Third District Banking Conditions as of June 30, 2015

PREPARED BY THE RISK ANALYTICS & SURVEILLANCE UNIT
SUPERVISION, REGULATION, AND CREDIT

FEDERAL RESERVE BANK OF PHILADELPHIA

Third District Conditions

Agenda and Table of Contents

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Section 1: Executive Summary

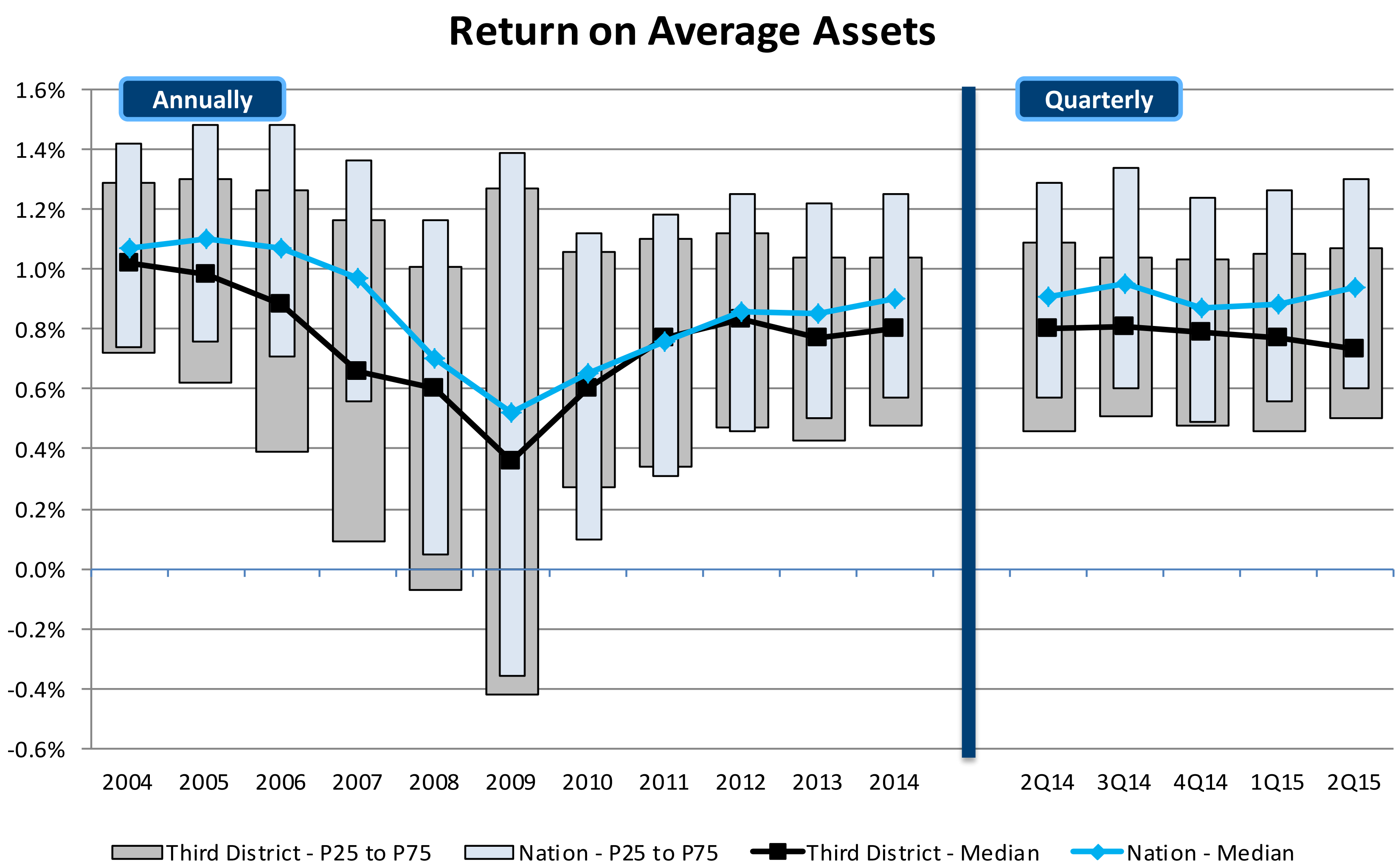
- Interest rate risk endures and is the most significant financial risk within the District. Have banks composed their balance sheets to withstand the potential rise in interest rates?
- Third District bank performance continues to recover, although sustainable earnings challenges remain because there was little change in the net interest margin (NIM).
- National asset quality metrics continue to depict improvement; however, the zero or negative provision expense reported over the past few quarters helped contribute to return on average assets (ROAA).
- Capital ratios are increasing as a result of earnings accretion.
- Third District banks’ reliance on noncore funding sources continues to outpace the industry.
- The number of problem banks continues to decline because of improved economic conditions.
- Qualitative and/or operational risks that remain on the risk radar include:
  - Cybersecurity
  - Third-party vendor management (including multiregional data processing servicers (MDPS))
  - Management succession planning
  - Model risk management (SR 11-7 compliance)

Section 2: Conditions of Third District Commercial Banks

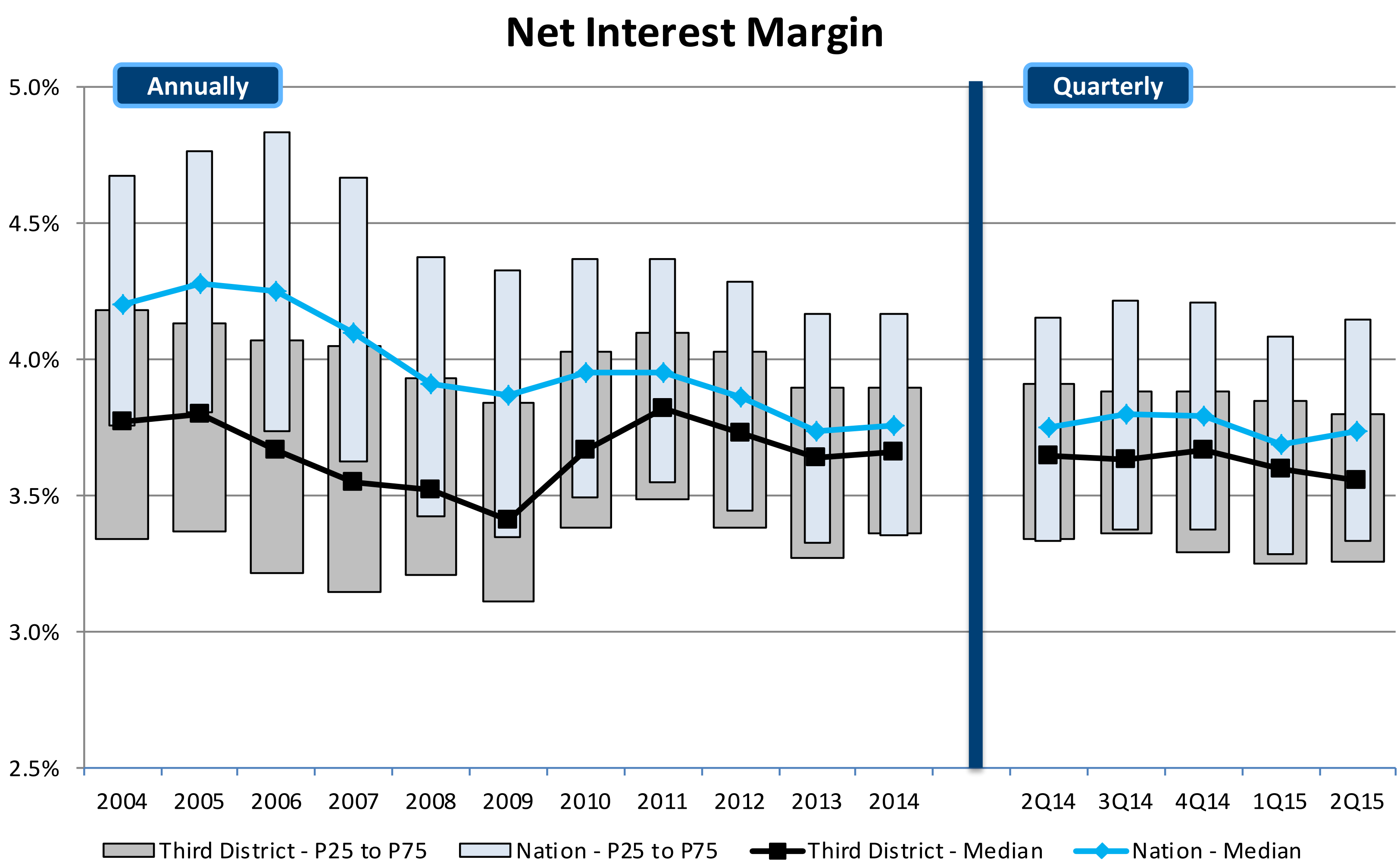
Reporting Methodology

- The quarterly **Reports of Condition and Income (Call Report) and Uniform Bank Performance Report (UBPR)** are the primary sources of all information contained in this report unless otherwise noted.
- Slides in this section focus on trends among the **117 commercial banks** within the Third District and national or nonmember commercial banks (CBs) that do not meet at least one of the following criteria as of **June 30, 2015**:
  - Institutions with total assets > $10 billion
  - Credit card banks (credit card loans and receivables > 50% net loans and credit card receivables)
  - Trust banks (income from fiduciary activities > 30% of interest + noninterest income)
  - Banks with loans to depository institutions > 30% of net loans
- **All Third District state member banks (SMBs) are included in Third District calculations.**
- The **nation** consists of all SMBs within the nation, regardless of asset size, and all national and nonmember banks with aggregate assets less than $10 billion.
- This report uses the **median, the 25th, and the 75th percentiles** to compare Third District and national ratios.
  - The line graphs represent the median for the District and the nation, whereas the bar graphs represent the range of results from the 25th through the 75th percentiles for the data included in each of the graphs.

