



Third District Banking Conditions as of March 31, 2016

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

FEDERAL RESERVE BANK OF PHILADELPHIA

Third District Conditions



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Section 1: Executive Summary



- Interest rate risk continues to be elevated throughout the banking industry; however, many banks have adjusted their balance sheet to mitigate the financial risk when interest rates rise.
- Third District bank financial performance continues to be challenged by the low-interest rate environment and competition for loans and deposits. As a result, core earnings challenges remain as the net interest margin (NIM) has continually declined since 2011 and has not shown a significant uptick over the past five quarters.
- Third District and national asset quality metrics continue to improve as the level of noncurrent loans is declining.
- Capital ratios are increasing as a result of earnings accretion but remain below the nation.
- Third District banks' reliance on noncore funding sources continues to outpace the industry.
- The number of problem banks have fallen by 18 banks to 165 as of 1Q2016.
- Qualitative and/or operational risks that remain on the risk radar include:
 - Commercial Real Estate (CRE) concentrations and the management of the portfolio (SR 07-1 and SR 15-17)
 - Cybersecurity
 - Third-party vendor management (including multiregional data processing servicers (MDPS))
 - Management succession planning and attracting qualified talent
 - Model risk management (SR 11-7 compliance)

Section 2: Conditions of Third District Commercial Banks



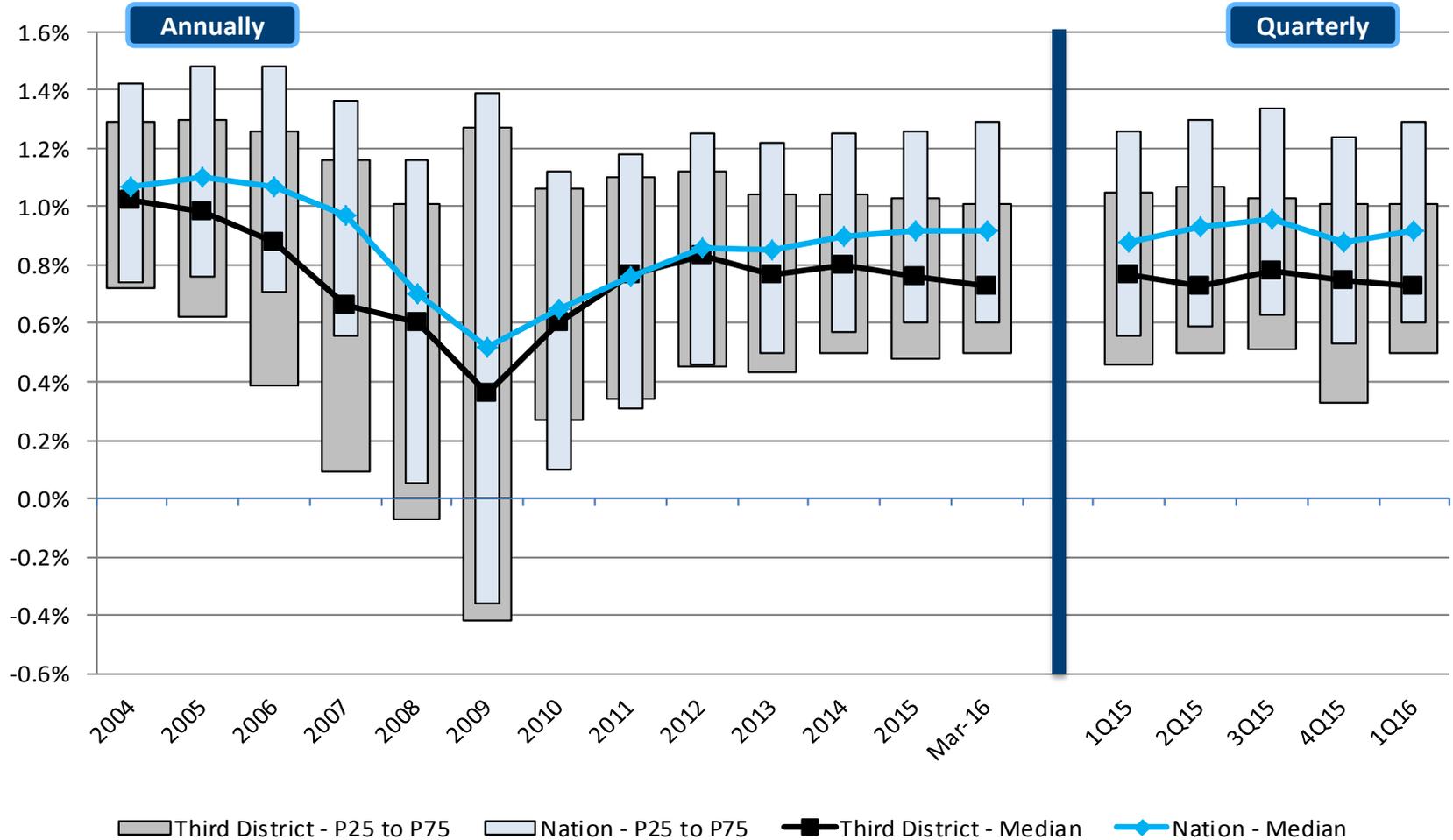
Reporting Methodology

- The quarterly **Reports of Condition and Income (Call Report)** and **Uniform Bank Performance Report (UBPR)** are the primary sources of all information contained herein unless otherwise noted.
- Slides in this section focus on trends among the **112 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 **December 31, 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 percentile, and the 75th percentile** to compare Third District and national ratios.
 - The line graphs represent the median for the District and the nation; 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, as defined by the return on average assets (ROAA) ratio, has lagged the nation since 2004.



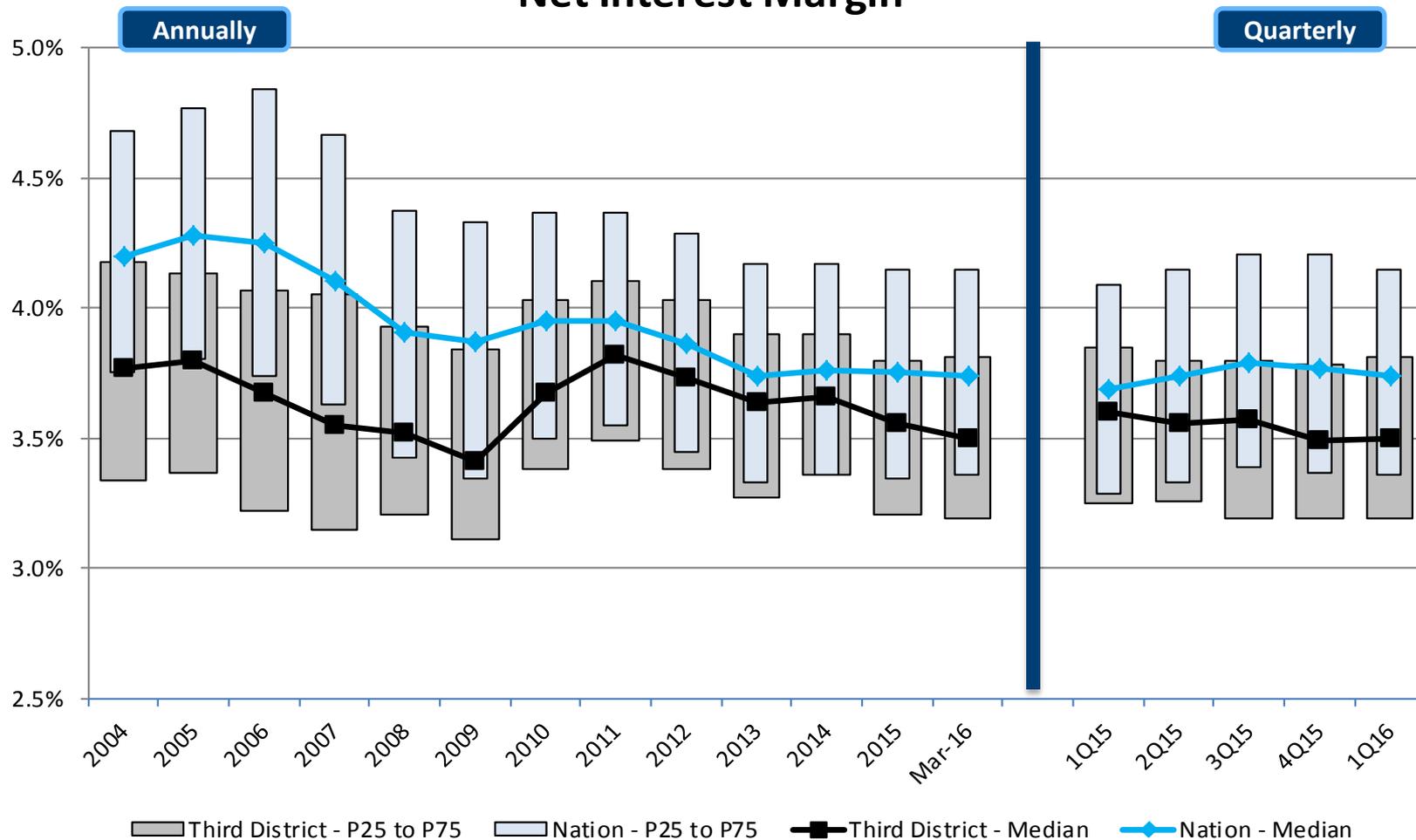
Return on Average Assets



Third District NIM remained lower than that of the nation as of 1Q2016; the yield on earning assets continued to decline, while the cost of funds increased slightly.



