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CONFERENCE OF STATE BANK SUPERVISORS

2017
Journal of Community Bank Case Studies

vol. 2

Preface

Journal of Community Bank Case Studies

Volume 2

The Journal of Community Bank Case Studies is an independent, adjudicated journal of case studies authored by undergraduate college students. The goal of this journal is to showcase the work of the top undergraduate student teams that participate in the annual Community Bank Case Study Competition, a national competition facilitated by the Conference of State Bank Supervisors. The competition partners undergraduate student teams with community banks to conduct original case studies focused on various topics.

This second volume of the Journal of Community Bank Case Studies includes the top three written submissions from the 2017 Community Bank Case Study Competition. The authors of the papers represent student teams from The University of Akron, Iowa State University, and Texas Tech University.

About

Conference of State Bank Supervisors

The Conference of State Bank Supervisors (CSBS) is the nationwide organization of banking and financial regulators from all 50 states, the District of Columbia, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands.

Established in 1902 as the National Association of Supervisors of State Banks, CSBS is uniquely positioned as the only national organization dedicated to protecting and advancing the nation's dual-banking system.

For more than a century, CSBS has given state supervisors a national forum to coordinate supervision and develop policy related to their regulated entities. CSBS also provides training to state banking and financial regulators.

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Letter

from John W. Ryan

President & CEO

Conference of State Bank Supervisors

On behalf of the Conference of State Bank Supervisors, I am pleased to present the *Journal of Community Bank Case Studies, Volume II*.

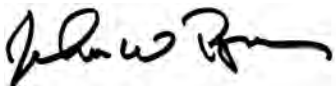
This publication showcases the outstanding work of the top undergraduate student teams from the 2017 Community Bank Case Study Competition. With this year's focus on succession planning, the work of the students is both important and timely; at any point in time, between 30 to 40 percent of senior executives at community banks are "at risk" to retire in five years. These case studies provide us firsthand insight into how community banks are preparing for and managing these risks.

One of the greatest benefits we can provide our youth is an opportunity to engage and excel outside of the classroom. At its core, the Community Bank Case Study Competition is about enriching undergraduate students with an experience that will better prepare them for a professional career or post-graduate studies. The competition is a practical and engaging learning opportunity for the students as they interact with their local community banks.

I am encouraged to see continued student interest in local community banks, and I'm excited that the Conference of State Bank Supervisors can provide a forum for students, professors, universities and community bankers to collaborate on a common objective.

I am pleased to be able to present these student papers in this *Journal of Community Bank Case Studies.*

Sincerely,
John W. Ryan



President and CEO
Conference of State Bank Supervisors

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Ames National Corporation: A Culture of Success

1) Community Banks and Bank Holding Companies

A Bank Holding Company (BHC) is broadly defined by the Bank Holding Company Act of 1956 as "any company that has control over a bank." The BHC structure provides several advantages that has driven the proportion of banks owned by a BHC to rise from 34.3% in 1980 to 84%. Perhaps most importantly, a BHC can raise capital more easily than can a stand-alone bank. It can allocate capital across its subsidiary banks in response to expected returns or to pool risk. Empirical studies have found that banks affiliated with a multi-bank holding company are significantly more resilient to financial distress and recover more readily than stand-alone banks (Ashcraft, 2008).

The multi-bank BHC structure allows for community banks to take advantage of economies of scale while retaining the personal quality of their front-end business. Cost savings can be achieved by centralizing the back-of-the-bank functions including accounting, regulation, and human resources. The subsidiary banks, which have closer connections to the customers, specialize in the front-of-the-bank operations. They manage customer financial services, originate loans, provide local brand recognition, and maintain relationships with customers in their communities.

The BHC structure also allows for coordinated personnel actions across subsidiaries, allowing greater flexibility in succession planning. Lines of succession and promotion can exist across banks as well as within banks, providing more career advancement opportunities than at stand-alone banks.

2) Community Banks and Relationships

The community bank's main competitive advantage over large national banks is its knowledge of the local market and its customer relationships. Contracting theories suggest that small banks have their center of decision making authority closer to the source of information collection than the larger banks, allowing them to act better on "soft information" (Berger, 2005). On the contrary, larger banks base lending decisions heavily on financial and credit information analyzed through statistical methods. Their reliance on statistical analysis simplifies the decision-making process, allowing repeatability across many clients and many loans. Statistical information, however, does not fully reflect customer attributes, many of which are unobservable without one-on-one contact with customers. This additional soft information can reveal opportunities the statistical methods of larger banks cannot. Community banks fill this niche. Community banks develop personal relationships with their clients that allow them to understand their customers' financial needs and dependability to better predict their potential as borrowers (Petersen and Raghuram, 1994). This relationship can also benefit borrowers, as the community bank can then confidently react to help their clients succeed. Given the importance of these relationships to a community bank's success, leadership with a strong understanding of and attention to the local community is of paramount importance. Future leaders must be groomed to understand and exploit the community banks' comparative advantages.

Future leaders must be groomed to understand and exploit the community banks' comparative advantages.

