



SMALL BANK

Comptroller of the Currency
Administrator of National Banks

PUBLIC DISCLOSURE

March 17, 2003

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

**The First National Bank of Deerwood
Charter Number 9703**

**20 Archibald Road
Deerwood, MN 56444**

**Comptroller of the Currency
Minneapolis North Field Office
302 West Superior Street, The Lonsdale Building, Suite 307
Duluth, MN 55802**

NOTE: This document is an evaluation of this institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods consistent with safe and sound operation of the institution. This evaluation is not, nor should it be construed as, an assessment of the financial condition of this institution. The rating assigned to this institution does not represent an analysis, conclusion, or opinion of the federal financial supervisory agency concerning the safety and soundness of this financial institution.

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INSTITUTION'S CRA RATING

This institution is rated Satisfactory.

The First National Bank of Deerwood (FNB Deerwood) is satisfactorily meeting the credit needs of its assessment area. This is best demonstrated by:

- Satisfactory loan volume, as evidenced by a quarterly average loan-to-deposit ratio that is comparable to other local banks of similar size.
- Strong distribution of loans to borrowers of various incomes, especially those with low- and moderate-income.
- Origination of a majority of loans within the assessment area.
- Reasonable geographic distribution of loans throughout the assessment area.

DESCRIPTION OF INSTITUTION

The First National Bank of Deerwood (FNB Deerwood) is a \$143 million bank located in north-central Minnesota. The bank has four full-service offices and a loan production office: the main office is located in Deerwood with branch offices located in Brainerd, Garrison, and Bemidji. The Bemidji branch was opened December 1, 2001. The loan production office is located in Crosslake and was opened May 1, 2002. The bank also maintains ten automated teller machines (ATM) in locations within the bank's assessment areas. All but two of the ATMs are cash-dispensing only. The ATMs at the main office in Deerwood and the branch office in Brainerd accept deposits for FNB Deerwood only. There are no legal or financial constraints inhibiting FNB Deerwood's CRA performance or its ability to meet the lending needs of its assessment area. FNB Deerwood received a rating of Satisfactory at the last CRA examination dated October 8, 1998.

FNB Deerwood continues to service residential real estate customers and has increased the volume of its commercial and commercial real estate loan portfolios. According to its Report of Condition and Income, FNB Deerwood had the following outstanding loans by dollar volume on December 31, 2002: commercial real estate (42 percent), residential real estate (27 percent), commercial (19 percent), and consumer (11 percent). Total net loans represent 66 percent of total assets.

FNB Deerwood is 100 percent owned by Deerwood Bankshares, Incorporated, a \$16 million one-bank holding company that is also located in Deerwood, Minnesota. Deerwood Bankshares, Incorporated purchased FNB Deerwood in January 1997.

DESCRIPTION OF THE ASSESSMENT AREA

FNB Deerwood has identified two geographically separate assessment areas (AA), both of which are rural and not located in a Metropolitan Statistical Area (MSA). The Deerwood/Brainerd/Garrison AA includes twenty-one block numbering areas (BNAs), which consist of all Crow Wing County BNAs plus five contiguous BNAs in Aitkin, Mille Lacs, and Cass Counties. Of the twenty-one BNAs in the Deerwood/Brainerd/Garrison AA, four are identified as moderate-income, sixteen are identified as middle-income, and one BNA, the city of Baxter, is identified as upper-income.

The Bemidji AA includes ten BNAs, including eight from Beltrami County and one each from Hubbard and Cass counties. Of the ten BNAs in the Bemidji AA, one is identified as low-income. Three of the BNAs are identified as moderate-income, with the remaining six considered middle-income.

While the AAs are geographically separate, for analysis purposes we will be considering them as one combined AA due to the similar demographics of the AAs and the fact that neither includes portions of a MSA. The AA meets the requirements of the Community Reinvestment Act and does not arbitrarily exclude low- or moderate-income geographies. According to 1990 U.S. Census Data, the total population for the AA is 91,497 persons. The 1990 Census Data reported a Median Family Income for the AA of \$28,933, while the updated 2002 Median Family Income for the AA is \$48,500. Also according to the 1990 Census Data, the weighted average value of homes in the AA was \$56,522; however, it is estimated that the value is significantly higher today. The following table summarizes the income levels of individual census tracts and families located within the bank’s combined AA:

| Income Distribution of Geographies and Families | | | | | | | |
|--|----------|--------|-------|--|----------|--------|-------|
| Percentage of Census Tracts | | | | Percentage of Families by Income Level | | | |
| Low | Moderate | Middle | Upper | Low | Moderate | Middle | Upper |
| 3% | 23% | 71% | 3% | 24% | 19% | 23% | 34% |

Lending competition from other financial institutions is strong as several banks, credit unions, savings institutions, and mortgage companies maintain main or branch offices within the AA. FNB Deerwood currently maintains a 5% market share of deposits in the six counties that it serves.

