Third District Banking Conditions as of June 30, 2018

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

FEDERAL RESERVE BANK OF PHILADELPHIA

Third District Conditions

Agenda and Table of Contents			
Section 1	Executive Summary	Slide	3–5
Section 2	Commercial Bank Performance	Slides	6–27
	Earnings	Slides	7–14
	Credit Quality	Slides	15–21
	Loan Growth	Slide	22
	Capital Adequacy	Slides	23–24
	Liquidity	Slides	25–26
	Problem Banks	Slides	27

For any questions about this presentation, please contact the Risk Analytics & Surveillance unit at the Federal Reserve Bank of Philadelphia.

Section 1: Executive Summary

- Financial performance results for Third District community banks* continue to demonstrate steady performance. Much of this progress is primarily because of the benign economic environment, the second-longest economic expansionary cycle of 114 months** (second only to the expansion between March 1991 through March 2001, or 120 months) and continued strength within the banking sector. Conditions are highlighted by the following:
  - Earnings ratios have returned to precrisis levels, driven primarily by strong loan growth and loan performance indicators.
  - Third District asset quality metrics continue to improve over time because the level of noncurrent loans have fallen to precrisis results.
  - Capital ratios remain well capitalized for most institutions because earnings have been accretive to capital. For Third District banks, however, capital ratios remain below those of the nation; however, the ratios remain above the well-capitalized threshold.
    - For some institutions, the excess capital may provide the opportunity for continued consolidation in the industry, or it might provoke stock buybacks to help improve shareholder ownership.

* Community banks are defined as national, nonmember, and state member banks with less than $10 billion in assets.
** The current economic expansionary cycle began in March 2009. The 114 months reported is inclusive through September 2018.

Section 1: Executive Summary (cont'd)

- Challenges do 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. Some banks will continue to reevaluate their on-balance sheet DTAs to ensure they are reported correctly, with some potentially taking more losses post the valuation exercise.
  - Interest rates are beginning to rise after the Federal Open Market Committee's seven fed funds rate increases since 2015. However, given the extended accommodative 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, especially by reporting zero or negative provisions to increase overall profitability. Nevertheless, this strategy artificially increases earnings during a time of strong asset quality metrics for a given time period. This practice is not sustainable for long-term earnings growth.
  - Competition for loans and deposits is increasing within the District and have compressed the net interest margin (NIM) considerably when compared with that of the nation. Third District banks normally maintain a lower yield on assets and a higher cost of funds when compared with the nation, a result of the overall competitive landscape for our institutions.
  - Reliance on noncore funding sources continues to aid in the growth of some banks' balance sheet within the Third District. This type of funding for District institutions remains elevated and outpaces the industry. Many of these funding costs (e.g., Federal Home Loan Bank (FHLB) borrowings, brokered deposits) are greater than that of core deposits and may reprice faster than assets 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, which could increase the level of interest rate risk by increasing duration, basis, and repricing risk.

Section 1: Executive Summary (cont'd)