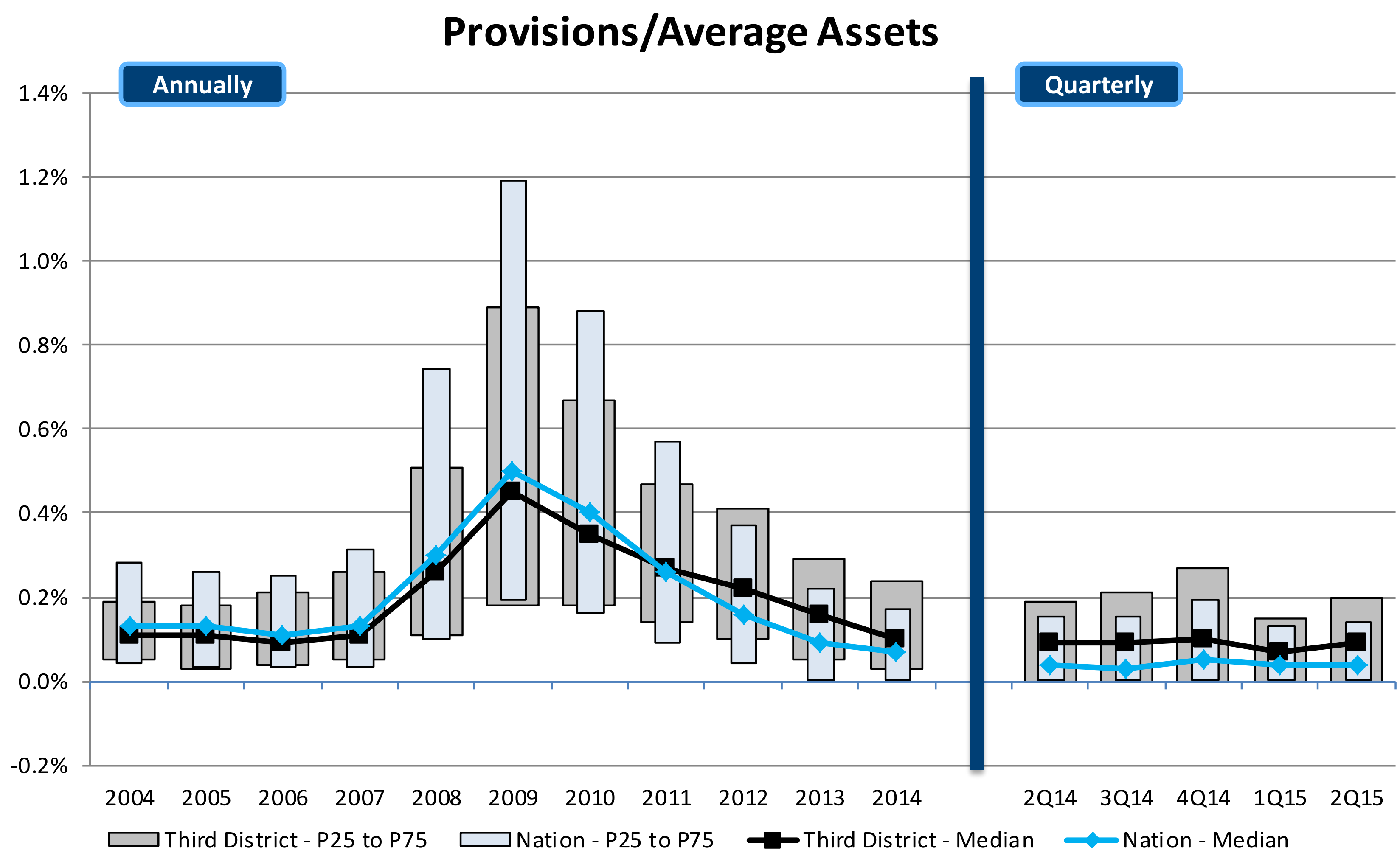
Third District earnings performance consistently lags behind the nation, and the gap is widening.



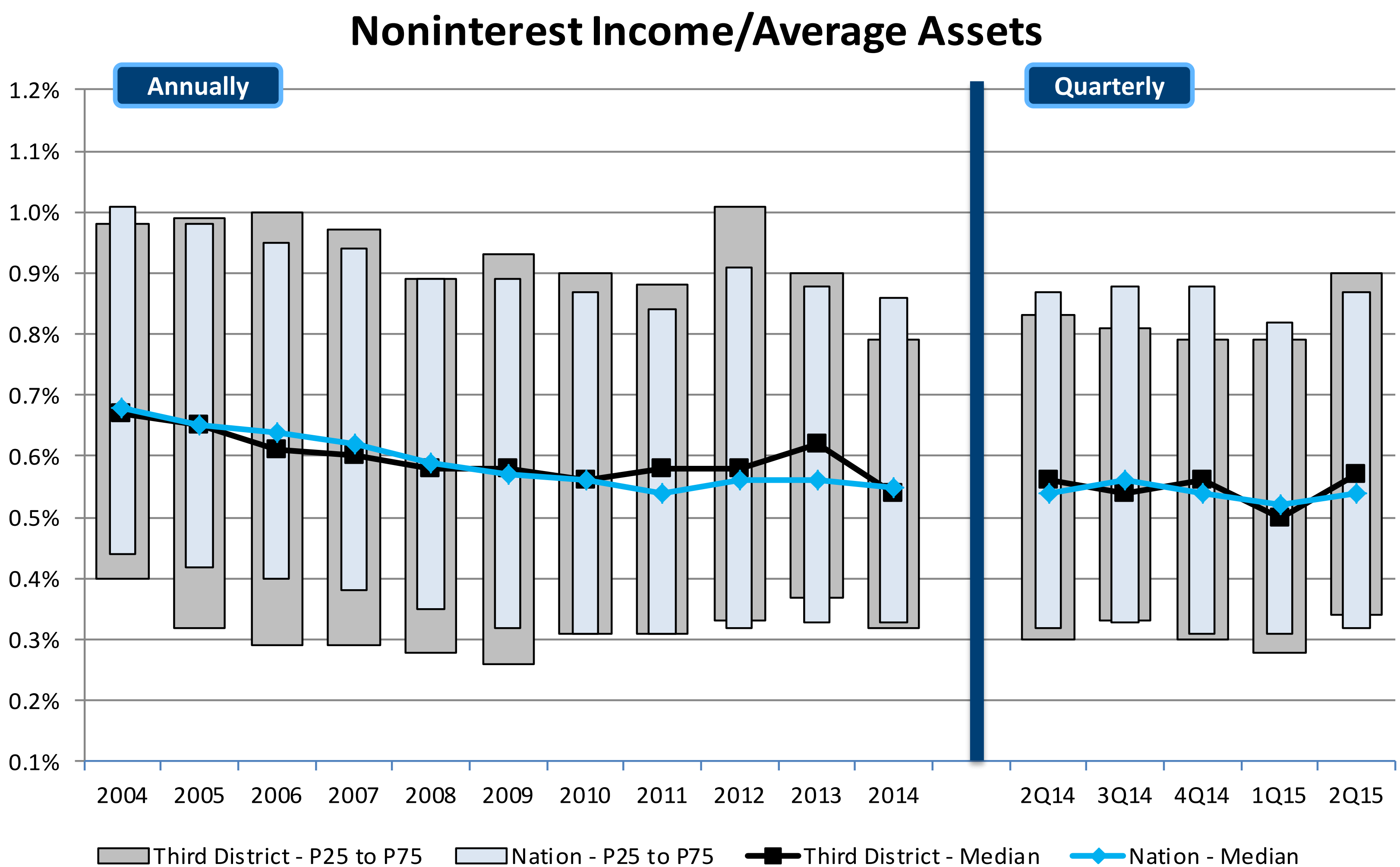
Third District NIM fell in 2015:Q2 compared with the rest of the nation; asset yield declines outpaced the drop in cost of funds.



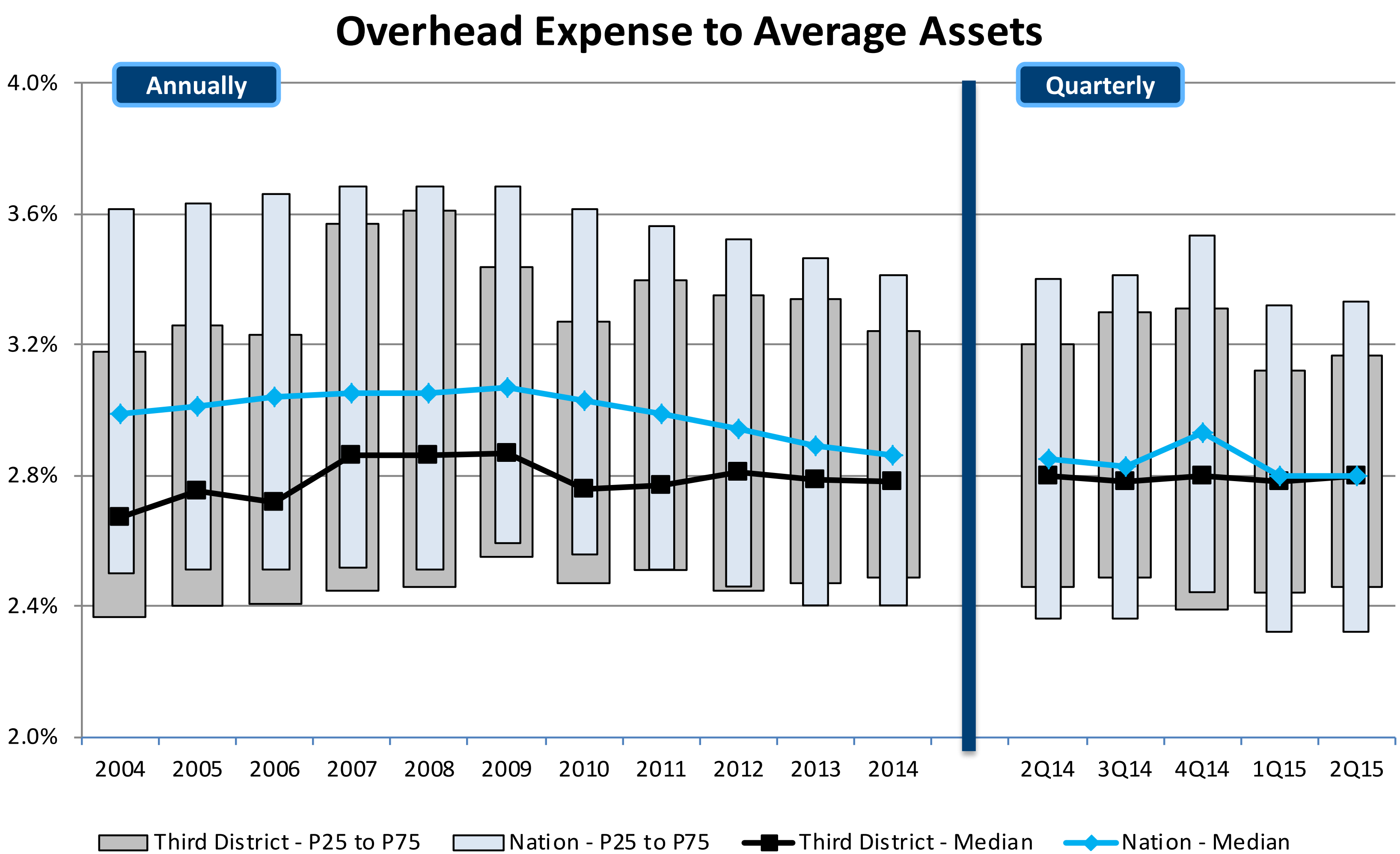
Provision expense is trending below precrisis levels, which continues to help bolster earnings.



