CBI
COMMUNITY BANKERS OF IOWA

December 2010

# BANKER UPDATE

"Banking that is building Iowa"

# Merry Christmas

*from*

CBI
COMMUNITY BANKERS OF IOWA
"Banking that is building Iowa"

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## All Aboard: Muni Investment Options May Leave the Station

There are few tangible benefits which community bankers have realized from the financial services meltdown in the past three years. One of them is the vast improvement in investment options for municipal securities, primarily as the result of (at the time) little-noticed segments of the main stimulus bill, the ARRA. As of this writing, all of those provisions are scheduled to disappear over the horizon at the end of 2010.

It is correct that high-performing portfolios have consistently had a significant portion of their investments allocated to municipal securities. Our bond accounting customer population, which is currently around 550 banks, shows that the top quartile by yield has around 32 percent of its bonds in munis, compared to about 7 percent for the bottom quartile.

This does not mean that all of these options are destined for the boneyard, though I would also opine that it is unlikely all will survive into 2011 and beyond. Still, the yield, diversification, and strategic benefits they provide deserve another recitation.

**Two Percent Rule**

Buried in the minutiae of the ARRA is a provision that allows a bank to purchase up to two percent of its assets in general market munis, and still receive favorable TEFRA treatment. In essence, the investor gets to treat the "2% bond" as if it were bank-qualified. The requirements are that the issues are dated 2009 or 2010, and that they are "new money." This means that the issuance cannot be for refinancing outstanding debt.

This creates other potential positives, including picking up CRA credits. Most CRA-qualifying bonds are in the form of general market issues, mainly due to the size restraints. So there are several benefits that could be derived from careful picking and choosing. This obviously requires your broker to be on top of the details, so be sure to get fully satisfied that all the facts are hammered out before agreeing to purchase a 2% bond.

**AMT-Free**

For banks that are at or near the Alternative Minimum Tax (AMT) threshold, we advise consideration of 2009 and 2010 issues, either bank-qualified or general market. These issues will be AMT-free for the life of the bonds even if the provision sunsets at the end of the year, according to current law. A restriction for AMT-free treatment is that the proceeds must be either for new money, or to refinance outstanding debt that was originally issued after December 31, 2003.

Be careful about the AMT-free bonds that you are considering, and put the onus on your broker to document a given offering's qualifications. I should also be on record as saying your tax accountant needs to be involved in this process to quantify the AMT exposure. And, in future years there may be a boost to the market value of these 2009-10 issues if there are no more being printed – a simple case of demand outstripping supply.

**BABs**

A very visible aspect of the ARRA is the creation of the Build America Bond program. These are taxable munis, not guaranteed by Uncle Sam, but whose cost is partly subsidized by him. Investors pay taxes on the yield received, and the issuer gets a rebate of 35 percent of the cost. So, to an issuer the cost is roughly the same as if it were tax-free debt. Over 25 percent of all munis issued in 2010 will be of the BAB variety.

Since BABs are taxable they are potentially suitable for many investors, including those that pay no federal taxes. If your bank will have little or no earnings in the near future, BABs may be a great way to invest in the muni sector. Even if your bank is fully taxable, and I hope it is, bonds are available in virtually every corner of the country, and in a wide variety of block sizes and maturities. They also are generally issued for the purpose of infrastructure, so they should not have much exposure to private activity mischief.

**Last Call**

This column just scratches the surface of the rapidly evolving municipal bond market. ICBA Securities has a research archive on its website that has a number of Strategic Insights addressing each of these issues in more depth. Other elements not discussed here include the possible reversion to $10 million for the maximum annual BQ issue size, or the prospect of the BABs subsidy shrinking to 28 percent or less.

Be sure to keep in touch with your broker about these and other elements of the muni market. ICBA's Government Relations staff is on top of the legislative matters with the Treasury Department and banking regulators as well. Let's hope these opportunities in late 2010 will enable community banks to take the muni train to more profitable destinations.

ICBA Securities can consult with you concerning a desirable mix of municipal investments. Contact your ICBA Securities sales rep or visit www.icbasecurities.com for recent Strategic Insights on municipals.

