



Third District Banking Conditions as of December 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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For any questions about this presentation, please contact Christopher Hahne at 215-574-6406 or christopher.hahne@phil.frb.org.

Section 1: Executive Summary



- Challenges remain for Third District bank financial performance primarily due to:
 1. Augmenting earnings with nonrecurring sources of income given that the low interest rate environment is not sustainable over a longer credit cycle. Third District banks maintain a lower yield on assets and a higher cost of funds when compared with the nation.
 2. Increasing competition for loans and deposits.
 3. Offsetting the lower amount of core earnings with nonrecurring items, such as the sale of loans and securities and/or reporting zero or negative provisions.
- Capital ratios continue to increase mostly as a result of earnings accretion; however, capital ratios remain below the nation.
- Third District and national asset quality metrics continue to improve as the level of noncurrent loans declined to 2008 levels.
- Third District banks' reliance on noncore funding sources continues to outpace the industry as core deposit competition persists. Some of these sources (FHLB borrowings, brokered deposits, etc.) may become more expensive as the federal funds rate increases, thus increasing earnings risk.
- Interest rate risk remains somewhat elevated throughout the banking industry; however, given the extended low interest rate environment, many banks have adjusted their balance sheet to reduce the adverse effects of rising rates.
- The number of problem banks fell by nine banks to 123 as of 4Q2016. This represents the lowest number of problem banks in more than seven years, declining significantly from the peak of 888 problem banks in 1Q2011. No banks failed during 4Q2016.
- Qualitative and/or operational risks that remain on the risk radar include:
 1. Cybersecurity
 2. Credit concentrations – Commercial Real Estate (CRE) (Refer to SR Letters 07-1 and SR 15-17), municipal loans, credit cards, and auto loans
 3. Model risk management (SR 11-7 compliance)
 4. Management succession and strategic planning

Section 2: Conditions of Third District Commercial Banks



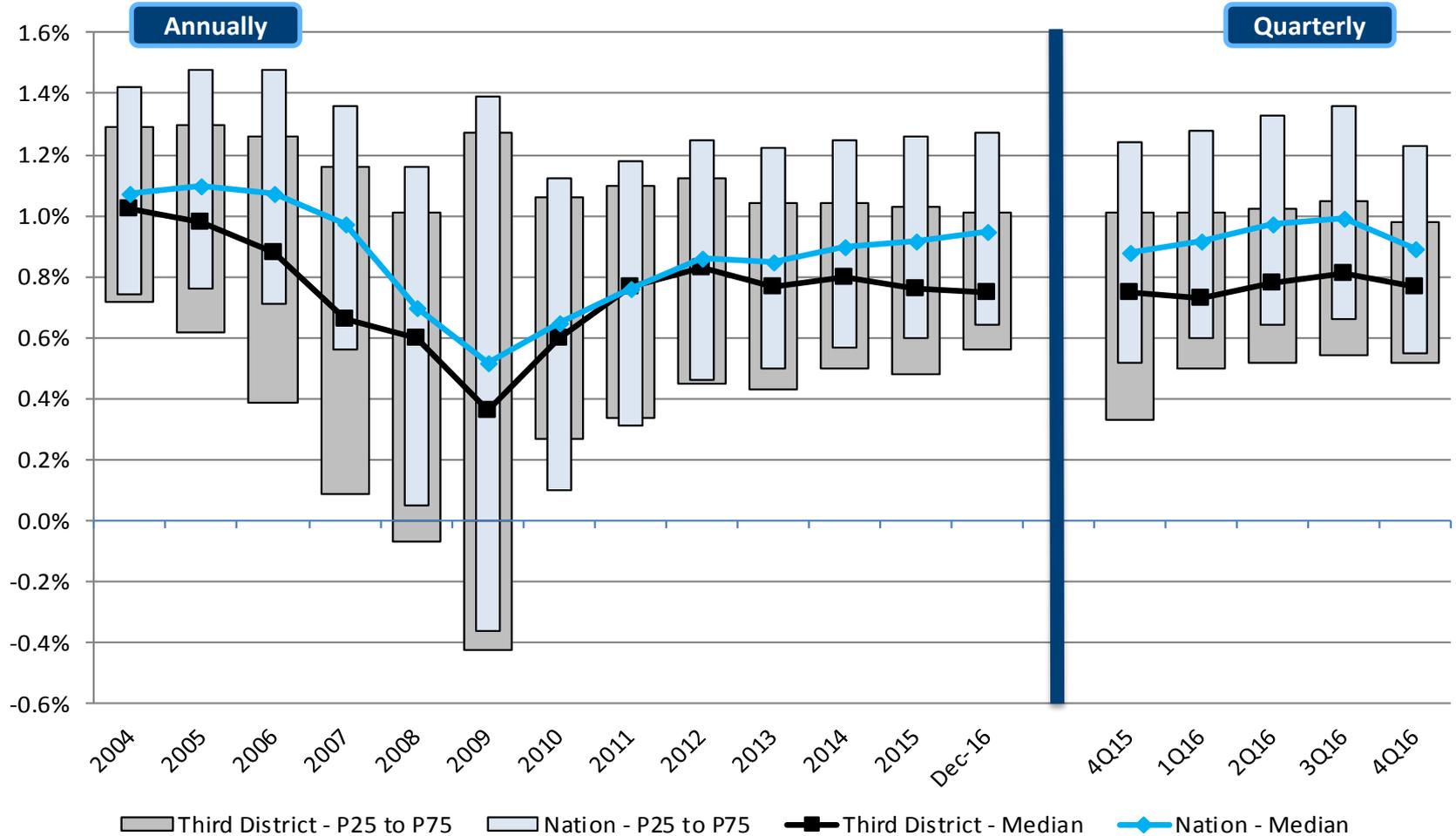
Reporting Methodology

- 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 **106 commercial banks** within the Third District and state member, national, and nonmember commercial banks (CBs). The banks excluded from this analysis meet at least one of the following criteria as of **December 31, 2016**:
 - 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 of 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, as defined by the return on average assets (ROAA) ratio, continues to lag the nation since 2004.



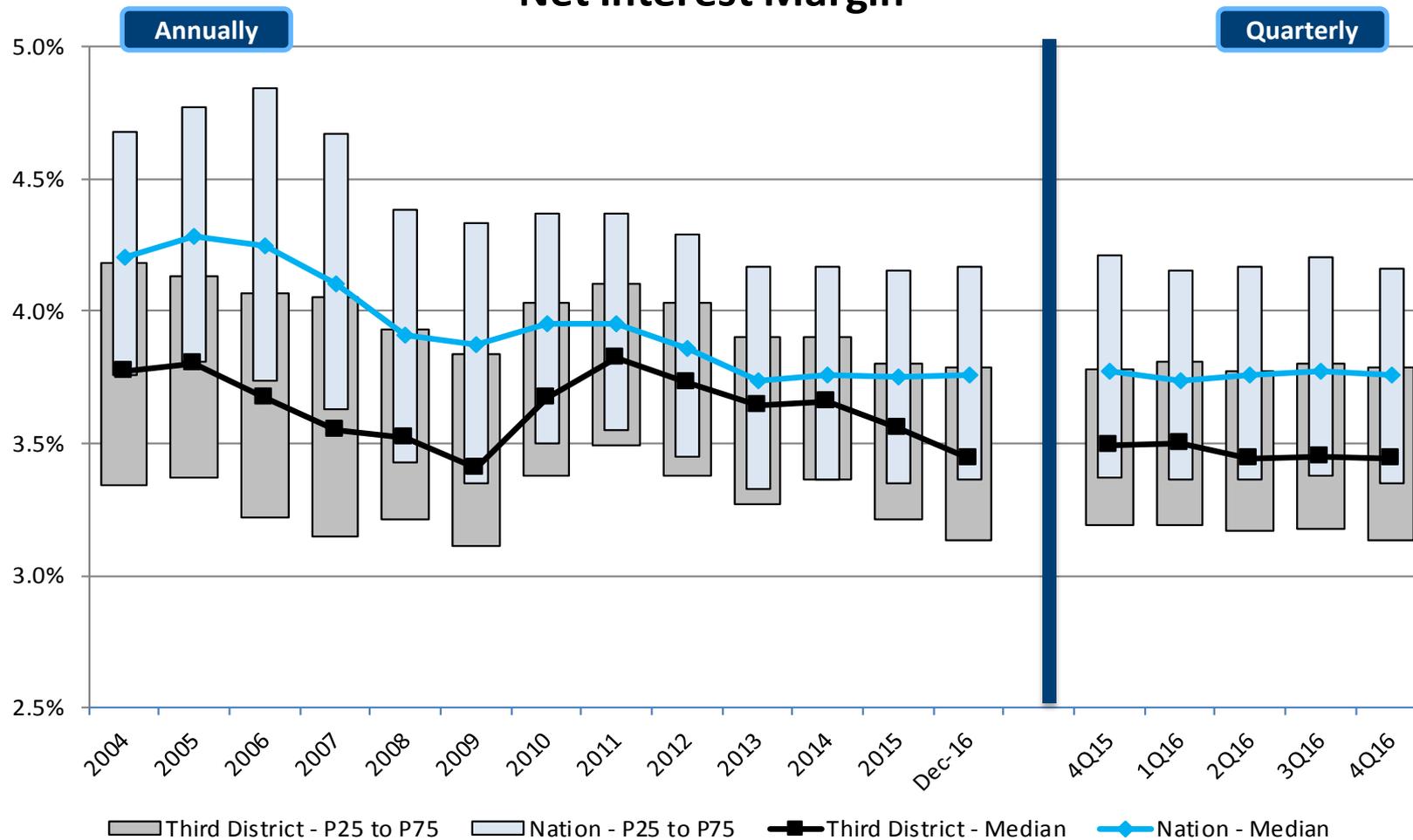
Return on Average Assets



The Third District net interest margin (NIM) continues to compress as of 4Q2016. This decline is a result of the Third District's lower yield on earning assets than that of the nation and the cost of funds being greater than that of the nation.



