



# Third District Banking Conditions as of March 31, 2017

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



- Challenges within the banking environment continue to impact Third District bank financial performance primarily due to:
  1. Earnings augmented with nonrecurring sources of income, which is not sustainable over a longer credit cycle.
  2. Third District banks maintaining a lower yield on assets and a higher cost of funds when compared with the nation, thus negatively impacting the net interest margin and core earnings as a whole.
  3. Organic growth in geographic areas where there is elevated competition for loans and deposits.
- Third District and national asset quality metrics continue to exhibit a stable, improving trend and are below 2008 levels. However, the negative or nonexistent growth in the allowance for loan and lease losses (ALLL) may pose a problem if credit quality begins to show signs of deterioration.
- Capital ratios continue to increase mostly as a result of earnings accretion; however, Third District capital ratios continue to remain below the nation.
- Third District banks' reliance on noncore funding sources continues to outpace the industry. This is primarily a result of increased competition on core deposit gathering within the District.
- Interest rate risk has subsided throughout much of the banking industry because many banks adjusted their balance sheet to reduce the adverse effects of potential rising interest rates.
- The number of problem banks fell by 11 banks to 112 as of 1Q2017. This represents the lowest number of problem banks since 2008.
- 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 and securities, credit cards, and auto loans
  3. Model risk management (SR 11-7)
  4. Management succession and strategic planning

# Section 2: Conditions of Third District Commercial Banks



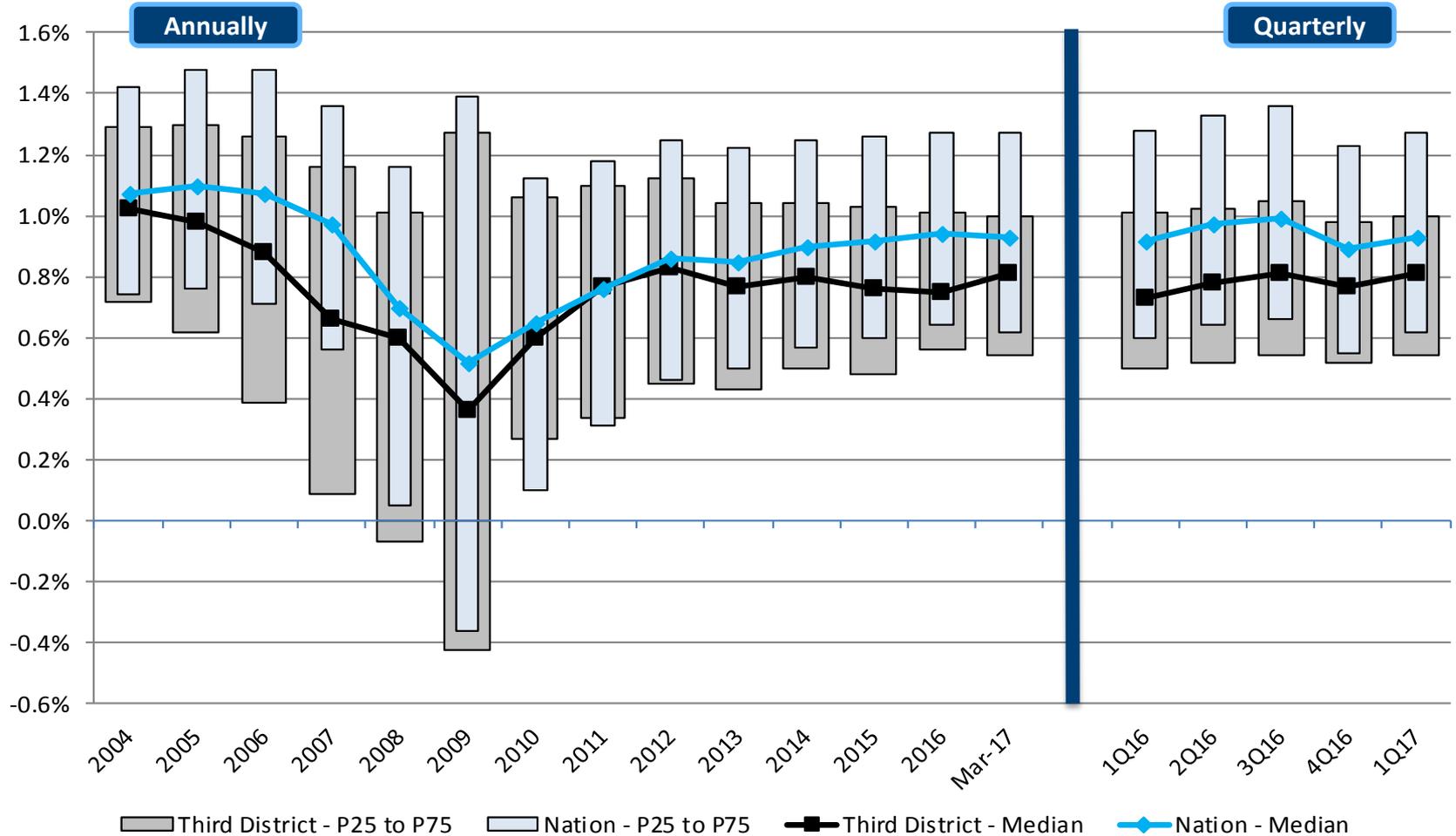
## Reporting Methodology

- The quarterly **Reports of Condition and Income (Call Report)** and **Uniform Bank Performance Report (UBPR)** are the primary sources of all information in this report unless otherwise noted.
- Slides in this section focus on trends among the **104 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 **March 31, 2017**:
  - 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 over the reported time period and has changed minimally since 2013.



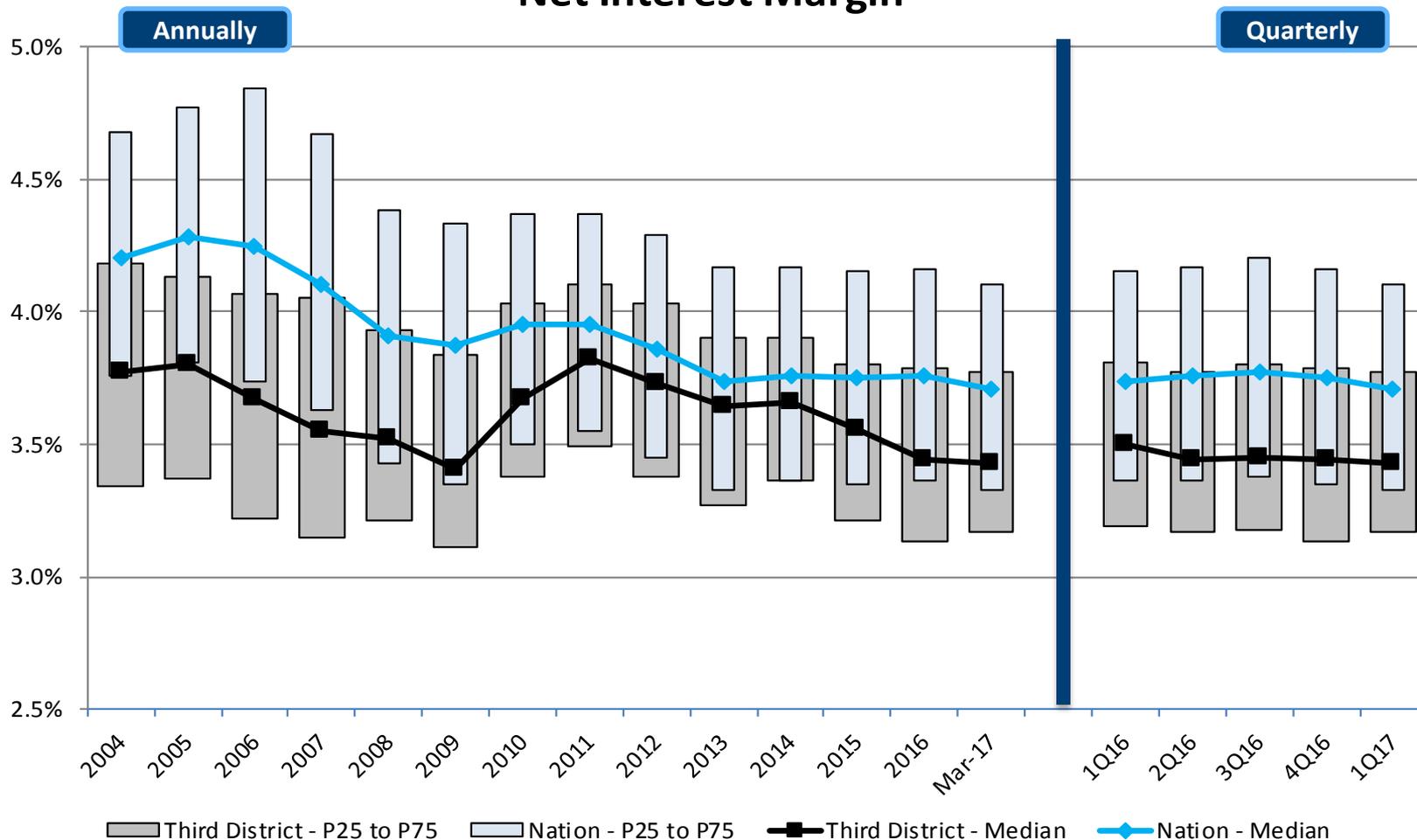
## Return on Average Assets



The competitive loan and deposit environment within the Third District continues to compress the net interest margin (NIM) as of 1Q2017. The compression is primarily a result of the Third District's lower yield on earning assets and greater cost of funds when both are compared with the nation.