*by Jim Reber, president/ CEO of ICBA Securities. Contact him at 800-422-6442 or jreber@icbasecurities.com.*

## *Election Fever*

*Cam Fine*

As the grinding, uneven recovery from the Wall Street financial crisis continues, many Americans are still hurting, some deeply. Clearly, voters from every perspective on the political compass are piping-hot mad. The anger and anxiety most Americans feel due to the Wall Street financial crisis and bailouts and our country's prolonged economic troubles is still very raw.

Against this backdrop, Americans are poised to cast their votes in the congressional midterm elections as I wrote this month's column, and Congress and all of Washington, D. C., are bracing for yet another political sea change. Just one congressional election after voters swept out the Republican majority, now Democrats are positioned to feel the voters' wrath most.

James Madison and Alexander Hamilton would not be surprised. Welcome to the miracle, genius, and amazing resiliency of the American political system of self-governance that our Founding Fathers created. As part of its checks and balances built into the U.S. Constitution, our democracy, raucous and messy in the best of times, is geared to allow continual grassroots political change from "We the People."

Certainly these are extraordinarily volatile times. But the pendulum of American public support is always drifting, in one direction or another. Sometimes that direction reverses abruptly and swiftly. One party's majority today can turn into an outvoted minority tomorrow.

Does this continually changing landscape of governance make it difficult for ICBA to represent the nation's community banks in Washington? No! That is because ICBA operates as both a bipartisan and nonpartisan advocacy organization: We simply advocate for the best public policies for community banks and Main Street America. We will work to engage and educate any public official, regardless of his or her party affiliation.

Certainly ICBA is directly and actively involved in supporting federal candidates for public office who understand and support community banking issues. Our federal political action committee, ICBPAC, distributed more than $1.2 million in campaign contributions to more than 300 Democratic, Republican, and Independent candidates during the 2009-10 congressional election cycle. However, that does not mean ICBA will ever shy away from vigorously opposing proposals or ideas that are harmful or unfavorable to community banks. We will not. Our longstanding advocacy record demonstrates that. But ICBA will also always work to ensure that policymakers consider community bank interests, whether that is working against damaging proposals or working for beneficial ones.

Whatever judgments the American people make in this election, in any election, ICBA will adapt and move forward working alongside our members, our leadership bankers and our state and regional association partners. Let our great, crazy-quilt, and often loud and tumultuous democracy reign. Community banks will always be united and ready to move forward, come what may after the final votes are counted. *Camden R. Fine is president and CEO of ICBA. Reach him at cam.fine@icba.org.*


## Never Allow the Regulatory Exclusions to Be Removed from the Bank's Directors and Officers Policy

The regulatory exclusion removes coverage for lawsuits filed by the FDIC against bank directors after a bank has failed. The only time that bank directors are subject to lawsuits filed by the FDIC, other than civil money penalties, is after the bank has failed.

The real problem is that if you allow that regulatory exclusion to be removed from your policy and your bank has a poor year or two, like many banks had during the mid-1980s, the insurance company will cancel the coverage before the bank has time to fail. That is not to say that all insurance companies are bad and will cancel your coverage if your bank gets in trouble. The fact is that if your bank is likely to fail, it is prudent business for the insurance company to cancel your coverage because the FDIC will sue your directors upon the failure of the bank if there is insurance available. It will be difficult, if not impossible, for your bank to purchase D and O insurance from another company when your bank is in financial trouble; thus, no protection at all for your directors and officers. If the regulatory exclusion is in the policy and your bank has a bad year or two, there will be no fear of the FDIC lawsuit and the insurance company will not cancel your coverage during bad times.

You may think that no good insurance company would cancel coverage because a bank has a bad year or two. However, most contracts contemplate a fairly even exchange of values. That is, a seller thinks that the price paid is about equal to the value of the goods and the buyer expects to get goods equal to the price paid. In an insurance contract, the buyer pays a very small premium for the insurer to assume the risk to pay a very large amount of money under conditions that probably will not occur.

