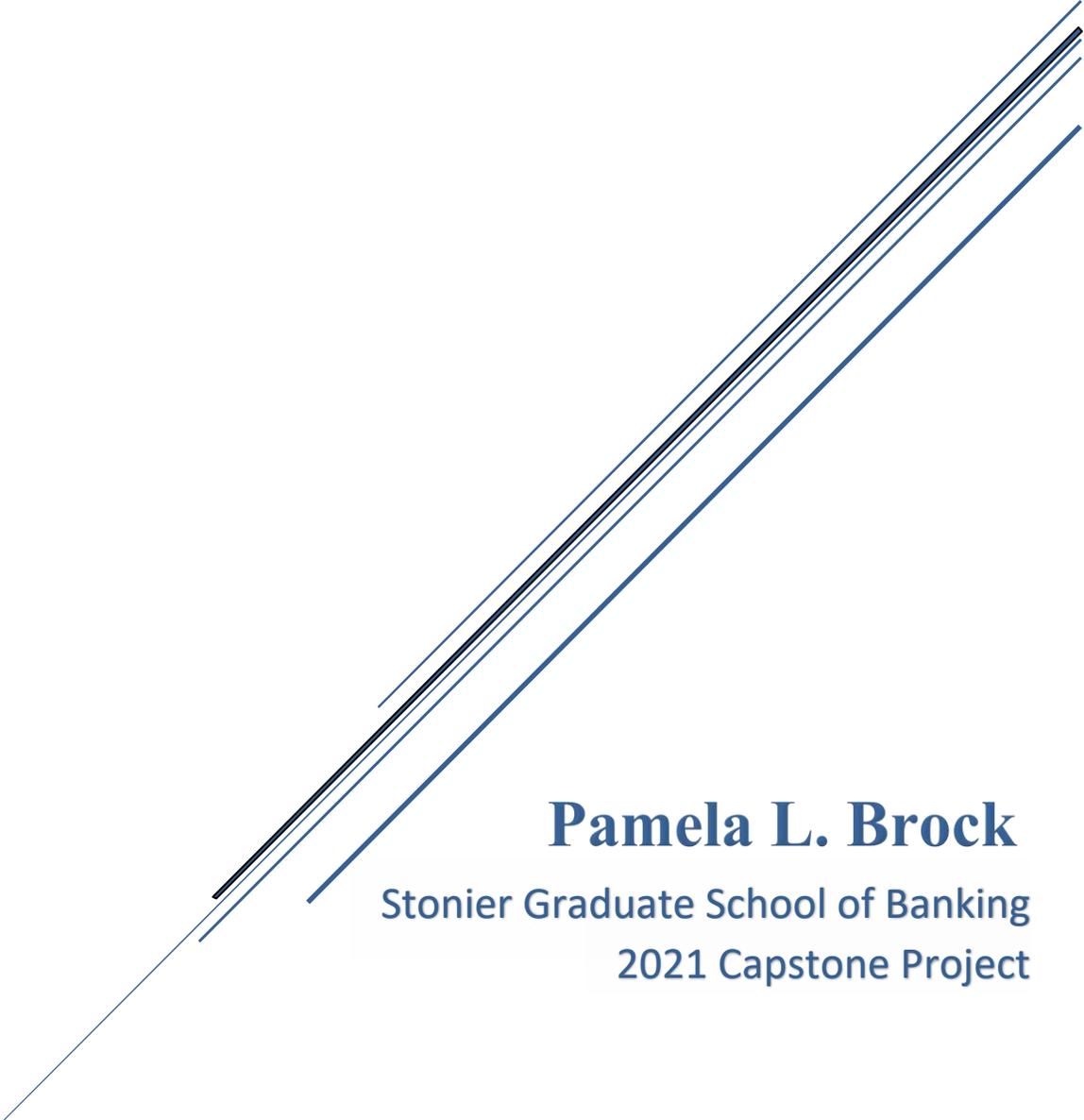


Interactive Teller Machines (ITMs)

A Proposal to Utilize ITMs to Reduce Overhead Costs in Rural Branches and Improve Overall Bank Efficiencies



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2021 Capstone Project

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Executive Summary

Adapting to our changing environment has been the foundation for success for Hyden Citizens Bank. Since 1904, the management of the bank has survived many changes and challenges while always centering the focus on serving our local community with the best financial services available and providing a strong return to the Shareholders. Finding the best solutions have often been challenging, especially for a small community bank located in a rural area. However, the evolving world of banking and technology has opened doors that once were not accessible due to the cost and/or feasibility.

Our newest challenge is the changing economic and demographic environment in the community we serve, which has been devastated by the decline of the coal industry. Hyden Citizens Bank currently operates four brick and mortar locations in their service area in Leslie County. The cost of operating these locations consumes a large portion of their overhead costs and is a major cause of the higher than Peer Efficiency ratio for the bank. This has become more so as the two smaller branches, which are located in more rural areas of the County, have seen a significant decline in transaction volumes due to the dramatic and seemingly permanent decline of the coal industry, which provided much of the transactional volume for these two locations. Management has decided to focus on finding an efficient and profitable solution to keep all four locations operating to serve our customers while reducing the high cost of operations at the two smaller branches. Interactive Teller Machines may be this solution.

Interactive Teller Machines (ITMs) are a natural evolution of Automated Teller Machines (ATMs). ITMs offer the same features and functions of an ATM plus the ability to talk and work with a live teller via video conference. Personnel costs are the single largest expense for any location and, due to security and audit requirements, the bank is required to keep two people

on staff at the two smaller branches located at Wooton and Stinnett even though the reduced transaction levels indicate one person could easily handle the daily volumes. By using ITMs, we could eliminate the need for live personnel at these two locations while providing our customers availability to bank services through a live video conference with bank staff. The staff could be located at the Main Office location and respond to the specific needs of our customers without having to be on-site since ITMs are capable of completing approximately 80-90% of transactions typically completed by a live in-person teller.

Based on cost estimates, each ITM would cost approximately \$149,500 and we propose to add an ITM to both Stinnett and Wooton Branches for a total one-time, initial cost of \$299,000. This cost includes setup, software, and implementation. In addition, there would be annual costs for software and maintenance for each machine. The ITMs would be depreciated for 7 years at approximately \$43,000 annually and the annual maintenance and licenses would cost approximately \$29,000 each year. These costs would be neutralized by the reduced utility costs of operating the branches and the elimination of part-time staff by the bank, which would no longer be needed due to the reallocation of full-time branch staff. The usage of part-time staff costs the bank an estimated \$60,000 annually and, combined with the reduction of daily operating expenses for the branches of approximately \$46,000 annually, there would be no additional costs to implement ITMs for Hyden Citizens Bank. In fact, even with the purchase of the ITMs and their expenses, the bank will have an estimated \$34,000 annual reduction in overhead expenses the first year and an estimated \$94,000+ decrease within five years by implementing this solution. Within the first five years, the bank will also see a steady increase in our ROA to 1.06% and a 300 basis points decline in the Efficiency Ratio to 73.92% due to this change.

The move to implement ITMs at the Wooton and Stinnett branches would also allow Hyden Citizens Bank to develop a dedicated customer call center. Since management does not recommend laying off any full-time employees due to this change, the current branch employees would be reallocated throughout the bank with several assigned to operate the new customer service center at no additional cost to the bank. The customer service center would be located in the Main Office and provide live personal service by video conference to branch customers using the ITMs at the Stinnett and Wooton branches. In addition, the customer service call center would provide switchboard services for the bank as well as a variety of additional services streamlined into one area. The efficiency this would provide will improve customer service throughout the entire bank.

