



PUBLIC DISCLOSURE

January 27, 2020

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

HIGHLANDS COMMUNITY BANK

COVINGTON, VIRGINIA

**Federal Reserve Bank of Richmond
Richmond, Virginia**

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

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Highlands Community Bank
RSSD# 3125315

307 Thacker Ave
Covington, Virginia 24426

Federal Reserve Bank of Richmond

P. O. Box 27622
Richmond, Virginia 23261

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INSTITUTION'S CRA RATING

Highlands Community Bank (the bank) is rated Satisfactory. This rating is based on the following conclusions with respect to the performance criteria:

- The bank's net loan-to-deposit ratio (NLTD) is reasonable given the bank's size, financial condition, and assessment area (AA) credit needs.
- A majority of the bank's loans were originated inside the AA.
- A reasonable dispersion of loans occurs throughout the bank's AA.
- Lending reflects an excellent penetration among individuals of different income levels, including low- and moderate-income (LMI), and businesses of different sizes.
- Neither the bank nor this Reserve Bank received any CRA-related complaints since the previous evaluation.

SCOPE OF EXAMINATION

The Federal Financial Institutions Examination Council's (FFIEC's) Interagency Examination Procedures for Small Institutions were utilized to evaluate the bank's CRA performance. The evaluation considered CRA performance context, including the bank's asset size, financial condition, business strategy, and market competition, as well as AA demographic and economic characteristics, and credit needs. Lending performance was assessed within the bank's Alleghany, VA NonMSA AA. The following data was reviewed:

- The bank's 16-quarter average NLTD ratio,
- All small business loans (96) originated by the bank during calendar year 2018
- Sample of 148 consumer motor vehicle secured loans from a universe of 430 such loans originated by the bank during calendar year 2018

DESCRIPTION OF INSTITUTION

Highlands Community Bank is a community bank headquartered in Covington, Virginia. The bank's characteristics include:

- The bank is a wholly owned subsidiary of Highlands Bankshares, Inc.
- The bank has total assets of \$152 million as of September 30, 2019.
- In addition to its main office in Covington, VA, the bank has two additional offices located in Clifton Forge, Virginia, and Hot Springs, VA.
- The bank's primary business focus is consumer lending.
- The bank opened one branch location (Hot Springs, VA) during 2018.

Table 1 Composition of Loan Portfolio as of [Month Day, Year]		
Loan Type	\$(000)	%
Agricultural	\$984	1.1%
Commercial	\$31,097	34.6%
Residential Real Estate	\$34,251	38.1%
Consumer	\$22,817	25.4%
Other	\$695	.8%
Gross Loans	\$89,844	100%

Note: Percentages may not total 100.0 percent due to rounding.

The bank’s previous CRA rating, dated December 7, 2015, was Satisfactory. There are no known legal, financial, or other factors impeding the bank’s ability to help meet the credit needs in its communities.

DESCRIPTION OF ASSESSMENT AREA

The bank’s AA is comprised of Alleghany County, Bath County, and the City of Covington in their entireties (see Appendix A for an AA map).

- The Alleghany County, VA NonMSA AA contains: one moderate-income, five middle-income, and three upper income census tracts. During the previous evaluation in 2015, this AA contained eight middle-income and one upper-income census tracts.
- As of June 30, 2019, the bank ranked second in deposit market share representing 24.2% of federally insured deposits according to data compiled by the Federal Deposit Insurance Corporation (FDIC).
- An individual knowledgeable of local economic development needs was contacted during this evaluation.

Table 2 Population Change			
Area	2010 Population	2015 Population	Percent Change
Alleghany County	16,250	16,066	-1.1%
Bath County	4,731	4,583	-3.1%
City of Covington	5,961	5,736	-3.8%
Commonwealth of Virginia	8,001,024	8,256,630	3.2%

*Source: 2010 U.S. Census Bureau Decennial Census
2011-2015 U.S. Census Bureau: American Community Survey*

- Although population in the Commonwealth of Virginia experienced growth from 2010 to 2015, all three areas delineated in the bank’s AA experienced declines in population suggesting an unfavorable population trend when compared to the Commonwealth as a whole.

