009. Back then was the end of the Great Recession that followed the 2007-2008 global financial crisis. The current expansion has continued, uninterrupted, ever since. While the annual economic growth has not been remarkable, it has been stable. GDP growth has been around 2% for each of the years of the recovery. However, the recovery has led to a near 50-year low unemployment rate of 3.7% while holding inflation below 2%. Highlights on the economic front include:

- On July 31, the Fed lowered its short-term benchmark interest rate by a quarter of a percentage point, the first rate cut since 2008. Previously, the Fed had conducted several rounds of raising rates as it expected inflation to surface due to the "full employment" conditions. Surprisingly, inflation has remained in check and concerns about the global outlook clouded by trade policy uncertainties allowed the Fed to concede that interest rates were too high.
- The June quarter, for the second quarter in a row, saw industrial production decline at an annual rate of 1.2%. Capacity utilization for the industrial sector decreased 0.2 percentage point in June to 77.9%, a rate that is 1.9 percentage points below its long-run (1972–2018) average.
- The trend in wage growth has slowed from late last year when wages were rising at their fastest rate in a decade. Average hourly earnings in June rose six cents, or 0.2 %. That kept the annual increase in wages at 3.1% for a second straight month.
- Strong consumer spending in the second quarter helped bring the GNP growth to 2.1% in the second quarter. The growth in personal consumption expenditures were reported at 4.3%, compared to 1.1% in the first quarter.
- Home price increases are cooling off after recording strong growth since the recovery began. The Case-Shiller National Home Price Index rose an annual 3.4% in May.
- Big fluctuations in oil prices have occurred in 2019. First, prices surged 48.2% by April 25, due in part to rising tensions between America and Iran. Then prices plunged 20%, with headlines blaming slower global oil demand growth and weak manufacturing data.
- The federal deficit is expected to top $1 trillion for the second year in a row. The principal factors leading to the deficits are the 2017 tax cuts while the federal budget exceeded the spending caps enacted by Congress in 2011 by $300 billion.

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- American farmers are hurting. Unusually heavy spring rains have delayed or completely prevented planting across many areas of the Midwest while trade disputes drag down agricultural exports and crop prices. The pain is spreading from farmers to businesses related to farming.
- The stock market has been strong in 2019. The Dow increased 15.16% in the first seven months while the broader Nasdaq market increased 23.21%. Banks followed the upward trend, rising 15.06% as measured by the Nasdaq Bank Index. Banks are reporting strong financial results. Based upon the March FDIC Quarterly Banking Profile, banks increased their net interest income by 6% from the prior year leading to an improvement of profitability by 8.7%. Noncurrent loans are below 1% while banks increased their reserves for future loan losses. Capital ratios continue to climb. The Fed recently announced the results of its annual capital stress tests (CCAR) for large banks and reported no objections to any of their capital plans. This will allow for increased dividends and continued stock buyback activity for these banks.
- Short-term interest rates have declined in 2019 with the 3-month T-Bill moving down from 2.45% at the end of 2018 to 2.08% at the end of July. The 10-year T-Note also declined from 2.69% to 2.02%. The yield curve is partially inverted, with the 3 and 5-year T-Notes trading below 2%.

Merger and Acquisition Activity

As of the end of July, bank and thrift merger activity was down approximately 10% from last year at the same time. The median price to tangible book for transactions involving bank sellers was 168%.

Capital Market Services

Capital Market Securities, Inc., has assisted clients in a variety of capital market transactions. For more information on our capital market services, please contact Stephen Clinton at 1.800.376.8662 or sclinton@younginc.com. ❑

Improving the Interview of Job Applicants

By: Mike Lehr, Human Resources Consultant

Never have businesses had to do so much recruiting. Never have they spent so much money on it. Yet, they have never been worse at it. The interviewing of applicants highlights this demise.

Imagine going to a team meeting. It has no agenda. It has no planning. It has no pre-work. People just "wing it." That's today's job interviews. More puzzling, these "meetings" play a key role in the buying of a $20,000 to $200,000 asset annually. In contrast, how much thought and planning went into the last technology purchase for only a one-time cost of $15,000?

Research shows these interviews are a waste. It shows that most times the winner is the applicant most like the interviewers, not the most talented, skilled, or experienced. Yes, some argue that this determines cultural fit. What is that culture though? What is fit? Ask a dozen senior employees. It's highly likely the responses will lead one to conclude that a unifying culture does not exist.

How to Improve Interviews

To improve interviews, they require more thought, planning, and analysis. That includes asking applicants the same set of questions. Ugh! Most likely, if you're like I am, my eyes rolled when I first heard this. Much of my thinking had to do with feedback from interviewees. They described straight-jacket interviews where interviewees couldn't ask or say anything but what was on their prep sheet. Moreover, the questions appeared very similar from one interview to another in the same company.

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It's only later after digging into the original design of this approach that I found that it was structured interviews gone awry. It's not how we should apply them.

How Structured Interviews Work

Here's how it should work. First, think about the job and the skills it needs. Don't make a laundry list. Start out with the half-dozen key ones. Then, come up with scenarios that can actually happen in your bank in which the applicant will need those skills. Now, devise "what if" questions around them that would require the use of those skills.

Examples of Questions in Structured Interviews

For example, take the job of branch manager. Take the skill of customer service. Let's say the scenario is a very upset customer at the platform over fees charged to her account. She is getting loud and stressing the teller or customer service rep. The question now becomes, "How would you handle this?"

As another example, take a customer service rep or teller. The aptitude you want is conscientiousness or integrity. The scenario here could easily be that he/she is out with coworkers in a public place. One of the coworkers starts talking about a customer. Yet, it doesn't seem he/she is talking loud enough for anyone outside the group to hear. The question could become then, "What would you do if this happened?"