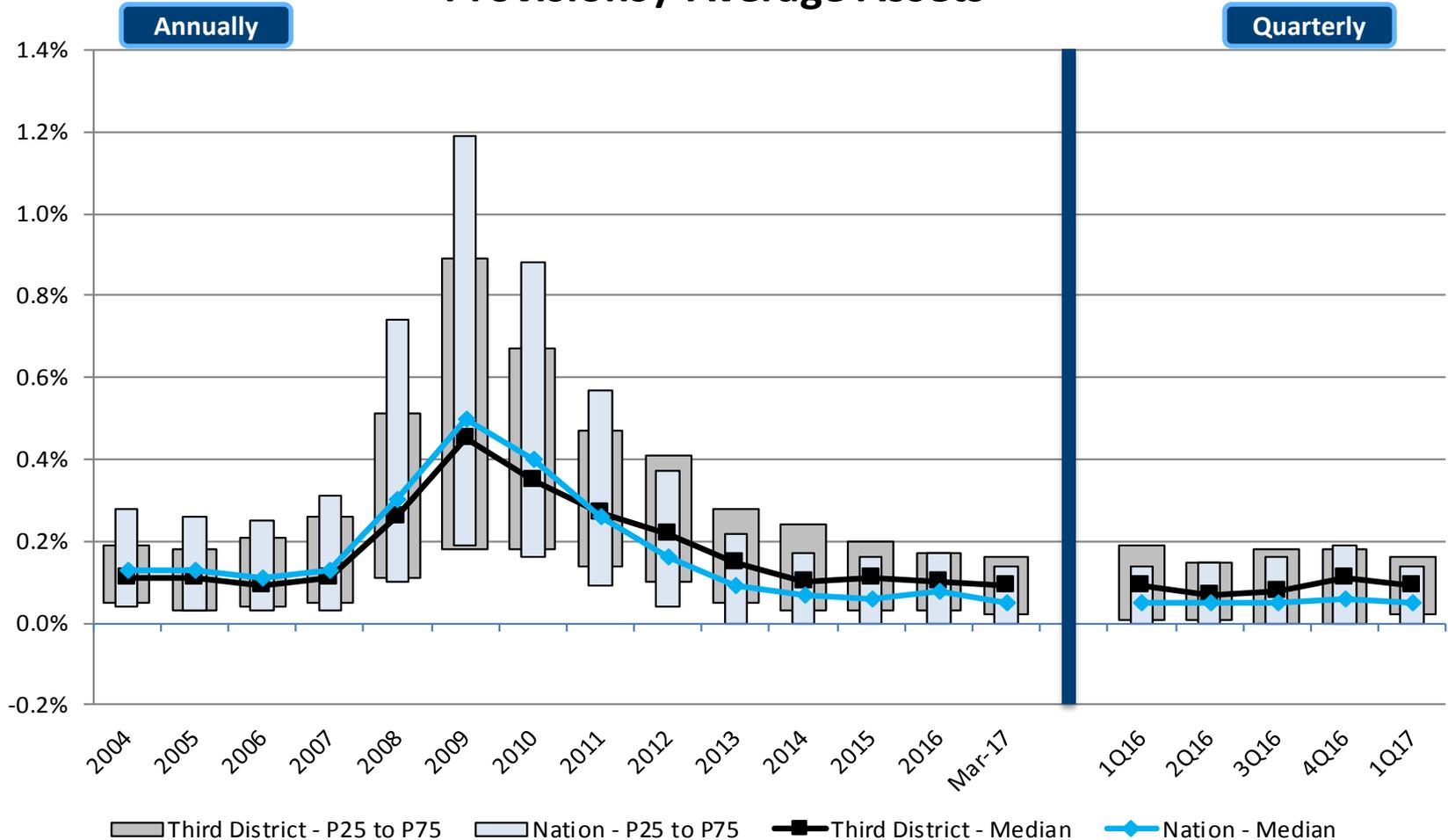
## Net Interest Margin



The provision expense continues to trend around or below precrisis levels. Given the current benign credit markets, the low level of provisioning is helping augment earnings. However, this trend will not be sustainable if the credit cycle begins to weaken.



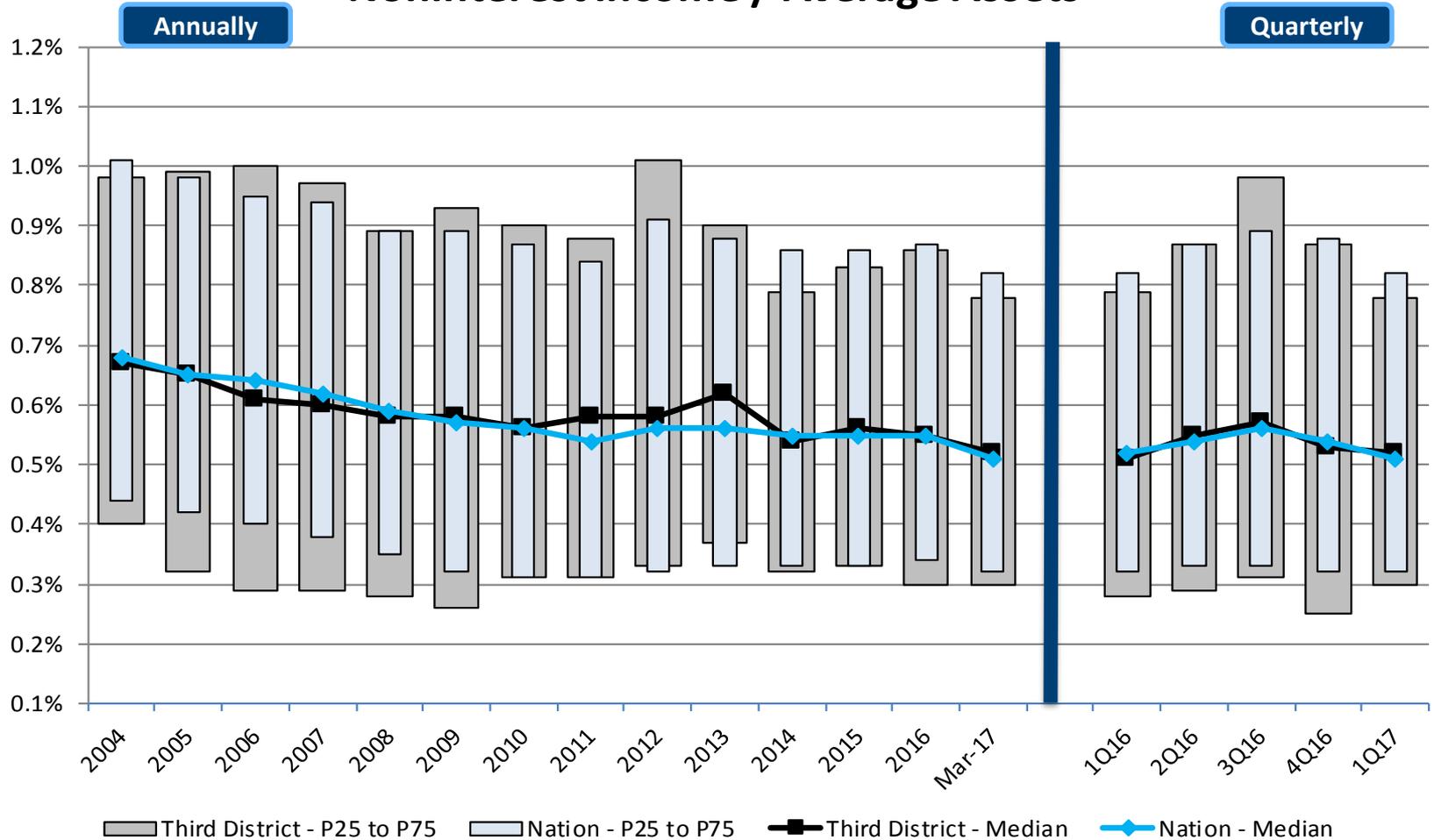
## Provisions / Average Assets



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.



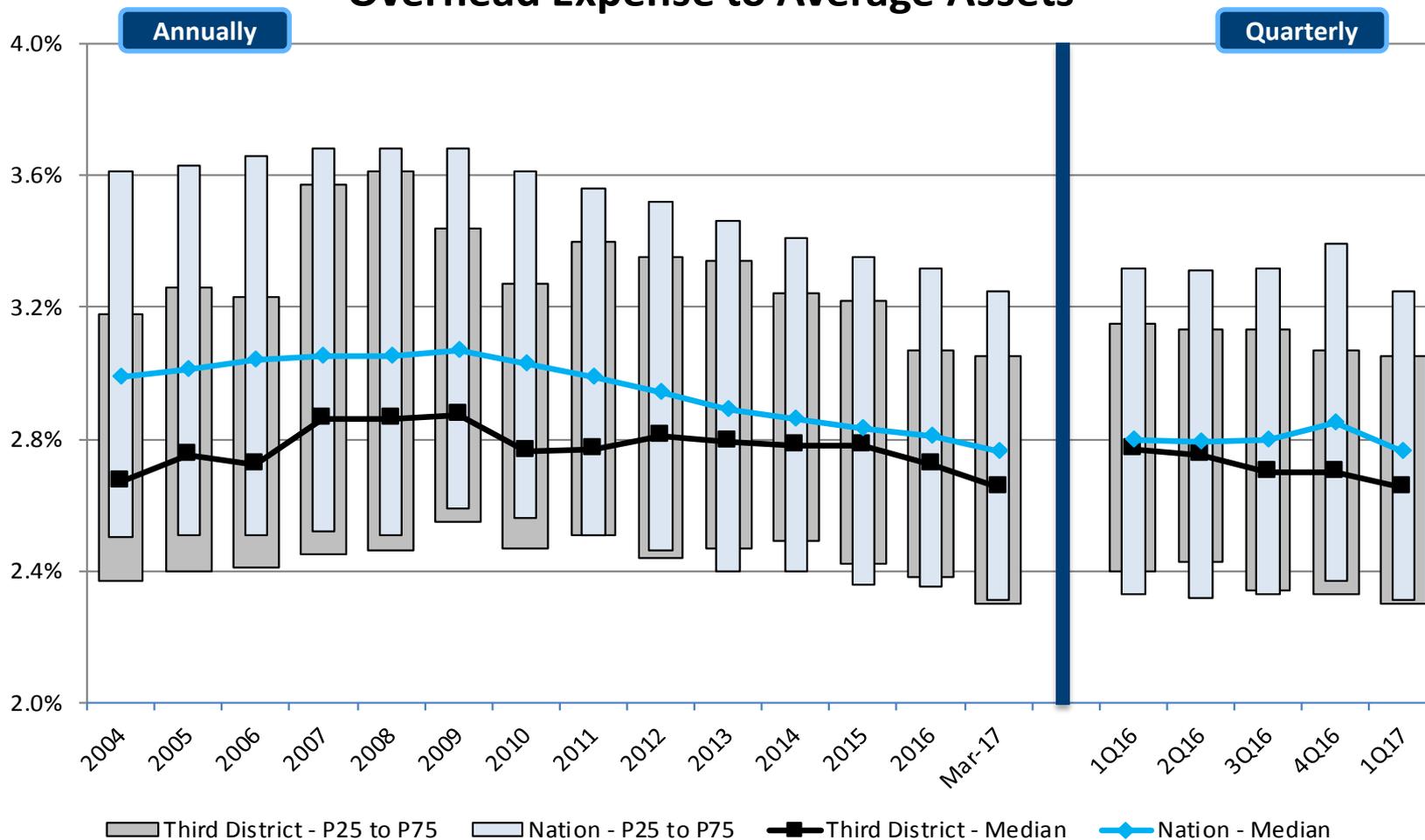
## Noninterest Income / Average Assets



Median overhead expense has decreased in the District and nation since 2010. The lower overhead costs generate a positive impact on ROAA.



