



# Third District Banking Conditions as of December 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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For any questions about this presentation, please contact the [Risk Analytics and Surveillance Unit](#) at the Federal Reserve Bank of Philadelphia.

# Section 1: Executive Summary



- Financial performance results for Third District community banks have not changed much from previous quarters. Banks continue to display improving financial conditions highlighted by:
  - Capital ratios remain well capitalized for most institutions as they continue to increase primarily as a result of earnings accretion; however, capital ratios remain below those of the nation.
  - Third District asset quality metrics continue to improve as the level of noncurrent loans declined below 2008 levels.
  - Many banks are adjusting their balance sheets to reduce the adverse effects of a rising rate environment.
- However, challenges remain for Third District bank financial performance primarily because:
  - The year-end change in the tax rate for Deferred Tax Assets (DTA) negatively impacted earnings at many institutions for quarterly and annual 2017 earnings performance.
  - Interest rates are beginning to rise after the FOMC's five fed funds rate increases since 2015. However, given the extended low interest rate environment, many banks have adjusted their balance sheet to reduce the adverse effects of rising rates.
  - Earnings have been augmented 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. Additionally, 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, artificially increases earnings for a given time period but is unsustainable for long-term gains.
  - 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 within the Third District remains elevated and outpaces the industry. Some of these funding costs (e.g., Federal Home Loan Bank (FHLB) borrowings, brokered deposits) are greater than that of core deposit costs and may reprice faster in an upward interest rate environment, which could negatively impact earnings.
  - The level of short-term assets is much lower for the District compared with the rest of the nation. This could increase the level of interest rate risk at an institution by increasing duration and repricing risk.
- Qualitative and/or operational risks that remain on the risk radar include:
  - Cybersecurity
  - Credit concentrations – Commercial Real Estate (CRE) (Refer to SR Letters 07-1 and SR 15-17), municipal loans, credit cards, and auto loans
  - Management succession and strategic planning
  - Model risk management (SR 11-7 compliance)
- The number of problem banks fell by nine banks to 95 as of 4Q2017. This represents the lowest number of problem banks in more than seven years, declining significantly from the peak of 888 problem banks in 1Q2011. Two banks failed during 4Q2017.

# Section 2: Conditions of Third District Commercial Banks



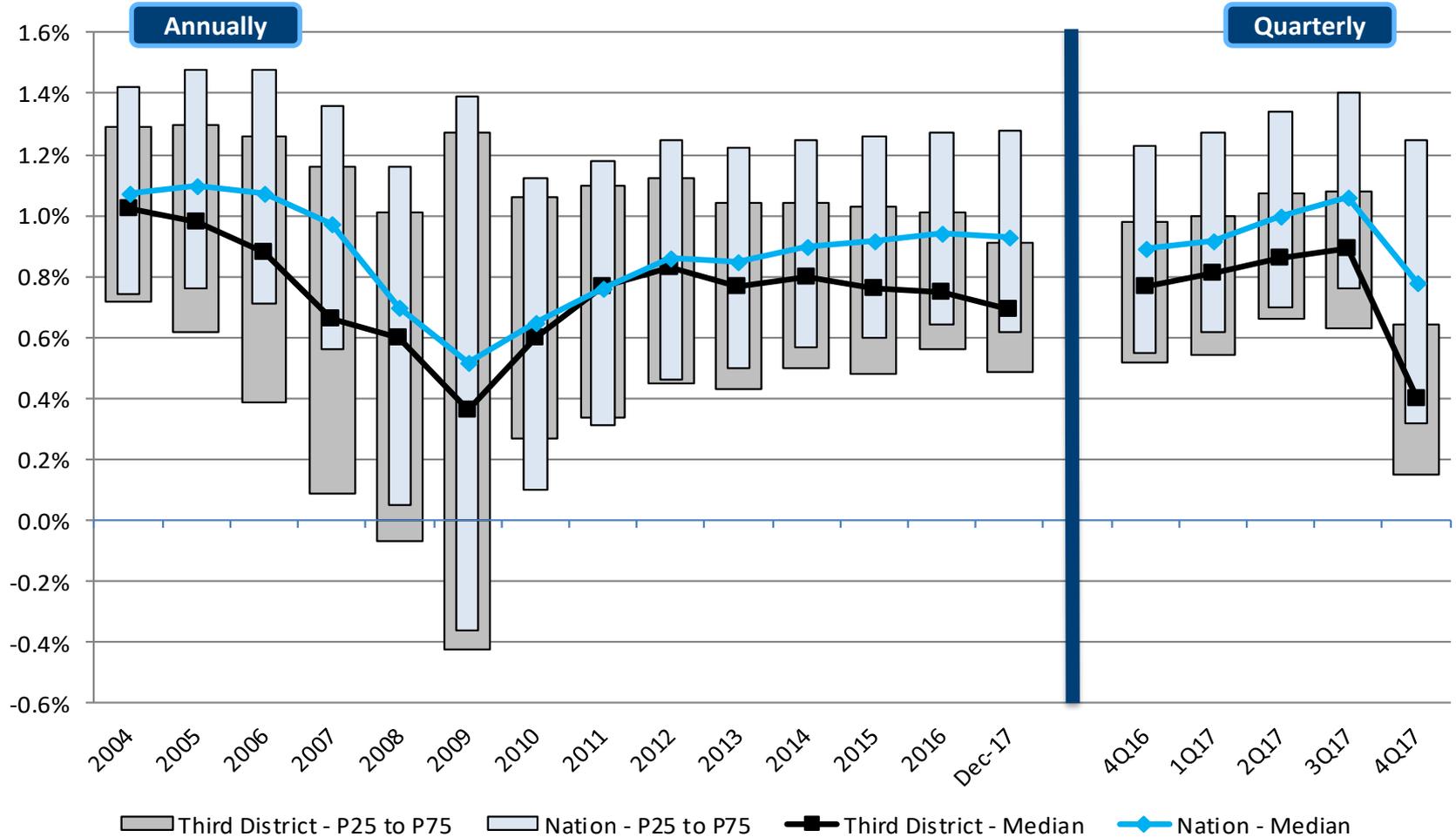
## Reporting Methodology

- 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 **100 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, 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 with 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 that of the nation since 2004. The steep decline in 4Q2017 for the District and nation is primarily due to the change in tax law for deferred tax assets (DTA) and mortgage servicing rights (MSR), with many banks having to revalue their position downward at year-end. This is a one-time reporting item change and ROAA should normalize as of 1Q2018.



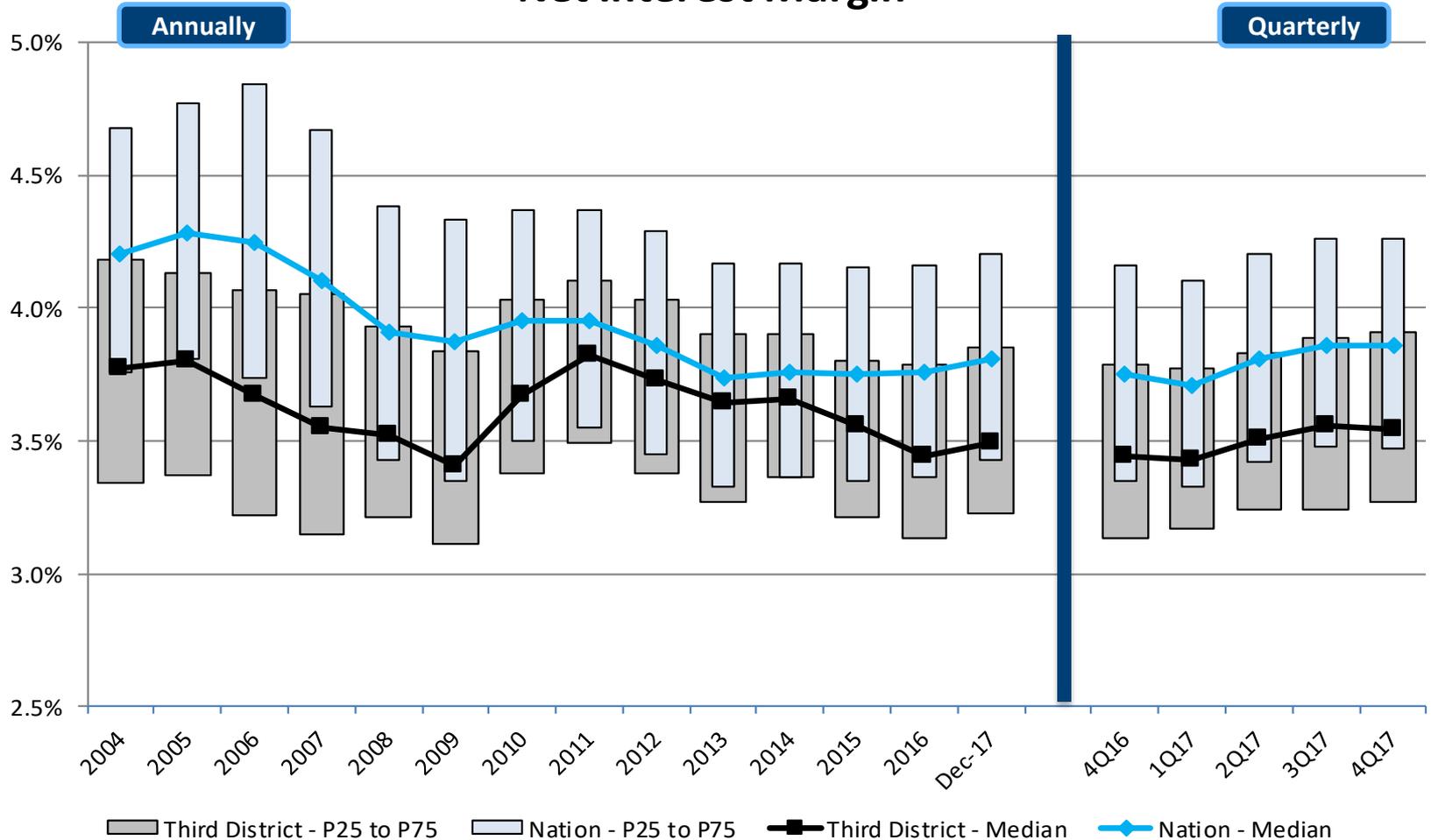
## Return on Average Assets



The Third District net interest margin (NIM) showed a slight uptick at year-end 2017; however, the median remains lower than that of the nation. This variance 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.