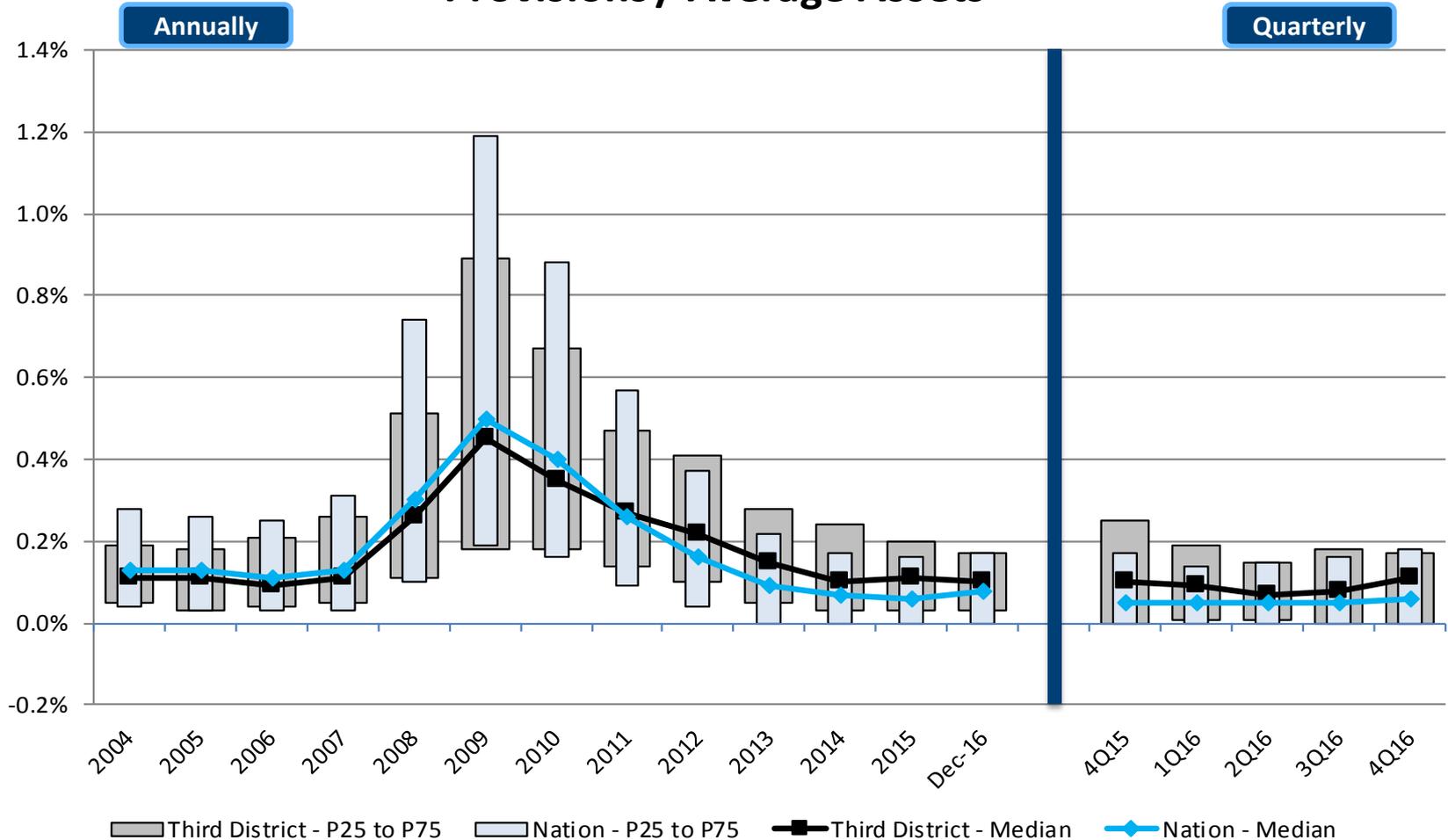
Net Interest Margin



The provision expense continues to trend around or below precrisis levels. Although the low provision figures currently help augment earnings, this trend will not be sustainable if a collapse in the credit cycle occurs.



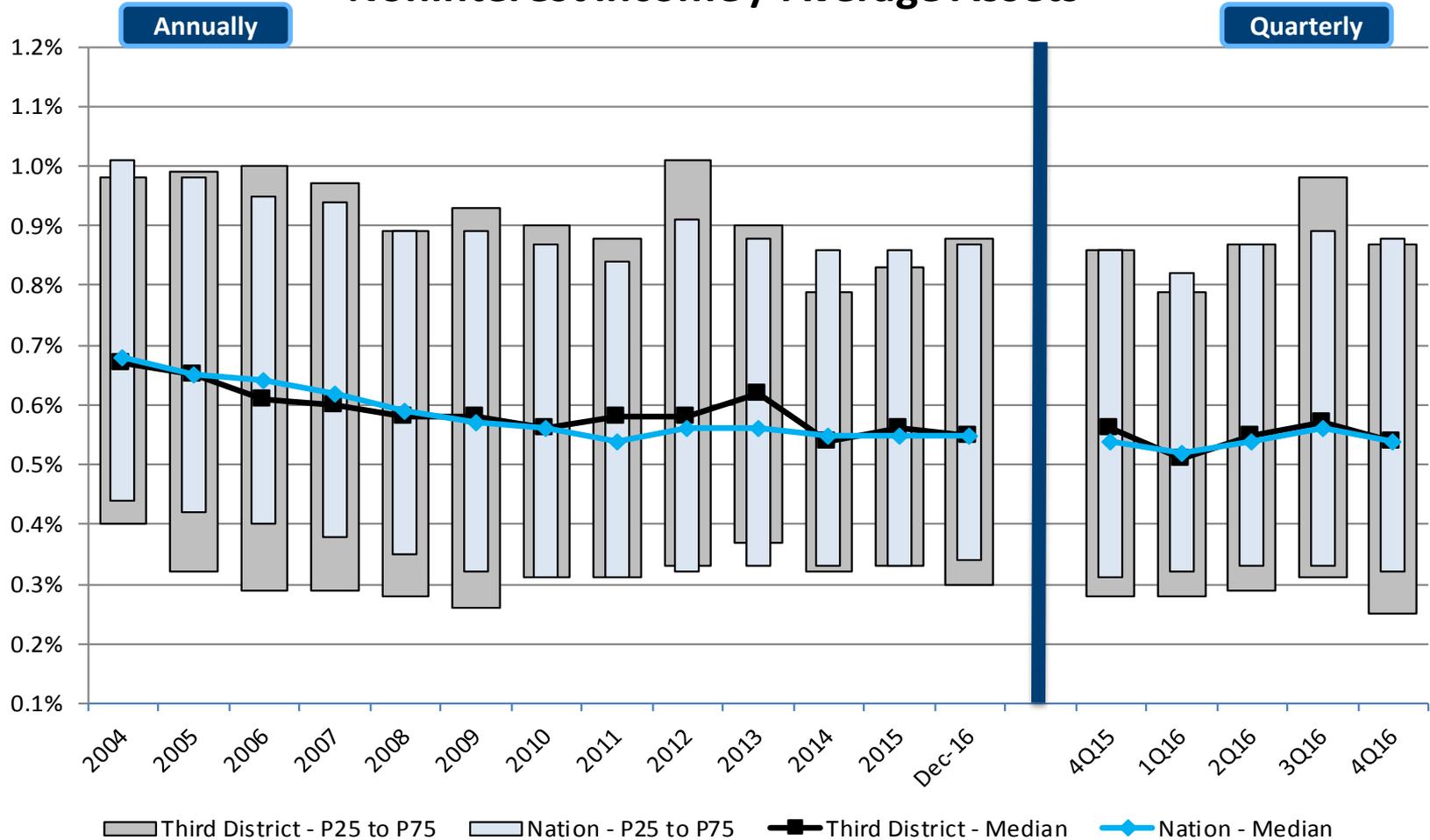
Provisions / Average Assets



Historically, noninterest income for the Third District has outpaced that of the nation. However, the decline in noninterest income since 2004 has placed further pressure on earnings for the District and the nation.



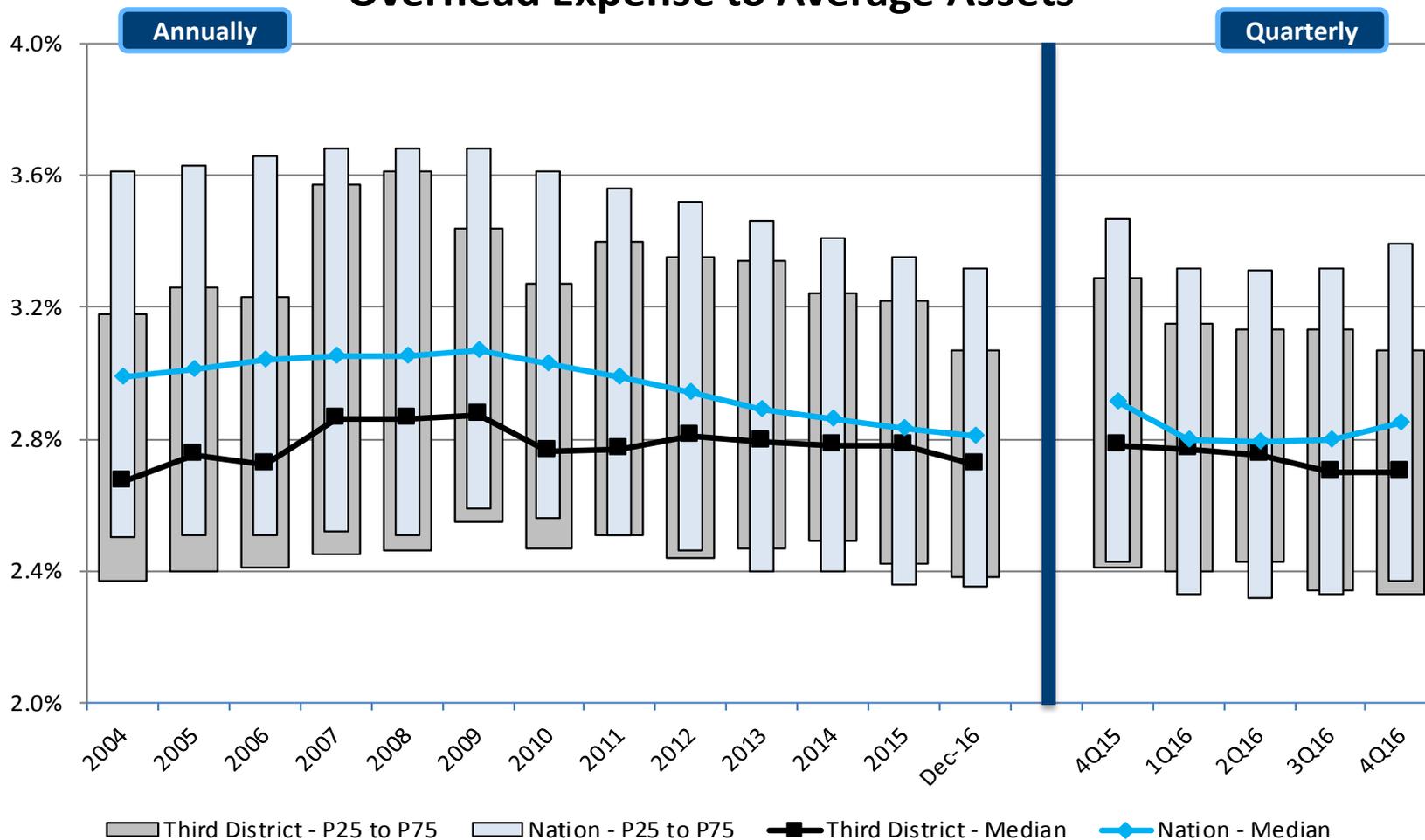
Noninterest Income / Average Assets



Median overhead expense has decreased in the nation since 2010, while it continues to moderate within the District. The lower overhead costs generate a positive impact on ROAA.