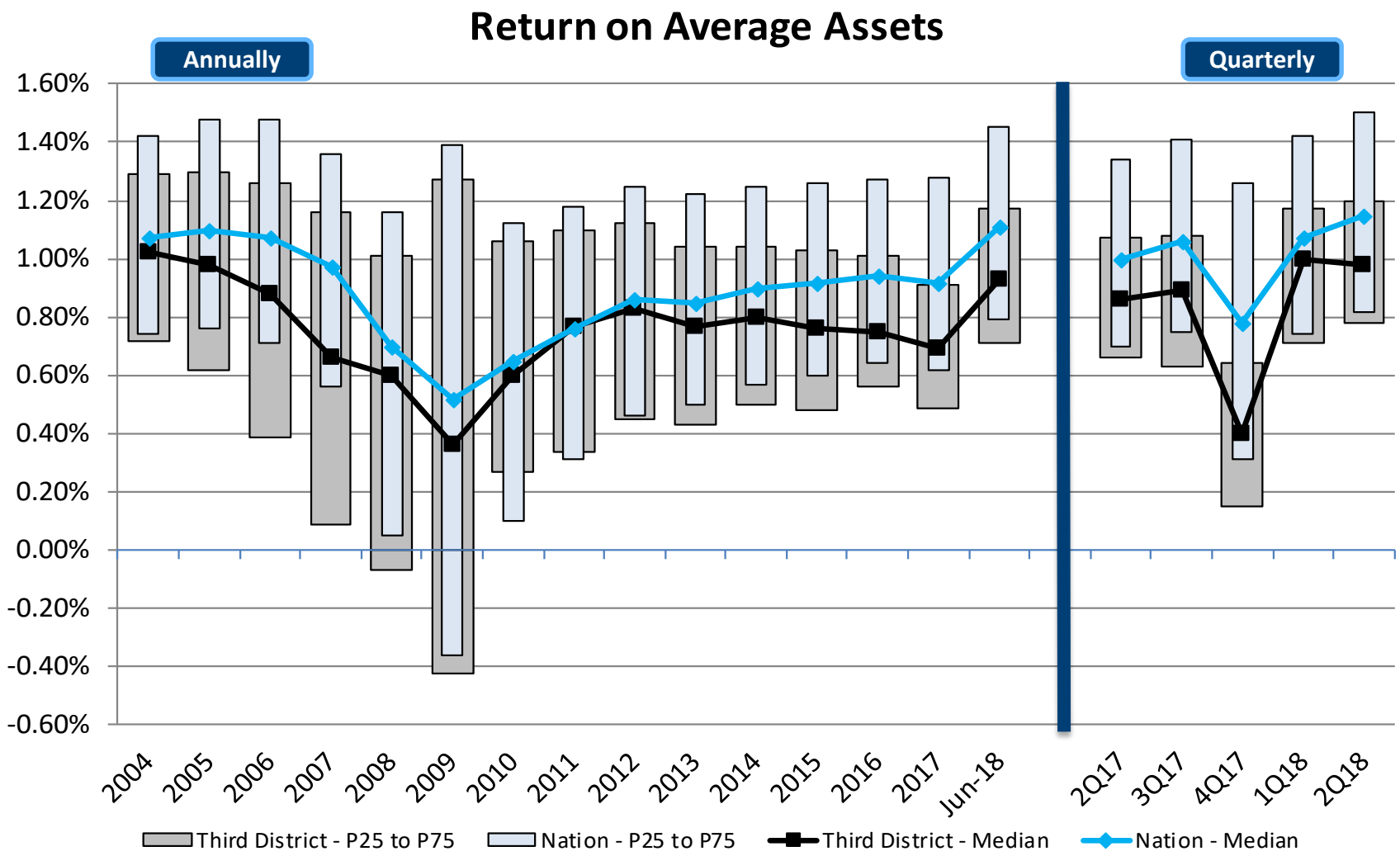
- Qualitative and/or operational risks that remain on the risk radar include:
  - Cybersecurity
  - Credit concentrations – Commercial Real Estate (CRE) (Refer to SR Letters 07-1 and SR 15-17), municipal loans, credit cards, and auto loans
  - Management succession and strategic planning
  - Model risk management (SR 11-7 compliance)
  - Competition from fintech firms and credit unions for loan and deposit growth
  - Continued pace of mergers and acquisitions may harm regional and community banks should they decide to look for new ways to find economies of scale
  - BSA/AML changes to customer due diligence (CDD) adjustments and compliance with the Act
- The number of problem banks fell by six banks from 95 in 2017:Q4 to 89 as of 2018:Q2. This represents the lowest number of problem banks in more than seven years, declining significantly from the peak of 888 problem banks in 2011:Q2.

Section 2: Conditions of Third District Community Banks

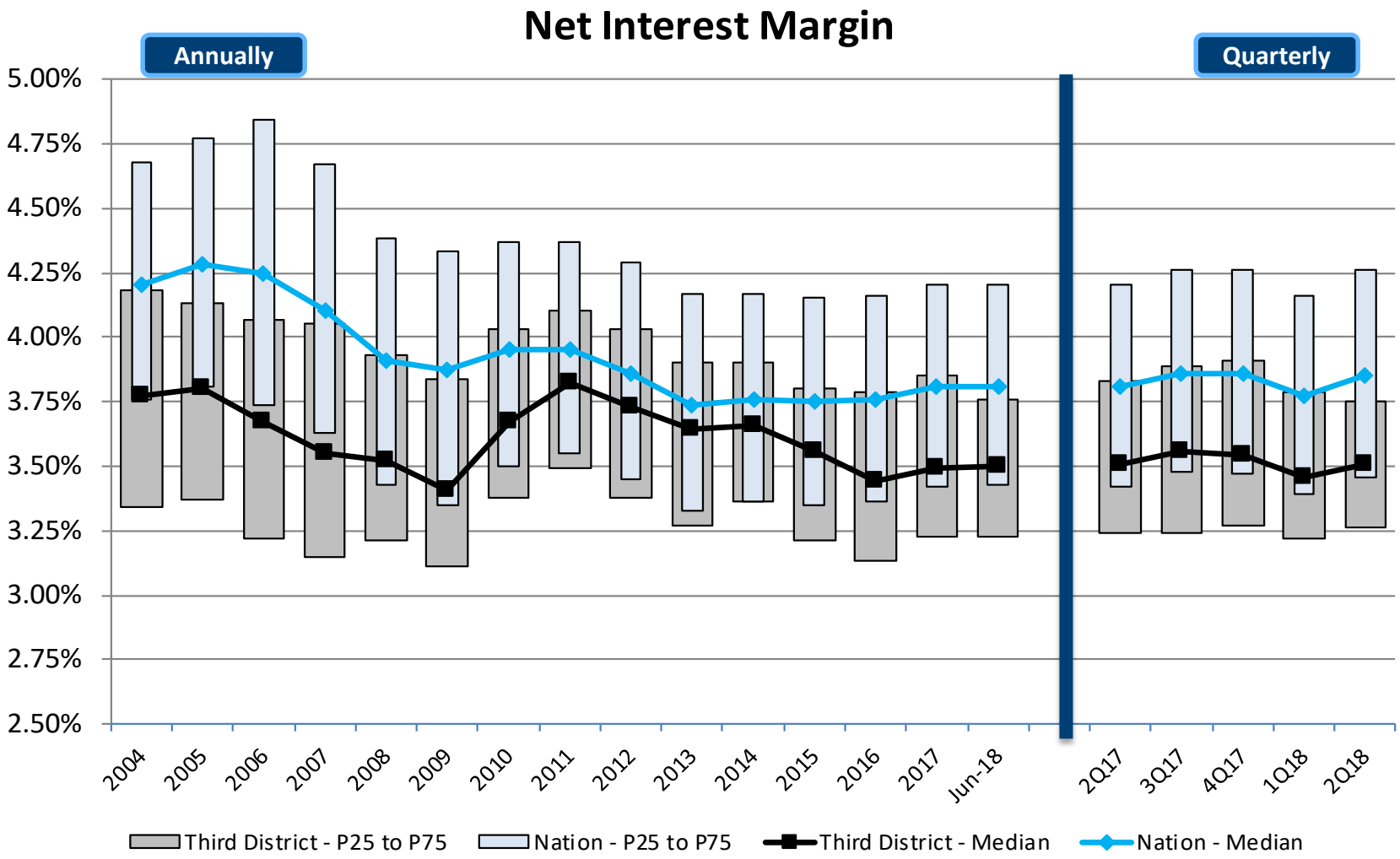
Reporting Methodology

- 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 **99 community 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, 2018**:
  - 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.

