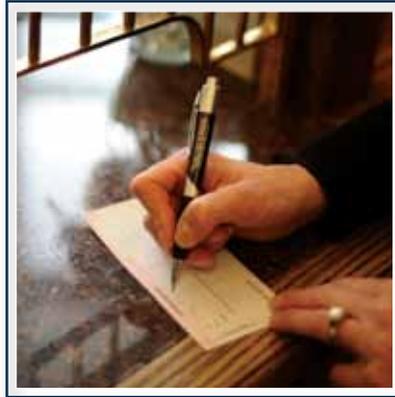


# Weathering the storm?

How community banks are managing tough times





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Ed Sauer has an answer to a multimillion-dollar question that, lately, he's been asked more than once.

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**O**ne man in particular called the Bank at Broadmoor in Colorado Springs to speak to the bank president—he wanted to ask Sauer about community banking. Shortly after that conversation, the man transferred his deposits to Broadmoor. He was one of three accounts of more than \$1 million to recently do so.

“We’re not a transaction-oriented bank; we’re a relationship-oriented bank,” explains Sauer, who is also the chairman of the Colorado Bankers Association.

That’s the mantra of community banks, which are small institutions (typically defined as having less than \$1 billion in assets) and often located in smaller cities or rural areas. In these times of financial institution failures, bank bailouts and overall economic uncertainty, community banking is appealing to bank customers, like those at Broadmoor. It’s their banking principles, community bankers say,

that are helping them weather the storm.

“Community banks are experiencing problems along with the rest of industry, but so far they seem to be suffering less today than during the crisis of the ’80s,” says Esther George, executive vice president of the Federal Reserve Bank of Kansas City.

George, who oversees the Supervision and Risk Management Division, is optimistic about the financial sector’s recovery, but based on historical precedents, acknowledges it will take time and perhaps the worst is still to come.

For the Kansas City Fed, which is one of 12 regional Federal Reserve Banks, its supervisory role includes examining state-chartered banks that have chosen to be members of the Federal Reserve, as well as all bank holding companies in the Tenth Federal Reserve District. This District includes western Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico.

In general, banks are impacted negatively

# Community banks in the region



Community banks are small in size (typically defined as having less than **\$1 billion** in assets) and do most of their business where they are located.

The median bank size in the Tenth District is **\$84 million**.

The median bank size in the nation is **\$133 million**.

There are **1,089** community banks in the Tenth District, which is **97** percent of all banks in the District.

There are **6,527** community banks nationwide, which is **93** percent of all banks in the country.

**17** percent of the country's community banks are located in the Tenth District.

**C**ommunity banks are an important part of the Kansas City Fed's District because a high percentage of this region's population lives in rural or small urban areas. Additionally, community banks play a major role in financing small business and farm lending.

Their importance in the economy supports the Federal Reserve's interest in and oversight of community banks. Through its supervision and regulatory

activities, the Federal Reserve helps ensure that community banks operate in a safe and sound manner.

The Kansas City Fed's relationship with the Bank at Broadmoor in Colorado Springs is "critical," says Ed Sauer, Broadmoor president. The bank relies on the Kansas City Fed for more than bank exams—it's also a resource.

"We're in the shape we're in today because of the regulators—

someone is paying attention, someone is there," Sauer says of his bank, which is faring well in these tough times.

Metcalfe Bank President Tom Fitzsimmons says the concept of the Federal Reserve regulating state member banks by region strengthens his bank's relationship with the Fed. He is confident his examiner understands the eastern Kansas, western Missouri market that Metcalfe Bank serves.

by declining economic conditions, especially when they rely on too much leverage to grow assets or concentrate their assets in certain sectors. Banks that had a heavy concentration in housing and commercial development loans are now dealing with declining values and sluggish markets which may compromise the repayment of these loans. Community banks have been affected by these realities, which is reflected in deteriorating asset quality and depressed earnings.

Many community bankers describe their strategy during bad times as conservative, disciplined and based on relationships with customers—the same strategy for good times. That’s the way it’s done at Collegiate Peaks, a community bank in Colorado.

“The basic principles,” says Charlie Forster, president of Collegiate’s mountain region, “work pretty well.”

### **‘Sticking with fundamentals’**

In an average year, less than 10 percent of banks nationwide have losses. However, in 2008, 22 percent of banks nationwide experienced losses.