Overhead Expense to Average Assets

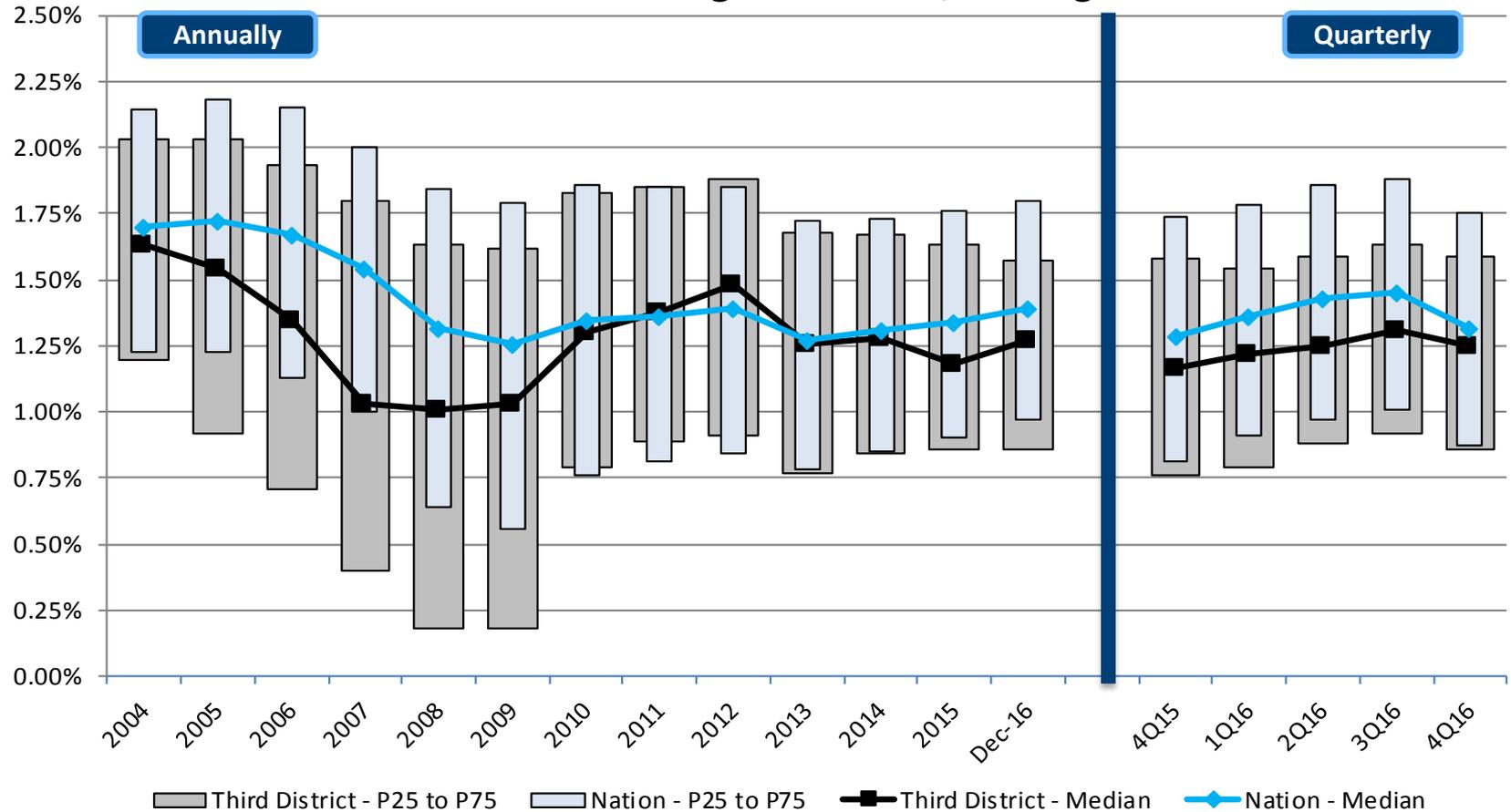


Core profitability continues to rise nationally, while the Third District remains well below precrisis levels.



Core Profitability

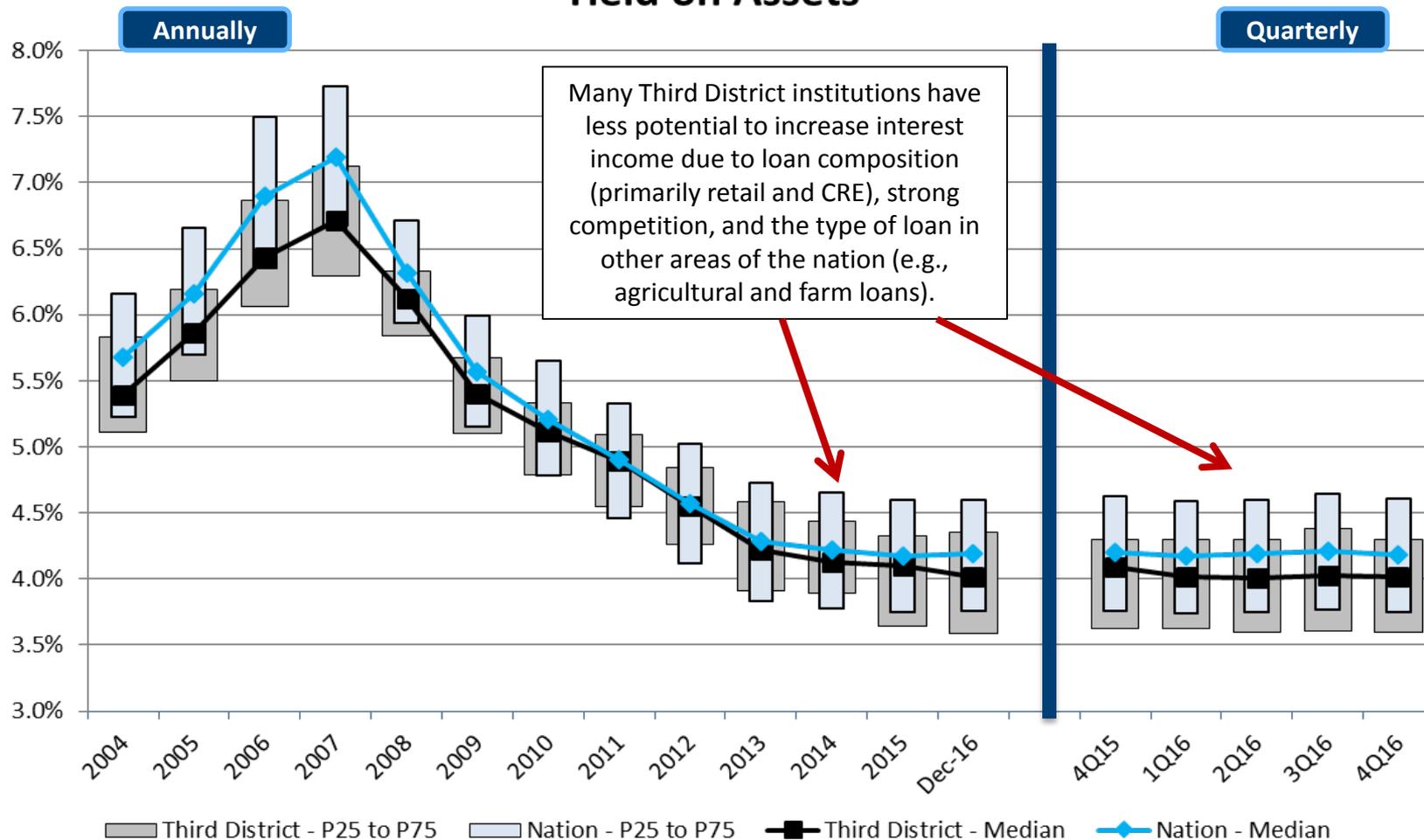
Pre-Tax Income Excluding Provisions / Average Assets



The continued low interest rate environment and overall loan composition suppresses the yield on assets within the District.



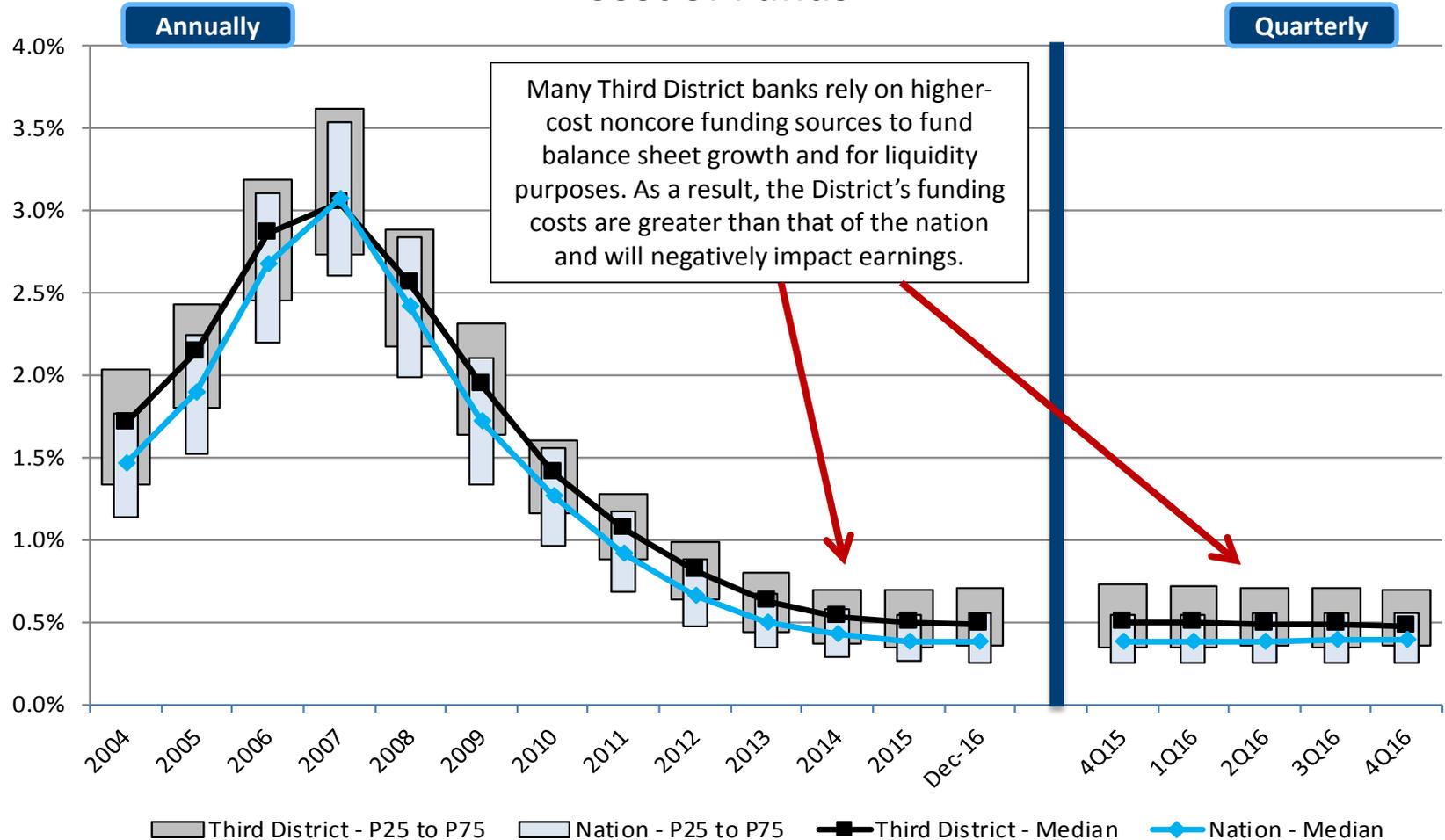
Yield on Assets



Most banks are able to reduce their cost of funds within the current interest rate environment; however, the Third District's costs remain elevated when compared with the nation.