Economic conditions within the AA are stable. Unemployment is 5.4 percent as of December 31, 2002, which is higher than the average for the state of Minnesota at 4.3 percent, yet lower than the national average of 5.9 percent. The major industry in the AA is hospitality and services related to tourism. Both AAs are located in popular vacation areas that offer fishing, watersports, and golf, among other activities. Additional industries include health care, regional shopping facilities, and both timber and paper mills. The area’s largest paper mill was closed in 2002.

Examiners spoke with a representative from a local nonprofit development organization. The contact indicated that the primary credit needs of the area are conventional residential real estate, consumer, and small business lending. It was the contact’s opinion that the financial institutions

in the area are adequately meeting the credit needs of the community.

CONCLUSIONS ABOUT PERFORMANCE CRITERIA

Lending to Borrowers of Different Incomes and to Businesses of Different Sizes

FNB Deerwood’s distribution of loans to borrowers of different incomes and businesses of different sizes reflects excellent penetration. Specifically, the performance in its primary product lines of residential real estate and commercial real estate lending exceeds the community demographics for lending to low- and moderate-income borrowers and small businesses, respectively.

Residential real estate lending exceeds the demographics of the AA for low- and moderate-income borrowers. FNB Deerwood originated 463 residential real estate loans between November 1, 1998 and December 31, 2002. Examiners sampled twenty-three loans to borrowers in the AA that were originated between January 1, 2000 and December 31, 2002. The following table compares the bank’s residential real estate lending activity by borrower income level to community demographics:

| Borrower Distribution of Residential Real Estate Loans by Income Level | | | |
|---|--|--|--|
| Borrower Income Level | Percent of Number of Loans Originated in Each Income Level | Percent of Dollar of Loans Originated in Each Income Level | Percent of Families in Assessment Area |
| Low | 35% | 21% | 24% |
| Moderate | 30% | 22% | 19% |
| Middle | 9% | 13% | 23% |
| Upper | 26% | 44% | 34% |

Source: Bank records (verified by examiners) and U.S. Census Demographic Data (1990)

Commercial real estate lending in the AA reflects community demographics for smaller sized businesses. For comparison purposes, small businesses are defined as those with annual revenues less than \$1 million. FNB Deerwood originated or purchased 385 commercial real estate loans between November 1, 1998 and December 31, 2002. Examiners sampled twenty-one loans to borrowers in the bank’s AA that were originated between January 1, 2000 and December 31, 2002. The following table compares the bank’s commercial real estate lending activity by borrower’s revenue size to community demographics:

| Borrower Distribution of Commercial Real Estate Loans by Revenue Size | | | |
|--|-----------------|----------------------------|---------------------------|
| Annual Gross Revenue | Number of Loans | Percent of Loans by Number | Business Demographic Data |

| | | | |
|--------------------------|-----------|-------------|-------------|
| Less than \$100,000 | 12 | 57% | 89% |
| \$100,000 - \$250,000 | 3 | 14% | |
| \$250,000 - \$500,000 | 1 | 5% | |
| \$500,000 - \$1,000,000 | 2 | 10% | |
| Greater than \$1,000,000 | 3 | 14% | 11% |
| Totals | 21 | 100% | 100% |

Source: Bank records (verified by examiners) and U.S. Census Business Demographic Data (1990)

Commercial lending in the AA is lower than the community demographics for small businesses. FNB Deerwood originated or purchased 959 commercial loans between November 1, 1998 and December 31, 2002. Examiners sampled twenty loans to borrowers in the bank's AA that were originated between January 1, 2000 and December 31, 2002. The following table compares the bank's commercial lending activity by borrower's revenue size to community demographics:

| Borrower Distribution of Commercial Loans by Revenue Size | | | |
|--|-----------------|----------------------------|---------------------------|
| Annual Gross Revenue | Number of Loans | Percent of Loans By Number | Business Demographic Data |
| Less than \$100,000 | 8 | 40% | 89% |
| \$100,000 - \$250,000 | 2 | 10% | |
| \$250,000 - \$500,000 | 2 | 10% | |
| \$500,000 - \$1,000,000 | 1 | 5% | |
| Greater than \$1,000,000 | 7 | 35% | 11% |
| Totals | 20 | 100% | 100% |

Source: Bank records (verified by examiners) and U.S. Census Business Demographic Data (1990)

Loan-to-Deposit Ratio

FNB Deerwood's quarterly net loan-to-deposit ratio is reasonable given the bank's size, financial condition, and area's credit needs. The bank's quarterly net loan-to-deposit ratio averaged 70 percent over the 16 quarters from March 31, 1999 to December 31, 2002.

FNB Deerwood's quarterly net loan-to-deposit ratio is comparable with other community banks

of similar size (with total assets between \$75 million and \$205 million). FNB Deerwood ranks sixth among a total of eight similarly situated banks chartered in the AA. The other seven banks had quarterly average net loan-to-deposit ratios averaging 86 percent and ranging from 59 percent to 109 percent over the same 16 quarters from March 31, 1999 to December 31, 2002.