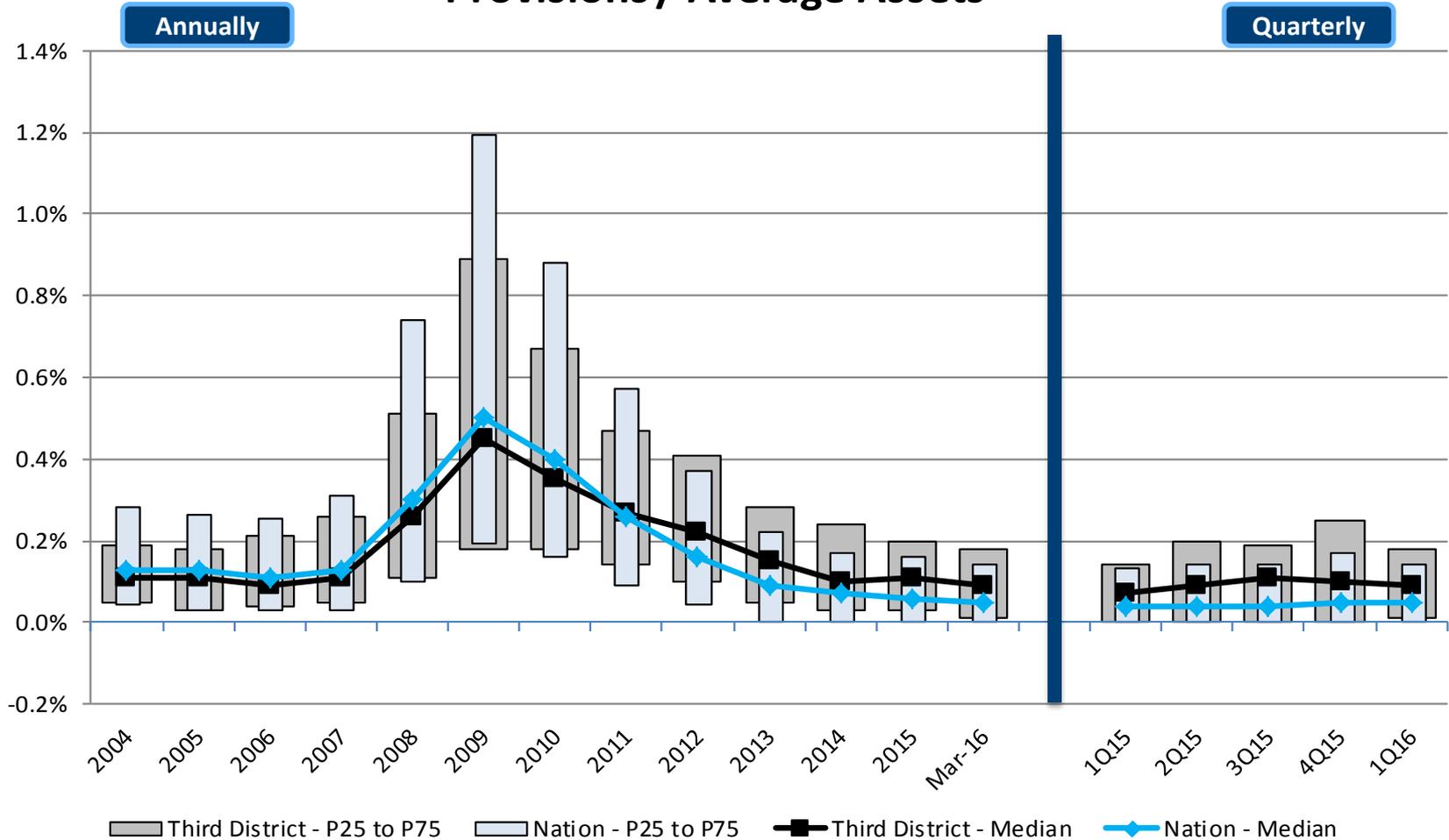
Net Interest Margin



The provision expense continues to trend at or below precrisis levels, which continues to help augment earnings. This trend will not be sustainable if a downfall in the credit cycle occurs.



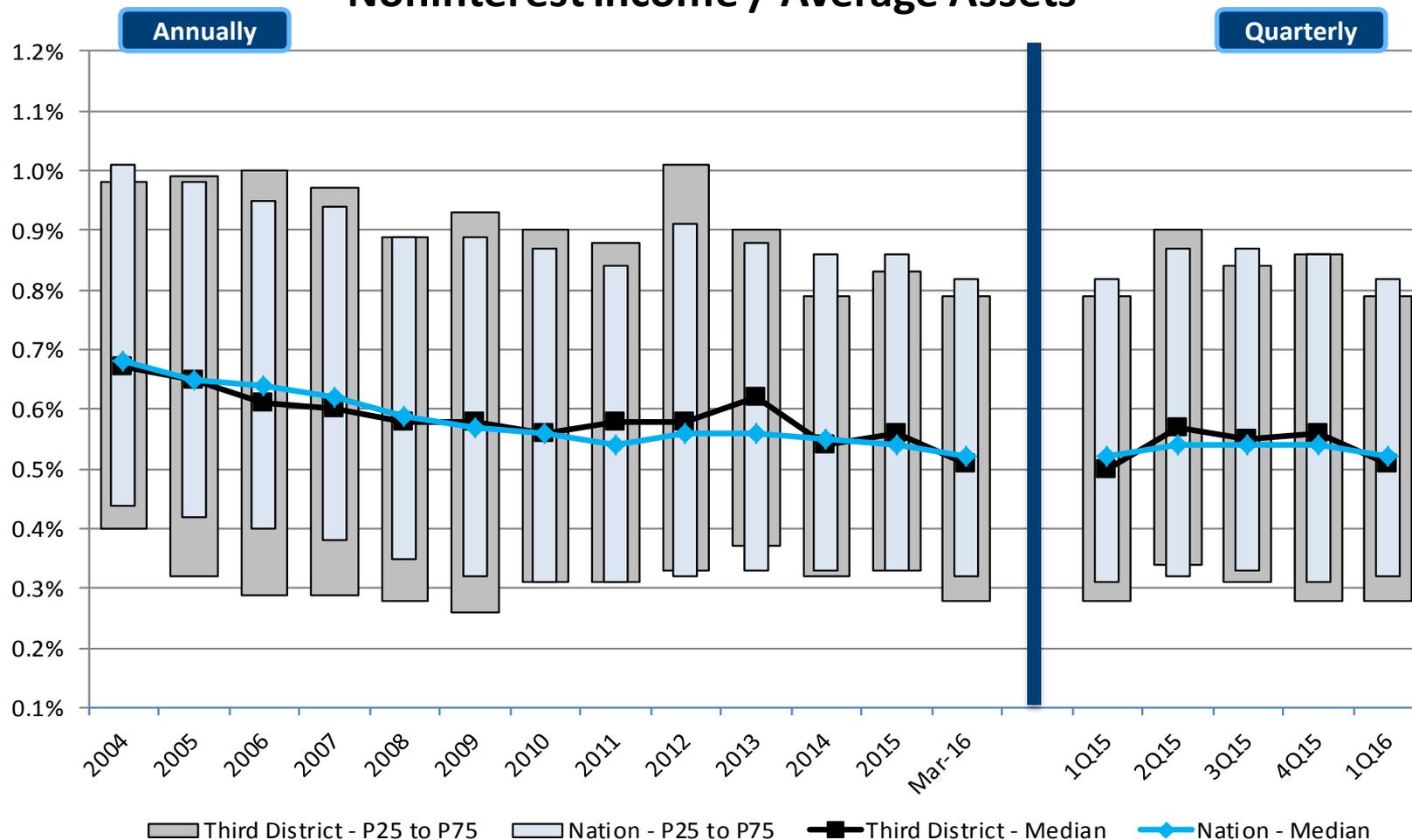
Provisions / Average Assets



Noninterest income declined in 1Q2016 and remains below precrisis levels, placing further pressure on earnings.



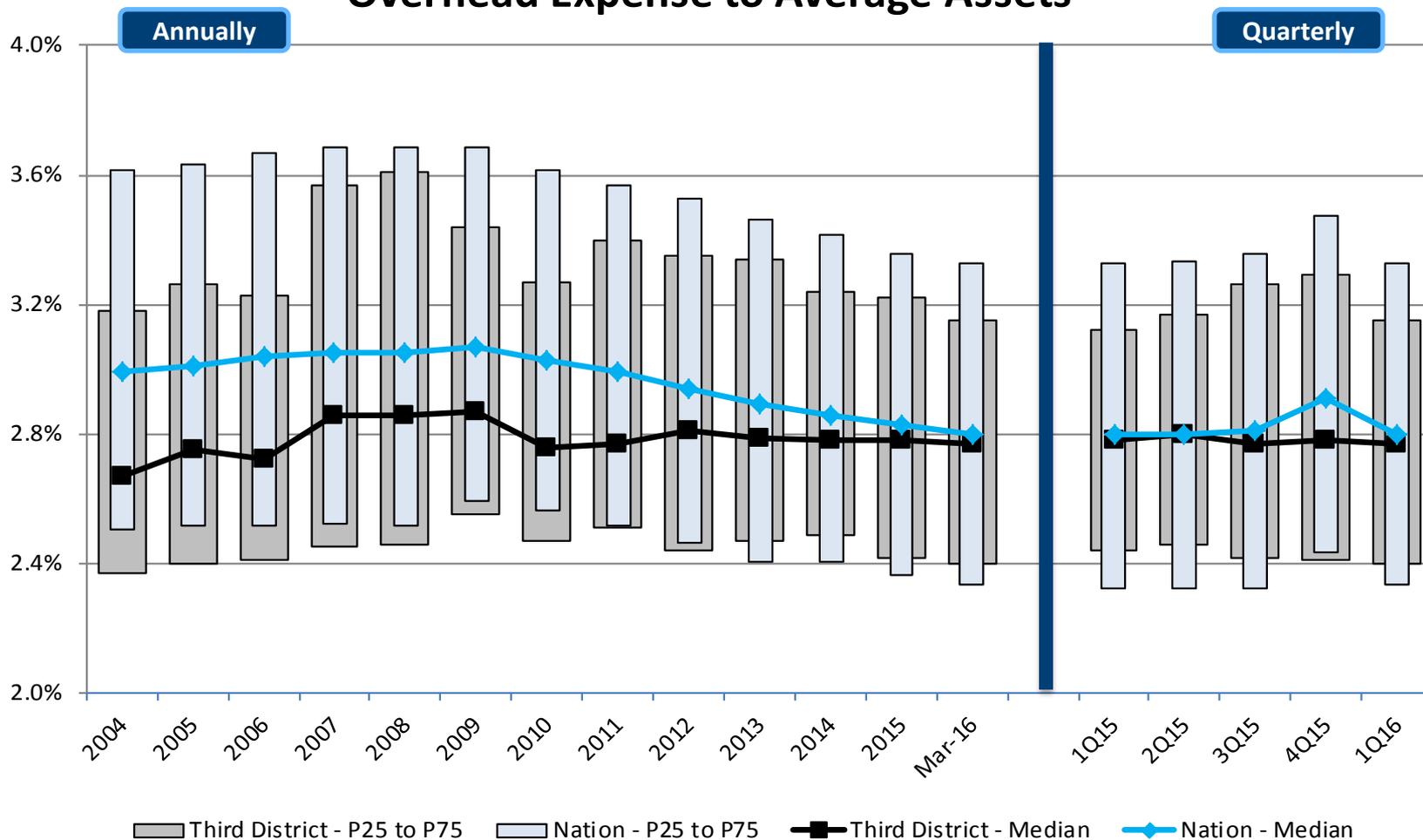
Noninterest Income / Average Assets



Median Third District overhead expense has remained relatively flat since 2010, which will have a positive impact on ROAA.