Table 3 Median Family Income Change			
Area	2010 Median Family Income	2015 Median Family Income	Percent Change
Alleghany County	\$53,205	\$59,570	12%
Bath County	\$50,974	\$56,510	10.9%
City of Covington	\$47,188	\$46,541	-1.4%
Commonwealth of Virginia	\$73,514	\$78,390	6.6%

Source: 2006-2010 U.S. Census Bureau: American Community Survey
2011-2015 U.S. Census Bureau: American Community Survey

- Wage growth in Alleghany and Bath counties outpaced wage growth across the Commonwealth, while the City of Covington experienced a decline in wages from 2010 to 2015.

Table 4 Housing Costs Change						
Area	Median Housing Value		Percent Change	Median Gross Rent		Percent Change
	2010	2015		2010	2015	
Alleghany County	\$104,000	112,000	7.7%	\$504	\$591	17.3%
Bath County	\$129,700	153,700	18.5%	\$712	\$535	-24.9%
City of Covington	\$65,900	68,600	4.1%	\$599	\$590	-1.5%
Commonwealth of Virginia	\$255,100	245,000	-4%	\$970	\$1,116	15.1%

Source: 2006-2010 U.S. Census Bureau: American Community Survey
2011-2015 U.S. Census Bureau: American Community Survey

- While the Commonwealth of Virginia overall experienced a decline in median housing value, all three areas delineated in the AA experienced growth in median housing value.

Table 5 Unemployment Rates					
Region	2015	2016	2017	2018	2019
Alleghany County	5%	5%	4.5%	3.7%	3.2%
Bath County	4%	3.6%	3%	2.5%	2.3%
City of Covington	5.9%	5.8%	6%	4.6%	3.9%
Commonwealth of Virginia	4.4%	4%	3.7%	2.9%	2.7%

Source: Bureau of Labor Statistics: Local Area Unemployment Statistics

- Similar to the Commonwealth of Virginia as a whole, all three areas in the bank's AA experienced declines in unemployment suggesting favorable labor conditions.
- Top employers in the AA include: Alleghany Highlands Public School Board, Omni Charlottesville, and Alliance Group Rock Tenn.

CONCLUSIONS WITH RESPECT TO PERFORMANCE CRITERIA

Relevant area demographic data from the 2015 American Community Survey (ACS) is used as a proxy for demand when evaluating the bank's lending performance. When evaluating the geographic and borrower distribution for a specific loan category within the AA, primary emphasis is placed on the number (and corresponding percentage) of loans originated. To arrive

at an overall AA conclusion regarding the distribution of lending, performance in each loan category is then generally weighted by the strength of performance and the dollar volume of such loans made in the AA. During 2018, the bank originated approximately \$3.6 million in small business loans and \$1.1 million in motor vehicle secured loans. As such, greater weight is given to small business performance when determining overall conclusions in a given performance criteria.

Within the bank’s assessment area, a high level of small business lending activity was reported by specialized lenders, who often originate or purchase small business loans in the form of credit cards. The loans, however, tend to be much smaller in size than traditional small business bank loans, and a substantial majority of such loans do not have revenue data reported. The presence of these lenders is reflected in a smaller market share for traditional lenders and tends to understate the percentage of aggregate lending to businesses with annual revenues of \$1 million or less. These factors were considered as an aspect of performance context when evaluating the level and distribution of small business lending.

Net Loan-to-Deposit Ratio

This performance criterion evaluates the bank’s average NLTD ratio to determine the reasonableness of lending in light of performance context, such as the bank’s capacity to lend, the availability of lending opportunities, the demographic and economic factors present in the AA, and in comparison to similarly situated FDIC-insured institutions. Within this AA, there are no similarly situated institutions based on asset size, as all of the other banks have significantly greater assets and, unlike Highlands Community Bank, have operations spanning multiple AAs. As reflected in the table below, the other banks have higher NLTD ratios. Given these factors, including the absence of a more similarly sized bank in the AA, the bank’s NLTD ratio is considered reasonable.