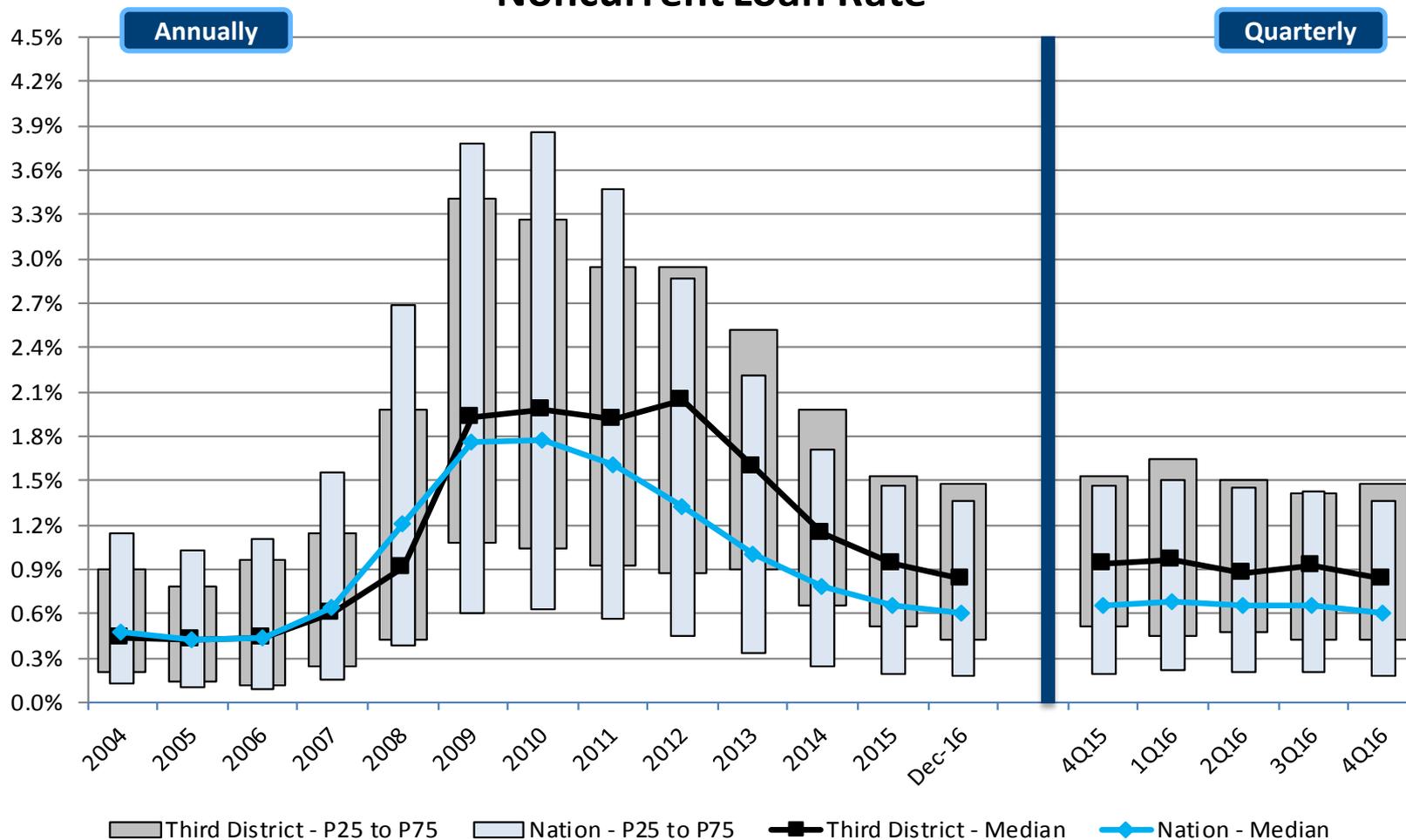
Cost of Funds



Although the noncurrent loan rate remains stable, the District's median result has remained above that of the nation since 2009.



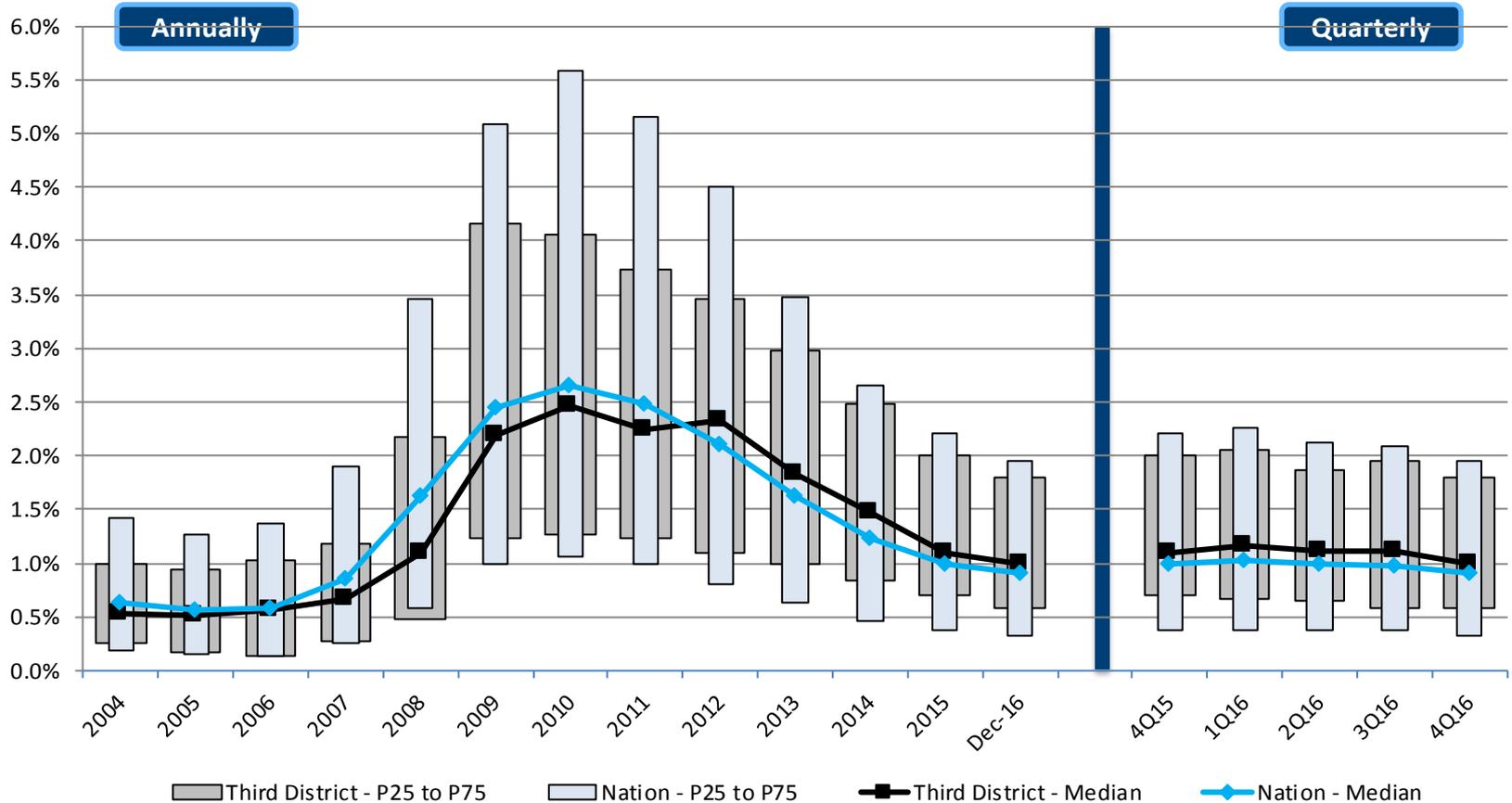
Noncurrent Loan Rate



Third District nonperforming assets remain stable, but the District's median remains slightly above that of the nation.



Nonperforming Assets*

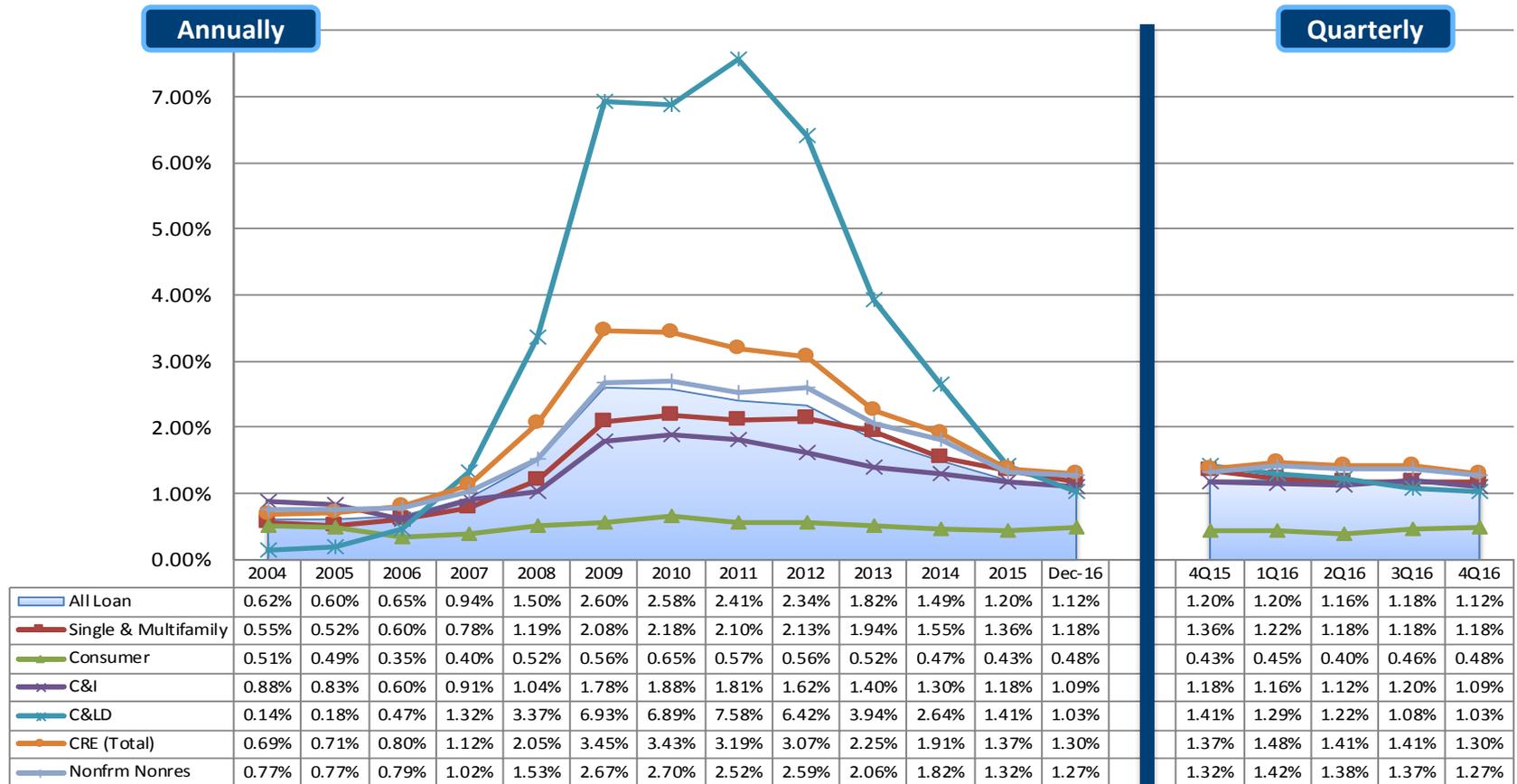


* NPAs (nonperforming assets) are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans)

Third District loan performance shows significant performance improvement among the principal loan categories. Total CRE loan delinquency remains the highest category.