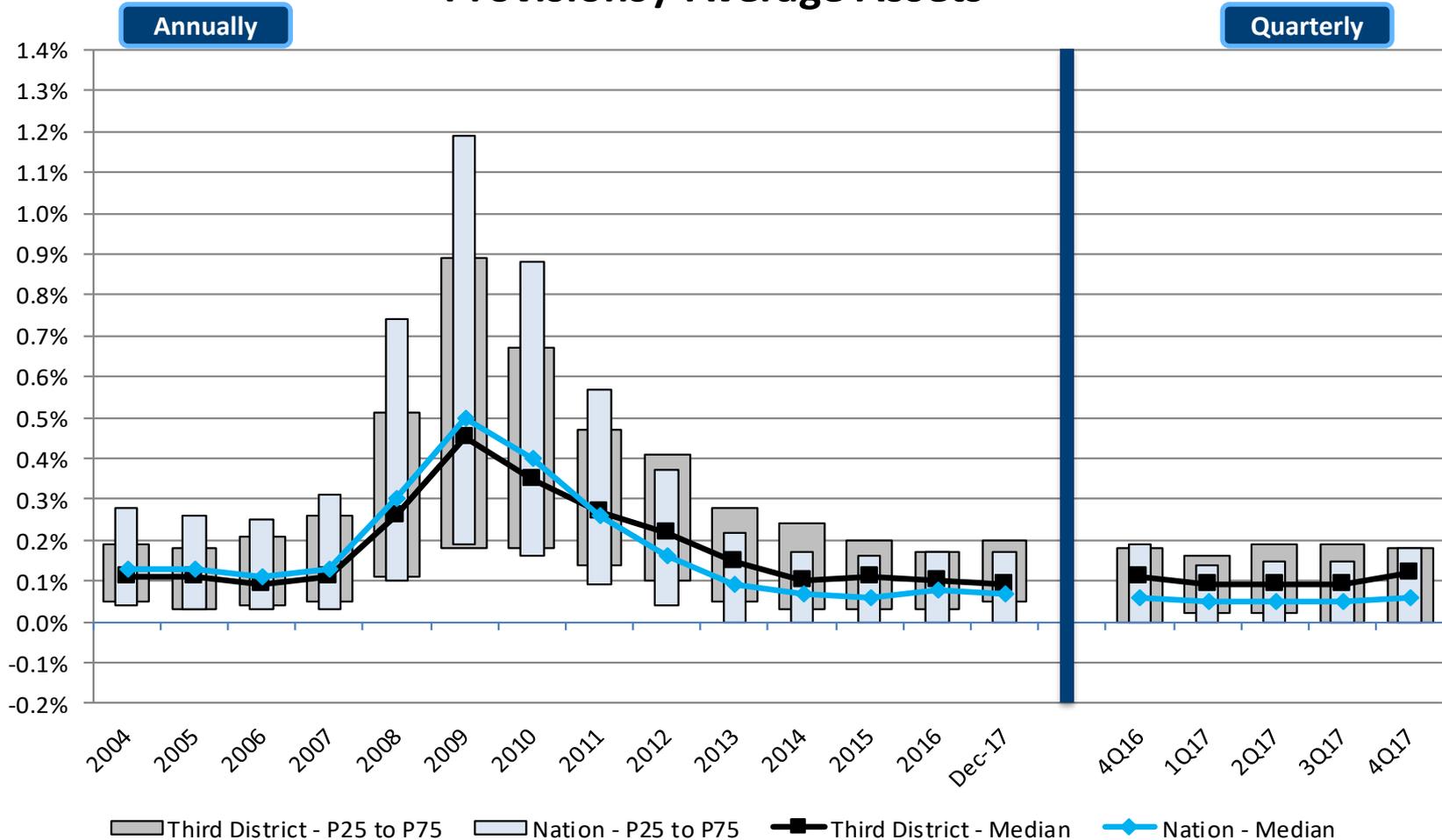
## Net Interest Margin



The provision expense continues to trend around or below precrisis levels. Consequently, the low provision expense helps augment earnings. However, should a collapse in the credit cycle occur, this trend will not be sustainable and thus may negatively impact overall earnings.