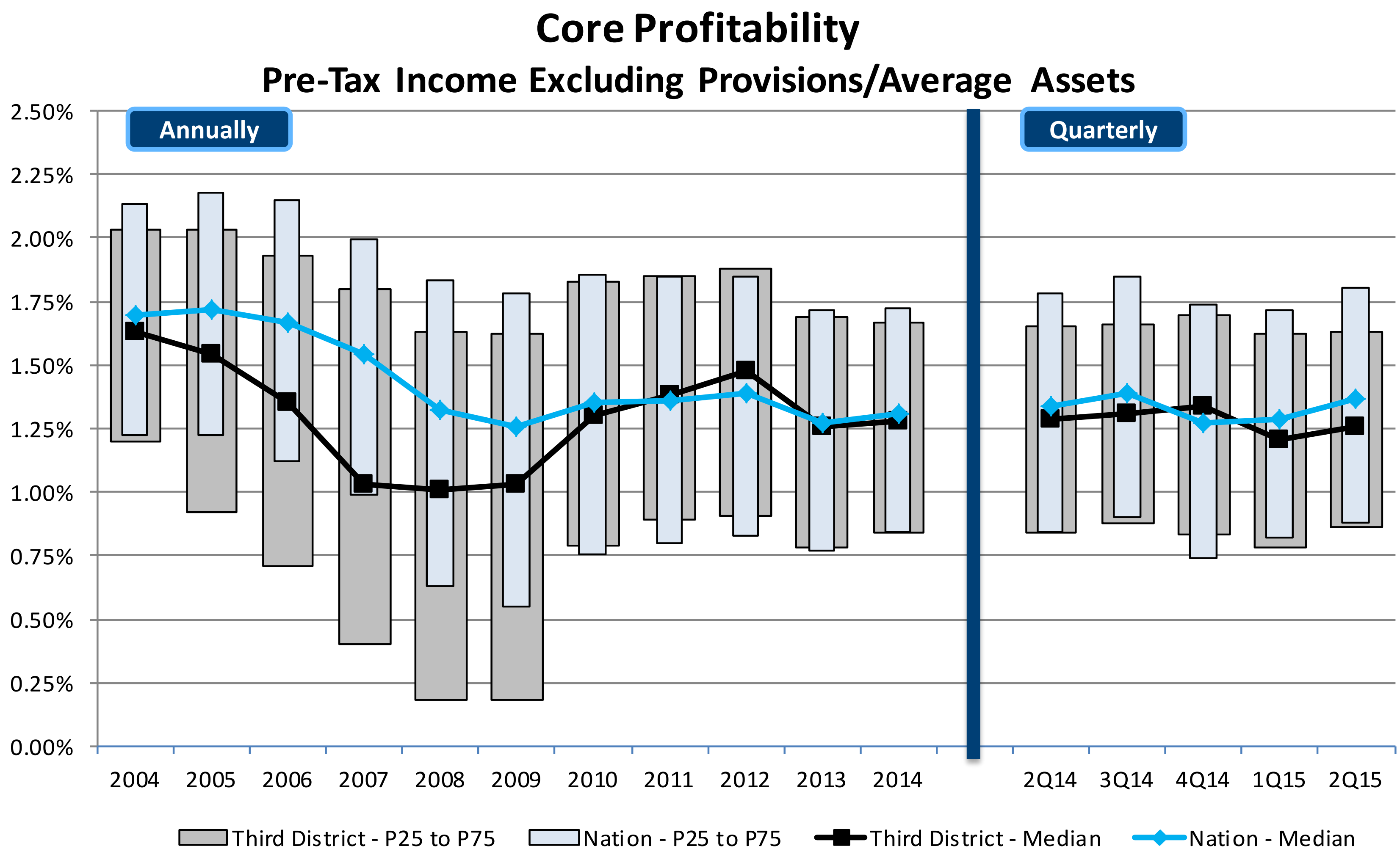
Noninterest income rose in 2015:Q2, which contributed more to ROAA in the Third District.



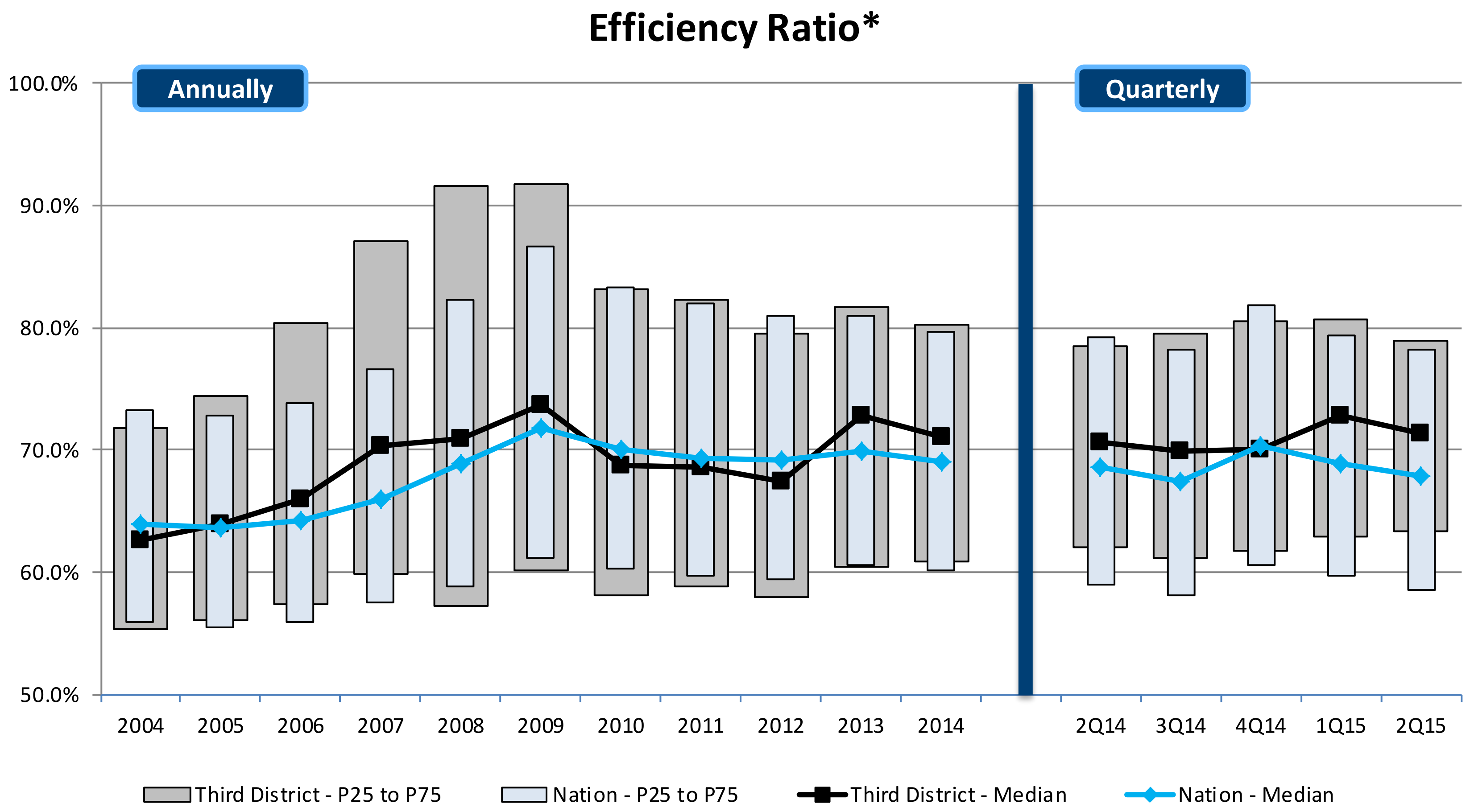
Median Third District overhead expense has remained relatively stable since 2010, contributing positively to ROAA.



Core profitability is recovering more quickly nationally; however, it remains well below precrisis levels.

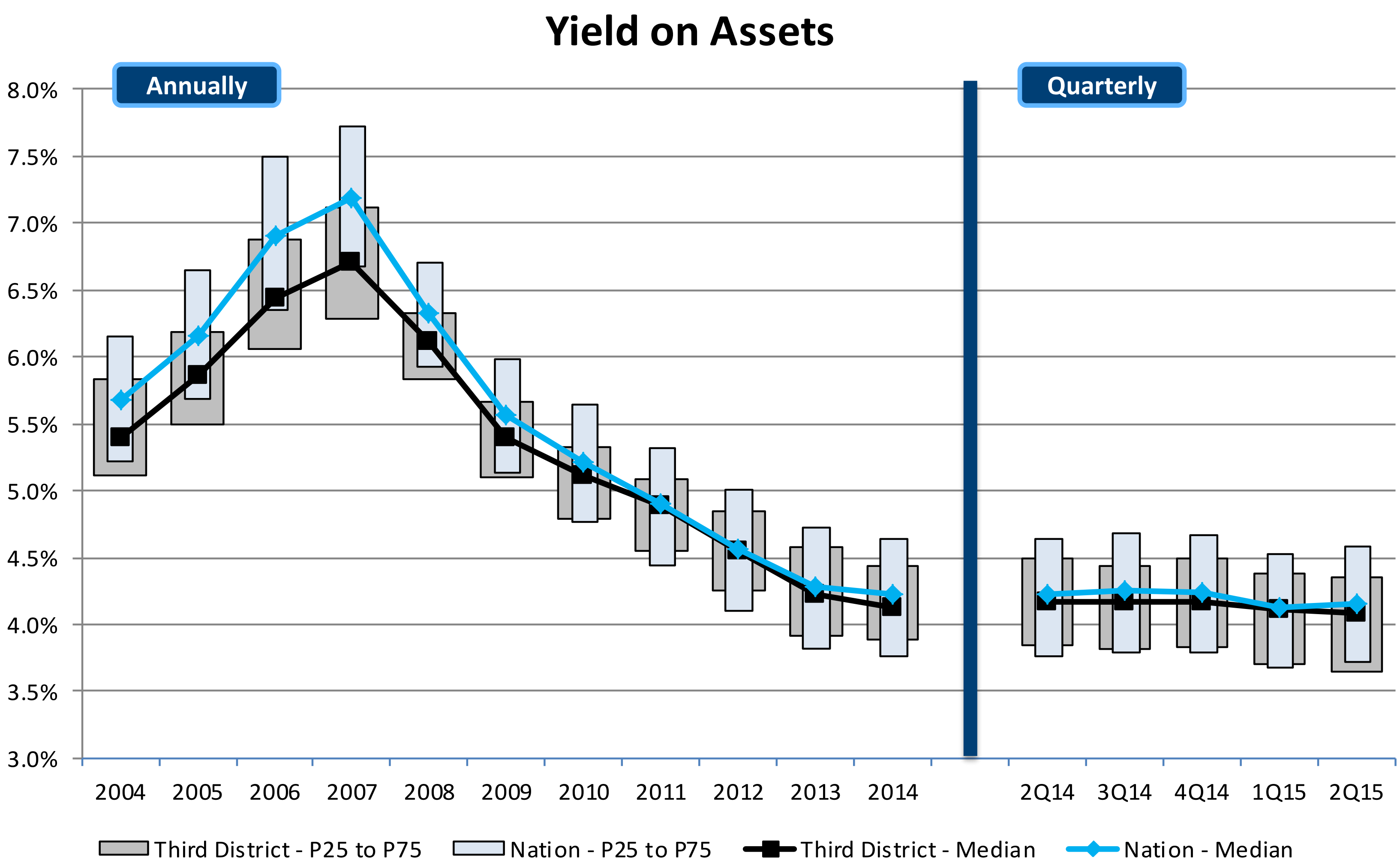


Efficiency ratios remain elevated but are stabilizing; the current ratios remain above precrisis levels.