Noncurrent Loan Ratios by Loan Category

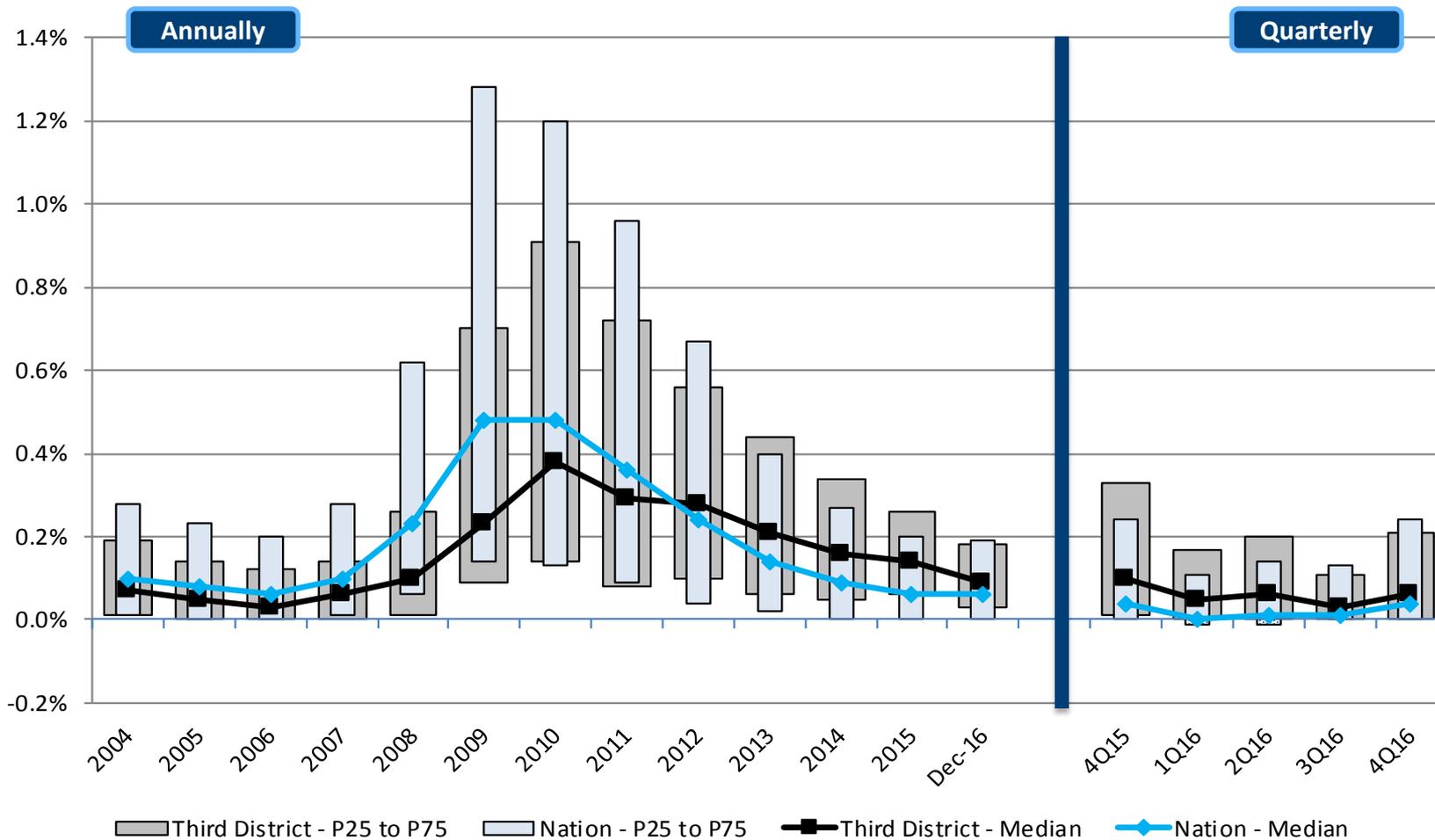


This chart uses a **10% capped mean, or winsorized mean**, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on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

Third District net charge-off rates have steadily declined since 2010 and are in line with precrisis levels.



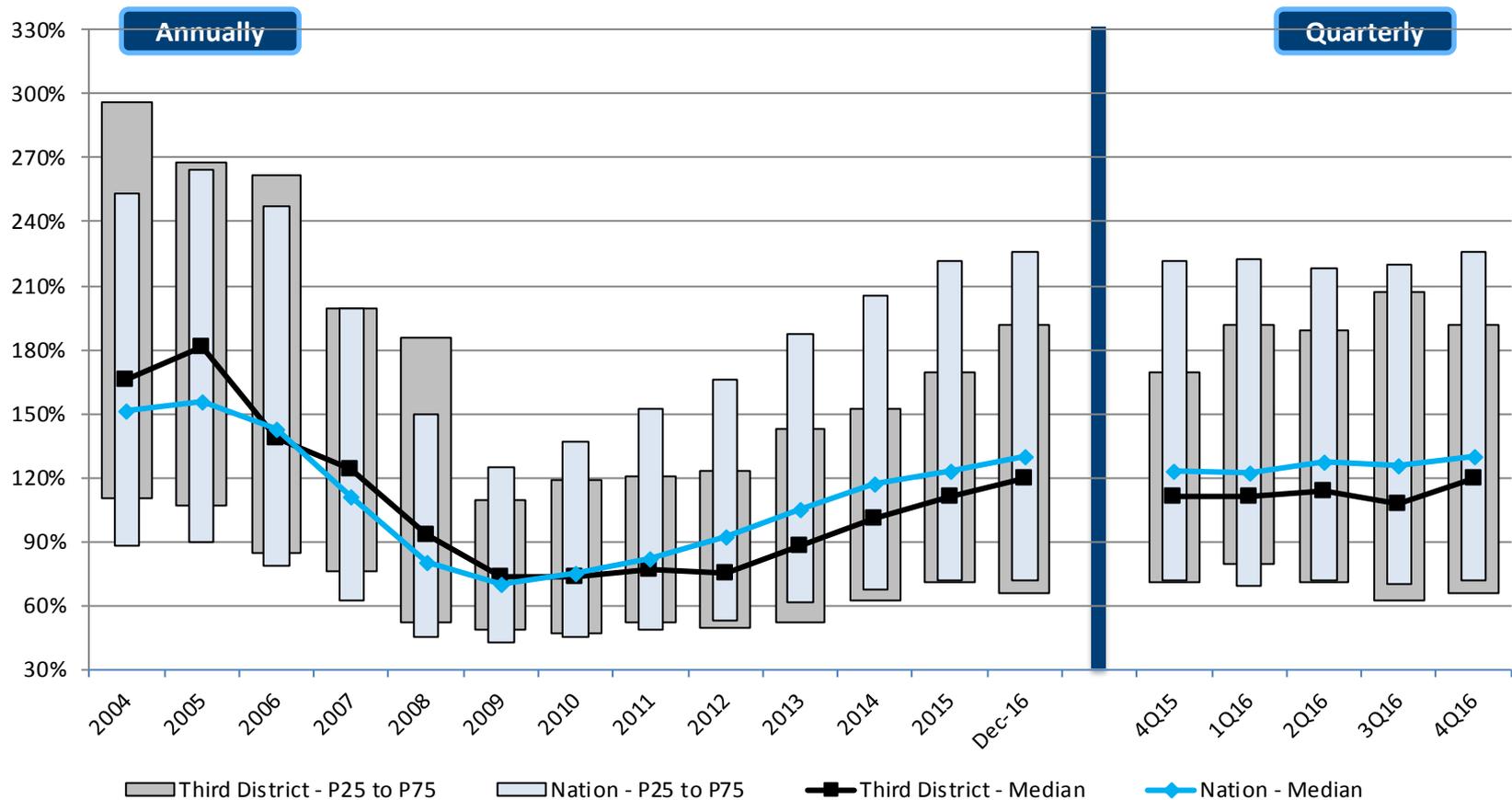
Net Charge-offs / Loans



The allowance for loan and lease losses (ALLL) reserve coverage ratio continues to improve due to improved asset quality metrics, not by increased provision expense.



