

PUBLIC DISCLOSURE

December 3, 2018

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

North Shore Bank of Commerce
131 West Superior Street
P.O. Box 16450
Duluth Minnesota 55802
RSSD 126553

**Federal Reserve Bank of Minneapolis
90 Hennepin Avenue, P.O. Box 291
Minneapolis, MN 55480-0291**

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 the 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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Definitions for many of the terms used in this performance evaluation can be found in section 228.12 of Regulation BB. For additional convenience, a Glossary of Common CRA Terms is attached as Appendix A at the end of this performance evaluation.

INSTITUTION’S CRA RATING: This institution is rated Satisfactory.

Examiners evaluated the Community Reinvestment Act (CRA) performance of North Shore Bank of Commerce, Duluth, Minnesota, using the Small Bank CRA Examination Procedures. Based on the bank’s asset size and financial conditions, the bank effectively meets the credit needs of residents and small businesses in its assessment area.

Several factors support the bank’s Satisfactory rating:

- Overall, the bank’s lending to borrowers of different income levels and to businesses of different sizes is excellent.
- The geographic distribution of the bank’s loans reflects reasonable dispersion throughout its assessment area.
- The bank originated a substantial majority of its loans within the assessment area.
- The bank’s net loan-to-deposit is reasonable given the bank’s size, financial condition, and the assessment area’s credit needs.

The bank received a Satisfactory rating at the previous evaluation dated July 28, 2014.

SCOPE OF EVALUATION

The scope of the evaluation covers the bank’s major product lines, which are residential real estate loans and small business loans, as shown in Table 1.

| TABLE 1¹ | | | | |
|--|------------------------|-----------------------------------|---------------------------|------------------------------------|
| Loan Originations From January 1, 2017, through December 31, 2017 | | | | |
| <i>Loan Type</i> | <i>Number of Loans</i> | <i>Percentage of Total Number</i> | <i>Total Loan Dollars</i> | <i>Percentage of Total Dollars</i> |
| Construction/Land Development | 44 | 4.7 | \$10,995,643 | 7.0 |
| Consumer | 47 | 5.1 | \$1,232,229 | 0.8 |
| Home Equity Lines of Credit | 68 | 7.3 | \$4,858,400 | 3.1 |
| Letters of Credit | 11 | 1.2 | \$2,731,581 | 1.7 |
| Residential Real Estate | 665 | 71.7 | \$115,931,742 | 73.3 |
| Small Business (≤ \$1 million) | 87 | 9.4 | \$11,103,294 | 7.0 |
| Commercial (> \$1 million) | 5 | 0.5 | \$10,362,200 | 6.6 |
| Tax Exempt | 1 | 0.1 | \$974,304 | 0.6 |
| Total | 928 | 100.0 | \$158,189,393 | 100.0 |

Examiners analyzed a statistical sample of 59 small business loans originated from August 1, 2017, through July 31, 2018. In addition, the bank is required to collect and report Home Mortgage Disclosure Act (HMDA) data, because it operates offices in the Duluth MN-WI Metropolitan Statistical Area (Duluth MN-WI MSA). Accordingly, examiners also analyzed the bank’s 2014, 2015, 2016, and 2017 HMDA-reportable loans, which total 2,941 home purchase, refinance, home improvement, and multifamily loans. Examiners analyzed the bank’s HMDA data to understand the residential real estate mortgage market and the bank’s performance in the assessment area. As part of the analysis, examiners

¹Note: Because the percentages presented in the tables are rounded to the nearest tenth, some columns or rows may not total 100.0%.

compared the bank's HMDA lending performance to that of aggregate lenders who reported HMDA loans in the bank's assessment area. Examiners determined that the bank's 2014 and 2015 HMDA lending was generally consistent with its 2016 and 2017 lending performance. The public evaluation only includes the analysis for 2016 and 2017.

Examiners analyzed the following criteria to determine the bank's CRA rating:

- Lending to borrowers of different income levels and to businesses of different sizes.
- Geographic distribution of loans.
- Lending inside the assessment area.
- Net loan-to-deposit ratio.
- Record of responding to complaints about the bank's CRA performance.

For the evaluation criteria, examiners placed the greatest weight on the bank's lending to borrowers of different income levels and to businesses of different sizes, followed by the geographic distribution of loans. Examiners weighted the remaining criteria equally. By product, HMDA lending received the greatest weight, as it represents the largest percentage of the bank's loan originations by number and dollar amount for the evaluation period. It also represents the largest percentage of the bank's overall loan portfolio. The bank has not received any CRA-related complaints since the previous evaluation.

This evaluation is based in part on discussions with bank management and interviews with members of the community familiar with economic issues and demographic characteristics of the assessment area. Examiners used information from these sources to evaluate the bank's CRA performance.

DESCRIPTION OF INSTITUTION

Offices. North Shore Bank of Commerce's main office and a nearby drive-up facility, Auto Bank, are located in downtown Duluth. The bank also operates three full-service branches, two in Duluth (Lakeside and Woodland) and one in Hermantown, Minnesota. Each branch offers drive-up services. The main office, Auto Bank, and branches each have a cash-dispensing-only ATM. The main office and Auto Bank are located in a moderate-income census tract, the Lakeside branch is located in a middle-income census tract, and the Woodland and Hermantown branches are located in upper-income census tracts. At the previous evaluation, the bank's main office and the Auto Bank were located in a low-income census tract, but during the evaluation period, the census tract demographics changed. The bank's hours of operation are reasonable and the drive-up facilities have extended weekday and Saturday hours.

Since the previous evaluation, the bank opened a loan production office (LPO) in Superior, Wisconsin, on January 2, 2015. The bank continues to have an LPO in Cloquet, Minnesota.