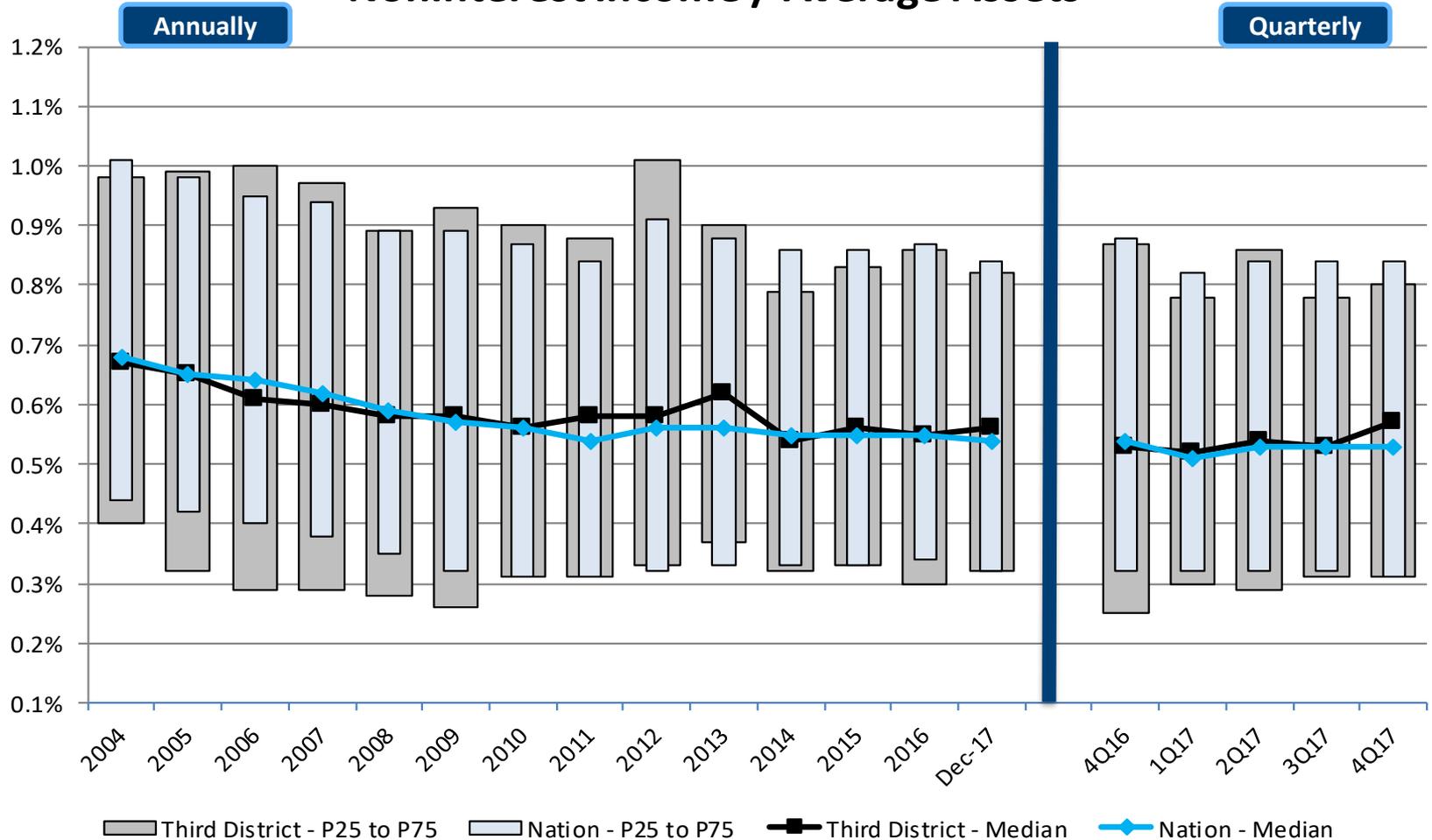
## Provisions / Average Assets



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



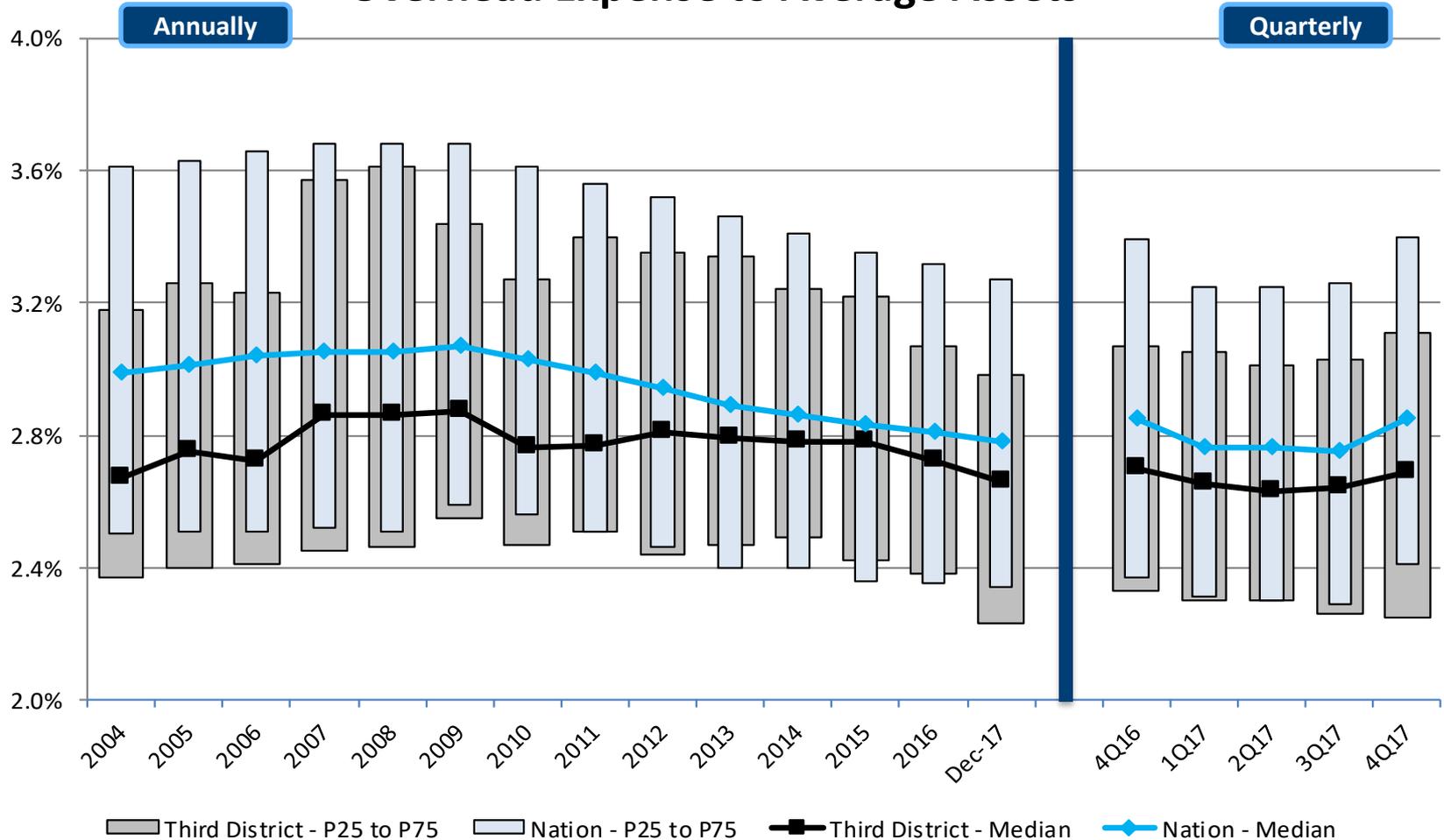
## Noninterest Income / Average Assets



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



## Overhead Expense to Average Assets

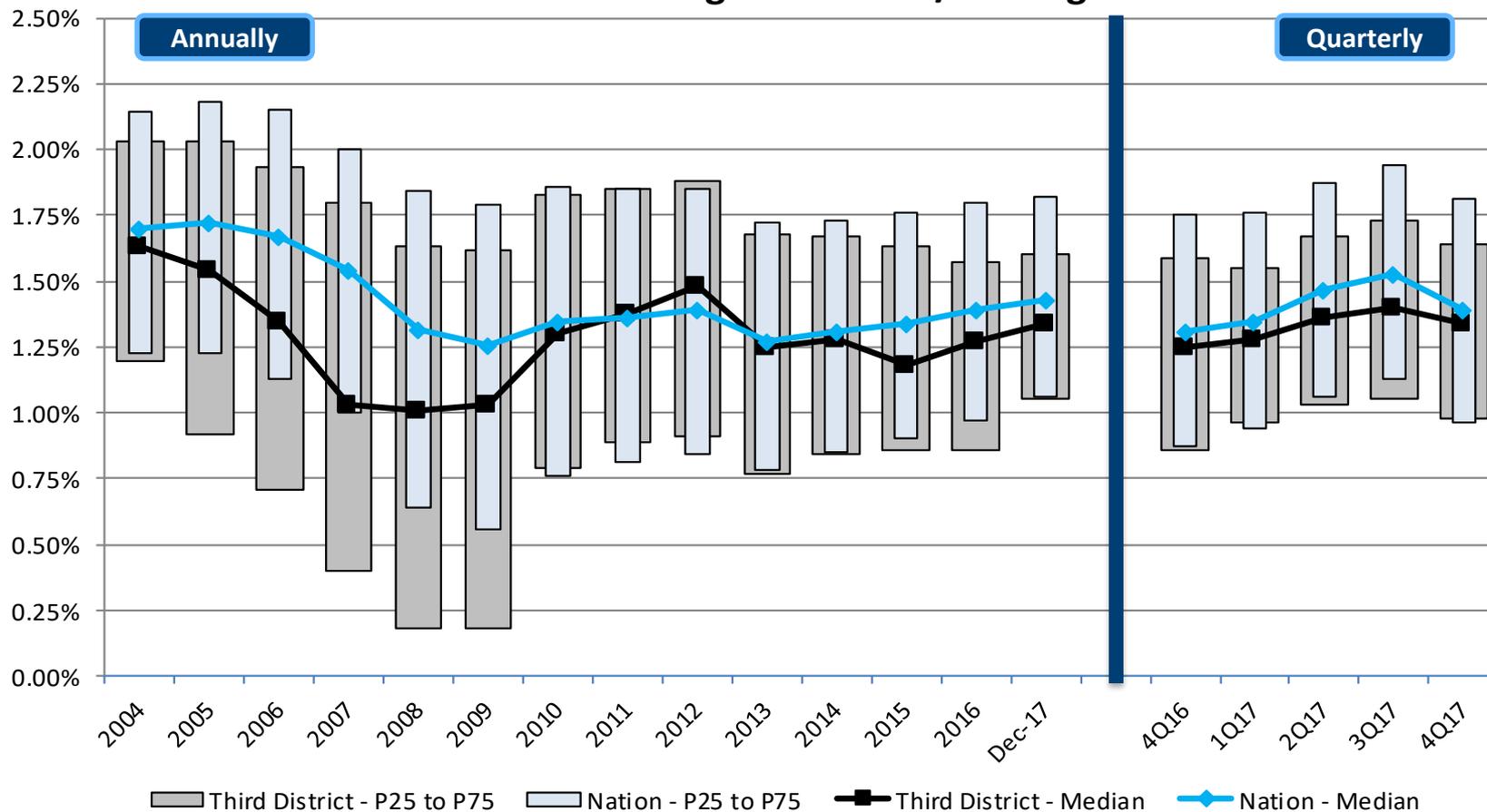


As of 4Q2017, Third District core profitability fell by 2 basis points to 1.34%. This remains higher than the postcrisis low of 1.18% at year-end 2015.



## Core Profitability

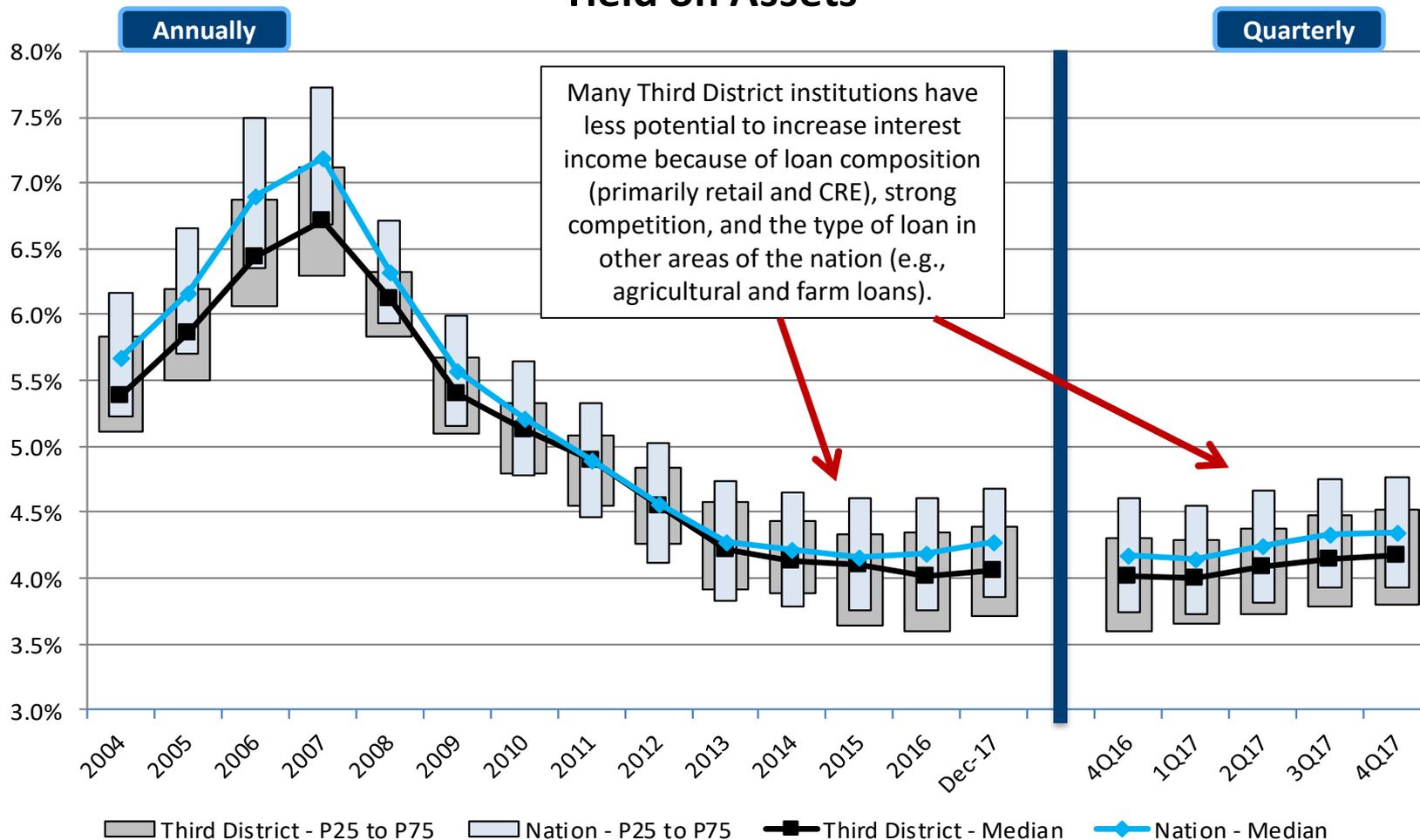
### Pre-Tax Income Excluding Provisions / Average Assets



The current interest rate environment, the concentration of retail and commercial real estate (CRE) loans, and the heightened competition for loans constrain the yield on assets within the Third District.



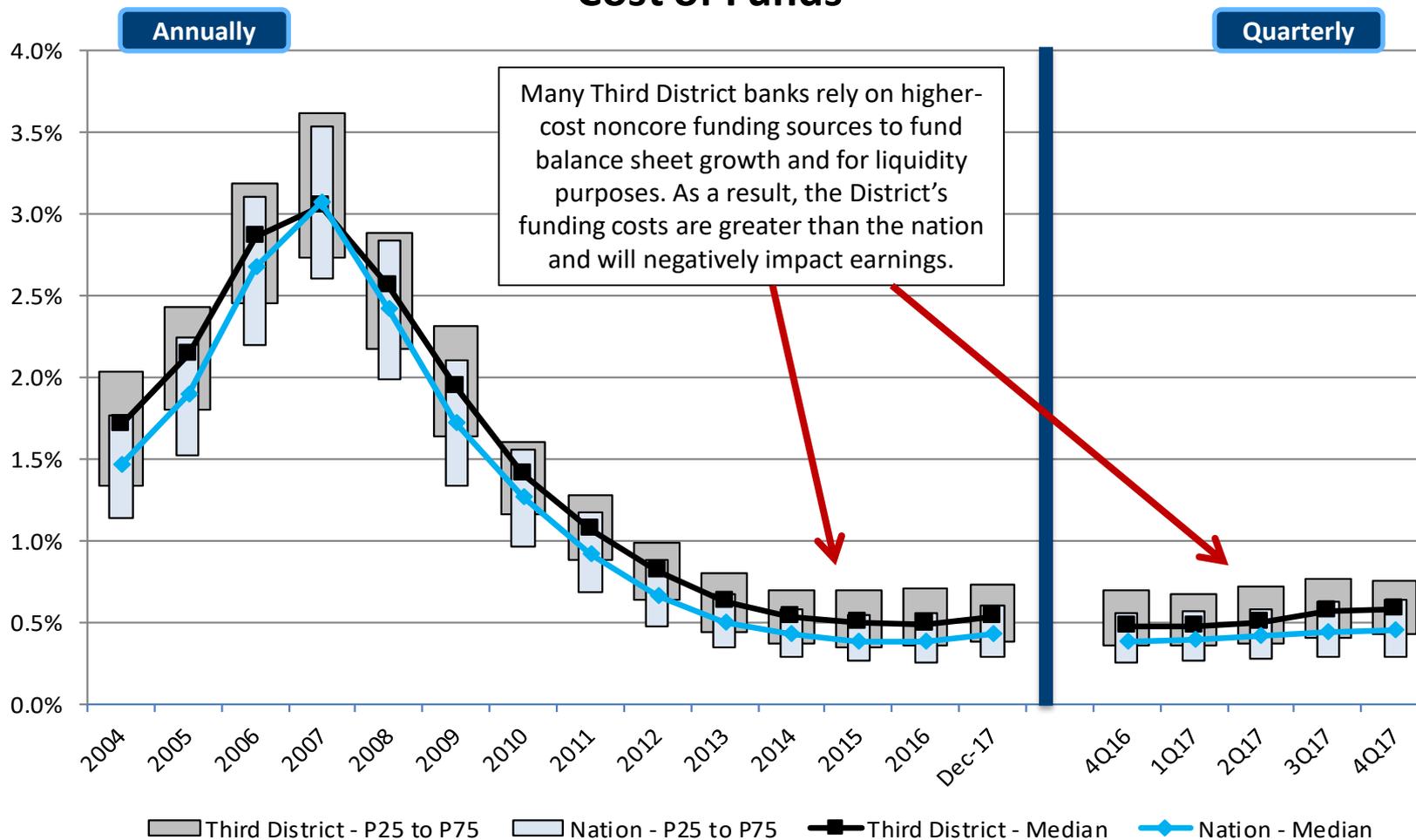
## Yield on Assets



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 compared with that of the nation because of concentrations in more expensive sources of noncore funding.



