# A Strong Performance by District Community Banks in 1998

By William R. Keeton and Michelle Holloway

Community banks in Tenth District states had another good year in 1998. They continued to benefit from solid growth in the district economy. And in contrast to some large banks in other parts of the country, they were largely unaffected by the turmoil in financial markets in the latter part of the year. To be sure, average profitability would have edged down in 1998 were it not for the decision by a substantial number of banks to change their tax status. Even accounting for this effect, however, district community banks remained highly profitable. Furthermore, overall loan quality showed no sign of deterioration, and loan growth and deposit growth were both healthy. Community banks in the district also compared favorably with their peers in the rest of the nation in all performance measures.

## *Description of sample*

This article focuses on community banks in district states, defining community banks broadly as those with less than $1 billion in assets.[1] Tracking the performance of such banks is complicated by the fact that the sample is continually changing due to startups and acquisitions by larger banks. To ensure that changes in measured performance do not reflect changes in the mix of banks, this article focuses on a constant sample of banks—those under $1 billion in size that were headquartered in a Tenth District state at the end of 1998 and in operation during both 1997 and 1998. Defined in this way, the sample included 1,631 banks.

[1] There are two reasons for focusing on these smaller banks. First, performance measures for large banks have become less meaningful due to the growth of interstate banking. Second, banking consolidation has generated keen interest in the long-run viability of community banks. For further details, see Keeton and Holloway.

Table 1 shows how many banks in the sample were headquartered in each district state, how many assets the banks held, and what share of local bank deposits they controlled. Altogether, the banks held $135.7 billion in assets and accounted for 45.7 percent of deposits in banking offices in Tenth District states. By comparison, banks under $1 billion in size accounted for only 28.1 percent of deposits nationwide. Community banks enjoyed the greatest market share in Nebraska, Kansas, and Oklahoma,

Table 1
**Profile of Banks in Sample**

| | Number of banks | Total assets (billions of dollars) | Local deposit share (percent) |
|---|---|---|---|
| Colorado | 177 | 20.6 | 38.4 |
| Kansas | 387 | 26.7 | 56.3 |
| Missouri | 360 | 34.3 | 36.6 |
| Nebraska | 308 | 19.5 | 57.6 |
| New Mexico | 49 | 7.0 | 39.5 |
| Oklahoma | 302 | 23.1 | 54.5 |
| Wyoming | 48 | 4.5 | 43.3 |
| Tenth District | 1,631 | 135.7 | 45.7 |

Note: Assets are for end of 1998 and deposit shares are for mid-1998. Each deposit share is a percent of total deposits at local banking offices, including offices of banks headquartered outside the area.

Source: Reports of Income and Condition, Summary of Deposits.

where they controlled well over half of all bank deposits. Community banks played the smallest role in Missouri, where their deposit share was a little more than a third.

*Profitability*

Profitability at district community banks was high and virtually unchanged from a year ago (Table 2). Profitability is measured by return on assets (ROA), the ratio of after-tax profits to average assets. Community banks in the district earned an average ROA of 1.31 percent in 1998, one basis point less than in 1997. Profitability was also slightly higher in the district than in the nation as a whole, where banks with less than $1 billion in assets earned an average ROA of 1.27 percent.

Profitability remained high because a small drop in net interest income and a modest rise in loan loss provisions were offset by a decline in taxes due to organizational changes. Interest income edged down and interest expense edged up, causing the ratio of net interest income to assets to fall four basis points to 4.32 percent. Adding to the downward pressure on profits, loan loss provisions increased three basis points to 0.29 percent of assets, as banks set aside funds to cover a small increase in chargeoffs. The negative impact of these changes was offset, however, by a seven-basis point decline in the ratio of taxes to assets. This decrease in taxes was due mainly to the conversion of over 120 banks to Subchapter S corporations, which are generally not subject to federal income taxes at the corporate level. With last year's conversions, about a fifth of district community banks now enjoy Subchapter S status.

Other components of profits were little changed. Noninterest expense and noninterest income both rose modestly, leaving net noninterest expense virtually unchanged at 2.13 percent of assets. Net gains from the sale of securities and from extraordinary items were small and unchanged from the previous year.

