



SMALL BANK

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

PUBLIC DISCLOSURE

April 4, 2005

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

**Heritage Bank, National Association
Charter Number 15401**

**120 South Street West
Spicer, Minnesota 56288**

**Comptroller of the Currency
Minneapolis West Field Office
4900 South Minnesota Avenue, Suite 300
Sioux Falls, South Dakota 57108**

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.

INSTITUTION'S CRA RATING

This institution is rated "Outstanding."

- Heritage Bank's average loan-to-deposit ratio of 87.43 percent is more than reasonable when compared to similarly situated banks and factoring in the bank's high volume of loan sales.
- A majority (74 percent) of the bank's residential, commercial, and consumer loans are originated within the assessment area.
- Residential lending patterns show good distribution of loans to borrowers of different income levels, especially through the use of two residential loan programs targeted to low- and moderate-income families. Commercial and consumer lending patterns show excellent responsiveness to the credit needs of businesses of various sizes and to borrowers of various income levels, respectively.
- Community development lending of over \$1.2 million enhances the bank's overall rating.

DESCRIPTION OF INSTITUTION

Heritage Bank, National Association (Heritage Bank) is a \$149 million commercial bank headquartered in Spicer, Minnesota, with additional branches in Willmar, Pennock, and Raymond, Minnesota. The bank owns and operates two cash-dispensing automated teller machines (ATMs), located at the Spicer and Willmar branch offices.

Heritage Bank is 100 percent owned by Heritage Bancshares Group, Inc., a \$266 million, two-bank holding company headquartered in Willmar, Minnesota. The sister bank is Heritage Bank, National Association (Iowa) located in Holstein, Iowa. On October 8, 2004, the bank acquired the Farmers State Bank of Raymond, Raymond, Minnesota.

The bank offers traditional community banking products. According to its December 31, 2004 Report of Condition and Income, the bank has the following outstanding loans by dollar volume: commercial (42 percent), residential real estate (22 percent), agricultural (21 percent), and consumer (14 percent). Net loans total 76 percent of total assets.

Heritage Bank received an "Outstanding" rating at its June 22, 1998 CRA examination. This Performance Evaluation assesses the bank's CRA activities from April 1, 1998 through March 15, 2005. There are no financial, legal, or other factors that impede the bank's ability to meet the credit needs of its assessment area.

DESCRIPTION OF ASSESSMENT AREA

The bank’s assessment area consists of Kandiyohi County in Minnesota. The county has a population of 41,203 persons according to the 2000 U.S. Census data. The assessment area contains 12 census tracts, 11 of which are middle-income and one of which is upper-income. The 2000 U.S. Census estimates the median housing value to be \$94,314 and 65 percent of all housing units are owner-occupied.

The assessment area complies with regulatory requirements. The assessment area includes all branches and ATMs as well as a majority of the bank’s loans. It does not arbitrarily exclude any low- or moderate-income census tracts.

The 2000 U.S. Census and 2004 Department of Housing and Urban Development estimated median family income for the non-metropolitan areas of Minnesota are \$45,925 and \$53,000, respectively. The following table summarizes the income levels of individual census tracts and families located within Heritage Bank’s assessment area:

Income Distribution of Census Tracts and Families								
Assessment Area	Number of Census Tracts				Percentage of Families			
	Low	Moderate	Middle	Upper	Low	Moderate	Middle	Upper
Kandiyohi	0 (0%)	0 (0%)	11 (92%)	1 (8%)	15%	19%	25%	41%

Source: U.S. Census Data (2000)

Economic conditions in the area are good. According to December 2004 U.S. Bureau of Labor Statistics, the Kandiyohi County unemployment rate is 4.8 percent. This is comparable to the Minnesota unemployment rate of 4.6 percent and below the national unemployment rate of 5.4 percent. Major employers in the area are centered in health care, meat processing, and education.

Competition in the area is healthy. Heritage Bank’s market share of deposits in Kandiyohi County is 12.4 percent, ranking third among the 14 banks operating in the assessment area. The three institutions in Kandiyohi County with the highest market share control approximately 44 percent of deposits.

During our evaluation, we contacted two Kandiyohi County organizations related to affordable housing and economic development to better understand the credit needs of the assessment area. Based on this information, we determined that Heritage Bank, along with other local banks, is effectively meeting the community’s credit needs.

CONCLUSIONS ABOUT PERFORMANCE CRITERIA

Loan-to-Deposit Ratio

Heritage Bank's net loan-to-deposit ratio is more than reasonable given the bank's size, financial condition, and assessment area credit needs. The quarterly net loan-to-deposit ratio averaged 87.43 percent for the 27 quarters beginning June 30, 1998 and ending December 31, 2004. The bank's net loan-to-deposit ratio has steadily increased over the 27 quarters and totals 90.9 percent at December 31, 2004.

The bank's net loan-to-deposit ratio compares favorably with other community banks of similar size (total assets over \$50 million) with substantial operations in the assessment area. The bank ranks second among six similarly situated banks. The other five banks had quarterly average net loan-to-deposit ratios averaging 65.6 percent and ranging between 13.8 percent and 87.8 percent for the 27 quarters from June 30, 1998 through December 31, 2004.

During the period beginning January 1, 2003 and ending March 15, 2005, the bank sold about 835 residential real estate loans totaling approximately \$100 million to the secondary market. Heritage Bank retains the servicing rights to these loans, but sells the principal portion to manage liquidity and interest rate risk. If the bank had retained these loans in its portfolio, the bank's loan-to-deposit ratio on December 31, 2004 would have been about 170 percent.

Lending in Assessment Areas

Heritage Bank originates a majority of its loans to borrowers located within its defined assessment area. Examiners sampled 60 residential, 20 commercial, and 20 consumer loans originated between January 1, 2003 and March 15, 2005; these are the bank's primary products, in order of importance. About 74 percent by number and 57 percent by dollar volume of the loans sampled were made to borrowers located within the bank's assessment area. The following table shows primary product loans originated inside the assessment area by number and dollar volume:

Lending in Assessment Area by Number and Dollar Volume				
Type of Loan	Number	Percent of Number	Dollars (000s)	Percent of Dollars
Residential	45 of 60	75%	\$5,151 of \$7,092	73%
Commercial	12 of 20	60%	\$374 of \$2,668	14%
Consumer	17 of 20	85%	\$169 of \$180	94%
Total	74 of 100	74%	\$5,694 of \$9,940	57%

Source: Bank records (verified by examiners)

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

Overall, the distribution of borrowers reflects good penetration among individuals of different income levels and excellent penetration among businesses of different sizes. Community development lending enhances the bank's CRA performance.

Residential lending activity shows good lending levels to borrowers of varying income levels. Our sample of 60 residential loans found lending to low-income borrowers is poor and is substantially below community demographics of 15 percent. However, lending to moderate-income borrowers is excellent, approximating community demographics of 19 percent. The following table compares the bank's residential lending activity by borrower income level to community demographics:

Borrower Distribution of Residential Real Estate Loans by Income Level			
Borrower Income Level	Number	Percent of Number	Percent of Families
Low	0	0%	15%
Moderate	11	18%	19%
Middle	13	22%	25%
Upper	36	60%	41%
Total	60	100%	100%

Source: Bank records (verified by examiners) and U.S. Census Data (2000)

The lack of lending to low-income borrowers is explained in part by the high median cost of housing for the assessment area. However, the majority of Heritage Bank's low- and moderate-income loans are made through the U.S. Department of Agriculture's Rural Housing Authority (RHA) guaranteed loan program. The program allows 100 percent financing of the purchase for a 30-year term. Heritage Bank is a leading lender for the program in Minnesota, ranking third among all financial institutions in loan originations. Since January 1, 2003, the bank originated 167 loans totaling over \$15 million in the RHA program. Of these, low-income families received 28 loans (17 percent) and moderate-income families received 70 loans (42 percent). The average loan size is \$90,500, which is very similar to the median housing cost of \$94,314.

In addition, Heritage Bank provides funding through the Minnesota Housing Finance Agency (MHFA). Programs available through MHFA provide below-market interest rates and other financial assistance to eligible first-time homebuyers. Since January 1, 2003, the bank originated 87 MHFA loans totaling \$6.9 million.

Commercial lending activity is excellent, exceeding business demographics of the assessment area. Eighty percent of commercial borrowers had gross annual revenues of less than \$1 million, which is well above assessment area demographics of 67 percent. In addition, the largest number of loans was originated to small businesses with less than \$100 thousand in gross annual revenues. The following table compares the bank's commercial lending activity by revenue size to community demographics:

Borrower Distribution of Commercial Loans by Revenue Size			
Gross Annual Revenue	Number	Percent of Number	Business Data
<\$100,000	8	80%	67%
\$100,000 - \$250,000	3		
\$250,000 - \$500,000	3		
\$500,000 - \$1,000,000	2		
>\$1,000,000	2	10%	6%
Unknown/Not Reported	2	10%	27%
Totals	20	100%	100%

Source: Bank records (verified by examiners) and U.S. Census Business Demographic Data (2003)

Heritage Bank maintains its Preferred Lender status with the Small Business Association (SBA). Through various programs available through the SBA, commercial borrowers are able to obtain more flexible terms and loan guarantees to start or grow small businesses that may otherwise not qualify for traditional bank financing. The outstanding balance of the 29 SBA loans originated since January 1, 2000 is \$6.8 million.

Consumer lending activity shows excellent lending levels to borrowers of varying income levels. Lending to low- and moderate-income borrowers is excellent and is substantially above community demographics of 20 and 18 percent, respectively. The following table compares the bank's residential lending activity by borrower income level to community demographics:

Borrower Distribution of Consumer Loans by Income Level			
Borrower Income Level	Number	Percent of Number	Percent of Households
Low	6	30%	20%
Moderate	5	25%	18%
Middle	3	15%	19%
Upper	3	15%	43%
Unknown/Not Reported	3	15%	0%
Total	20	100%	100%

Source: Bank records (verified by examiners) and U.S. Census Data (2000)

Geographic Distribution of Loans

Analysis of lending by geographic distribution is not meaningful. The assessment area contains only middle- and upper-income census tracts.

Community Development Loans, Investments, and Services

Community development lending reflects favorably on Heritage Bank's CRA performance. The bank provided loans totaling \$871 thousand to two nonprofit organizations that provide housing and assistance with living skills to handicapped individuals in Kandiyohi and surrounding counties in Minnesota. The bank originated 19 loans totaling \$393 thousand for economic development purposes. Funds may be used for acquisition, construction, conversion, modernization, or development of businesses located in downtown Willmar.

In 2003, Heritage Bank partnered with a housing organization to secure a \$120,000 Affordable Housing Program grant from the Federal Home Loan Bank of Des Moines. The recipient of the grant is a domestic violence shelter in Willmar that serves an 18-county area of southwestern Minnesota.

Responses to Complaints

The bank has not received any substantive CRA-related complaints since the last examination.

Fair Lending or Other Illegal Credit Practices Review

We found no evidence of illegal discrimination or other illegal credit practices.