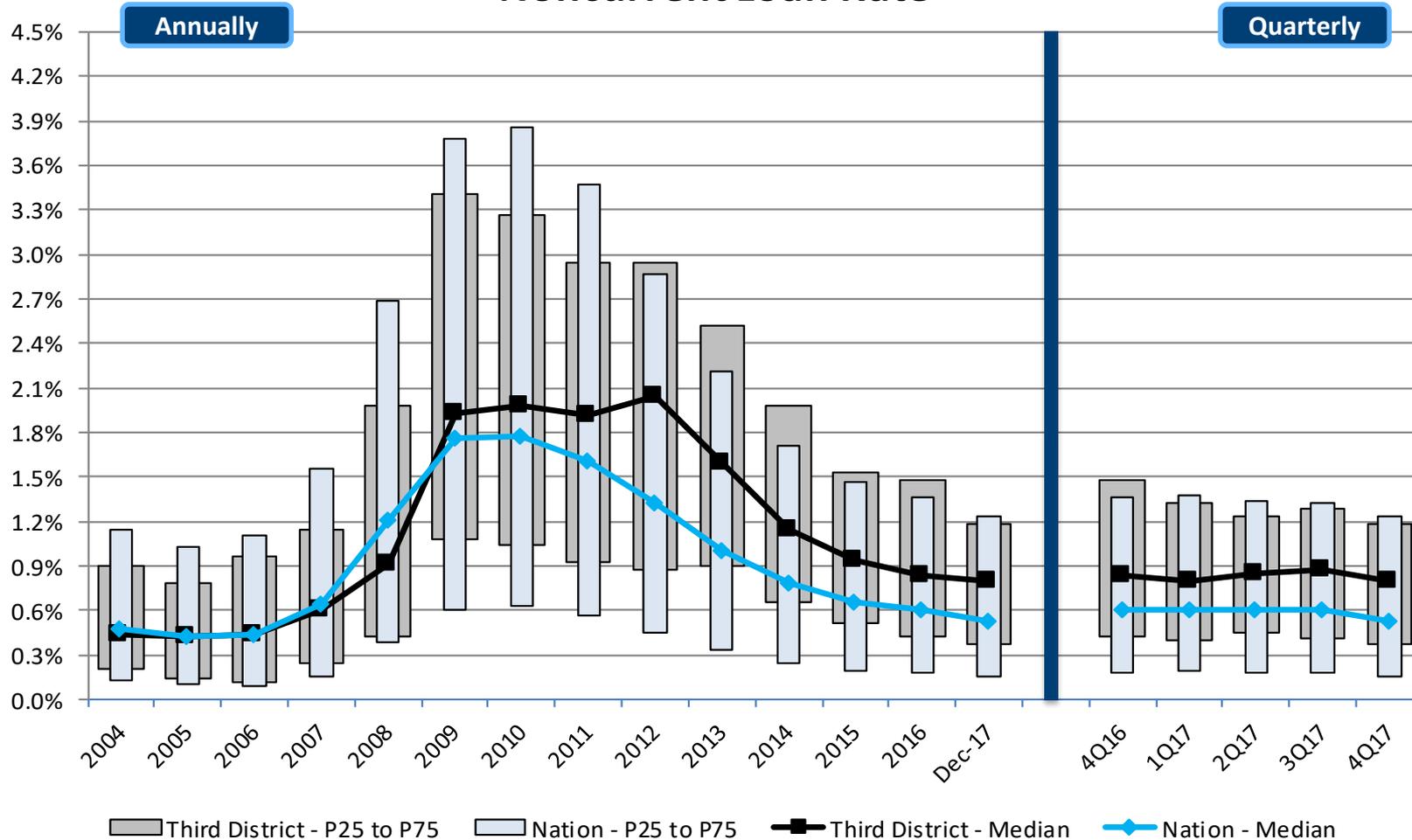
## Cost of Funds



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



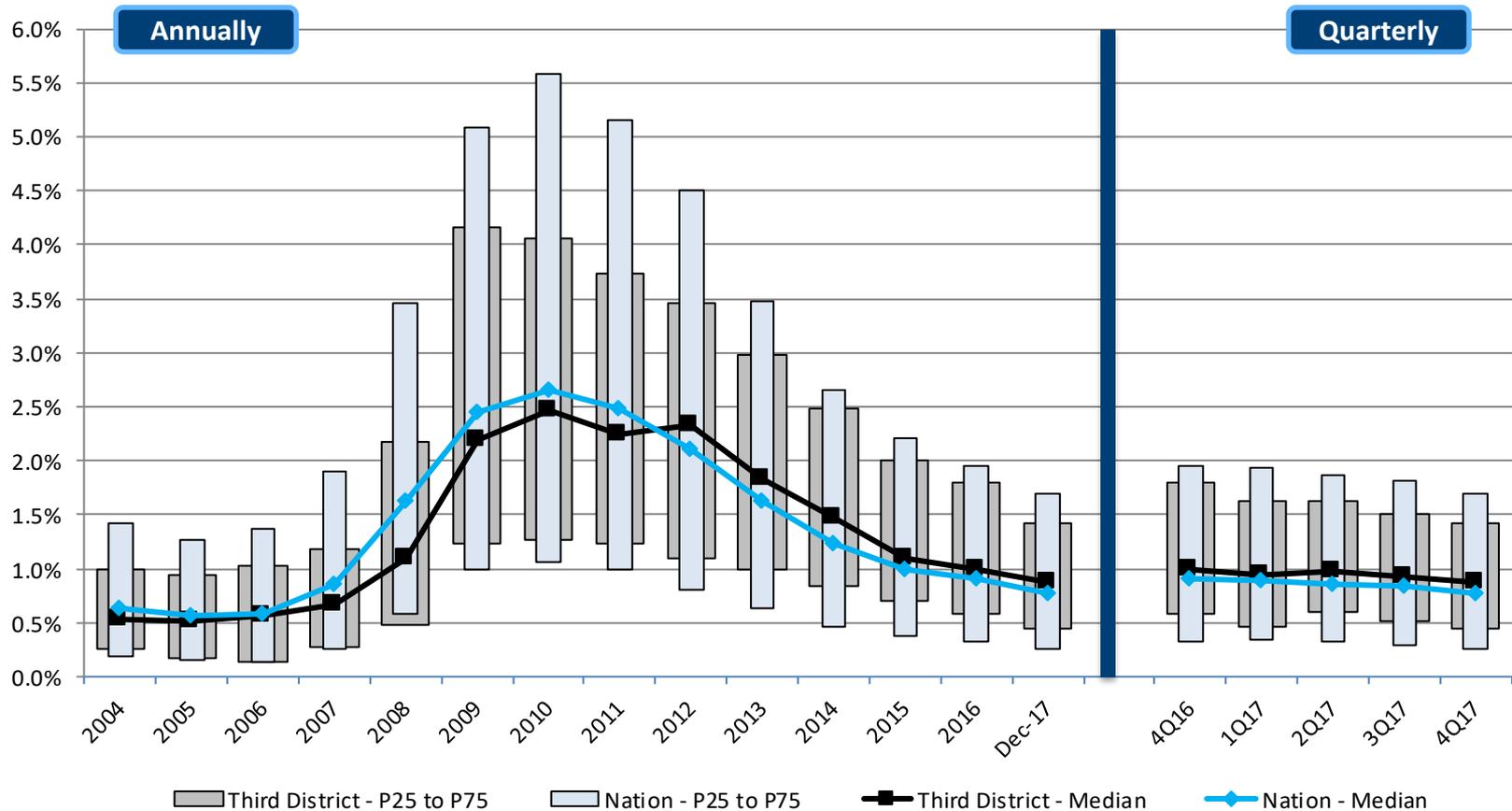
### Noncurrent Loan Rate



Additionally, the Third District's median level of nonperforming assets has been decreasing slightly during the past five quarters, although it remains slightly above that of the nation.