Overhead Expense to Average Assets

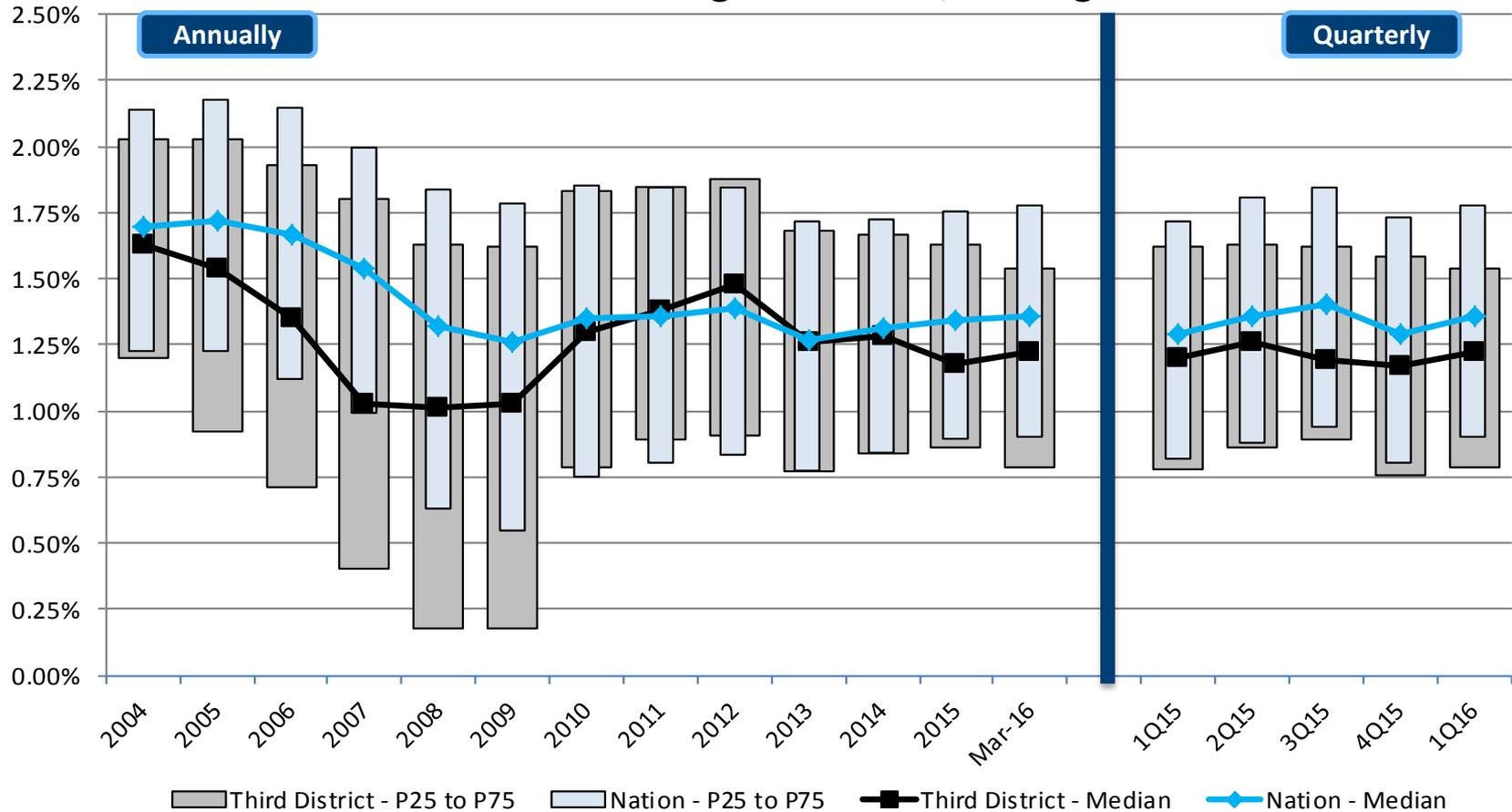


Core profitability has been rising slightly nationwide, while the Third District remains well below precrisis levels.



Core Profitability

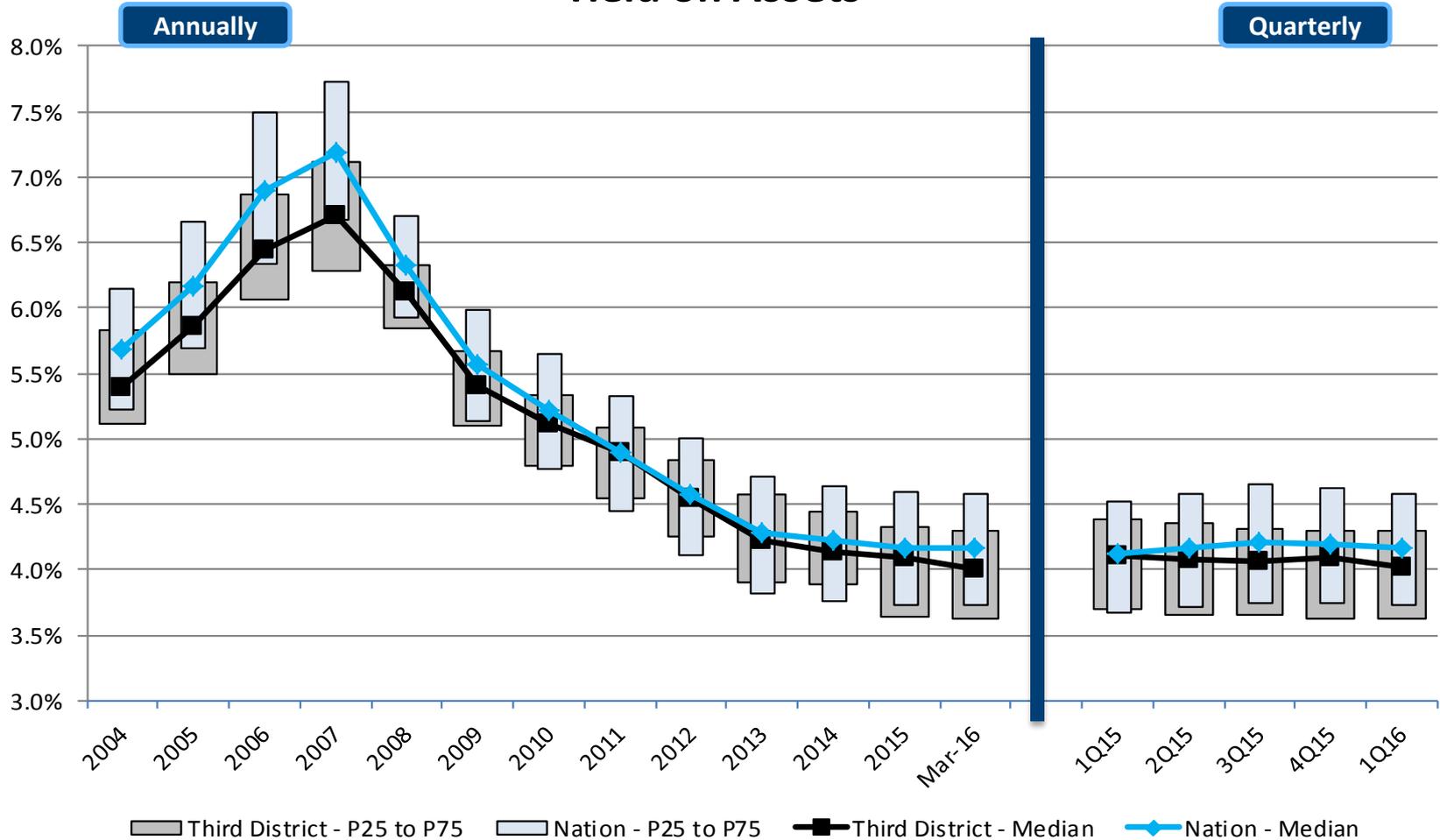
Pre-Tax Income Excluding Provisions / Average Assets



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



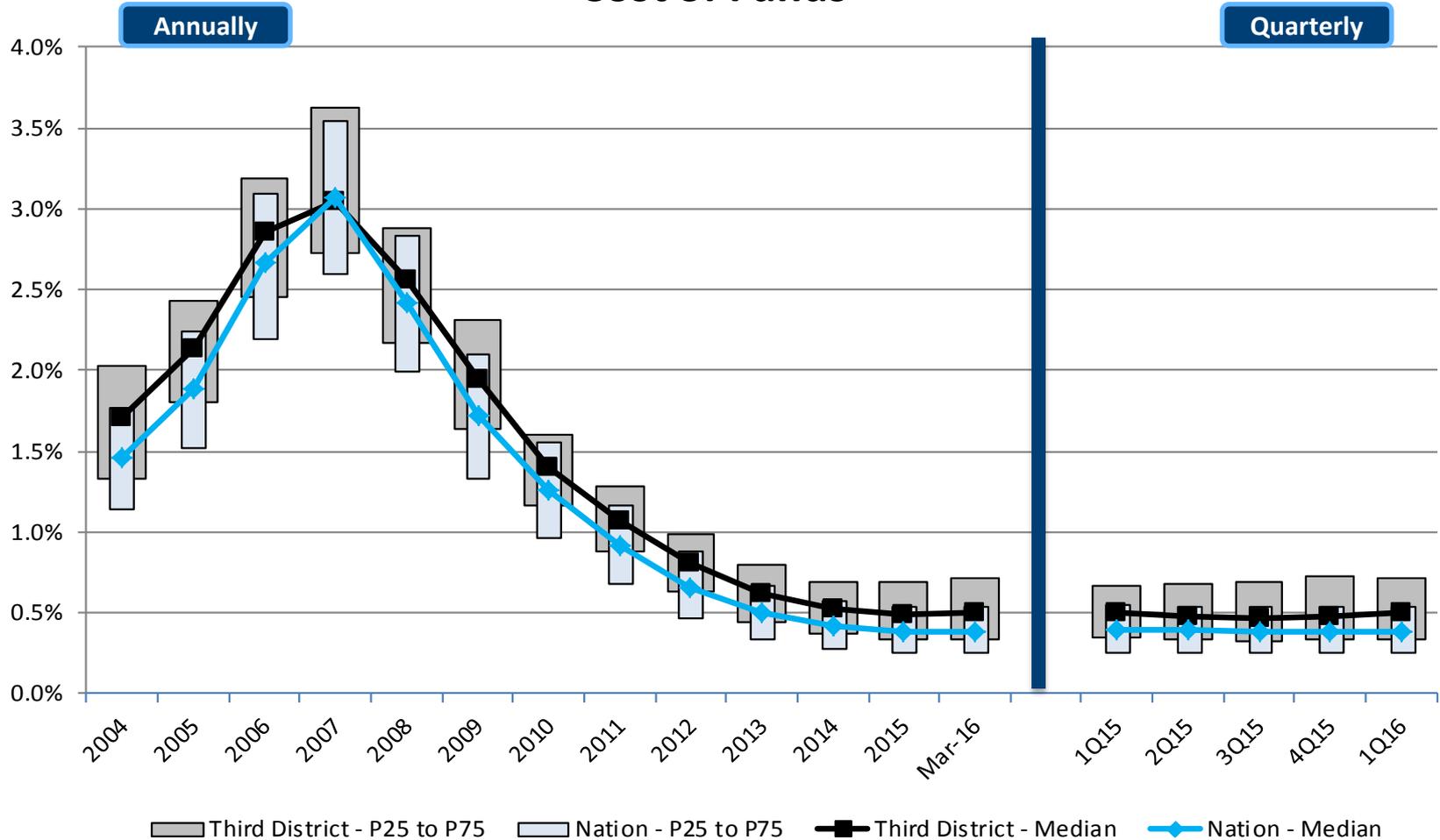
Yield on Assets



On the other hand, the low interest rate environment enables lower cost of funds; however, the District's funding costs remain higher than those of the nation.