Table 6 Comparative NLTD Ratios			
Institution	Location	Asset Size (\$000s)	NLTD Ratio (%)
			16 Quarter Average
Highlands Community Bank	Covington, VA	\$152,617	66.8%
Premier Bank	Huntington, WV	\$1,221,060	81.1%
Summit Community Bank	Moorefield, WV	\$2,401,941	100%
Sonabank	Tappahannock, VA	\$2,723,850	102.9%

Assessment Area Concentration

This performance criterion evaluates the percentage of lending extended inside and outside of the AA. A majority of the bank’s loans, by number and dollar, were originated inside the AA. Overall, the institution’s level of lending in its AA is considered responsive to community credit needs.

Table 7 Lending Inside and Outside the AA								
Loan Type	Inside				Outside			
	#	\$(000)	#%	\$%	#	\$(000)	#%	\$%
Small Business Loans	86	3,556	89.6%	63.8%	10	2,022	10.4%	36.2%
Motor Vehicle Loans	77	1,145	52%	50.4%	71	1,129	48%	49.6%
Total Loans	163	4,701	66.8%	59.9%	81	3,151	33.2%	40.1%

Note: Percentages may not add to 100.0 percent due to rounding.

Geographic Distribution of Loans

This performance criterion evaluates the bank’s distribution of lending within its AA by income level of census tracts. The bank’s geographic distribution of loans reflects reasonable dispersion among the different census tracts within the AA. The bank’s assessment area does not include any low-income census tracts. As such, the geographic lending performance conclusion considered the bank’s penetration into moderate-income census tracts.

Small Business Lending

The geographic distribution of small business lending is reasonable. The AA includes one moderate-income census tract containing 9.5% of small businesses, which suggests small business lending opportunities in moderate-income tracts is limited. While the bank’s level of lending (5.8%) lags the percentage of businesses located in the moderate-income census tract (9.5%), the bank’s small business lending penetration in the census tract is considered reasonable. As part of performance context, the aggregate level of small business lending (8.4%) also lagged the percentage of small businesses located in the moderate-income census tract.

Table 8 Distribution of 2018 Small Business Lending By Income Level of Geography					
Census Tract Income Level	Bank Small Business Loans				% of Businesses
	#	\$(000)	#%	\$%	
Low	NA	NA	NA	NA	NA
Moderate	5	610	5.8%	17.2%	9.5%
Middle	63	1,851	73.3%	52.1%	72.2%
Upper	18	1,094	20.9%	30.7%	18.3%
Unknown	NA	NA	NA	NA	NA
Not Reported	NA	NA	NA	NA	NA

*Source: 2015 FFIEC Census Data
2018 Dun & Bradstreet data
2015 U.S. Census Bureau: American Community Survey*

NOTE: Percentages may not add up to 100.0 due to rounding.

Consumer Lending: Motor Vehicle Secured Lending

The geographic distribution of motor vehicle secured lending is reasonable. The bank’s lending in the moderate-income census tract (6.5%) lagged the percentage of households located in the tract (12%). However, poverty rates are high within the assessment area, especially within the moderate-income census tract (24.3%). The concentration of households below the poverty level likely reduces the viable demand for consumer loans in the moderate-income census tract.

Table 9 Distribution of 2018 Motor Vehicle Secured Lending By Income Level of Geography					
Census Tract Income Level	Bank Loans				% of Households
	#	\$(000)	#%	\$%	
Low	NA	NA	NA	NA	NA
Moderate	5	100	6.5%	8.8%	12%
Middle	48	786	62.3%	68.6%	64.3%
Upper	24	259	31.2%	22.6%	23.7%
Unknown	NA	NA	NA	NA	NA
Not Reported	NA	NA	NA	NA	NA

*Source: 2015 FFIEC Census data
2015 U.S. Census Bureau: American Community Survey
NOTE: Percentages may not add up to 100.0 due to rounding.*

Lending to Borrowers of Different Income Levels and to Businesses of Different Sizes

This performance criterion evaluates the bank’s lending to borrowers of different income levels and businesses of different revenue sizes. The bank’s lending has an excellent penetration among individuals of different income levels and businesses of different sizes.