### Nonperforming Assets\*

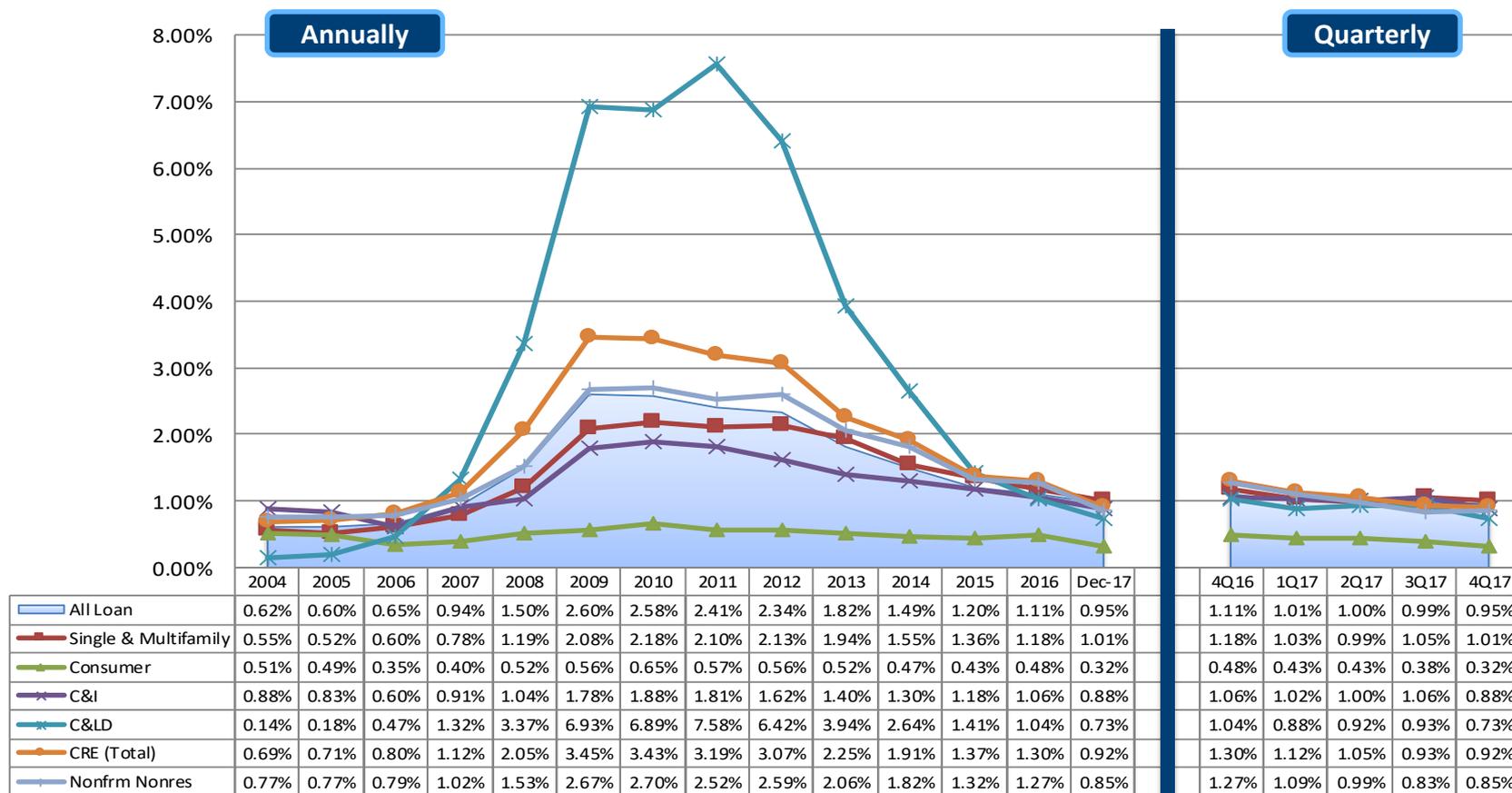


\* NPAs (nonperforming assets) are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans)

# Third District loan performance continues to show ongoing improvement among the principal loan categories, which are at or below 2007 levels.



## Noncurrent Loan Ratios by Loan Category

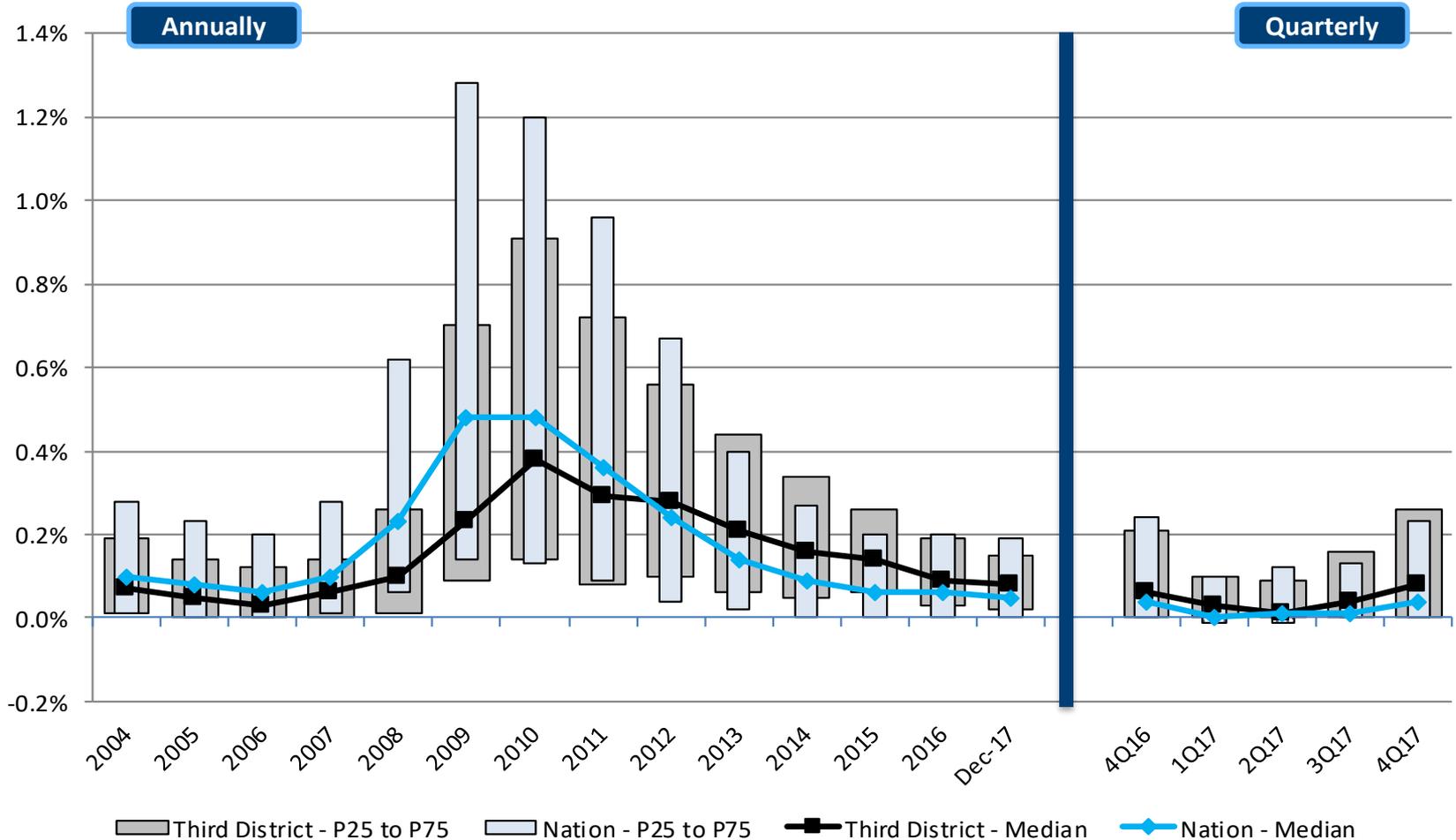


This chart uses a 10% capped mean, or winsorized mean, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on the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

The Third District's and the nation's net charge-off rates have declined steadily since 2010 and are now in line with precrisis loss levels.



