



Third District Banking Conditions as of June 30, 2017

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 the [Risk Analytics & Surveillance unit](#) at the Federal Reserve Bank of Philadelphia .

Section 1: Executive Summary



- Results for Third District community banks continue to depict improving financial conditions, highlighted by:
 - Capital ratios continuing to increase mostly as a result of earnings accretion; however, capital ratios remain below those of the nation.
 - Third District asset quality metrics continuing to improve as the level of noncurrent loans declined to 2008 levels.
 - Many banks adjusting their balance sheet to reduce the adverse effects of a rising rate environment.
- However, challenges remain for Third District bank financial performance, primarily because:
 - Augmenting earnings with nonrecurring sources of income, such as the sale of loans and securities and/or reporting zero or negative provisions, is not a sustainable long-term strategy.
 - Increasing competition for loans and deposits within the District has compressed the net interest margin (NIM) considerably when compared with the nation.
 - Relying on noncore funding sources to grow the balance sheet continues within the Third District, and it outpaces the industry. Some of these funding costs (Federal Home Loan Bank (FHLB) borrowings, brokered deposits, etc.) may reprice faster in an upward interest rate environment, which could negatively impact earnings.
- Qualitative and/or operational risks that remain on the risk radar include:
 - Cybersecurity and operational risk
 - Credit concentrations – commercial real estate (CRE) (Refer to SR Letters 07-1 and SR 15-17), municipal loans, credit cards, and auto loans
 - Model risk management (SR 11-7 compliance)
 - Management succession planning
- The number of problem banks fell by seven banks to 105 as of 2Q2017. This represents the lowest number of problem banks since 2008, declining significantly from the peak of 888 problem banks in 1Q2011. Three banks failed during 2Q2017.

Section 2: Conditions of Third District Commercial Banks



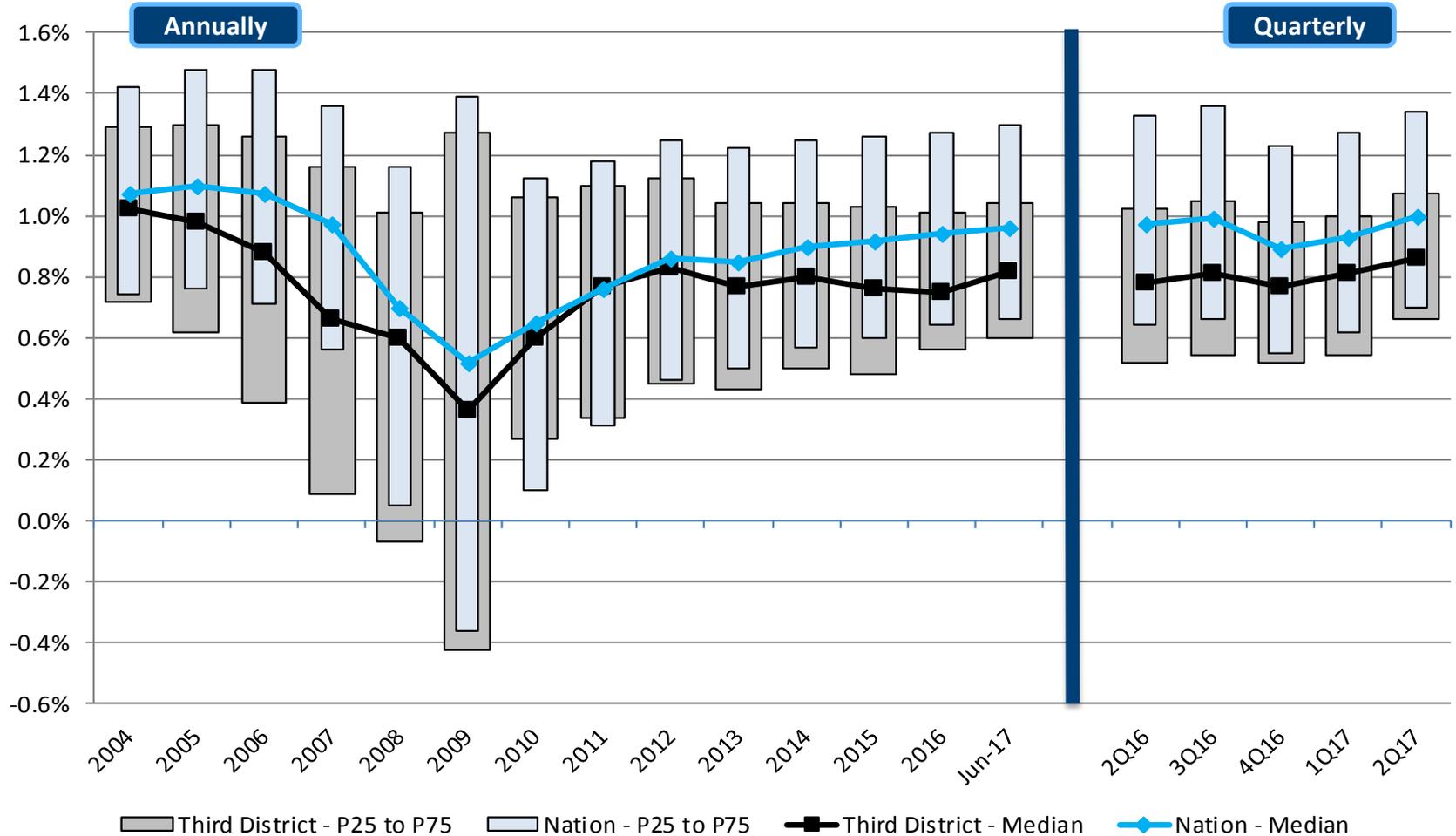
Reporting Methodology

- 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 **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 **June 30, 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 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, has increased in recent quarters. The Third District median ROAA of 0.86% for 2Q2017 is the highest it has been since 2006.



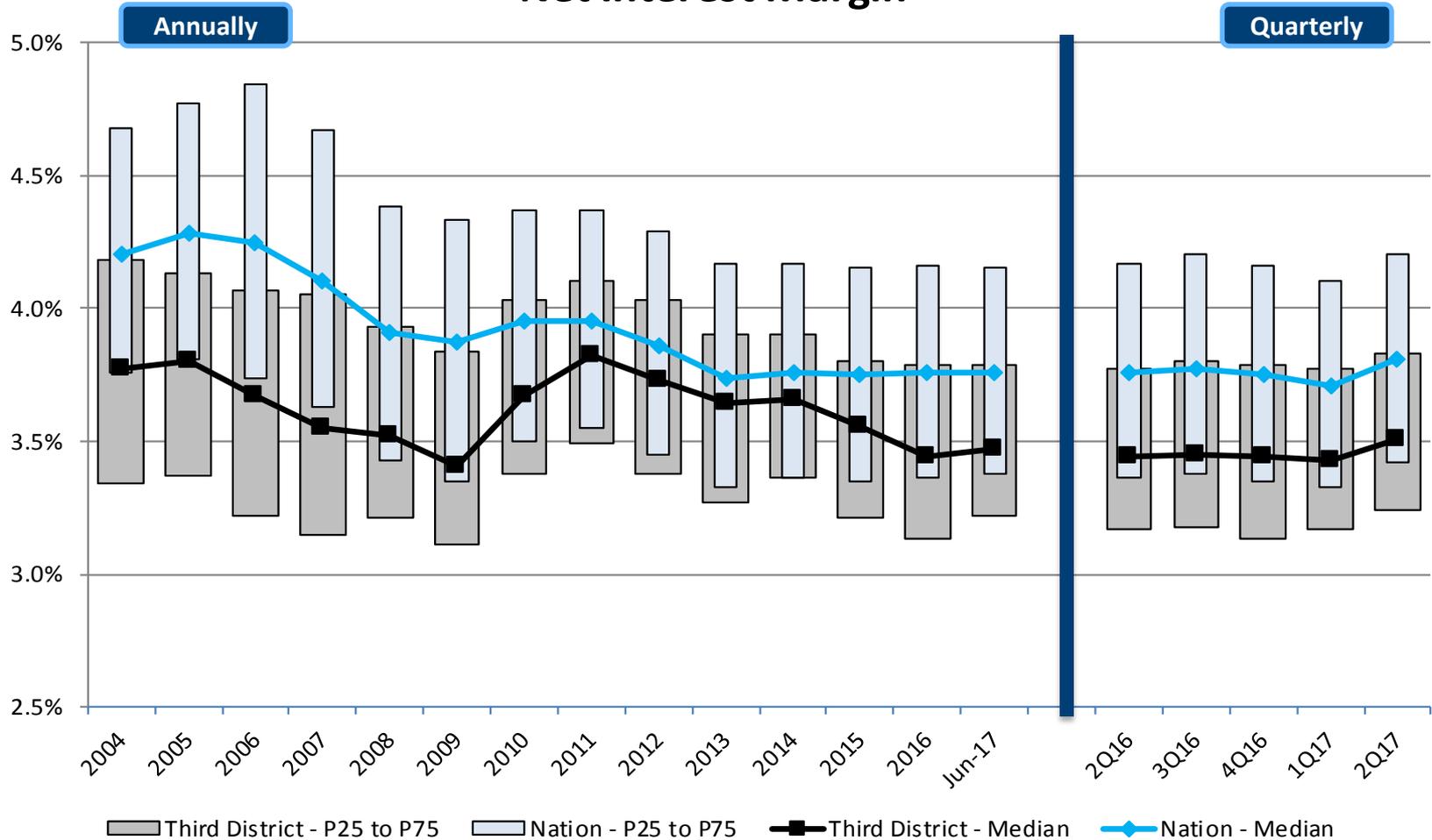
Return on Average Assets



The median NIM spread between the Third District and the nation has increased since 2014 and is 30 basis points as of 2Q2017. This variance is primarily the result of the District's lower yield on earning assets than that of the nation and the cost of funds being greater than that of the nation.