*Loan quality*

Loan quality at district community banks was strong at yearend, showing little change from a year earlier. Loan quality can be measured by noncurrent loans, which include loans at least 90 days overdue and not accruing interest. At the end of 1998, these noncurrent loans were 0.92 percent of total loans, one basis point higher than a year earlier (Table 2). The overall delinquency rate was about the same in the district as the nation, where banks with less than $1 billion in assets held noncurrent loans equal to 0.90 percent of total loans.

Delinquency rates were stable for consumer loans and home mortgage loans, as strong job and income growth enabled households to keep up with debt payments (Table 3). At yearend, 0.59 percent of home mortgage loans were noncurrent, little changed from a year earlier. The delinquency rate on consumer loans edged up three basis points to 0.87 percent. Within this loan category, the delinquency rate on credit card loans remained stubbornly high at 1.88 percent. Such loans account, however, for less than a fifth of total consumer loans at district community banks. Furthermore, the delinquency rate on other consumer loans was a more moderate 0.67 percent, holding down the average for the category.

Delinquency rates were little changed for business loans and down for commercial real estate loans. Noncurrent business loans were 1.36 percent of total business loans at yearend, up a mere two basis points from a year earlier. During the last two years, regulators have repeatedly warned that easy credit standards could lead to higher losses on business loans. By yearend, however, the favorable effects of the strong economy on loan repayments still appeared to outweigh any adverse effects from easy credit standards. The delinquency rate on commercial real estate loans also remained low, falling12 basis points to 0.61 percent at yearend. Contributing to the low delinquency rate was the strong market for office, industrial, and retail space in most of the district. While edging up in some cities, vacancy rates remained significantly lower than in the early 1990s. Rental rates were also stable to up slightly in most cities, helping sustain property values.

Reflecting unfavorable developments in the agricultural sector, the delinquency rate on farm loans increased somewhat. Noncurrent farm loans were 1.39 percent of total farm loans at yearend, up 25 basis points from a year earlier. Livestock and

Table 2
**Performance Measures for Community Banks**
Tenth District states (constant sample)

| | Tenth District States | | Colorado | | Kansas | | Missouri | |
|---|---|---|---|---|---|---|---|---|
| | 1997 | 1998 | 1997 | 1998 | 1997 | 1998 | 1997 | 1998 |
| Profits (ROA) | 1.32 | 1.31 | 1.48 | 1.43 | 1.23 | 1.24 | 1.30 | 1.29 |
| Net interest income | 4.36 | 4.32 | 4.96 | 4.78 | 4.20 | 4.20 | 4.10 | 4.17 |
| – Loan loss provisions | .26 | .29 | .31 | .28 | .28 | .33 | .17 | .19 |
| – Net noninterest expense | 2.12 | 2.13 | 2.38 | 2.37 | 2.05 | 2.03 | 1.95 | 2.01 |
| + Net securities gains and extraordinary gains | .01 | .01 | .00 | .01 | .00 | .02 | .02 | .01 |
| – Total taxes | .68 | .61 | .79 | .70 | .65 | .61 | .70 | .70 |
| Net chargeoffs | .21 | .23 | .23 | .22 | .24 | .28 | .10 | .12 |
| Noncurrent loans | .91 | .92 | .68 | .77 | .98 | .89 | .80 | .77 |
| Loan growth | 12.6 | 7.9 | 15.3 | 11.0 | 13.8 | 7.8 | 14.4 | 9.4 |
| Deposit growth | 8.4 | 9.2 | 13.4 | 13.3 | 8.3 | 8.3 | 10.4 | 10.6 |
| Loan-deposit ratio | 69.1 | 68.3 | 62.3 | 61.0 | 67.3 | 67.0 | 74.0 | 73.2 |