Alternative Delivery Methods: The bank offers online, mobile, and telephone banking; bill payment services; and access to a surcharge-free ATM network. These features allow customers to review account information, transfer funds, make payments, and view periodic statements. Since the previous evaluation, the bank has increased the functionality of its website and now allows customers to open accounts and to submit residential real estate applications online. The bank also introduced person-to-person payments and a variety of digital wallet applications.

Loan Portfolio. According to the September 30, 2018, Report of Condition, the bank's assets total \$274.9 million. The bank's \$194.9 million loan portfolio consists of 53.6% residential real estate, 39.6% commercial, 6.1% other, and 0.7% consumer loans. Since the previous evaluation, the loan

portfolio increased by 16.2%; however, the overall composition of the loan portfolio remained relatively stable.

Credit Products. The bank offers a variety of loan products to meet the needs of the residents and small businesses in its assessment area. Residential real estate loans include purchase, refinance, closed-end home equity, and construction loans. The bank actively participates in various residential real estate loan programs sponsored by the Federal Housing Administration (FHA), U.S. Department of Veterans Affairs (VA), U.S. Department of Agriculture Rural Development (USDA), Minnesota Housing Finance Agency (MHFA), and Wisconsin Housing and Economic Development Authority (WHEDA). The bank offers traditional commercial and consumer loan products, including term loans and lines of credit. In addition, the bank participates in Small Business Administration (SBA) loan programs.

Market Share. According to the June 30, 2018, Federal Deposit Insurance Corporation Deposit Market Share Report, the bank ranks sixth of 29 FDIC-insured financial institutions in the Duluth MN-WI MSA, with 5.5% of the total deposits.

DESCRIPTION OF ASSESSMENT AREA

Assessment Area Information. The bank designates one assessment area for CRA purposes that is within the Duluth MN-WI MSA. The Duluth MN-WI MSA consists of St. Louis and Carlton counties in Minnesota and Douglas County in Wisconsin. The bank's assessment area includes the entire MSA except for the three northernmost census tracts in St. Louis County. The bank increased the size of its assessment area in 2015 to better align with its trade area. Previously, the bank took portions of Douglas and St. Louis counties and the entirety of Carlton County. At that time, the assessment area consisted of nine low-, 10 moderate-, 27 middle-, and 14 upper-income census tracts.

During the evaluation period, the income classifications of several census tracts changed, based on 2017 Federal Financial Institutions Examination Council (FFIEC) adjusted census data. In 2015 and 2016, the assessment area consisted of nine low-, 17 moderate-, 42 middle-, 14 upper-, and two unknown-income census tracts. Beginning in 2017, the assessment area has consisted of eight low-, 16 moderate-, 42 middle-, 16 upper-, and two unknown-income census tracts. The unknown-income tracts cover portions of Lake Superior.²

Table 2 shows the demographic characteristics of the assessment area based on the 2018 FFIEC adjusted census data³ and 2017 Dun & Bradstreet data.

² Some ranges of census tract numbers in the 2010 Census are used to identify distinctive types of tracts. These two unknown-income tracts (9900s) were delineated specifically to cover large bodies of water. .

³ The FFIEC adjusted census data is based on decennial U.S. Census data and American Community Survey (ACS) five-year estimate data, and it reflects the Office of Management and Budget's metropolitan statistical area revisions.