Allowance for Loan & Lease Loss Coverage Ratio*

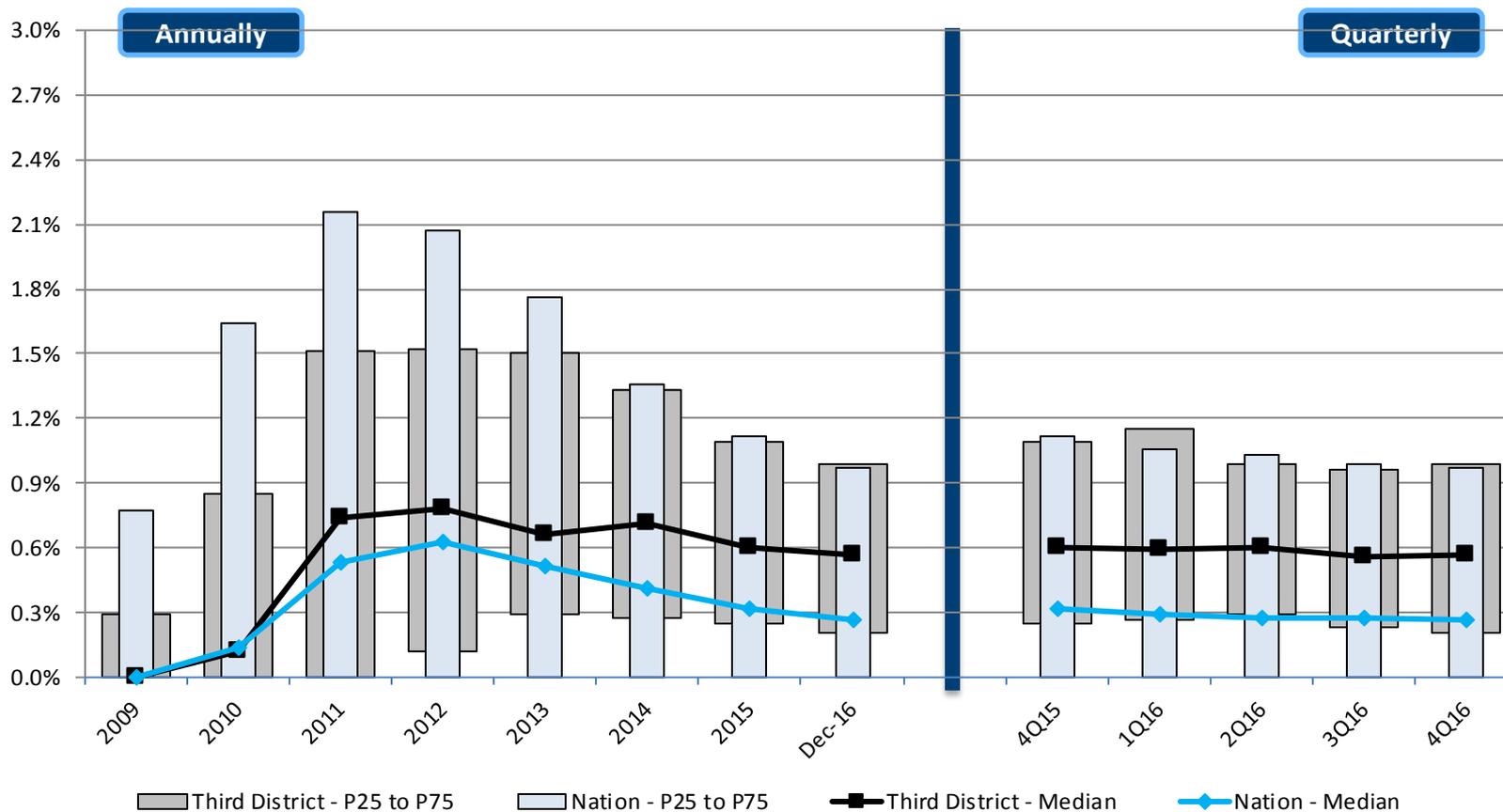


* The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.

Third District troubled debt restructurings remained stable; however, it is elevated compared with that of the nation.



Troubled Debt Restructurings*

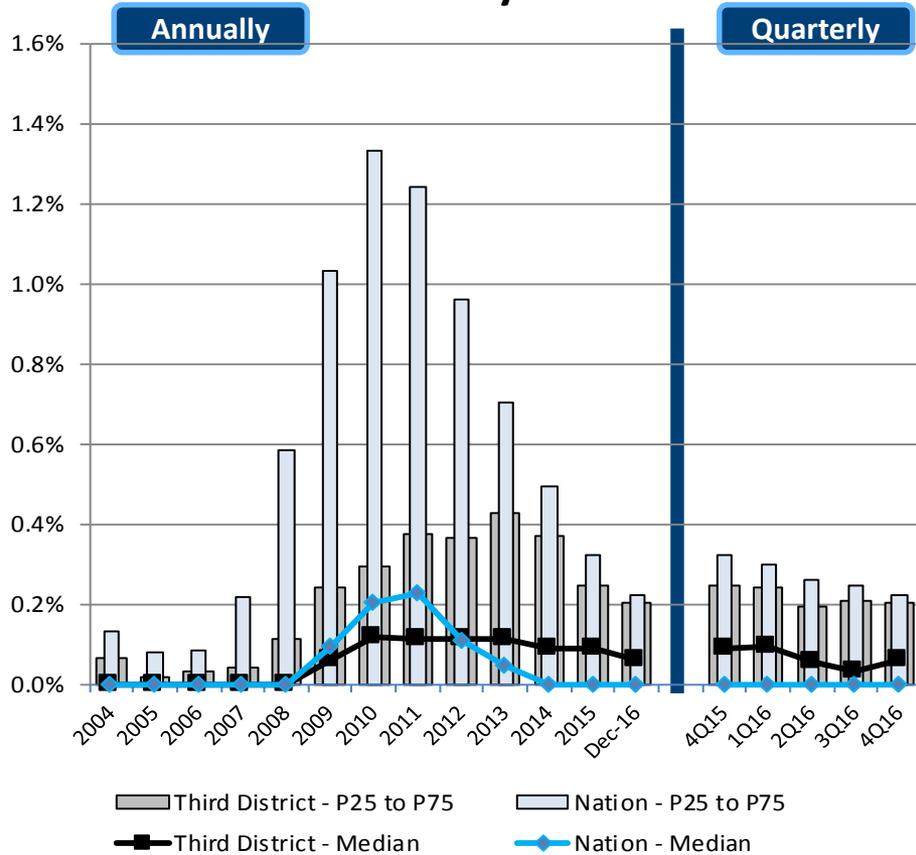


* Troubled debt restructurings (TDRs) were not included on the Call Report until the March 2009 reporting period.

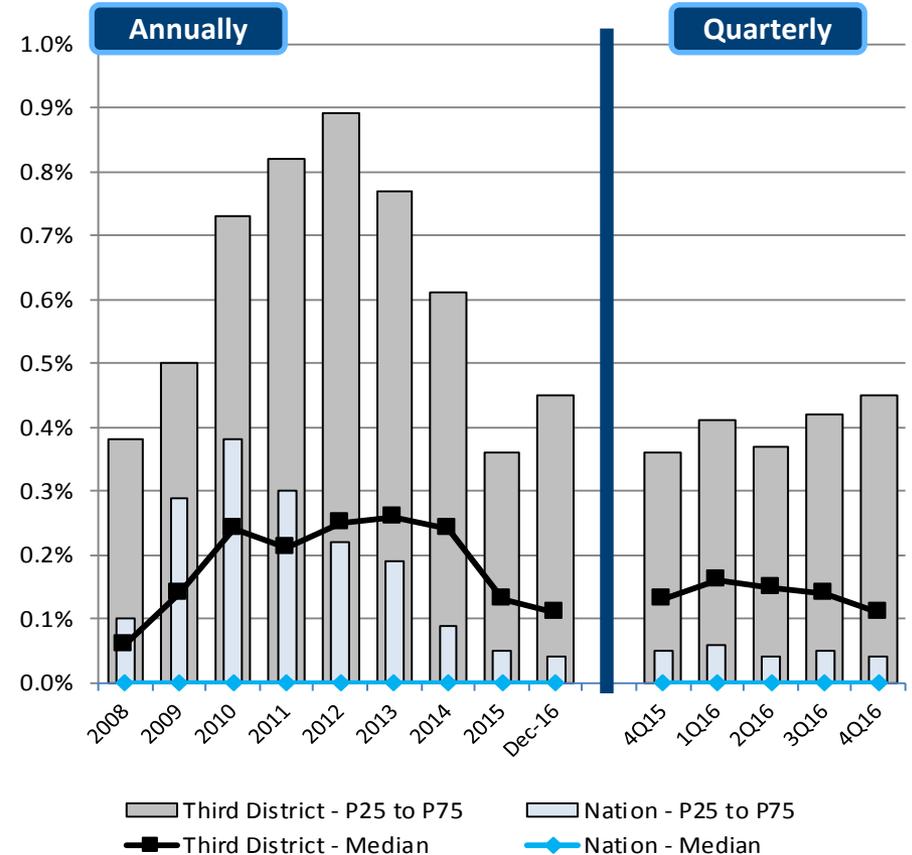
One- to four-family OREO continues to decrease, but the Third District trails in the foreclosure process due to the judicial foreclosure process in PA, DE, and NJ.