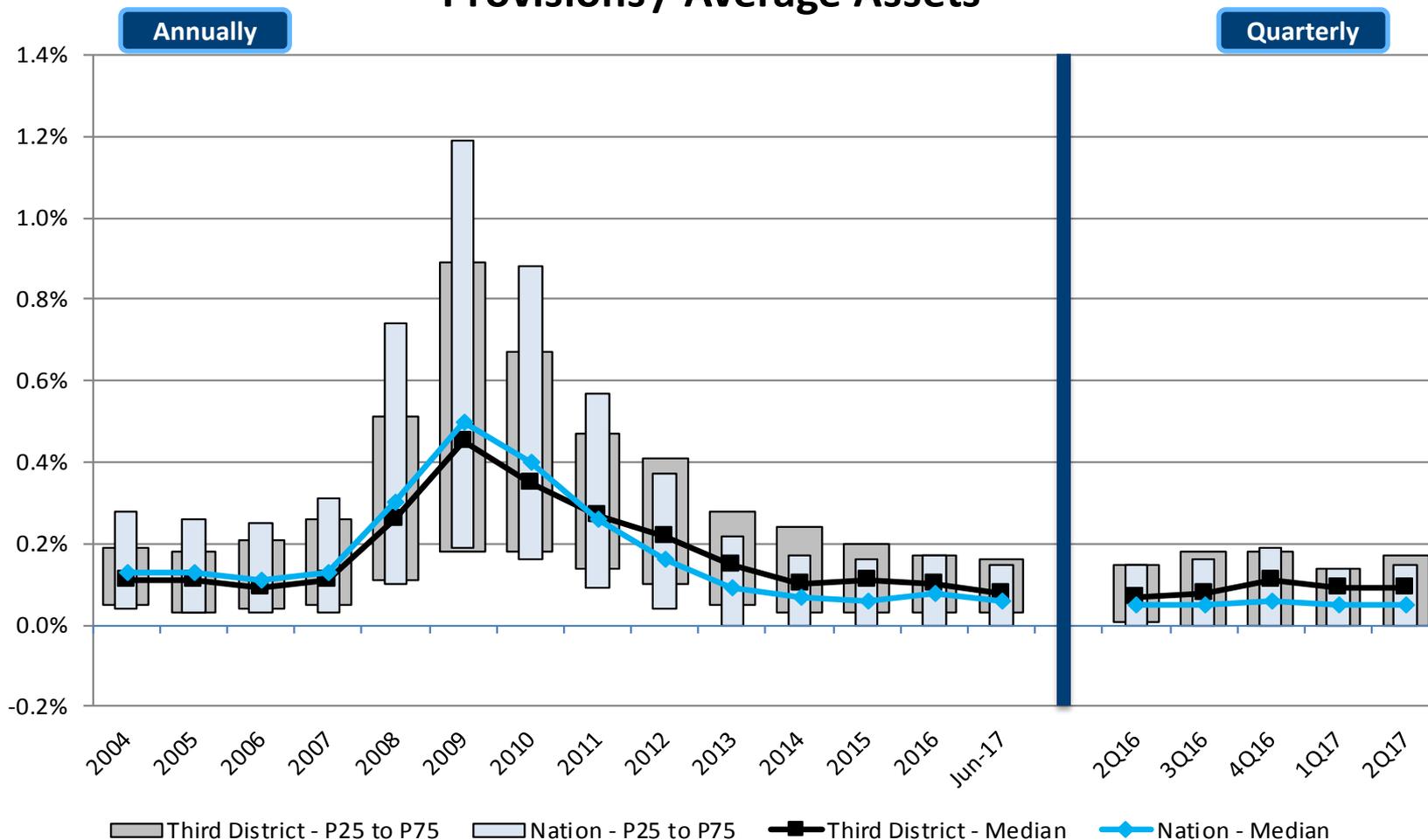
Net Interest Margin



The provision expense continues to trend near or below precrisis levels, which currently helps artificially augment earnings. However, if a collapse in the credit cycle occurs, provision expense should increase and thus may negatively impact earnings.



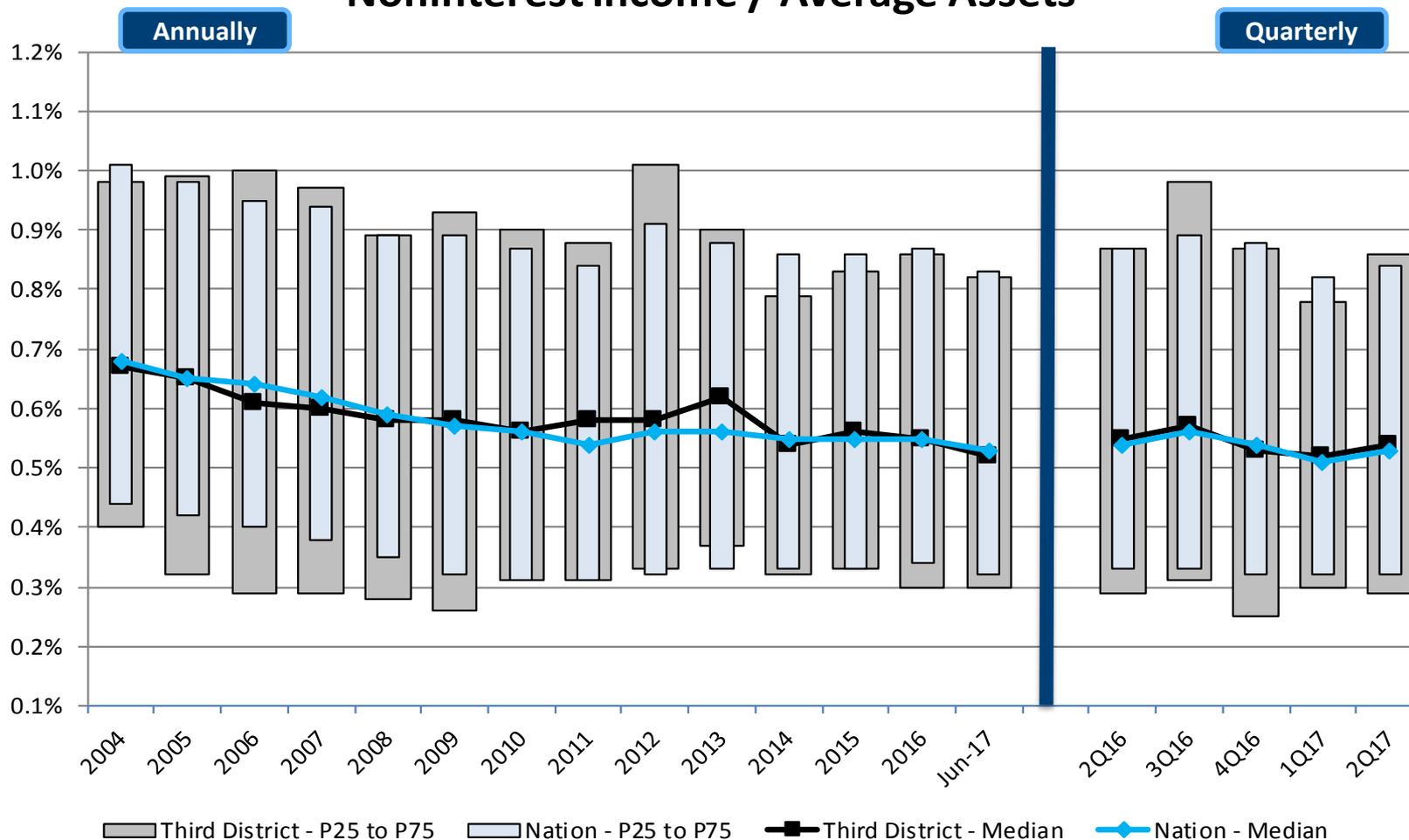
Provisions / Average Assets



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



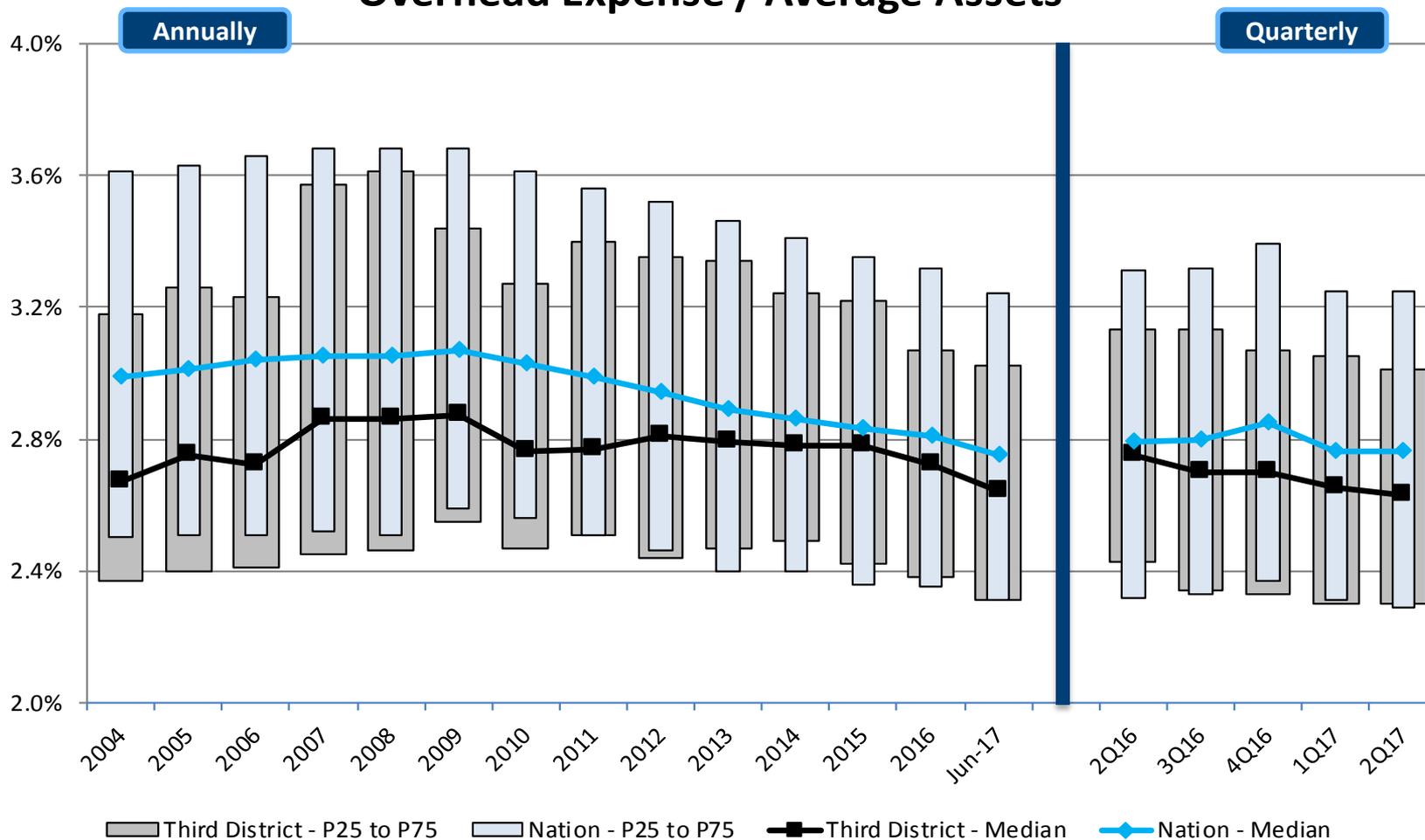
Noninterest Income / Average Assets



Median overhead expense has decreased in the nation since 2010 and in the Third District since 2015. The lower overhead costs generate a positive impact on ROAA.



Overhead Expense / Average Assets

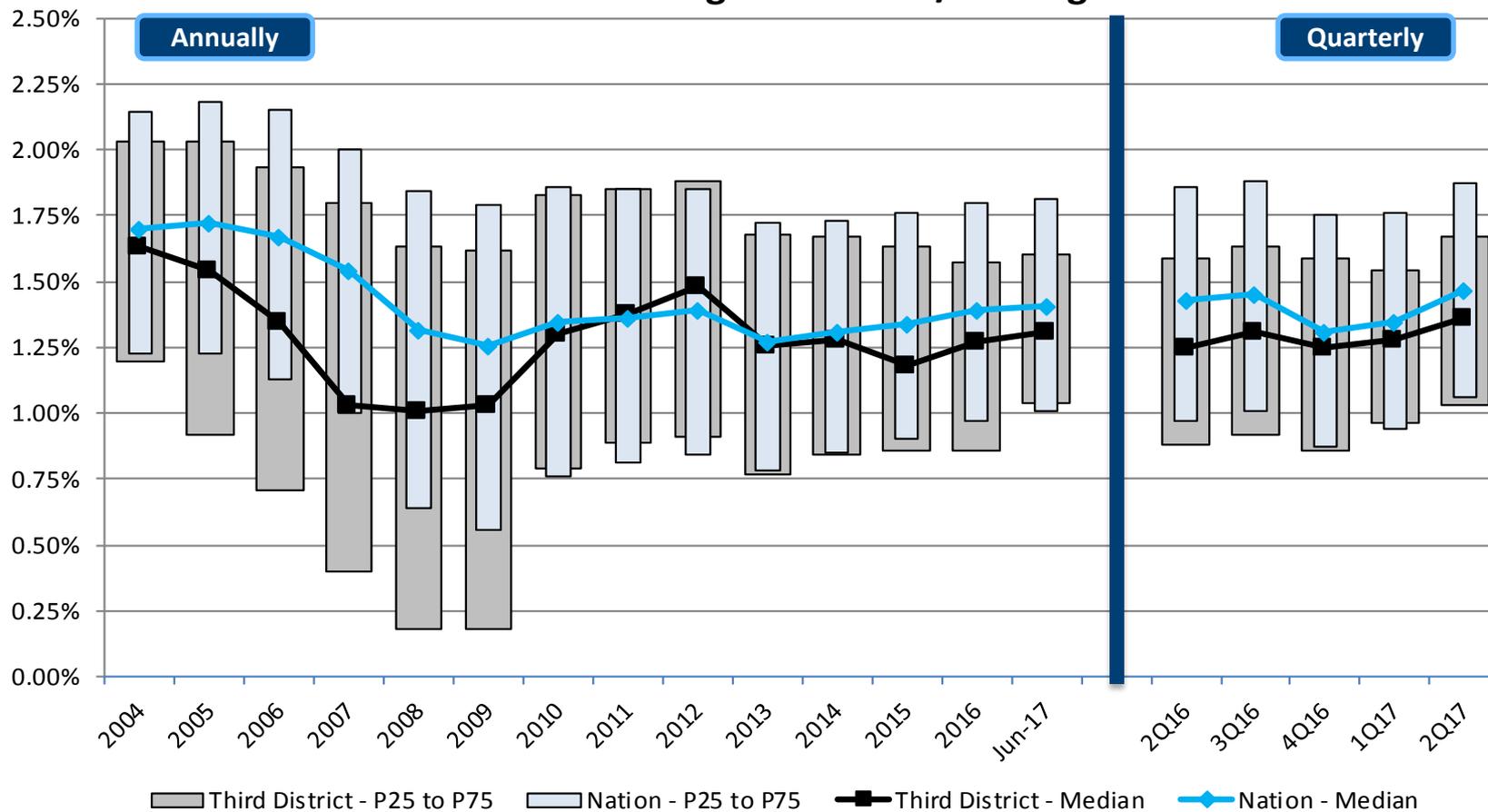


As of 2Q2017, the Third District median core profitability has risen 18 basis points to 1.36% since the postcrisis low of 1.18% at year-end 2015.



Core Profitability

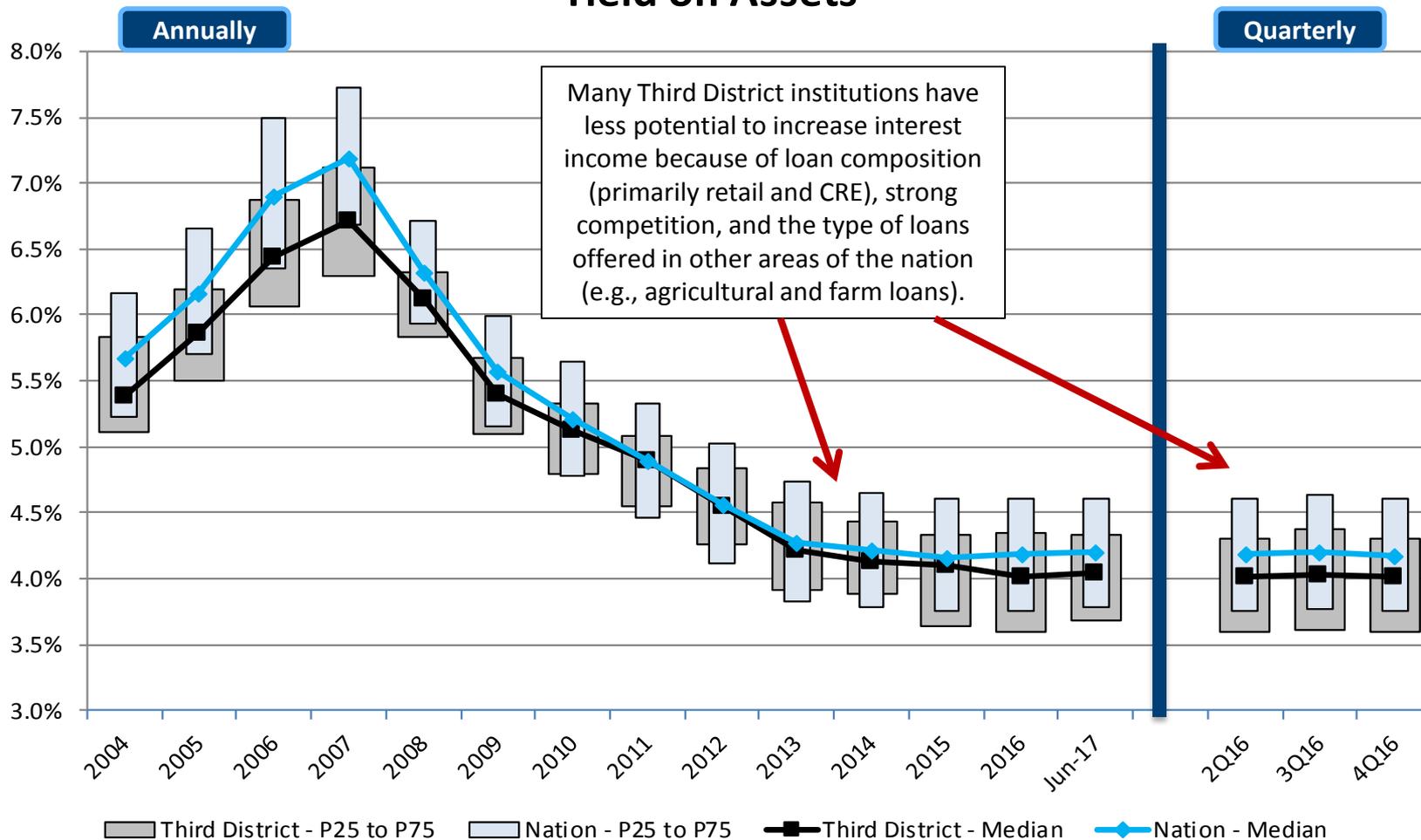
Pre-Tax Income Excluding Provisions / Average Assets



The low interest rate environment and loan composition suppress the yield on assets within the Third District.



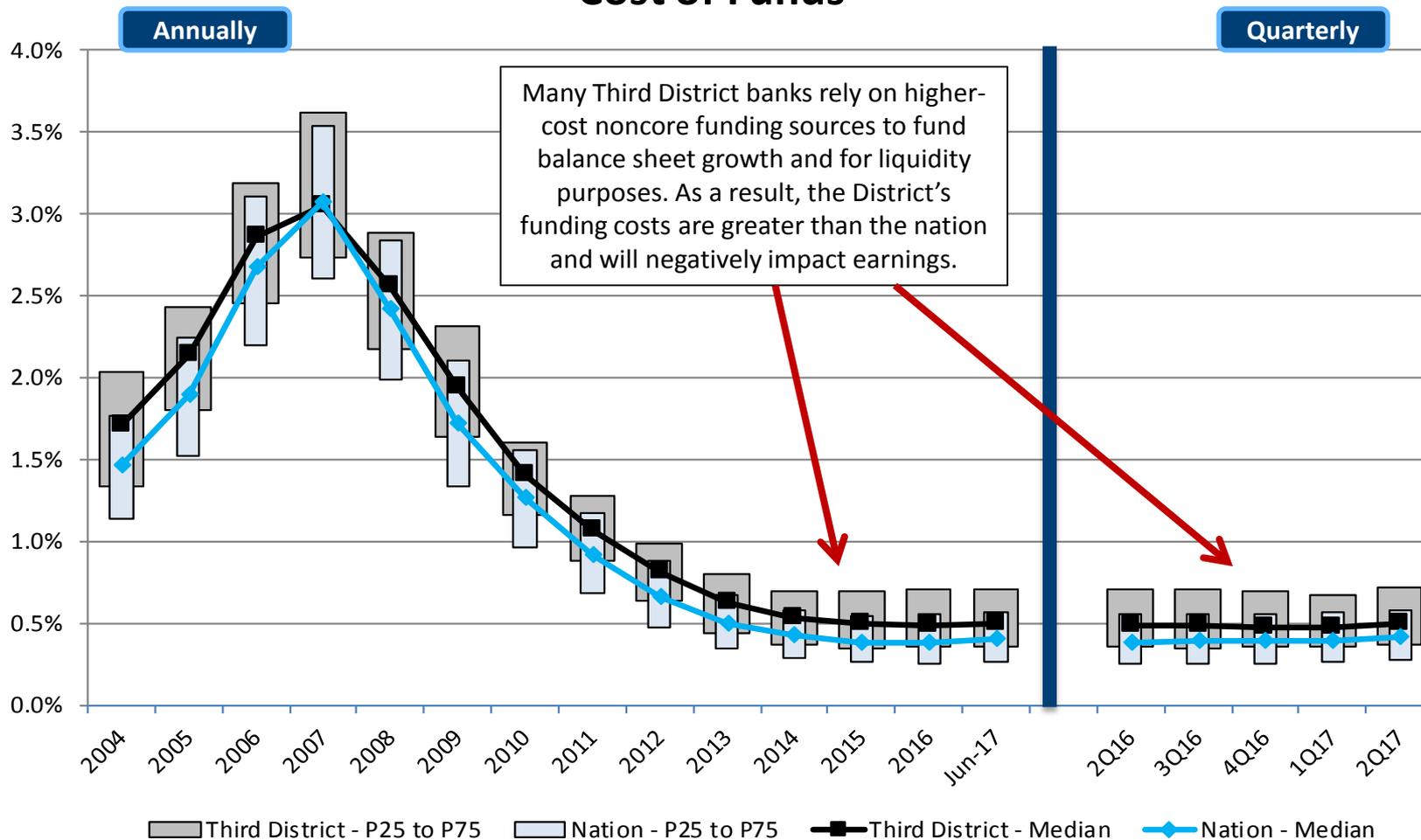
Yield on Assets



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



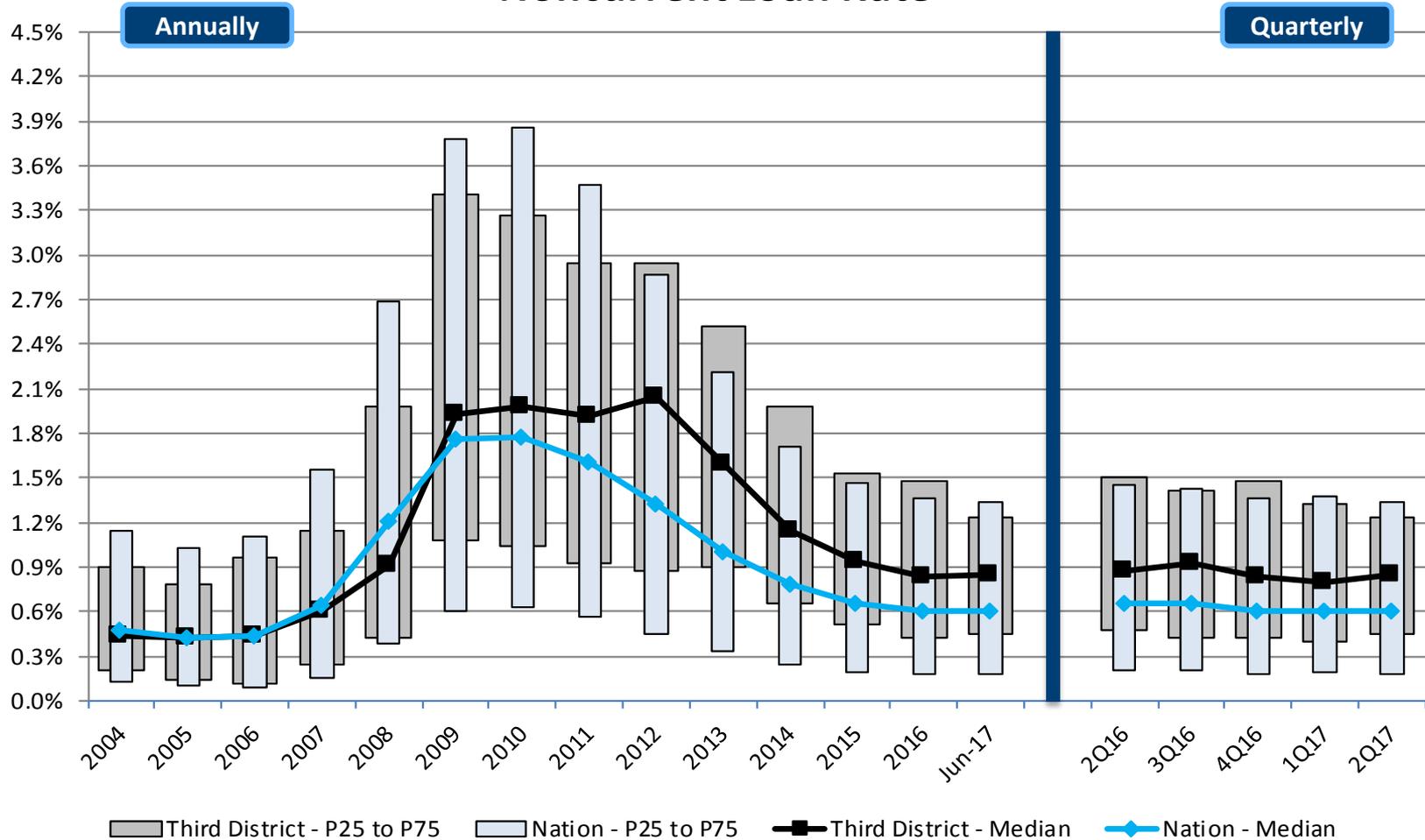
Cost of Funds



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



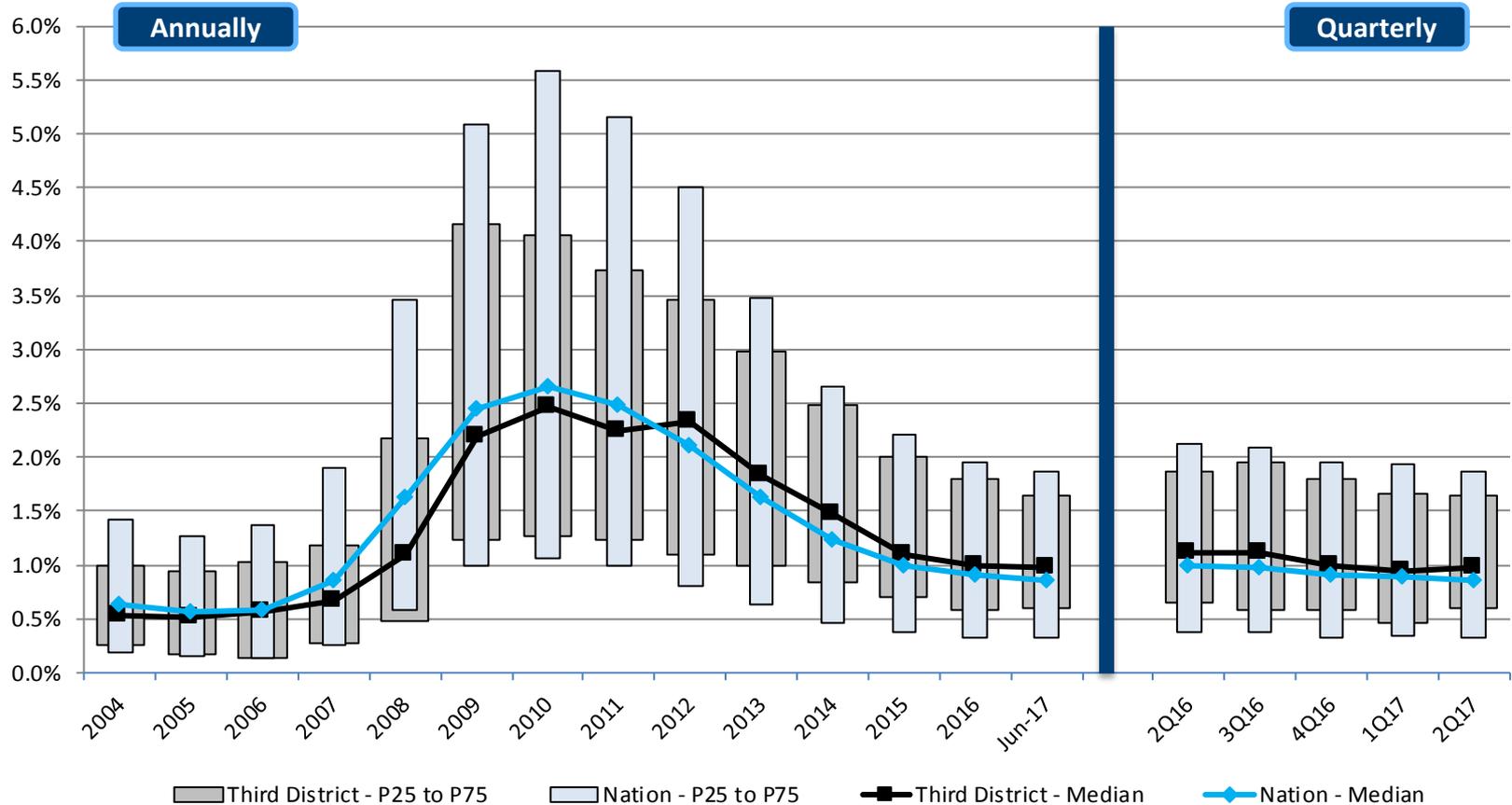
Noncurrent Loan Rate



Additionally, the Third District's level of nonperforming assets also remains stable and is slightly above that of the nation.



Nonperforming Assets*

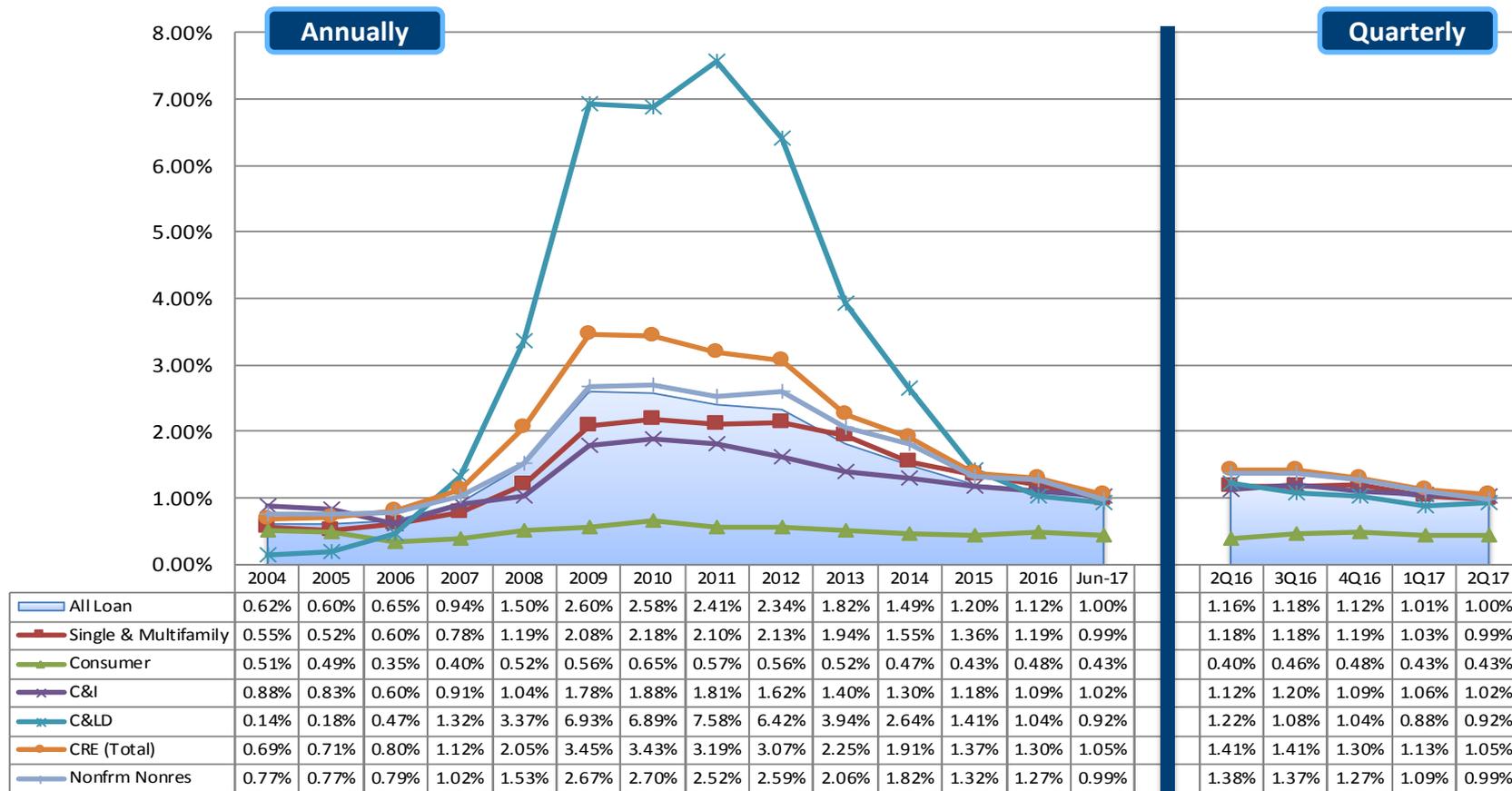


* NPAs (nonperforming assets) are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans)

Third District loan performance continues to show performance improvement among the principal loan categories and are near or below 2007 levels.



Noncurrent Loan Ratios by Loan Category

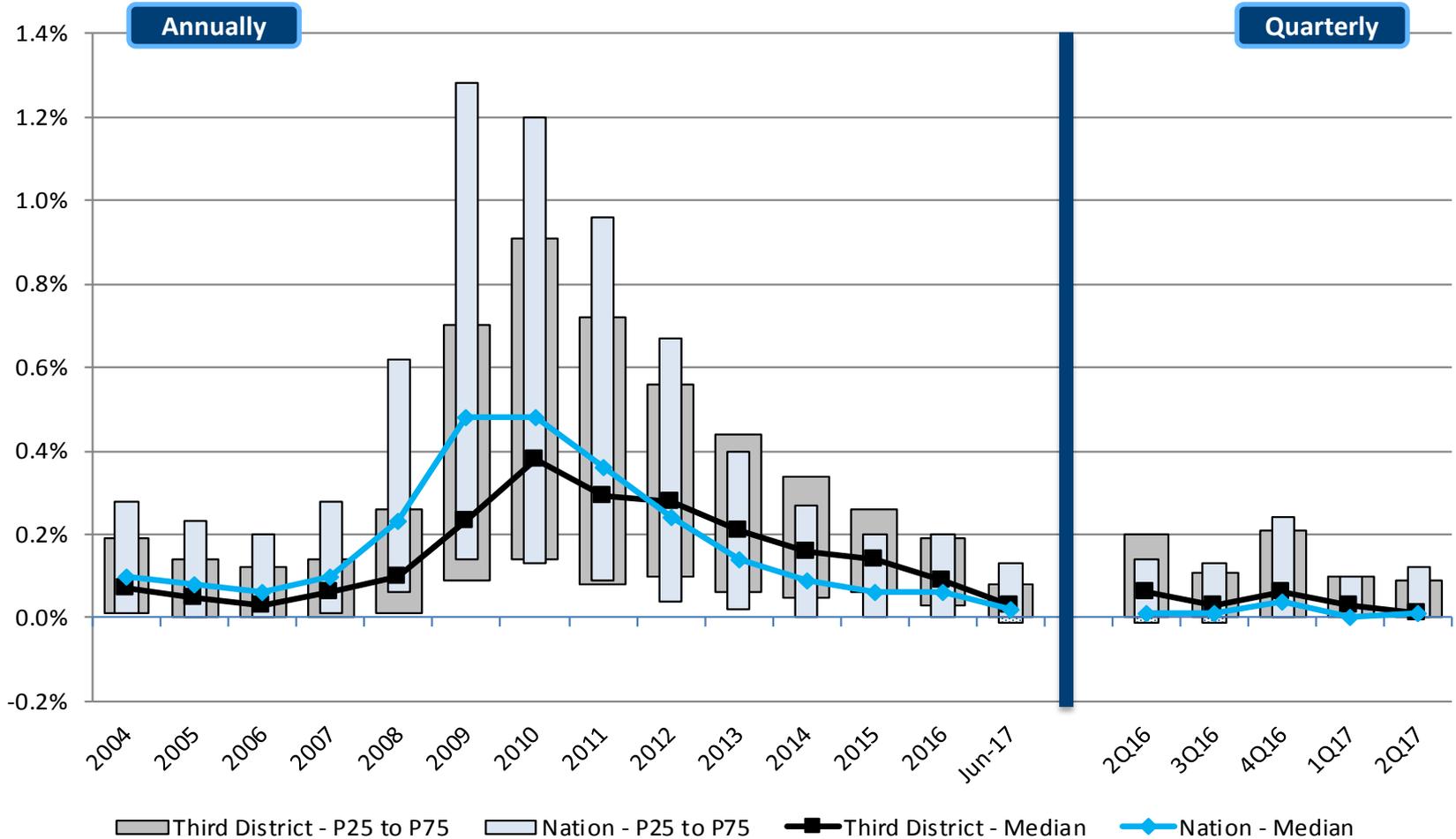


This chart uses a 10% capped mean, or winsorized mean, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on the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

The current credit environment continues to perform well, given that Third District net charge-off rates have steadily declined since 2010 and are in line with precrisis levels.



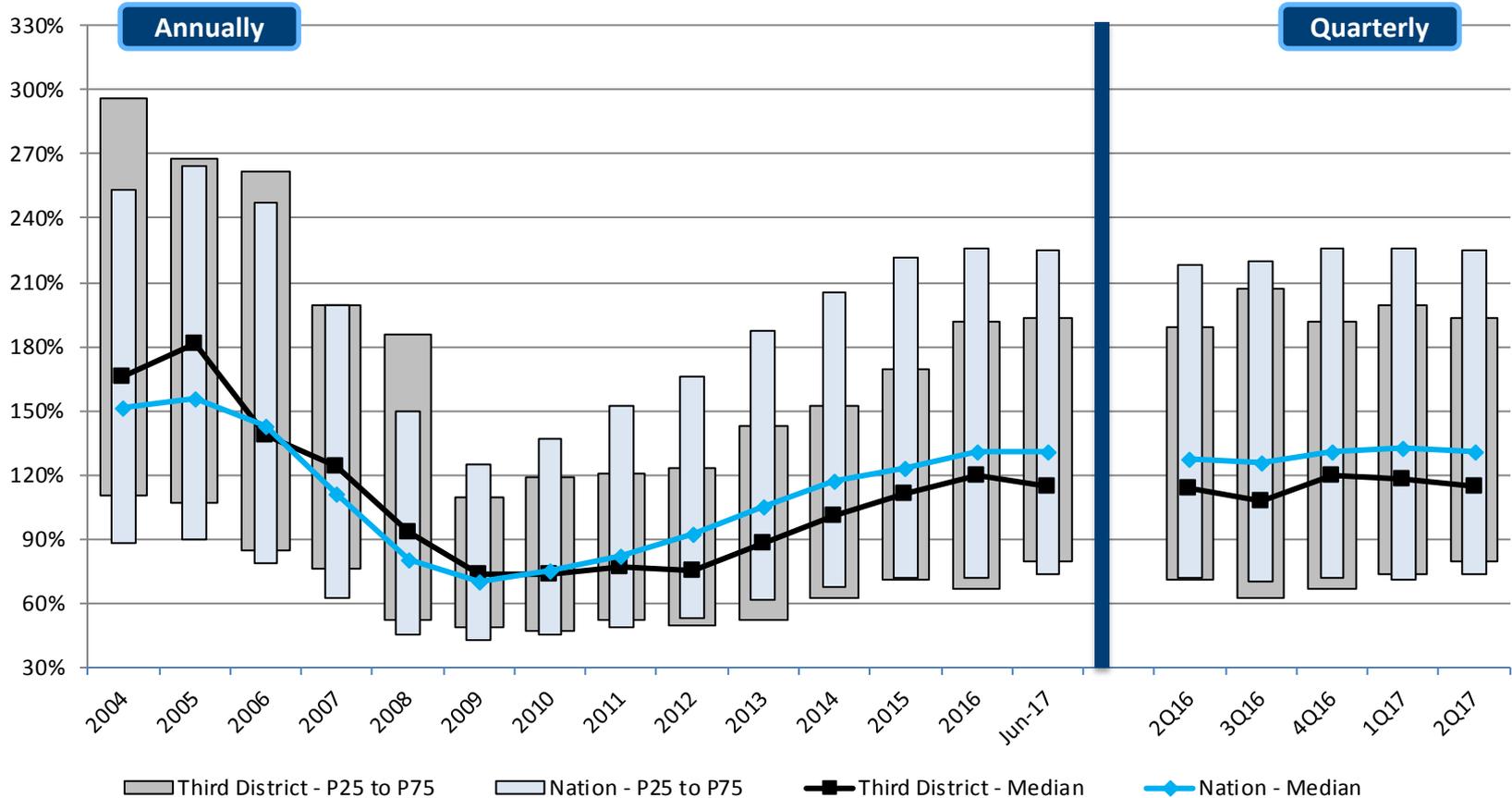
Net Charge-offs / Loans



The allowance for loan and lease losses (ALLL) reserve coverage ratio continues to improve because of better asset quality metrics, not by increased **provision expense** (see slide 7).