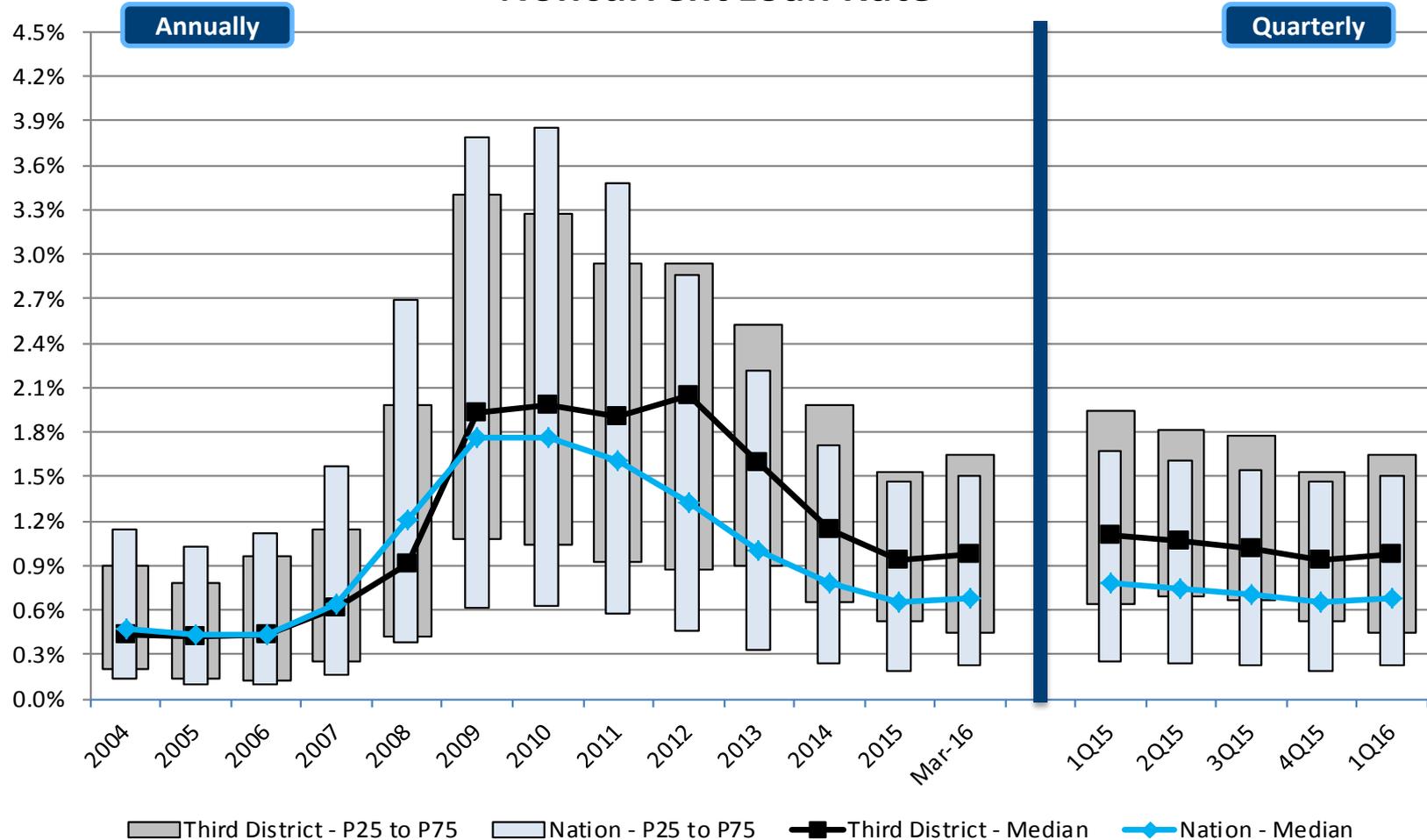
Cost of Funds



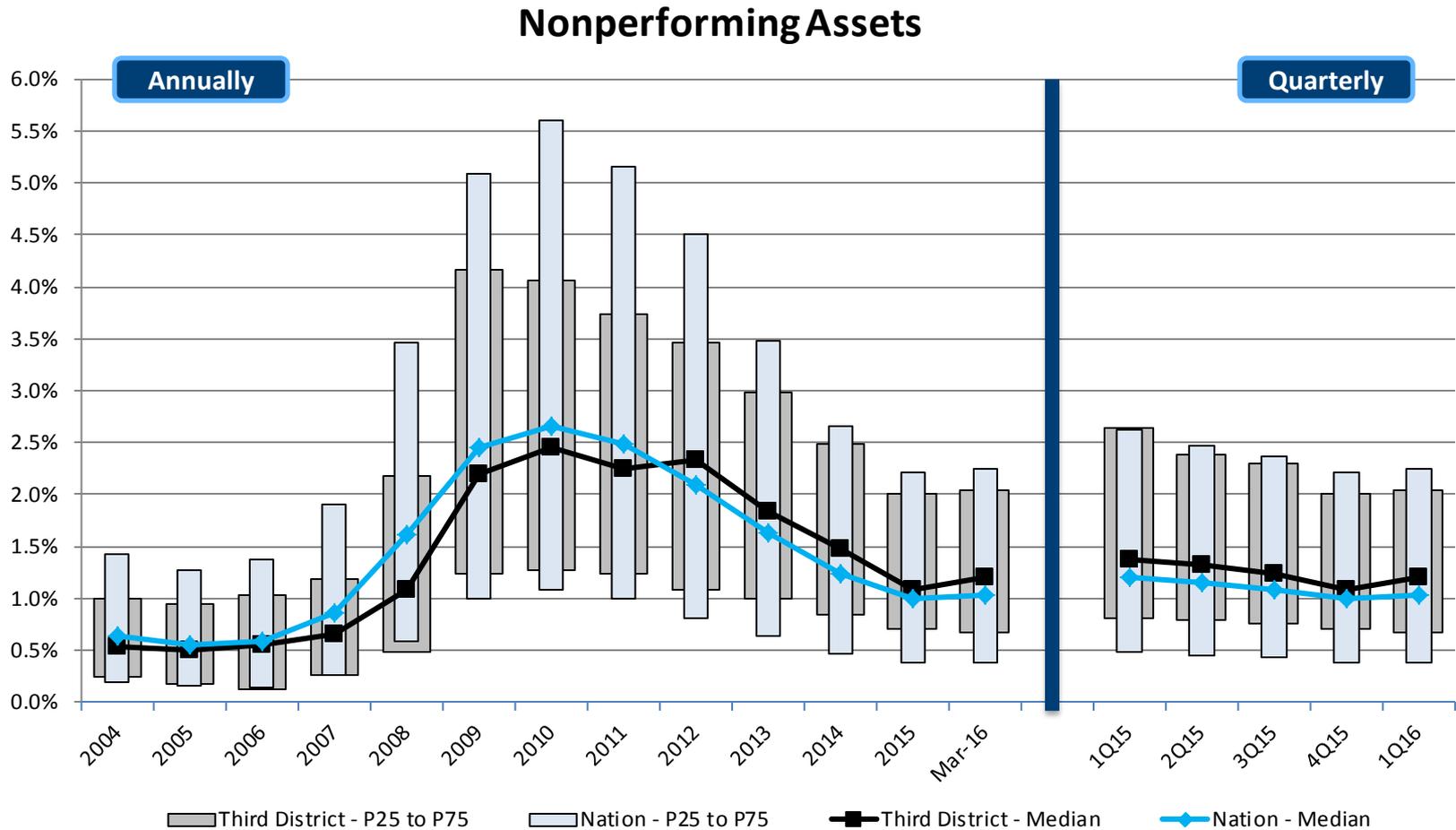
Although the noncurrent loan rate continues to decline, the District is not recovering as quickly as the nation.



Noncurrent Loan Rate



Third District nonperforming assets* are falling, but the District's levels remain slightly above the nation.

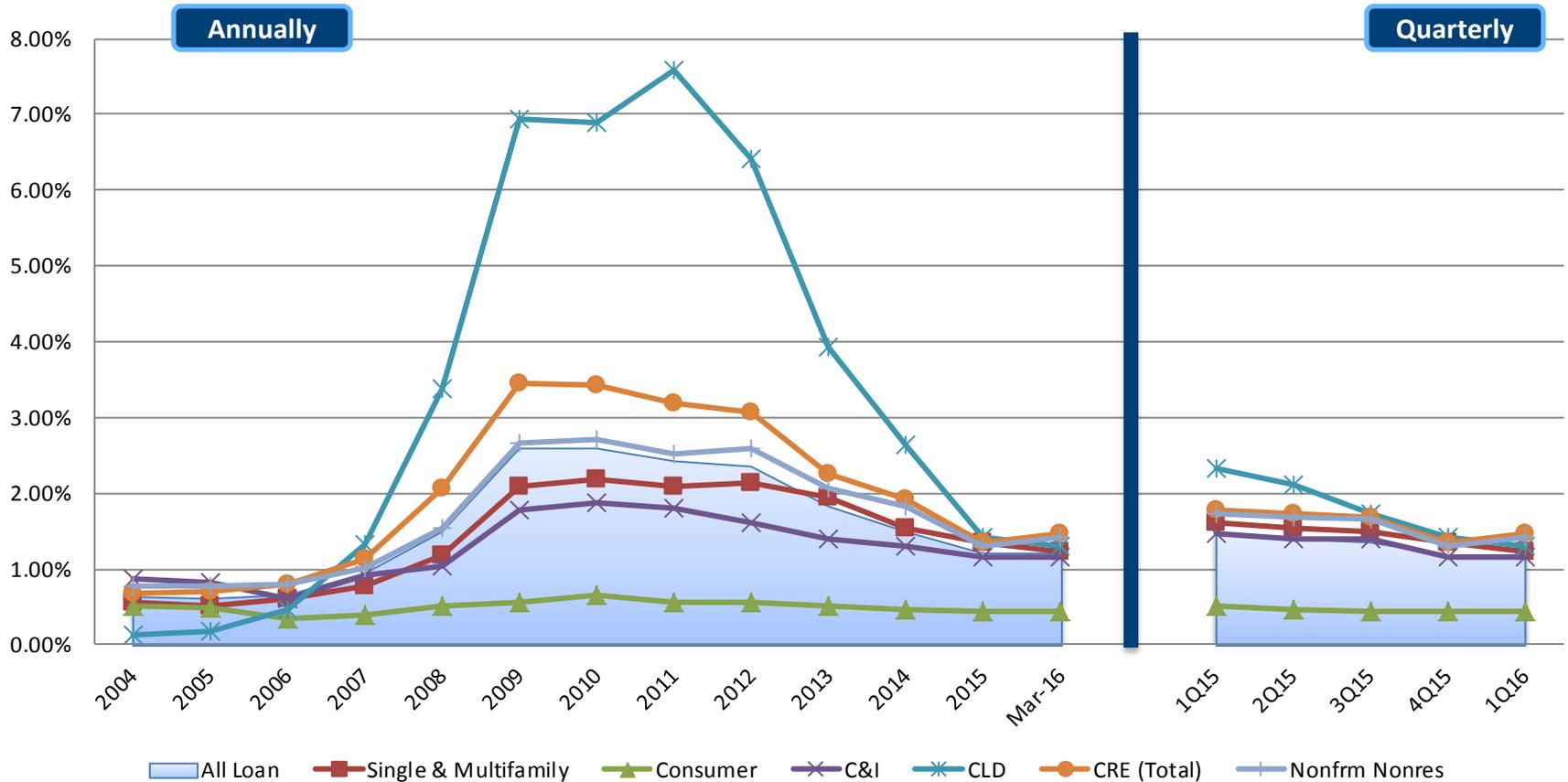


* Nonperforming assets are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans)