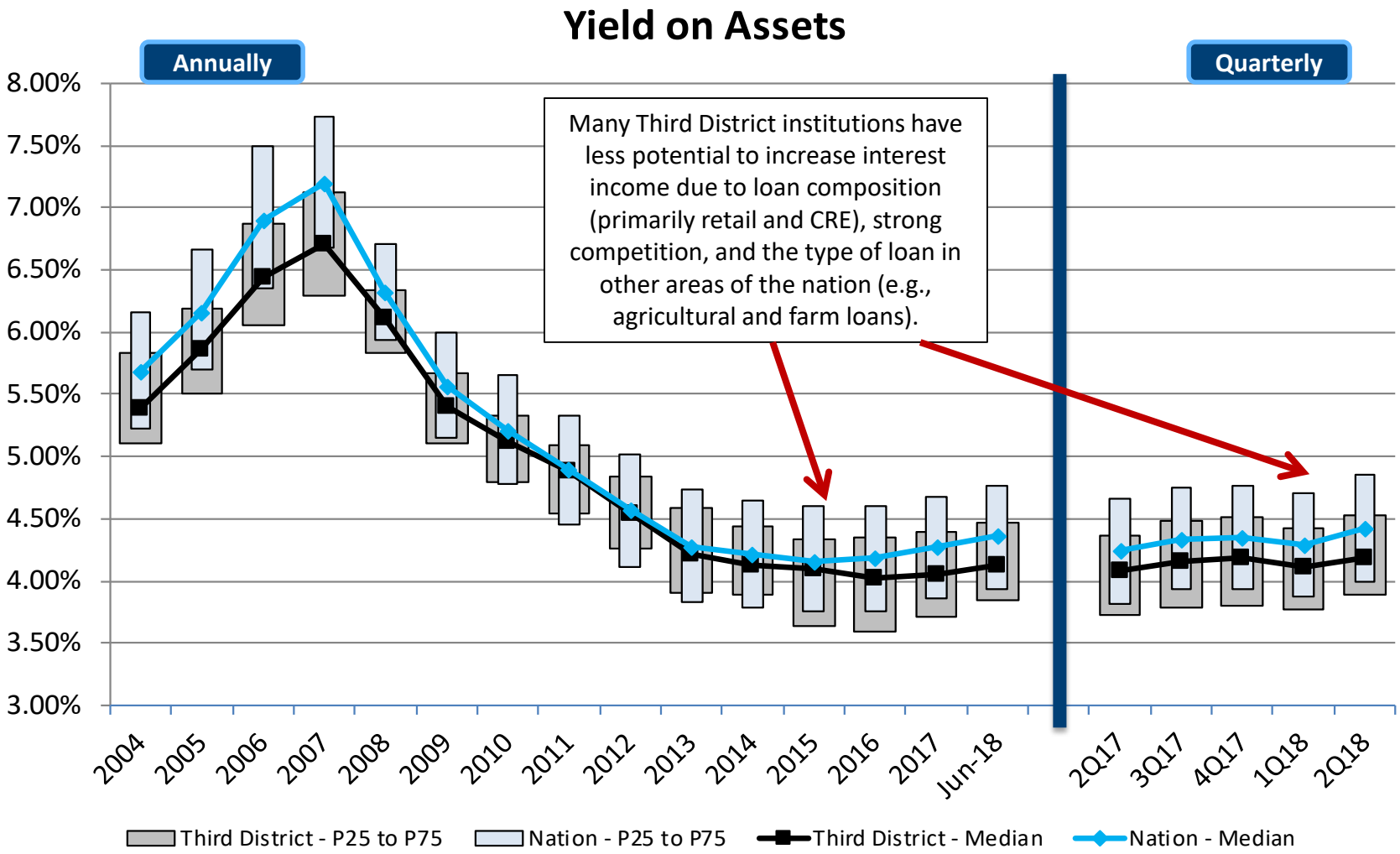
Third District earnings performance, based on the return on average assets (ROAA) ratio, continues to lag that of the nation since 2004. The steep decline in 2017:Q4 for the District and nation is primarily due to the change in tax law for deferred tax assets (DTA) and mortgage servicing rights (MSR). Many banks had to revalue their position downward at year-end, thus negatively impacting earnings. This was a one-time reporting item change, and ROAA normalized as of 2018:Q1.