Allowance for Loan & Lease Loss Coverage Ratio*

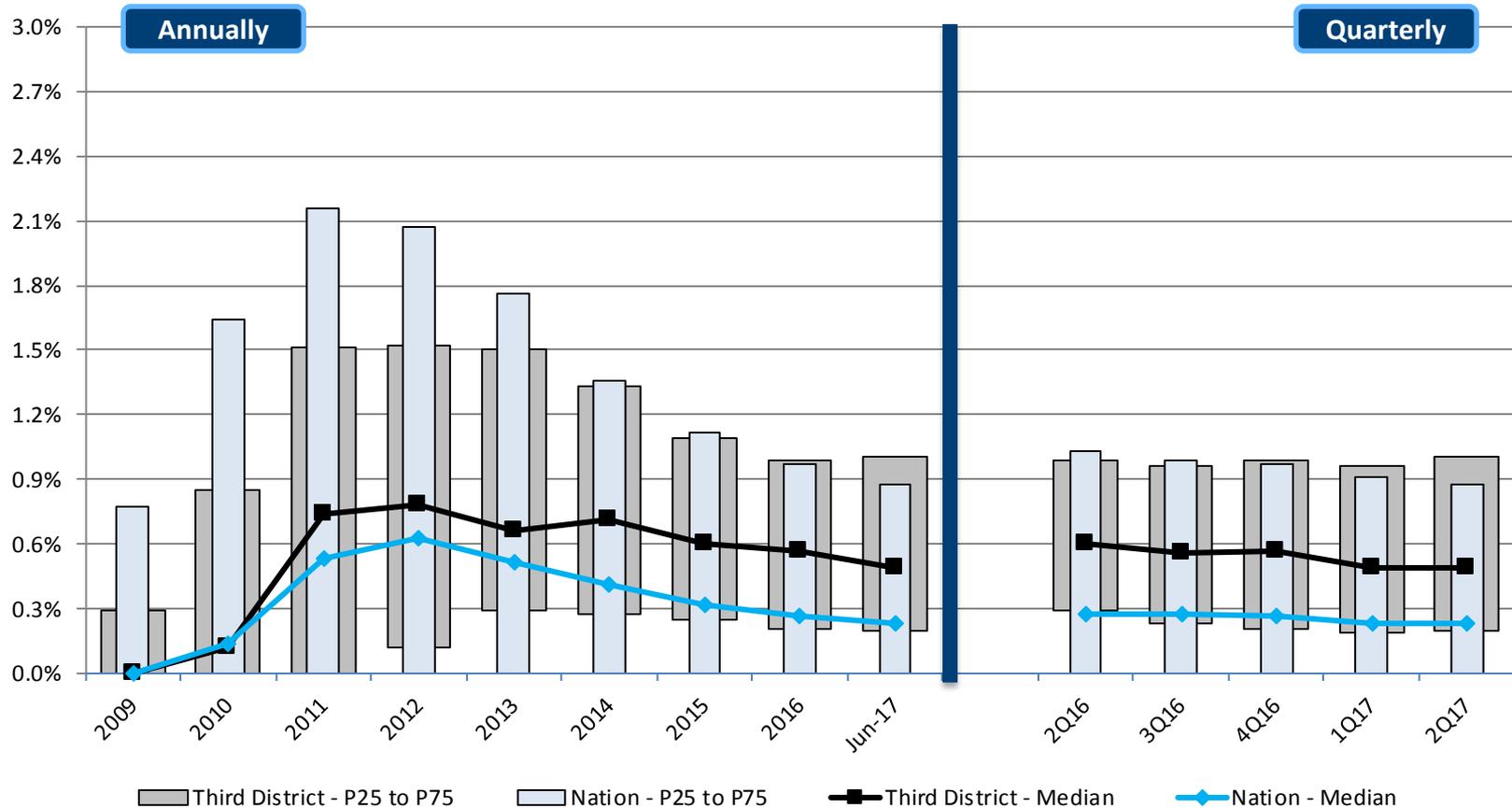


* The ALLL reserve coverage ratio is calculated by dividing noncurrent loans by the ALLL.

The Third District's troubled debt restructurings remained stable; however, they are elevated compared with the nation's.



Troubled Debt Restructurings*

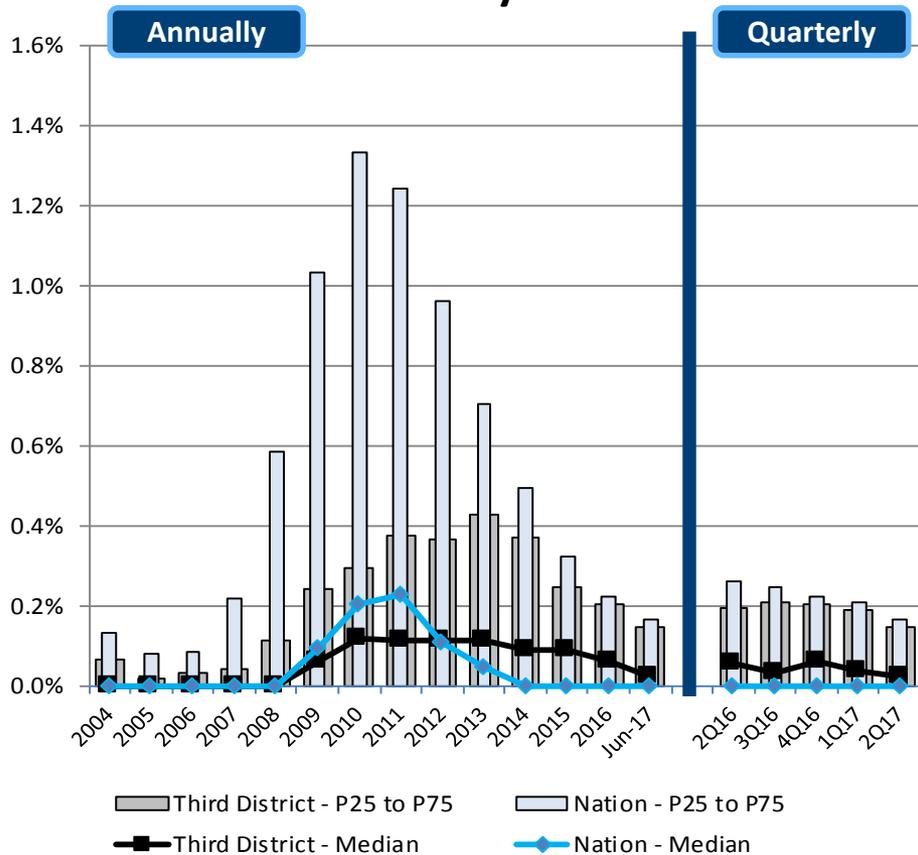


* Troubled debt restructurings (TDRs) were not included on the Call Report until the March 2009 reporting period.

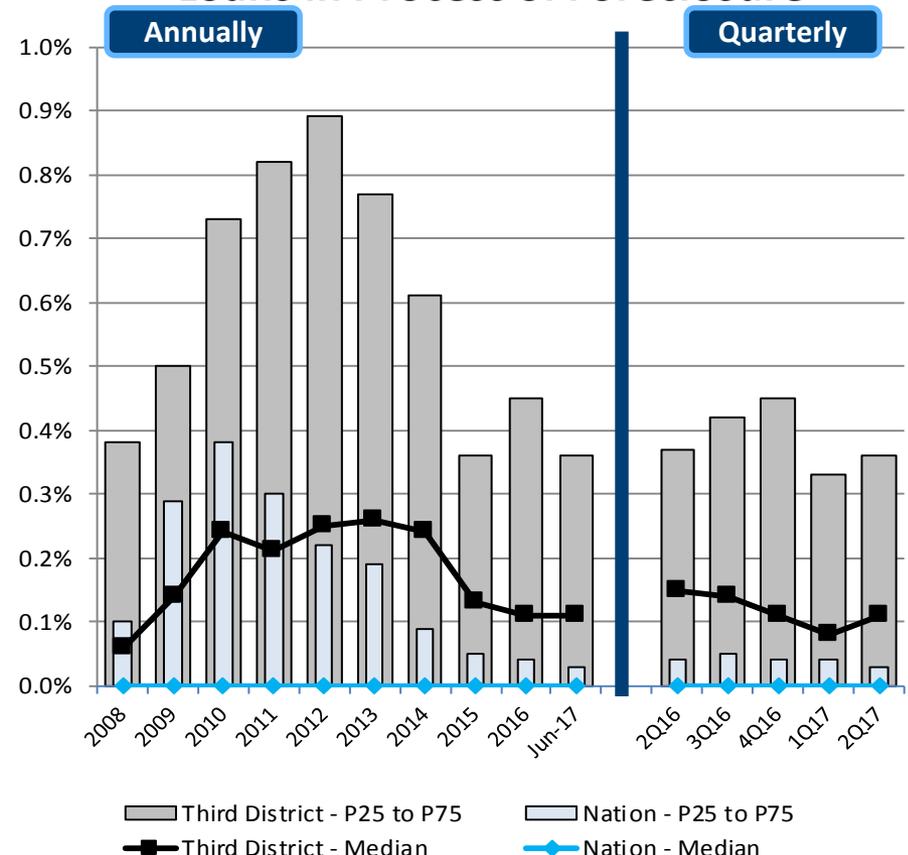
One- to four-family other real estate owned (OREO) continues to decrease, but the Third District continues to trail in the foreclosure process because of the judicial foreclosure process in PA, DE, and NJ.



1-4 Family OREO*



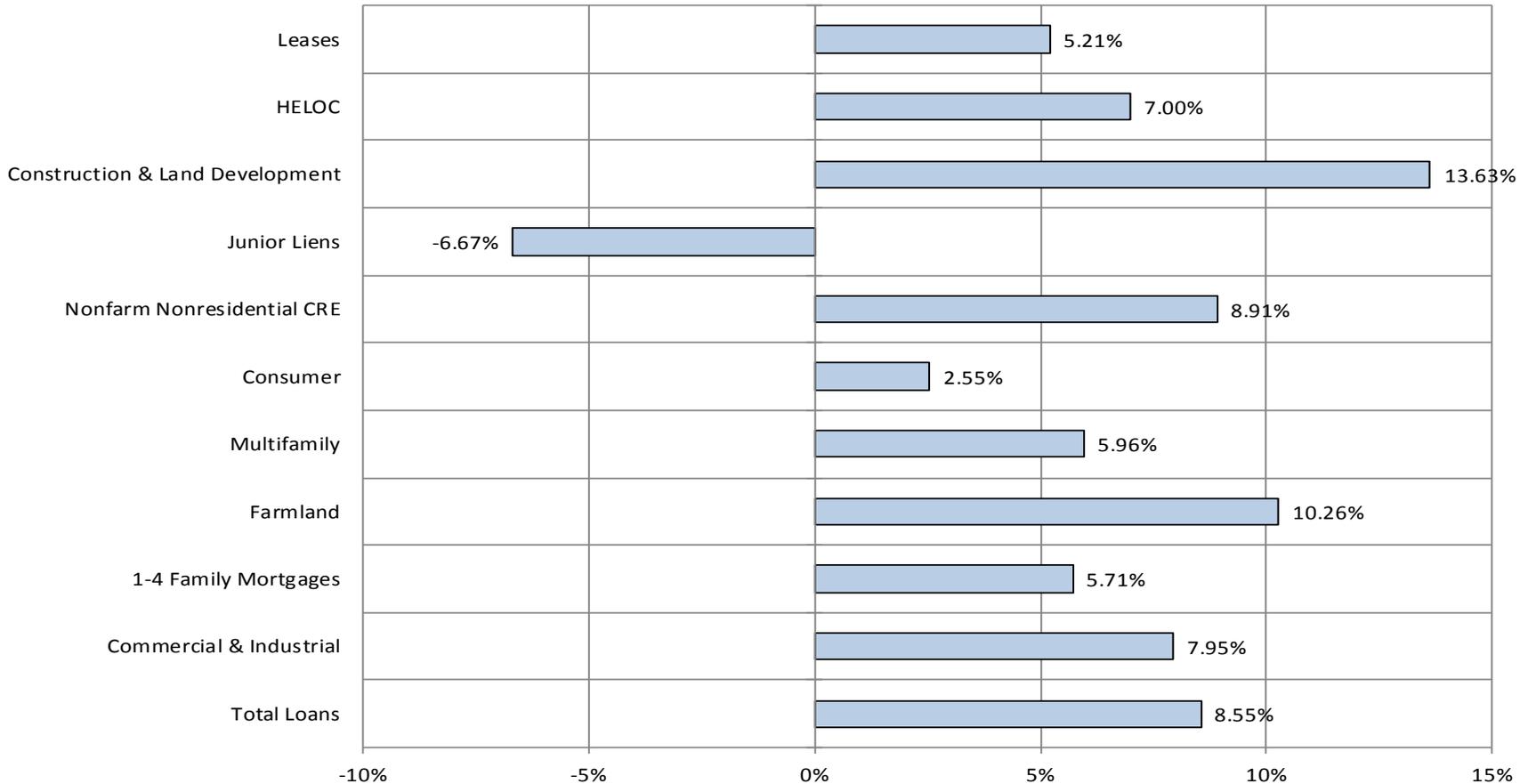
Loans in Process of Foreclosure**



* 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.