Third District loan performance shows significant improvement among the principal loan categories.*



Noncurrent Loan Ratios by Loan Category

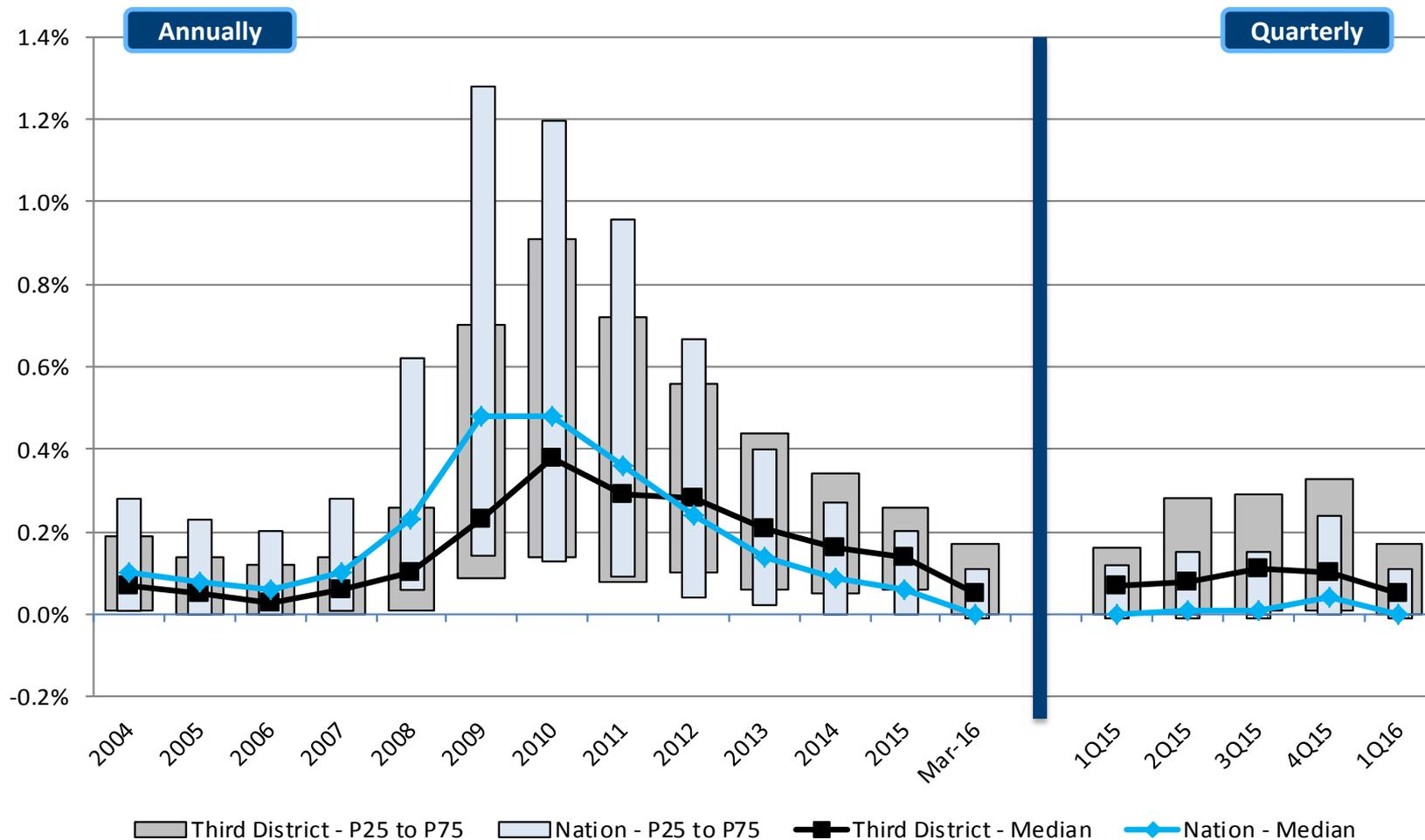


*This chart uses a 10% capped mean, or winsorized mean, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on the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

Net charge-off rates have declined annually since 2009; the nation is at precrisis levels, while the District continues to recover.



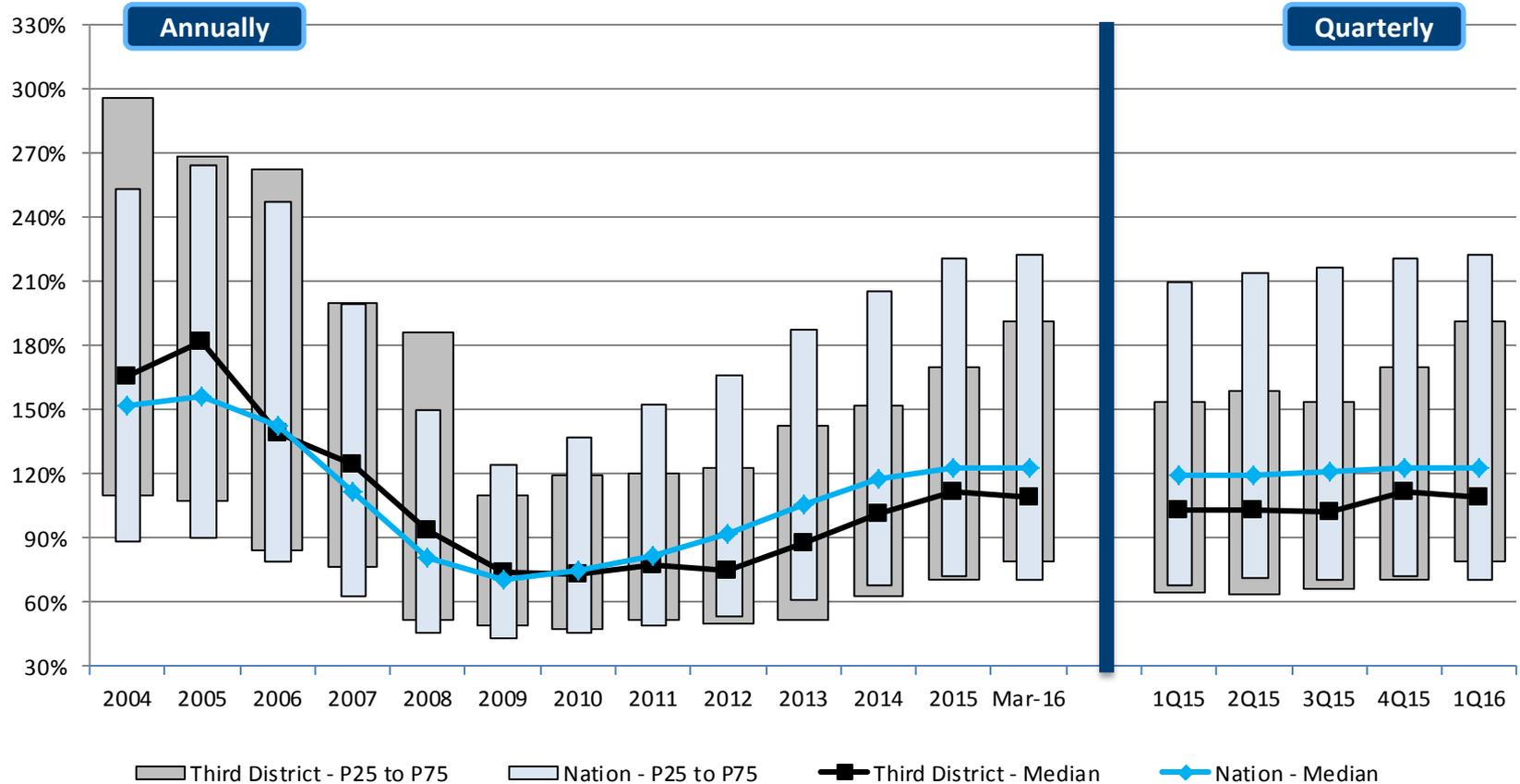
Net Charge-Offs / Loans



The allowance for loan and lease losses (ALLL) reserve coverage ratio is improving due to recovering asset quality metrics (declines in noncurrent loans), not by increasing provision expense.*