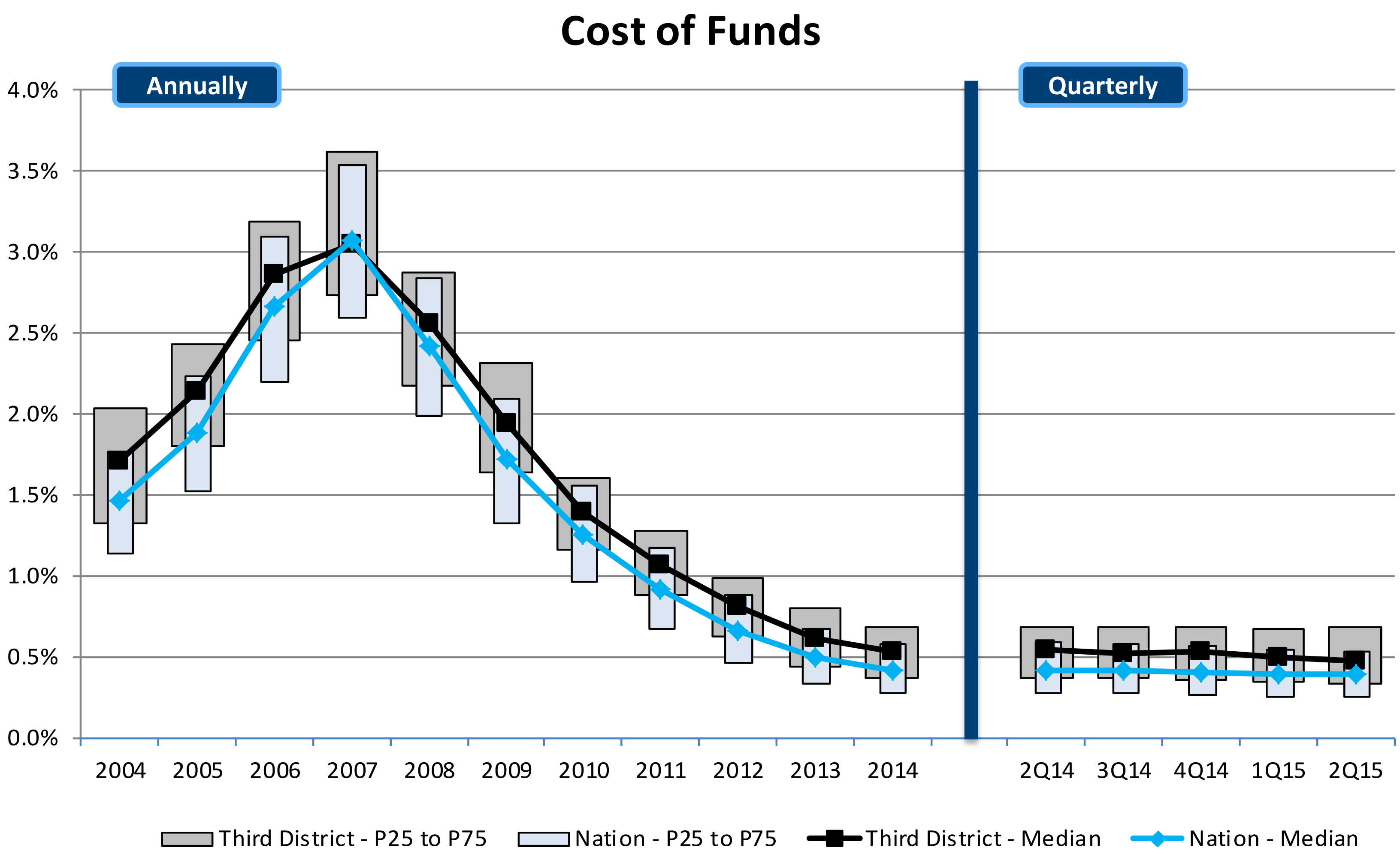


*The efficiency ratio is a measure of total overhead expense expressed as a percentage of net interest income plus noninterest income.

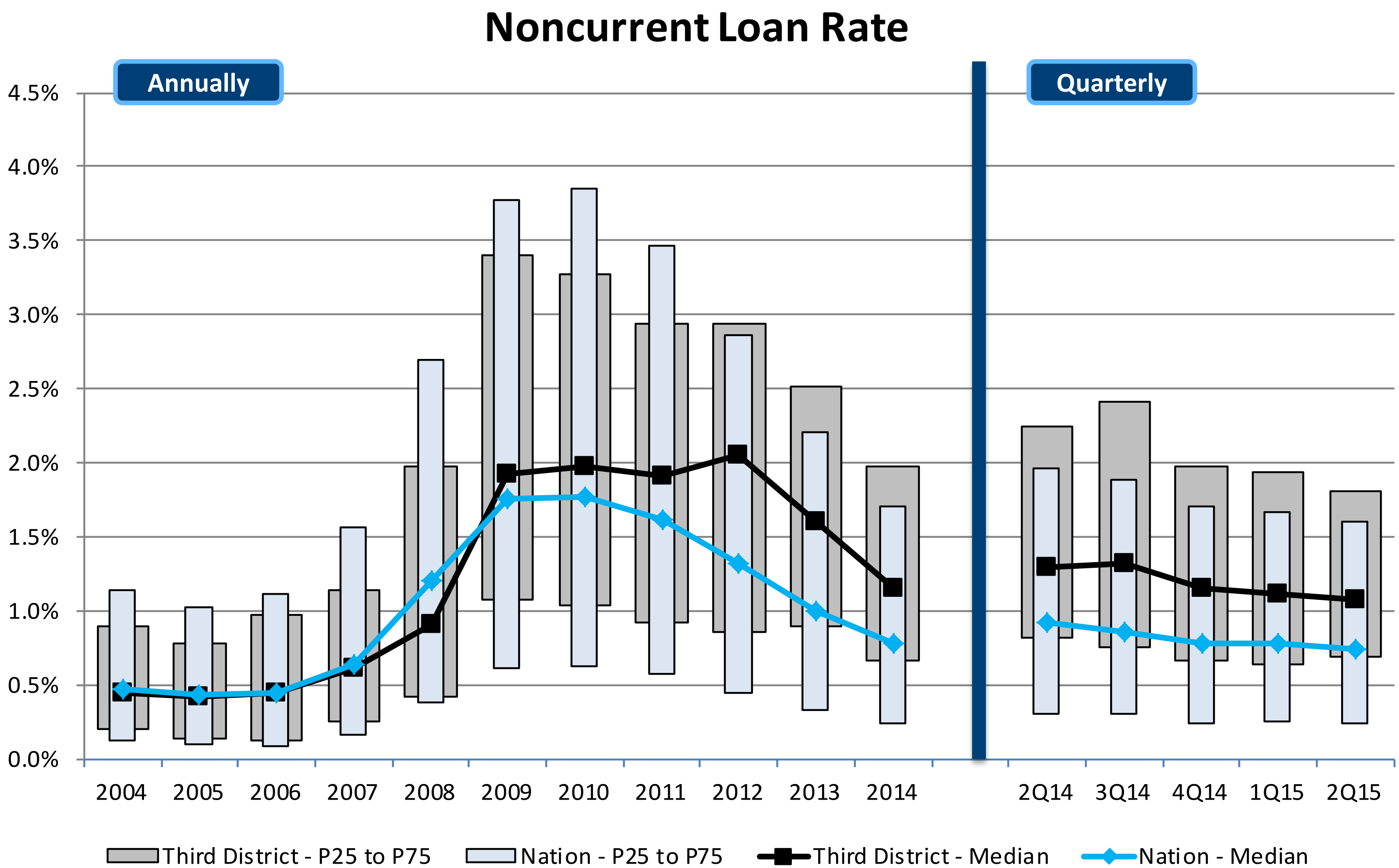
The continued low interest rate environment suppresses the yield on assets within the District and within the nation.



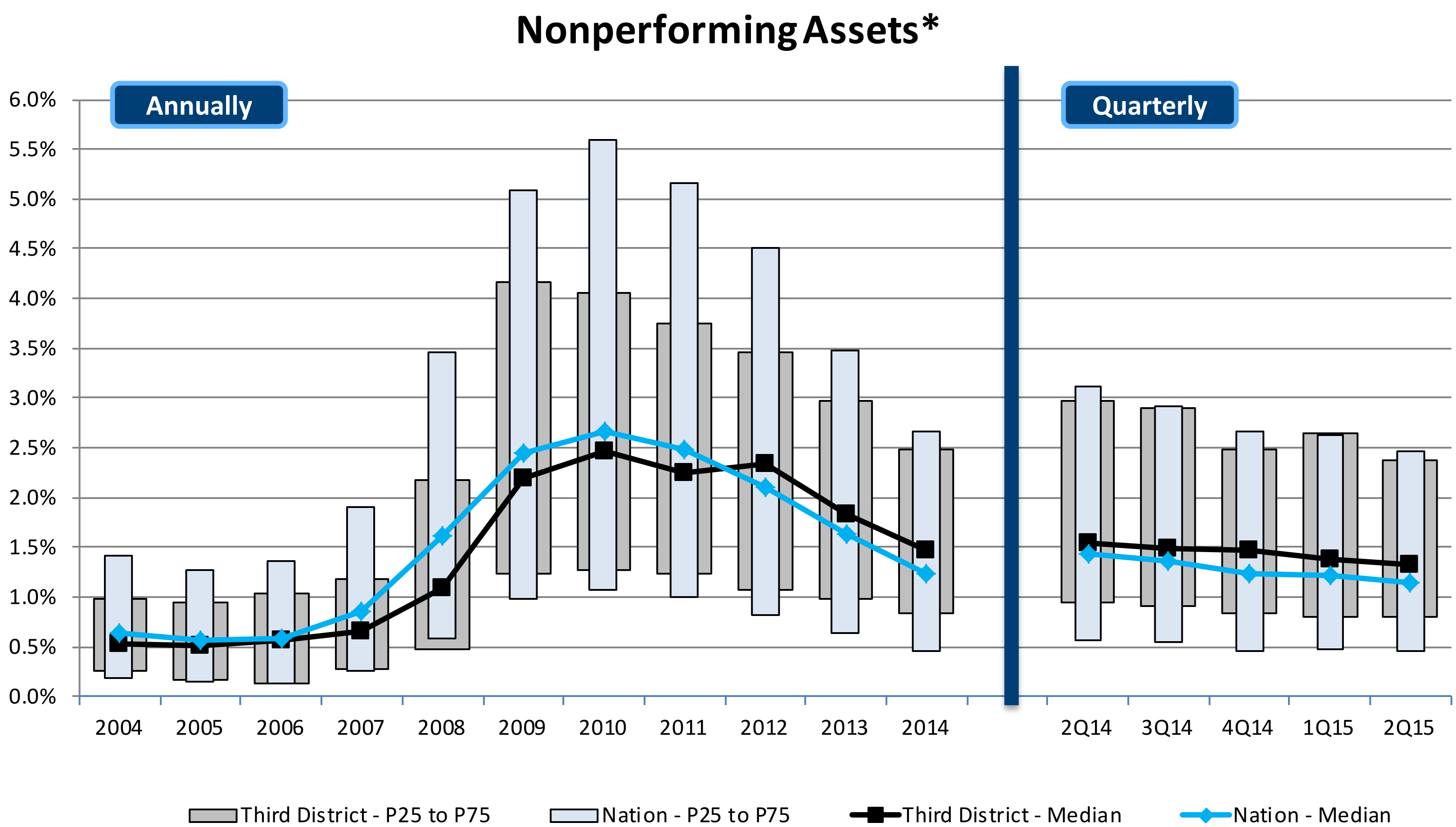
The low interest rate environment enables lower cost of funds; the District's costs remain higher than those of the nation.



Although the noncurrent loan rate continues to decline, the District is not recovering as quickly as the nation.



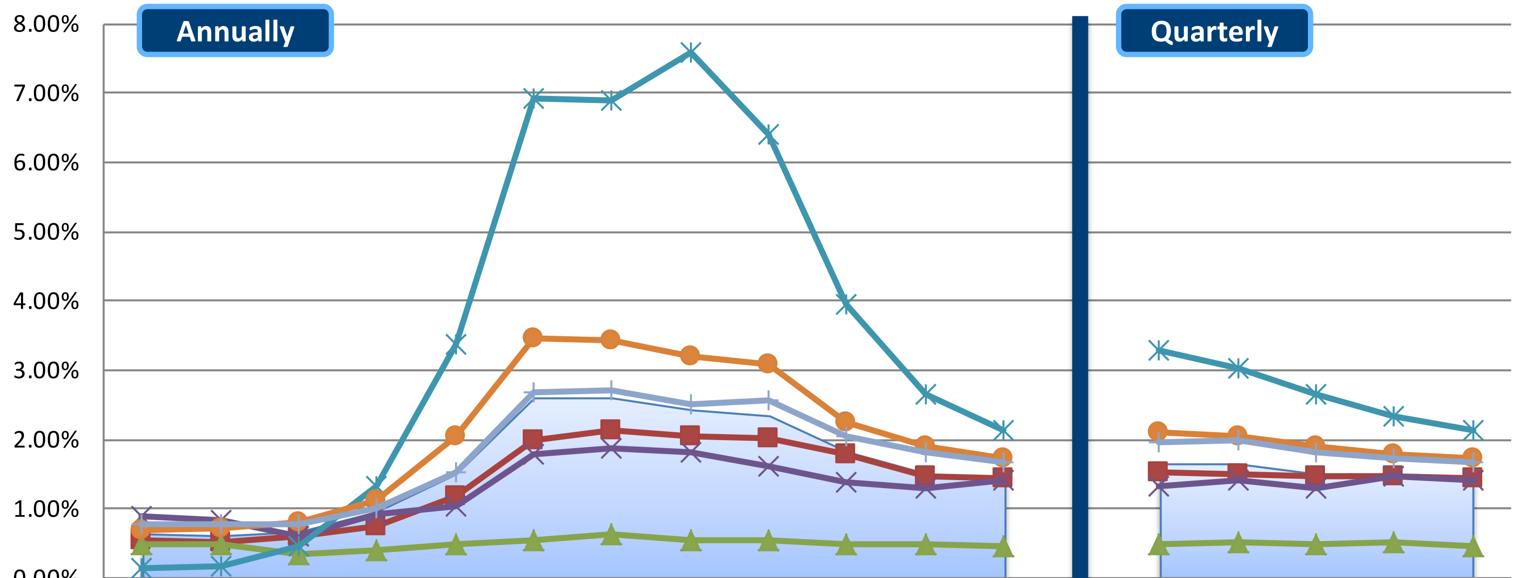
Third District NPAs are falling, but the District's levels remain slightly above the nation.



