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Community bank checkup
A look at financial fundamentals shows how local banks are weathering the economy

By Nicole Garrison-Sprenger 06/22/2008

It's certainly not the best of times for community banks.

With the economy on the verge of recession, a credit crunch, and residential construction grinding to a near halt, Minnesota's small and medium-sized banks are feeling the stress. Last month, Minnesota saw its first bank failure in eight years, when r**egulators closed First Integrity Bank of Staples, which had operated for almost 90 years.**
But all the news isn't bad.

The Pioneer Press looked at some of the measures of health that regulators rely on to determine if a bank is troubled. We found that **most local banks were profitable and all were well-capitalized at the end of the first quarter. The Staples bank was neither. We found that the size of the bank wasn't nearly as important as how it was managed:** the banks at the top of our list included some of the smallest — one, First National of Cokato, had just $27 million in assets. More important, we learned, were the extent of a bank's bad loans compared to its total assets — an indication of trouble down the road. One big caveat: Looking at financials from a single quarter gives only a snapshot of a bank's true health. Regulators prefer year-end numbers, and to look at trends over time.

We'll have a much better idea of how banks weathered the economic downturn and real estate market collapse when the year is complete, said Marshall MacKay, CEO of Independent Community Bankers of Minnesota. Banks could choose to realize a loss later in the year, or conditions could worsen. Most likely, some of the banks now toward the top of the list could move down a bit in months to come.

Indeed, few bankers who are doing well now are eager to pat themselves on the back. Even 30- and 40-year veterans of the business say this is the worst time they've ever seen for the community banking business in the Twin Cities. "I don't want to give the impression that everything is wonderful and grand. It's not," said Bob Barsness, president and chairman of Prior Lake State Bank since 1989. "There will be stresses for our customers and that will mean stresses for us. ... I don't think we're out of the woods at this point."

WHAT WE LOOKED AT

We started by focusing on the 117 Twin Cities-based banks with fewer than $2 billion in assets, according to the Federal Deposit Insurance Corp. Of those in what we determined to be the top quintile, 12 can trace their roots back at least 90 years. Five started in the 1960s and 1970s. Only two — Venture Bank and Community Bank Corp. in Chaska — have opened this century. Not that age has anything to do with whether a bank is healthy. The failed First Integrity Bank started in 1919.

Instead, regulators determine how banks are faring with what they call the "CAMELS" system — an acronym for six different metrics: capital, asset quality, management, earnings, liquidity and sensitivity of the market, which basically means how well banks' investments are positioned. The ratings aren't made public, so we crafted a simplified version using a few of those metrics.

Capital is basically a cushion that a bank has against possible losses. We used the core capital ratio, which is considered a more pure form of capital, because it excludes intangible assets. A core capital ratio of 4 percent is considered adequate, and 5 percent is considered well capitalized. All the community banks on our list have core capital ratios above 5 percent.

Asset quality. Loans make up most of a bank's assets, so regulators look closely at how a bank manages its portfolio. There are many measures of asset quality. We looked at assets in "nonaccrual status," which means loans that were at least 90 days overdue and not expected to be fully repaid, as a percent of total assets. Nonaccrual loans can be a future indicator of problems, said MacKay of the community bankers association. Though the FDIC does not have a benchmark for this metric, generally, the fewer "bad loans," the better.

Earnings. We used pre-tax return on assets, a key measure of profitability. An ROA of at least 1.0 is the benchmark, according to the FDIC. Most of the banks in our top quintile had ROAs above 1.0. Many startup banks have lower ROAs, because it usually takes a few years to achieve profitability.

So, for example, while Annandale State Bank posted a high first-quarter return on assets, of 1.9, it also reported $2.4 million in nonaccrual loans—about 2.2 percent of its assets—and therefore ended up in the second quintile. Beacon Bank in Shorewood, meanwhile, didn't quite hit the 1.0 benchmark for return on assets, but it reported just a fraction of a percent of seriously late loans. As a result, the little bank landed in the top quintile.

Some bad loans are more problematic than others. Park Midway Bank, which landed in the third quintile on our list with a return on assets of just under 1.0 and about 1.4 percent of its assets in nonaccrual status, does a lot of SBA loans, which are backed by the Small Business Administration.
"If there's a loss on those loans, we'll get reimbursed," said Rick Beeson, Park Midway's president.

There are several factors that might make a bank stronger or weaker than they appear in our list. Some banks with a high percentage of problem loans may have already dipped into their earnings to cover potential future losses, whereas some may yet have to do so, MacKay of the community bankers association said. And what kind of loans a bank has on its books may also have a bearing on how well it fares.

For example, if 50 percent of a bank's assets were real estate-related, they would likely feel the impact of a real estate decline more sharply than someone with a more diverse portfolio, MacKay said.

When Michael Zenk and his partner Gwen Stanley started Bloomington-based Venture Bank in 2001, they chose to work exclusively with small and mid-sized businesses that need money for operations and expansion. That kind of lending sometimes makes for fewer big-dollar deals, but more stability.

Today, although some of Venture's customers are hurting in the down economy, the pain of the small business owners is nowhere near as deep as that felt by the real estate developers that other banks were so keen on doing business with. Venture showed up in the top quintile of our list, in part because the bank reported $261,000, or 0.1 percent of total assets, in nonaccrual loans in the first quarter.

"To be completely honest, I don't know if it was a strategic decision to say we're not going to get into real estate development," Zenk said. "**It was more we're a decision to stick to what we know best — business banking."**

No. 3-ranked Prior Lake State Bank, in fast-growing Scott County, by contrast, has managed to keep its nonaccrual loans to 0.7 percent of total assets without avoiding real estate lending entirely.

"So far we're holding," Barsness said. "We're working with borrowers that are having some difficulties. Sometimes we have to extend things out for them. We understand their product is not moving for them right now. We have to work out ways we can hold on and maintain until the market does turn."

THE FUTURE

While the first quarter was a useful preview to how Twin Cities banks might fare this year, the next few quarters will likely be even more telling.

The economy doesn't seem to be improving and no one is sure the real estate market has hit bottom yet. Even banks that are doing well now could falter as the year goes on, said Larry Albert, of Central Bank in Stillwater, which narrowly missed the top quintile on our list. "You think your borrowers are pretty strong, but if difficult times wear on long enough, even the strongest of people can have trouble," he said.