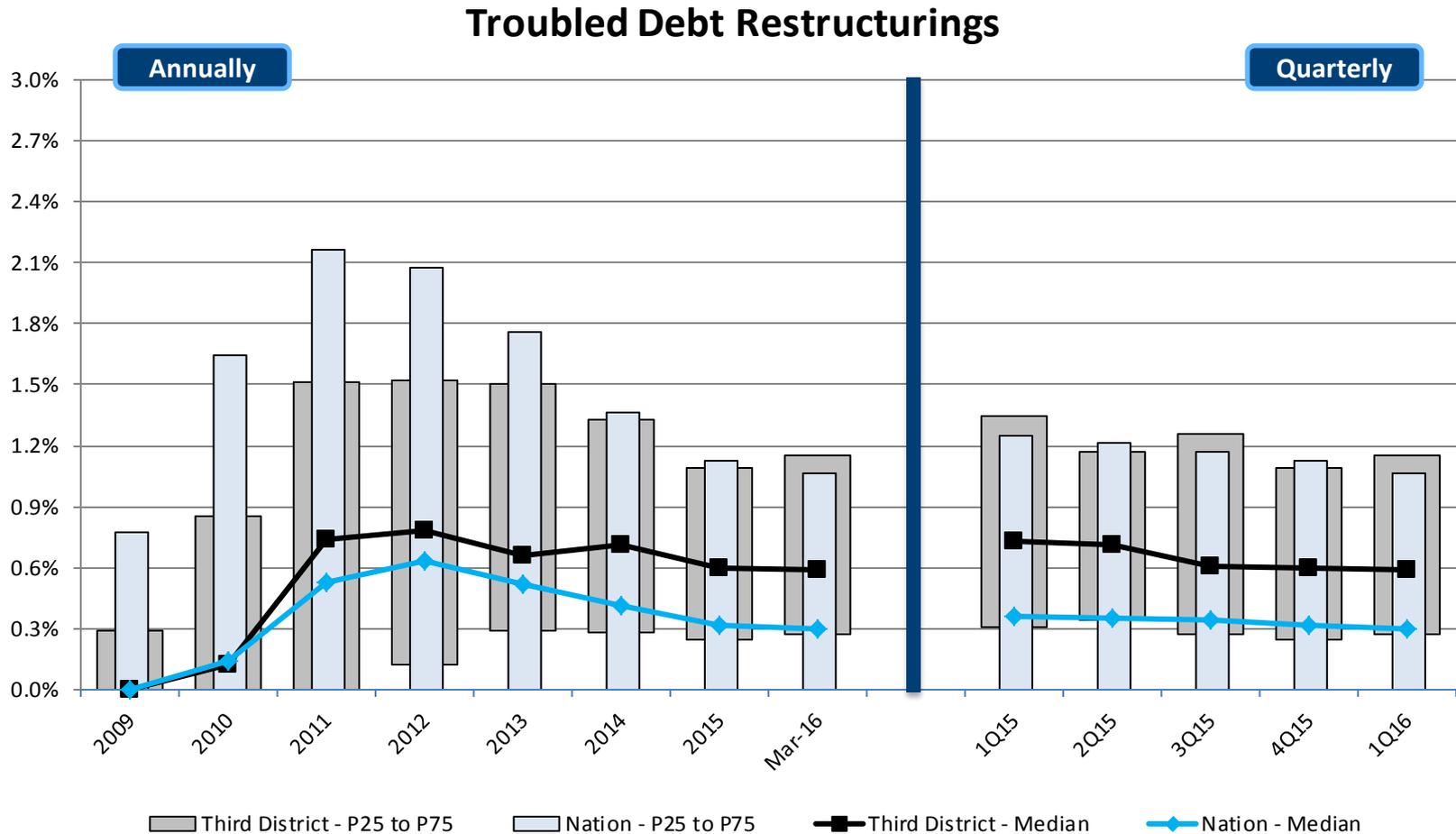


Allowance for Loan & Lease Loss Coverage Ratio



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

Third District troubled debt restructurings remained stable but are elevated compared with the nation.*

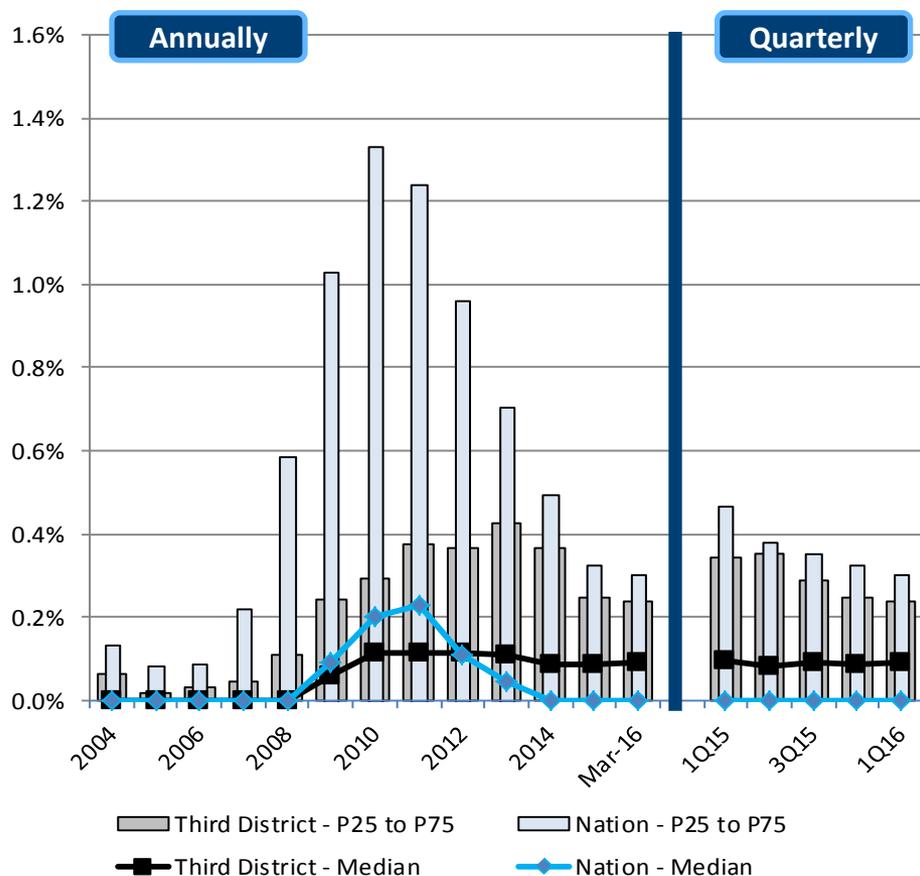


*Troubled debt restructurings (TDRs) were not included on the Call Report until the March 2009 reporting period.

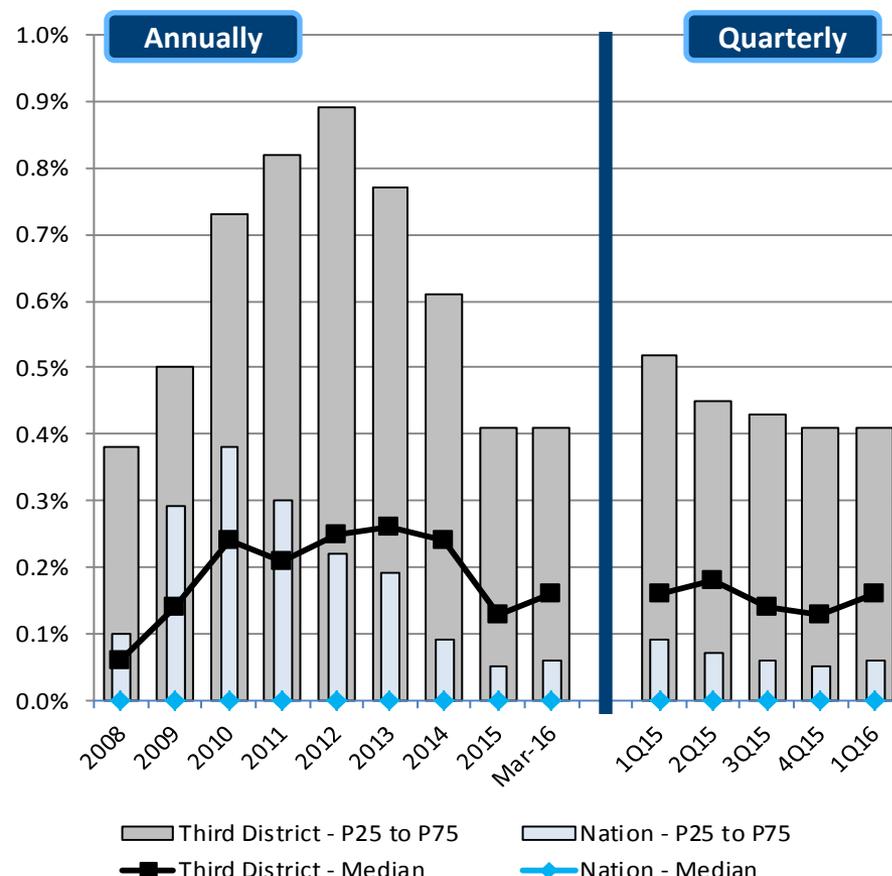
One- to four-family OREO* is decreasing faster within the nation, but the Third District trails in the foreclosure process.**



1-4 Family OREO



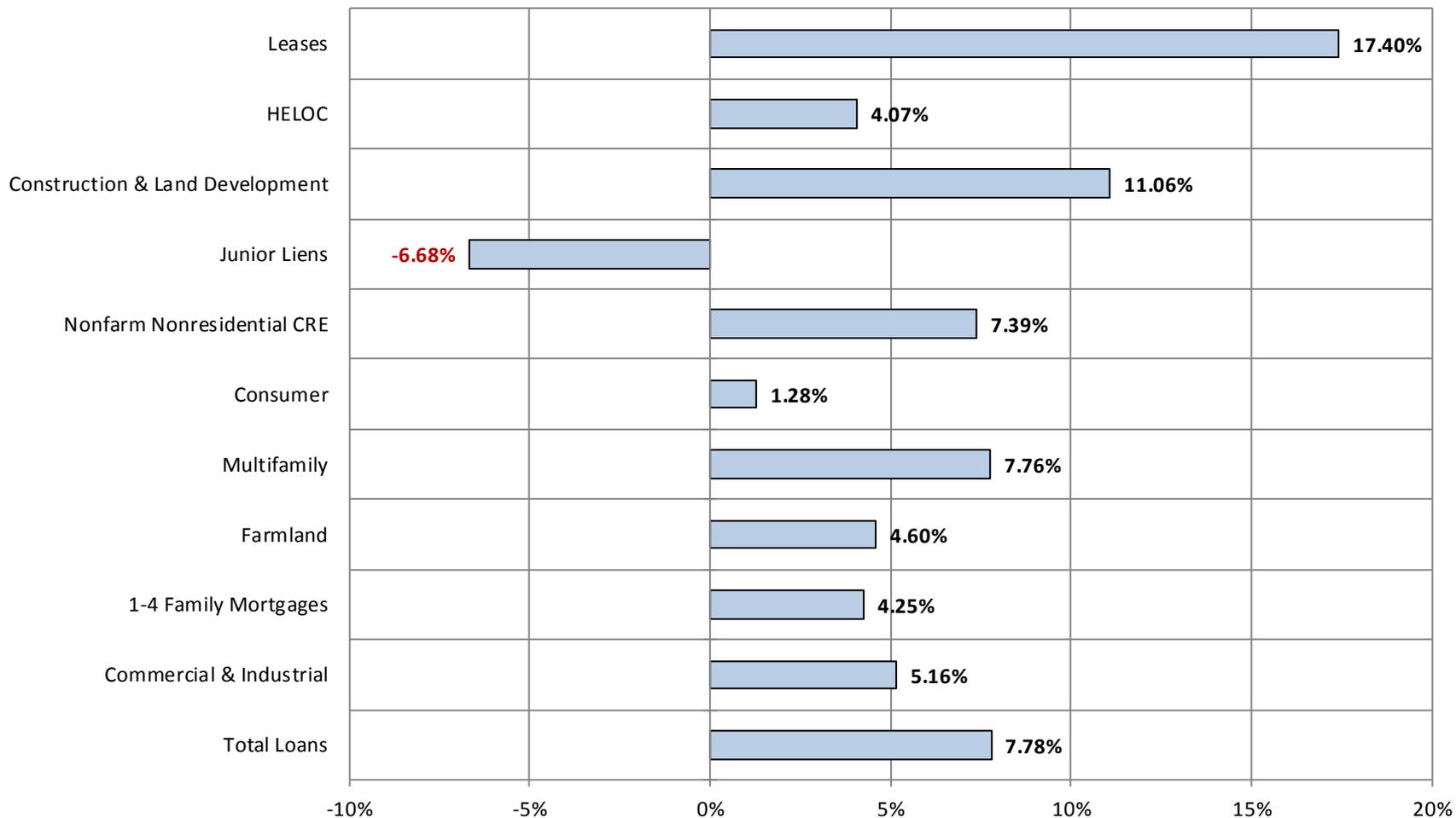
Loans in Process of Foreclosure



*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 most categories was positive year over year; loan contraction continues in the junior lien loan category.