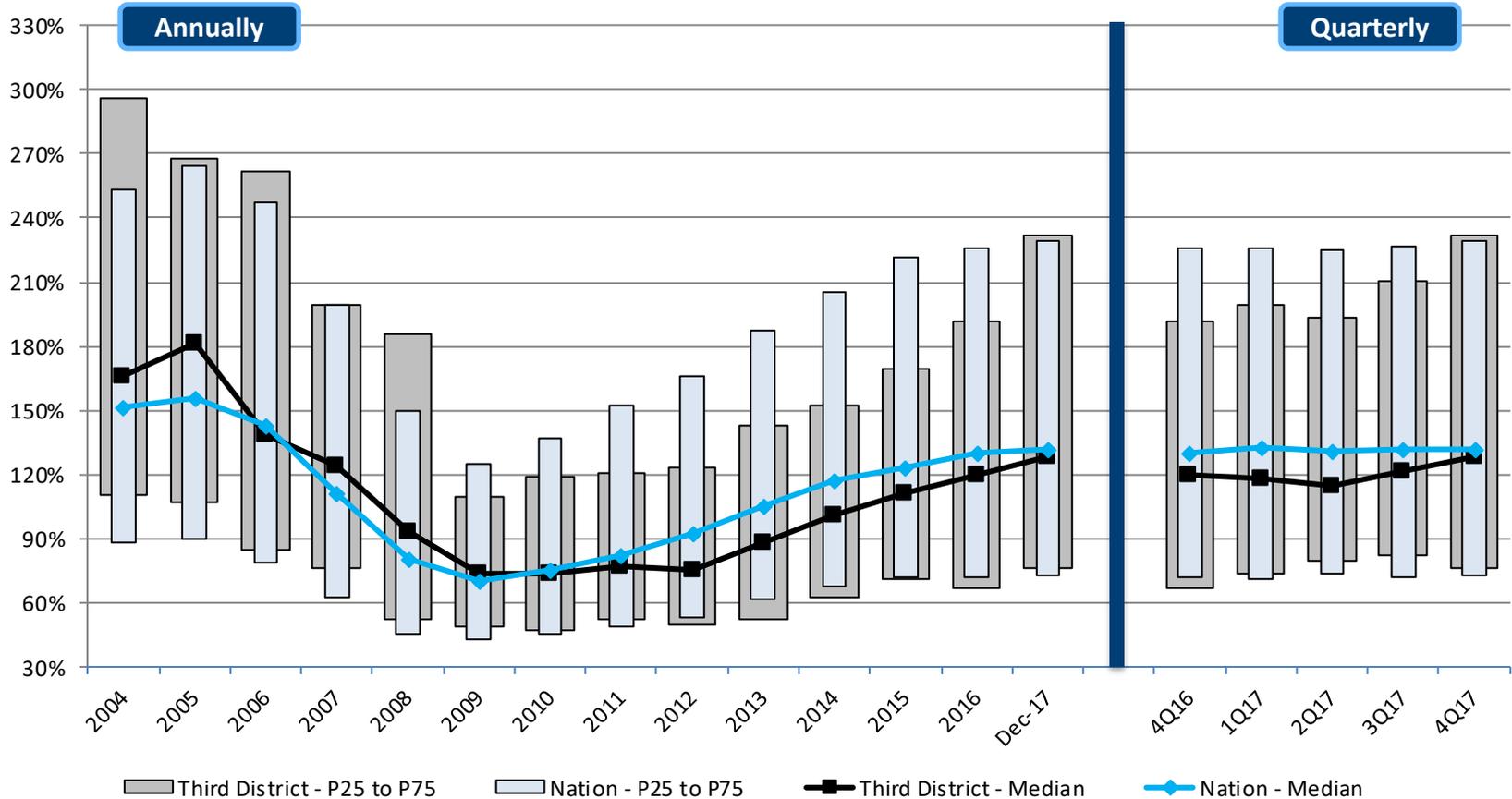
## Net Charge-offs / Loans



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



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

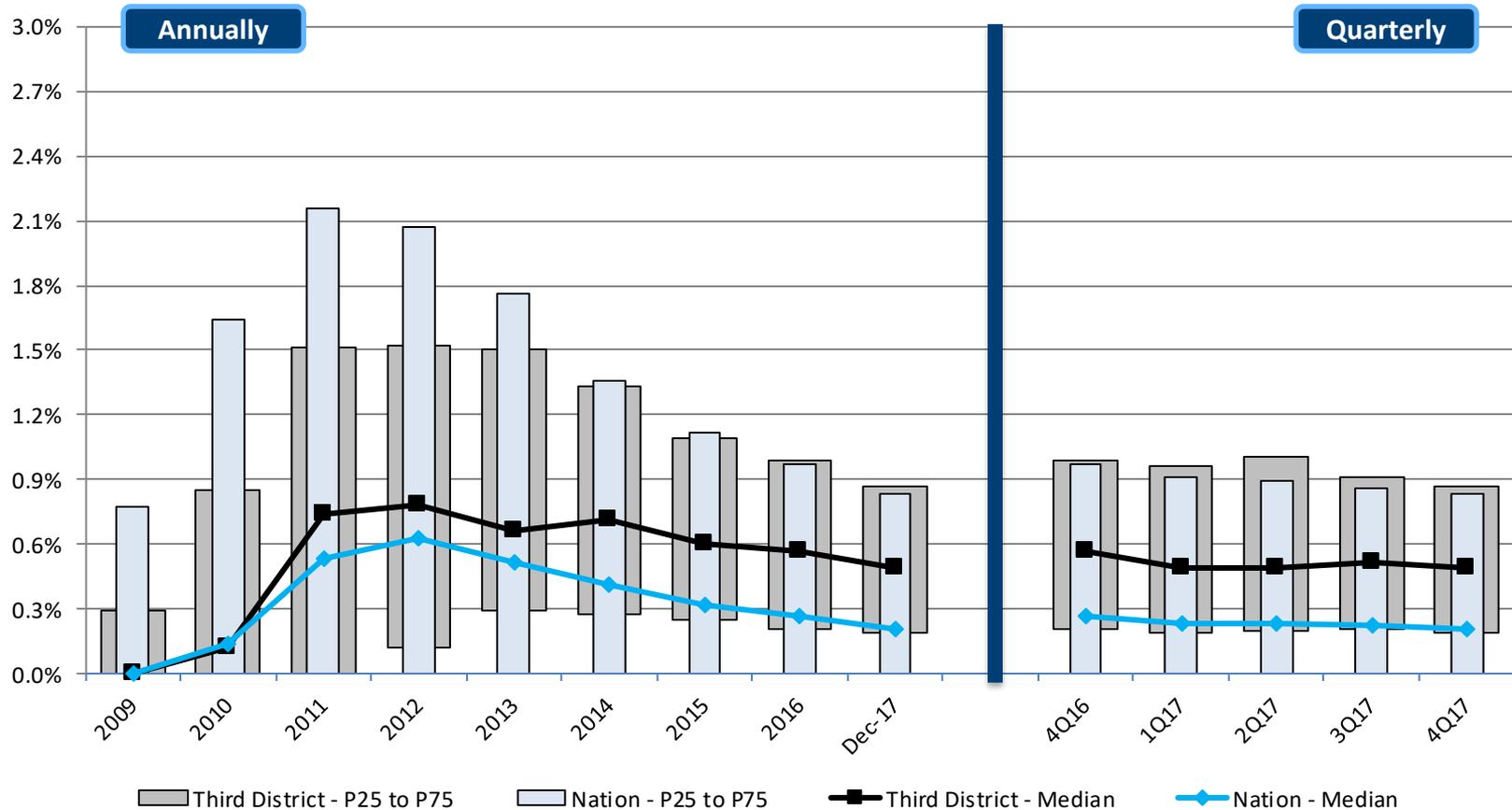


\* The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.

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



## Troubled Debt Restructurings\*

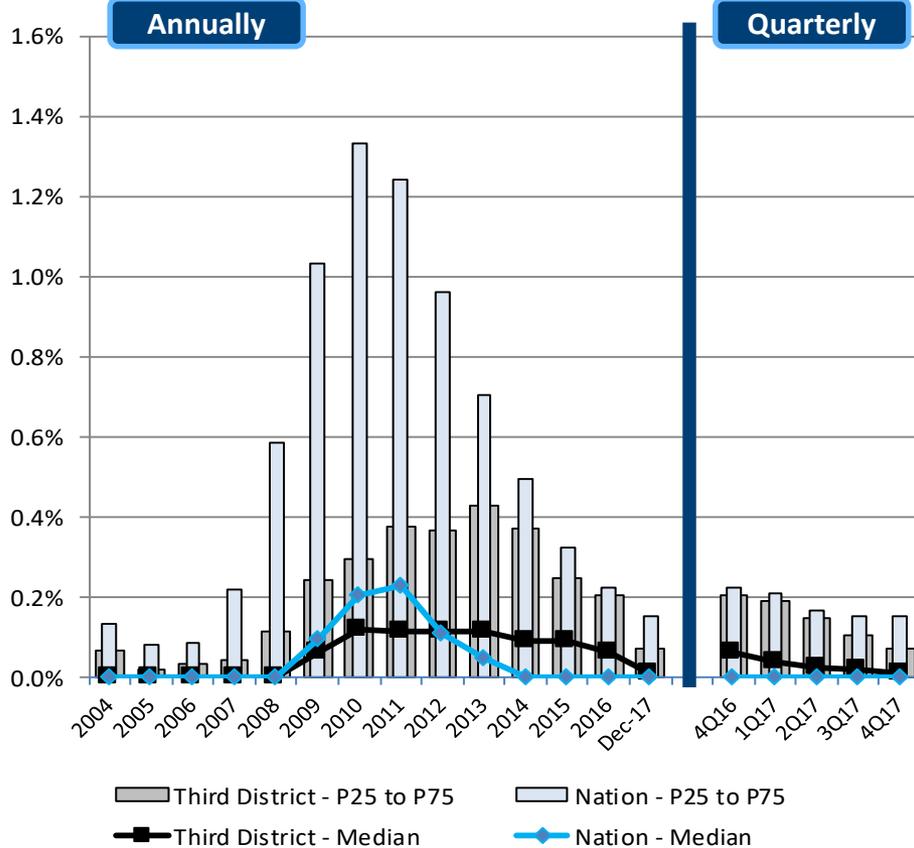


\* Troubled debt restructurings (TDRs) were not included in the Call Report until the March 2009 reporting period.

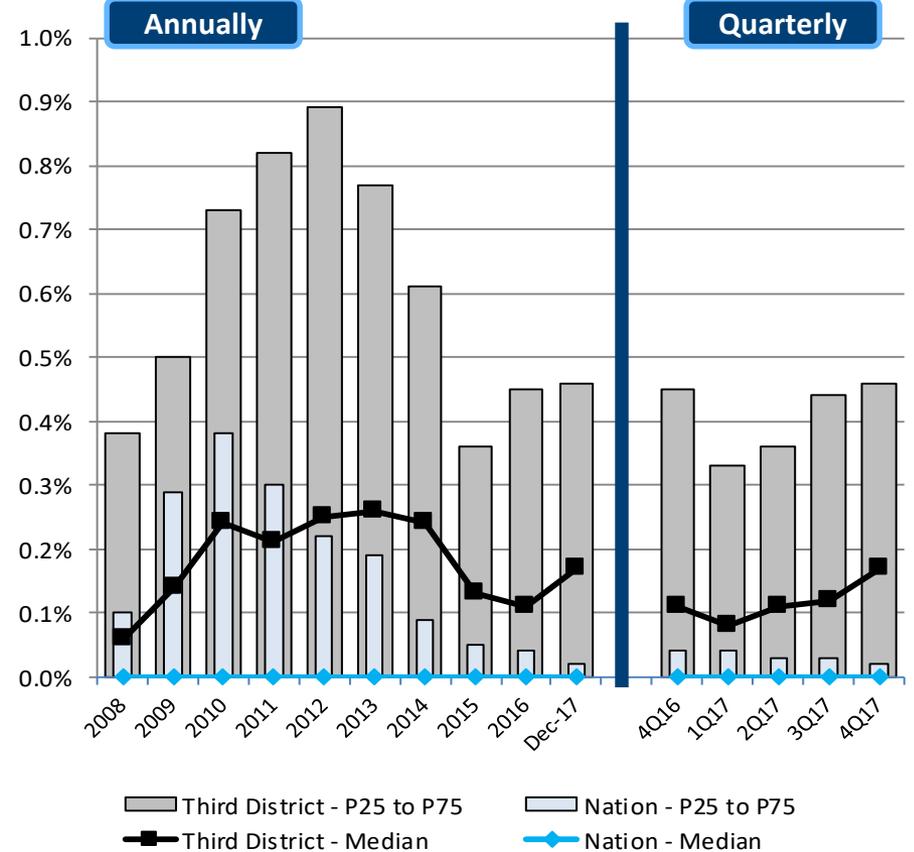
One- to four-family other real estate owned (OREO) continues to decrease; however, the Third District continues to trail in the foreclosure process because of the judicial foreclosure process in Pennsylvania, Delaware, and New Jersey.



1-4 Family OREO\*



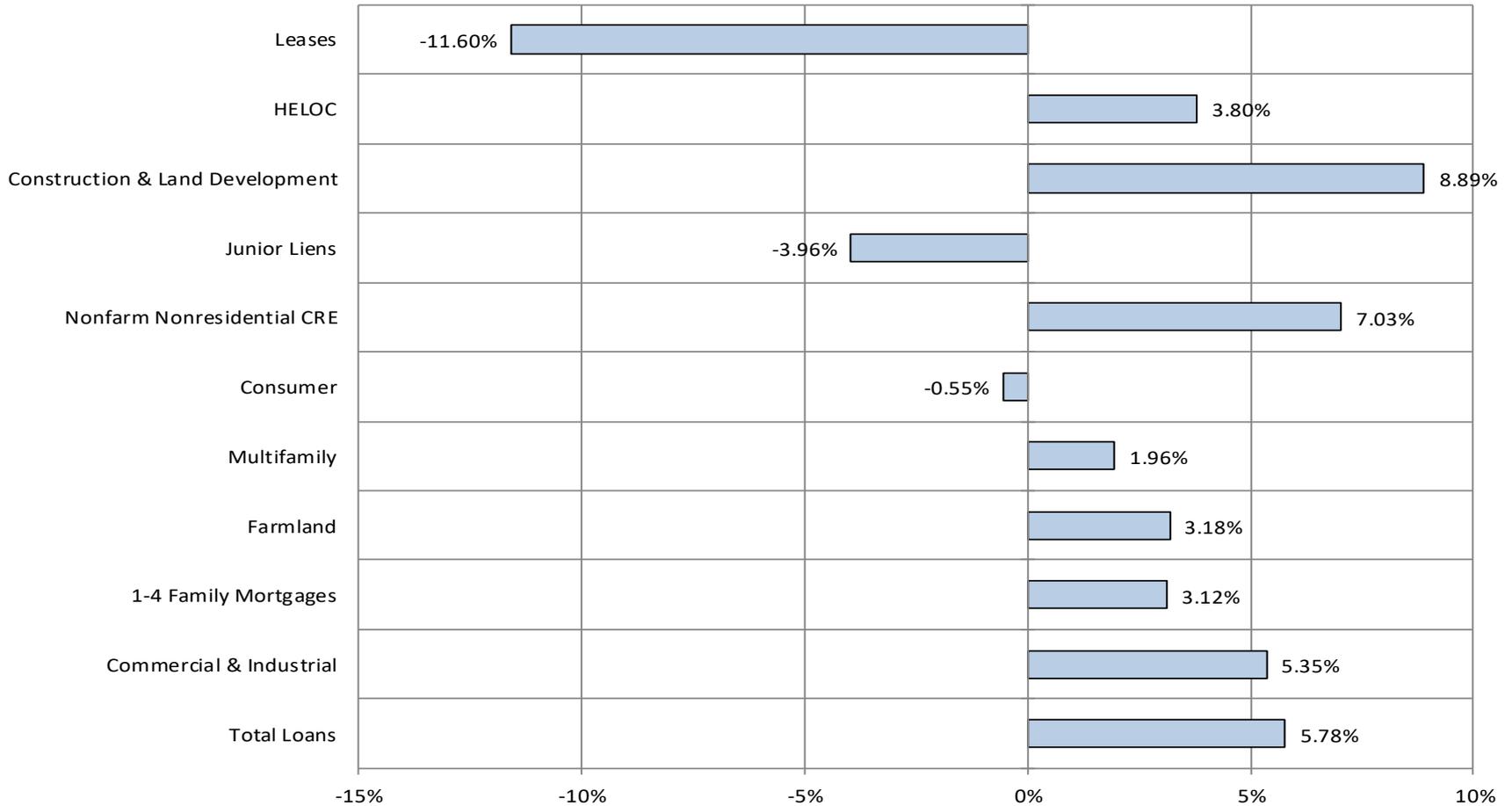
Loans in Process of Foreclosure\*\*



\* 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 has occurred in the junior lien loan and the leases categories.