Made up primarily of community banks, the Tenth District mirrors national banking

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**ESTHER GEORGE, EXECUTIVE VICE PRESIDENT** at the Kansas City Fed, oversees the Supervision and Risk Management Division. She often speaks publically about the current economic crisis and the role of the banking industry.

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PHOTO BY GARY BARBER

trends. Though community banks’ problems generally haven’t been as severe, those in this District have seen:

- A drop in earnings from 1.16 percent of assets in 2007 to 0.89 percent in 2008. Eleven percent of community banks in the District are losing money.

- An increase in noncurrent (past due or non-accruing) assets from less than 1 percent of loans in 2006 to nearly 2.6 percent by March 2009. This is driven in large part by asset quality deterioration in commercial real estate.

- A decline in net interest income from an average of 4.5 percent of assets in the ’90s to about 4 percent by March 2009. This is the largest source of income for community banks.

However, many community banks are profitable and growing. At the Bank at Broadmoor, president Sauer says there has been a decline in income, primarily from lower interest rates and increased expenses, but the bank is still profitable.

“Overall, we’re in pretty good shape,” he says. “I attribute it to the conservative way we’ve managed our bank in the last few years. ... I think people today want four things: safety; soundness; security; and, above all, they want knowledge.”

Agricultural banks specifically have performed better than other commercial banks and appear to have funds available for agricultural loans, says Jason Henderson, vice president and Branch executive at the Kansas City Fed’s Omaha office. However, the recession has dimmed economic prospects for the agricultural economy and trimmed profits at many agricultural banks, says Henderson, who recently researched agricultural bank conditions.

Fidelity Bank & Trust Company is a family-owned agricultural bank in Dodge City, Kan. There hasn’t been much change at the bank since Ben Zimmerman started as a management trainee 34 years ago. Now chairman of the board and president, Zimmerman thinks that’s a good thing.

“I think it’s a matter of sticking with

fundamentals,” Zimmerman says. “We’ve kind of stuck close to home.”

Others also attribute staying the course—and staying local—with their bank’s ability to manage tough times today.

“Most community banks stuck with their core business,” says Tom Fitzsimmons, president, chairman and CEO of Metcalf Bank. “And that did not include exotic mortgages.”

Metcalf Bank serves counties on both sides of the Kansas-Missouri state line. In April, Metcalf Bank bought a failed thrift. When banks serve a localized area, they have a better sense of conditions and can react quicker in times of trouble, Fitzsimmons says.

Many community banks are strong enough to continue making loans. This means community banks could provide credit to local businesses and consumers who have been unable to secure a loan elsewhere, thus playing a role in the nation’s economic recovery, says Federal Reserve Chairman Ben Bernanke. In a speech last spring, Bernanke told community bankers to avoid letting fear factor into their decisions to make sound loans.

“If community banks are prudent but opportunistic in extending credit to strong borrowers, they will help the economy recover while benefiting from that recovery themselves,” Bernanke said in March.

However, community banks’ relatively small share of assets compared to the country’s largest financial institutions may be a limiting factor to the boost community banks could give to the economy. Community banks have \$1.2 trillion of the \$12 trillion total banking assets nationwide.

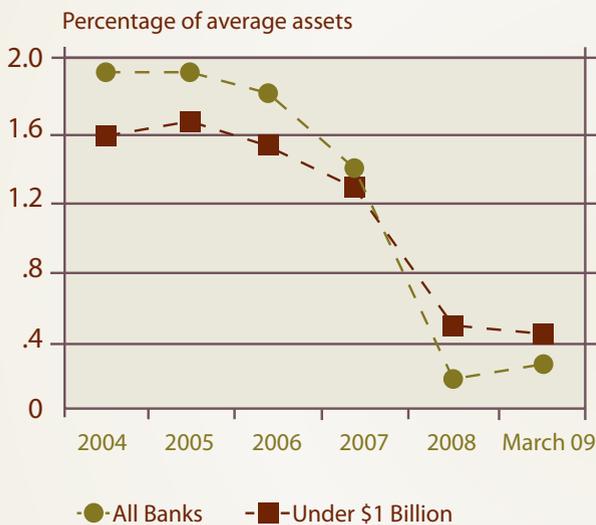
“Community banks make up just 10 percent of all banking assets, but are 93 percent of all banks nationwide,” George says. “They are a lot of small institutions in a lot of small towns that are vital to our nation’s financial system.”