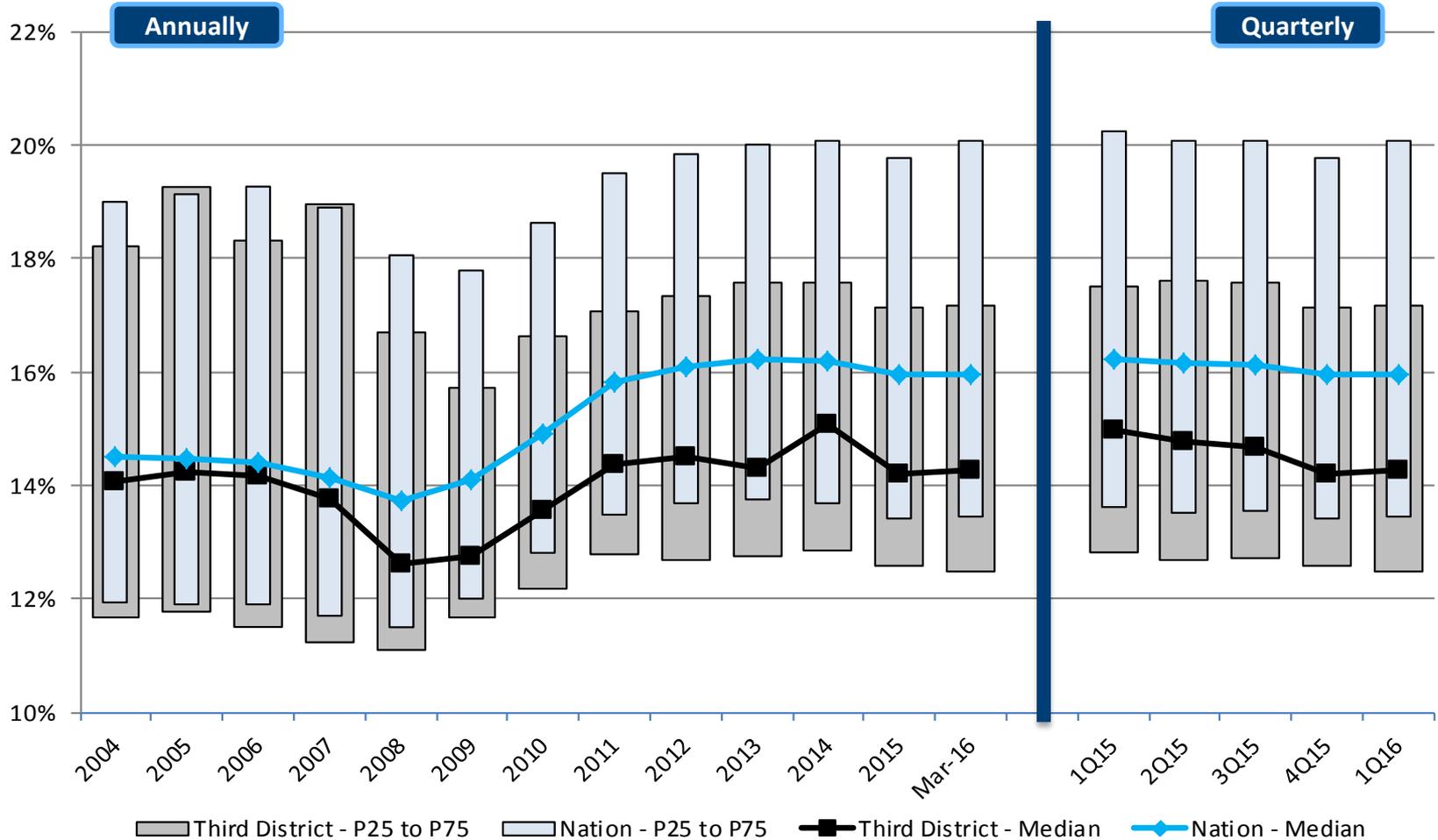


*This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 4.

Capital ratios have increased postcrisis; however, District levels have fallen in recent quarters.



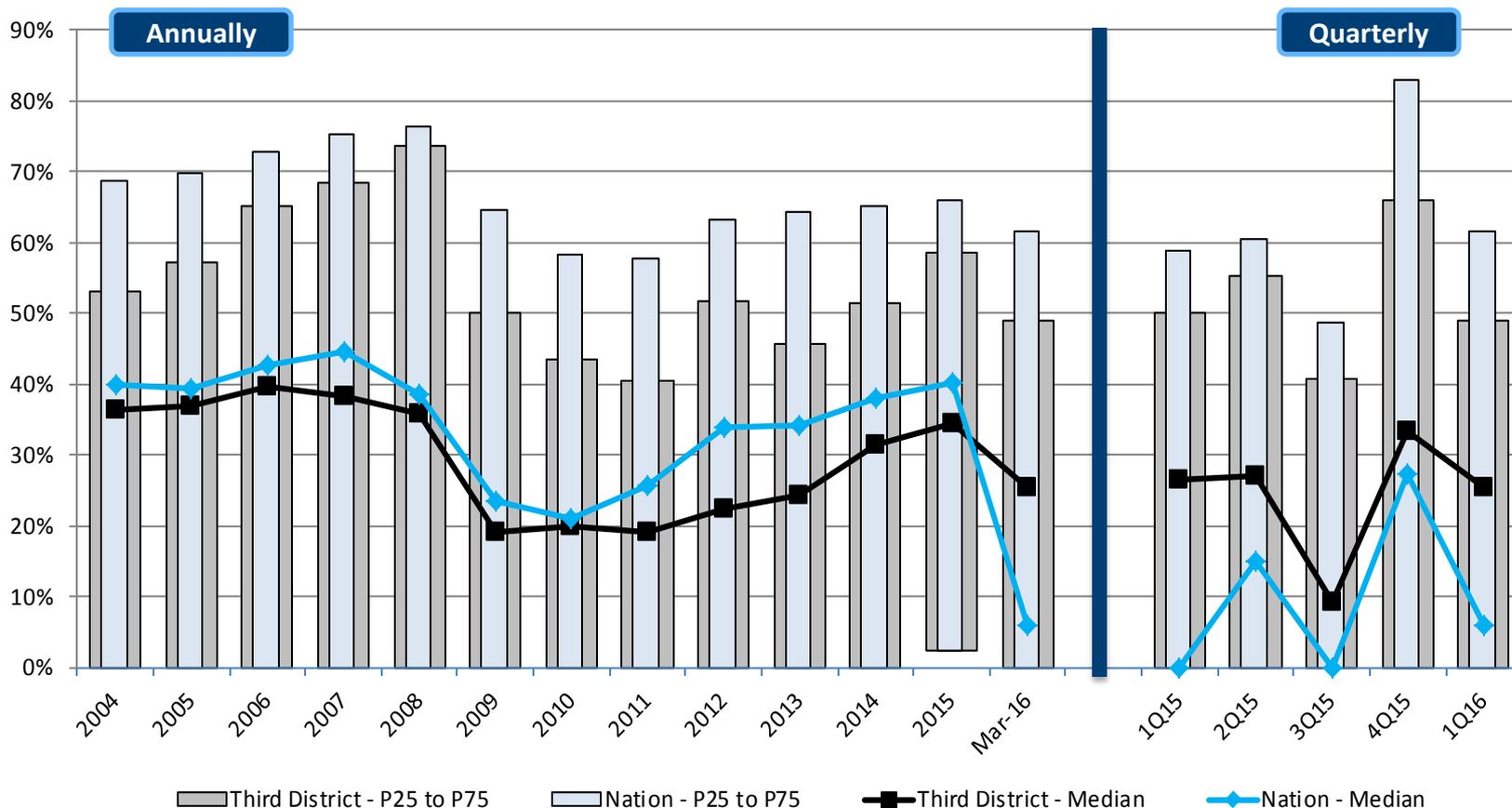
Total Risk-Based Capital



Dividend payments are volatile in the first and third quarters; however, the District may outpace the 2015 dividends based on the year-over-year increase.*



Dividends

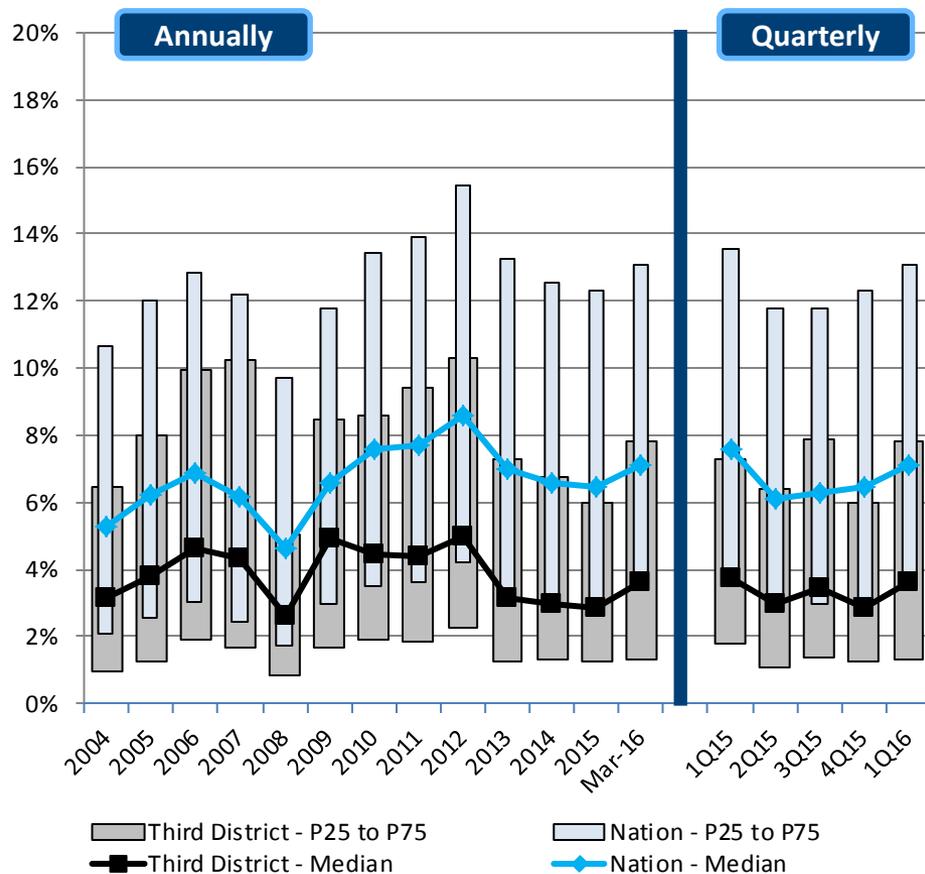


* Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout (DPO) ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income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