1-4 Family OREO*



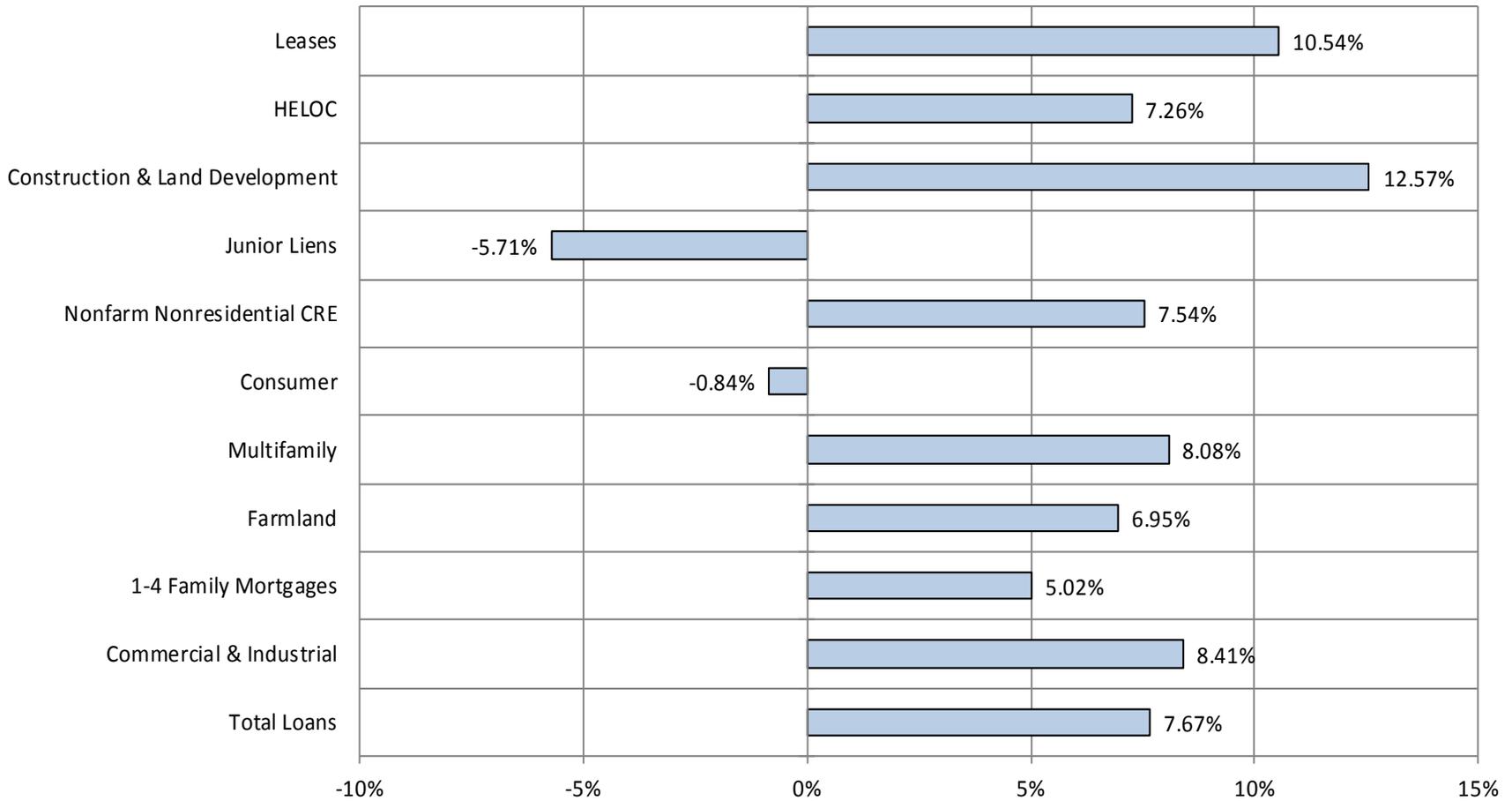
Loans in Process of Foreclosure**



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

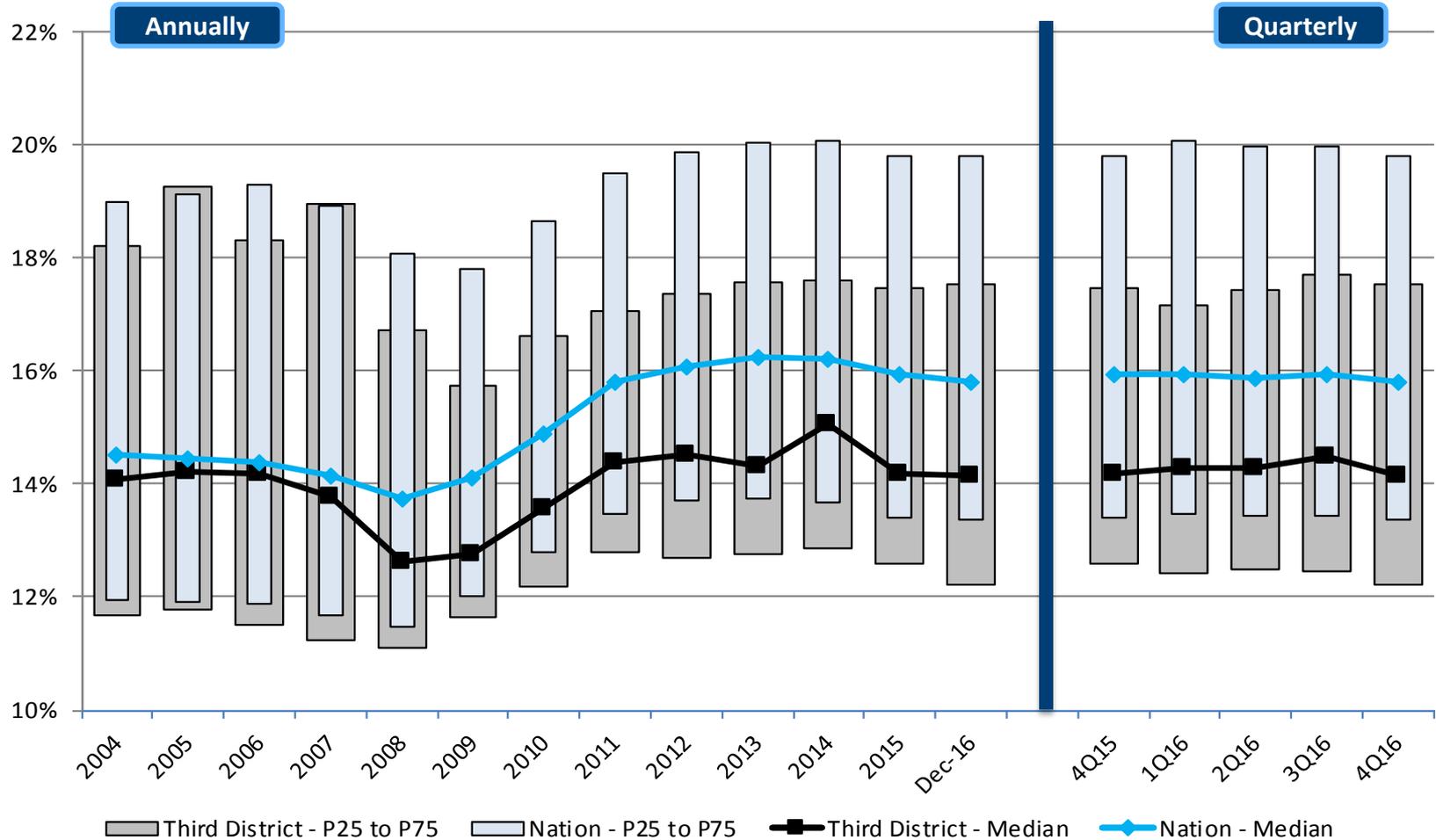


* This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 4.

Capital ratios have increased postcrisis; however, Third District capital levels have flattened since 2011 and remain below that of the nation.



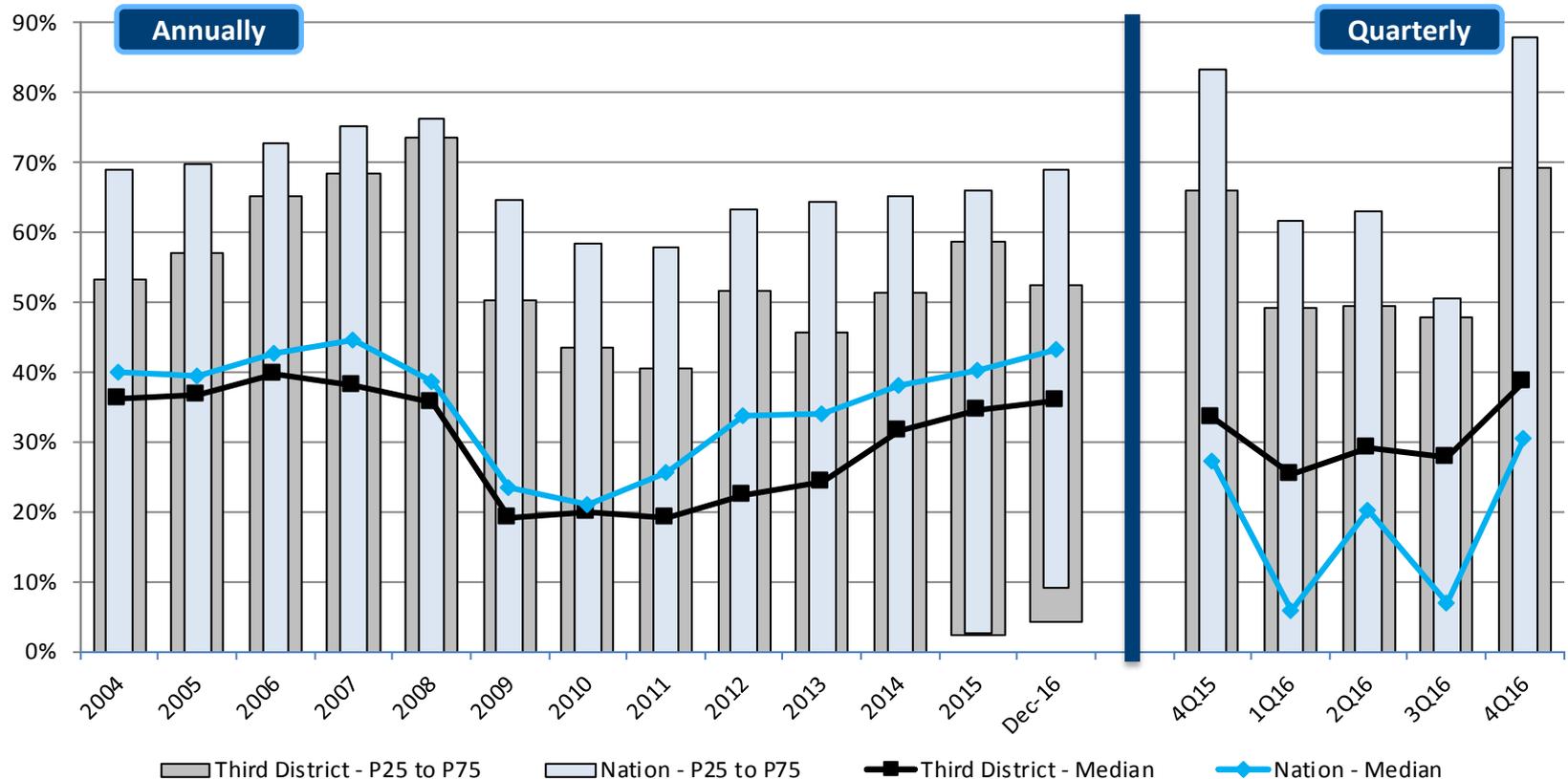
Total Risk-Based Capital



Median dividend payments in the Third District have increased and may outpace the nation in 2016.



Dividends*

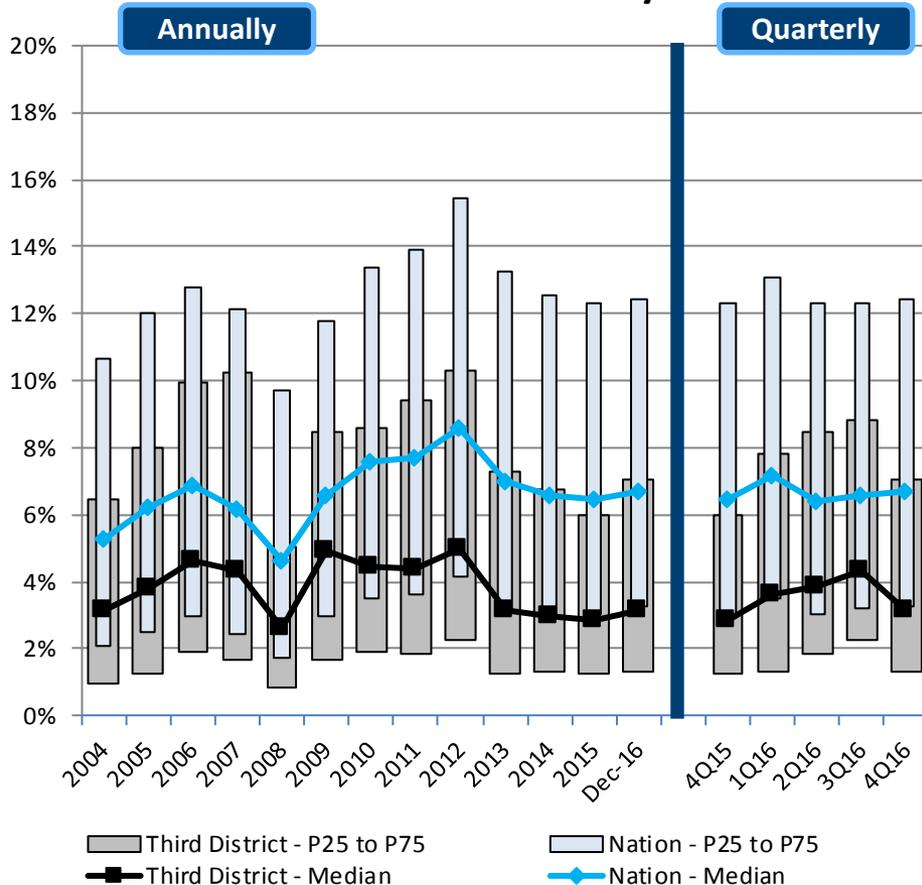


* Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income as dividends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

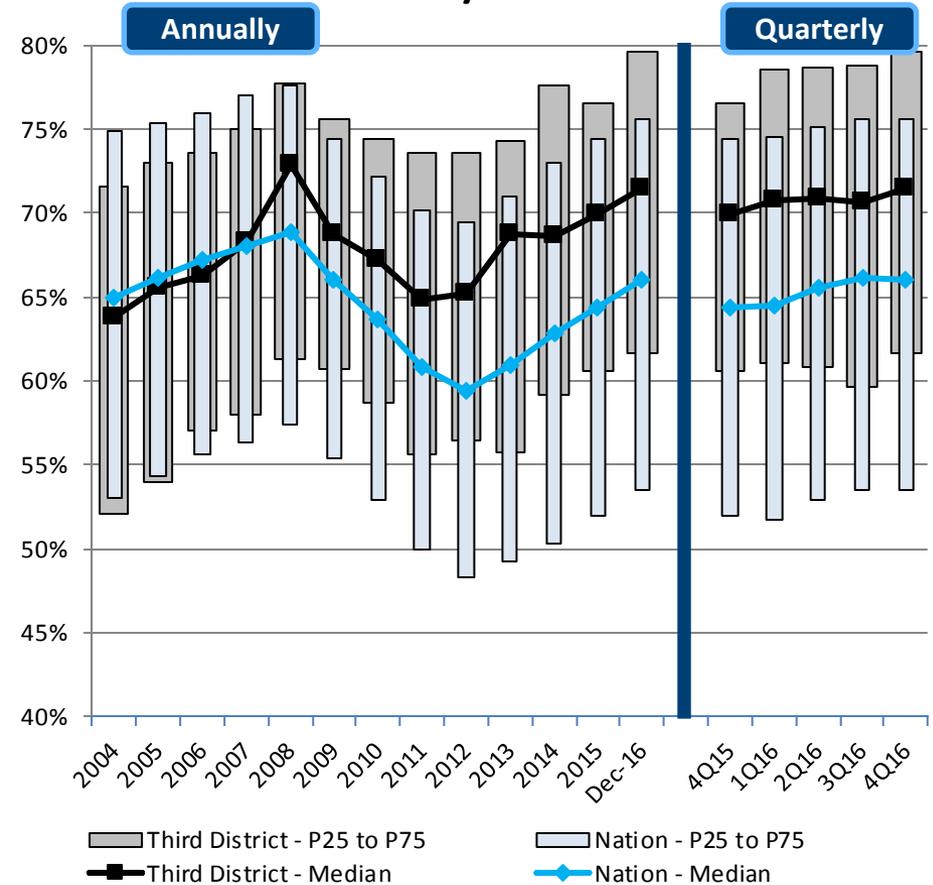
Third District banks hold fewer short-term investments compared with the nation. Additionally, the District continues to grow its loan portfolio, which may increase duration and interest rate risk depending on the loan type.



Short-Term Investments / Assets*



Loans / Assets

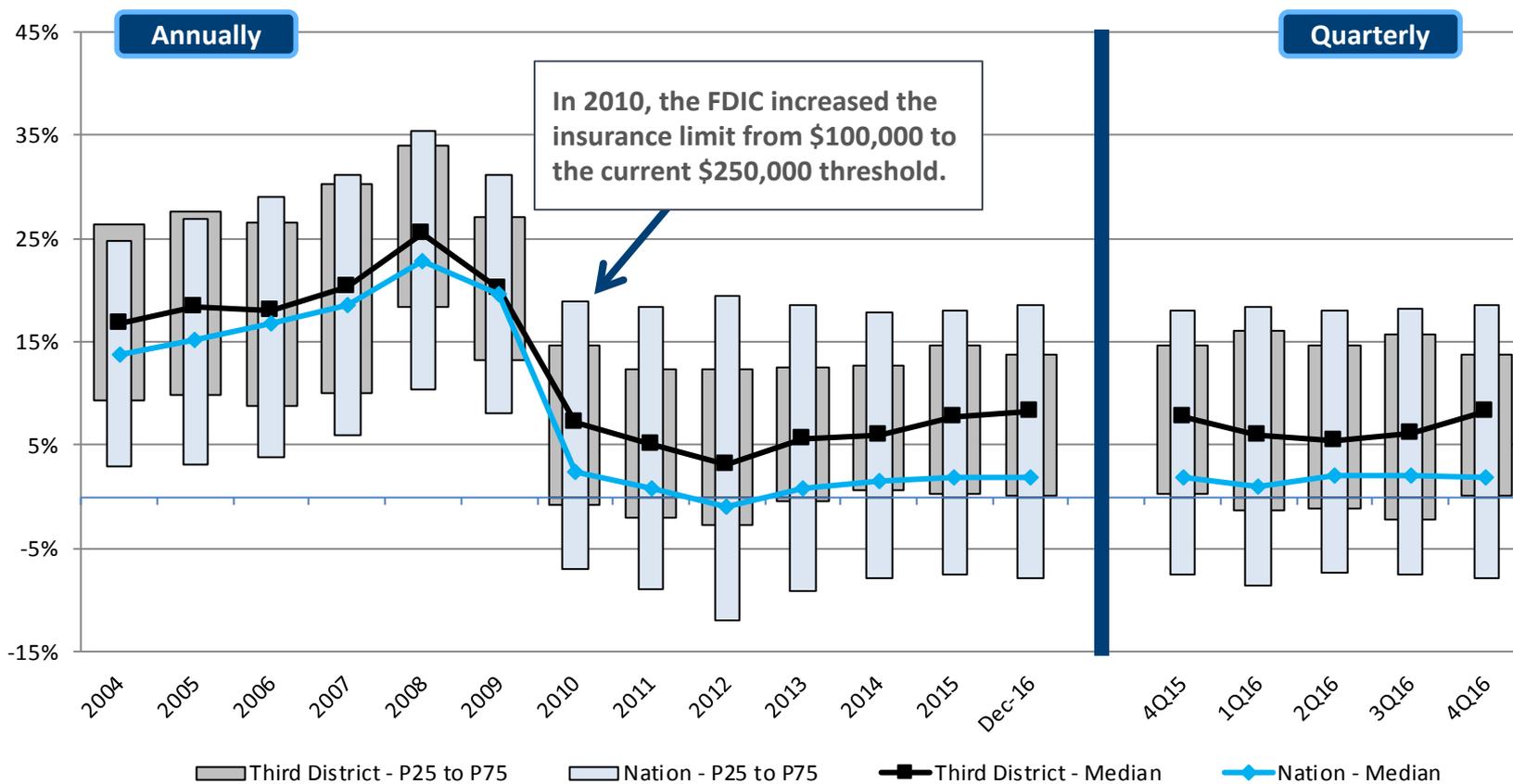


* Short-term investments equals the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

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

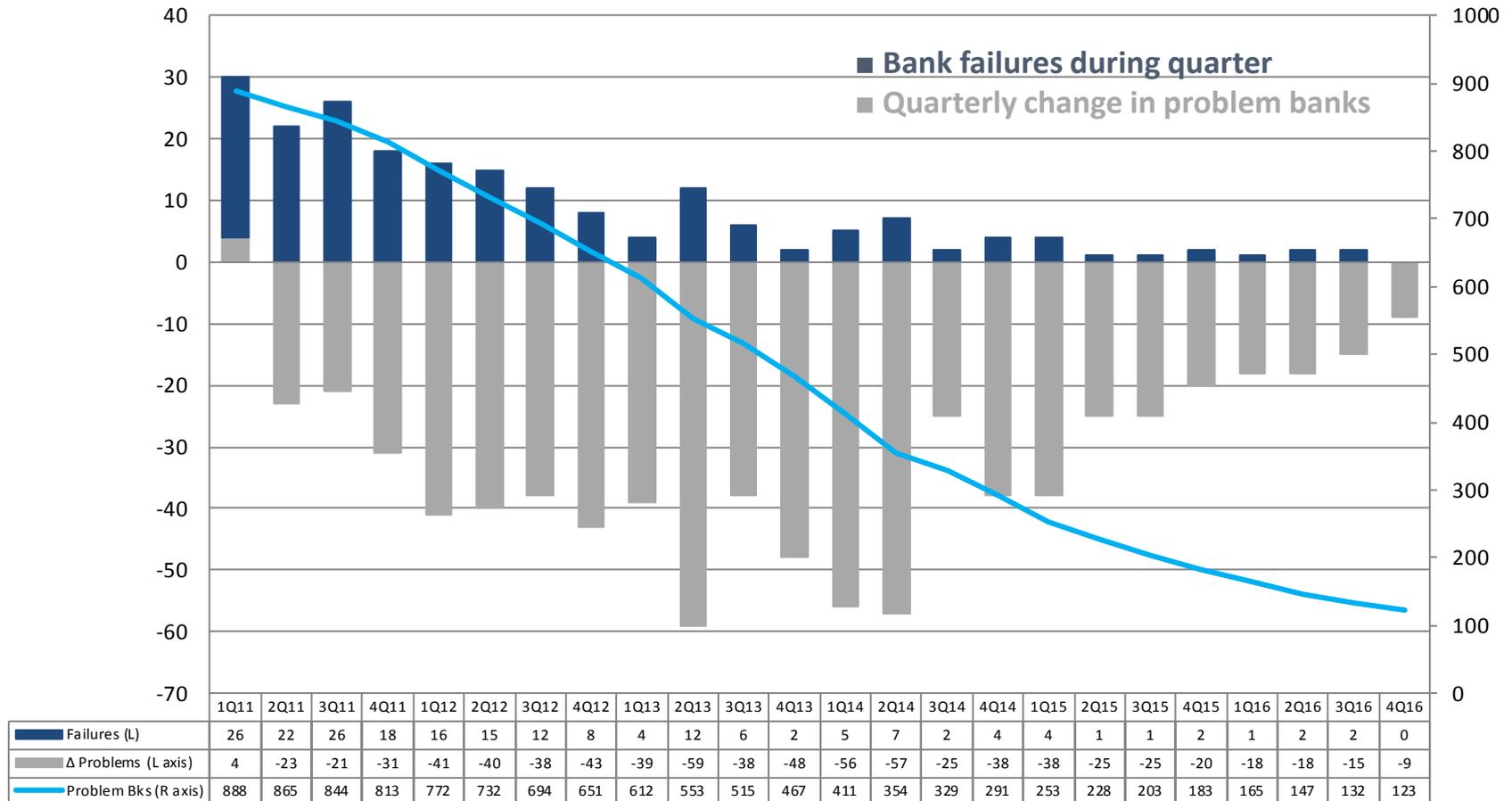


Net Noncore Funding Dependence*



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

Problem banks within the nation fell by 9 to 123 as of 4Q2016, and no banks failed in that quarter.



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.