There are important considerations beyond the monetary cost benefits to consider with this proposed change. The positive benefits include improved customer service benefits through the development of the customer service call center, maximizing the efficiency of our staff throughout the bank, the time-saving benefits of not having to manage the part-time staff, and improved security through the use of ITMs at the two remote branch locations which reduces robbery exposure, while continuing to provide banking services to our customers at the Stinnett and Wooton branch locations. The potential negative impacts to consider would be the limitations of our local internet service as the ITMs require this to provide the ITM video interaction with our customers, ensuring our staff have “buy-in” to this change, and the possible rejection of the ITMs by the loyal branch customers who enjoy the personal interaction from our staff at these two locations. Our IT manager feels confident that a new internet provider in the area will resolve any internet issues that may be arise and the communication and education of our staff and customers about this change will be key to the ITMs’ success and our ability to

keep these two branches operating. We will dedicate time and energy to training, developing in-house videos and holding community forums to ensure this is seen as a positive move by our employees and customers in our community to ensure it is successful.

In summary, I recommend the incorporation of ITMs into the branch network for Hyden Citizens Bank at the Wooton and Stinnett branch locations. Based on the cost estimates and potential savings to the bank through improved ratios and earnings as well as improvements to efficiencies throughout the bank, I believe this will be a positive move. It will position the bank to grow forward instead of being held back by the burden of static overhead costs associated with the operational requirements of the two smaller branches. As the financial analysis indicates, the costs to implement the ITMs will not result in an increase in expenses due to the reduction of the part-time staff and other expenses but the bank will continue to benefit over the next several years as the technology improves efficiencies throughout the bank. In addition, the benefits from the development of the customer call center and proper reallocation of staffing at the two remaining locations will be a much more efficient use of our employees in meeting the needs of our customers and communities. Overall, Hyden Citizens Bank will be better prepared for the next century of operations with this change as we maintain our position in the marketplace while controlling overhead costs and maximizing our return to our Shareholders.

About Hyden Citizens Bank

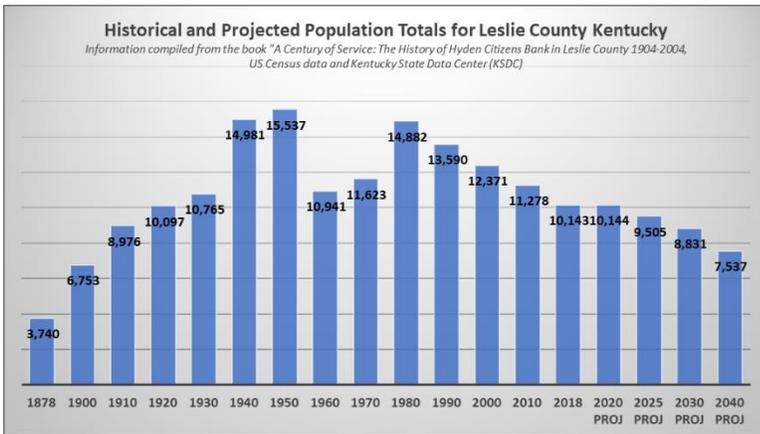
Hyden Citizens Bank, Inc. is a community bank located in Hyden, Kentucky, which is in the southeastern part of the state in the western Appalachian Mountains. The bank was established in 1904 and has approximately \$135,000,000 in assets. The bank's President and Chief Executive Officer (CEO) is W. Fred Brashear II, who has served in this role since the mid-80s, following in the footsteps of his father who previously served as President & CEO. It is the first and only physical bank in the county with 100% deposit market share. The bank employs approximately 30-35 employees, seasonally. Hyden Citizens Bank, Inc. is the flagship bank of Middlefork Financial Group, Inc. (MFG), which is a bank holding company with total assets of \$245,000,000. MFG is comprised of three community banks, an insurance agency, and a property management company, which are all located in southeastern Kentucky. The Holding Company is privately held by 42 Shareholders with six of these Shareholders comprising 89% of ownership and serving on the Board of Directors for Hyden Citizens Bank.

The Market Area, Yesterday and Today

To better understand Hyden Citizens Bank, it is important to understand their market area. This includes the physical location of the market area and the current and historical aspects of key elements impacting this region such as population and economic issues. Through this analysis, you will develop a deeper understanding of how the bank has survived and thrived over the last 116 years.

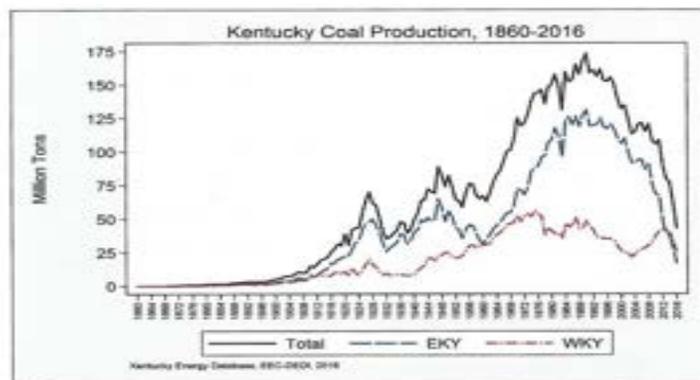


The bank’s primary market is Leslie County. The county is small in size, comprising just over 400 square miles in rural southeastern Kentucky. The bank is the only bank in their primary market with four brick and mortar branches located in strategic areas of the county to maximize access to the community. Leslie County currently has a population of 9,877, according to the United States Census Bureau Quick Facts. When the county was formed in 1878, the population



was 3,740, according to the book “A Century of Service: The History of Hyden Citizens Bank in Leslie County 1904-2004”, and the population steadily increased to over 15,500 by the middle of the twentieth century when a negative trend of

decline would begin and continue until today. Future projections, according to the Kentucky State Data Center, indicate a continued decline in population for Leslie County through 2040 of -29.6% to a population of just 7,537 by 2040. This negative trend is due to various factors, which include the county’s isolation from the expansion seen in other parts of the state and country, a limited industrial footprint, and dependency on the coal industry which has traditionally provided steady, high paying jobs. The dependency on coal has contributed to the most recent negative population trends. Since 2008, over 20,000 jobs have been lost in the Southeastern Kentucky region due to the decline in

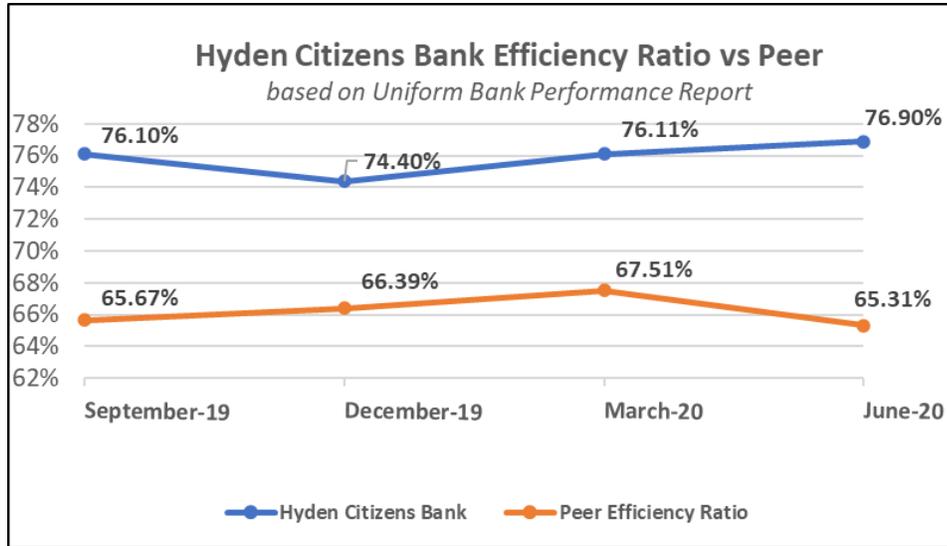


the coal industry, according to the Kentucky Economic Analysis report compiled by the Kentucky Center for Statistics (KYSTATS) in September 2019. While there are various efforts ongoing to assist the region economically, over 60% of the population in Leslie County receives some form of government assistance which means there is a lack of available workforce and limits the per capita income within the county. In addition, high rates of poverty and unemployment also plague the region. While these statistics are not favorable, they are not new. Leslie County and the surrounding region have historically been depressed. Even when the nation, as a whole, is thriving, this region has remained below national and state averages. As you reflect on the economy of Leslie County and consider the bank's long history of solid performance, you realize that Hyden Citizens Bank has found a way to make the local economy work for them.

History of Performance

When examining the financial performance of the Hyden Citizens Bank, it performs solid and steady in most every area. The bank maintains strong ROA and ROE ratios, 0.97% and 10.02% respectively, in comparison to peer, with strong asset quality ratios, excellent regulatory ratings, a solid return to our Shareholders and net income of \$1,200,000 or more consistently for the last fifteen years. The bank maintains a strong deposit core base, which has allowed the bank to sustain its net interest margins and growth levels. The Net Interest Margin is also bolstered by our strong Investment portfolio performance, which performs above peer. While the loan footings are more of a struggle due to the lack of demand in the local market, management has been aggressive in finding participation loan partners which have allowed the bank to maintain loan footings and earnings. One key area of concern for the bank's financial performance is the high Efficiency Ratio, specifically Non-Interest Expense. The Efficiency Ratio analyzes the bank's efficiencies by measuring the cost of producing a dollar of revenue net of financing cost and is calculated by

taking Net Interest Income plus Non-Interest Income and dividing that figure by Non-Interest Expense. According to the Uniform Bank Performance Report (UBPR) for June 30, 2020, the



bank's efficiency ratio was 76.90% and has ranked in the 80th percentile compared to peer for the last four quarters. The main driver impacting the Efficiency Ratio is Non-interest Expenses which are comprised of personnel expenses, cost of premises, fixed assets, and other non-interest expense items. While the bank does control other expenses such as personnel, the occupancy expenses related to property owned and managed by the bank have contributed to the higher than peer occupancy expense. These expenses are being driven by the cost of operating four brick and mortar locations and the fixed costs associated with them. The bank opened their last branch in 2006 when the coal industry was thriving in the region and the demand in that section of the county justified the cost. However, within four years, the level of coal production county-wide had shrunk by over 75% and the demand at two of the four locations decreased drastically. Despite the expenses of the four locations, the bank has been able to maintain personnel expense at or below Peer, which is often a main driver in a high efficiency ratio. We are controlling this expense and ranked in the 50th percentile compared to peer. Also, the assets per employee remains at or below

peer levels and is ranked in the 35th percentile compared to peer, which also indicates the proper management of staffing levels. However, while the bank does control employee expenses and maintain staffing levels at or below peer levels, the physical locations demand a certain level of staff, no matter the volume, due to security and regulatory requirements. This drives our occupancy expenses higher and, thus, the efficiency ratio higher.

The Evaluation Process

For Hyden Citizens Bank to ensure longevity and our continued ability to serve a community we are deeply rooted in, we must continue to adjust to our market as the bank has for over 116 years. This includes looking for innovative ways to serve our community while maintaining financial performance at an acceptable level for the Shareholders. Management must always be looking for ways to improve and ensure the bank is performing as strongly as possible. A key area that management would like to focus on is lowering the Efficiency Ratio for the bank, specifically lowering the non-interest expenses related to operating four locations as discussed above. We would like to consider options to allow the two smaller branches, which are located in less populated, rural areas, to continue to serve their local communities but in a more efficient way. This is the main driver for this analysis—finding a solution to maintain Hyden Citizens Bank’s position in our market area while controlling overhead costs related to branch operations.

Strategy and Implementation

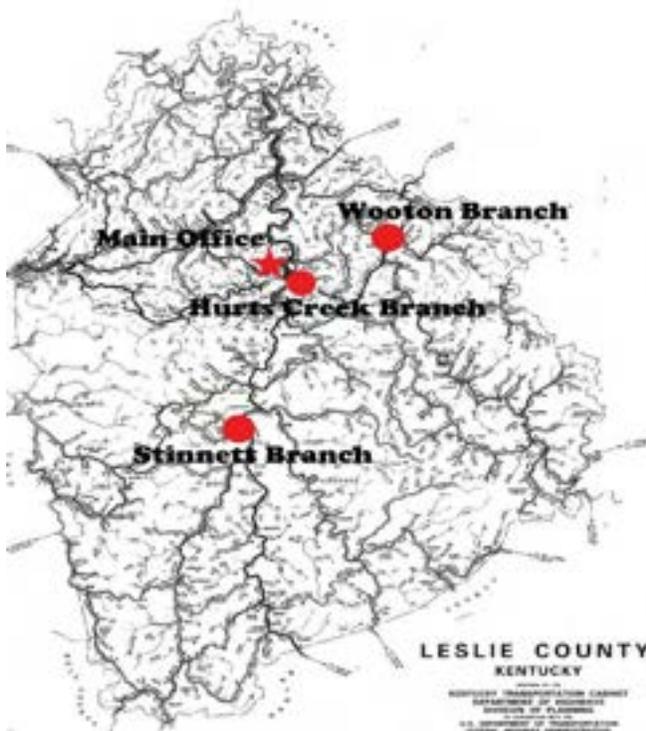
The strategy for the bank is to determine the most optimal way to keep the four-branch structure the bank currently has while reducing expenses related to their operations and ensuring

that the bank maintains our presence within the community and market area. In addition, the high Efficiency ratio continues to strain earnings so management is actively searching for a workable solution which will allow the bank to perform better and stronger in future years.

Management would like to review several components impacting this decision to determine the best solution. These components include

- (1) evaluating the current branch structure,
- (2) evaluating automation as a cost reducing solution and development of an action plan to implement this solution,
- (3) analyzing the cost of the automation to determine viability of the project,
- (4) evaluating other areas impacted by the potential solution such as technology needs, community impact, staffing issues, etc.

Evaluating Where We are Today



Today, Hyden Citizens Bank has four brick and mortar locations located in Leslie County and a strong online banking presence. The physical locations and internet options allow the bank to service customers within our market as well as customers located in areas outside of our physical market. The branch locations are strategically located throughout the county of Leslie to maximize availability to all areas. Two locations are relatively close

together which are the Main Office and the Hurts Creek Branch.

The Main Office was established in 1904 and is located on Main Street. This facility offers full-service banking, including deposits services such as checking, savings, certificates of deposit and individual retirement accounts, loan services for consumer and commercial purposes, lockbox services and ATM



services. This location has, on average, 20 employees daily. In addition to the operations for the entire bank, the 3-story facility houses the operations for the holding company, Middlefork Financial Group, and the Hyden office of Middlefork Insurance Agency. The bank operations and holding company encompass the 2nd floor of the building while the retail side is located on the 1st floor. This facility, due to restrictions at its location, does not offer drive-thru services. As a result of growth and the need to offer more convenience within the city limits of Hyden, the Hurts Creek Branch was opened in the late '80s.

This branch is located within one mile of the Main Office and is a full-service location



offering four drive-thru lanes to provide the convenience not available at the Main Office. Hurts Creek branch is a much smaller, more traditional size branch, built to provide quick service. The services provided include deposit services including checking, savings, certificates of deposit and individual retirement account,

lockbox access, and ATM services. Previously, loans were offered at this location, but, due to staffing issues, this was discontinued but may resume in the future. This branch has 3-5 employees, depending on workflows.

The other two branch locations are located outside of the city limits in more remote areas of the county. The Wooton Branch was the first branch expansion for Hyden Citizens Bank in 1981 and is located at the

intersection of Highway 80 and Junction 699 in Wooton. This location offers drive-thru services, deposit services for checking, savings, certificates of deposit and individual



retirement accounts, lockbox availability and ATM services. The location is regularly staffed with two employees: a branch manager who oversees the daily operations of the branch and an assistant branch manager. Each employee works as a full-time teller. The staffing is supplemented with part-time staff who fill in during absences, vacations, and breaks. The location for this branch was chosen due to coal mining activity in the area in the 1980s but teller transaction counts have been on the decline at this location over the past 10 years as coal mining in the area declined. On an average, daily teller transactions average about 100 transactions for the entire branch which means each teller is doing about 50 transactions in a 7.50-hour workday. This is extremely low and, on paper, clearly does not justify two full-time workers at this location. However, due to security issues and audit requirements, two employees are required on-site at all times while open. It is important to note that, due to the rural location, this location

has been robbed twice and had two more attempted robberies over the last two decades which further solidifies the need for ensuring security compliance at this location.

The fourth and newest branch mirrors the features of the Wooton branch in services offered and staffing. The Stinnett Branch is located across from the Stinnett Elementary School



on Highway 421 and opened in 2006. This location also has two drive-thru lanes and offers deposit services for checking, savings, certificates of deposit and individual retirement accounts, lockboxes, and ATM services. Loans were previously

offered at this location at its opening in 2006 but, due to low volume, they were discontinued several years ago. Two full-time employees are on-site daily and part-time staff are utilized during breaks and days off. As with the Wooton Branch, the teller transaction counts have been reducing at this location over the past ten years as the coal industry shrank. The daily transactions at this branch also average about 100 transactions per day with the two full-time staff members.

While transactions at all locations have declined over the last decade, the Main Office serves the purpose of housing the operations of the bank along with the loan operations which are key elements to the bank's continued success. The Hurts Creek branch, located closely to the Main Office, serves the purpose of a quick-service, check cashing facility for customers with the convenience of several drive-thru lanes which are not possible at the Main Office. These two locations serve to meet the needs of over 70% of the bank's local customers. The purpose of the two smaller, rural branches is clear but not efficient. They are needed to assist our customers

who live further away in more rural areas of the community and would have a 20-30-minute travel to the nearest branch location. However, the requirement of staffing levels and lack of foot traffic in these two smaller branches continue to be a drain on the bank's efficiency ratio and the balance sheet as a whole.

Over the years, different operational solutions to reduce the expenses at the smaller branches have been suggested and tried with limited success. Staffing is by far the largest driver of the expenses and inefficiencies so looking for creative ways to reduce staffing levels have been explored. The bank has worked with auditors, consultants, and suggestions from their operations staff for safe, compliant options but no suggestions have been successful. Management has considered suggestions such as closing the Wooton and Stinnett branches during lunch time to reduce the need for part-time employees to fill in for staff on their break but, after careful review, it was determined that this would not result in a significant reduction in expenses or staffing requirements because the need for part-time staff would not be eliminated but only slightly decreased. Possibly the most obvious first steps would be to reduce the staff at each branch to one full-time employee which would be a good start in lowering costs and has been seriously considered. However, after much analysis and based on the security, audit and compliance requirements, the additional costs and management it could incur to adjust the work flows throughout the bank to ensure the branches operate safely and in compliance would result in limited, if not zero, benefit to the bank.

While discussing solutions for the low volume branch locations, it may seem like an obvious option could be to close the underperforming branches and merge operations into the remaining facilities to maximize profits. In today's banking environment, this is becoming increasing more common as locations merge for efficiencies. For Hyden Citizens Bank, all the

locations are within one county and could be consolidated into the Main Office and Hurts Creek branch locations which are centrally located in Leslie County. However, the Board of Directors of Hyden Citizens Bank do not plan to consider this step at this time and are more interested in finding other workable solutions. While there is an obvious monetary benefit to closing the facilities, the potential erosion of the customer base and possibility of additional banks entering the market area are strong impacts that could produce long term negative results for the bank. In addition, the Board has a deep commitment to this community and believe strongly that the bank's presence throughout the community helps to ensure the longevity of the area. In fact, in January 2017, the Middlefork Financial Group Board of Directors had a very open and frank discussion about their desires for the long-term goals of the Company. As a reminder, the MFG and HCB Board of Directors memberships are comprised of 89% of the ownership of the company. Their discussions revolved around the desire to maintain low risk levels throughout the company and ensure compliance in all areas which have resulted in solid asset quality and strong audit and examination results. They openly stated that they understood this may sacrifice short-term earnings but felt that this was the best way to ensure long-term earnings compacity for the Company, built on a solid foundation. This discussion also included talks regarding expansion into other markets through acquisitions and/or opening additional locations. They did not express a desire to expand at that time and, as of the 2020-2021 Strategic Plan document, this has not changed as there is no mention of exploring or considering expansion. So, if expansion to other markets or acquisitions are not a plan for future growth which would help bring the high efficiency ratio into peer level range by adding addition customers, loans and deposits, then reducing the overhead through an in-house solution is the most viable solution based on the strategic mindset of the Board.

Branch Automation: Interactive Teller Machines (ITMs)

Based on management's stated desire to find an alternative solution to the high cost of operating four brick and mortar facilities, the use of technology makes perfect sense. With the ongoing advances in every aspect of the financial industry, the implementation of Interactive Teller Machines (ITMs) seems like a logical fit for the needs of Hyden Citizens Bank.

Interactive Teller Machines (ITMs) are a natural evolution of Automated Teller Machines (ATMs). ATMs first came into the banking world in 1967 with the first one in the US in 1969. ATMs offer the ability to withdraw cash, check account balances, deposit checks into accounts and transfer money between account.

Interactive Teller Machines were introduced in 2013 and offer the efficiency and flexibility of an ATM plus the features and functions of a live teller. While the ITMs offer

the same features and functions of an ATM, they provide the customer a way to connect with bank staff live via video conference which transforms the machine into a personal assistant who can respond to their specific needs, unlike an ATM. I find it particularly interesting that rural areas were the first to adopt interactive teller machines because they provide a cheaper option than a human teller working the location and the smaller populations with less foot traffic made ITMs a cost-effective option. This is the same scenario as the two small rural branches of Hyden Citizens Bank.

According to industry experts, approximately 80-90% of transactions typically completed by a live teller can be completed by an ITM. Common transactions that can be performed by an ITM include:



- Deposits into checking and savings accounts,
- Withdrawing cash from a checking or savings account in various denominations,
- Balance inquiries for all account types,
- Account transfers,
- Check Cashing,
- Loan Payments,
- Exchange bills for different denominations,
- Order Checks,
- Requesting a replacement debit card,
- Account address changes,
- And more complex transactions such as
 - loan payoffs,
 - HSA contributions and distributions,
 - CD withdrawals,
 - Opening New Accounts

These machines are easy to use with most common transactions taking less than 2-3 minutes. *See an example of a step-by-step transaction in Appendix 1.* With the popularity of ATMs and the fact that almost everyone of legal age has used one, these machines could be a nature progression for our customers.

Benefits of Using ITMs for the Bank and Customers

There are many potential benefits to installing an ITM at one of our branch locations. They include:

1. Maximizing the Efficiency of Staff

The use of ITMs will reduce the need for live, in-person branch staff which reduces the overall operating costs. For Hyden Citizens Bank, we would eliminate all live staff at the Wooton and Stinnett branches due to the low volume of transactions and high cost of staffing.

This would reduce the Efficiency Ratio, which is above Peer, while allowing the bank to continue to serve customers in the rural areas of our market area. The current branch staff of two full-time employees each would become part of a call center which would be set up in the Main Office of the bank and operate under the normal bank hours. This call center would provide live teller services via the ITMs to the physical branch locations for Wooton and Stinnett but could also serve as a customer service center for the entire bank's customers by consolidating various functions of customer service into one area for improved efficiency. This could be an extra benefit of adding the branch automation because it would allow the bank to streamline and improve efficiencies in other areas.

By using ITMs, the need for part-time staff to supplement the full-time staff at all locations for their days off and work breaks would be eliminated with the reallocation of full-time staff from the two smaller branches to other areas throughout the bank. This would be a cost savings of over \$60,000 annually and would lower employee turnover which is primarily within the part-time staff. The bank would not layoff or eliminate the jobs of the current branch full-time employees. However, they would not plan to replace an employee who retires or leaves employment so the benefit would come through attrition.

In addition, ITMs offer greater flexibility for the bank to offer expanded hours at these two smaller branches at reduced costs. Hyden Citizens Bank could offer extended hours without actually having a teller on site. Instead of 8:30am-4pm regular banking hours, ITMs could be available 7am-6pm daily to allow customers to conduct transactions that do not require assistance from a live teller. This would increase the level of customer service and offer more convenience while, at the same time, reduce overhead costs.

2. Reduced Transactional Costs and Times

By using ITMs, transactional costs are greatly reduced. According to the ITM Buying Guide produced by QDS, Inc., the estimated cost of most branch transactions by a teller is, on average, \$4.50 per transaction. The same transaction completed at an ITM costs between \$0.50 and \$0.70. This is an 85% cost reduction per transaction. This is significant to any bank and, combined with the live teller feature, offers a solution that is very appealing. Interactive Teller Machines could also reduce transaction times through the drive thru. The amount of time it takes to complete a transaction through the tube system could be cut in half by using ITMs from an average of 5 minutes to 2-3 minutes. These quick transactions could further improve customer service levels while reducing overhead costs associated with the tubes.

3. Improved Security Benefits for the Bank and Customer

The use of ITMs will offer greater security at our rural locations. As mentioned earlier, with the exception of one, every robbery or attempted robbery has been at the rural locations of the bank because they are so far away from police in less populated areas. The plan to remove live staff from these two locations with the installation of ITMs will reduce this robbery exposure, thus protecting the bank and staff. Our live tellers would be located in the call center at the Main Office which provides a more secure location. This could also improve job satisfaction among the existing branch staff who will be relocated to another location since they may feel a sense of added security.

In addition, cash is securely stored in locked machines instead of teller drawers through the use of ITMs so this will provide another layer of security at the branch location by reducing teller fraud and costly errors.

4. Privacy Options for Customers

Secure communication through the use of phone headsets at the ITMs will provide our customers with a private way of conducting their transactions at the branch. ITMs are equipped with phone headsets which can be used to ensure the transaction is private so that only the video teller can hear your conversation. This is more private than transactions taking place in a regular branch setting with the video teller focused only on the customer they are working with.

5. Marketing Aspect

The Interactive Teller Machines can be programmed to perform many advertising functions while the customer is focused on their transaction. The bank could display an advertisement about a new product or service, make an offer to them, and/or offer personalized services and products that are specific to that customer, in a low-cost manner. In addition, our staff can cross sale products and provide customer service that would be helpful to the customer as they wait for the money to be dispersed or the employee looks up requested information. These would be additional ways the bank could full utilize the functions of the ITM.

Implementation Planning

Next, we will discuss how the implementation would work if Hyden Citizens Bank decides to purchase ITMs for the two branch locations.

The estimated implementation time to install ITMs from start to finish will be approximately 180 days depending on configuration, location, and availability. This process will begin with the contract negotiations and equipment purchase, site preparation at each branch location, equipment installation, training for necessary personnel, and testing before going live. During the installation phase, the bank will begin ongoing communications with customers and our community about this new change to ensure they are aware of this change and how it will affect them leading up to the Go Live date. I am recommending the use of how-to videos

produced in-house to assist customers in understanding how to fully utilize the ITMs and conducting 2-3 community forums to encourage citizens to see the new features and convenience the ITMs will offer in-person through a live demo. These will provide an opportunity to discuss the ITMs with our customers and relieve any fears or concerns they may have so that they can fully embrace this new technology and the convenience it will offer.

In addition to the ITMs installation, the development and setup of the customer call center will begin simultaneously with the ITM setups. This will be comprised of designating an area at the main office to house this new function and setting up the technology needed to ensure it operates smoothly. I recommend the call center be located on the second floor of the main office in the data processing department. This setup will include furniture, computers and phones which can be repurposed from the two branch locations who will be utilizing the ITMs and no longer have personnel on site.

In addition to the hardware installation, there will be audit and compliance reviews for the new processes necessary for the ITMs. This will ensure compliance protocols are followed and new procedures and policies will be developed, approved and implemented as needed. Regulatory communication will begin prior to the Board's review to address any potential issues and ensure compliance with their requirements.

This project will be comprised of various departments within the bank to ensure that all areas of importance are covered. Personnel involved in the implementation process will include myself as Human Resources Manager and President/CEO, Fred Brashear, Operations Manager, Amber Barger, IT Manager, Frank Baker, Building/Security Officer, Russell Hornsby, and Marketing/Business Development Officer, Joel Brashear.

Below is an estimated timeline for the project:

Project Timeline		
ITM Installation and Setup / Call Center Development		
Project Timeline: Estimated timeframe is 9 months		
Projected Start Date is March 31, 2021; Projected Start Date of January 1, 2022		
		Personnel Responsible
Completion of Analysis for ITMs <i>including financial analysis, strengths/weaknesses</i>	31-Mar-21	Pamela Brock
Management Review and Approval <i>including recommendations and updates</i>	30-Jun-21	MFG & HCB Mgt Teams
Board Review and Authorization <i>(presented at Annual Strategic Plan)</i>	21-Jul-21	Pamela Brock, Fred Brashear
Implementation		
Onsite Consultation by NCR <i>(seller)</i>	August-21	Pamela Brock, Frank Baker, Russell Hornsby
Sign Contract and Purchase of Equipment	August-21	Pamela Brock, Fred Brashear
Announcement to the Staff about the ITM setup	August-21	Fred Brashear, Pamela Brock
Site Preparation <i>includes branch modifications</i>	September-21	Russell Hornsby
Equipment Installation	November-21	Frank Baker, Russell Hornsby
Staff Training for use of Equipment	Oct/Nov-21	Amber Barger, Frank Baker, Russell Hornsby
This will include IT Personnel Training, Building Maintenance Staff training, and Employee Training		
Testing of Equipment LIVE	Nov/Dec 2021	Amber Barger, Frank Baker, Russell Hornsby
Communication with Customers	Sept-Dec2021	Joel Brashear, Pamela Brock
Phases including initial notification, ongoing advertising, social media posts, website updates which include how-to videos and community forums on this change		
Marketing Materials <i>includes development and production of materials</i>	Sept/Oct-21	Joel Brashear
Reassignment of Staff <i>includes staff which will be reallocated to Customer Call Center and other positions</i>		
Management reassignments reviewed and completed	September-21	Amber Barger, Fred Brashear, Pamela Brock
Staff notified of reassignments	October-21	Amber Barger
Development of Customer Service Call Center		
Site Preparation <i>includes location determination & equipment install</i>	September-21	Amber Barger, Frank Baker, Russell Hornsby
Personnel Training	Oct/Nov-21	Amber Barger
GO LIVE date for Customer Call Center	1-Jan-21	Amber Barger
Audit and Compliance Reviews	Sept/Nov/Dec-21	Amber Barger, Tina Caldwell, Angela Woods (MFG Compliance Officer)
Regulatory Communication	June-21	Fred Brashear, Amber Barger
ITM GO LIVE DATE at branch locations		January 1, 2022
Staff on-site at each location to train customers through January 31, 2022		Amber Barger

Let's Talk About Location

As we further discuss the implementation of ITMs at each branch, let's discuss where they would be placed within each branch. Key areas to focus on will be convenience, security, and ease of installation to reduce setup costs.