| | Nebraska | | New Mexico | | Oklahoma | | Wyoming | |
|---|---|---|---|---|---|---|---|---|
| | 1997 | 1998 | 1997 | 1998 | 1997 | 1998 | 1997 | 1998 |
| Profits (ROA) | 1.28 | 1.26 | 1.47 | 1.43 | 1.25 | 1.26 | 1.53 | 1.60 |
| Net interest income | 4.31 | 4.26 | 4.81 | 4.59 | 4.30 | 4.24 | 4.54 | 4.48 |
| – Loan loss provisions | .42 | .47 | .16 | .24 | .25 | .29 | .16 | .16 |
| – Net noninterest expense | 1.95 | 1.94 | 2.49 | 2.43 | 2.23 | 2.24 | 2.17 | 2.24 |
| + Net securities gains and extraordinary gains | .00 | .01 | .00 | .01 | .00 | .02 | .00 | .02 |
| – Total taxes | .67 | .61 | .69 | .51 | .58 | .47 | .69 | .50 |
| Net chargeoffs | .36 | .37 | .16 | .18 | .23 | .24 | .12 | .10 |
| Noncurrent loans | .94 | 1.08 | .81 | .88 | 1.18 | 1.21 | .82 | .87 |
| Loan growth | 10.6 | 5.7 | 10.2 | 3.0 | 9.3 | 7.2 | 10.6 | 7.2 |
| Deposit growth | 5.5 | 6.9 | 8.2 | 8.8 | 4.8 | 6.8 | 7.3 | 8.0 |
| Loan-deposit ratio | 76.8 | 76.0 | 70.9 | 67.2 | 64.4 | 64.7 | 62.5 | 62.1 |

Note: For 1998, sample consists of all banks under $1 billion in size that were headquartered in a Tenth District state at year end and in operation during both 1997 and 1998. For 1997, the sample consists of these banks plus all banks that were later acquired by them through mergers. ROA, components of ROA, and net chargeoffs are a percent of average assets. Noncurrent loans are a percent of total loans. Loans are net of unearned income and deposits are for domestic offices only.

Source: Reports of Income and Condition

crop prices were both low in 1998, making it difficult for some ranchers and farmers to turn a profit. Repayment problems were somewhat eased, however, by high crop yields in much of the district, the strong financial condition of most farm borrowers, and a substantial farm assistance package from Congress. Some problem loans may also have been rolled over by banks in hopes of eventual repayment, limiting the increase in the delinquency rate.

While the rise in farm loan delinquencies has been modest so far, some further increase can be expected in 1999. Farm prices remain low, reflecting large supplies and weak demand in export markets. The adverse impact on district farm income may be dampened somewhat by additional government payments. Even with this aid, however, farm loan delinquencies are likely to be higher at the end of 1999 than at the end of 1998.

*Loan and deposit growth*

Loan growth at district community banks slowed markedly in 1998 but remained solid. Loans at district banks rose 7.9 percent last year, down about 5 percentage points from 1997 (Table 2). Loan growth was identical at community banks nationwide, having slowed about 3 percentage points from the year before.

Loan growth varied greatly across categories (Table 4). Helped by the strong property market, commercial real estate loans grew a rapid 15.2 percent in 1998, virtually unchanged from a year earlier. Business loans rose 9.4 percent, down two percentage points from 1997 but still healthy. After growing at double-digit rates in 1997, farm loans and home mortgage loans both rose only moderately in 1998. Growth in home mortgage loans held by community banks slowed from 11.6 percent to 6.4 percent, despite low mortgage rates and a robust housing market. The slowdown does not necessarily mean community banks were making fewer home mortgage loans, however, because banks sell many of the home mortgage loans they originate on the secondary market. Growth in farm loans fell by about half to 5.5 percent, a slowdown some observers attribute to the reluctance of farm borrowers to take on additional debt at a time when farm income is expected to decline.

Table 3
**Noncurrent Loans by Category**
Percent of total loans

| | 1997 | 1998 |
|---|---|---|
| Consumer | .84 | .87 |
| Home mortgage | .60 | .59 |
| Business | 1.34 | 1.36 |
| Commercial real estate | .73 | .61 |
| Farm | 1.14 | 1.39 |
| Total | .91 | .92 |

Note: Commercial real estate loans consist of construction loans and loans secured by multifamily residential property or nonfarm, nonresidential property. Business loans consist of commercial and industrial loans and all loans not included in other categories.

Source: Reports of Income and Condition.

The weakest growth was in consumer loans, which were essentially flat last year after rising a strong 9.0 percent in 1997. Some of the slowdown in this category may have been in reaction to the rapid runup in consumer debt during previous years. The high level of mortgage refinancings in 1998 may also have contributed to the weakness in consumer loan growth. Specifically, some households appear to have taken out bigger mortgages when they refinanced, using the extra money to pay off consumer debts.