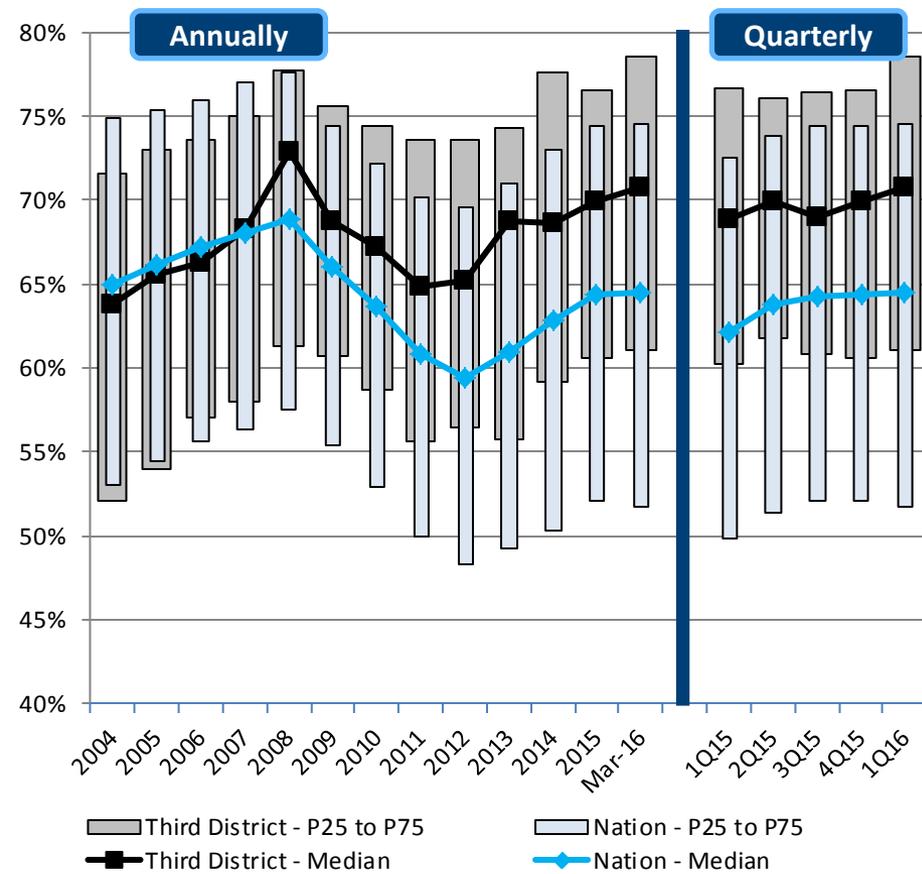
Third District banks hold less short-term investments compared with the nation. Additionally, the District maintains a higher percentage of loans, which may increase duration and interest rate risk.*



Short-Term Investments / Assets



Loans / Assets

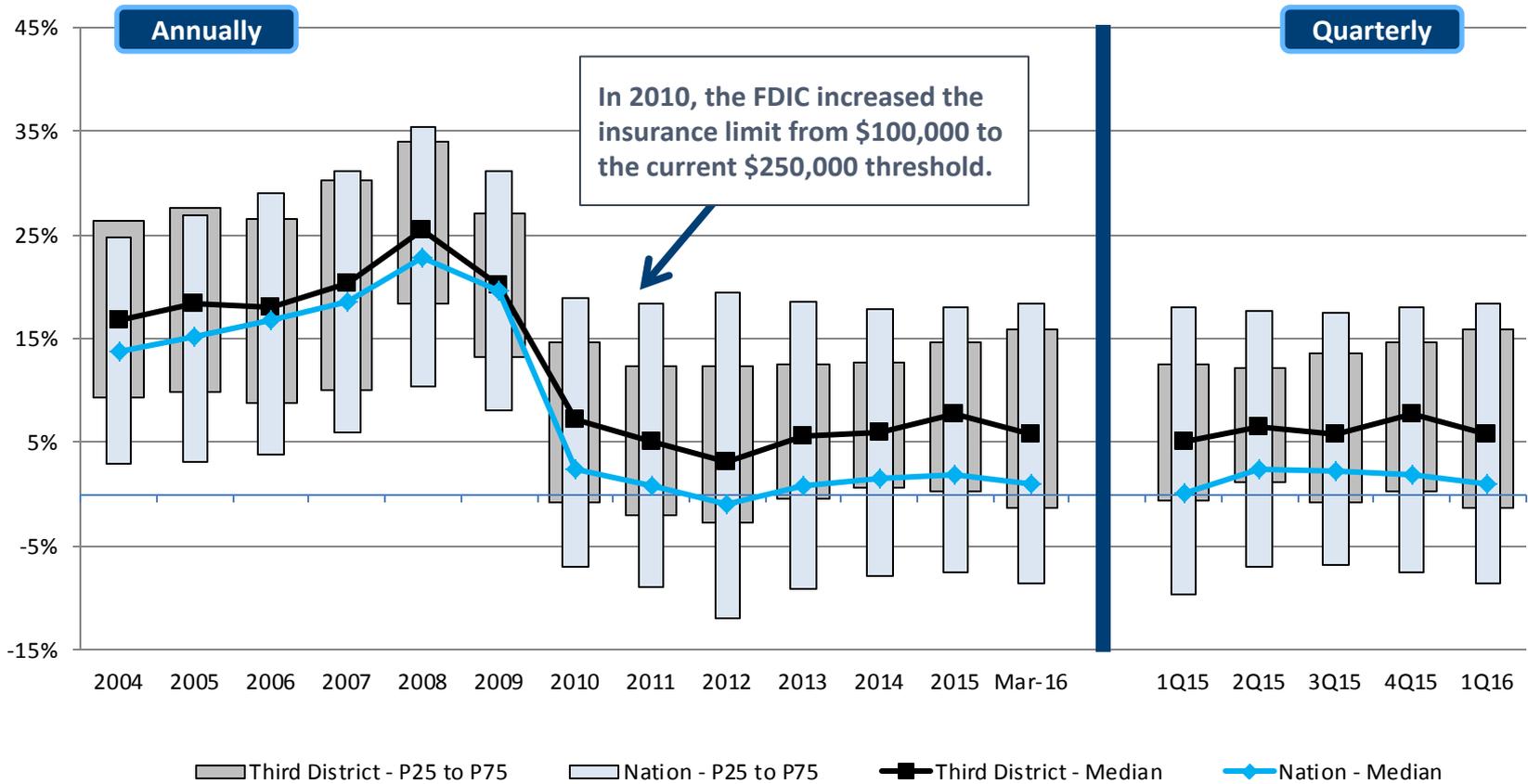


*Short-term investments equals the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

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

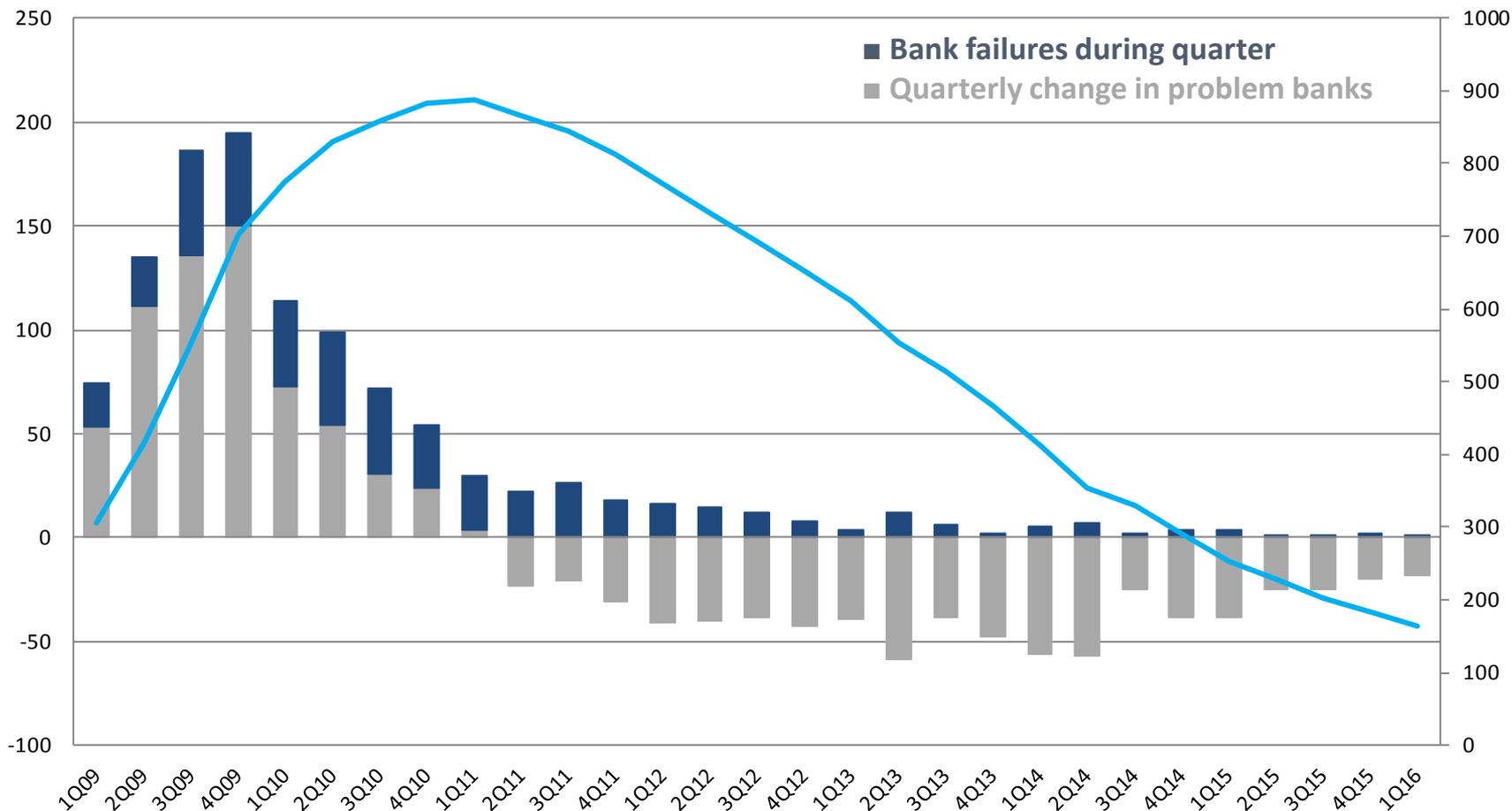


Net Noncore Funding Dependence



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

Problem banks within the nation fell by 18 institutions to 165 as of 1Q2016.



Source: FDIC; *problem banks* are defined as having a CAMELS composite rating of 4 or 5. CAMELS is an acronym for the components assessed at a safety and soundness examination. The components are capital, asset quality, management, earnings, liquidity, and sensitivity to market risk.