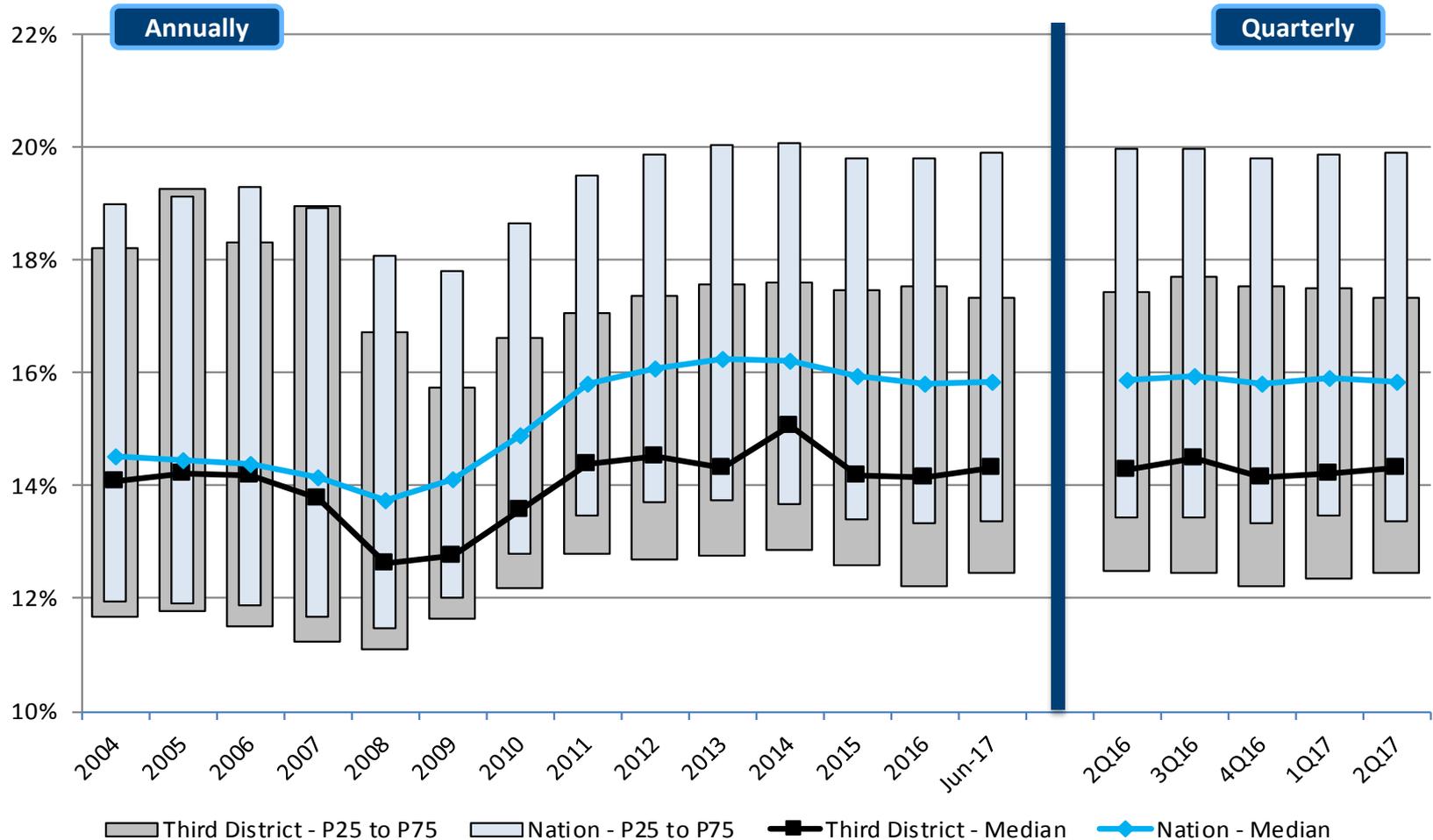


* This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 4.

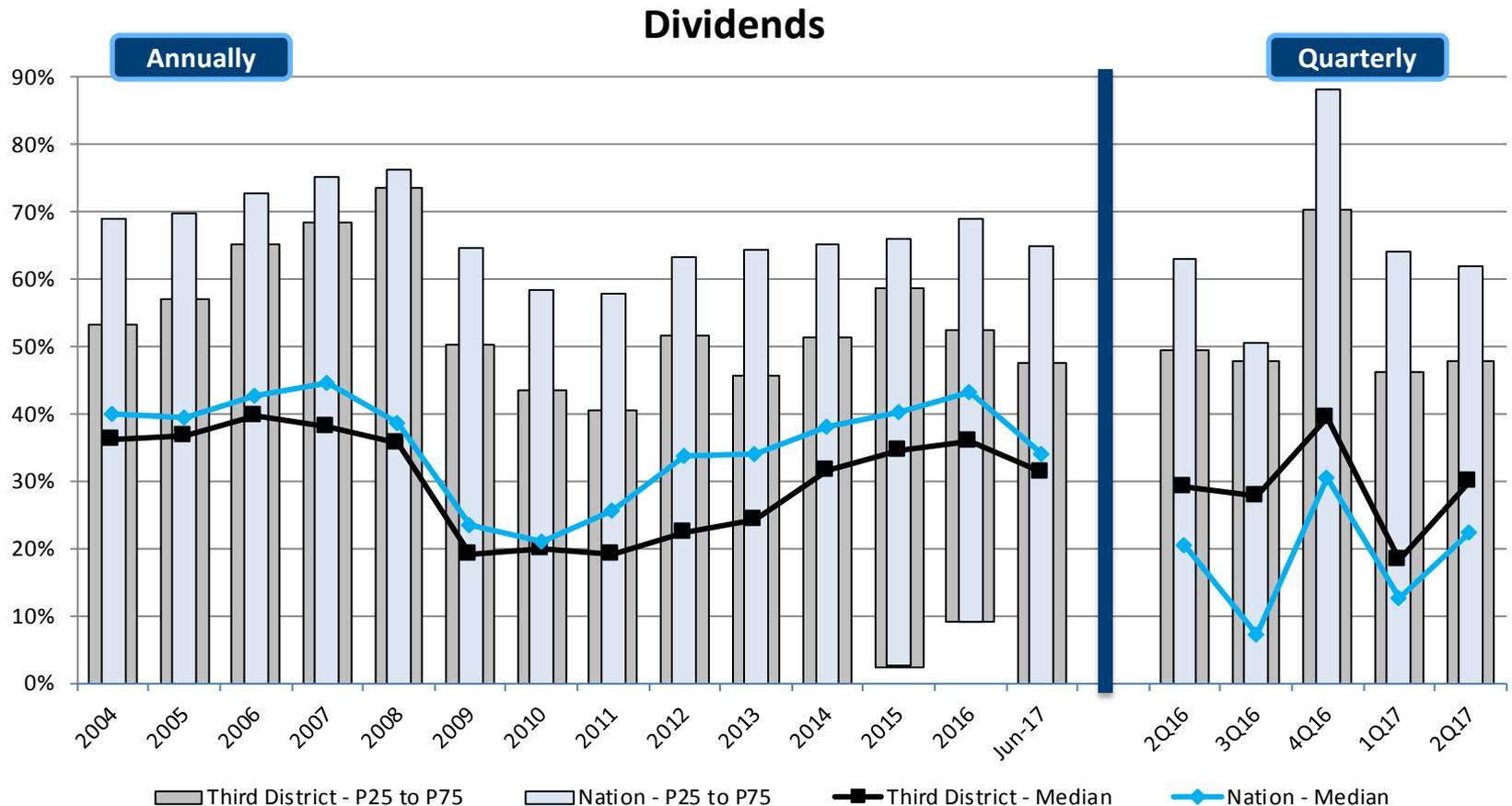
Capital ratios have increased postcrisis; however, Third District total risk-based capital levels have flattened since 2011 and remain below those of the nation.



Total Risk-Based Capital



As of 2Q2017, the median dividend payments* in the Third District are comparable with the same period in 2016.

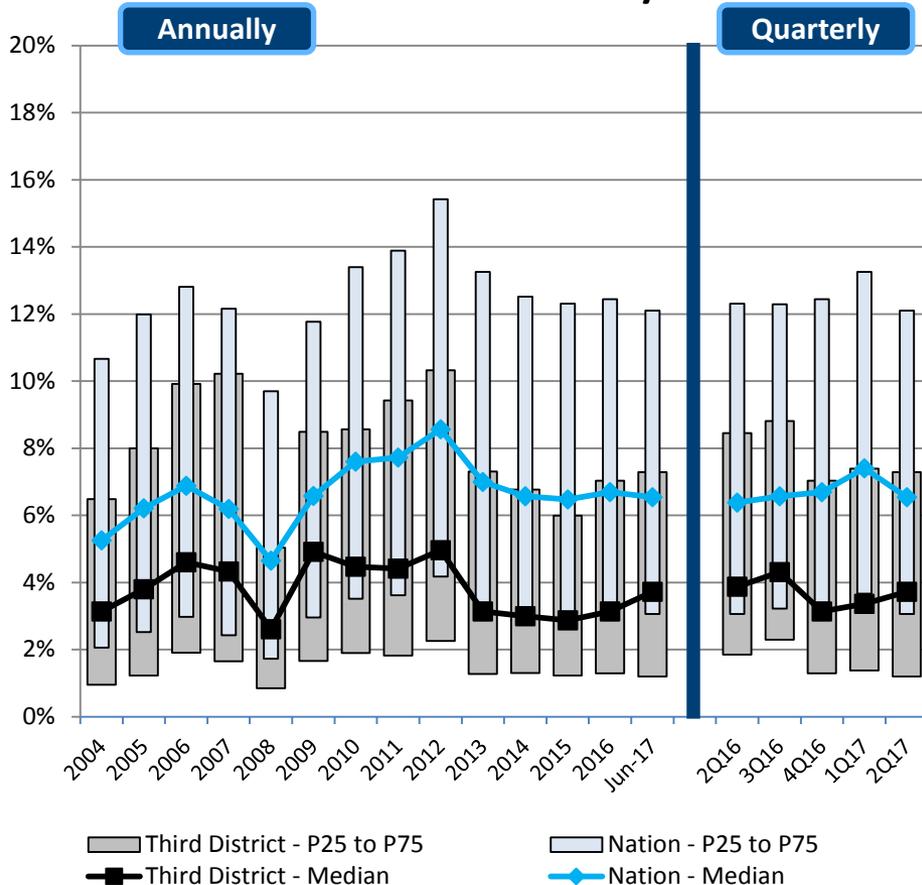


* Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout (DPO) ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income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