3) Succession Planning

Succession Planning is defined as a structured process to facilitate the identification and preparation of prospective talent to fill future vacancies. Succession plans not only allow future leadership to achieve their full performance immediately after assuming a position, but they also provide insurance against unexpected deaths. Davidson and Worrell (1990) examined 60 cases of unexpected CEO deaths and found that firms with an immediately available successor were more resilient to unanticipated loss of a key manager. Behn et al (2005) found that firms with a designated heir apparent had higher cumulative returns in the case of the CEO's death. The analysis of CEO deaths points to the broader implication that planned succession assures continuity. Investors have an assurance that the firm will outlive the CEO. Despite the unambiguous benefits of having succession plans in place, Garman and Glawe, (2004) estimate that only 40% - 65% of firms have established succession plans.

Many companies have adopted leadership development programs or talent pools to facilitate the development of future leadership.

Succession planning is not just about providing contingency plans. It is planning for the long-term success of the organization. The broader literature on succession planning outside of banking advises adopting a mindset of continually "identifying and developing promotable individuals" as opposed to "finding an individual to promote when the need arises." Many companies have adopted leadership development programs or talent pools to facilitate the development of future leadership. Designated successors are provided assignments with the greatest opportunity for learning and visibility including planned rotations to learn the full range of company lines of business and strategic initiatives. When a position becomes available, company leadership has access to a pool of prepared candidates for promotion. For the position of CEO, however, only one potential successor is typically identified to prevent uncertainty about the future transitions.

To identify potential candidates for leadership development, the set of desired skills and characteristics must first be clearly defined. The skills and characteristics of interest vary across industries, business models, and organizational structures. In our application, community banks prefer leadership with strong personal connections to the community while large national banks de-emphasize personal relationships with customers while focusing on portfolio management. For example, the current

CEO of Citigroup, Michael O'Neill, spent most of his early life in Europe and Asia and doesn't have deep roots with any local community.

Studies have found firm size to be a significant factor in determining successor preferences. As a rule, smaller firms more strongly prefer external successors than do larger firms. That is not the case with community banks. The importance of lasting relationships in the community bank business model leads to a preference for internal successors.

4) Financial Performance of Ames National Corporation

Ames National Corporation (ANC) is a multi-bank holding company located in central Iowa. ANC is composed of First National Bank, Ames, IA; State Bank & Trust Co., Nevada, IA; Boone Bank & Trust Co., Boone, IA; Reliance State Bank, Story City, IA; and United Bank & Trust, Marshalltown, IA. With total assets of over $1.3 billion as of December 31, 2016, ANC is the 6th largest Iowa-based commercial bank holding company based on total deposits.

Before we delve into ANC's corporate personnel strategies, we want to compare its financial performance with that of comparable peers. Our control group includes six bank holding companies or large individual banks that operate exclusively in the Midwest. They are listed in Table 1. ANC had assets of $1.37 billion at the end of 2016, 62% lower than the peer group average. We will look at ANC's productivity, performance, loan portfolio composition, and capital levels and planning compared to its peers.

Table 1: Descriptions of the Bank Peer Group[2]

Security National Bank of South Dakota is a Bank Holding Company with 3 subsidiaries headquartered in Dakota Dunes, SD. It has $1.38Bn in assets and its loan portfolio is primarily comprised of Real Estate (53%; 22% domestic and 13% farm) and agriculture production loans (28%).
West Bancorporation, Inc. is a standalone bank that is headquartered in West Des Moines, IA. It has $1.85Bn in assets focused on commercial lending. Only 0.02% of its loan portfolio is agricultural. The bank is highly levered with a high Loan to Deposit ratio of 91%.
MidWestOne Financial Group is the holding company of MidWestOne Bank which operates in Iowa, Minnesota, Wisconsin and Florida. They had $3.08Bn in assets at the end of 2016.
Great Southern Bancorp is the holding company of Great Southern Bank which is headquartered in Springfield, MO. It operates 104 retail banking centers with retail branches in throughout the Midwest and commercial lending offices in Tulsa, OK, and Dallas, TX. It has $4.55Bn is assets.
Hills Bancorp is the holding company of Hills Bank & Trust Company. All of its operations are within the state of Iowa. They had $2.66Bn in assets.
Heartland Financial is a Bank Holding Company with 10 subsidiary banks spread over 108 locations throughout the West and the Midwest. It has $8.25Bn in assets.

ANC is far more productive than its peers. While it has 44% lower asset growth over the past 15 years compared to its peer banks, ANC has been able to grow assets per employee at a much higher rate: 1.4% versus 0.8% annually. Consequently, ANC consistently sustained a statistically significant advantage in net income per employee through both cyclical expansions and contractions, as shown in Figure 1.

Figure 1: Real Assets and Real Income per Employee for Ames National Corporation and Peer Banks, 2002-2016