## Overhead Expense to Average Assets

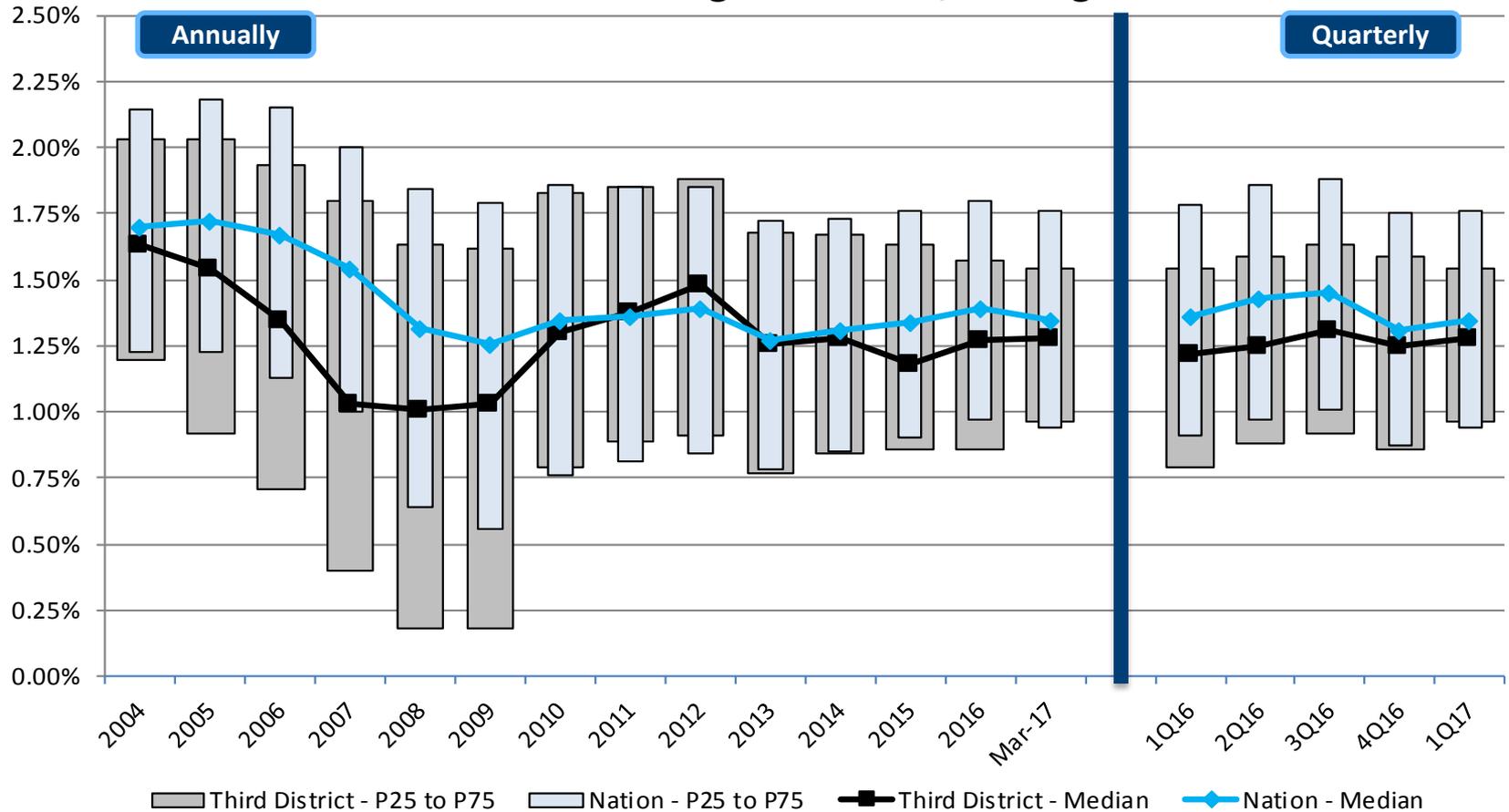


Core profitability has flattened within the District and the nation, with both entity types' earnings results plateauing in recent quarters.



## Core Profitability

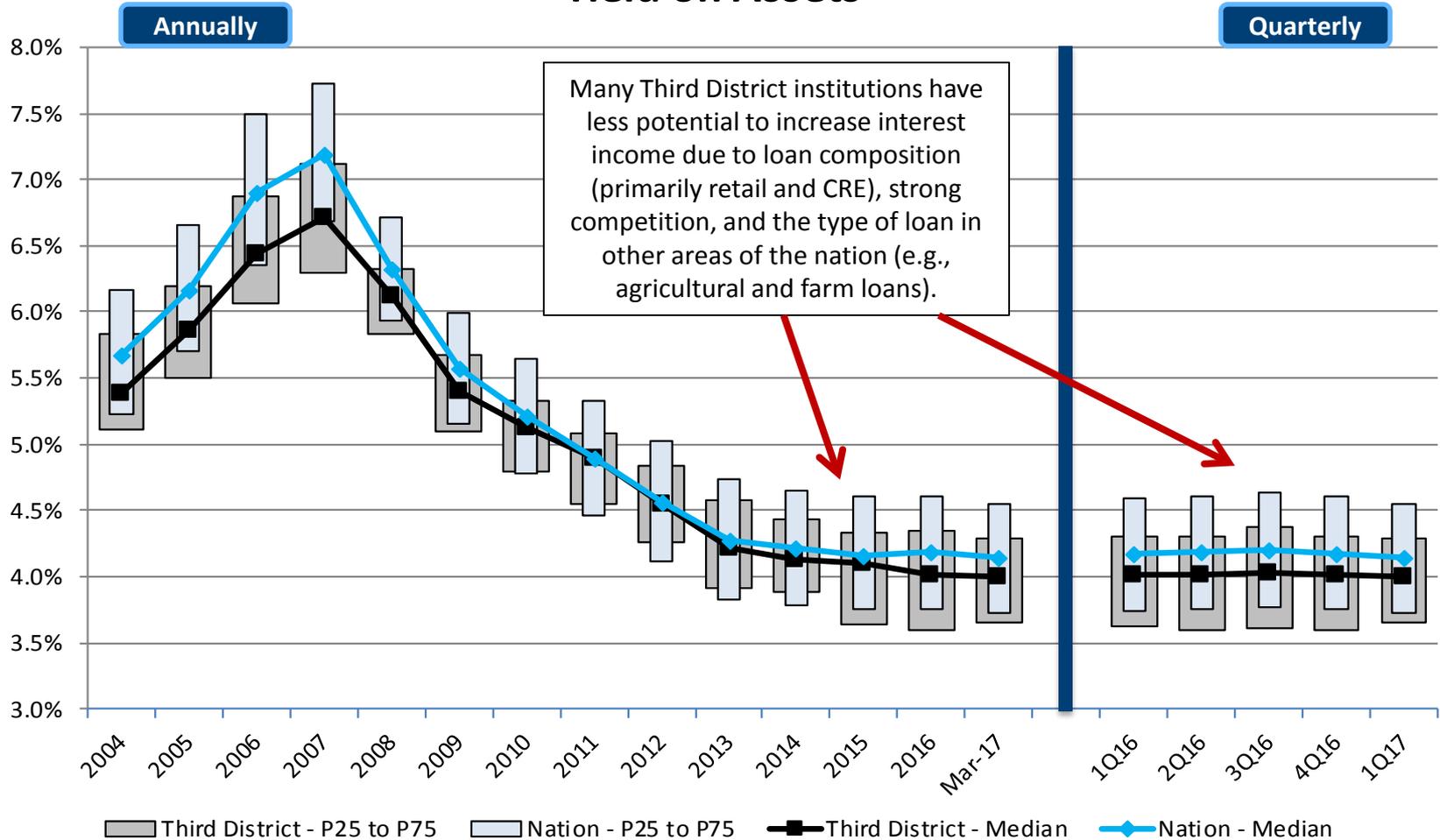
### Pre-Tax Income Excluding Provisions / Average Assets



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



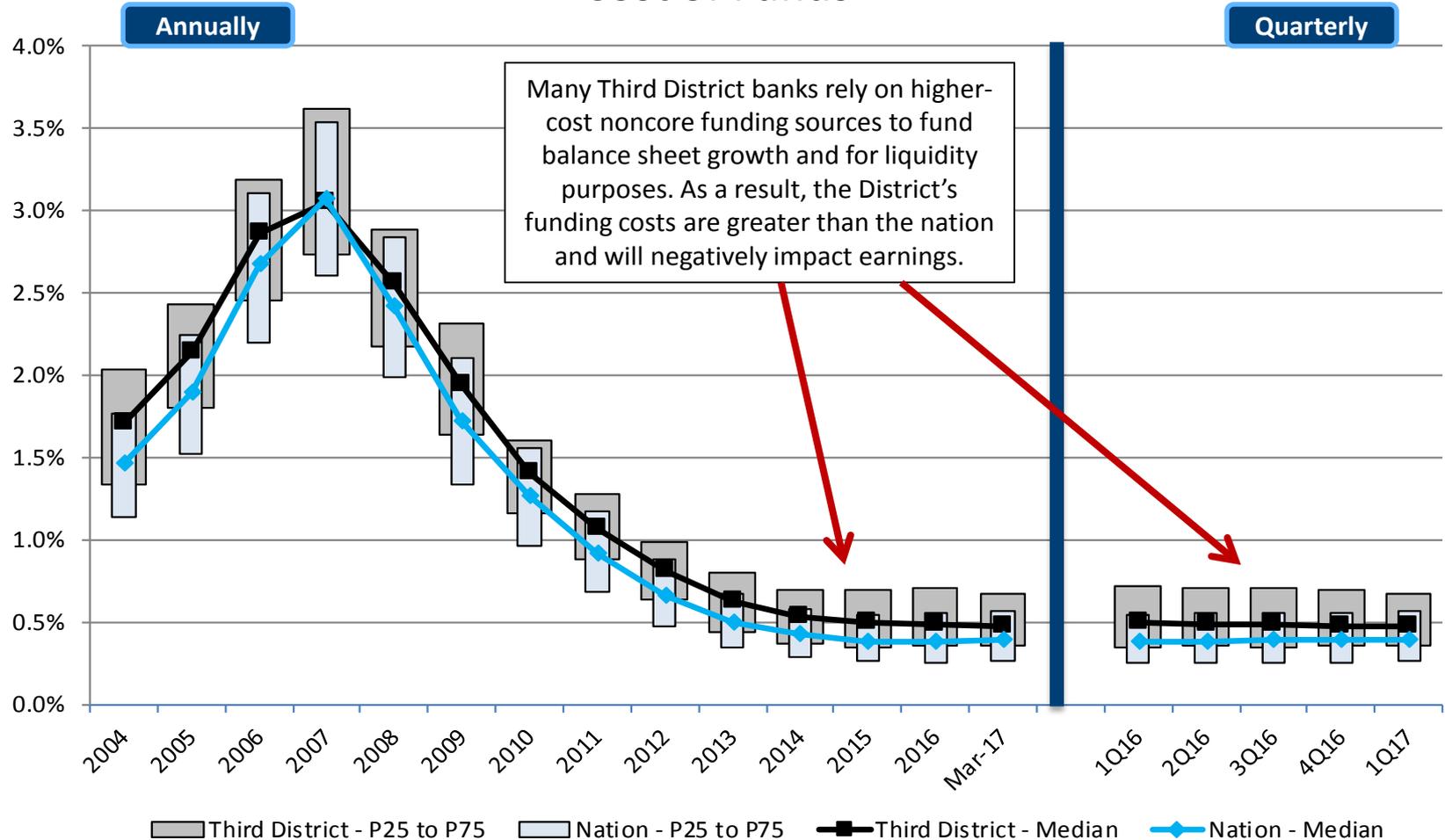
## Yield on Assets



Although many banks are able to reduce their cost of funds within the current interest rate environment, the elevated deposit competition has led to many Third District institutions using noncore funding sources. These noncore funding costs remain elevated when compared with the nation.