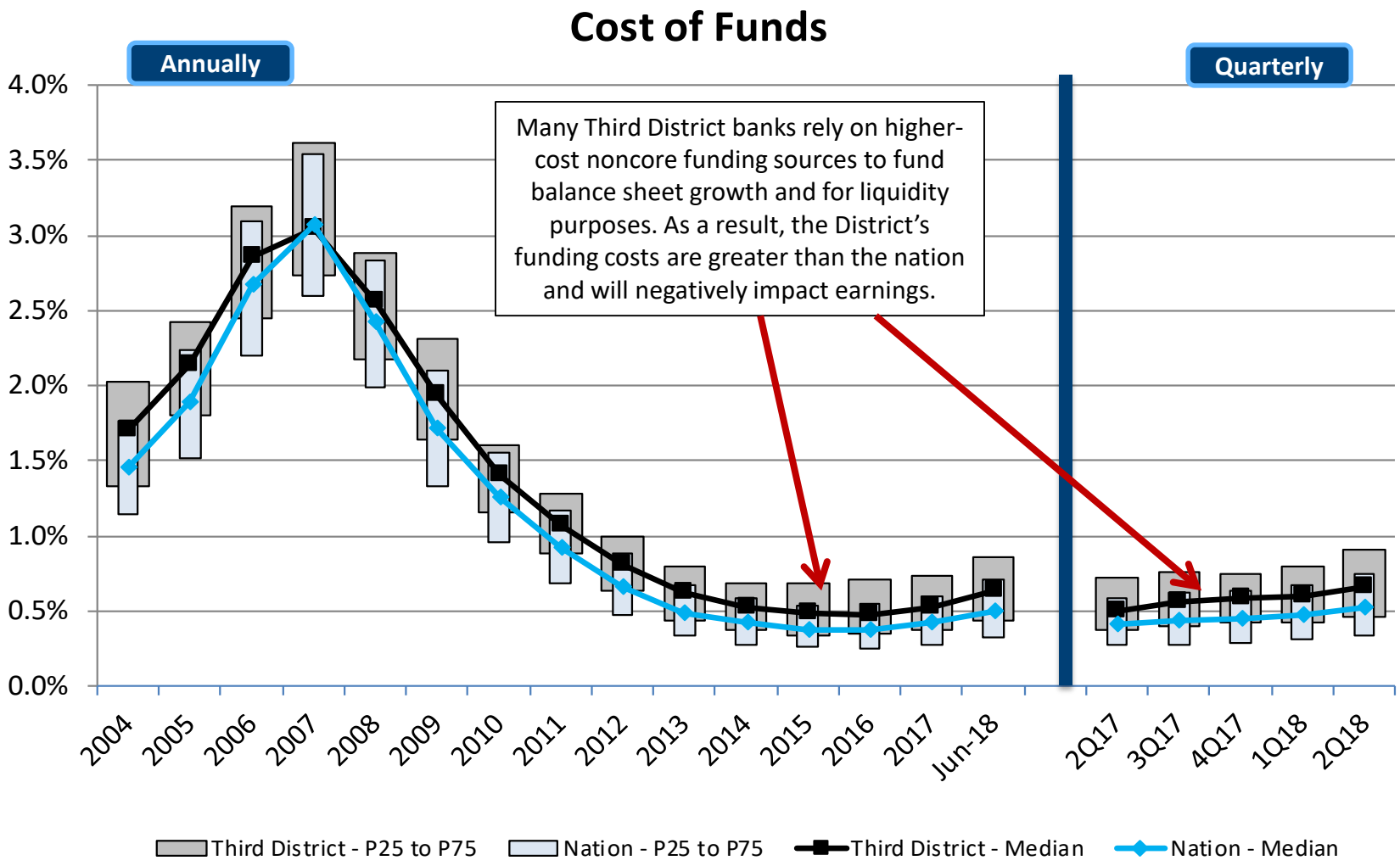
The Third District net interest margin (NIM) remains steady as of 2018:Q2; however, the NIM remains lower than that of the nation before, during, and after the Great Recession. This variance is a result of the Third District's lower yield on earning assets than that of the nation and the cost of funds being greater than that of the nation.



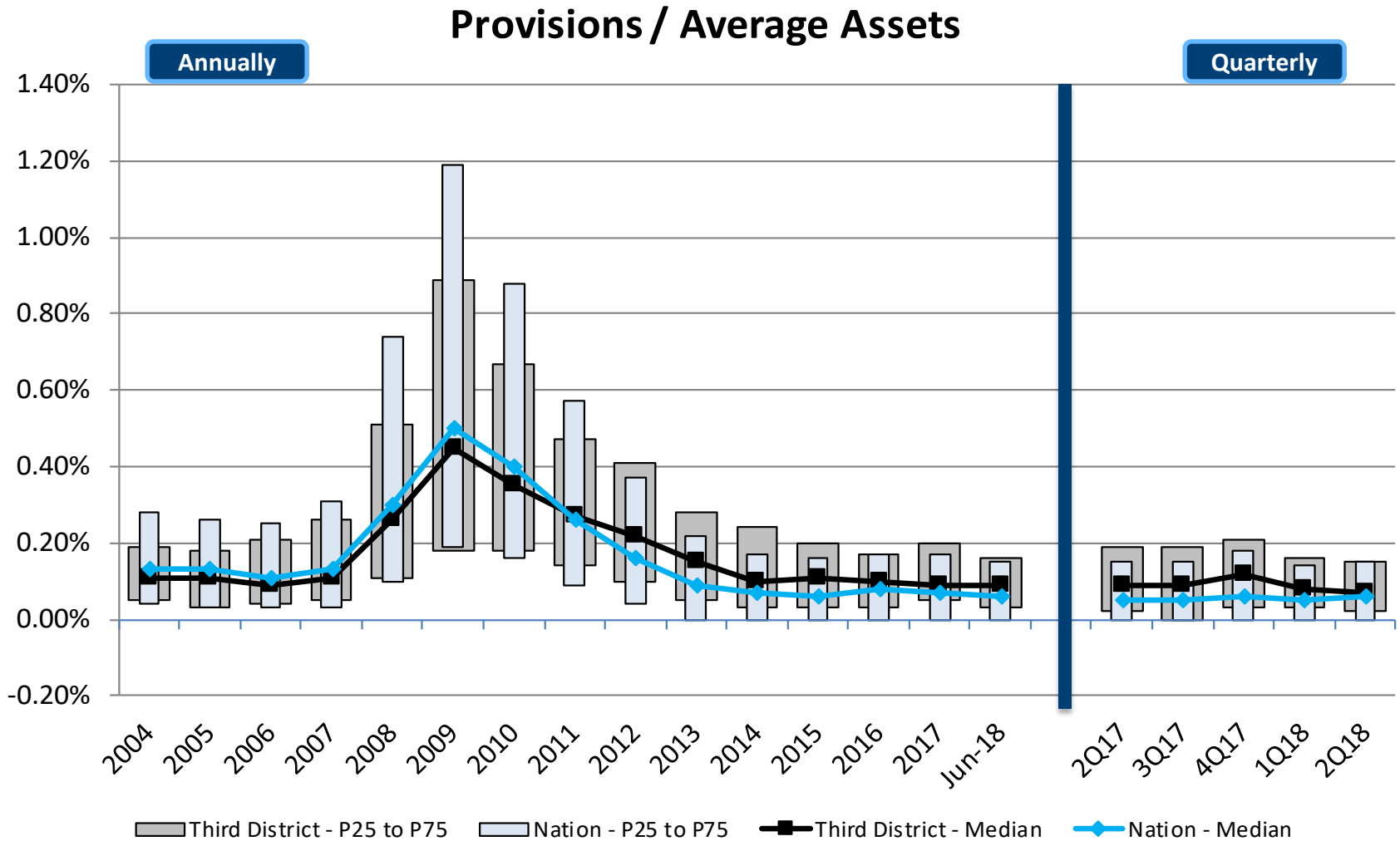
The yield on assets within the Third District are constrained by the current interest rate environment, the concentration and composition of retail and commercial real estate (CRE) loans at lower asset yields, and the overall heightened competition for loans.