## Learning from the past

Although the current economic crisis is more global and has a greater level of complexity, some comparisons to the past can be made.

During the 1980s, there were more bank

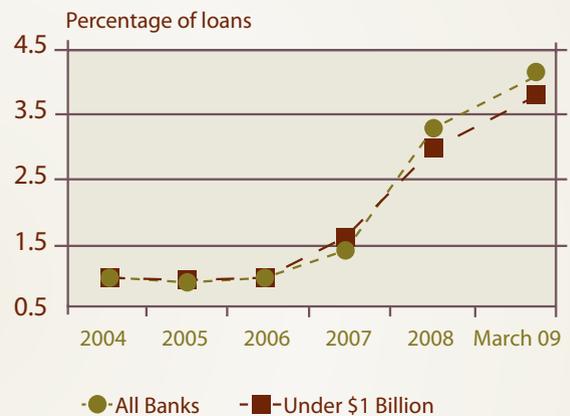
## Earnings remain weak



All U.S. Commercial Banks - Net Operating Income Before Taxes, as a percentage of average assets.

Source: Reports of Condition and Income

## Problem assets are high



All U.S. Commercial Banks - Noncurrent Assets-to-Total Loans.

Source: Reports of Condition and Income

and thrift failures than any single decade since the Great Depression. From 1982-92, more than 2,800 institutions failed, peaking in 1989 with 534 failures. In comparison, there were 25 failures in 2008 and 37 failures by early June.

“Failures in the ’80s make the number today seem small even though failures this year are climbing,” George says.

There are similarities today to the crisis in the 1980s.

**Bubbles:** In the ’80s, there were bubbles in commodity prices, land values and energy prices, much like today’s real estate bubble.

**Overbuilding:** In the ’80s, there was a rapid increase in commercial real estate lending, even when vacancy rates were rising, which resulted in significant overbuilding and even higher vacancy rates, much like today’s residential real estate market.

These factors, and others, have led to today’s declining bank earnings and continued problems that likely will lead to further weakness. Nationwide, non-current loans (past due or non-accruing) are approaching levels seen in the late ’80s. The charge-off of these troubled loans has increased only recently, which is why more loan losses are probable. At the same time, the reserves set aside to cover these losses are not keeping pace with the rising non-current loans. Reserves likely will decline further as additional losses are realized, and maintaining adequate reserves will bite into future earnings.

George says lessons from the ’80s remind us:

- **Fundamentals matter:** Banks should keep their focus on fundamentals. Those that have during the past few years likely are in a relatively good position today.
- **Board and management oversight must be emphasized:** Strong risk management practices are critical.
- **Quick action is vital:** Problems need to be recognized and addressed in a timely manner to avoid deeper losses.

## What’s ahead?

“Looking forward, we’ll undoubtedly see more tough times,” George says, “but maintaining the fundamentals will help community banks navigate through the turmoil that remains.”

Banks will continue to be challenged by weak credits, and downward pressure on earnings, but can prepare themselves by minimizing outside risks and maintaining good management and strong capital, she says.

“We need to remember this recovery will take time,” George says. “I have confidence that the economy and banking industry will come out of this strong and vibrant.”

As for community banks specifically, this financial crisis ultimately could strengthen their value as uneasy customers seek out relationship banking.

Back in Colorado at Collegiate Peaks Bank, knowing the customers and understanding portfolios allows the bank to grow during these shaky times. Collegiate opened two new branches earlier this year.

“I believe community banks will fare very well,” Forster says. “Customers rely on community banks.”



BY BRYE STEEVES, SENIOR WRITER

## FURTHER RESOURCES

### “THE 2008 SURVEY OF COMMUNITY BANKS IN THE TENTH FEDERAL RESERVE DISTRICT”

By Eric Robbins and Forest Myers

### “AGRICULTURAL CREDIT STANDARDS TIGHTEN”

By Jason Henderson

### “TENTH DISTRICT BANKING CONDITIONS”

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**COMMENTS/QUESTIONS** are welcome and should be sent to [teneditors@kc.frb.org](mailto:teneditors@kc.frb.org).