***NPAs** (nonperforming assets) are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans)

Third District loan performance shows improving conditions within each major loan category.

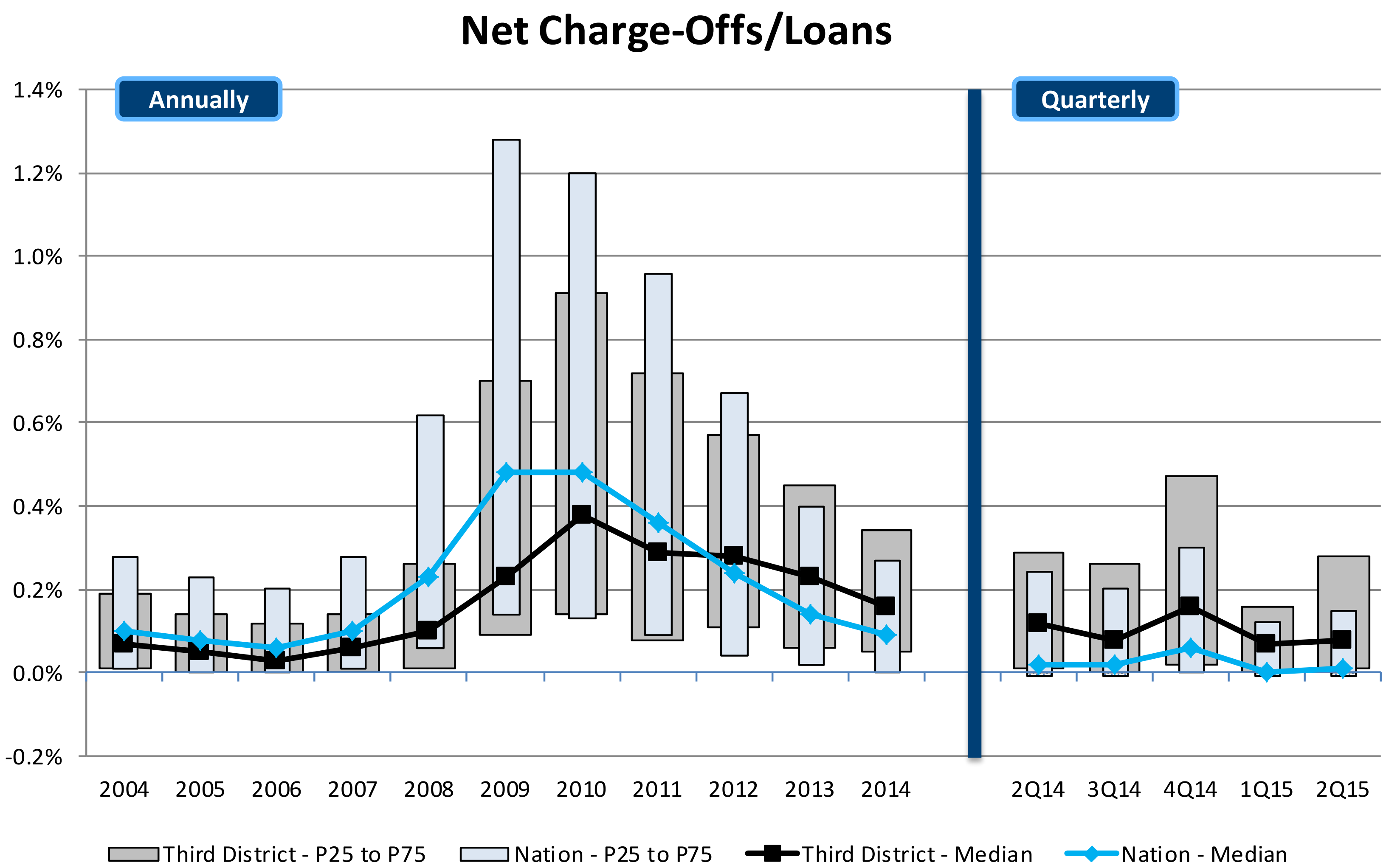
Noncurrent Loan Ratios by Loan Category*



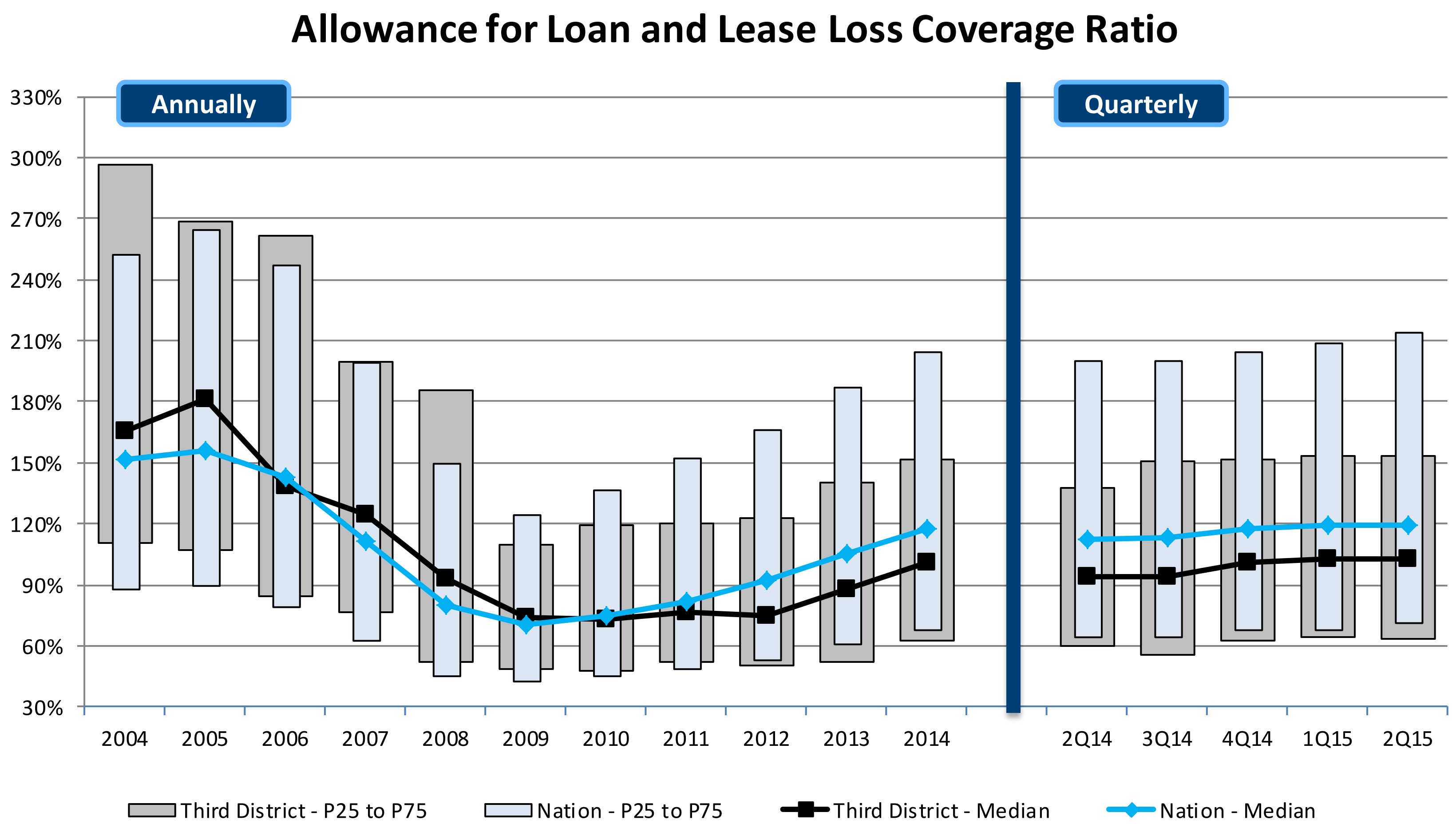
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Jun-15	2Q14	3Q14	4Q14	1Q15	2Q15
All Loans	0.62%	0.60%	0.65%	0.94%	1.50%	2.60%	2.58%	2.41%	2.33%	1.81%	1.49%	1.40%	1.65%	1.64%	1.49%	1.49%	1.40%
Single & Multifamily	0.54%	0.52%	0.60%	0.75%	1.17%	2.00%	2.14%	2.04%	2.03%	1.80%	1.46%	1.43%	1.54%	1.51%	1.46%	1.48%	1.43%
Consumer	0.50%	0.49%	0.35%	0.40%	0.49%	0.54%	0.63%	0.55%	0.55%	0.50%	0.48%	0.47%	0.48%	0.53%	0.48%	0.51%	0.47%
C&I	0.88%	0.83%	0.60%	0.91%	1.04%	1.78%	1.88%	1.81%	1.61%	1.38%	1.30%	1.40%	1.32%	1.40%	1.30%	1.47%	1.40%
C&LD	0.14%	0.18%	0.47%	1.32%	3.37%	6.93%	6.89%	7.58%	6.41%	3.94%	2.64%	2.12%	3.30%	3.04%	2.64%	2.34%	2.12%
CRE (Total)	0.69%	0.71%	0.80%	1.12%	2.05%	3.45%	3.43%	3.19%	3.07%	2.25%	1.91%	1.72%	2.10%	2.06%	1.91%	1.78%	1.72%
Nonfrm Nonres	0.77%	0.77%	0.79%	1.02%	1.53%	2.67%	2.70%	2.52%	2.58%	2.06%	1.82%	1.68%	1.97%	1.98%	1.82%	1.72%	1.68%

This chart uses a **10% capped mean, or winsorized mean**, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on the calculated average by “capping” values of the upper and lower 5% bounds of institutional data reported.

Net charge-off (NCO) rates have declined annually since 2009; the nation is at precrisis levels, while the District is lagging.