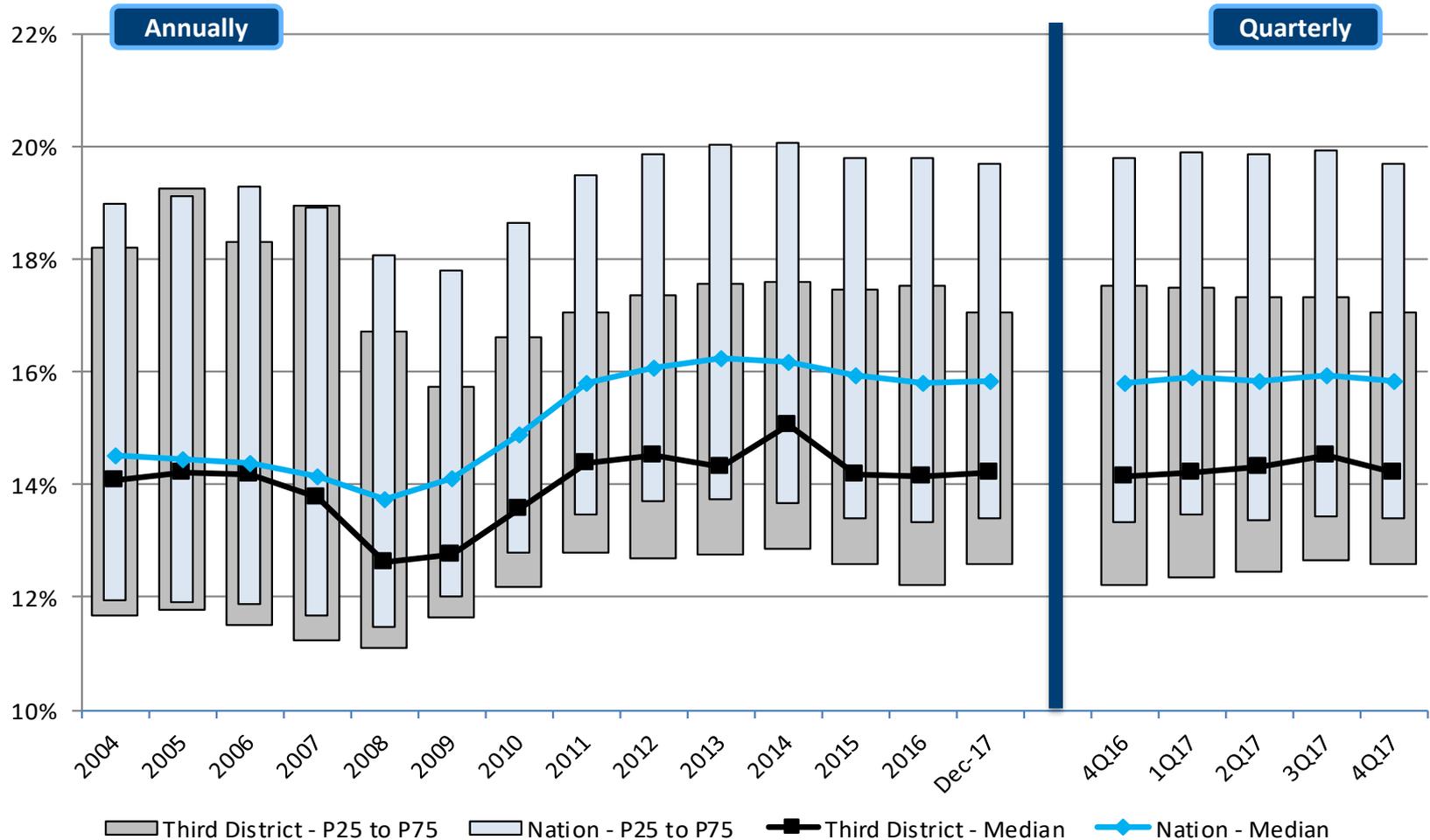


\* This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 4.

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



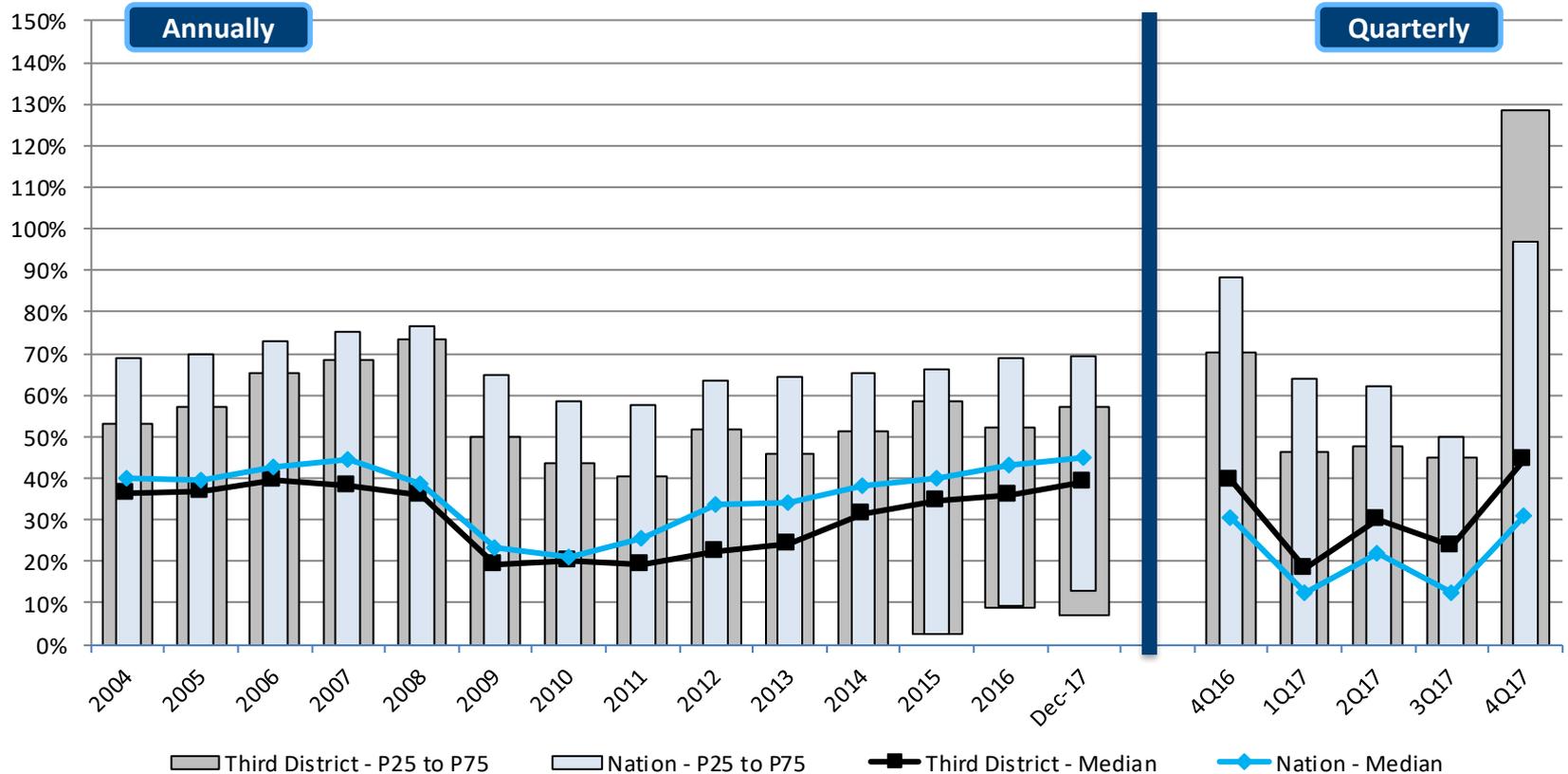
## Total Risk-Based Capital



# As of 4Q2017, median dividend payments\* in the Third District increased to comparable precrisis levels.



## Dividends

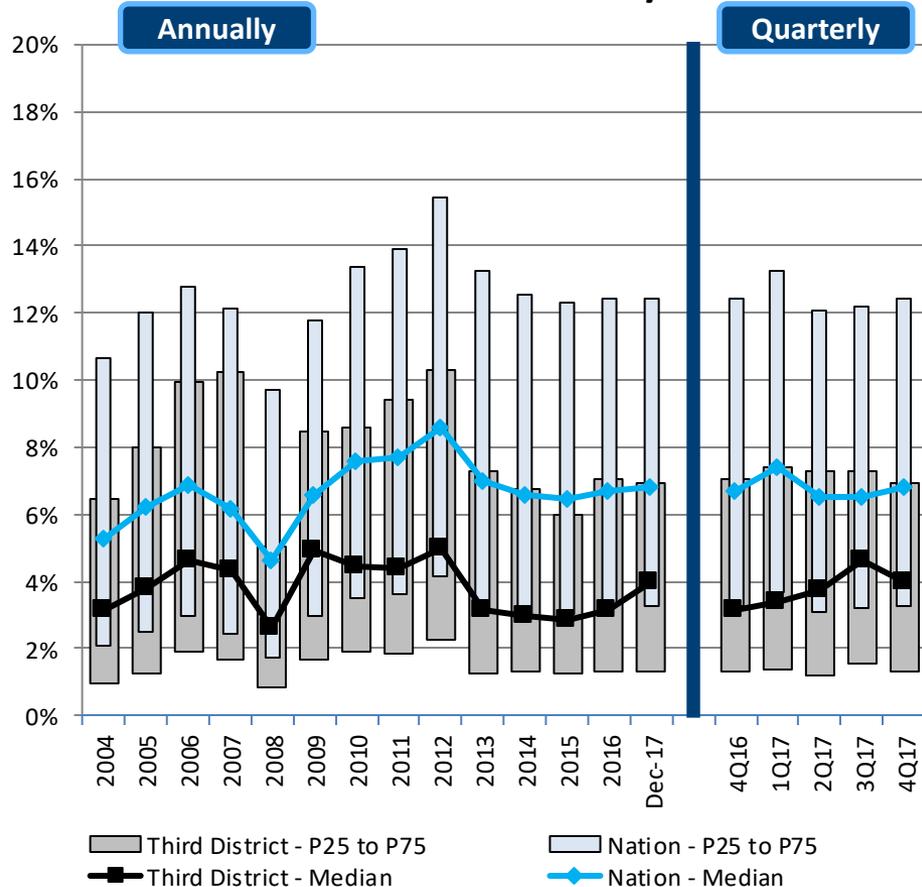


\* Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout (DPO) ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income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