Directors and Officers insurance is a guarantee of being sued by the FDIC when the bank fails, and an absolutely guaranteed very large loss to the insurance company that received the very small premium. The insurance company has no choice. It must cancel your coverage when the bank gets into economic trouble.

Let us put the same situation in banking terms. If I had a net worth of $3,000,000 dollars, your bank would be happy to loan me $50,000 and renew that note without any problem. If I should lose that $3,000,000 on poor investments or lose a lawsuit so that my net worth was only $8,000, your bank would not renew the note or loan me any more money. That is just good business judgment on the part of the loan officer. That is the same as the insurance company that will not continue your insurance when your bank is likely to fail. It is in your bank's best interest to have a policy with a regulatory exclusion so that the policy is not likely to be canceled by the insurance company if you have a bad year or two.

Having the regulatory exclusion removed from the Directors and Officers policy does not mean civil money penalties imposed by regulators are covered. It is against the law for a bank to indemnify its directors and officers for fines and penalties imposed by law and it is against the law for a bank to use bank funds to pay a premium to protect the bank's directors and officers for civil money penalties imposed by bank regulators.

Please give us a call at 785-228-0000 for more information, *by Donald M. Towle, president, Kansas Bankers Surety Company*

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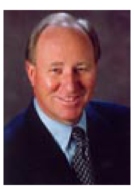
## *OPPORTUNITY KNOCKING?*



*Jim MacPhee*

If you are like me, you have a real love-hate relationship with your computer and with technology in general. I love the speed, accuracy, capabilities and access to information – and, in the case of my BlackBerry, the ability to communicate quickly and have access to data at my fingertips, day or night. Of course, we all have problems with using our core processors daily at our banks, and it can be frustrating when the technology fails to perform properly.

In either case, I cannot imagine a world without technology. Remember when all our records were on paper? We had carbon paper, account ledgers, note cards, loan cards, subsidiary books … and then came that technological wonder, the facsimile machine. Core processors brought the big debate on whether to do their functions in-house or to outsource them. We set up websites (perhaps reluctantly at first), which allowed us to send information into the world. Online banking, more refined and complex, allowed customers and the rest of the banking system to interact with us; there are many avenues for fraud but even more for efficiencies and helping customers. And mobile banking has us speculating on whether we even need a brick-and-mortar presence – and what shape it might take in the future.

My point? It is exciting to think of the advancements we are already seeing with customers accessing their accounts and making transactions by iPhone alone. No question it is only the beginning of greater access and customer service. We do not know exactly what is next, but we will need to prepare for it to offer the most convenience and service and to maintain our status with customers.

The best part is that with today's technology, all of us community bankers can compete on a par with big banks and nonbanks due to advancements available to even the smallest institutions. Keeping up means knowing our own needs, adding where possible and keeping what we have in top shape.

ICBA can be a tremendous resource in the search for qualified vendors. In many cases, our association has helped with the vetting process and – in the case of its endorsed vendors – has done much of the due diligence, saving you time and money in your search for that new core processor, ATM, or forms processor.

Today, with the help of ICBA, we have the ability to compete with the best technology at our fingertips – and the highly skilled staff at ICBA ready to point us in the right direction.

Plan now to come to San Diego next March 20-24 for the ICBA National Convention and Techworld, where you will find hundreds of vendors displaying their technolog – all geared to the particular needs of community banks, all in one place. And seize that opportunity.

*by ICBA Chairman Jim MacPhee, CEO of Kalamazoo County State Bank in Schoolcraft, Michigan*

Creighton
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# Mainstreet Economic Survey

## Rural Mainstreet Economy Improves for November:
### *Irrigated Farmland Rose 8 Percent in Last Year*

*Ernie Goss*

**November Survey Results at a Glance**:

- Rural Mainstreet index expands to highest level since May 2010
- Approximately 23 percent of bankers report irrigated farmland prices are up in their area over past year by 11 to 20 percent with average growth of almost 8 percent
- Approximately 18 percent of bankers think the blenders' tax credit for ethanol should expire at the end of the year
- Farm equipment sales rise to highest level since May 2008

For the first time since June, the overall index for the Rural Mainstreet economy moved above growth neutral 50.0, according to the November survey of bank CEOs in a 10-state region.