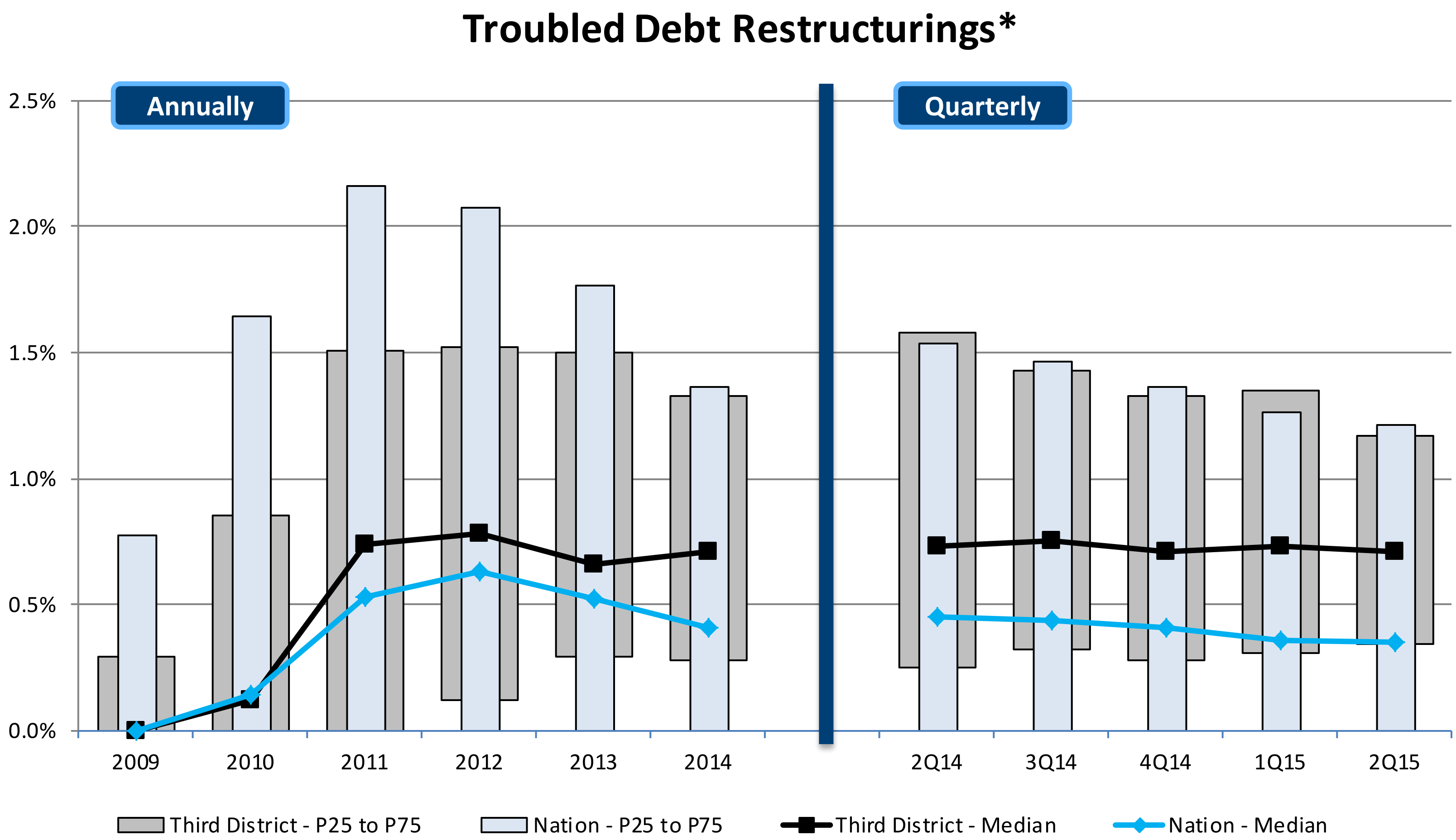


The Third District allowance for loan and lease losses (ALLL) reserve coverage ratio* continues to lag behind the nation.



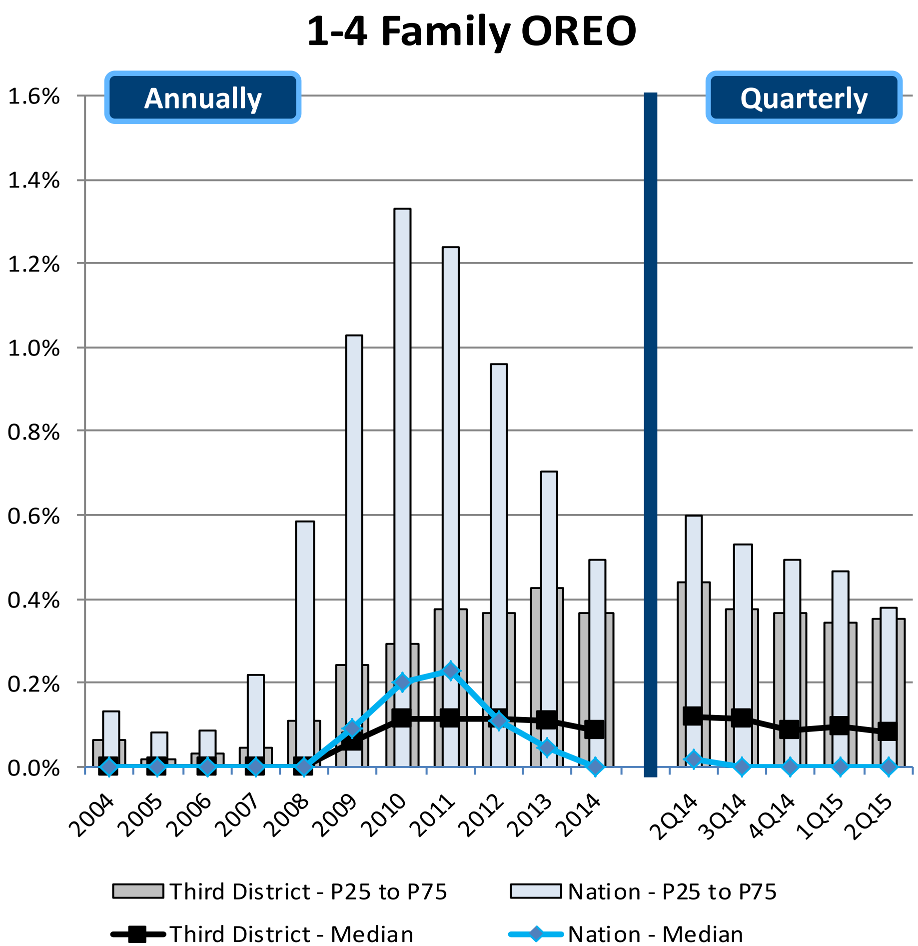
*The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.

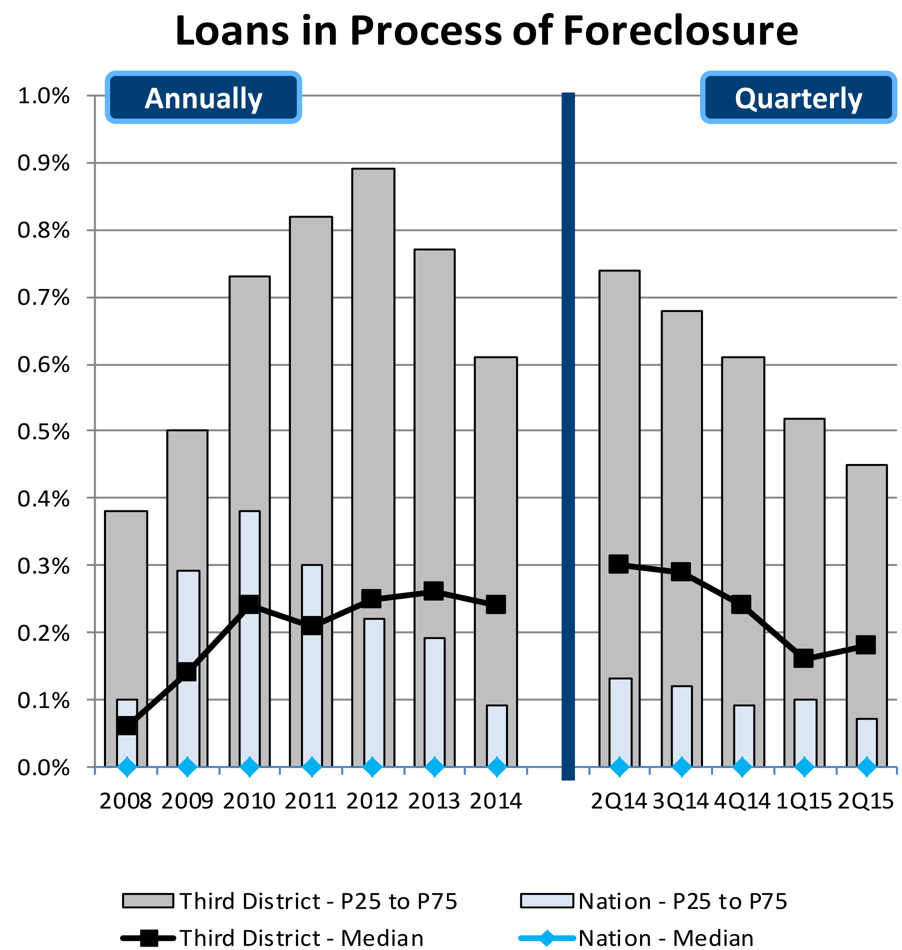
District troubled debt restructurings (TDRs) remained stable but are elevated compared with the nation.



*Troubled debt restructurings (TDRs) were not included on the Call Report until the March 2009 reporting period.

One- to four-family OREO* is decreasing faster within the nation, but the Third District trails in the foreclosure process.**