The Grading of Answers to Interview Questions

Once you have these questions, come up with your own answers and grade them. This is key because you've thought about the answers before any bias could set in. As the research shows, if we like the person, we are more apt to look at a response favorably even if it's one we were lukewarm about beforehand.

Now, this doesn't mean that answers falling outside of those are wrong. It just means you've established a guide for determining good answers. After all, if you're looking for creative problem solving skills, answers that aren't like yours are important.

Practically Applying Structured Interviews

As I described in my early experiences with this, it's easy to go over the edge. The entire interviewing team doesn't have to ask the same questions. In fact, it's better if they don't. You can decide who might be best at asking a question. The circumstances, scenario, and importance of that question to the interviewer will often make the decision for us.

This also doesn't mean that interviewers can't ask other questions. Some might work to make the interview more conversational as in the case of exchanging pleasantries. In this case though, the answers don't matter or they count less. After all, if the question was that important, we should have thought of it before any interviews began.

Better Interviews Yield Better Employees

According to Bureau of Labor statistics, 95% of hiring activity aims at filling existing positions. Turnover is at record highs. While many factors contribute to this, such as more employers preferring to hire from outside rather than to promote from within, some are myths, such as increased mobility. According to the same statistics, people are just as likely to move out of state for a better job as they were in the late 1960's.

So, we can't use outside factors as excuses. Hiring outside candidates is risky. The data shows promoting from within is better, less costly, and yields better outcomes. Therefore, to remove the risk of hiring outside applicants, improving the interview is low-hanging fruit to lowering drastically that risk.

Yet, even with this it's easy to bypass the interviews and not take them seriously. Just think of the outside candidate that the president or other employees know. Think of employee referrals. It's a myth that they automatically produce better employees. Research doesn't support it. They, too, need to go through the same rigorous interviewing process as lesser known applicants.

In the end, there's an easy way to determine if your interviewing process is in good shape. Ask this question: Does it have the same or better planning, analysis, and research that went into the bank's last major technology outlay?

For more insights and guidance on how to improve interviewing of job applicants, including advice on questions, you can reach Mike Lehr at mlehr@younginc.com. ❑

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Capital Planning System – Updated May 2019

Assess capital adequacy in relation to your bank's overall risk and develop a customized capital plan for maintaining appropriate capital levels in all economic environments.

The latest update addresses the proposed Community Bank Leverage Ratio (CBLR) framework, as well as the impact that the anticipated implementation of the Current Expected Credit Loss (CECL) approach may have on the bank's capital levels.

Allows you to:

Develop a base case scenario in which minimum capital adequacy standards are established.

Identify and evaluate risk for your bank. Parameters in this analysis have been field-tested in our work with banks over the years and closely resemble adequacy standards established in consent orders.

Stress test capital by loan classification (as recommended by the FDIC and OCC).

Perform contingency planning for stressed events. All assumptions are stressed to determine the amount of capital needed and possibilities for increasing capital are examined.

Generate your capital plan in as little as 1 day. Data from the Microsoft® Excel spreadsheets can be easily transferred directly into a Word document that can be customized to fit the unique circumstances at your bank.

First Year License Fee (#304) – $1,095

Update/Annual License (#306) – $495

System Requirements: Microsoft® Excel 2007 or higher

Customizable Bank Policies

Young & Associates, Inc. has developed over 95 practical bank policies designed specifically for community banks that will ease the burden of developing bank policies from scratch.

- **Flood Insurance (#123) – $225**
- **Bank Secrecy and Anti-Money Laundering (#109) – $350**
- **ADA Website Accessibility Accommodations (#327) – $125**
- **Cybersecurity (#313) – $195**
- **Identity Theft (#224) – $250**
- **Complete List of Available Policies** – over 95 management, lending, and compliance topics

Liquidity Toolkit (#273) – $1,250

Includes:

- **Liquidity Cash Flow Planning Model (#271):** Forecast funding sources, funding needs, and cash flow gaps. Monitor availability of contingent liquidity. Monitor funding concentrations and dynamic cash flow ratios. Perform liquidity stress testing and multiple-scenario what-if analyses. (*regularly $950*)
- **Liquidity Contingency Funding Plan (#272):** Delineates strategies and actions addressing potential liquidity shortfalls in emergency situations. Includes identification of stress events, stress levels, early warning indicators, parameters for liquidity stress testing, sources of funds and funding strategies, lines of responsibility and communication, as well as a detailed crisis action plan. (*regularly $275*)
- **Liquidity Management Policy (#096):** Customizable policy designed to ensure that the bank is managed to provide an adequate level of liquidity to meet both predicted and unexpected cash needs while maintaining a planned net interest margin. (*regularly $225*)

System Requirements: Microsoft® Word 2007 and Excel 2007 or higher

Save $200 when you purchase the Liquidity Toolkit.

Threat Intelligence Program (#324) – $299

Documents the requirements for the institution's threat intelligence program, including: threat intelligence sources, the monitoring process, the analysis and response process, documentation requirements, and the reporting process.

- **Threat Tracking Summary Worksheet:** Microsoft® Excel-based workbook for tracking threat notifications and responses
- **Threat Tracking Detail Worksheet:** Microsoft Word-based worksheet for tracking details about the threat analysis and response process performed for each specific threat
- **Information Systems Event Management Policy:** Policy template that documents the requirements for information systems event management procedures
- **Event Management Procedures for Specific Systems Worksheet:** Excel-based workbook for documenting the event management procedures for each information system

System Requirements: Microsoft® Excel 2007 and Word 2007 or higher