Small Business Lending

The borrower distribution of small business lending is excellent. The bank’s level of lending to business with revenues of \$1 million or less (91.9%) exceeded the percentage of businesses with reported revenues of \$1 million or less within the AA (89.4%). As part of performance context, the aggregate data was also considered after excluding certain specialty lenders. Of the remaining small business loans originated by traditional bank lenders, 69.9% were made to businesses with annual revenues of \$1 million or less. The bank’s level of lending substantially exceeded this aggregate level of lending.

Table 10 Distribution of 2018 Small Business Lending By Revenue Size of Businesses					
	Bank Loans				Total Businesses
	#	\$(000)	#%	\$%	%
By Revenue					
\$1 Million or Less	79	\$2,791	91.9%	78.5%	89.4%
Over \$1 Million	7	\$765	8.1%	21.5%	8.2%
Not Known	0	\$0	0%	0%	2.4%
Total	86	\$3,556	100%	100%	100%
By Loan Size					
\$100,000 or less	76	\$2,012	88.4%	56.6%	
\$100,001 - \$250,000	9	\$1,254	10.5%	35.3%	
\$250,001 - \$1 Million	1	\$290	1.1%	8.1%	
Total	86	\$3,556	100%	100%	
By Loan Size and Revenue \$1 Million or Less					
\$100,000 or less	72	\$1,847	91.1%	66.2%	
\$100,001 - \$250,000	7	\$943	8.9%	33.8%	
\$250,001 - \$1 Million	0	\$0	0%	0%	
Total	79	\$2,790	100%	100%	
<i>Source: 2015 FFIEC Census Data 2018 Dun & Bradstreet data 2015 U.S. Census Bureau: American Community Survey NOTE: Percentages may not add up to 100.0 due to rounding.</i>					