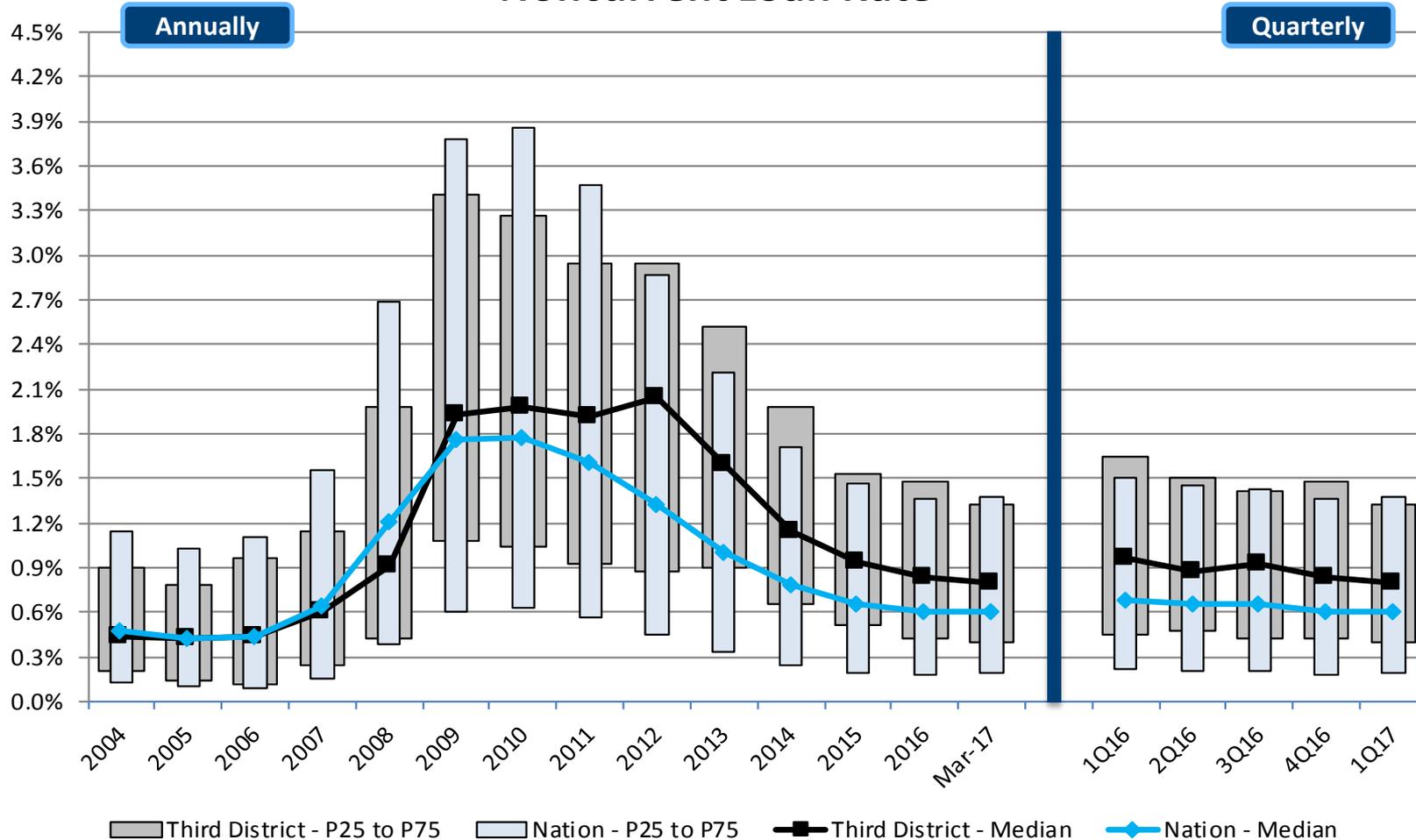
## Cost of Funds



The noncurrent loan rate has declined in recent years, given the strong performance of the credit industry. The District's median result has remained above that of the nation's since 2009.



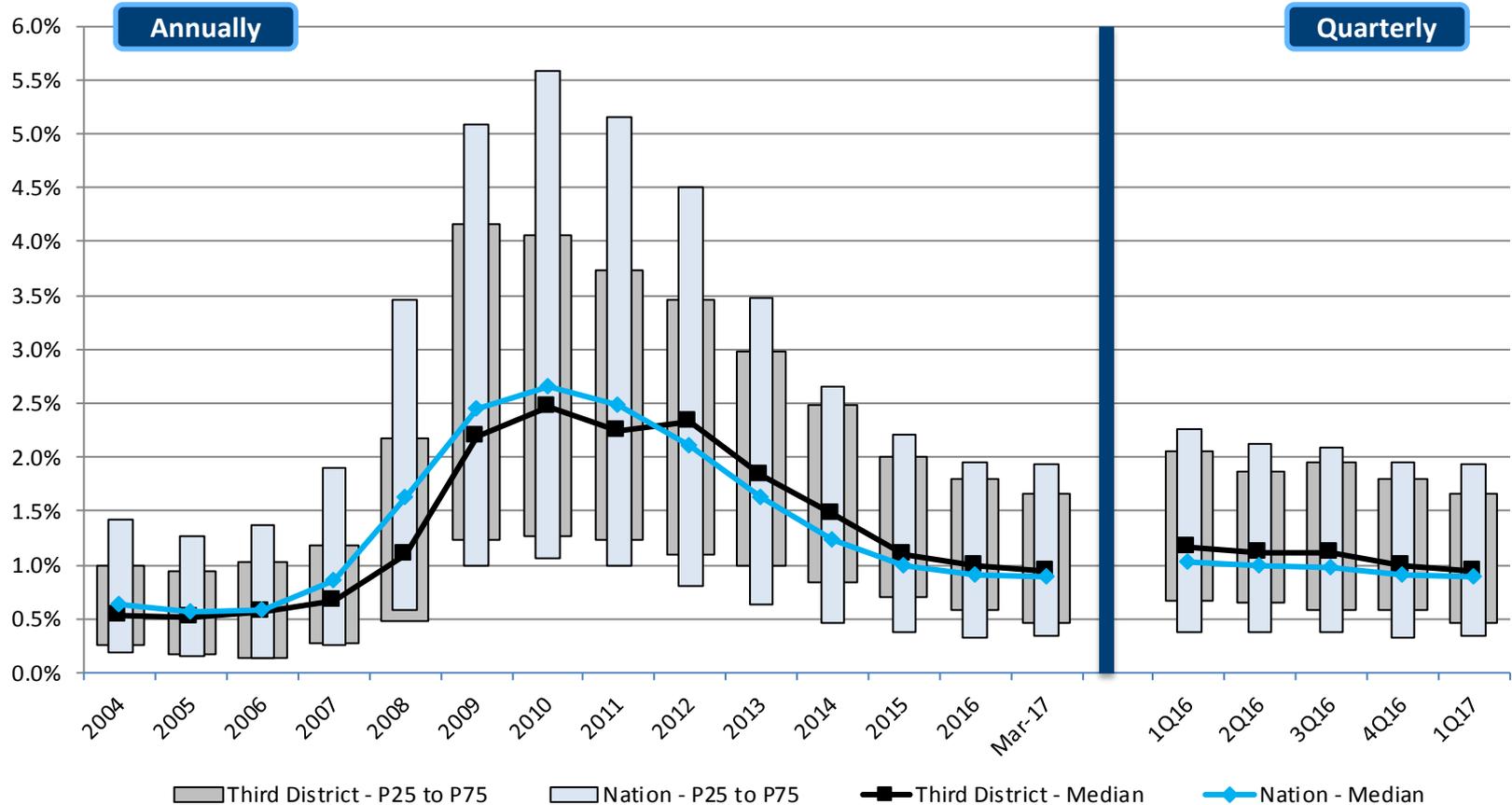
## Noncurrent Loan Rate



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



## Nonperforming Assets\*

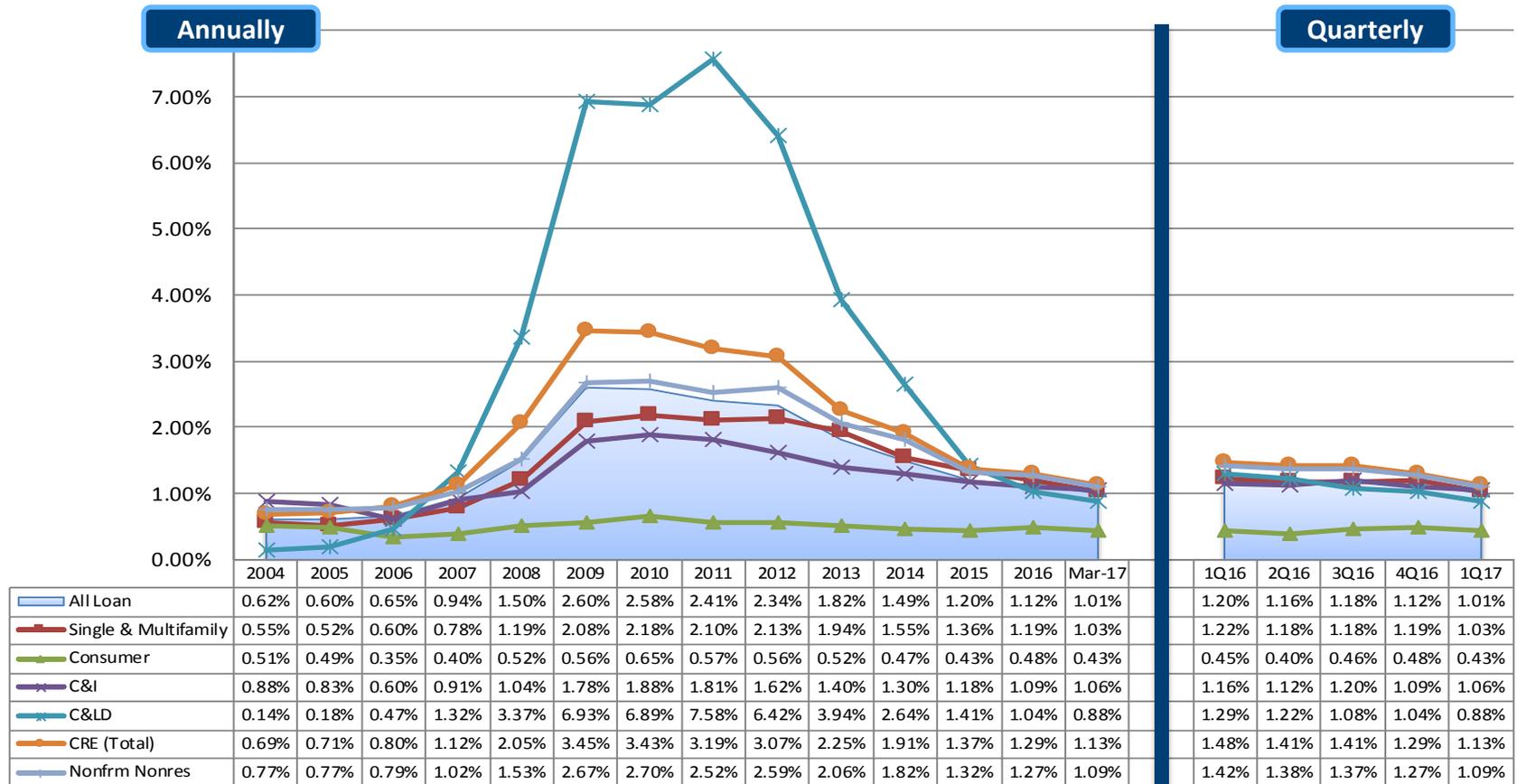


\* NPAs (nonperforming assets) are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans).