Deposits at district community banks rose 9.2 percent in 1998, about a percentage point faster than in the previous year (Table 2). The strong deposit growth was not unique to the district. At community banks nationwide, deposits grew 9.8 percent, up one and a half percentage points from a year earlier. Several factors contributed to the strong deposit growth in 1998. First, the yield curve was flatter than any time since 1990, causing deposits to look more attractive relative to longer-term investments. Second, the decline in short-term rates late in the year increased the attractiveness of bank deposits relative to short-term assets, such as Treasury bills, since deposit rates

Table 4
**Loan Growth by Category**
Percent

| | 1997 | 1998 |
|---|---|---|
| Consumer | 9.0 | .7 |
| Home mortgage | 11.6 | 6.4 |
| Business | 11.5 | 9.4 |
| Commercial real estate | 17.2 | 15.2 |
| Farm | 11.8 | 5.5 |
| All other | 15.1 | 12.1 |
| Total | 12.6 | 7.9 |

Note: Business loans include commercial and industrial loans.
Source: Reports of Income and Condition.

adjust only slowly to changes in market rates. Finally, some investors may have concluded that the booming stock market had caused their portfolios to become too heavily weighted toward risky assets, especially in light of the increased volatility in financial markets last fall.

The combination of strong deposit growth and more moderate loan growth helped ease liquidity pressures at district community banks. The average loan-deposit ratio was 68.3 percent at the end of 1998, down almost a percentage point from a year earlier. Although modest, last year's decline in the loan-deposit ratio was in sharp contrast to the steep rise in the ratio over the previous several years. From 1993 to 1997, loan growth at district community banks consistently outstripped deposit growth, causing the loan-deposit ratio to rise by an average of two and a half percentage points per year. Some of the increase in the loan-deposit ratio over this period merely made up for a sharp decline in the ratio during the banking slump of the late 1980s and early 1990s. By the end of 1997, however, the loan-deposit ratio had surpassed its previous high, causing some community banks to worry about their vulnerability to a sudden outflow of funds or slowdown in loan payments. For these banks, the turnaround in the loan-deposit ratio in 1998 presumably came as a welcome relief.

### *Performance by state*

While Tenth District community banks performed well on average during 1998, performance across the district's seven states was mixed. Compared with a year ago, profitability edged up in Wyoming and slipped in Colorado and New Mexico. Profitability stayed about the same in Kansas, Missouri, Nebraska, and Oklahoma (Chart 1 and Table 1). Loan quality worsened somewhat in Nebraska, Colorado, and New Mexico but held steady or improved in all other states. Loan growth slowed to a modest pace in New Mexico, but stayed healthy elsewhere in the district. In all states, deposit growth was strong.

*Wyoming.* Profits at community banks in Wyoming rose modestly as ROA climbed seven basis points to 1.60 percent, making Wyoming the profit rate leader for the district. The earnings gain was largely the result of a tax decline of almost 20 basis points, which more than offset a drop in net interest income and a rise in net noninterest expense. The significant drop in taxes was the result of a number of banks converting to Subchapter S corporations, which generally do not pay federal income taxes at the corporate level.

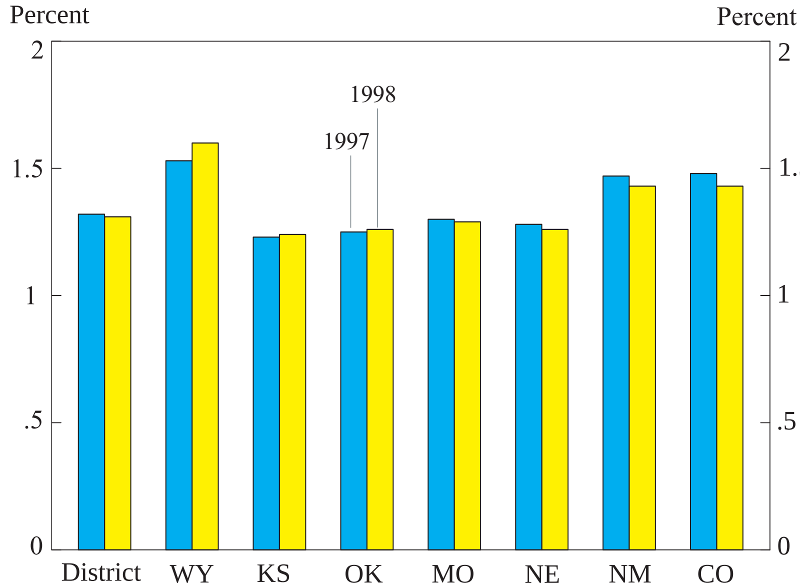
Loan quality weakened slightly compared to a year ago but remained healthy. Noncurrent loans rose five basis points to 0.87 percent, below the district average. The delinquency rate on farm loans increased by more than 60 basis points to 1.46 percent, exceeding the district average, while delinquencies for commercial real estate loans and business loans both showed improvement.