Consumer Lending: Motor Vehicle Secured Lending

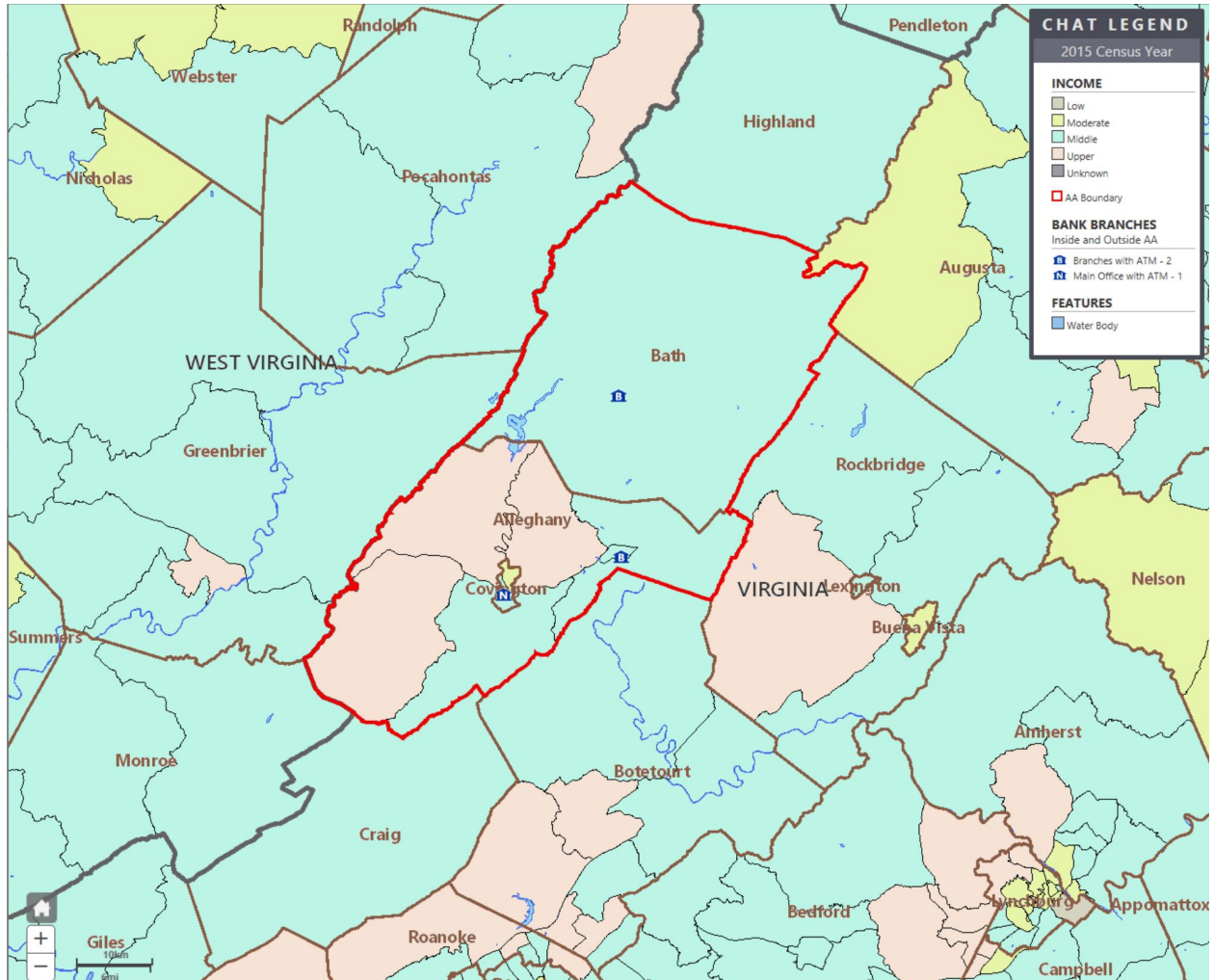
The borrower distribution of motor vehicle secured lending is excellent. Although the bank’s motor vehicle lending to low-income borrowers (18.2%) lagged the percentage of low-income households in the AA (23.7%), lending performance to low-income borrowers is considered reasonable. The bank’s lending to moderate-income borrowers (27.3%) significantly exceeded the percentage of moderate-income households in the AA (13.9%) and is considered excellent. On a combined basis, the bank’s lending performance to low- and moderate-income borrowers is considered excellent.

Table 11 Distribution of 2018 Motor Vehicle Secured Lending By Borrower Income Level					
Borrower Income Level	Bank Loans				% of Households
	#	\$(000)	#%	\$%	
Low	14	\$118	18.2%	10.3%	23.7%
Moderate	21	\$392	27.3%	34.2%	13.9%
Middle	22	\$288	28.6%	25.2%	19.3%
Upper	20	\$347	25.9%	30.3%	43.1%
<i>Source: 2015 FFIEC Census data 2015 U.S. Census Bureau: American Community Survey NOTE: Percentages may not add up to 100.0 due to rounding.</i>					

FAIR LENDING OR OTHER ILLEGAL CREDIT PRACTICES REVIEW

A violation of section 5 of the Federal Trade Commission Act involving unfair and deceptive acts or practices for an add-on product for one of the bank's consumer loan products was identified during the concurrent consumer compliance examination. Bank management is committed to correcting the violation and improving its risk controls, policies, procedures, and training programs. The violation did not cause the rating to be downgraded.