Third District loan performance shows significant performance improvement among the principal loan categories. Although Total CRE loan delinquency remains the highest category, the level of noncurrent loans has fallen meaningfully since 2007.



## Noncurrent Loan Ratios by Loan Category

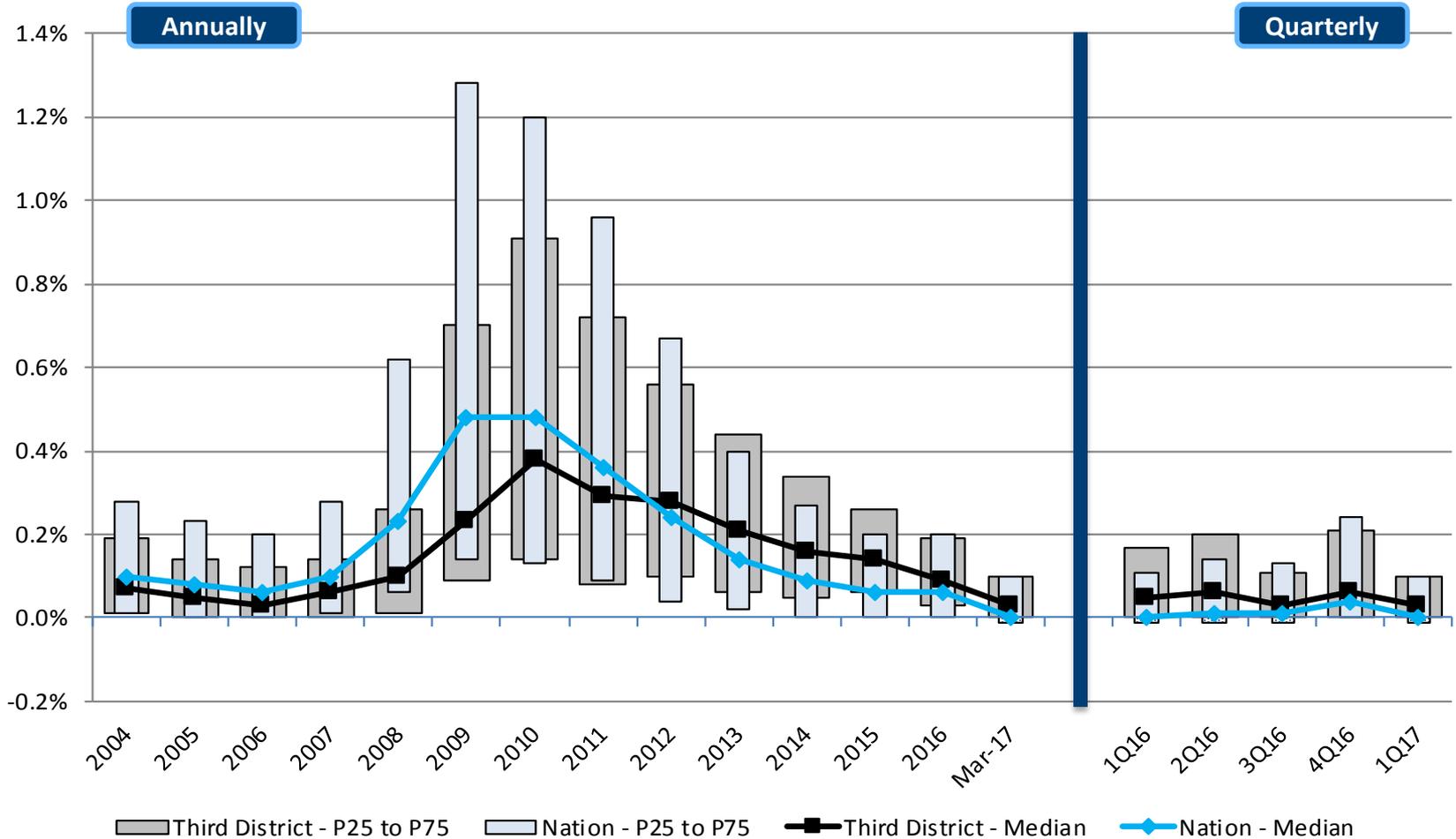


This chart uses a **10% capped mean, or winsorized mean**, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on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

# Third District net charge-off rates have continued to decline steadily since 2010 and are now below precrisis levels.



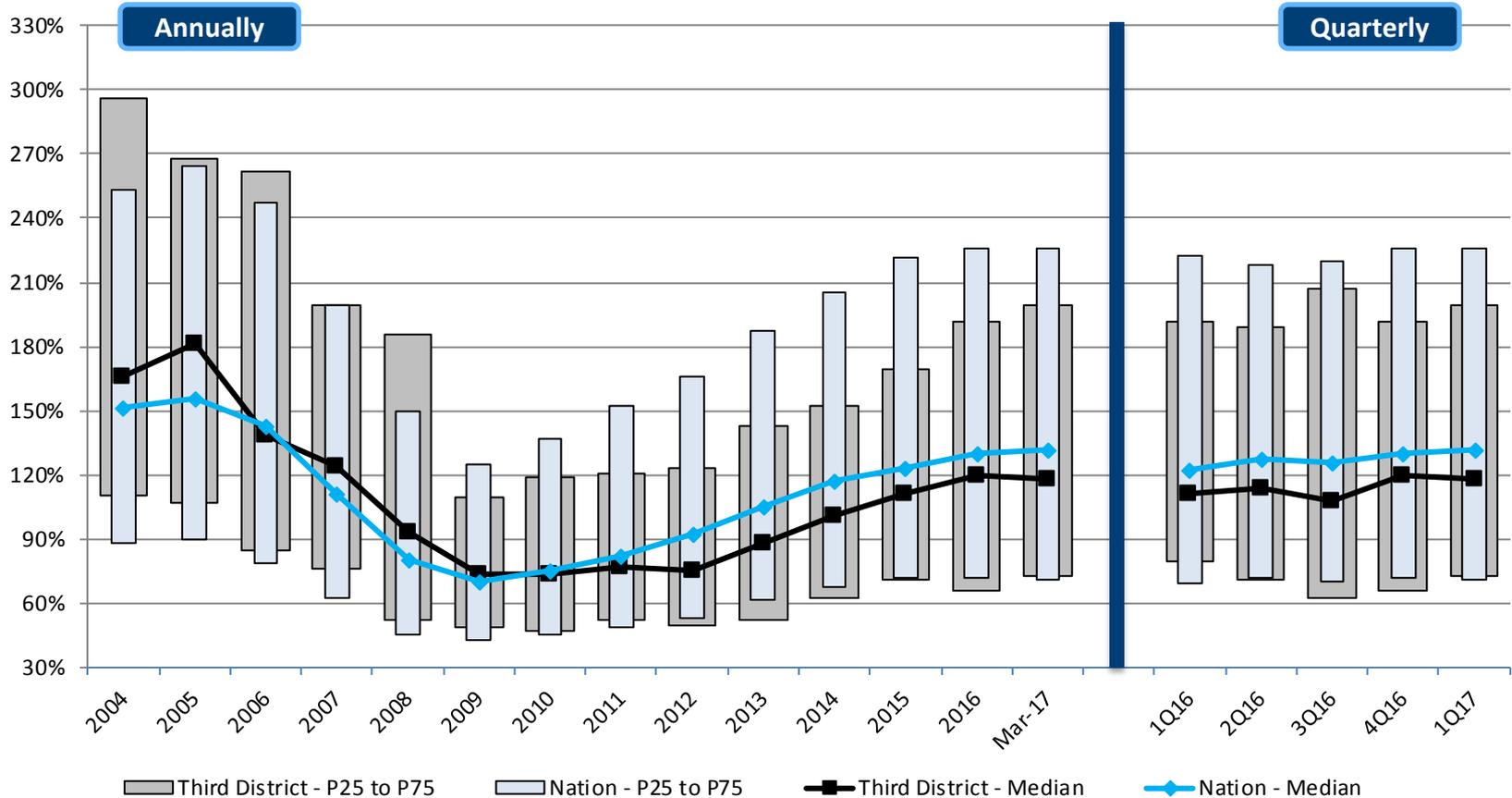
## Net Charge-offs / Loans



The allowance for loan and lease losses (ALLL) reserve coverage ratio continues to increase as a result of improved asset quality credit metrics, not by building the ALLL via the provision expense.



### Allowance for Loan & Lease Loss Coverage Ratio\*

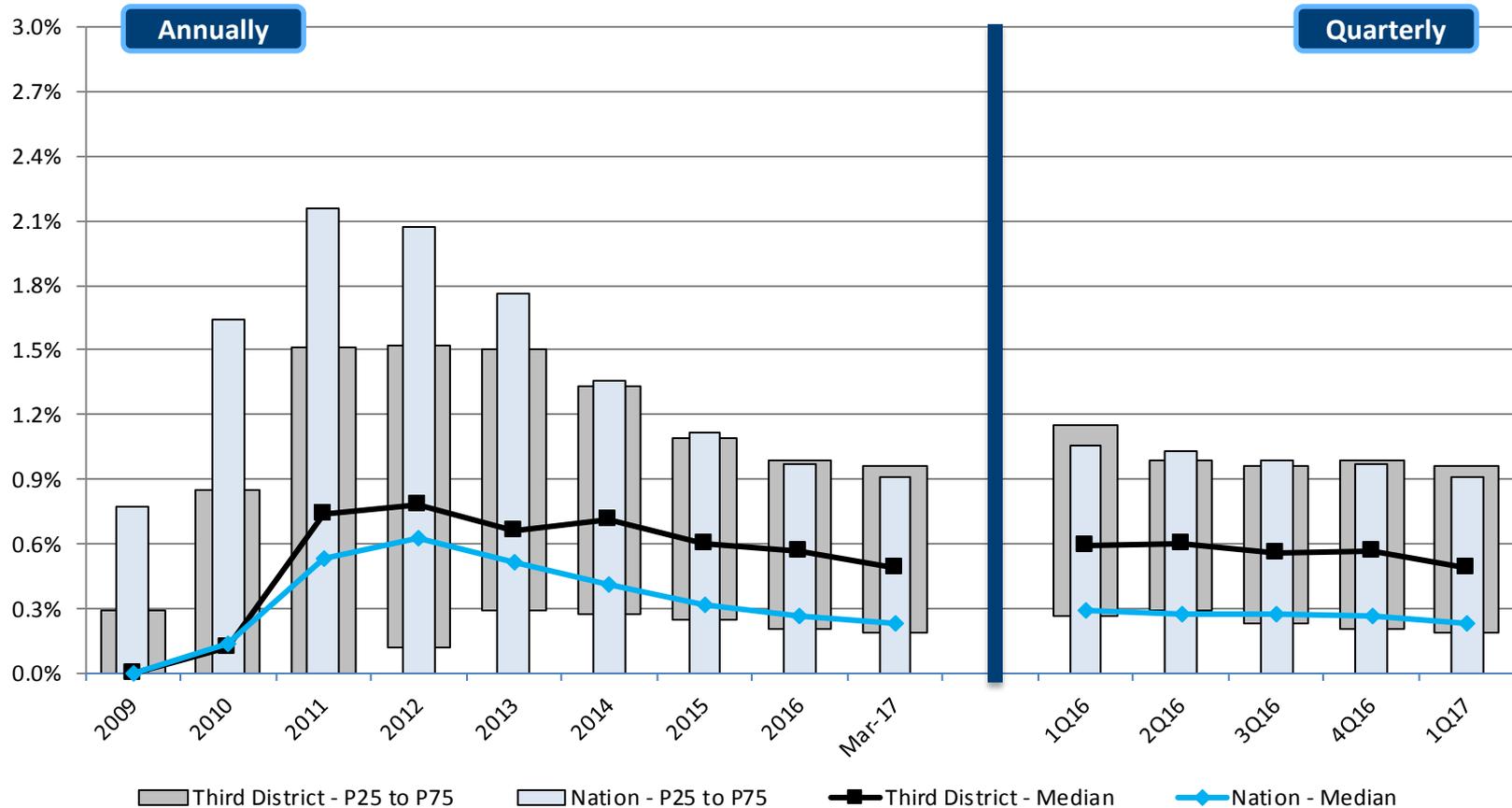


\* The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.

# The median Third District troubled debt restructurings remained stable and has had very little movement since 2011.



## Troubled Debt Restructurings\*

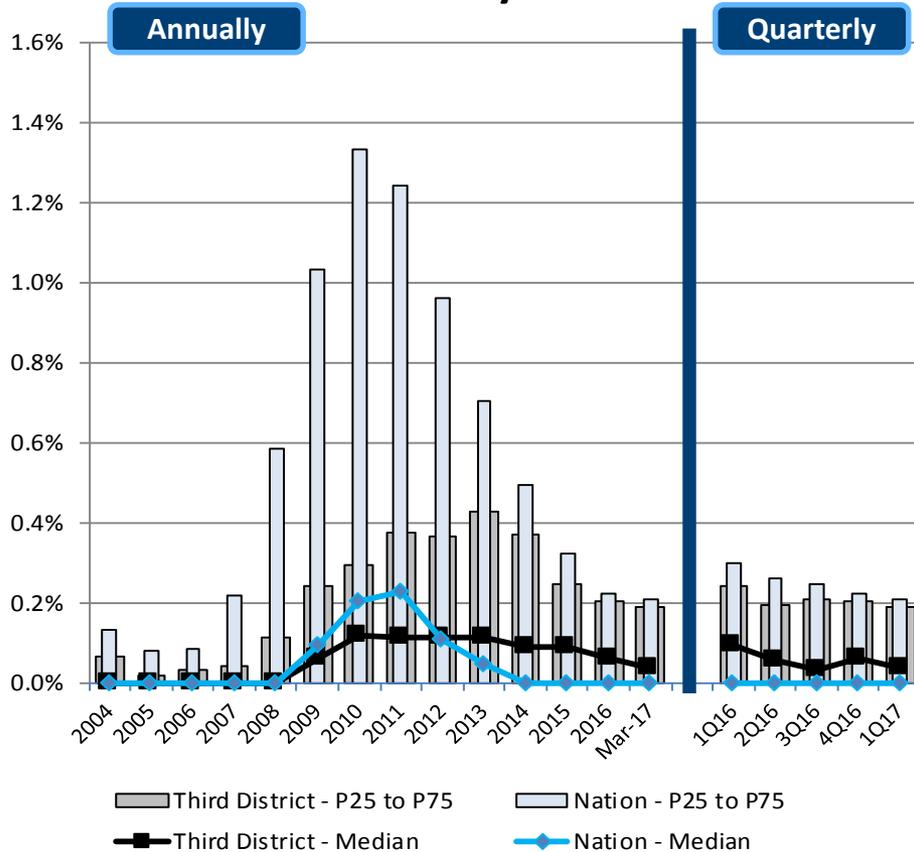


\* Troubled debt restructurings (TDRs) were not included on the Call Report until the March 2009 reporting period.

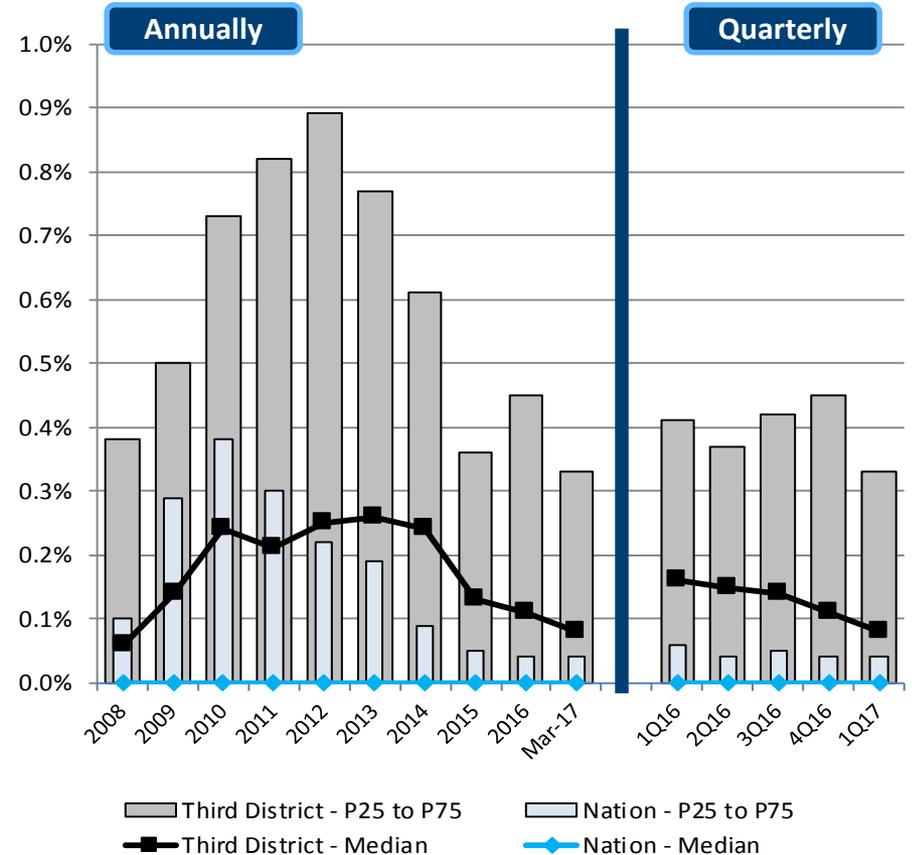
One- to four-family OREO continues to decrease in the District and the nation. However, the Third District trails in the foreclosure process due to the judicial foreclosure process in PA, DE, and NJ.



**1-4 Family OREO\***



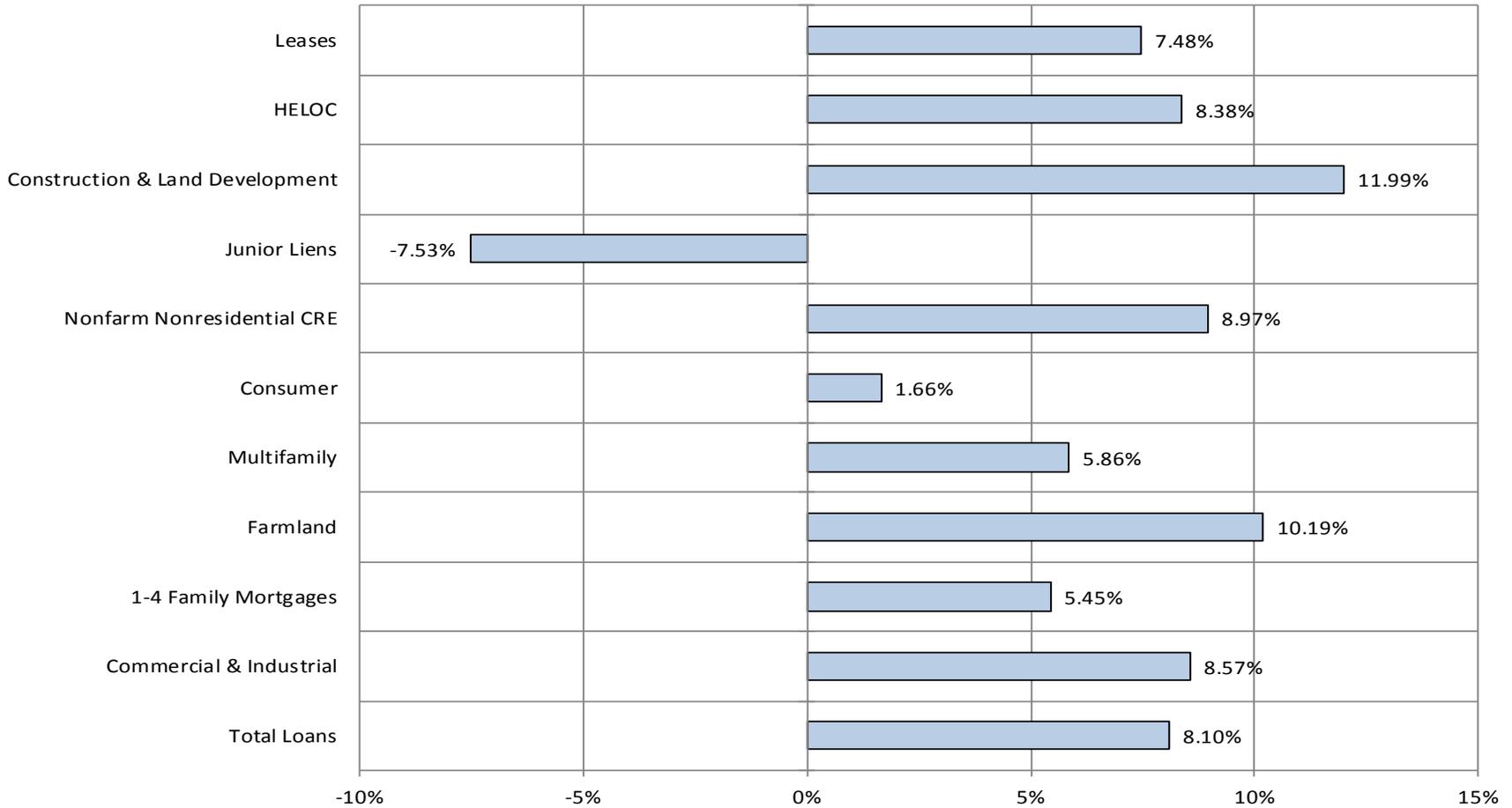
**Loans in Process of Foreclosure\*\***



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

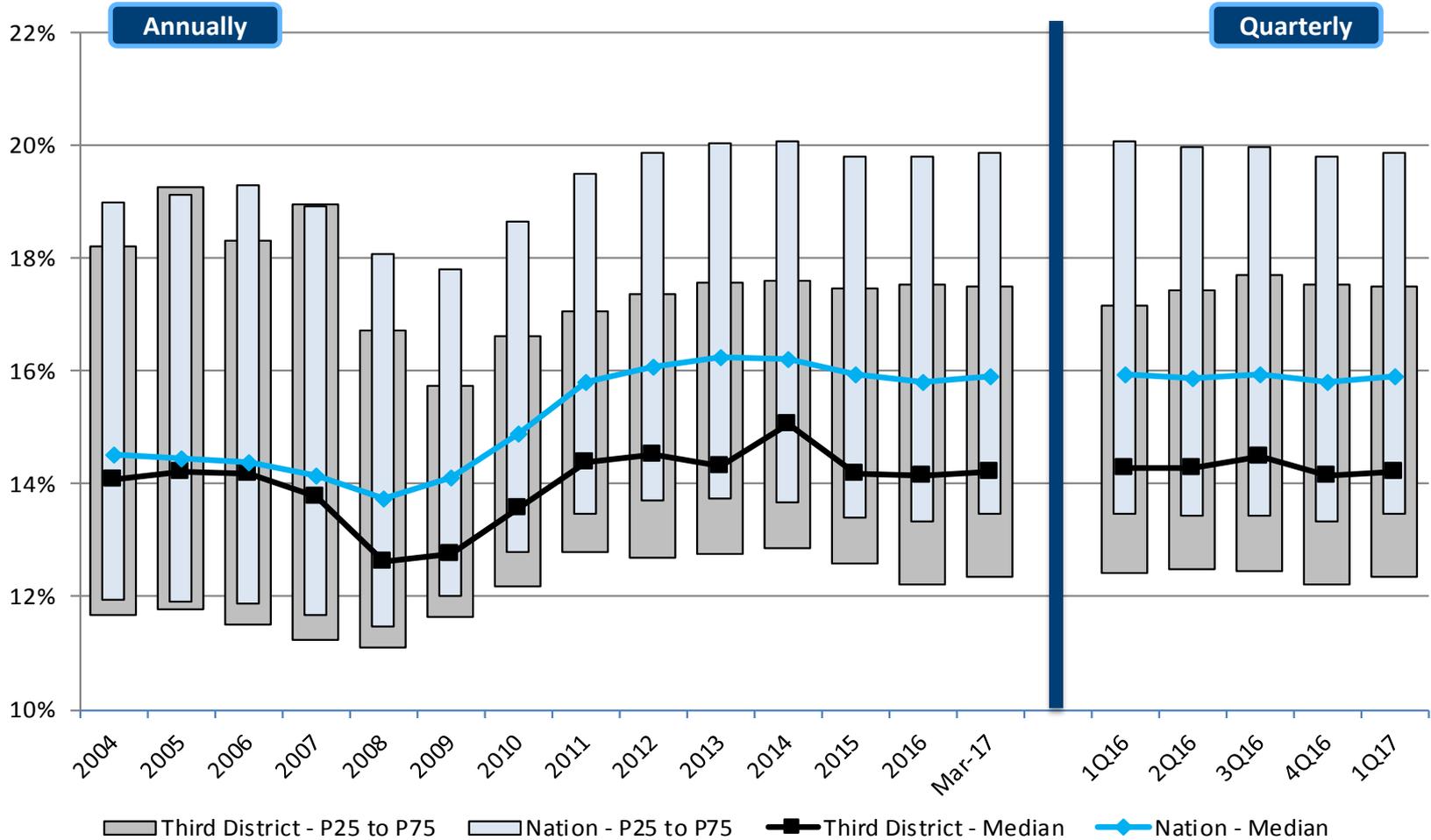


\* This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 4.

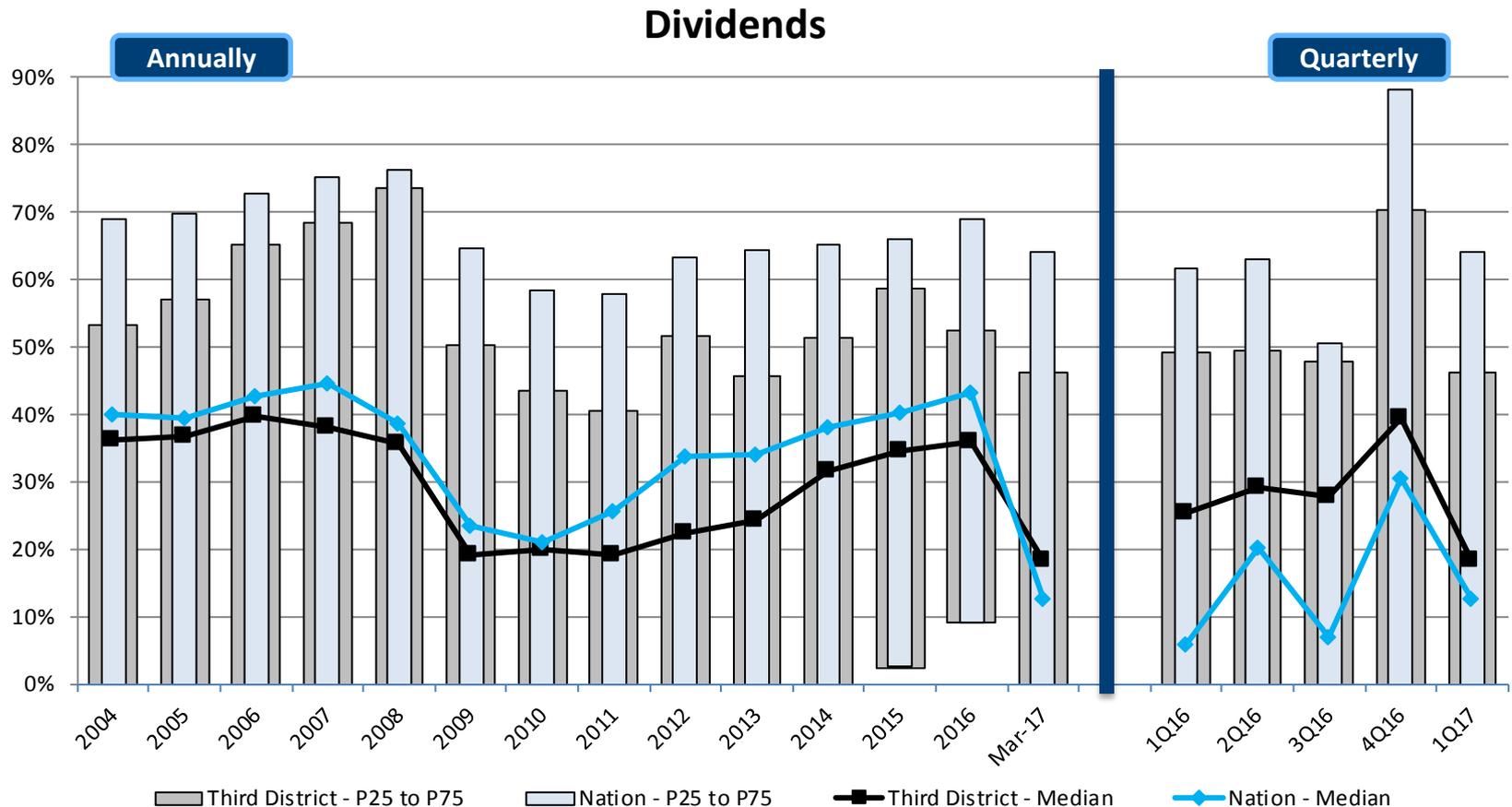
Capital ratios have increased postcrisis; however, Third District capital levels have flattened since 2011 and remain below that of the nation.



## Total Risk-Based Capital



# Median dividend payments\* in the Third District are currently outpacing the nation year-over-year as of 1Q2016.

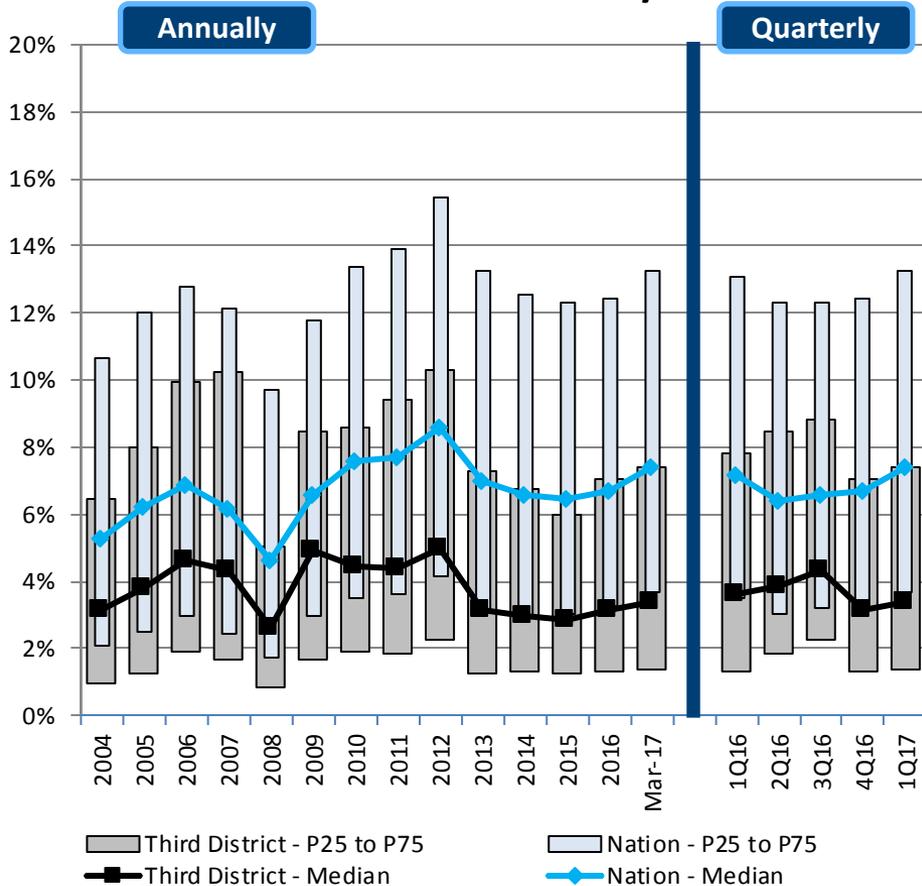


\* Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout (DPO) ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income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

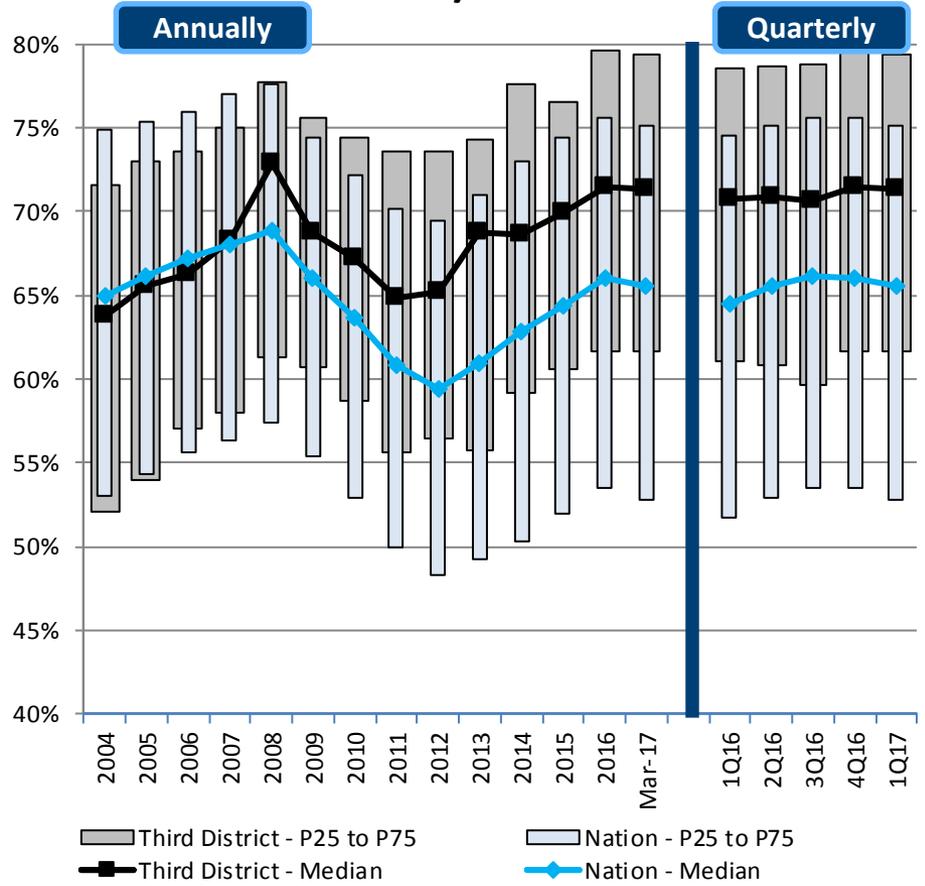
Third District banks hold fewer short-term investments compared with the nation. Additionally, the District continues to grow its loan portfolio, which may increase duration and interest rate risk depending on the loan type.



### Short-Term Investments / Assets\*



### Loans / Assets

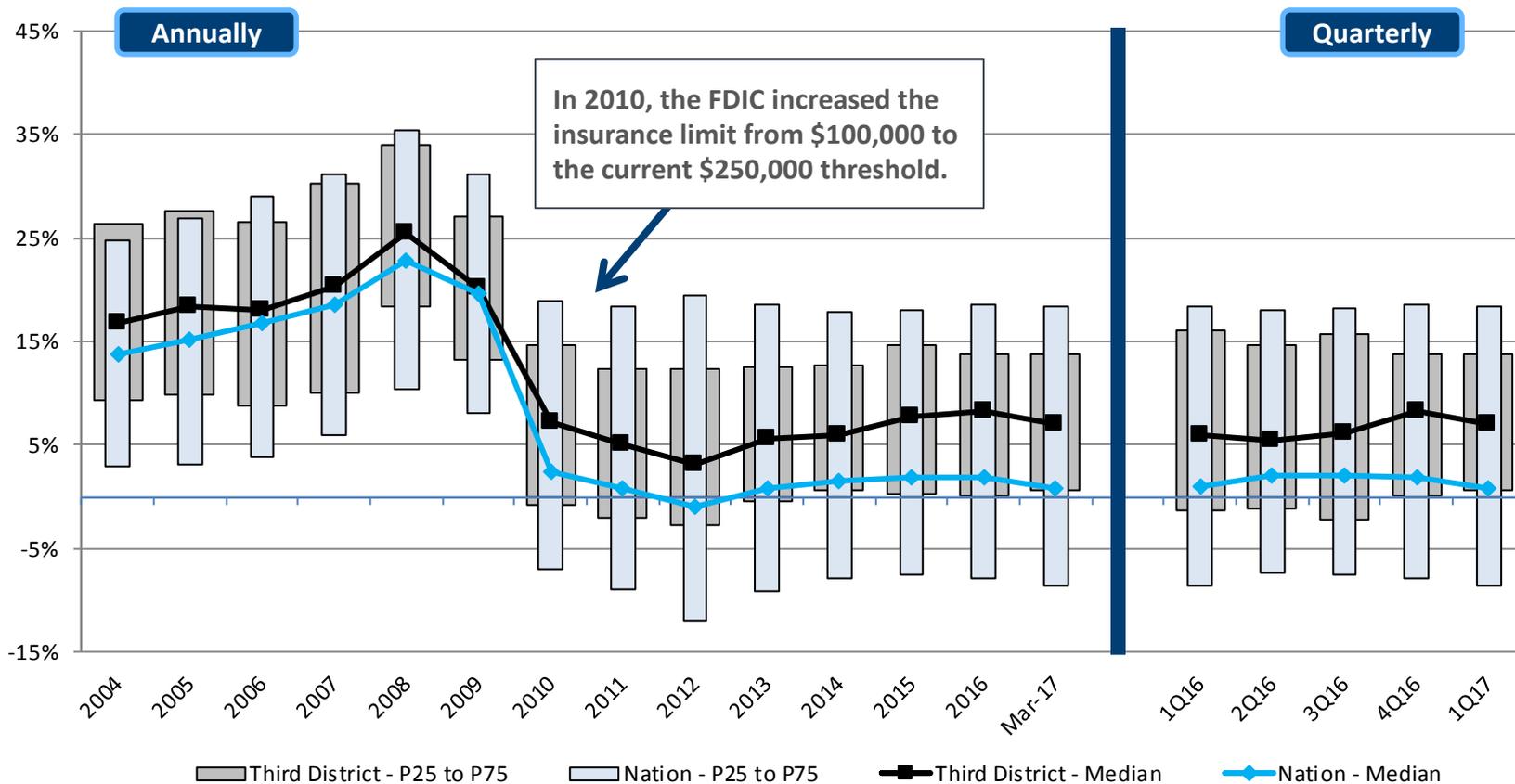


\* Short-term investments equal the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

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

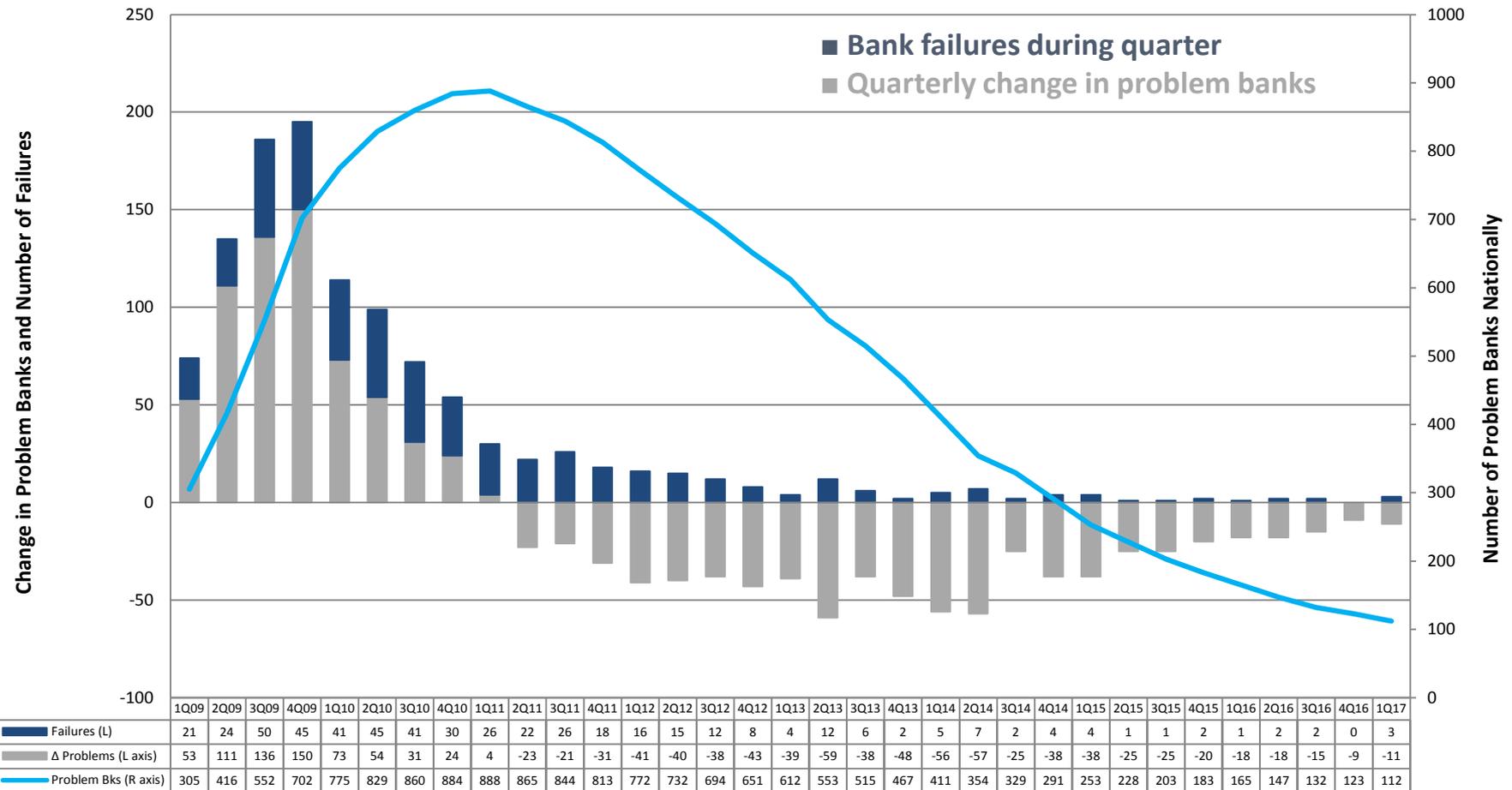


## Net Noncore Funding Dependence\*



\* 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 11 to 112 as of 1Q2017. This represents the smallest number of problem banks since 1Q2008. In addition, three banks failed within 1Q2017, with Harvest Community Bank located within the Third District footprint.



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 **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk.