

SPECIAL EDITION

FEDERAL RESERVE BANK OF KANSAS CITY - OMAHA BRANCH

Nebraska's Top Ten Economy Fuels Top Ten Profits at Nebraska's Banks

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EXECUTIVE SUMMARY

A flourishing economy underpinned strong profits at Nebraska's banks in 2011. In addition to having the second-lowest unemployment rate in the nation last year, Nebraska ranked sixth in personal income growth. The strong economy contributed to Nebraska's banks remaining national leaders in return on average assets (ROAA) and net interest margin (NIM). Nebraska's banks also have lower credit risk profiles than their national peers.

The drivers of Nebraska's bank profits shifted over the past year. After avoiding the steep losses associated with commercial real estate (CRE) lending, Nebraska banks are reaping the benefits of a booming farm economy and strong labor markets.

Looking ahead, the prospect for the continued profitability of Nebraska banks looks promising. Elevated commodity prices and resulting incomes could keep delinquency rates low and repayment rates high, especially at Nebraska's agricultural banks. With banks flush with

cash, future profitability hinges on a strengthening Main Street economy and a resurgence of loan activity based on solid underwriting standards.

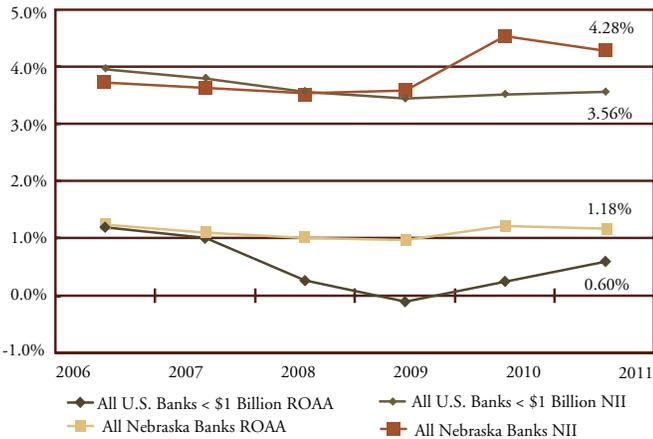
BANK PROFITABILITY

In 2011, Nebraska remained a national leader in bank profitability. Last year, Nebraska banks continued to post stronger net interest income—the difference between interest payments received on loans outstanding and interest paid to customers on their deposits—than their national peers. In fact, Nebraska banks ranked third in net interest income (NII) at 4.25 percent (Chart 1). Although still strong, net interest margins narrowed at Nebraska banks as the interest received on outstanding loans declined.

Strong NII helped keep overall profits high at Nebraska banks. In banking, overall profitability is measured by ROAA, a bank's net income as a percentage of average assets. In 2011, Nebraska ranked seventh in the ROAA after holding relatively steady at 1.18 percent



Chart 1: Nebraska Bank Earnings Continue to Outperform Banks Nationwide



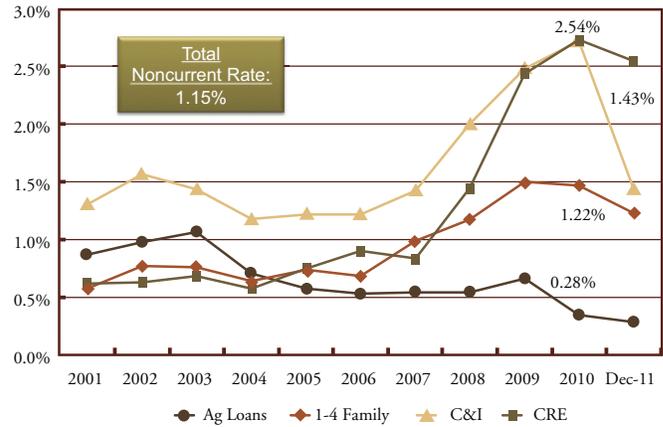
Still, the relative strength of Nebraska banks when compared to their national peers narrowed, mainly because Nebraska banks avoided the pitfalls of the past. Since Nebraska banks did not suffer like their national peers from losses associated with noncurrent loans that are past due 90 days or more and no longer accruing interest, they also did not experience the rebound associated with lower loan losses.

SHIFTING RISK PROFILES AND PERFORMANCE

In addition to stronger profits, Nebraska banks have a lower risk profile. In 2011, Nebraska banks had fewer noncurrent loans. Nebraska's noncurrent loans fell to 1.15 percent in 2011 (Chart 2), well below the 4.76 percent at banks nation-wide. In fact, Nebraska had the fourth lowest rate of noncurrent loans in the nation, which contributed to lower net charge-offs last year.

The decline in loan delinquencies was widespread. Noncurrent commercial and industrial (C&I) loans fell to the lowest level in three years and noncurrent loan rates on commercial real estate loans dropped to the lowest level in two years, with the biggest declines emerging from

Chart 2: Noncurrent rates for Nebraska Banks



Excludes First National of Nebraska

C&I. In addition, noncurrent loan rates on residential loans eased.

The booming farm economy also helped the risk profile of Nebraska banks. Nebraska has the most agriculturally concentrated banks in the nation. Over 80 percent of the state's banks are considered agricultural banks, or a bank with agricultural loans accounting for more than 25 percent of its loan portfolio. With strong farm incomes and high repayment rates, only 0.28 percent of agricultural loans at Nebraska's banks were noncurrent.

With fewer noncurrent loans, Nebraska banks have ample funds to cover future loan losses. Nebraska has the third-highest level of loan loss reserves as a percentage of noncurrent assets, or also known as a coverage ratio. Nebraska's coverage ratio of 156 percent is more than double the national ratio.

WILL STRONG PROFITS AND LOW RISK CONTINUE?

With ongoing economic strength in Nebraska, the state's banks could enjoy another year of strong profits and low risk in 2012. During the first quarter of 2012, Nebraska businesses continued to turn economic gains into new



jobs and higher wages. Low unemployment rates are one indicator that the strength of Nebraska's economy, combined with rebounding housing markets and strong personal income gains, could lead to higher loan repayment rates and lower delinquency rates on residential construction and business loans.

Nebraska banks could further benefit from their strong relationship with Nebraska's farm sector. Sustained farm profitability has provided additional business opportunities for Nebraska's agriculture equipment manufacturers, agricultural service firms and other Main Street businesses with close ties to the farm sector. In turn, thriving agricultural enterprises could enhance loan repayment and sustain profits at Nebraska banks, especially in the state's rural communities.

Yet, bank performance hinges on quality loan demand. Despite high deposit ratios and ample funds available for loans, Nebraska's nonfarm loan volumes fell in 2011, especially in higher risk loan categories. For example, construction and land development (CLD) and commercial and industrial (C&I) loan volumes decreased by \$353 million

and \$237 million, respectively. In addition, strong profits in agriculture led to limited growth in agricultural lending as farmers used cash to finance operating needs and capital investments.

While Nebraska banks have weathered the recent financial crisis and recession better than banks nationwide, risks, primarily concentration risk, do remain. With large concentrations in agricultural lending, narrowing profit margins and weakness in the national or global economy could strain loan repayment rates at Nebraska banks, especially those with poor credit risk management processes. Ultimately, banking is a risk management business. The key to sustained prosperity is through strong and effective underwriting standards and overall risk management

Nebraska's heavy concentration in agricultural lending increases its vulnerability to economic downturns in commodity markets, especially for rural banks. With volatile commodity markets and uncertain economic conditions, Nebraska banks still need to be vigilant about the potential risks that may lie ahead, even in good times.

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