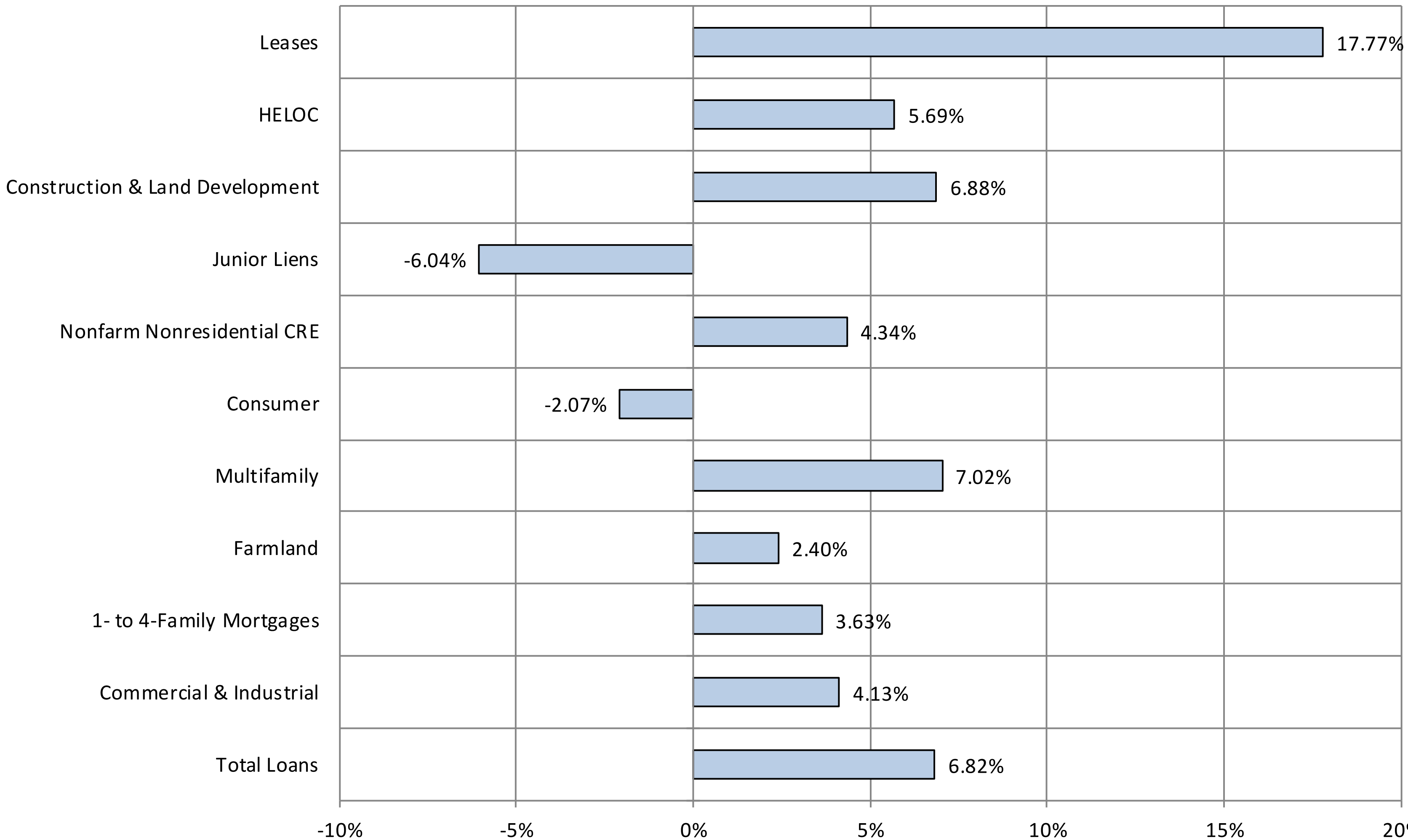




*As a percentage of one- to four-family loans

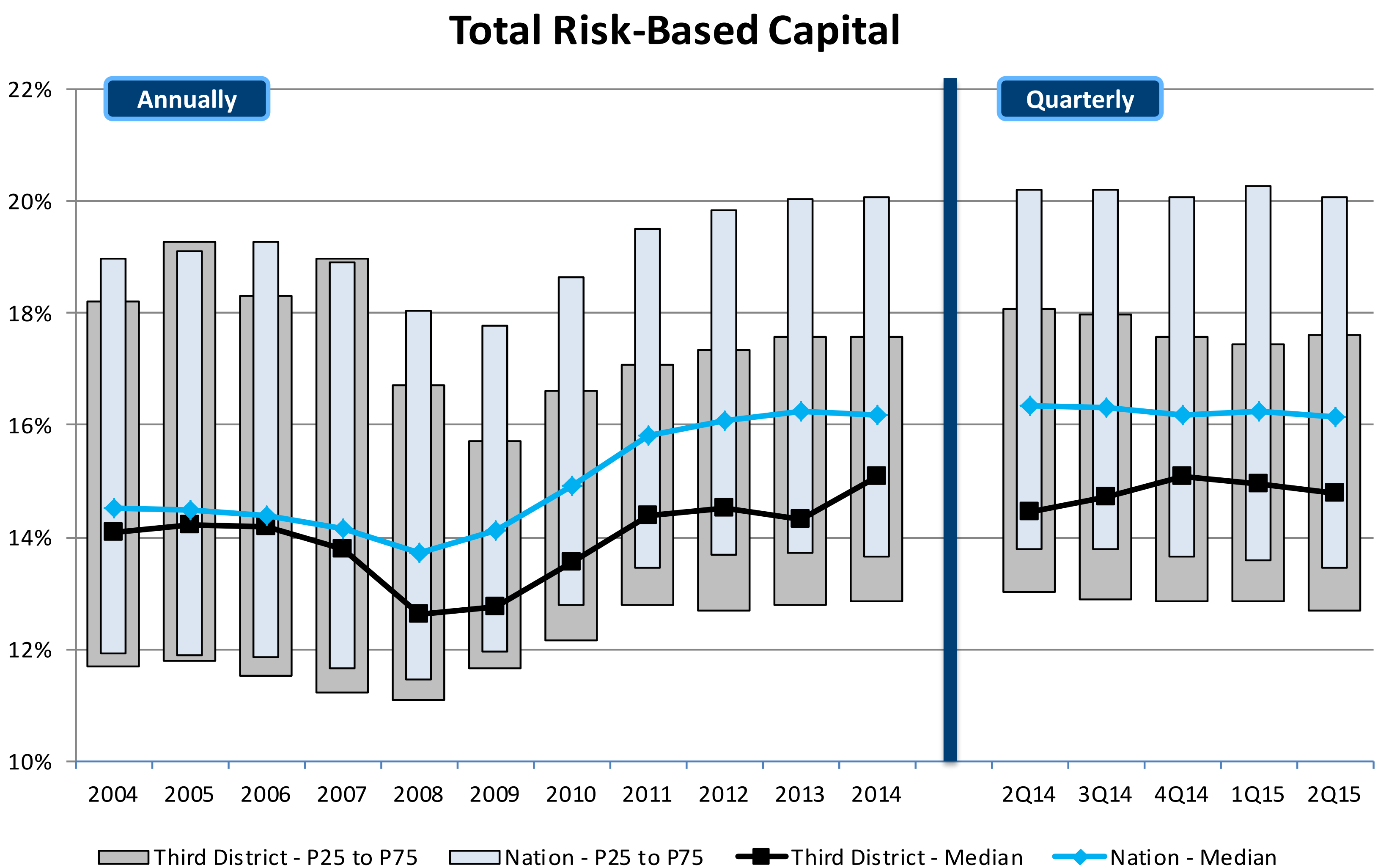
**Loans in the process of foreclosure were not included in the Call Report until the March 2008 reporting period. New Jersey, Pennsylvania, and Delaware are all judicial foreclosure states that can extend the foreclosure process.

Third District commercial bank median loan growth in select categories year-over-year was mixed; loan contraction continues in the junior lien and consumer loan categories.

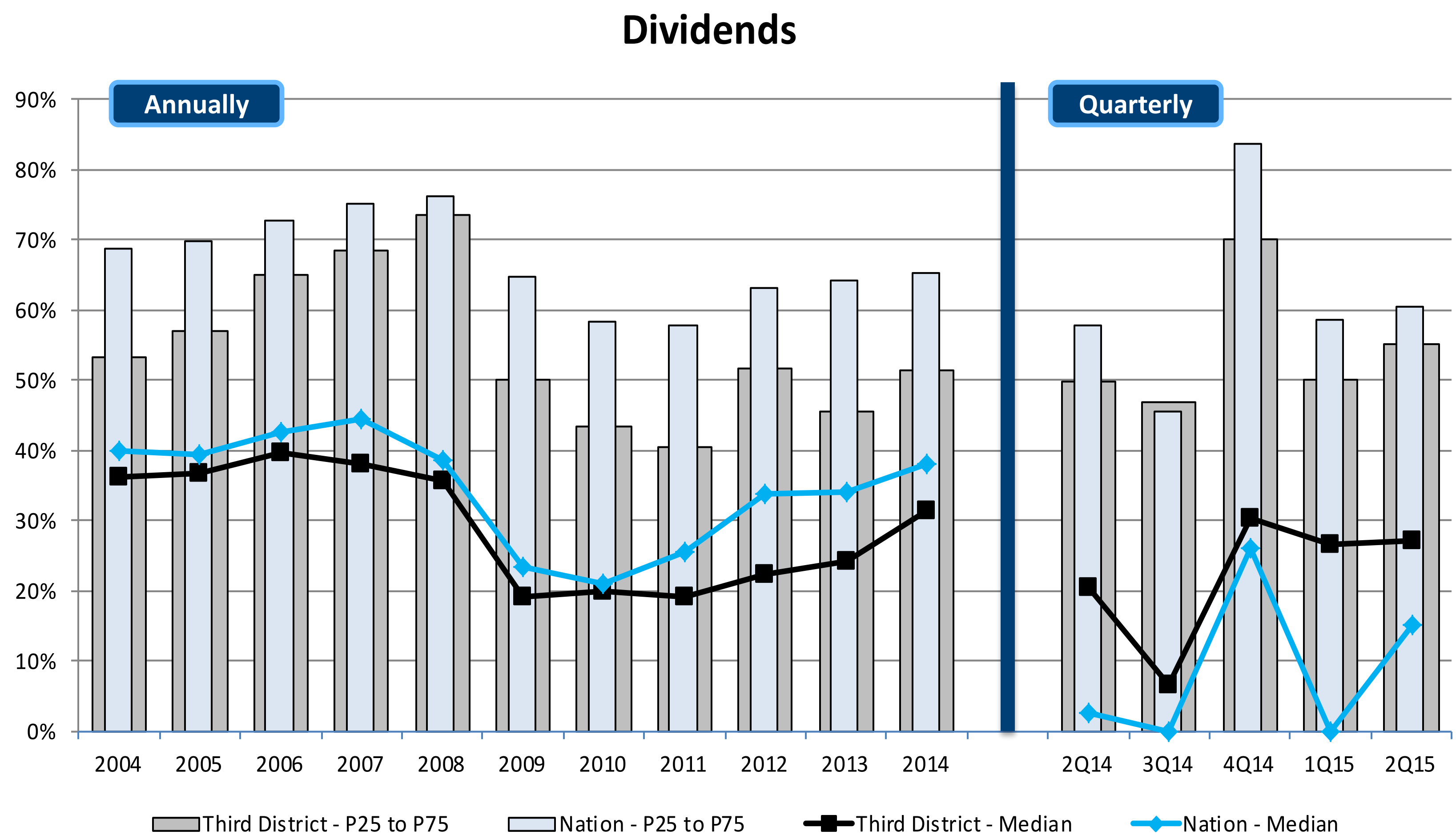


*This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 4.

Capital ratios have increased considerably postcrisis; however, District levels remain below those of the nation.



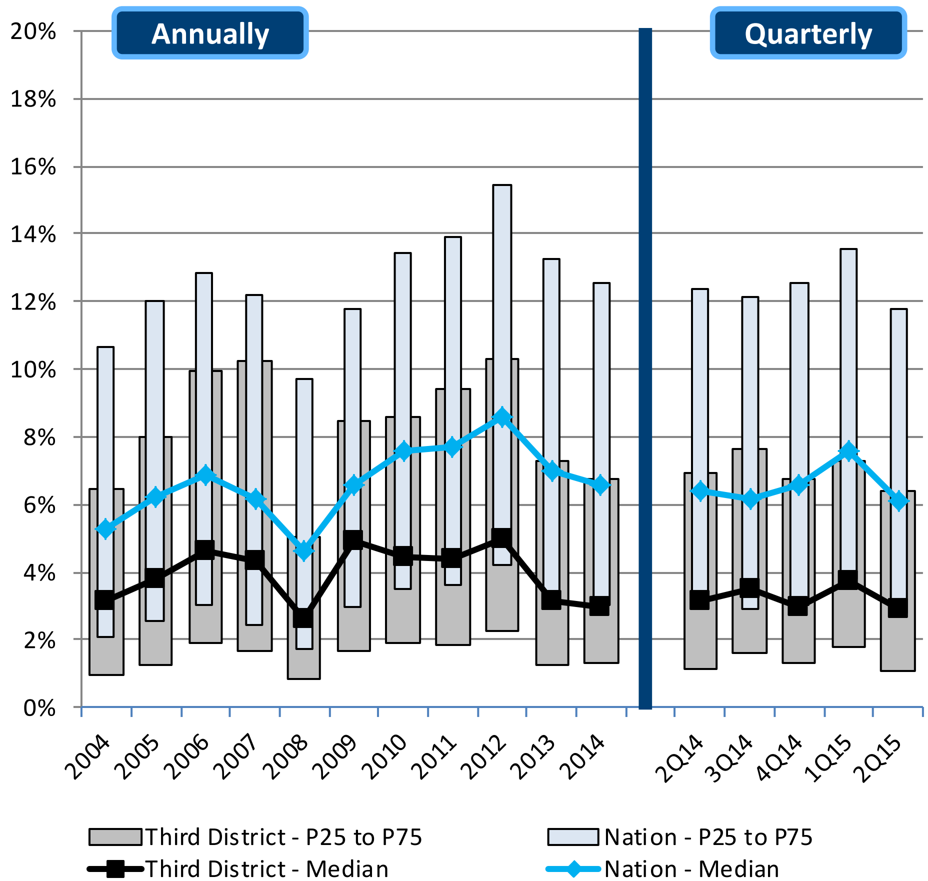
Dividend payments have continued to increase after the recessionary period.