Loans and deposits both grew at a healthy rate. Loans grew 7.2 percent, down three and a half percentage points from the previous year. Business loan growth accelerated and commercial real estate loan growth was strong, both registering a double-digit pace. In contrast, farm loan growth slowed to half the previous year's pace, while the volume of home mortgage and consumer loans fell after growing moderately the year before. Deposits grew a healthy 8.0 percent, outpacing the 1997 rate by 0.7 percentage point. The slower growth in loans than in deposits reduced the loan-deposit ratio to 62.1 percent.

Chart 1

**Return on Assets by State**

Community banks




*Kansas*. Profitability at community banks in Kansas showed little change as ROA edged up one basis point to 1.24 percent of total assets. The increase in profits was due to a small decrease in total taxes, a slight decline in net noninterest expense, and a modest rise in net securities gains. These changes more than offset an increase in loan loss provisions. Total taxes fell due to a growing number of Subchapter S corporations.

Loan quality was favorable, improving slightly from the previous year. Noncurrent loans decreased nine basis points to 0.89 percent, dipping below the district average. Commercial real estate delinquencies fell more than 50 basis points, and business loan delinquencies improved modestly. Farm loan delinquencies climbed nearly 25 basis points to 1.01 percent, but stayed well below the district average. Delinquency rates for consumer loans rose modestly.

Loan growth slowed to a more moderate pace, and deposit growth remained strong. Loan growth fell by six percentage points to 7.8 percent. Loan growth slowed significantly in all categories except commercial real estate, which continued to grow at a double-digit pace. Deposit growth held steady at 8.3 percent, nearly a full percentage point below the district average. Because loan growth trailed deposit growth, the loan-deposit ratio fell three tenths of a percentage point to 67 percent.

*Oklahoma.* Profitability among Oklahoma community banks was little changed in 1998. ROA rose one basis point to 1.26 percent, trailing the district average. Bank profits were aided by a moderate decrease in total taxes due to Subchapter S conversions and a boost in net securities gains. These positive effects on profits were partially offset by a drop in net interest income and a rise in loan loss provisions.

Loan quality in Oklahoma was little changed. Noncurrent loans rose three basis points to 1.21 percent, the highest delinquency rate in the district. The rise was primarily due to a higher farm loan delinquency rate, which jumped more than 30 basis points to 2.18 percent of total loans. On a positive note, delinquency rates for business loans and commercial real estate loans both edged down.

Loan growth and deposit growth both stayed healthy. Loans grew 7.2 percent, close to the district average. Double-digit loan growth for both commercial real estate loans and business loans spurred healthy loan growth. The volume of consumer loans shrank and agricultural loan growth slowed by half. Deposits grew by 6.8 percent, two percentage points more than the previous year. Oklahoma was the only district state with a greater rate of loan growth than deposit growth. Consequently, it was the only district state in 1998 to see an increase in its loan-deposit ratio, which edged up three tenths of a percentage point to 64.7 percent.

*Missouri.* Profitability edged down at community banks in Missouri as ROA slipped one basis point to 1.29 percent, just shy of the district average. In addition to an increase in net noninterest expense, a rise in loan loss provisions and a decrease in net securities gains helped lower profits. Net interest income rose seven basis points, helping to minimize the drop in ROA.

Loan quality remained strong in 1998. Noncurrent loans slipped three basis points to 0.77 percent, well below the district average. Delinquencies for commercial real estate loans and consumer loans both eased. Loan quality held steady for other categories.

Loan growth and deposit growth were both strong, exceeding district averages. Loans grew 9.4 percent in 1998, down five percentage points from the previous year. The slowdown was largely due to slower growth for home mortgage loans, consumer loans, and business loans, following double-digit growth rates in 1997. Commercial real estate loans continued to grow rapidly. Deposit growth held steady at 10.6 percent, helping to lower the loan-deposit ratio to 73.2 percent, nearly a full percentage point lower than the year before.