For the Stinnett Branch location, I would recommend a wall unit ITM to be located in the current New Accounts area. This area is

located beside the safe deposit boxes in the lobby for customers. By locating the unit in the wall, it will provide added security for bank staff because they will work behind closed doors when restocking cash boxes, pulling any



necessary reports from the machine, and/or when repairs or cleaning is required. By using this location, the teller line remains intact for use in the future and this location will require very little



interior changes which will reduce the installation cost. An alternative location could be one of the current teller windows. This branch's teller line is

behind glass for extra security so there would be a cost associated with retrofitting this area for the ITM.

For the Wooton Branch, I would recommend placement of the ITM in the wall which is currently the New Accounts office. There will be cost associated with retrofitting the unit to fit the area, but this will be the most efficient placement. Much like the placement at the Stinnett

Branch, it will allow bank staff to work behind the unit to load cash, work on the unit, etc. As an alternative location, one of the teller windows could also be used. The teller windows at this location are also behind glass so the cost to retrofit will be larger than the cost to place the unit in the first proposed place.



Financial Analysis

As with all projects, one of the most important considerations is and must be money. While it should not be the deciding factor in the decision to make this change at the branch locations, it is a key aspect of why we want to make this change. Our goal is to reduce overhead expenses which will reduce the Efficiency Ratio, result in a higher ROA, and increased profits.

In evaluating the branch operations and profitability, it is important to note that Hyden Citizens Bank does not use a formal accounting process for branch profitability. The branches that have been constructed have been built for the convenience of our customers and to solidify the hold on our market share within Leslie County which is why individual branch profitability has not been tracked. So, as we determine the cost benefits of this solution, we will use hard costs to determine if the solution suggested would reduce expenses and assist in improving the bank's overall profitability. These hard costs will include salaries, benefits, utilities, and other fixed costs associated with these two smaller branches.

The hard costs for each branch are very similar. Salaries and benefits for the Stinnett Branch are approximately \$100,000 annually while the cost for the Wooten Branch is approximately \$95,000. These costs will remain unchanged for the bank because I am not

recommending a reduction in full-time personnel due to the use of ITMs at the branches. Instead, I am recommending the four full-time employees be reallocated to the Main Office and Hurts Creek branch in the following manner. At the Main Office, two employees will staff the customer call center and assist customers using the ITMs daily. One employee will be reassigned to the Hurts Creek branch as a full-time teller and the other full-time employee will be a floating teller for both remaining locations. While the bank will be overstaffed for a period of time with only two locations with employees, this will resolve itself through attrition and result in a further reduction of expenses due to the installation of the ITMs. This reduction is projected into the financial analysis beginning in Year 2.

Because of the use of the ITMs at the Stinnett and Wooton branches and the reallocation of staff to the Main Office and Hurts Creek locations, the need for part-time staff will be eliminated. This is an annual cost savings of \$60,000 to the bank. Currently, part-time staff are necessary to work at all branch locations during lunches, absences, and flex days.

The annual cost for utilities and other operational expenses is \$61,000 for the branches but it is notable that this cost will not entirely disappear with the implementation of the ITMs. There will continue to be electric, phone, water, etc. at each location but the plan is to drastically reduce this cost as much as possible. I project a 75% reduction in these expenses upon the full implementation of the ITM solution at the two branch locations as the chart indicates below.

Cost Reductions Due to new Technology						
Reduction in Part-time Salaries	\$ 60,000	\$ 60,000	\$ 60,000	\$ 60,000	\$ 60,000	<i>Eliminate Part-time expense at the Branches</i>
Reduction in Utilities Expenses	\$ 33,000	\$ 33,000	\$ 33,000	\$ 33,000	\$ 33,000	<i>Estimated 75% Reduction</i>
Reduction in Other Expenses	\$ 13,000	\$ 13,000	\$ 13,000	\$ 13,000	\$ 13,000	<i>Includes: Supplies, Janitorial, other equip maint, etc.</i>
Reduction in Salary and Benefits	\$ -	\$ 15,000	\$ 45,000	\$ 60,000	\$ 60,000	<i>Assumes attrition of 1 full time employee in YR 2 and 1 in YR 3</i>
TOTAL Cost Reductions	\$ 106,000	\$ 121,000	\$ 151,000	\$ 166,000	\$ 166,000	

Purchasing the ITMs

The cost to purchase and install the two Interactive Teller Machines will be \$299,000. This cost of \$149,500 per unit includes \$77,500 for the actual unit and onetime expenses for software and implementation of \$72,000 per unit. This cost will be depreciated over 7 years. The annual maintenance costs per unit are estimated at \$6,800 for software licenses and maintenance fees and \$7,800 for hardware maintenance for the unit for a combined annual maintenance cost of \$14,600 for each unit. The reduction in part-time personnel cost and branch operational expenses will off-set the cost of the depreciation, annual maintenance, and licenses for the ITMs. In fact, even with the purchase of the ITMs and their expenses, the bank will have a \$34,000 annual reduction in overhead expenses the first year and an estimated \$94,000+ decrease within five years by implementing this solution.

Cost of New Technology					
	Year 1	Year 2	Year 3	Year 4	Year 5
Depreciation Expense	\$ 42,714	\$ 42,714	\$ 42,714	\$ 42,714	\$ 42,714
Annual Maintenance	\$ 15,600	\$ 15,600	\$ 15,600	\$ 15,600	\$ 15,600
Annual Software License	\$ 13,600	\$ 13,600	\$ 13,600	\$ 13,600	\$ 13,600
Total Cost of New Tech.	\$ 71,914	\$ 71,914	\$ 71,914	\$ 71,914	\$ 71,914
		<u>Based on:</u>			
		\$149,500 per units (2) with 7 Years Useful Life			

	Net Impact to Overhead with Cost Reductions and New Technology Costs				
Net Increase or (Decrease) to Overhead	\$ (34,086)	\$ (49,086)	\$ (79,086)	\$ (94,086)	\$ (94,086)

Due to the unknown aspect of the site preparation, I cannot estimate this cost. However, based on the layouts within each branch I am recommending, there will be little structural changes which should be less expensive one-time costs. The bank employs a local contractor who handles these types of needs so this will be handled locally and less expensively.

Based on the projections in the Financial Analysis below, the bank will experience a steady decline in the Efficiency Ratio over the 5 years following implementation of the ITMs. The current ratio of 76.88% will decline 300 basis points over this time to 73.92%. This will have a positive effect on the bank’s ROA and net income. The ROA will steadily increase during this time from 0.98% today to 1.06% in 5 years. The increase to profitability will be approximately \$94,000 during this time period. Overall, this will be a positive impact to the bank through improved service and efficiency while improving key ratios and the bottom line, all while maintaining the presence in the community that is very important to the bank and our community.