| <i>Income Categories</i> | <i>Tract Distribution</i> | | <i>Families by Tract Income</i> | | <i>Families < Poverty Level as % of Families by Tract</i> | | <i>Families by Family Income</i> | |
|--|----------------------------------|-------------------------------|---|---------------|--|---------------|----------------------------------|--------------|
| | <i>#</i> | <i>%</i> | <i>#</i> | <i>%</i> | <i>#</i> | <i>%</i> | <i>#</i> | <i>%</i> |
| Low Income | 8 | 9.5 | 3,066 | 4.6 | 1,183 | 38.6 | 13,238 | 19.8 |
| Moderate Income | 16 | 19.0 | 8,788 | 13.1 | 1,706 | 19.4 | 11,622 | 17.4 |
| Middle Income | 42 | 50.0 | 38,144 | 57.0 | 3,025 | 7.9 | 15,455 | 23.1 |
| Upper Income | 16 | 19.0 | 16,962 | 25.3 | 574 | 3.4 | 26,645 | 39.8 |
| Unknown Income | 2 | 2.4 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| Total Assessment Area | 84 | 100.0 | 66,960 | 100.0 | 6,488 | 9.7 | 66,960 | 100.0 |
| <i>Income Categories</i> | <i>Housing Units by Tract</i> | <i>Housing Types by Tract</i> | | | | | | |
| | | <i>Owner-Occupied</i> | | <i>Rental</i> | | <i>Vacant</i> | | |
| | | <i>#</i> | <i>%</i> | <i>%</i> | <i>#</i> | <i>%</i> | <i>#</i> | <i>%</i> |
| Low Income | 9,001 | 2,000 | 2.5 | 22.2 | 6,079 | 67.5 | 922 | 10.2 |
| Moderate Income | 20,017 | 9,208 | 11.6 | 46.0 | 8,477 | 42.3 | 2,332 | 11.7 |
| Middle Income | 74,232 | 47,673 | 60.1 | 64.2 | 13,015 | 17.5 | 13,544 | 18.2 |
| Upper Income | 27,952 | 20,497 | 25.8 | 73.3 | 4,670 | 16.7 | 2,785 | 10.0 |
| Unknown Income | 0 | 0 | 0.0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| Total Assessment Area | 131,202 | 79,378 | 100.0 | 60.5 | 32,241 | 24.6 | 19,583 | 14.9 |
| <i>Income Categories</i> | <i>Total Businesses by Tract</i> | | <i>Businesses by Tract and Revenue Size</i> | | | | | |
| | | | <i>≤ \$1 Million</i> | | <i>> \$1 Million</i> | | <i>Revenue Not Reported</i> | |
| | | | <i>#</i> | <i>%</i> | <i>#</i> | <i>%</i> | <i>#</i> | <i>%</i> |
| Low Income | 1,015 | 9.7 | 800 | 8.7 | 206 | 19.7 | 9 | 3.9 |
| Moderate Income | 1,846 | 17.7 | 1,551 | 16.9 | 264 | 25.3 | 31 | 13.5 |
| Middle Income | 5,273 | 50.5 | 4,686 | 51.1 | 434 | 41.6 | 153 | 66.8 |
| Upper Income | 2,302 | 22.1 | 2,126 | 23.2 | 140 | 13.4 | 36 | 15.7 |
| Unknown Income | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| Total Assessment Area | 10,436 | 100.0 | 9,163 | 100.0 | 1,044 | 100.0 | 229 | 100.0 |
| Percentage of Total Businesses: | | | | 87.8 | 10.0 | | | 2.2 |
| <i>Income Categories</i> | <i>Total Farms by Tract</i> | | <i>Farms by Tract and Revenue Size</i> | | | | | |
| | | | <i>≤ \$1 Million</i> | | <i>> \$1 Million</i> | | <i>Revenue Not Reported</i> | |
| | | | <i>#</i> | <i>%</i> | <i>#</i> | <i>%</i> | <i>#</i> | <i>%</i> |
| Low Income | 5 | 2.4 | 4 | 1.9 | 1 | 100.0 | 0 | 0.0 |
| Moderate Income | 5 | 2.4 | 5 | 2.4 | 0 | 0.0 | 0 | 0.0 |
| Middle Income | 157 | 75.5 | 157 | 75.8 | 0 | 0.0 | 0 | 0.0 |
| Upper Income | 41 | 19.7 | 41 | 19.8 | 0 | 0.0 | 0 | 0.0 |
| Unknown Income | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| Total Assessment Area | 208 | 100.0 | 207 | 100.0 | 1 | 100.0 | 0 | 0.0 |
| Percentage of Total Farms: | | | | 99.5 | | 0.5 | | 0.0 |

Income. For purposes of classifying borrower income, this evaluation uses the FFIEC estimated median family income for the Duluth MN-WI MSA, for the year of loan origination. This figure is \$62,700 for 2016 and \$67,200 for 2017.⁴ For purposes of classifying census tracts by income level, this evaluation

⁴ This figure is \$63,500 for 2015 and \$64,300 for 2014.

uses the FFIEC adjusted census data median family income for the Duluth MN-WI MSA, which is \$59,812 for 2014 through 2016 and \$64,345 for 2017 and 2018.

Population Characteristics. According to the 2018 FFIEC adjusted census data, the population of the assessment area is 269,286. The majority of the population, 74.5%, lives in St. Louis County. Within St. Louis County, 43.0% of the residents live in the city of Duluth. The population of the assessment area is predominantly white, non-Hispanic, at 91.5%. According to demographic data, the majority of the population in the assessment area is 25 to 64 years of age (51.8%). The remaining population is 17 years and younger (20.3%), 65 and older (16.2%), and 18 to 24 years of age (11.8%). Despite a number of post-secondary schools in the assessment area, which attract residents for a few years, the population in the Duluth area has not changed significantly, as students tend to leave the area after graduation.

American Indian Reservation. The Fond du Lac Reservation is located in portions of Carlton and St. Louis counties and is home to the Fond du Lac Band of Lake Superior Chippewa. The population of the reservation is 4,048 according to 2012 to 2016 ACS data. Prior to the census update in 2017, a portion of the reservation in Carlton County was in a moderate-income census tract; however, the reservation is currently located in middle-income census tracts.

Economy and Business Characteristics. The economy in the assessment area is stable, according to bank management and community contacts. The area benefits from a number of diverse industries, including health care, higher education, manufacturing, transportation, aviation, and tourism (including hospitality). Duluth is the regional center for northeastern Minnesota and people come to the area for health care, services, and retail. In addition, many people commute to Duluth for work from surrounding areas, including Superior, Wisconsin. Because of the varied industries, bank management indicated that the Duluth area economy does not experience much volatility. Contacts indicated that the health-care industry employs around 60% of the population in the Duluth area and major employers include Essentia Health and St. Luke's Hospital. Seasonality drives the tourism industry, with higher volumes of tourists in the warmer months. However, bank management stated that the area does attract travelers during the winter months with special sports tournaments and holiday attractions. No industry has downsized significantly in recent years; however, a few larger retailers have closed at the local mall. The craft brewing industry, in the small business sector, is growing. In addition, some revitalization efforts in West Duluth neighborhoods are focusing on small business start-ups and expansions.

The bank's assessment area includes a portion of the Iron Range, an area composed of iron-ore mining districts. Bank management and community contacts stated that the Iron Range economy is dependent on mining. A community contact stated that the town of Virginia is considered the heart of the Iron Range, while areas east of the Iron Range depend more on tourism, with the Boundary Waters Canoe Area Wilderness located nearby.

According to the Bureau of Labor Statistics, the September 2018 nonseasonally adjusted unemployment rate was 2.7% for the Duluth MN-WI MSA, 2.2% for Minnesota, and 2.6% for Wisconsin. These rates are lower than the national rate of 3.6% for the same period. Bank management and community contacts noted that the area is experiencing a workforce shortage, which is partially due to a lack of available housing. In addition, a community contact indicated the low unemployment rate for the area is misleading for disadvantaged groups, including minorities, whose unemployment rate is much higher.

Housing Characteristics. According to community contacts and bank management, affordable housing is a concern in the assessment area. In Duluth and surrounding areas, the costs of both home purchases and rentals are out of reach for some low- and moderate-income residents, as wages have not kept pace with housing costs. Lack of workforce housing for all income levels is a barrier to bringing additional labor

into the area. Bank management and community contacts stated that high construction costs are an obstacle, as new construction tends to be market rate in order to make projects profitable. In addition, the high construction costs have slowed new construction, even in the fastest-growing parts of the assessment area, such as Hermantown, northwest of Duluth. However, bank management and community contacts stated there is demand for homes, as houses do not stay on the market for long. In areas that could be affordable for low- and moderate-income residents, much of the housing stock is older and needs renovations, which can make the homes too expensive. Contacts mentioned that it would be difficult for low- and moderate-income residents to purchase a home, as the median housing value in Duluth is too high.

Rental prices are also difficult for low- and moderate-income residents to afford. Many affordable apartments tend to be small and in need of repair. Similar to single-family homes, new apartment buildings tend to be market rate in order to cover high construction costs. While there have been some affordable rental housing projects recently, these projects did not increase the number of affordable housing units in the area but maintained current numbers. Some older buildings were either demolished and replaced or restored. Community contacts stated that the vacancy rate is low, around 3.5%, which limits the opportunities for people to find adequate rental housing.

While there is demand for HMDA and small business loans in the assessment area, bank management and community contacts stated that there is also significant competition. Numerous financial institutions, including large national banks, regional banks, credit unions, and mortgage companies operate in the Duluth MN-WI MSA and surrounding areas. Community contacts did not identify any unmet credit needs in the assessment area.

CONCLUSIONS WITH RESPECT TO PERFORMANCE CRITERIA

The bank's performance in meeting the credit needs of its assessment area is rated Satisfactory. Overall, the bank's lending to borrowers of different income levels and to businesses of different sizes is excellent. The geographic distribution of loans throughout the assessment area is reasonable and does not reveal any unexplained gaps in lending. The bank originated a substantial majority of its loans within the assessment area, and the bank's net loan-to-deposit ratio is reasonable for the bank's asset size and complexity.

The evaluation compares the bank's lending activity to demographic information, including census data. Although demographic information provides context for understanding and evaluating the bank's performance, comparisons to the demographic data do not define an expected level of lending. Instead, examiners evaluate each individual bank's CRA performance in light of its overall performance context.

LENDING TO BORROWERS OF DIFFERENT INCOME LEVELS AND TO BUSINESSES OF DIFFERENT SIZES

Overall, the bank's lending to borrowers of different income levels and businesses of different sizes is excellent, based on an excellent level of HMDA lending to low- and moderate-income borrowers and a reasonable level of lending to small businesses.

Residential Real Estate lending. The bank's HMDA lending to low- and moderate-income borrowers is excellent. Table 3 shows the bank's 2017 and 2016 HMDA lending by borrower income level.

| TABLE 3 | | | | | | | | | | |
|--|------------|------------|-----------------|-------------|---------------|-------------|--------------|-------------|----------------|------------|
| 2017 HMDA Loans by Income Level of Borrower | | | | | | | | | | |
| <i>Income Level of Borrower</i> | <i>Low</i> | | <i>Moderate</i> | | <i>Middle</i> | | <i>Upper</i> | | <i>Unknown</i> | |
| <i>Loan Type</i> | # | % | # | % | # | % | # | % | # | % |
| Home Purchase | 40 | 8.3 | 99 | 20.5 | 132 | 27.3 | 190 | 39.3 | 23 | 4.8 |
| Refinance | 6 | 4.6 | 16 | 12.3 | 28 | 21.5 | 79 | 60.8 | 1 | 0.8 |
| Home Improvement | 1 | 3.6 | 4 | 14.3 | 2 | 7.1 | 17 | 60.7 | 4 | 14.3 |
| Multifamily | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 1 | 100.0 |
| Total 2017 HMDA Loans | 47 | 7.3 | 119 | 18.5 | 162 | 25.2 | 286 | 44.5 | 29 | 4.5 |
| 2016 HMDA Loans by Income Level of Borrower | | | | | | | | | | |
| <i>Income Level of Borrower</i> | <i>Low</i> | | <i>Moderate</i> | | <i>Middle</i> | | <i>Upper</i> | | <i>Unknown</i> | |
| <i>Loan Type</i> | # | % | # | % | # | % | # | % | # | % |
| Home Purchase | 39 | 7.3 | 109 | 20.5 | 154 | 28.9 | 222 | 41.7 | 9 | 1.7 |
| Refinance | 7 | 3.7 | 22 | 11.5 | 40 | 20.9 | 118 | 61.8 | 4 | 2.1 |
| Home Improvement | 0 | 0.0 | 5 | 15.6 | 5 | 15.6 | 21 | 65.6 | 1 | 3.1 |
| Multifamily | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 | 3 | 100.0 |
| Total 2016 HMDA Loans | 46 | 6.1 | 136 | 17.9 | 199 | 26.2 | 361 | 47.6 | 17 | 2.2 |

The bank originated 643 HMDA-reportable loans in the Duluth MN-WI MSA in 2017 and 759 HMDA-reportable loans in 2016. In 2017, the bank ranked third among 286 lenders that reported HMDA loans in the assessment area, with an 8.0% market share. In 2016, the bank ranked third among 303 HMDA reporters, with an 8.8% market share. The largest reporters for each year were large, nationally chartered financial institutions.

In 2017, the bank originated 7.3% and 18.5% of its HMDA loans to low- and moderate-income borrowers, respectively. In 2016, the bank originated 6.1% and 17.9% of its HMDA loans to low- and moderate-income borrowers, respectively. According to demographic data, 19.8% of families in the assessment area are low income and 17.4% are moderate income for both years. Aggregate lenders extended 8.1% of their HMDA loans to low-income borrowers and 17.6% to moderate-income borrowers in 2017; in 2016, aggregate lenders extended 6.7% of their HMDA loans to low-income borrowers and 16.5% to moderate-income borrowers. For 2017 and 2016, the bank’s performance is below demographics for low-income borrowers but it is similar to aggregate lenders. For moderate-income borrowers, the bank’s performance is comparable to both demographic and aggregate lenders.

The majority of the bank’s HMDA loans were for home purchases (75.3% in 2017 and 70.2% in 2016). In this category, the bank’s performance is comparable to aggregate lenders for loans to low-income borrowers and slightly exceeds aggregate lenders for loans to moderate-income borrowers. In 2017, the bank originated 8.3% and 20.5% of its home purchase loans to low- and moderate-income borrowers, respectively, while aggregate lenders originated 8.3% and 19.2% of their home purchase loans to low- and moderate-income borrowers, respectively. In 2016, the bank originated 7.3% and 20.5% of its home purchase loans to low- and moderate-income borrowers, respectively, while aggregate lenders originated 7.4% and 18.9% of their home purchase loans to low- and moderate-income borrowers, respectively.

As previously noted, affordable housing is a concern in the assessment area. Using the assumption that a borrower can obtain a loan for approximately three times the borrower’s annual income, based on the 2017 FFIEC estimated median family income of \$67,200 for the Duluth MN-WI MSA, an individual with

the highest income in the low-income bracket (\$33,599) could afford a \$100,797 home. Using the same assumption for borrowers with the highest income in the moderate-income bracket (\$53,759), a borrower could afford a \$161,277 home. According to the 2017 FFIEC adjusted census data, the median housing value in the Duluth MN-WI MSA is \$140,975. However, community contacts stated that this figure seemed low, and one contact estimated that it is difficult to find homes priced lower than \$200,000. This data suggests that homeownership would not be affordable for many low- and moderate-income residents in the assessment area.

The bank offers a number of programs through MHFA and WHEDA that help lower-income individuals (including first-time homebuyers) purchase, refinance, or rehabilitate a home. The programs include loans with down payment assistance, affordable interest rates, closing cost assistance, and loans with monthly payment assistance. The bank also offers a variety of federal government-sponsored loan programs to help serve the needs of all borrowers in the assessment area, including low- and moderate-income borrowers. These loan programs are responsive to the needs of borrowers in the area.

Given the assessment area’s affordable-housing challenges, the competition for HMDA loans, and the programs the bank has to meet the credit needs of borrowers, the bank’s lending performance is excellent.

Examiners also evaluated the bank’s 2015 and 2014 HMDA lending activities. The distribution of HMDA loans by borrower income level for 2015 and 2014 is generally comparable to 2017 and 2016 performance.

Small Business Lending. The bank’s lending to small businesses is reasonable. Table 4 shows the bank’s small business lending by business income level in 2018 and 2017.

| <i>Small Business Loan Originations</i> | <i>≤ \$100,000</i> | <i>\$100,000 to ≤ \$250,000</i> | <i>> \$250,000 to ≤ \$1,000,000</i> | <i>Total Originations</i> |
|--|--------------------|-------------------------------------|--|-------------------------------|
| Percentage of Small Business Loans | 63.5% | 26.9% | 9.6% | 100.0% |
| Percentage of Loans to Businesses with Revenues of \$1 Million or Less | 51.5% | 33.3% | 15.2% | 63.5% |

The bank originated 63.5% of its small business loans to entities with gross annual revenues of \$1 million or less. According to 2017 Dun & Bradstreet data, 87.8% of businesses in the assessment area are small businesses. The bank’s performance is lower than demographics; however, the performance is reasonable given the performance context.

The bank originated a majority of its loans to small businesses (51.5%) for amounts of \$100,000 or less. Of those loans, more than half were for amounts of \$50,000 or less. This demonstrates the bank’s commitment to lend to small businesses, as they typically request small-dollar loans. The bank also offers SBA loans, which is another way the bank helps meet the needs of small businesses in its assessment area. According to bank management, there is competition for small business loans but the opportunity to gain new business loan customers is lacking, as many small businesses are loyal to their financial institutions.

GEOGRAPHIC DISTRIBUTION OF LOANS

The geographic distribution and dispersion of the bank’s HMDA and small business loans in the assessment area is reasonable and does not reveal any unexplained gaps in lending. As previously mentioned, two of the census tracts in the assessment area are unknown-income tracts that cover portions of Lake Superior; therefore, no loans were originated in these tracts.

Residential Real Estate Lending. The bank’s geographic distribution and dispersion of 2017 and 2016 HMDA loans throughout the assessment area is reasonable. Table 5 shows the geographic distribution of the bank’s HMDA loans by census tract income level for both years.

| TABLE 5 | | | | | | | | |
|--|------------|------------|-----------------|------------|---------------|-------------|--------------|-------------|
| 2017 HMDA Loans by Census Tract Income Level | | | | | | | | |
| <i>Loan Type</i> | <i>Low</i> | | <i>Moderate</i> | | <i>Middle</i> | | <i>Upper</i> | |
| | # | % | # | % | # | % | # | % |
| Home Purchase | 23 | 4.8 | 41 | 8.5 | 226 | 46.7 | 194 | 40.1 |
| Refinance | 3 | 2.3 | 6 | 4.6 | 50 | 38.5 | 71 | 54.6 |
| Home Improvement | 0 | 0.0 | 0 | 0.0 | 15 | 53.6 | 13 | 46.4 |
| Multifamily | 1 | 100.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| Total 2017 HMDA Loans | 27 | 4.2 | 47 | 7.3 | 291 | 45.3 | 278 | 43.2 |
| 2016 HMDA Loans by Census Tract Income Level | | | | | | | | |
| <i>Loan Type</i> | <i>Low</i> | | <i>Moderate</i> | | <i>Middle</i> | | <i>Upper</i> | |
| | # | % | # | % | # | % | # | % |
| Home Purchase | 30 | 5.6 | 43 | 8.1 | 274 | 51.4 | 186 | 34.9 |
| Refinance | 10 | 5.2 | 10 | 5.2 | 85 | 44.5 | 86 | 45.0 |
| Home Improvement | 0 | 0.0 | 2 | 6.3 | 15 | 46.9 | 15 | 46.9 |
| Multifamily | 3 | 100.0 | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| Total 2016 HMDA Loans | 43 | 5.7 | 55 | 7.2 | 374 | 49.3 | 287 | 37.8 |
| Note: The bank did not extend any loans in the unknown-income tracts, as they cover portions of Lake Superior. Accordingly, this table does not include a column for this tract designation. | | | | | | | | |

In 2017, the bank originated 4.2% of its HMDA loans in low-income census tracts and 7.3% in moderate-income tracts. According to the 2017 FFIEC census data, 4.6% and 13.1% of the families in the assessment area are located in the low- and moderate-income tracts, respectively. In 2017, aggregate lenders originated 3.3% and 10.9% of loans in the low- and moderate-income tracts, respectively. The bank’s performance is comparable to demographics and exceeds aggregate lenders for low-income census tracts. However, for moderate-income census tracts, the bank’s performance is lower than demographics and aggregate lenders.

In 2016, the bank originated 5.7% of its HMDA loans to low-income census tracts and 7.2% in moderate-income tracts. According to the 2016 FFIEC census data, 5.0% and 13.2% of the families in the assessment area live in low- and moderate-income tracts, respectively. In 2016, aggregate lenders originated 3.9% and 10.2% of loans in the low- and moderate-income tracts, respectively. The bank’s performance is comparable to demographics and exceeds aggregate lenders for the low-income census tracts, while its performance in the moderate-income census tracts is lower than demographics and aggregate lenders.

The demographic data indicates there are limited lending opportunities in the low- and moderate-income tracts. According to 2017 FFIEC census data, only 22.2% of homes in the low-income tracts and 46.0%

in the moderate-income tracts are owner-occupied. In addition, 10.2% of the homes in the low-income tracts and 11.7% in the moderate-income tracts are vacant. According to 2016 FFIEC census data, only 23.9% of the homes in the low-income tracts and 51.4% in the moderate-income tracts are owner-occupied. In addition, 9.9% of the units are vacant in the low-income tracts, and 11.2% in the moderate-income tracts. Finally, bank management and community contacts stated that the houses in the low- and moderate-income tracts tend to be older and in need of repair, which can limit affordability.

The bank did not originate HMDA loans in every census tract in the assessment area; however, this is reasonable based on the performance context. In 2017, the bank did not make any HMDA loans in two low-income tracts and eight moderate-income tracts. In 2016, the bank did not make any HMDA loans in three moderate-income tracts. One of the low-income tracts is located on the Duluth waterfront, northeast of downtown. The other encompasses downtown Superior and the surrounding commercial and industrial areas. The banking environment here is competitive. Both tracts have a high percentage of rental housing, reducing the bank’s opportunity to lend. In addition, the Superior tract has a substantial poverty level (40.1%), according to 2017 FFIEC census data. The moderate-income tracts with no HMDA loans are located on the Iron Range, where the bank does not have a physical presence and there are other financial institutions serving that area.

The geographic distribution and dispersion of the bank’s 2017 and 2016 HMDA loans throughout the assessment area is reasonable, given the opportunities to lend in the low- and moderate-income census tracts and the competition for HMDA loans in the assessment area.

Examiners also reviewed the bank’s 2015 and 2014 HMDA lending activity. The distribution of HMDA loans by census tract for 2015 and 2014 is generally consistent with 2017 and 2016 performance.

Small Business. The geographic distribution and dispersion of the bank’s small business loans throughout the assessment area is reasonable. Table 6 shows the geographic distribution of small business loans by census tract income level in 2018 and 2017.

| TABLE 6 | | | | | | | | |
|--|------------|-------|-----------------|------|---------------|-------|--------------|-------|
| Geographic Distribution of Small Business Loans by Census Tract Income Level* | | | | | | | | |
| <i>Loan Type</i> | <i>Low</i> | | <i>Moderate</i> | | <i>Middle</i> | | <i>Upper</i> | |
| | # | \$ | # | \$ | # | \$ | # | % |
| Small Business | 36.5% | 48.1% | 11.5% | 8.8% | 15.4% | 19.7% | 36.5% | 23.4% |
| Demographic Data | | | | | | | | |
| Number of Census Tracts | 8 | | 16 | | 42 | | 16 | |
| Percentage of Census Tracts | 9.5% | | 19.0% | | 50.0% | | 19.0% | |
| Percentage of Businesses** | 9.7% | | 17.7% | | 50.5% | | 22.1% | |
| *Income classification of census tracts based on 2018 FFIEC census data. | | | | | | | | |
| **Percentages are based on 2017 Dun & Bradstreet data. | | | | | | | | |
| Note: The bank did not extend any loans in the unknown-income tracts, as they cover portions of Lake Superior. Accordingly, this table does not include a column for this tract designation. | | | | | | | | |

The bank originated 36.5% and 11.5% of its small business loans in low- and moderate-income tracts, respectively. According to 2017 Dun & Bradstreet data, 9.7% of businesses are located in low-income census tracts and 17.7% are located in moderate-income tracts. The bank’s lending in low-income census tracts significantly exceeds demographics. While the bank’s lending in moderate-income census tracts is lower than demographics, it is reasonable, as stated below.

The bank did not originate small business loans in every census tract in the assessment area; however, this dispersion of loans is reasonable based on the performance context. The bank did not originate small business loans in three low-income and 13 moderate-income tracts. These low-income tracts and several of the moderate-income tracts are in and around the cities of Duluth and Superior, where there are numerous banking institutions and a competitive banking environment. The other moderate-income tracts are on the Iron Range, and one is southeast of Superior. The bank does not have a presence near these tracts. In addition, bank management and community contacts indicated that there are limited opportunities for small business loans in some of the low- and moderate-income census tracts in the Duluth area where there is manufacturing, as many of those companies would not be considered small businesses.

The geographic distribution and dispersion of the bank’s small business loans throughout the assessment area is reasonable, given the opportunities to lend in the low- and moderate-income census tracts as well as the competition for loans in the assessment area.

COMPARISON OF CREDIT EXTENDED INSIDE AND OUTSIDE THE ASSESSMENT AREA

The bank originated a substantial majority of its loans within its assessment area; overall 94.8% by number and 94.4% by dollar amount. Table 7 shows lending activity by loan type inside and outside the assessment area.

| <i>Loan Category</i> | <i>Inside</i> | | | | <i>Outside</i> | | | |
|----------------------|---------------|-------------|-----------------|-------------|----------------|------------|-----------------|------------|
| | <i>#</i> | <i>%</i> | <i>\$(000s)</i> | <i>%</i> | <i>#</i> | <i>%</i> | <i>\$(000s)</i> | <i>%</i> |
| HMDA | 2,793 | 95.0 | 477,894 | 94.5 | 148 | 5.0 | 27,711 | 5.5 |
| Small Business | 52 | 88.1 | 6,241 | 88.3 | 7 | 11.9 | 825 | 11.7 |
| TOTAL | 2,845 | 94.8 | 484,135 | 94.4 | 155 | 5.2 | 28,536 | 5.6 |

Bank management stated that the bank’s focus is to provide loans to customers in and near its assessment area. The bank originates loans for current customers, even if those customers are outside the assessment area. A majority of the loans originated outside the assessment area were to borrowers in adjacent counties. The bank’s lending demonstrates its commitment to meeting the credit needs of the residents and businesses within its assessment area.

LOAN-TO-DEPOSIT RATIO ANALYSIS

The bank’s net loan-to-deposit ratio is reasonable, given its asset size, financial condition, and the credit needs of the assessment area. According to the September 30, 2018, Uniform Bank Performance Report, the bank’s net loan-to-deposit ratio is 77.9%, which is slightly lower than the national peer group’s net loan-to-deposit ratio of 81.6%. The bank’s national peer group includes all insured commercial banks having assets between \$100 million and \$300 million with three or more full-service banking offices located in a metropolitan statistical area.

As shown in Table 8, the bank’s 17-quarter average net-loan-to-deposit ratio is 75.3%, which is lower than the bank’s 17-quarter average net loan-to-deposit ratio of 80.8% at the previous evaluation. Since then, the bank’s quarterly net loan-to-deposit ratio has ranged from 69.9% to 79.0%.

| <i>Bank</i> | <i>Total Assets as of September 30, 2018 (in thousands)</i> | <i>Average Net Loan-to-Deposit Ratio</i> |
|---|---|--|
| North Shore Bank of Commerce Duluth, Minnesota | \$274,922 | 75.3% |
| Park State Bank Duluth, Minnesota | \$145,530 | 89.4% |
| Western NB Duluth, Minnesota | \$110,643 | 70.0% |

Bank management indicated that competition is strong for HMDA and small business loans, given the number of financial institutions operating in the Duluth MN-WI MSA. The bank faces competition from large national banks, regional banks, credit unions, and mortgage companies. The bank’s net loan-to-deposit ratio demonstrates the bank’s willingness to fulfill credit needs throughout its assessment area. In addition, community contacts did not identify any unmet credit needs in the assessment area.

RECORD OF RESPONSE TO CRA-RELATED COMPLAINTS

Neither the bank nor the Federal Reserve Bank of Minneapolis has received any CRA-related complaints concerning the bank since the previous evaluation.

FAIR LENDING OR OTHER ILLEGAL CREDIT PRACTICES REVIEW

The examination did not reveal any evidence of violations of antidiscrimination laws or regulations (including Regulation B – Equal Credit Opportunity Act, Regulation C – Home Mortgage Disclosure Act, and the Fair Housing Act) or other illegal credit practices inconsistent with the bank helping to meet community credit needs.

Appendix A

Glossary of Common CRA Terms

Aggregate lending: The number of loans originated and purchased by all reporting lenders in specified income categories as a percentage of the aggregate number of loans originated and purchased by all reporting lenders in the metropolitan statistical area/assessment area.

Census tract: A small subdivision of metropolitan and other densely populated counties. Boundaries do not cross county lines; however, they may cross the boundaries of metropolitan statistical areas. Census tracts usually have between 2,500 and 8,000 persons, and their physical size varies widely depending on population density. Census tracts are designed to be homogeneous with respect to population characteristics, economic status, and living conditions to allow for statistical comparisons.

Community development: An activity associated with one of the following five descriptions: (1) affordable housing (including multifamily rental housing) for low- or moderate-income individuals; (2) community services targeted to low- or moderate-income individuals; (3) activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs (13 C.F.R. 121.301) or have gross annual revenues of \$1 million or less; (4) activities that revitalize or stabilize low- or moderate-income census tracts, designated disaster areas, or distressed or underserved nonmetropolitan middle-income census tracts; or (5) Neighborhood Stabilization Program (NSP)-eligible activities in areas with HUD-approved NSP plans, which are conducted within two years after the date when NSP program funds are required to be spent and benefit low-, moderate-, and middle-income individuals and census tracts.

Consumer loan: A loan to one or more individuals for household, family, or other personal expenditures. It does not include a home mortgage, small business, or small farm loan. This definition includes the following categories: motor vehicle loans, credit card loans, home equity loans, other secured consumer loans, and other unsecured consumer loans.

Distressed nonmetropolitan middle-income census tract: A middle-income, nonmetropolitan census tract will be designated as distressed if it is in a county that meets one or more of the following triggers: (1) an unemployment rate of at least 1.5 times the national average, (2) a poverty rate of 20.0% or more, or (3) a population loss of 10.0% or more between the previous and most recent decennial census or a net migration loss of 5.0% or more over the 5-year period preceding the most recent census.

Family: Includes a householder and one or more other persons living in the same household who are related to the householder by birth, marriage, or adoption. The number of family households always equals the number of families; however, a family household may also include nonrelatives living with the family. Families are classified by type as either a married-couple family or other family, which is further classified into "male householder" (a family with a male householder and no wife present) or "female householder" (a family with a female householder and no husband present).

Full-scope review: Performance is analyzed considering performance context, quantitative factors (e.g., geographic distribution, borrower distribution, and total number and dollar amount of investments), and qualitative factors (e.g., responsiveness).

Geography: A census tract delineated by the United States Bureau of the Census in the most recent decennial census.

Home Mortgage Disclosure Act (HMDA): The statute that requires certain mortgage lenders that do business or have banking offices in a metropolitan statistical area to file annual summary reports of their mortgage lending activity. The reports include data such as the race, gender, and income of applicants; the amount of loan requested; and the disposition of the application (i.e., approved, denied, or withdrawn).

Home mortgage loans: Includes home purchase and home improvement loans as defined in the HMDA regulation. This definition also includes multifamily (five or more families) dwelling loans, loans for the purchase of manufactured homes, and refinancings of home improvement and home purchase loans.

Household: Includes all persons occupying a housing unit. Persons not living in households are classified as living in group quarters. In 100 percent tabulations, the count of households always equals the count of occupied housing units.

Limited-scope review: Performance is analyzed using only quantitative factors (e.g., geographic distribution, borrower distribution, and total number and dollar amount of investments).

Low income: Individual income that is less than 50 percent of the area median income or a median family income that is less than 50 percent, in the case of a geography.

Market share: The number of loans originated and purchased by the institution as a percentage of the aggregate number of loans originated and purchased by all reporting lenders in the metropolitan statistical area/assessment area.

Metropolitan statistical area (MSA): An area, defined by the Office of Management and Budget, based on the concept of a core area with at least one urbanized area that has a population of at least 50,000. The MSA comprises the central county or counties containing the core, plus adjacent outlying counties having a high degree of social and economic integration with the central county as measured through commuting.

Middle income: Individual income that is at least 80 percent and less than 120 percent of the area median income or a median family income that is at least 80 percent and less than 120 percent, in the case of a geography.

Moderate income: Individual income that is at least 50 percent and less than 80 percent of the area median income or a median family income that is at least 50 percent and less than 80 percent, in the case of a geography.

Multifamily: Refers to a residential structure that contains five or more units.

Other products: Includes any unreported optional category of loans for which the institution collects and maintains data for consideration during a CRA examination. Examples of such activity include consumer loans and other loan data an institution may provide concerning its lending performance.

Owner-occupied units: Includes units occupied by the owner or co-owner, even if the unit has not been fully paid for or is mortgaged.

Qualified investment: A qualified investment is defined as any lawful investment, deposit, membership share, or grant that has as its primary purpose community development.

Rated area: A rated area is a state or multistate MSA. For an institution with domestic branches in only one state, the institution's CRA rating would be the state rating. If an institution maintains domestic branches in more than one state, the institution will receive a rating for each state in which those branches are located. If an institution maintains domestic branches in two or more states within a multistate MSA, the institution will receive a rating for the multistate metropolitan area.

Small loan to business: A loan included in "loans to small businesses" as defined in the instructions for preparation of the Consolidated Report of Condition and Income (Call Report). These loans have original amounts of \$1 million or less and typically are either secured by nonfarm or nonresidential real estate or classified as commercial and industrial loans.

Small loan to farm: A loan included in "loans to small farms" as defined in the instructions for preparation of the Consolidated Report of Condition and Income (Call Report). These loans have original amounts of \$500,000 or less and are either secured by farmland or classified as loans to finance agricultural production and other loans to farmers.

Underserved middle-income census tract: A middle-income, nonmetropolitan census tract will be designated as underserved if it meets criteria for population size, density, and dispersion that indicate the area's population is sufficiently small, thin, and distant from a population center that the tract is likely to have difficulty financing the fixed costs of meeting essential community needs.

Upper income: Individual income that is more than 120 percent of the area median income or a median family income that is more than 120 percent, in the case of geography.

(For additional information, please see the Definitions sections of Regulation BB at 12 C.F.R. 228.12.)