*Nebraska.* Profitability was slightly weaker at community banks in Nebraska. ROA slipped two basis points to 1.26 percent. The lower earnings were caused by a decrease in net interest income and an equal increase in loan loss provisions. The decrease in ROA was limited by a decline in total taxes, an effect of Subchapter S conversions.

Loan quality in the state worsened somewhat. Noncurrent loans climbed 14 basis points to 1.08 percent, surpassing the district average. Higher delinquencies on farm loans, business loans, and commercial real estate loans accounted for most of the weakening. Farm loan delinquencies increased 30 basis points to 1.44 percent, slightly above the district average. Delinquencies for business loans edged up 20 basis points to 1.19 percent, still below the district average. On a positive note, the quality of home mortgage loans and consumer loans improved somewhat.

Loans and deposits both grew moderately. Loans grew 5.7 percent, down almost five percentage points from 1997. The largest decreases in loan growth were for home mortgages and farm loans, following double-digit growth the previous year. Commercial real estate loans continued to grow strongly. Deposit growth rose to 6.9 percent, surpassing loan growth and producing a lower loan-deposit ratio of 76 percent.

*New Mexico.* Community banks in New Mexico suffered a slight drop in profits as ROA fell four basis points to 1.43 percent. Net interest income deteriorated more than 20 basis points, and loan loss provisions jumped 8 basis points, the largest change in the district. A modest decrease in net noninterest expense and a sharp drop in taxes due to Subchapter S conversions helped limit the decrease in profits.

Loan quality worsened somewhat during 1998 but remained strong. Noncurrent loans inched up seven basis points to 0.88 percent, slightly below the district average. The delinquency rate for farm loans ratcheted up a full percentage point, the largest change in the district. Among district states, New Mexico had the highest farm loan delinquency rate. The delinquency rate on consumer loans also edged up. On a positive note, business loan delinquencies showed modest improvement, easing 11 basis points to 0.99 percent, almost 40 basis points below the district average.

Loan growth was weak, while deposit growth was healthy. Loans grew 3.0 percent, only about one-third as fast as the year before. The volume of both consumer loans and home mortgage loans fell from the previous year. Growth in other loan categories was healthy, but slower than the year before. Deposits grew 8.8 percent, surpassing loan growth by almost six percentage points. Weak loan growth was the primary driver of a loan-deposit ratio of 67.2 percent, nearly four percentage points lower than a year earlier.

*Colorado.* Community bank profits in Colorado were high, although modestly weaker than the year before. ROA declined five basis points to 1.43 percent of total assets. Net interest income fell 18 basis points to 4.78 percent. The adverse effect on profits was partly offset by a decrease in loan loss provisions and a decline in total taxes of nearly 10 basis points, reflecting Subchapter S conversions.

Loan quality weakened compared to a year ago but remained strong and well below the district average. Noncurrent loans rose nine basis points to 0.77 percent. The largest increase in delinquency rates was for business loans, which gained nearly 40 basis points. The delinquency rate on farm loans was also higher, rising 15 basis points and exceeding the district average.

Loan growth and deposit growth were both strong in 1998, outpacing all other district states. Loan growth slowed somewhat, falling four percentage points to 11.0 percent. The steepest slowdown was in consumer loans, where the volume of loans actually decreased after growing by 15 percent in 1997. Growth in business loans, commercial real estate loans, and farm loans continued at double-digit rates, while home mortgage loans grew over 9 percent. Deposit growth was little changed at 13.3 percent. Because loan growth slowed below deposit growth, the loan-deposit ratio fell by more than a full percentage point to 61.0 percent.

## *Conclusion*

Tenth District community banks performed well in 1998. Average profitability remained high, as a small decline in before-tax profits was offset by a favorable change in tax status at a substantial number of banks. Loan quality also remained favorable, with overall delinquencies showing virtually no change from a year earlier. Loan growth slowed but was still solid. Furthermore, deposit growth exceeded loan growth for the first time in five years, easing liquidity pressures. Community banks in Tenth District states also compared well with their peers nationwide, approximately matching them by all performance measures.

The outlook for 1999 is less certain. While the district economy has continued to grow, there have been some signs of easing. Slower economic growth could hurt bank profitability by reducing loan demand and raising loan losses. And even without such a slowdown, the continued weakness in farm prices this year is likely to cause some further increase in delinquencies on farm loans, an important asset category for many community banks in the district.

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