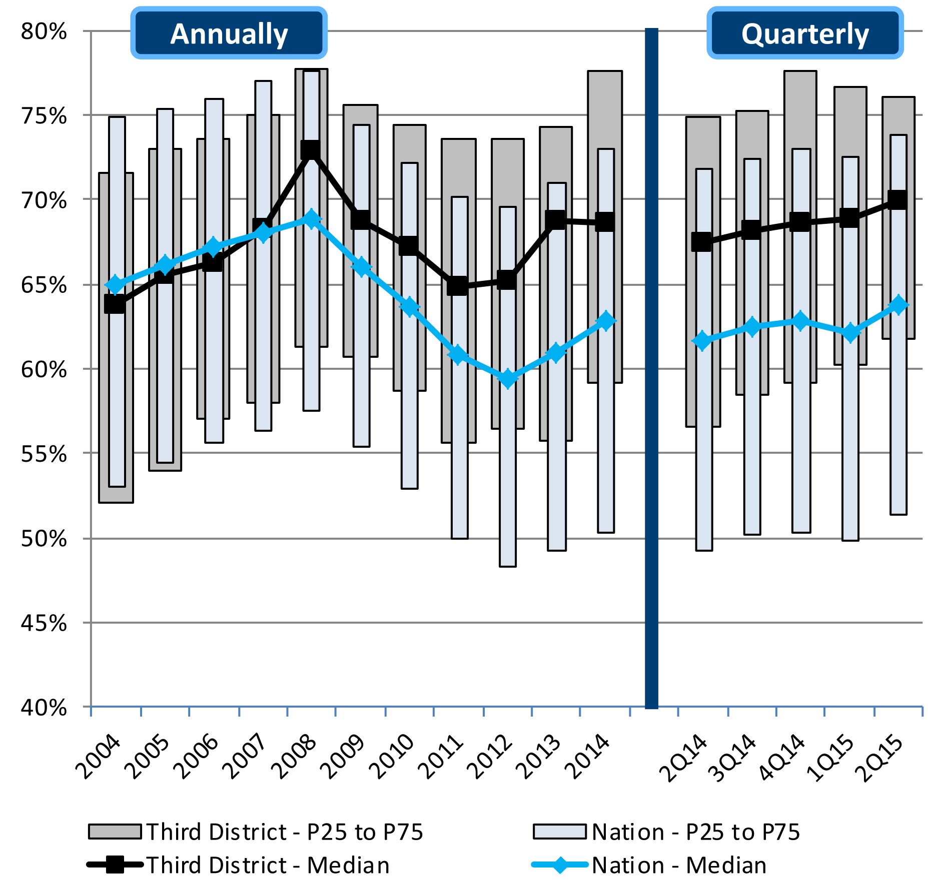
Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout (DPO) ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income as dividends in 2014.

Interest rate risk remains a concern as Third District banks are not as flush with short-term investments* compared to the nation while also maintaining higher loan levels.

Short-Term Investments/Assets



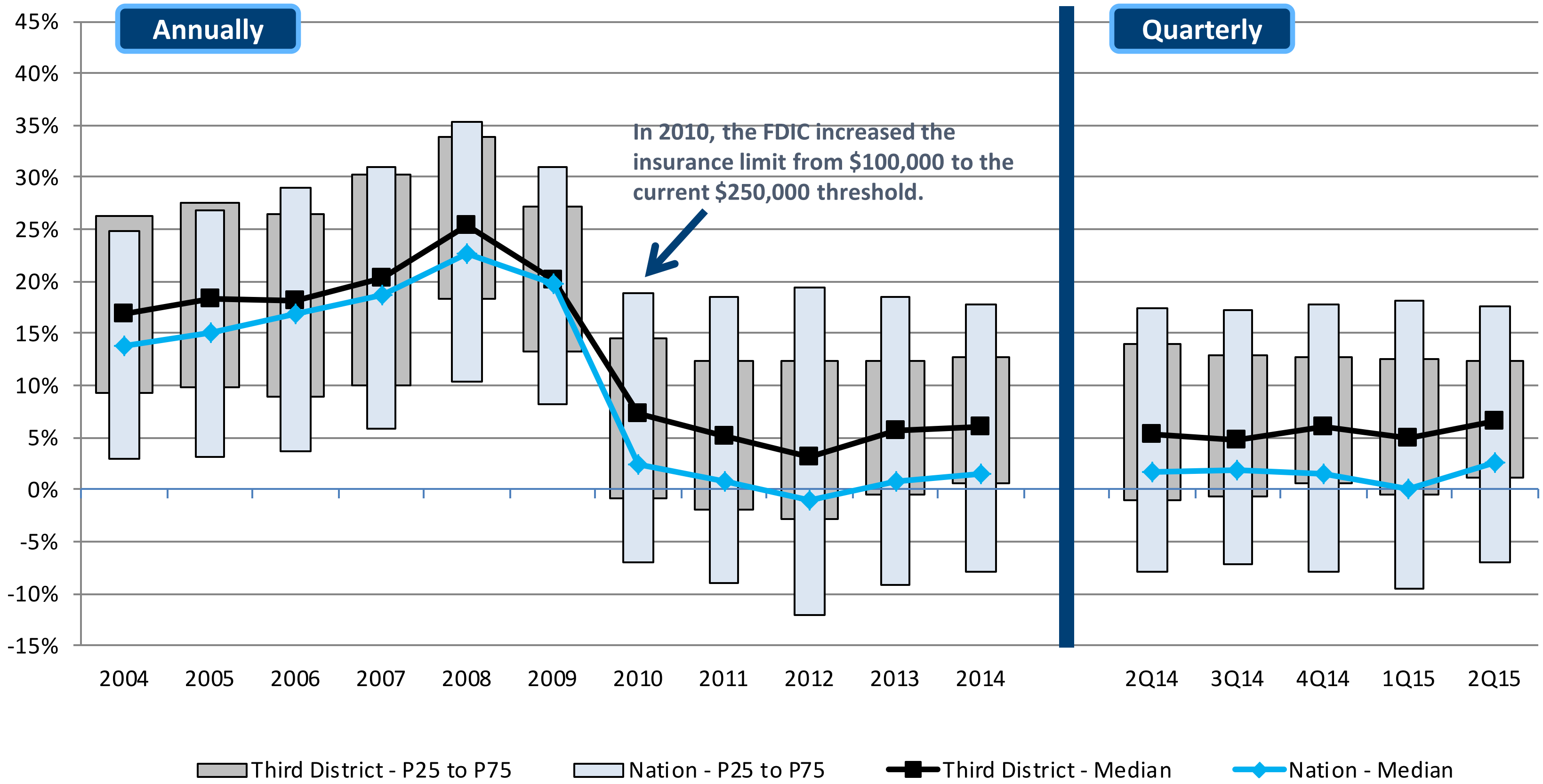
Loans/Assets



***Short-term investments** equals the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

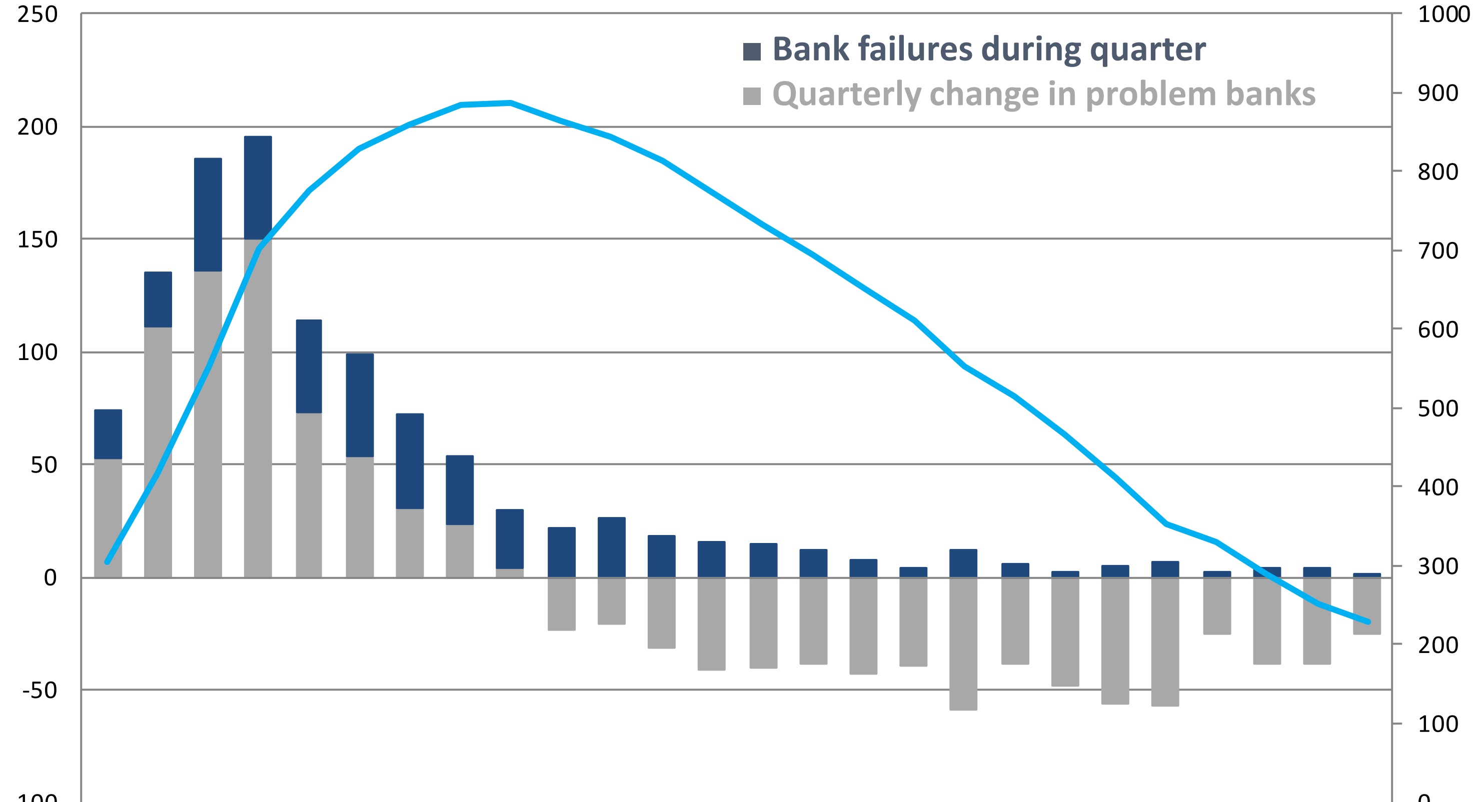
Third District banks' reliance on noncore funding sources continues to outpace that of the nation.

Net Noncore Funding Dependence*



*Net noncore funding dependence measures the degree to which banks fund longer-term assets with noncore funding sources.

Industry problem banks and failures continue to decline.



	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15
Failures (L)	21	24	50	45	41	45	41	30	26	22	26	18	16	15	12	8	4	12	6	2	5	7	2	4	4	1
Δ in Problem Banks (L axis)	53	111	136	150	73	54	31	24	4	-23	-21	-31	-41	-40	-38	-43	-39	-59	-38	-48	-56	-57	-25	-38	-38	-25
Problem Banks (R axis)	305	416	552	702	775	829	860	884	888	865	844	813	772	732	694	651	612	553	515	467	411	354	329	291	253	228

Source: FDIC; *problem banks* are defined as having a CAMELS composite rating of 4 or 5.