<u>Impact to the Efficiency Ratio</u>						
	<u>Current</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Total Overhead (Annualized)	3,938,000	3,903,914	3,888,914	3,858,914	3,843,914	3,843,914
Total Net Interest Income TE	4,464,000	4,489,000	4,500,000	4,525,000	4,550,000	4,525,000
Total Non-Interest Income (A	658,000	665,000	660,000	665,000	670,000	675,000
Efficiency Ratio (Annualized)	76.88%	75.75%	75.37%	74.35%	73.64%	73.92%
<u>Impact to ROA</u>						
	<u>Current</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Net Income (Annualized)	\$ 1,244,000	\$ 1,278,086	\$ 1,293,086	\$ 1,323,086	\$ 1,338,086	\$ 1,338,086
Average Assets (Annualized)	\$ 126,694,000	\$ 126,694,000	\$ 126,694,000	\$ 126,694,000	\$ 126,694,000	\$ 126,694,000
ROA	0.98%	1.01%	1.02%	1.04%	1.06%	1.06%

Non-Financial Impacts

While the financial impact to the bank is crucial, there are many non-financial impacts that must be considered. As we examine the implementation of ITMs more closely, it is important to determine if this is the right move for the bank, our customers and the community.

Development of a Customer Call Center

One of the biggest positive impacts to the bank from a non-financial standpoint will be the addition of the customer call center. This will allow for more efficient handling of customer service needs for all customers by employees who are dedicated to this area. Currently, our tellers and new accounts personnel handle customer service calls. They may be assisting other customers which means their attention is divided between two or more customers at any given time and results in lower customer service satisfaction.

I propose that the Customer Call Center be staffed with two full-time employees from the current branch staff. The implementation and setup of the customer call center will take place while the ITM implementation is ongoing which will allow both to be fully operational at the same time. The Customer Call Center will house the employees who will be working with customers using the live video conference feature on the ITMs at the branch locations. But, as we know from teller counts, the number of transactions are low at each branch so these employees will also be able to handle the incoming phone calls for the bank and work with customers for many of the most common call requests such as:

- Check account balance(s), paid transactions or pending deposits
- Online Banking issues such as password resets, adding/deleting accounts, transfers or other issues.

- Order checks using our in-house check printing services
- Debit card issues such as requesting dollar limit increases, password changes, a new card, reporting a lost/stolen card or other issues

By having trained employees available to consistently provide these services, we will greatly improve workflow efficiency and customer service throughout the bank.

Training will be a key element for the success of the call center which will be a new operation for the bank. The bank will assign one employee as the Call Center Manager who will ensure all functions are being performed, develop work schedules, train staff on the services performed by the call center and work in-line with the Operations Manager to ensure an efficient work flow. *See Appendix 2 for a proposed Organizational Chart with the changes.*

Community Impact

Our customers place a tremendous amount of priority on personal interaction and, as in most small rural communities, everybody knows everybody. This personal touch is a key feature of our bank and it matters a great deal to our customers. Hyden Citizens Bank is known as Leslie County's bank and the introduction of self-service machines replacing our employees who are local citizens could be ill received, if we do not carefully implement the change. If our local customers become dissatisfied or feel abandoned with this change, the bank could experience loss of accounts and customers. It will be crucial to the success of this project that we communicate openly and honestly with our customers and assist them as much as possible in learning how to use this new technology to serve them better. I suggest investing in online videos with detailed how-to instructions available on our websites and placing a former branch employee at the location for approximately four weeks following the installation to assist our customers during this time. In addition, it may be prudent to hold community forums in the affected communities

to provide a live demo while openly answering questions and discussing the reasons for this change. This could show our continued commitment to the community while highlighting the positive aspects of this change. The community's reception of this new branch dynamic will be a key part of the success of our project. The local communities must see this as progress, not abandonment.

To monitor the acceptance and usage of the machines, it is recommended that management develop a monthly reporting system. The ITMs provide reporting features which will allow us to track the number and types of transactions, length of the time it takes to complete each transaction, and the number of customers daily at each location. By monitoring these reports, we will be able to determine any areas that may need adjustments to improve the customer's experience or if a location is being underutilized. If a location is underutilized, the bank could employ additional marketing strategies to improve usage. In the unlikely event that an ITM at the Wooton and/or Stinnett branch is deemed to be ineffective, management would need to strategically evaluate the best solution. Possible solutions might include the permanent closing of the underperforming branch with the drive-thru ATM remaining open and the ITM relocated to the another location or bringing the live staff back to the facility.

Technology Needs

The need for strong internet access with the necessary bandwidth for high-resolution video integration will be key to the success of this project. It must be capable of allowing the ITMs to successfully and quickly connect to the live tellers in their remote location then process and upload the transactions. Currently, the two branches have poor connections and lack enough bandwidth, on some days, to process new account documents successfully. However, a new telecommunications provider has entered the area and is currently signing new customers. Our

IT manager expects access to these two areas within the next six months. With this improved, fiber optic connection, there will be no issues with connectivity for the ITMs.

Another consideration, depending on the setup, will be the use of video integration which could slow down transaction times. The bank will need to be careful in setup to determine which transactions require live teller assistance and which can be completed solely by the machine without assistance to ensure transactions are completed as efficiently as possible.

This technology will allow Hyden Citizens Bank to cater to the Millennials who focus on the need to incorporate technology into every aspect of their lives. ITMs are relatively new in our area and would offer a competitive advantage for the bank with this demographic who gravitate towards innovative companies while also allowing us to reduce our expenses and bring our ratios into peer range.

Another technology-related aspect to address will be determining if and how our core processor, Shazam Core Services, will interact with the machines to ensure seamless integration. An interface between our core processor and our ITMs will allow for uploading of daily transactions and settlements so it will be imperative that we work closely with these two vendors to ensure this process works efficiently.

It may also be helpful to develop IT operational guidelines to follow if one or both ITMs experience a disruption of service which could impact our customers' ability to conduct business. It will be important to include a well thought out plan in the bank's Disaster Recovery Plan. This plan should include the estimated restoration timelines as detailed in the vendor's agreement, notification of the temporary branch closure due to the unavailability of the ITM, which will redirect those affected customers to another location, and other operational needs.

Staffing Impacts

With the implementation of ITMs, there will be significant changes in staffing and workflows within the bank. Management will need to be aware of how this is impacting the affected employees and communicate effectively throughout the bank. Staff engagement will be a key component to the success of this change.

The operations staff will need to work closely to ensure the new workflows are maximizing the benefit of the costs associated with installing the ITMs as the reallocated staff will take on different roles within the bank. There is currently a branch manager at each location but only one management position will be available with the reassignments. It will be important to carefully reassign staff to ensure the right person is chosen for the new positions from the staff.

As mentioned above, the bank will open a call center at the Main Office location. The staffing of a call center will be new to Hyden Citizens Bank so this will require a change to management's structure and mindset to accommodate this change. In addition, training will be critical to the call center's success so time and energy will need to be prioritized to ensure that this happens effectively.

Change is scary. There could be employees who do not like the changes so managers will need to closely monitor this throughout the staff to ensure negativity regarding this change does not impact the results. Resistance is normal with changes such as these and it will be key for managers to work with their employees and assist them as much as possible during the transition.

As mentioned above, the cost of \$60,000 is the hard dollar costs associated with eliminating the part-time staff, but this figure does not recognize the non-financial benefits of this aspect of the change. These benefits include:

- Removal of the high cost of turnover in this area because these are mostly college students and are low paying jobs with fluctuating hours and,

- Reduction in the time spent training new tellers and;
- Reduction in the amount of time scheduling for the locations

By eliminating these, it will allow the Operations Manager to focus on the daily operations of the bank and the full-time staff. I actually believe these benefits may have more of a benefit to the bank as a whole than the actual reduction in dollars spent.

In addition, with this reduction of staffing to two locations only, the teller staff will only have to work one Saturday a month. Currently, all full-time tellers work every other Saturday. To work only one Saturday a month would be an added benefit to the staff which would be highly valued and improve moral. This benefit should be openly discussed with the staff to encourage the positive aspects of this change.