APPENDIX A – MAP OF THE ALLEGHANY, VA NONMSA ASSESSMENT AREA



APPENDIX B – DEMOGRAPHIC INFORMATION

ALLEGHANY COUNTY, VA NONMSA AA DEMOGRAPHICS								
Income Categories	Tract Distribution		Families by Tract Income		Families < Poverty Level as % of Families by Tract		Families by Family Income	
	#	%	#	%	#	%	#	%
Low	0	0.0	0	0.0	0	0.0	1,494	21.4
Moderate	1	11.1	769	11.0	198	25.7	1,067	15.3
Middle	5	55.6	4,489	64.4	600	13.4	1,243	17.8
Upper	3	33.3	1,716	24.6	166	9.7	3,170	45.5
Unknown	0	0.0	0	0.0	0	0	NA	NA
Total AA	9	100.0	6,974	100.0	964	100	6,974	100
	Housing Units by Tract	Housing Type by Tract						
		Owner-occupied			Rental		Vacant	
		#	% by tract	% by unit	#	% by unit	#	% by unit
Low	0	0	0	0	0	0	0	0
Moderate	1,646	945	10.9	57.4	422	25.6	279	17
Middle	9,663	5,434	62.7	56.2	1,895	19.6	2,334	24.2
Upper	3,183	2,287	26.4	71.9	420	13.2	476	15
Unknown	0	0	0	0	0	0	0	0
Total AA	14,492	8,666	100	59.8	2,737	18.9	3,089	21.3
	Total Businesses by Tract		Businesses by Tract & Revenue Size					
			Less Than or = \$1 Million		Over \$1 Million		Revenue Not Reported	
			#	%	#	%	#	%
Low	0	0	0	0	0	0	0	0
Moderate	80	9.5	72	9.6	7	10.1	1	5
Middle	607	72.2	543	72.2	46	66.7	18	90
Upper	154	18.3	137	18.2	16	23.2	1	5
Unknown	0	0	0	0	0	0	0	0
Total AA	841	100	752	100	69	100	20	100
Percentage of Total Businesses:				89.4		8.2		2.4
<p>Source: 2015 FFIEC Census Data 2018 Dun & Bradstreet data 2015 U.S. Census Bureau: American Community Survey NOTE: Percentages may not add up to 100.0 due to rounding.</p>								

APPENDIX C – GLOSSARY

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 area/assessment area.

Census tract: A small subdivision of metropolitan and other densely populated counties. Census tract 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 upon 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: Affordable housing (including multifamily rental housing) for low- or moderate-income individuals; community services targeted to low- or moderate-income individuals; 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 CFR 121.301) or have gross annual revenues of \$1 million or less; or, activities that revitalize or stabilize low- or moderate-income geographies, designated disaster areas; or designated distressed or underserved nonmetropolitan middle-income geographies.

Consumer loan(s): A loan(s) to one or more individuals for household, family, or other personal expenditures. A consumer loan 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.

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 (for example, geographic distribution, borrower distribution, and total number and dollar amount of investments), and qualitative factors (for example, innovativeness, complexity, and 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 such data as the race, gender, and the income of applications, the amount of loan requested, and the disposition of the application (for example, approved, denied, and 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 (for example, geographic distribution, borrower distribution, total number and dollar amount of investments, and branch distribution).

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 area/assessment area.

Metropolitan area (MA): A metropolitan statistical area (MSA) or a metropolitan division (MD) as defined by the Office of Management and Budget. A MSA is a core area containing at least one urbanized area of 50,000 or more inhabitants, together with adjacent communities having a high degree of economic and social integration with that core. A MD is a division of a MSA based on specific criteria including commuting patterns. Only a MSA that has a population of at least 2.5 million may be divided into MDs.

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 metropolitan area. 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 metropolitan area, the institution will receive a rating for the multistate metropolitan area.

Small loan(s) to business(es): A loan included in 'loans to small businesses' as defined in the Consolidated Report of Condition and Income (Call Report) instructions. These loans have original amounts of \$1 million or less and typically are either secured by nonfarm or nonresidential real estate or are classified as commercial and industrial loans. However, thrift institutions may also exercise the option to report loans secured by nonfarm residential real estate as "small business loans" if the loans are reported on the TFR as nonmortgage, commercial loans.

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

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 a geography.