In addition, FNB Deerwood originates residential real estate loans and sells loans through the secondary market. While these activities assist in FNB Deerwood’s efforts to meet local credit needs, the volume of brokered and sold loans are not reflected in the quarterly loan-to-deposit ratio.

Lending in Assessment Area

FNB Deerwood originates a majority of its loans to borrowers located within its defined AA. Based on a sample of thirty-three residential real estate loans, twenty-five commercial loans, and twenty-eight commercial real estate loans originated between November 1, 1998 and December 31, 2002, the bank originated or purchased 81 percent by number and 67 percent by dollar amount of its loans within its assessment area. The following table shows loans originated inside the AA by number and dollar amount:

| Lending in Assessment Area by Number and Dollar | | |
|--|----------------------------|-----------------------------|
| Type of Loan | Percent of Loans by Number | Percent of Loans by Dollars |
| Residential Real Estate | 88% | 89% |
| Commercial | 80% | 78% |
| Commercial Real Estate | 74% | 53% |
| Total | 81% | 67% |

Source: Bank records (verified by examiners)

Geographic Distribution of Loans

FNB Deerwood’s performance for lending to borrowers in low- and moderate-income BNAs is reasonable. Examiners sampled twenty-three residential real estate, twenty-one commercial real estate, and twenty commercial loans to borrowers in the bank’s AA that were originated between January 1, 2000 and December 31, 2002. Loan distribution within the low- and moderate-income BNAs is reasonably consistent with the demographics of the AA, as shown in the following tables:

| Geographic Distribution of Residential Real Estate Loans by Income Level | | | | | |
|---|-----------------|---------------------|------------------------|---------------------|-------------------|
| Census Tract Income Level | Number of Loans | Percent of Loans by | Dollar Amount of Loans | Percent of Loans by | Percent of Owner- |

| | | Number | | Dollar | Occupied Homes |
|---------------|-----------|-------------|--------------------|-------------|----------------|
| Low | 0 | 0% | \$0 | 0% | 2% |
| Moderate | 5 | 22% | \$269,000 | 22% | 16% |
| Middle | 16 | 70% | \$732,985 | 61% | 76% |
| Upper | 2 | 8% | \$198,240 | 17% | 6% |
| Totals | 23 | 100% | \$1,200,225 | 100% | 100% |

Source: Bank records (verified by examiners) and U.S. Census Demographic Data (1990)

| Geographic Distribution of Commercial Real Estate Loans by Income Level | | | | | |
|--|-----------------|----------------------------|--------------------|----------------------------|-----------------------|
| Census Tract Income Level | Number of Loans | Percent of Loans by Number | Dollar of Loans | Percent of Loans by Dollar | Percent of Businesses |
| Low | 0 | 0% | \$0 | 0% | 1% |
| Moderate | 2 | 9% | \$742,000 | 27% | 10% |
| Middle | 18 | 86% | \$1,937,669 | 72% | 80% |
| Upper | 1 | 5% | \$30,000 | 1% | 9% |
| Totals | 21 | 100% | \$2,709,669 | 100% | 100% |

Source: Bank records (verified by examiners) and U.S. Census Business Demographic Data (1990)

| Geographic Distribution of Commercial Loans by Income Level | | | | | |
|--|-----------------|----------------------------|--------------------|----------------------------|-----------------------|
| Census Tract Income Level | Number of Loans | Percent of Loans by Number | Dollar of Loans | Percent of Loans by Dollar | Percent of Businesses |
| Low | 0 | 0% | \$0 | 0% | 1% |
| Moderate | 0 | 0% | \$0 | 0% | 10% |
| Middle | 18 | 90% | \$1,572,600 | 81% | 80% |
| Upper | 2 | 10% | \$360,315 | 19% | 9% |
| Totals | 20 | 100% | \$1,932,915 | 100% | 100% |

Source: Bank records (verified by examiners) and U.S. Census Business Demographic Data (1990)

The lack of penetration in the sample of loans to borrowers and businesses in the one low-income BNA is not a concern due to the geographically distant location of the BNA and the fact that FNB Deerwood's nearest branch to that location was only recently opened. Also, the lack of

commercial loans in the moderate-income BNAs is not a concern due to the residential real estate and commercial real estate loan penetration which carries greater weight in this evaluation.

Responses to Complaints

FNB Deerwood has not received any CRA-related complaints during the time frame of this evaluation.

Fair Lending Review

An analysis of 1999, 2000, 2001, and 2002 public comments and consumer complaint information was performed according to the OCC's risk based fair lending approach. Based on its analysis of the information, the OCC decided that a comprehensive fair lending examination would not need to be conducted in connection with this CRA evaluation. The latest comprehensive fair lending examination was performed in 1998.