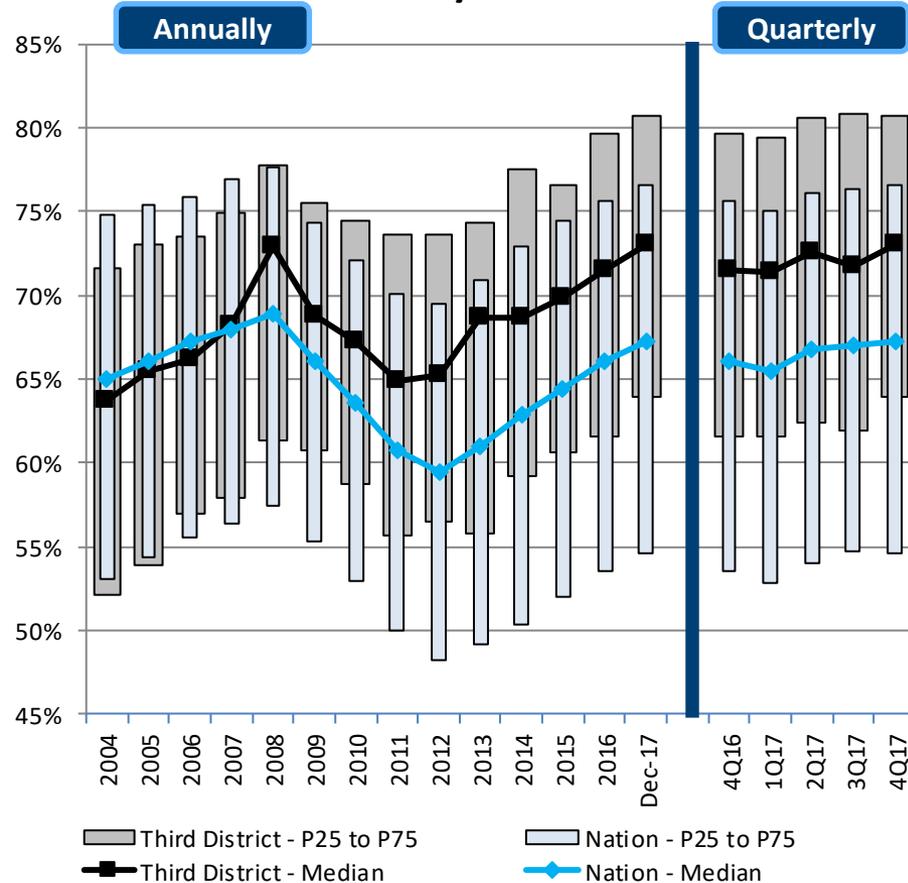
Third District banks hold fewer short-term investments compared with that of the nation. Additionally, the District continues to grow its loan portfolio, which may increase duration and interest rate risk depending on the loan type.



### Short-Term Investments / Assets\*



### Loans / Assets

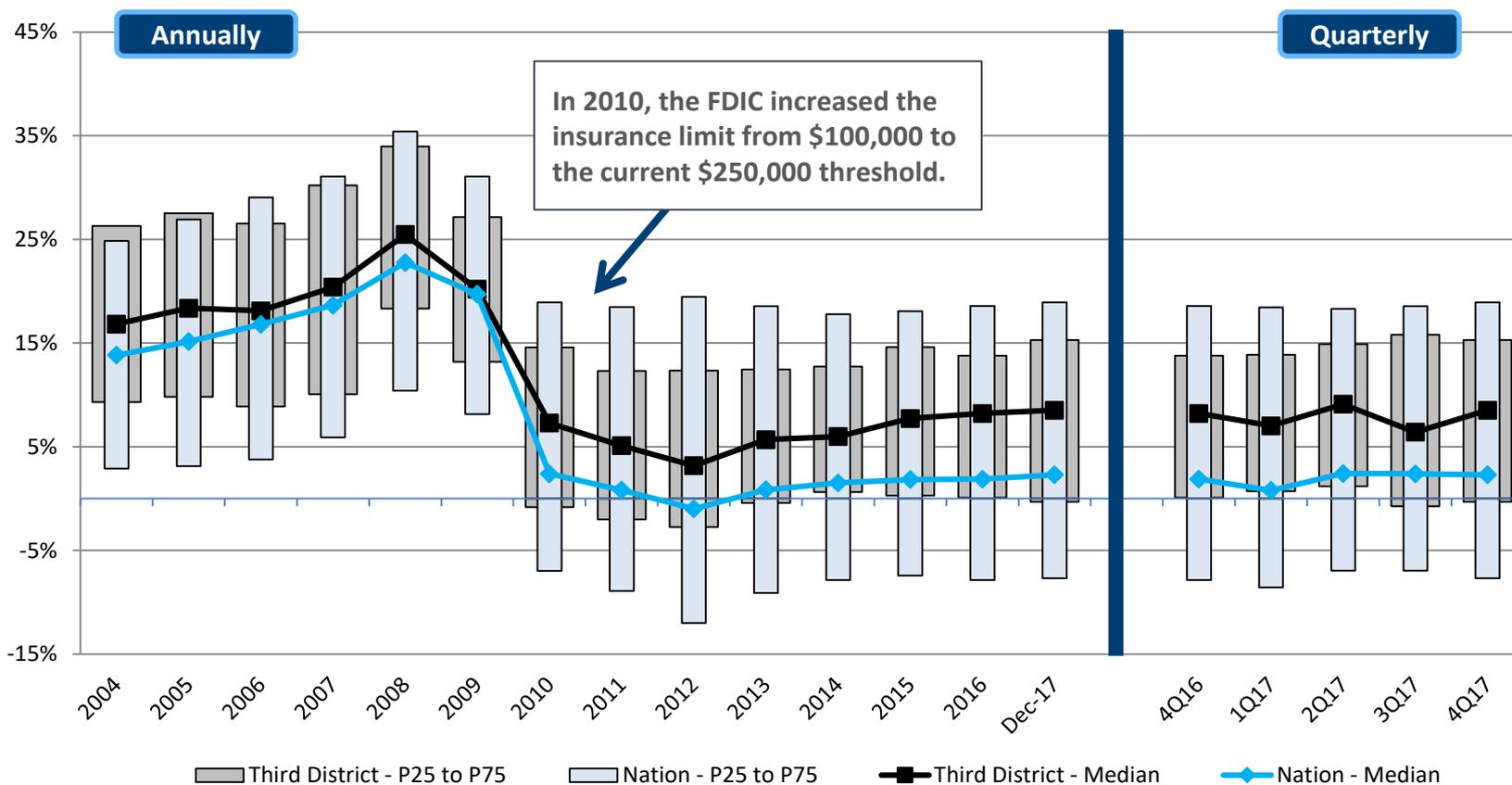


\* Short-term investments equals the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

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

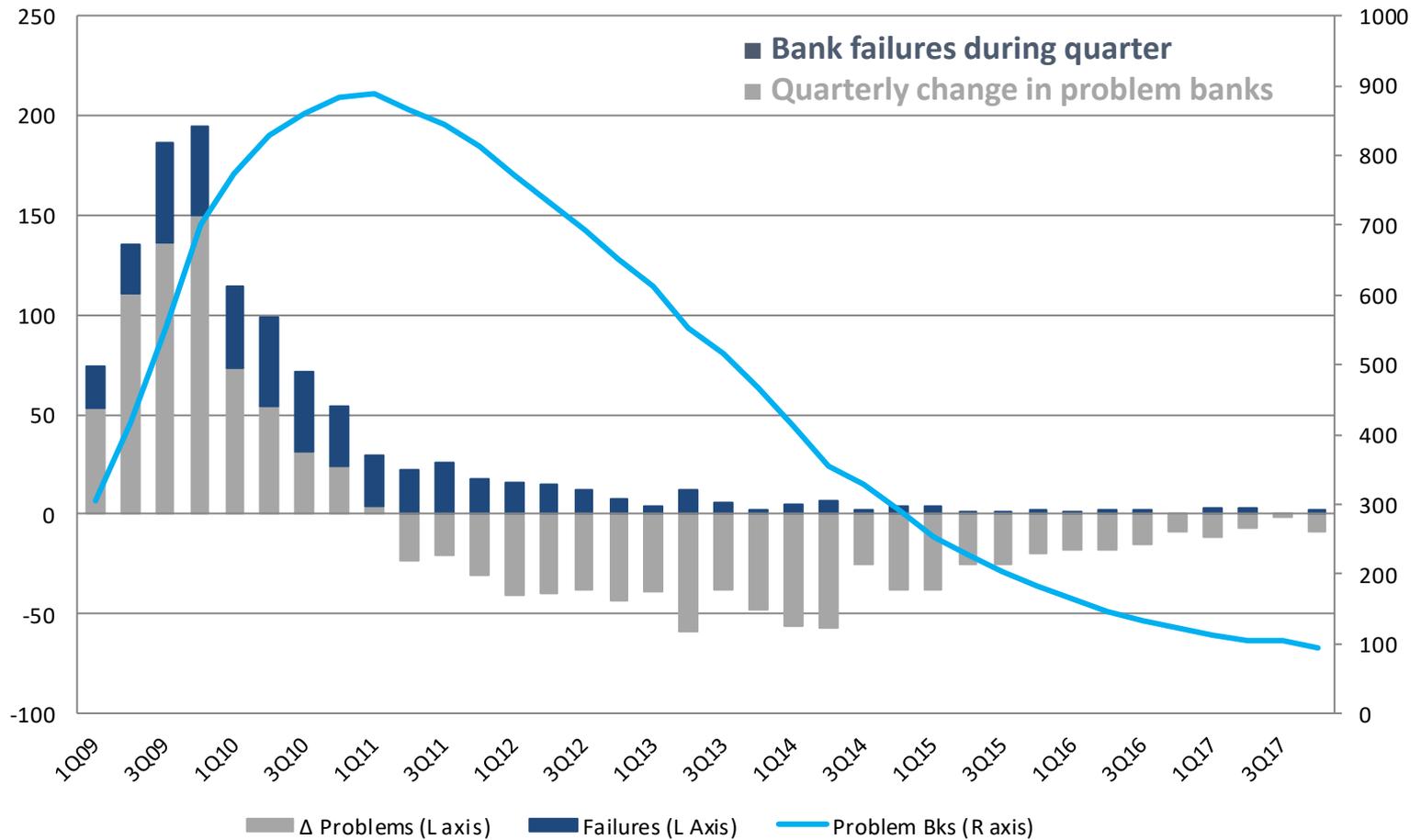


## Net Noncore Funding Dependence\*



\* 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 95 as of 4Q2017, which is the smallest number of problem banks since 1Q2008. Additionally, two banks failed within the 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 **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk.