90 Day Note

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A Young & Associates, Inc. Publication

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Young & Associates, Inc. Changes Ownership on 1/31/18

We are pleased to announce that Young & Associates, Inc. has been sold by Gary J. Young, the company's founder, to Jerry Sutherin, a Senior Consultant with the firm, effective January 31, 2018. While ownership has changed, the company's name, mission, personnel, quality of services, and structure will not change in any way.

Upon the effective date of the sale, Mr. Young became Chairman of the Board, and Mr. Sutherin became President and CEO. Young will remain actively involved with the firm for one year, continuing to provide the same high quality service he has provided for the past 40 years. Mr. Young said, "I founded Young & Associates with a goal of assisting community banks while maintaining a family atmosphere that valued and respected all of the people that I work with. After 39+ years, I have accomplished that goal, and that mission will continue through Jerry's leadership."

Tommy Troyer, Executive Vice President, will continue to serve in that position, where he successfully uses his professional expertise, detail-oriented management style, and excellent people skills while working with both clients and employees.

Mr. Sutherin has worked at Young & Associates, Inc. for nearly four years. Mr. Sutherin said, "I look forward to making a seamless transition at Young & Associates, building upon the solid foundation that Gary has built over the past 40 years. It is my goal that our clients and employees will continue to receive the same professional, high-quality experience that they have come to expect here over the years."

With over 30 years in the financial services industry, Sutherin has worked primarily in the company's Lending and Loan Review Division where he provided community banks throughout the U.S. with third-party loan review, lending policies and procedures, loan portfolio due diligence, and ALLL Review services. Prior to joining Young & Associates, Inc., Sutherin worked in varying capacities ranging from overseeing an Asset Quality/Loan Review function at a large regional bank, to managing a $2.5 billion loan portfolio responsible for loan performance, credit quality, and departmental efficiency.

Young & Associates, Inc. has provided practical products and services to community financial institutions since 1978, and we look forward to serving our clients for many years to come. Please join us in congratulating both Jerry and Gary on this sale. ❑

A Current Perspective on Concentrations of Credit

By: Tommy Troyer, Executive Vice President

Concentrations of credit are certainly not a new risk for community banks, but for many banks they are an increasing challenge. While effective concentration risk management involves much more than we have room to discuss here, we would like to use this article to highlight a few timely considerations related to concentration risk management.

Growing Concentrations

We all know that, though we can calculate statistical averages for various

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measures across community banks, there is no “average community bank” in the real world. Each bank has its own unique combination of characteristics. However, concentrations of certain types of credit do seem to be increasing across community banks as average loan-to-asset ratios have been increasing and banks are, for the most part, still trying to stick to in-market lending and to loan types with which they have experience.

Continued regulatory emphasis on prudent concentration risk management practices, especially related to CRE, has been one result of these trends. One of the ways some banks have experienced this attention is to have examiners note a greater interest in measures of total CRE exposure, including owner occupied loans, as opposed to the more traditional measures of non-owner occupied concentrations described in the well-known 2006 interagency guidance on CRE concentrations. (This emphasis has been driven in part by the growing realization that the industry’s loss history on these two types of CRE loans has not been that different over the last decade.)

As a simple example of the growth in credit concentrations for community banks, I collected some data on commercial banks and savings banks in four Midwestern states (Ohio, Michigan, Indiana, and Illinois) with less than $2 billion in total assets. While we work with community banks nationwide and with some banks larger than this threshold, I thought this would be a sample of banks of interest to many of the readers of this newsletter. Of these banks, 700 met these criteria as of 2017Q3. I compared selected concentration levels for these banks to their levels five years earlier, as of 2012Q3.

- The number of banks with construction and land development loans totaling 100% or more of total capital doubled, though it certainly remains low at just 2% of the sample.
- The number of banks with non-owner occupied loans totaling 300% or more of total capital increased from 29 to 42.
- The number of banks with total CRE loans totaling 400% or more of total capital increased from 50 to 66.

None of the figures above total even 10% of the banks in the sample, but I have also chosen to test quite significant concentration levels. Our consulting work indicates that many more banks, which have chosen to set their internal concentration limits at more conservative levels than described above, are experiencing challenges as they near internal limits. This applies for both broad categories of concentrations, such as non-owner occupied CRE, and for more narrowly defined categories, such as hotels.

“...concentration risk must be factored into capital planning and must be appropriately evaluated as a qualitative factor impacting the ALLL.”

In some other cases, concentrations that banks have always understood were necessary given the community they serve have become more concerning. For example, many community banks operate in markets where agriculture is a dominant industry. Such banks have always accepted the risk associated with heightened ag concentrations, but continued challenging ag conditions have made such concentrations more of a concern in recent years.

Risk Management Considerations

The fundamentals of effective management of concentration risk are well-known, and can be found in a variety of regulatory sources. I will not rehash all of them here, though I do feel obliged to emphasize that concentration risk must be factored into capital planning and must be appropriately evaluated as a qualitative factor impacting the ALLL. I would also like to highlight a couple of trends in concentration risk management we have noted recently:

- **Incorporating concentration considerations into strategic planning.** Yes, detailed analysis of concentration risk and recommendations for concentration limits will likely be provided to the board by management. However, such limits should reflect the board’s risk appetite and desired strategic direction for the bank. It has been encouraging to me to hear in several recent strategic planning retreats thoughtful, forward-looking discussion about what the bank should look like in the future and what that means for the bank’s approach to credit concentrations.

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- **Incorporating a proactive approach to monitoring and managing relationship levels.** We have seen an increasing number of clients take what can be described as a more proactive and sophisticated approach to monitoring and actively managing concentration levels. Instead of testing concentration levels quarterly and simply "turning off the spigot" when a limit has been reached, these banks incorporate a proposed loan's impact on their concentration profile into their underwriting analysis. They also use their pipeline and runoff projections to forecast their various concentration levels in coming quarters, and then manage prospective and existing borrowers to maximize the quality and profitability of a given portfolio. This can help prevent, for example, a couple of marginally profitable and purely transactional deals that may be easy to "win" from crowding out prospective deals that can lead to profitable long-term banking relationships.
- **Utilizing portfolio stress testing.** Portfolio stress testing has long been a tool for evaluating concentration risk, but more community banks seem to be making efforts to implement forms of portfolio stress testing than ever before.
- **Utilizing collateral valuation and collateral management.** One important way of ensuring that downturns in an industry in which a bank has a concentration do not cause excessive losses is to have in place effective practices for both managing the initial valuation and assessment of the collateral (especially for real estate collateral) and for monitoring collateral on an ongoing basis. The ongoing monitoring of the status and value of collateral can be especially important for banks with ag concentrations. While we see plenty of good work done by banks in both of these areas, we would also note that these seem to be some of the most common areas about which we, and also often examiners, provide recommendations for improvements in practices.

Conclusion

Effectively managing concentrations of credit will remain important for as long as lending remains a primary source of income for banks (in other words, forever). Young & Associates, Inc. has assisted clients by providing portfolio stress testing services (both CRE and ag), loan reviews, and more targeted consulting focused on enhancing collateral valuation processes or credit policies. We also assist clients by facilitating strategic planning sessions that encourage the board and management to think about and plan for the future of the bank. This can result in a bank better defining its lending strategy and ensuring its lending approach is consistent with its overall strategy. To discuss this article or any of our services further, please contact Tommy Troyer at ttroyer@younginc.com or 330.422.3475. ❑

"Effectively managing concentrations of credit will remain important for as long as lending remains a primary source of income for banks (in other words, forever)."

Community Bank IT Staffing – Doing More with Less

By: Mike Detrow, Senior Consultant and Manager of IT

Over the past two years, we have seen a significant increase in the number of community bank IT managers that have voiced substantial concerns about the ability of their bank's current staff to properly secure their information systems and maintain regulatory compliance. These concerns are the result of IT managers trying to meet the requirements of new regulatory guidance related to information security and working to prevent potential damage from evolving cyber threats without supplemental staffing or other resources.

Some of the potential risks for a community bank with insufficient resources to properly maintain and secure its information systems include:

- A data breach resulting from inadequate configuration management or security monitoring
- A system outage, disruption, or data loss due to inadequate maintenance or system monitoring
- The resignation of an overwhelmed IT manager, leaving an unusable IT infrastructure for a bank with an insufficient succession plan

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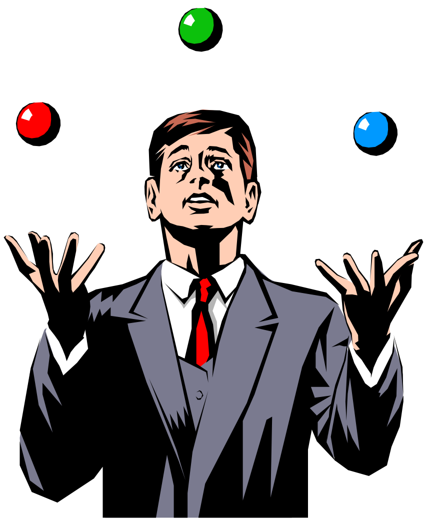
- Regulatory compliance issues due to repeat audit and examination findings

In many cases, it will be difficult for a community bank to add internal staff to address these risks, especially those that are located in rural areas. However, there are a number of cost-effective ways for a community bank to make its current IT staff more efficient and its information systems more secure through the use of automation and by adding additional expertise through education and/or the use of service providers.



1. **Education**. Providing opportunities for the bank's IT staff to attend training classes or to participate in peer discussions during industry conferences or forums will help them to learn best practices and gain other valuable insights that will increase their efficiency and improve security practices. Many state banking associations host annual technology conferences that can be an invaluable resource for the IT staff of a community bank, especially those that do not have a formal IT background.

2. **Automation**. Tools to automate labor-intensive tasks such as patch management, capacity and performance monitoring, and event management can be implemented. Many manual tasks can be automated by implementing a remote monitoring and management (RMM) solution. By installing a management agent on each of the bank's workstations and servers, the bank's IT staff can manage all of the servers and workstations through a single dashboard. Some of the features of an RMM solution include: patch management, antivirus management, event monitoring, software installation monitoring, automated tasks, email alerts, and remote access. An RMM solution also assists with proactive monitoring to identify issues before they cause downtime.

3. **Engage a Consultant**. Engaging a consultant to assist with policy updates and other compliance tasks can provide valuable insight and eliminate hours of research time spent by the bank's staff. An experienced consultant will be familiar with regulatory requirements and he/she will have valuable insight, sample templates, and policy language to share.

4. **Outsource Network Management**. Outsourcing the management and monitoring of the bank's in-house servers, workstations, and other network devices to a managed services provider (MSP) can free up a significant amount of time for the internal IT staff and also offers additional expertise for complex systems such as virtual servers. In addition, having a team of professionals from the MSP supporting the bank mitigates the risks associated with relying on a single bank employee to maintain the entire IT infrastructure. There are even service providers that can move all of the bank's critical information systems to their secure datacenter, which can significantly enhance the ability for a bank to recover from and function during a disaster.

5. **Outsource Firewall Monitoring**. While we still see some banks utilizing internal staff or their MSP to monitor their firewall, most lack the expertise and 24x7x365 availability to properly monitor this critical system. Early detection and eradication of a threat can drastically reduce the potential damage caused to the bank's information systems and its reputation. A managed security services provider (MSSP) maintains the appropriate expertise and staffing levels within its security operations center to quickly identify a threat and follow agreed upon response procedures.

6. **Outsource Vendor Management**. Gathering all of the required documents from each of the bank's service providers and properly reviewing all of this documentation can require a significant amount of time and expertise. There are a number of service providers that can perform the majority of this work on the bank's behalf and provide a summary of their findings for management's review.

Just like moving from in-house to outsourced core processing, utilizing service providers to assist with the management of the bank's IT infrastructure and compliance needs can provide additional expertise and allow the bank to operate efficiently and securely with limited internal resources. As with any outsourced relationship, it is critical for management to perform appropriate due diligence for any service providers that the bank may consider for the services listed above. During the due diligence process, it is very important to ensure that the service

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provider has experience working with financial institutions and understands the regulatory requirements that must be met.

With cyber risks remaining a significant concern for community banks for the foreseeable future, failing to address staffing limitations now will only compound these risks in the future. If you have any questions about this article or you would like to discuss the ways that Young & Associates, Inc. can assist your bank through a consulting relationship, please contact Mike Detrow at mdetrow@younginc.com or 330.422.3447. ❑

Capital Market Commentary

2018 Forecast and 2017 in Review

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

The stock market continued its climb to new heights in 2017. The stock market was propelled by the election of President Trump, which brought the expectation of lower taxes, less regulation, and an administration favorable to businesses. The Dow ended 2017 at 24,719.22, an increase of 25.08% for the year. The S&P 500 also improved nicely, ending up 19.42%. The market, despite a correction in early February, has increased further from 2017's year-end values.

The Fed continued its plan to move short-term interest rates higher in 2017. The Fed moved short-term rates up 25 b.p. in March, June, and December. The three-month T-Bill ended December at 1.39%, an increase of 88 b.p. from year-end 2016. Longer-term interest rates were little changed from year-end 2016, resulting in a flatter yield curve.

Job creation continued in 2017, and the unemployment rate in December was 4.1%. The unemployment rate is at a level not seen in 17 years. The low unemployment rate would typically lead to rising wages, but wage growth was only around 2% in 2017.

As we enter 2018, there are a number of items worth monitoring:

Economic Growth. U.S. economic growth for 2017 came in at 2.5%, comparable to prior years. The slow but steady expansion that began in mid-2009 ranks as the third longest economic expansion in U.S. history. Should the recovery continue into the second half of 2019, it would become the longest recovery on record, surpassing the 1990's economic boom.

Housing. Home prices continued to rise in 2017. The S&P/Case-Shiller National Home Price Index rose 6.2% in the 12 months ending in November. The rising price for homes has exceeded inflation and wage growth for several years. The limited housing inventory has aided the rise in prices along with historically low mortgage rates. U.S. single-family homebuilding surged to more than 10-year highs in November. Existing home sales were up 5.6% in December, while new home sales increased 17.5%.

Industrial Production. U.S. manufacturing activity remains strong. The Institute for Supply Management said its purchasing managers index rose to 59.7 in December, the second highest level since early 2011. A reading over 50 indicates expansion in the sector; below 50 suggests contraction. Boeing recently announced deliveries of 763 aircraft in 2017, a record for the company. Auto sales were down 1.8% in 2017, but with sales of 17.2 million vehicles, it marked the first time the industry has surpassed 17 million for three consecutive years.

Consumers. Consumer confidence is positive. The University of Michigan's consumer sentiment index average level for 2017 was the highest since 2000. A sign of the strong consumer sentiment is reflected in consumer debt. In the fourth quarter, consumer debt, excluding mortgages and other home loans, rose 5.5% from a year earlier. That is the highest amount since the Federal Reserve Bank of New York began tracking the data in 1999. Moreover, consumers' non-housing debts accounted for just over 29% of their overall debt load, also the highest amount on record.

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Inflation. The Fed's preferred measure of inflation in January was 2.1%, moving above the Fed's target of 2% for the first time in a while. The anticipated 3% growth of the economy along with the tight labor market and rising interest rates is expected to finally push inflation upward.

Political Risks. There are a number of geo-political risks that could significantly change the outlook for 2018. Among these are the ongoing Brexit process, North Korea nuclear saber rattling, and President Trump's plans to renegotiate NAFTA. Furthermore, the dysfunction in Washington creates uncertainty.

Predictions for 2018

Lending Activity. We anticipate an increase in lending activity. We think the lower tax rate for businesses will encourage businesses to expand their operations.

Interest Rates. The Fed has indicated that three rate increases are probable in 2018. We think that we will get those increases.

Home Prices. We expect the growth rate in home prices to be lower than in the past several years. We think higher interest rates will come into play and make housing less affordable. We also think that the less favorable tax status of the deductibility of mortgage interest will have an impact on some home buyers.

Inflation. We do see inflation moving up in 2018. As mentioned above, we expect wage increases to heighten. The low unemployment rate and the shortage of skilled labor in many markets will put pressure on employers to increase wages to attract and retain workers. We also think the growing economy will impact commodity prices.

Jobs. We envision unemployment to remain low as businesses expand.

Regulation. We expect bankers to be disappointed about the lack of regulatory relief in 2018. It will be difficult for regulatory relief to filter down the bank regulatory bureaucracy.

Merger and Acquisition Activity

Merger activity in 2017 was slightly higher than the activity in 2016. In 2017, there were 267 announced mergers of banks and thrifts compared to 244 deals in 2016. In terms of deal size, the total assets of sellers totaled $147 billion in 2017, compared to $188 billion in 2016 and $459 billion in 2015. Pricing on 2017 bank sales improved significantly from 2016's pricing, recording a median price to book multiple of 162% and a price to earnings multiple of 20.9 times. We believe that 2018 will see increased merger activity spurred, in part, by bank buyers' enhanced profitability from reduced corporate taxes.

Compliance Outlook: 2018

By: Bill Elliott, CRCM, Manager of Compliance Services

For those of us who are news junkies, the current environment is interesting. Unfortunately, the environment is also so toxic that it is difficult to determine what actually may or may not happen during 2018.

We do know that some items that are being considered. For instance, bills are pending regarding issues like HMDA, flood, qualified mortgages, and call reports for smaller institutions. It remains to be seen whether any of these bills (or any of

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the other bills pending) actually will become law, or whether Congress will continue the infighting that has resulted in a haphazard and uncertain regulatory and law environment.