**Overall:** The Rural Mainstreet Index (RMI), which ranges between 0 and 100, increased to 53.3 from October's much weaker 48.4 and September's 47.6. This is the highest reading recorded since May of this year and is well above the reading for November 2009.

Creighton University economist Ernie Goss said, "The Rural Mainstreet economy is behaving like the nation with a lot of zigzags in growth. However, I expect very healthy farm income to begin to have positive but somewhat muted impacts on businesses on Rural Mainstreet. Businesses heavily dependent on the farm economy continue to do quite well though." Goss and Bill McQuillan, CEO of CNB Community Bank of Greeley, Nebraska, created the monthly economic survey in 2005.

**Farming:** The farmland price index soared for the month with the index moving above growth neutral for a tenth straight month to 68.1 from 60.0 in October. This is the highest recorded index since May 2008. The farm equipment sales index likewise bounced higher with a November reading of 68.1, up significantly from October's 61.0 and moving to its highest level since May 2008.

"While growth for businesses on Rural Mainstreet has been fragile at best, farm indicators remain very strong, including farmland prices and the sale of agricultural equipment. This month, we asked bankers how much prices for irrigated farmland had expanded in their area over the past year. Approximately 23 percent indicated that prices had grown between 11 percent and 20 percent with average growth of almost 8 percent," said Goss, the Jack A. MacAllister Chair in Regional Economics at Creighton.

**Banking:** Flush with cash, farmers have significantly reduced their borrowing. Loan volumes plummeted for a second straight month to 35.3 from October's 48.4. For the ninth straight month, the other two banking indicators stood above growth neutral. The checking deposit index improved to 76.3 from October's robust 73.0. The index for certificates of deposit and other savings instruments expanded to 55.8 from October's 54.9.

This month, bankers were asked what factors were limiting their lending. "The most frequently cited reason – with 37 percent indicating that it was the number one issue – was a lack of demand from potential borrowers. Only 13 percent indicated that bank regulator concerns was the prime factor limiting lending, while 19 percent reported that the credit quality of applicants was the chief impediment to greater lending," said Goss. Pete Haddeland, CEO of First National Bank in Mahnomen, Minnesota, said, "The regulators are overreacting to the small banks. At the same time, they are handing money out left and right to the big banks."

On the other hand, **Kurt Henstorf, president of the First National Bank in Shenandoah, Iowa**, indicated that loan ratios had declined for several reasons, but foremost among them being lack of borrower demand. "However, credit quality since 2008 has been impacted by the economy and banking regulators are very restrictive, especially with regards to commercial real estate," said Henstorf.

**Jobs:** Once again the region lost jobs with a November hiring index rising slightly to a still weak 46.8 from October's 46.0. "Many areas in the Rural Mainstreet area are still losing jobs," said Goss.

**Ethanol blenders' tax credit.** The federal blenders' tax credit of 45 cents per gallon of ethanol produced is set to expire on December 31. Bankers were asked what action Congress should take regarding the program. Only 13 percent of bankers supported extending the program permanently, while 18 percent called for the expiration of the program at the end of the year. One-third support extending the credit for three to five years, while the remaining 36 percent support extending it for one to two years.

**Confidence:** Despite a slow-growth rural economy, bankers continue to be optimistic regarding future economic prospects. The economic confidence index, which reflects expectations for the economy six months out, advanced to 63.8 from 57.3 in October. This is significantly up from the weak 46.0 recorded three months ago.

**Home and retail sales**: Home sales remained weak with a November reading of 45.1 which was up from October's 42.1. This is the fifth straight month the reading was below growth neutral 50.0. In a very unexpected turn, the retail sales index moved above growth neutral with a November reading of 50.1, up from 45.1 in October.

Each month, community bank presidents and CEOs in nonurban, agriculturally, and energy-dependent portions of a 10-state area are surveyed regarding current economic conditions in their communities and their projected economic outlooks six months down the road.

**Illinois:** For a seventh straight month, Illinois' RMI advanced above growth neutral. The November reading was 62.7, a regional high and up from October's 55.6. For a tenth straight month, farmland prices advanced above growth neutral with a November reading of 69.3, up from October's 63.6. Farm equipment sales for November expanded to 67.5 from 64.6 in October. The rate of job **gains** for Rural Mainstreet Illinois over the past 12 months was 5.5 percent.

**Iowa:** The state's RMI rose above growth neutral for the month with a November reading of 54.3, which was higher than October's 48.6. The farmland price index expanded to 68.6 from 60.1 in October. The state's farm equipment sales index grew to 69.2 from October's 61.1. The rate of job **gains** for Rural Mainstreet Iowa over the past 12 months was 0.8 percent.

**Minnesota:** The November RMI for Minnesota climbed to 60.7 from October's 55.2. Minnesota's farmland price index rose to 71.8 from 63.4 in October. The agricultural equipment sales index stood at 72.4, which was up from October's 64.4. The rate of job **gains** for Rural Mainstreet Minnesota over the past 12 months was 3.0 percent.

**Missouri:** The RMI for Missouri increased to 45.8 in November from 41.6. The farmland price index for Missouri climbed to 64.4 from 56.6 in October. The November farm equipment sales index advanced to 65.0 from October's 57.6. The rate of job **losses** for Rural Mainstreet Missouri over the past 12 months was 4.1 percent.

**Nebraska:** The November RMI for Nebraska moved higher to 56.7 from October's 52.0. The farmland price index climbed to 69.8 from 61.8 in October. The farm equipment sales index grew to 70.4 from October's 62.8. Larry Rogers, president of the First Bank of Utica reported, "We have plenty of liquidity and very strong loan demand for agriculture. But, it appears the small business community is suffering as people are being laid off." The rate of job **gains** for Rural Mainstreet Nebraska over the past 12 months was 1.0 percent.

**South Dakota:** For the first time since July, the RMI for South Dakota climbed above growth neutral. The index for November advanced to 54.8 from 49.7 in October. The farmland price index climbed to 68.8 from October's 60.7. South Dakota's farm equipment sales index was 69.4, up from 61.7 in October.

**Table 1: Rural Mainstreet Economy for Last Two Months and One Year Ago: (index > 50 indicates expansion)**

| | Nov. 2009 | Oct. 2010 | Nov. 2010 |
|---|---|---|---|
| Area economic index | 38.4 | 48.4 | 53.3 |
| Loan volume | 38.3 | 48.4 | 35.3 |
| Checking deposits | 66.4 | 73.0 | 76.3 |
| Certificates of deposit and savings instruments | 50.9 | 54.9 | 55.8 |
| Farmland prices | 45.6 | 60.0 | 68.1 |
| Farm equipment area sales | 39.9 | 61.0 | 68.7 |
| Home sales | 43.1 | 42.1 | 45.1 |
| Hiring | 36.3 | 46.0 | 36.3 |
| Retail business | 38.5 | 45.2 | 50.1 |
| Confidence index (area economy six months out) | 50.1 | 57.3 | 63.8 |

Table 2: The Rural Mainstreet Economy, November 2010

| | Extend permanently | Extend for 1-2 years | Extend for 3-5 years | Let it expire |
|---|---|---|---|---|
| Unless Congress acts, the 45 cents per gallon blenders' tax credit for ethanol is set to expire at the end of 2010. Which of the following actions do you recommend? | 13% | 36% | 33% | 18% |
| | | | | |
| | Nothing, we have plenty of liquidity and are lending as needed. | Credit quality of loan applicants | Bank regulators' concerns | Lack of demand from potential borrowers |
| Which of the following is limiting your bank's lending? (n.a. and other equal 10%) | 21% | 19% | 13% | 37% |
| | | | | |
| | 0% - 5% | 6%-10% | 11%-20% | Over 20% |
| How much has your local irrigated crop ground increased in price, year-over -year? | 39.0% | 38.0% | 23.0% | 0.0% |