Regulatory Compliance

During management's review prior to the Board's approval, it will be key to communicate the implementation of ITMs at our two smaller branch locations with our regulators from the Kentucky Department of Financial Institutions and FDIC. The bank should focus on the fact that this is not a closing and, based on the McFadden Act, the branches will continue to meet the definition of a branch after this change. The McFadden Act states that a branch is defined as "any branch bank, branch office, branch agency, additional office, or any branch place of business located in any State or Territory of the United States or in the District of Columbia at which deposits are received or checks paid or money lent." The ITMs will perform two of these functions upon implementation and could possibly process loans in the future, just as the branches do today. However, there is a possibility that the standalone ITMs in a branch facility with no employees on site may not be considered a branch, under regulatory interpretation, and would require a branch closure notification. This could cause significant

issues within the community including customer and account losses. It will be critical to communicate and work closely with our regulators to ensure we find the best possible solution.

Conclusion

In conclusion, after analysis, I recommend the implementation of Interactive Teller Machines (ITMs) at the Wooton and Stinnett Branches. I believe, based on the cost estimates and potential savings to the bank through improved ratios and earnings as well as improvements to efficiencies throughout the bank, this will be a positive move. It will position the bank to grow forward instead of being held back by the burden of static overhead costs associated with the operational requirements of the two smaller branches. The bank will be more prepared to handle increases in customers and accounts through the development of the customer call center and proper reallocation of staffing at the two remaining locations. In my opinion, this is a much more efficient use of our employees in meeting the needs of our customers and communities. In addition, if business should improve in the two communities with the ITMs, branch operations with full-time staff could resume with no cost to prepare the branches. The financial analysis indicates that the costs to implement the ITMs will not result in an increase in expenses due to the reduction of the part-time staff and other expenses but the bank will benefit over the next several years as the technology improves efficiencies throughout the bank. Hyden Citizens Bank will be better prepared for the next century of operations with this change as we maintain our position in the marketplace while controlling overhead costs and maximizing the return to our Shareholders.

Appendix 1: How to use an Interactive Teller Machine (ITM)

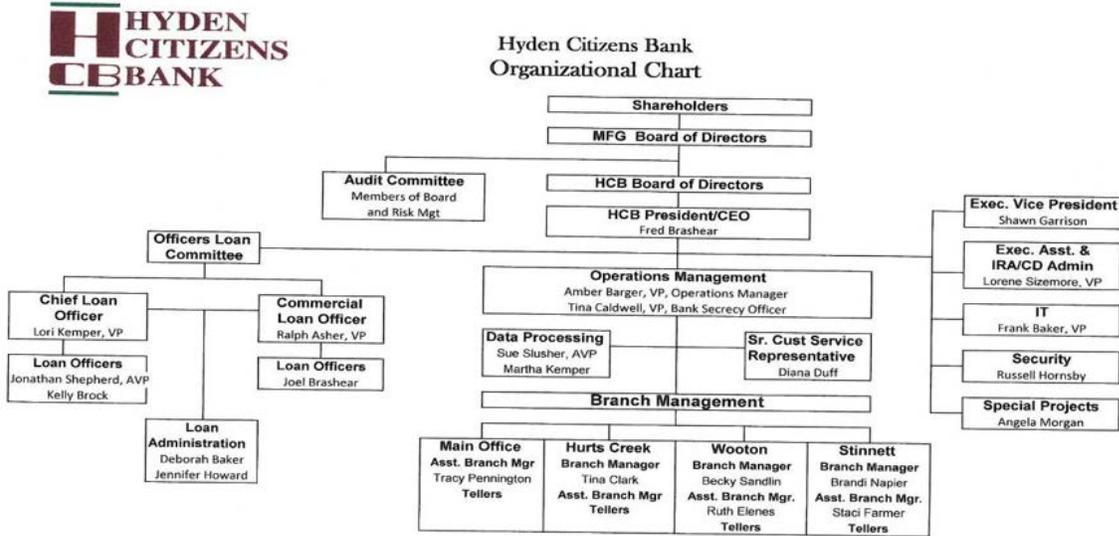
Below is an example of a common transaction and the steps to perform this transaction using an Interactive Teller Machine (ITM). The example transaction is for a simple cash withdrawal and here are the steps:

1. Walk up to the screen and touch the screen to connect with a live teller.
2. When the teller appears on the screen, announce the purpose of your visit which is to withdraw \$100.
3. Enter your account number on the screen or touchpad. Or, if you do not know your account number, ask the live teller to locate your account number.
4. After you finish entering the number, press enter.
5. The teller will likely verify the banking function for accuracy.
6. After confirming the function, put a form of ID into the scanner.
7. The image of your ID will pop up on the screen for verification purposes.
8. At this point, you may need to reiterate the purpose for this visit which is to withdraw \$100.
9. The teller will then verify the account (if you have more than one) you want to withdraw the money from. You will have the option to watch the screen to follow the actions of the teller.
10. An acknowledgment of your withdrawal will pop up on the screen.
11. Press the acknowledgment button.
12. Click the submit button – this takes the place of a signature.
13. The money will then dispense (similar to using an ATM).
14. Take the money out of the dispenser.
15. Take your receipt and close out the interaction.

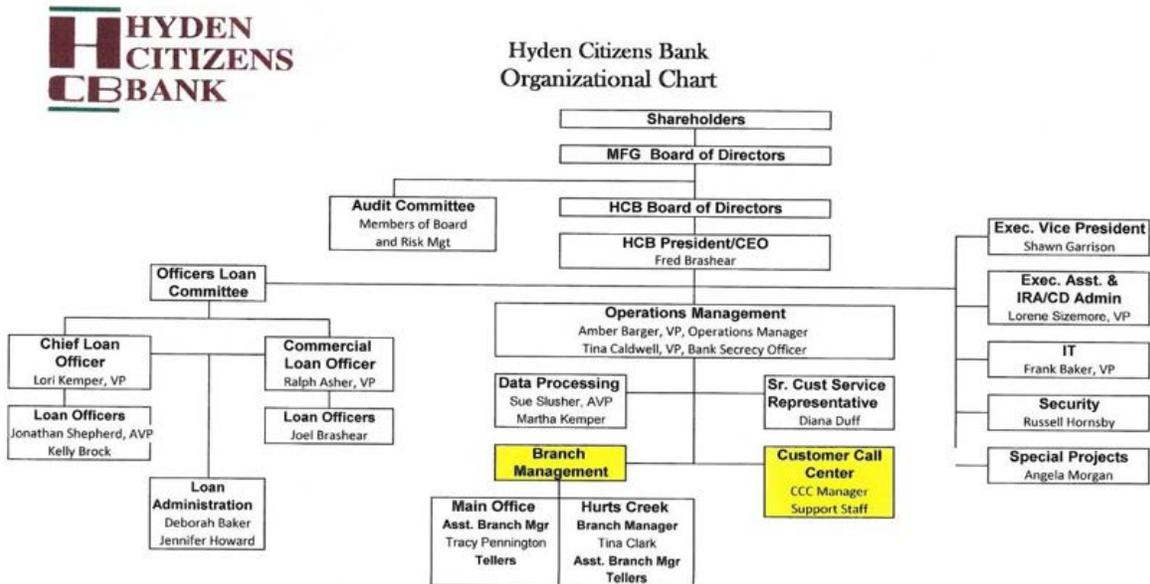
By this example, you can see the ease of use for these machines and how quickly the transaction was completed and in compliance.

Appendix 2: Current and Proposed Organizational Charts

Current Organization Chart for Hyden Citizens Bank



Proposed Organizational Chart for Hyden Citizens Bank with the implementation of ITMs at Wooton and Stinnett Branches and the development of the Customer Call Center



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