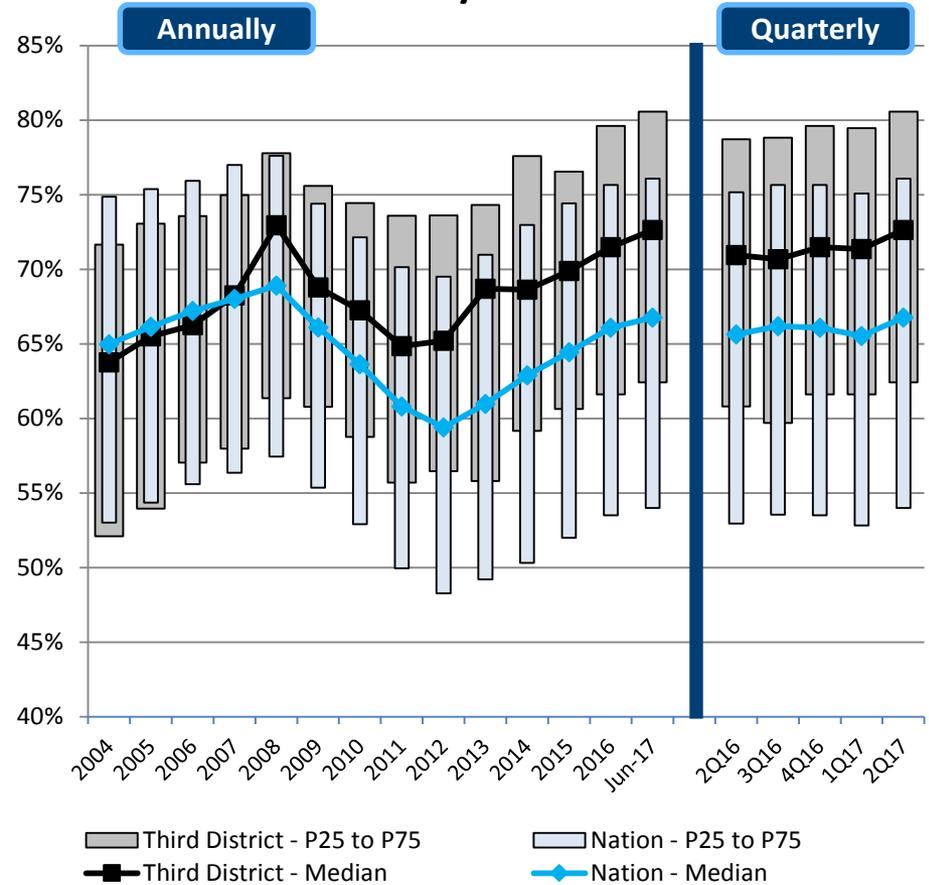
Third District banks hold fewer short-term investments compared with the nation. Additionally, the District continues to grow its loan portfolio, which may increase duration and interest rate risk depending on the loan type.



Short-Term Investments / Assets*



Loans / Assets

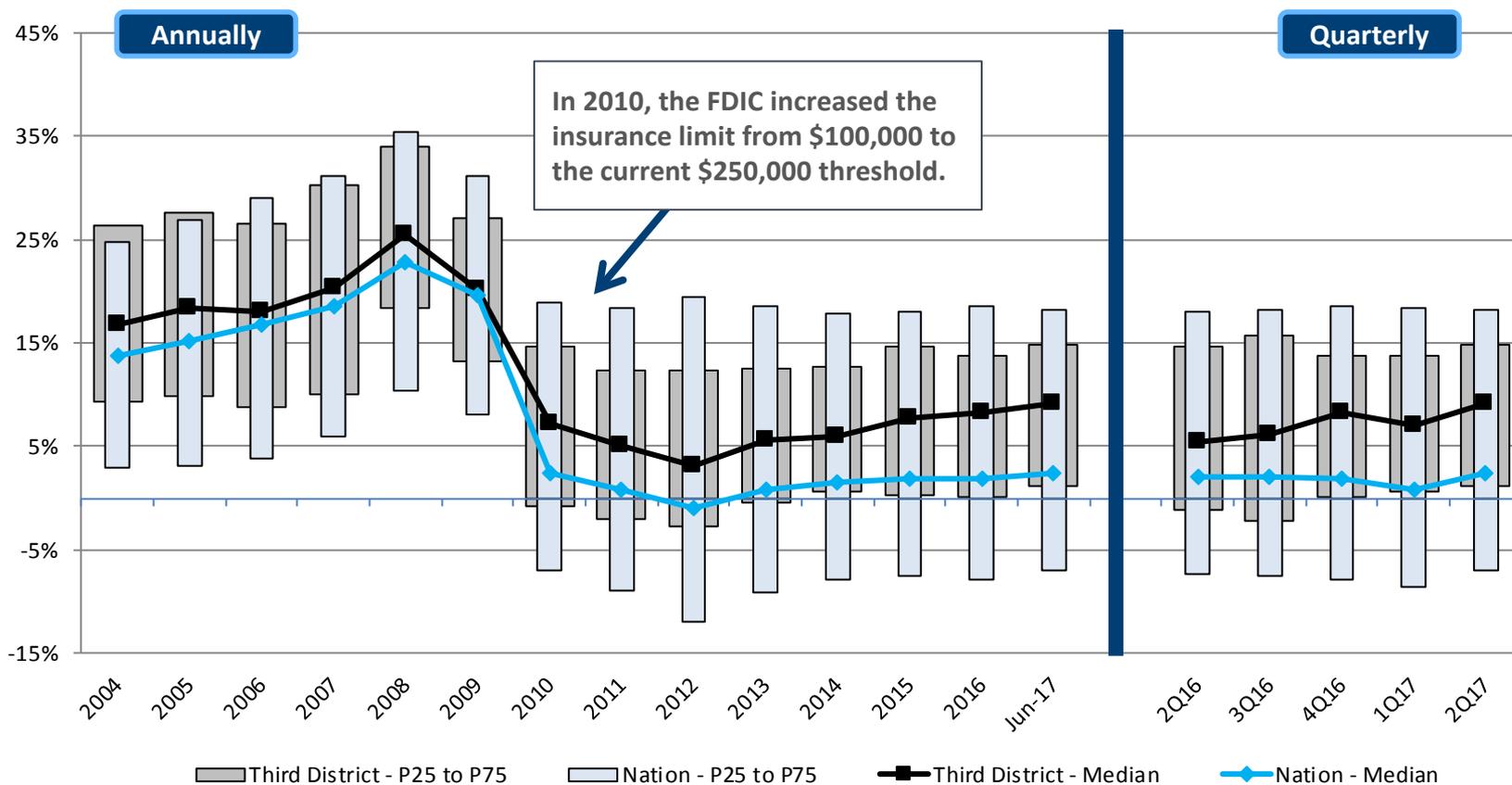


* Short-term investments equal the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

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

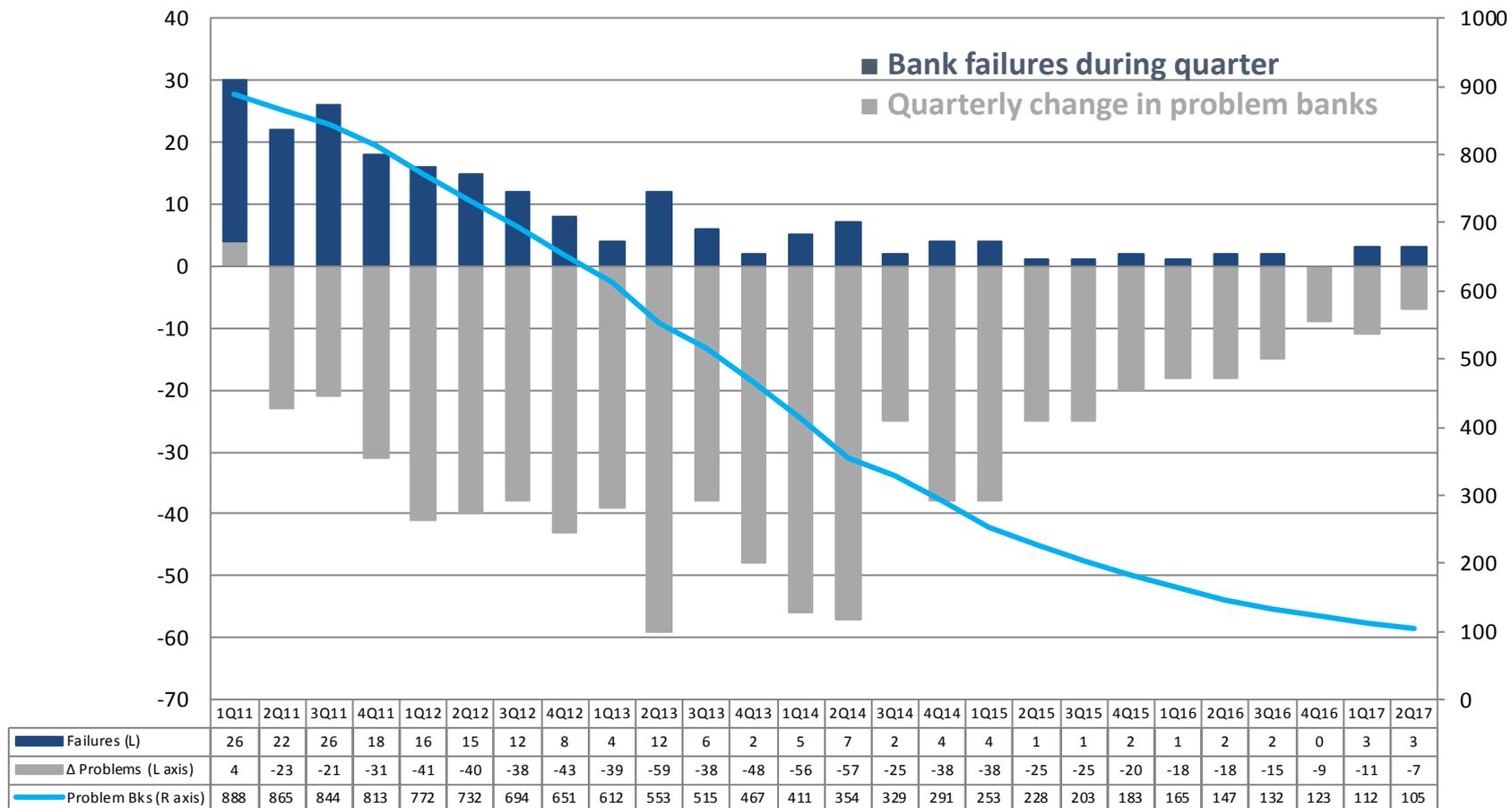


Net Noncore Funding Dependence*



* 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 7 to 105 as of 2Q2017, which is the lowest number of problem banks since 1Q2008. Additionally, three banks failed within the quarter, and none were in the Third District.



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.