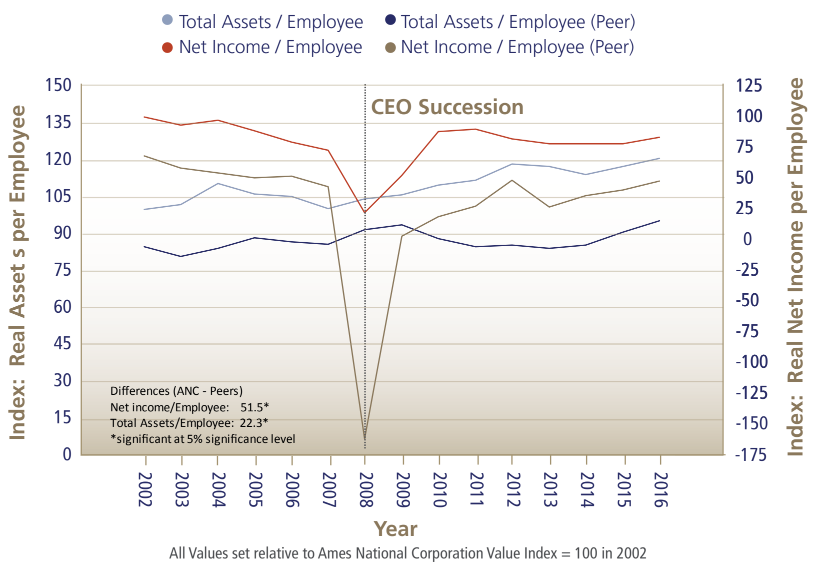
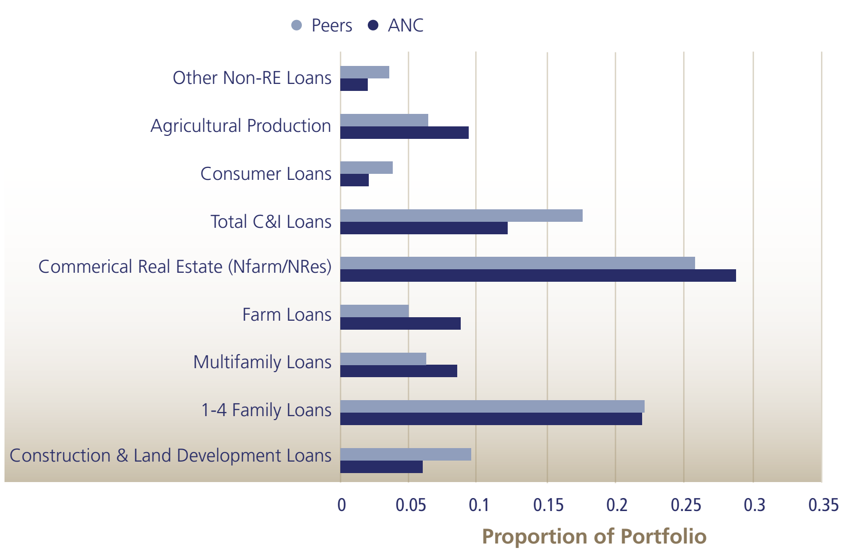


Figure 2: Loan Portfolio Composition, 2002-2016, Ames National Corporation and Peer Banks



The difference in productivity is due partly to a difference in loan focus compared to the peer banks, as illustrated in Figure 2. ANC's loan portfolio places greater weight on agricultural and commercial real estate loans and larger residential developments. In contrast, peers place a greater weight on shorter-term consumer, construction and industrial loans. The longer-term business loans and the agricultural loans arguably require greater knowledge of the borrower and of local business conditions than would shorter-term, smaller loans.

The ANC loan mix is a result of a long-standing strategy. There have been no significant changes in ANC's loan portfolio composition over the past 15 years. This loan portfolio requires expertise in the local agricultural and commercial markets. ANC's human capital and succession strategies provide a comparative advantage in identifying and retaining employees who are knowledgeable about their borrowers and local market conditions.

ANC's superior productivity is reflected in ANC's Return on Average Assets (ROAA) as well. As illustrated in Figure 3, ANC has achieved significantly higher ROAA than its peer banks throughout the past 15 years, while limiting the losses during the recession. Part of ANC's advantage is achieved by limiting costs. ANC averaged 6.4% lower operating expenses per dollar of operating revenue, referred to as the efficiency ratio. The link between high ROAA and low costs is evident in the -0.59 correlation between ANC's efficiency ratio and its ROAA.

ANC achieves this lower cost and greater productivity while maintaining asset quality. Its high underwriting standards and knowledge of its borrowers are apparent in Figure 4. While ANC had the same percentage of nonperforming loans as its peers through the first years of the Great Recession, it has had lower rates of nonperforming loans since 2010. Over the past 15 years, ANC has had a 22% lower rate of nonperforming loans. Meanwhile, there are no significant differences between

Figure 3: Return on Assets and Operating Expenses Relative to Operating Revenue, Ames National Corporation and Peer Banks, 2002-2016

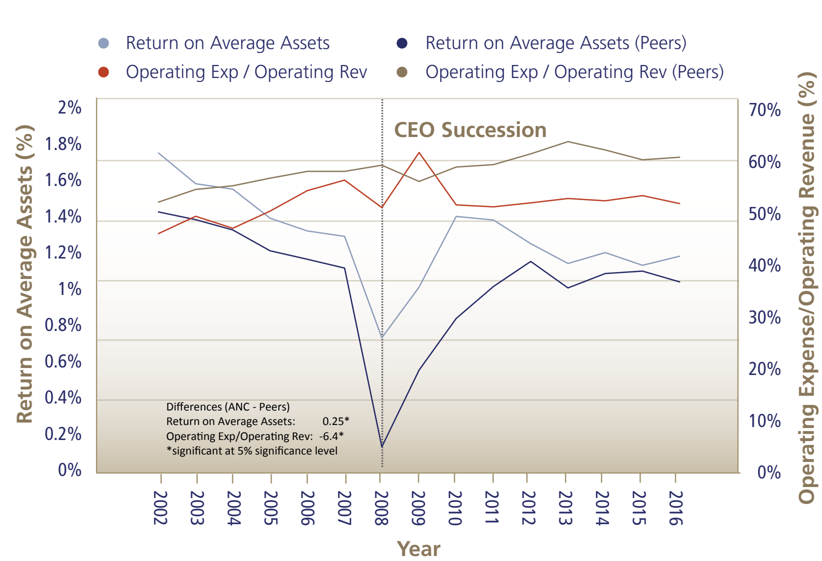
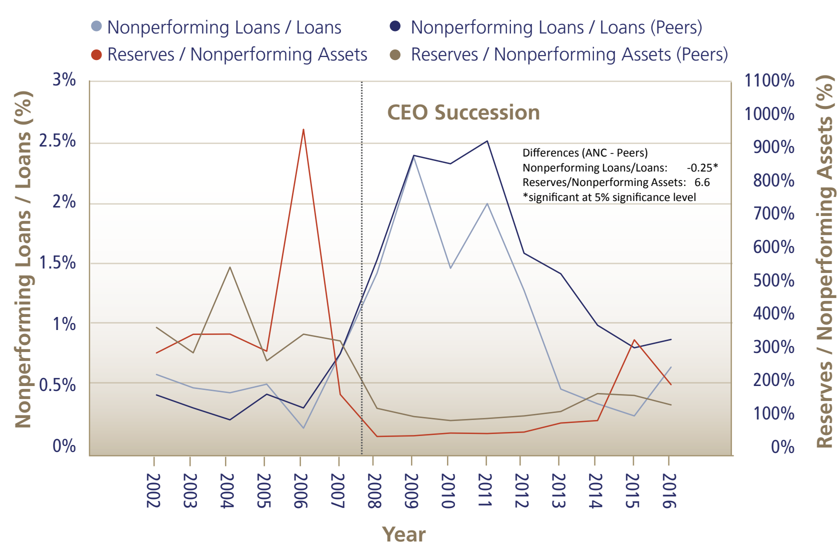


Figure 4: Percent of Loans that are Nonperforming and Reserves per Dollar of Nonperforming Assets, Ames National Corporation and Peer Banks, 2002-2016



ANC is more conservative than its peer banks. ANC holds much more capital while maintaining similar or superior asset quality.

ANC and the peer banks in the ratio of reserves to nonperforming assets.

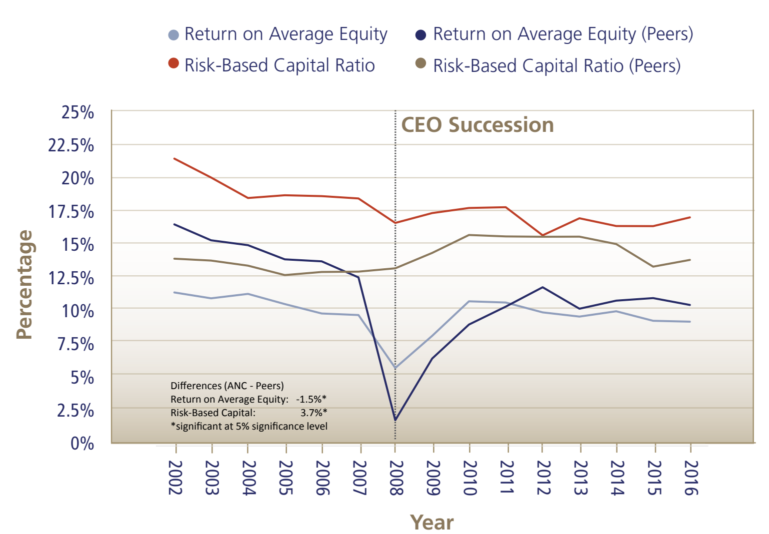
As illustrated in Figure 5, ANC is more conservative than its peer banks. ANC holds much more capital while maintaining similar or superior asset quality. In the past 15 years, ANC has had a 27% higher average risk-based capital ratio than the peer banks. The additional reserves give ANC a cushion in the event of a bad shock. More importantly, the added reserves provide a potential source of liquid funding if an acquisition opportunity appears. The additional security also allows ANC to issue a dividend relative to net income that has been 80% higher than its peers on average.

The charts demonstrate that ANC outperforms its peers through greater efficiency of its staff, lower costs per dollar of revenue, and lower default rate on originated loans. The higher quality of loans originated by ANC is consistent with the presumption that ANC staff are highly informed of their local markets and the reliability of their borrowers. The subsidiary banks retain many of their loans rather than selling them, ANC leadership explains their reluctance to sell loans because they expect that their loan origination is atypically profitable.[1] Next, we will review how ANC's personnel policies aim to attract and retain employees who are knowledgeable about the local communities.

5) ANC Succession Planning and Human Resource Policies

ANC's human resources staff are committed to working with employees on their professional development to help them succeed and incentivize them to stay. ANC has achieved low employee turnover rates which allows it to develop and maintain knowledge of the

Figure 5: Percent Return on Equity and Risk-Based Capital Operating, Ames National Corporation and Peer Banks, 2002-2016



local community and to foster long-term relationships with clients. The firm believes that staff with extensive experience in the local market will be able to originate higher quality loans with low default rates. These beliefs represent a culture that has been fostered at ANC since its founding in 1975.

Given its growth, ANC adopted a formal succession plan in 2016. The succession plan is designed "to identify and prepare employees for high-level management positions that become vacant due to retirement, resignation, death or new business opportunities." Succession planning at ANC is a coordinated activity between managers and employees. Both are responsible for insuring the succession plan works. Every January, each subsidiary bank president is charged with providing a review of the key positions of the bank delineating the following:

- Leadership positions that likely will need to be replaced
- Employees who show potential for progression into leadership
- Actions to prepare identified talent to develop
  - Leadership skills
  - Interpersonal skills
  - Demonstration of ANC core values

In addition, management is charged with continually assessing each employee's potential, having honest discussions with the employees about their futures, and working on career development plans with the employees

While management holds the power to decide whom to promote, leadership development is not a unilateral process and needs employee engagement. Employees are responsible for expressing their interests in pursuing new roles, creating and keeping up-to-date career development plans, working with managers to identify career development opportunities, and being open to and acting on feedback. These interactions benefit both parties. They enable managers to better understand the skills of their employees and to identify better promotion prospects for the future within and across constituent banks. The process also demonstrates that the company values its employees and wants them to stay with ANC. ANC's demonstrated commitment to the employee's future success in the firm lowers the chance the employee will be attracted to positions in other banks.

Succession planning at ANC is a coordinated activity between managers and employees.

To see the process in action we interviewed Nick Johnson, a recent MBA graduate of University of Iowa, who is now working as an Investment Analyst at ANC's First National Bank. He attests to the commitment of bank leadership in developing future talent: "I have the ability to say, 'John (Nelson, CFO), my goal is to be CEO, train me." He experienced the flexibility of the ANC leadership immediately when he started as his position of Investment Analyst did not exist until he started at the bank. His position was tailored to his specific skills and interests, which the leadership realized benefits the bank. CFO Nelson has also been continually engaged in helping Nick develop his skills. CFO Nelson recently helped Nick purchase a $3 million asset. "That is not something I would want to do the first time without John," says Nick.

As mentioned previously, the leadership development process works best when both employee and employer are putting in effort.

The leadership development process works best when both employee and employer are putting in effort.

Employees are encouraged to ask themselves the following questions:

- "What are my career goals? Am I interested in a leadership position within this department? Which position?"
- "Are my career goals and target dates realistic?"
- "What are my strengths?"
- "Are there additional competencies, technical, or leadership skills for a desired future role that need my attention?"
- "What types of career development opportunities do I prefer?"

In larger firms, the Human Resource division is much more engaged in the succession planning process, as they typically operate the leadership development programs. In the case of ANC, however, the focus is shifted to the interactions between employees and management, with HR playing a supportive role in completing clerical tasks.

There are two primary objectives that succession planning addresses, one being insurance in the case of an unexpected loss of leadership, the other being strategic development of leadership for the future. ANC addresses these two separate objectives of succession planning by identifying both a short-term and a long-term successor, who may not be the same individual. In the event of an unexpected loss of leadership, the short-term successor takes over the tasks for a transition period while the long-term successor is prepared and trained. The short-term successor needs to be immediately ready to fill the position, therefore at ANC they tend to be more senior members of the organization. While we traditionally think of succession involving a lower-level employee taking on a higher position, the short-term need of finding a successor led ANC to designate some higher-level employees as the successor for their subordinates. However, it is generally desirable for a long-term successor to be younger and groomed to lead the organization strategically into the future. The contingent short-term successor allows the organization to act judiciously and avoid rushing to a premature decision on who will fill the position.

Table 2: Summary information on the Ames National Corporation Lines of Succession

Internal Candidates

Bank	Short Term	Long Term	Positions
AMES NATIONAL CORPORATION	80%	60%	5
BOONE BANK AND TRUST	100%	50%	4
FIRST NATIONAL BANK	100%	43%	7
RELIANCE STATE BANK	100%	80%	5
STATE BANK AND TRUST COMPANY	100%	66%	3
UNITED BANK AND TRUST COMPANY	75%	0%	4
Total	**93%**	**50%**	**28**

External Candidates

Bank	Short Term	Long Term	Positions
AMES NATIONAL CORPORATION	20%	20%	5
BOONE BANK AND TRUST	0%	25%	4
FIRST NATIONAL BANK	0%	29%	9
RELIANCE STATE BANK	0%	20%	5
STATE BANK AND TRUST COMPANY	0%	33%	3
UNITED BANK AND TRUST COMPANY	25%	50%	4
Total	**7%**	**29%**	**30**

Internal or External Candidates

Bank	Short Term	Long Term	Positions
AMES NATIONAL CORPORATION	0%	20%	5
BOONE BANK AND TRUST	0%	25%	4
FIRST NATIONAL BANK	0%	29%	9
RELIANCE STATE BANK	0%	0%	5
STATE BANK AND TRUST COMPANY	0%	0%	3
UNITED BANK AND TRUST COMPANY	0%	50%	4
Total	**0%**	**22%**	**30**

Past research advises against identifying multiple individuals for the role of CEO/President. Being composed of several subsidiary banks, ANC is in a unique situation where it has many internal presidents. This allows ANC to fully utilize its potential executive talent by moving targeted future leaders across its subsidiary banks to positions that will groom them for advancement. For example, three of the five current subsidiary bank presidents with ANC were once officers of State Bank and Trust. Because there are several president positions in the bank holding company structure, there can be multiple subordinates under consideration for future presidential roles. The main presidential role of the parent company, however, has a sole internal candidate for its successor and thus follows literature recommendations.

The succession plan for ANC is summarized in Table 2. Most of the long-term and short-term candidates are taken from positions in the bank. For the short-term succession planning, over 90% of the future vacancies will be filled by candidates already in the company. The remaining short-term successors will be filled by external candidates. For long-term succession, 50% of the positions will be filled exclusively from internal candidates. Another 20% of long-term successors will be either internal or external candidates. The final 30% of long-term successors will be sought from external candidates. ANC's preference for internal successors reflects its preference for keeping its current personnel, which allows it to retain the relationships already established by the bank. ANC does note that for certain positions, external candidates can bring a fresh perspective, improved techniques and skills that benefit the bank.

6) The Leadership Transition Process

The importance of a smooth transition when changing leadership cannot be understated. The ability for the successor to begin effective leadership immediately contributes strongly to an organization's financial success. The literature regarding this transition process encourages detailed preparation long before the transition occurs. Garman and Glawe (2004) suggest that the best practices include having training programs tailored toward the one person taking over as well as having post-succession assessments to identify future potential problems. Another major part of the process centers on the person leaving the position. Garman and Glawe (2004) believed that it is essential to have a clear exit strategy in place to assure that there is never uncertainty about who is in the role, the leaving or the new individual. In a study of small firms, Sambrook (2005) found that a common problem for CEO or high level succession is transferring the knowledge stored only in the leaving individual's mind to the incoming successor. This problem could potentially occur in small community banks that have had one person in charge for a large number of years.

In the case of ANC, this transition process is a situation that will take place in the very near future. Its current CEO will be stepping down with the current CFO taking over the position. This strategy of identifying one successor well in advance has been found to be the most

The importance of a smooth transition when changing leadership cannot be understated.

effective and reliable mode of action. Previous literature also emphasizes further preparation through training and during the transfer of responsibility, which ANC has already begun. Employees of lower positions have started training to take over some of the CFO's responsibilities as seen in the previously stated training of Investment Analyst Nick Johnson. If not already instituted, some form of assessment on the way the transition process plays out after completion could be very beneficial to ANC as it pertains to other future leadership successions.

There has been only one transition of major ANC leadership (CEO and CFO) since 2000. It occurred when the bank's CEO retired and was replaced by a subsidiary bank president. This transition occurred in 2008 at the start of the Great Recession, so it is possible that the transition succeeded even as the measured financial performance of the bank deteriorated. Nevertheless, we can use the peer banks as controls for the changing financial environment in the banking industry and examine if there is a change in ANC's returns when it changed leadership. Consider the regression

(1) $y_{At} = \alpha_0 + \alpha_P\, y_{pt} + \beta_S\, D_{08} + \epsilon_{it}$

Where y_{At} is a measure of ANC bank performance in year t, y_{pt} is the corresponding performance of the peer group in year t, and D_{08} is a dummy variable that takes the value of 1 after the new CEO is installed. The coefficient α_P will measure how sensitive ANC's performance is to average market conditions for the Midwest banking sector. The peer banks should capture common cost and revenue trends in the area.

The coefficient β_S will capture the change in performance that coincides with the tenure of the new leadership. If the succession from old to new leadership results in continuity of performance, we will not reject the null hypothesis that $\beta_S = 0$.

Results are reported in the first panel of Table 3. We use three different measures of bank performance: real net income per employee; return on average assets; and the efficiency ratio. All are converted into natural logs. We report the results without (column A) and with (column B) the succession dummy variable. The coefficient on the peer measures are always positive but less than 1, suggesting that ANC responds to the same average cyclical profitability that affects its peer banks, but more moderately. ANC's returns rise slower than its peers when business conditions improve, but its costs also rise slower when market operating expenses are rising. Our primary interest is in the coefficient on succession. For the first and third measures, the coefficient is not significantly different from zero, meaning that the change in CEO had no discernible effect on bank net income per employee or efficiency. The second measure does show some evidence of reduced performance compared to the peers on return on average assets. The coefficient implies that ANC's advantage over its peers in return on average assets, apparent in Figure 3, shrank by 12% after the change in CEO.

We were also able to run equation (1) for two of the subsidiary banks experiencing transition in leadership: First National Bank and Reliance

Table 3: Estimation of Equation (1) Explaining the Performance of Ames National Corporation Compared to its Peer Banks

	ln (Real Net Income/ Employee)		ln (Return on Average Assets)		ln (Efficiency Ratio)	
	A	B	A	B	A	B
Dependent Variable is the Performance of Ames National Corporation, 2002 – 2016						
Constant α_o	2.90*	2.95*	0.258*	0.320*	2.14	3.00
p-value	< 0.001	< 0.001	< 0.001	< 0.001	0.14	0.16
Succession β_S		-0.03		-0.12*		0.03
p-value		0.64		0.048		0.56
Peer α_p	0.32*	0.31*	0.308*	0.261*	0.45	0.23
p-value	< 0.001	< 0.001	< 0.001	< 0.001	0.21	0.65
Adj R-Sq	0.79	0.78	0.74	0.79	0.12	0.14
Dependent Variable is the Performance of Subsidiary First National Bank, 2002 – 2016						
Constant α_o	1.27*	1.20*	0.238*	0.295*	-0.60	3.39
p-value	< 0.001	< 0.001	< 0.001	0.002	0.74	0.14
Succession β_S		0.04		-0.10		0.15*
p-value		0.60		0.34		0.02
Peer α_p	0.08*	0.812*	0.709*	0.671*	1.08	0.09
p-value	< 0.001	< 0.001	< 0.001	< 0.001	0.28	0.86
Adj R-Sq	0.92	0.91	0.85	0.85	0.27	0.50
Dependent Variable is the Performance of Subsidiary Reliance State Bank, 2002 - 2016						
Constant α_o	4.08*	3.57*	0.228*	0.280*	4.68*	1.97
p-value	< 0.001	< 0.001	< 0.001	< 0.001	0.004	0.25
Succession β_S		0.268*		-0.10		-0.10*
p-value		0.01		0.22		0.04
Peer α_p	0.048*	0.147	0.07	0.028	-0.22	0.46
p-value	< 0.001	0.06	0.30	0.67	0.52	0.27
Adj R-Sq	-0.05	0.50	0.01	0.06	-0.04	0.22

*Note: * indicates significant at the 0.05 confidence level*

Bank. The promotion of the First National Bank president to CEO of the holding company resulted in a change of presidency in First National Bank in 2008. Using the methodology outlined above, the results in the second panel of Table 3 show no change in subsidiary bank performance as measured by net income per employee and returns on average assets following the change in leadership. But operating expenses relative to operating revenue rose by 15% after 2008, narrowing ANC's efficiency advantage in that bank. Reliance Bank also had a succession in 2008. As shown in the 3rd panel of Table 3, there was a significant improvement in net income per employee and a reduction in operating costs relative to revenues following that change. There was no significant change in return on average assets.

All in all, ANC's recent leadership successions show a general tendency of continued steady performance. Bank performance declined in only 2 of the 9 estimates of β_S and rose or stayed constant in the other 7. Where significant

While the physical capital comes with the purchase contract, retaining human capital is a bigger challenge through any transition process.

changes are observed, they are not sufficiently large to alter ANC's performance advantage over its peers.

The immediate availability of a successor positively affects a firm's financial performance in the event of a disturbance. ANC's 2016 succession policy is too new for us to evaluate, but its past leadership transitions have been successful on the whole. It is reasonable to assume that ANC's more comprehensive succession plan will generate even more stability in firm performance with future successions.

7) Board of Directors

ANC has a current Board of Directors made up of its CEO and CFO, along with a diverse range of other individuals from many different sectors. This includes CEO/Presidents from different firms, a farmer, a retired veterinarian, who is the chairman, and an attorney. Board members are chosen and replaced with a nominating committee for the Board of Directors. The responsibility of the committee is to identify and select individuals to fill board vacancies. The committee first identifies the competencies, experience, and personal attributes needed to enhance the existing mix of talents on the Board and then identifies individuals who have the desired attributes. The mandatory qualifications include a sound understanding of business and finance, community involvement, and high moral and ethical standards. Board members are also expected to reinforce the bank's culture as along with maintaining its financial success.

The Board must include a minimum of three members independent of the organization. This external membership on the committee is in place to assure an outside perspective is heard when bank decisions are being made in the ever-changing financial environment. The Board also tries to include a mix of demographic groups. The nonprofit 2020 Women on Boards recently singled out ANC for its inclusion of women on their Board.

The Board of Directors is particularly important in fostering a smooth leadership transition for its CEO and other leadership positions across ANC's subsidiary banks. It also is tasked with maintaining the bank culture as it decides on mergers and acquisitions. As ANC expands into new communities, the succession plan for the Board will need to accommodate a broader group of potential future leaders who will continue the tradition of strong community involvement in those new geographic areas.

At ANC, the process of acculturalization is a pre-merger and not a post-merger activity.

8) Mergers and Acquisitions

Ames National Corporation incorporates its human capital policies into its strategy for acquisitions they pursue. ANC views mergers and acquisitions as an opportunity to strengthen not just its physical capital, but also its human capital. The presumption is that the targeted bank's employees have the necessary locational knowledge to assure the profitability of the acquisition. While the physical capital comes with the purchase contract, retaining human capital is a bigger challenge through any transition process.

Goyal and Joshi (2012) identified three stages to the merger and acquisition process; pre-merger, acquisition, and post-merger. They suggest that the pre-merger stage involves assessing the financials of the target bank while also checking with shareholders and customers on the overall culture of the bank. The acquisition stage is a time when the bank is actually acquired, the necessary information transfers occur and developing relationships with new customers takes place. The post-merger stage is one of the most important in terms of the long-term success of the acquisition. This stage is where the employees of the newly acquired bank must be integrated into the new bank culture. Goyal and Joshi (2012) heavily emphasize that behind all these business processes there are people whose lives are being greatly affected by the change. Therefore, it is important for the bank to assure that these new employees are taken care of and thought about on a personal level.

This leads to a broadening of the view of succession planning, namely, what is ANC's philosophy regarding succession of employees in banks that they acquire? Because ANC will provide the back-of-bank support for marketing, auditing, regulation, and other centralized operations, some positions in the acquired bank will be eliminated. However, ANC does not want to lose the accumulated community-specific skills and knowledge embodied in those workers. At ANC, the process of acculturalization is a pre-merger and not a post-merger activity. When ANC is looking to acquire a bank, a prerequisite for acquisition is that the personnel fit the ANC culture and that they will remain with the company after acquisition. The operational belief is that keeping the experienced employees in the acquired bank is key to the successful acquisition. Employees whose tasks are no longer required will be moved to other functions where their locational experience will be most profitable. ANC has opted out of a prospective acquisition when if felt the employees of the acquired bank lacked the client relationships or location-specific knowledge that would generate the competitive advantage in originating quality loans and customers.

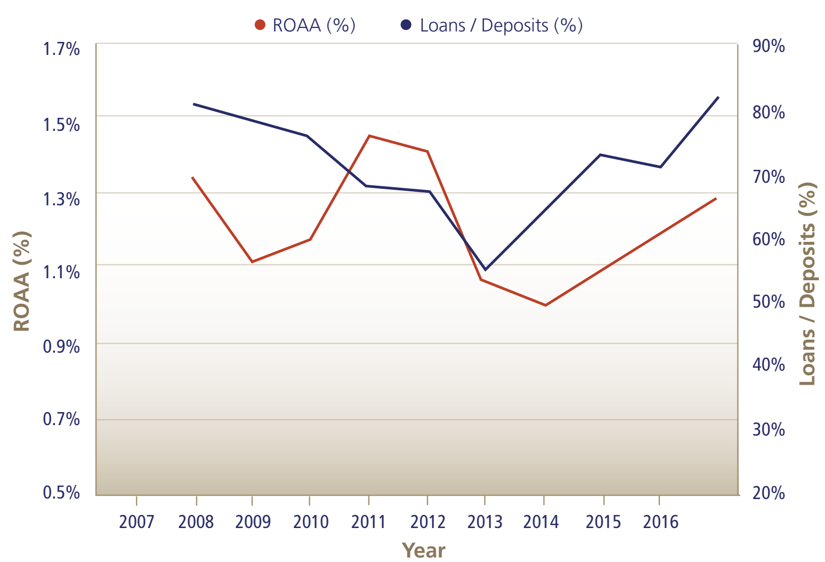
Because ANC's acquisition strategy depends on retaining the employees in the acquired bank, it must deal with the personnel challenges that arise during a merger or acquisition. ANC addresses this issue by first interviewing every employee in the acquired bank. It is then assessed where each person would fit into the organization and even where they might fit in the succession plan. The benefit of being a bank holding company allows ANC to have the option of placing the person in a position of need at a different bank, thus keeping as many of the same employees and their locational knowledge as possible.

9) Two examples of Acquisitions

ANC has made two acquisitions since the Great Recession. In April 2012, Reliance State Bank, a subsidiary of ANC, acquired two branch banks located in the Iowa towns of Garner and Klemme totaling \$98 million in deposits and \$47 million in net loans. The seller, Liberty Bancshares, was facing financial problems and was in the process of reducing its assets from \$1.2 billion in Q3 2010 to \$267 million in assets by Q3 2013. However, the acquired banks were considered well-managed, and ANC made retention of the existing leadership a requirement for the transaction to be consummated. Through incentives and contracts agreed to with the Liberty Bancshares employees before the acquisition, ANC was able to retain all experienced employees in the acquired banks. This acquisition grew Reliance's assets by 107%, its loans and leases by 90% and its employee base by 138%.

The second occurred in August 2014, First National Bank of Ames, a subsidiary of ANC, acquired First Bank of West Des Moines, IA. The acquisition added \$80 million in deposits and \$49 million in loans. The transaction increased First National Bank's asset base by 7.0% and its liabilities by 14.0%. This acquired bank was in financial trouble and was on the verge of being shut down. However, after ANC interviewed all the employees, it determined that the bank's problems were not due to poor employees but to poor economic circumstances

Figure 6: Performance of Reliance State Bank Before and After Acquisition of Two Liberty Bancshares Banks in April 2012



related to the recession. ANC retained all but one of the employees in the bank, reassigning back-of-the-bank employees to its loan origination, trust, and other client-based functions.

Both acquisitions have been relatively recent, and both are considered successful thus far. We have enough time elapsed since the Lincoln Bancshares acquisition to evaluate bank performance after the takeover. We illustrate the results in Figure 6. Both return on average assets and loans relative to deposits have grown since the April 2012 acquisition.

With these, other bank acquisitions, and business practices, ANC believes that its employees will be able to generate a more reliable book of business than would larger, more impersonal banks. Both of these specific examples clearly demonstrate ANC's human resources strategy when it is looking to acquire a bank. As noted earlier, ANC does not want to lose the accumulated community-specific skills and knowledge embodied in the employees of the acquired bank and believes they will be key components of a successful acquisition. The strength of the ANC culture is exhibited in the success of both acquisitions.

10) Conclusion and Recommendations

As we have shown in this paper, ANC is an efficient and well-functioning organization with a stable culture and robust plans for the future. The bank holding company consistently outperforms similar banks on many measures of efficiency and financial performance. Their succession planning strategy is consistent with established best-practices, and their human capital strategy has produced a highly effective staff. In acquiring other community banks, they introduce their strategy and corporate culture while retaining the connections with the local community it serves. Both recent acquisitions that we analyze including one well-performing and one poorly-performing bank have proven successful.

We do recommend Ames National Corporation explore adopting college programs. Its hometown, Ames, is home to Iowa State University, the largest university in the state. There are also several community colleges and Drake University in some of the communities ANC banks serve. These colleges could serve as a talent pipeline of highly educated members of the local community. If college students are identified early on as future employees, this also presents the opportunity for ANC to integrate students into their culture before becoming full-time staff after graduation.

MLA Citation

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For information on the Liberty Bancshares operation, go to http://www.businessrecord.com/Content/Finance---Insurance/Finance---Insurance/Article/Patience-will-pay-off-in-bank-acquisition/171/833/63598

Endnotes

1 From interviews with Tom Pohlman and John Nelson, CEO and CFO of ANC.

2 All assets are valued on December 31, 2016.

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