Home Mortgage Disclosure Act (HMDA)

Based on the questions we have received at Young and Associates, Inc., it would appear that that the 2018 HMDA implementation (so far) is going fairly well. However, we have received numerous questions regarding issues that were not addressed directly in the "HMDA Instructions." This is not new or surprising, as not every situation can be covered in a rule as massive as HMDA.

For HMDA, as with every other new/updated regulation, preparation was the key. The regulatory world is getting so complicated that it is necessary for banks to really consider all processes and procedures to avoid either duplication of work or unnecessary work.

Customer Due Diligence

Speaking of duplication and unnecessary work, one of the items that must be addressed quickly is the new Customer Due Diligence rule under the Bank Secrecy Act, **effective May 11, 2018**. While many regulations can be handled by only one division of the bank, this regulation will impact almost everyone, as it requires updates regarding the ownership of a business every time a new account is opened. Accounts can be loans, deposits, safe deposit boxes, or any other kind of account that you may offer. It will require the customer to inform you of all individuals who own at least 25% of the business, as well as indicating a control person for the business.

For new loans, this will most likely be an inconvenience, although driver's licenses and/or other methods of identification will be required every time a new commercial loan to a business with at least one 25% or more owner (LLC, partnership, corporation, etc.) is opened.

For deposits or other account types, this may mean what is now a 30-minute procedure to open a new account will become a multi-day ordeal, as the person opening the account may well not be the only owner, and certainly will not have identification information for all 25% owners and control persons with them (including identification). The only saving grace is that every financial institution will have to deal with this issue, so there will be no competitive advantage or disadvantage. With a May time limit, if your institution has not started the implementation process, time is running short.

"With a May time limit, if your institution has not started the implementation process, time is running short."

Consumer Protection

As you well know, there has been a change in the administration of the Consumer Financial Protection Bureau (CFPB). With Mr. Cordray's recent exit from the agency, it is likely that's the CFPB will consider new approaches to the issue of consumer protection. To this end, the CFPB has announced steps to request information from the public and review how things are done, how they actually impact or help the consumer, and how they impact and create costs for the industry.

Some of the requests will be more useful than others. The first request to be issued by the CFPB will seek public comment on Civil Investigative Demands (CIDs), which are issued during an enforcement investigation. Comments received in response to this RFI and all others that follow will help the Bureau evaluate the existing framework and determine whether any changes are warranted. Make sure you are part of the process by commenting or otherwise making your voice heard.

Conclusion

If we can offer you training, implementation assistance, or any other compliance related service, please contact Karen Clower, Compliance Operations Manager, at kclower@younginc.com or 330.422.3444. ❑

Capital Planning System

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. **Addresses the impact of growing cybersecurity risks, as well as the impact of the anticipated tax reduction from a capital planning perspective.**

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

Threat Intelligence Program (#324) – $299

Includes:

- **Threat Intelligence Program:** 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® Word 2007 and Excel 2007 or higher

HMDA Survival Toolkit (#294) – $595

Ensure that your bank's HMDA data is acccurate prior to submission and that bank policies and procedures comply witht the January 2018 requirements.

Includes:

- **2018 HMDA Survival Guide:** A consolidation of the 2015 Final Rule, 2017 amendments, and the Official Commentary
- **Customizable HMDA Policy:** Updated to incorporate the new requirements effective January 1, 2018
- **HMDA PowerPoint Presentation:** Designed to train staff on the new HMDA requirements – customize to fit your bank's HMDA process
- **Data Integrity:** Includes the banking agencies' transaction testing guidelines and designated key data fields
- **Compliance Review Model:** Excel spreadsheet designed to facilitate a review of your compliance with the new HMDA requirements
- **Sample HMDA Review Report Template:** Document your compliance review with this report template – edit to include the review scope, relevant findings, and recommendations regarding data integrity, as well as disclosure and notice requirements
- **Reference Guide:** Provides links to CFPB's resources for HMDA filers and other agency information

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

Customizable Bank Policies

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

- **Bank Secrecy and Anti-Money Laundering Policy (#109) - $350**
- **Customer Identification Program Policy (#217) - $195**
- **ADA Website Accessibility Accommodations (#327) - $125**
- **Cybersecurity (#313) – $195**
- **Indentity Theft (#224) – $250**
- **Complete List of Available Policies –** management, lending, and compliance topics