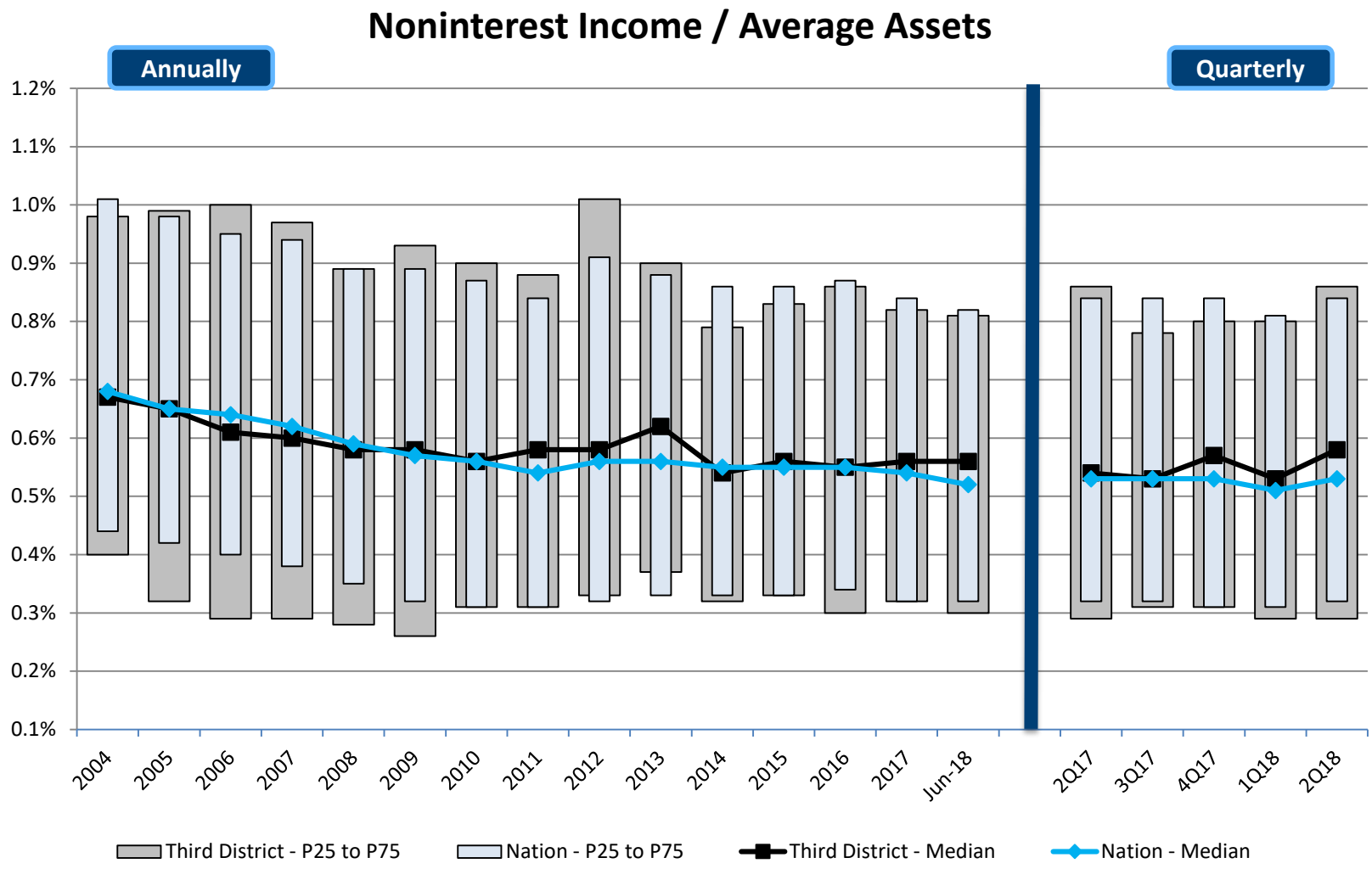
Although many banks in the nation are able to better manage their cost of funds, the Third District's ability to reduce interest expense costs is hindered based on deposit competition. The District, therefore, relies on noncore funding sources more heavily. These types of liquidity sources (FHLB borrowings, brokered deposits, CDs > $250K, etc.) are more expensive than most core deposits.



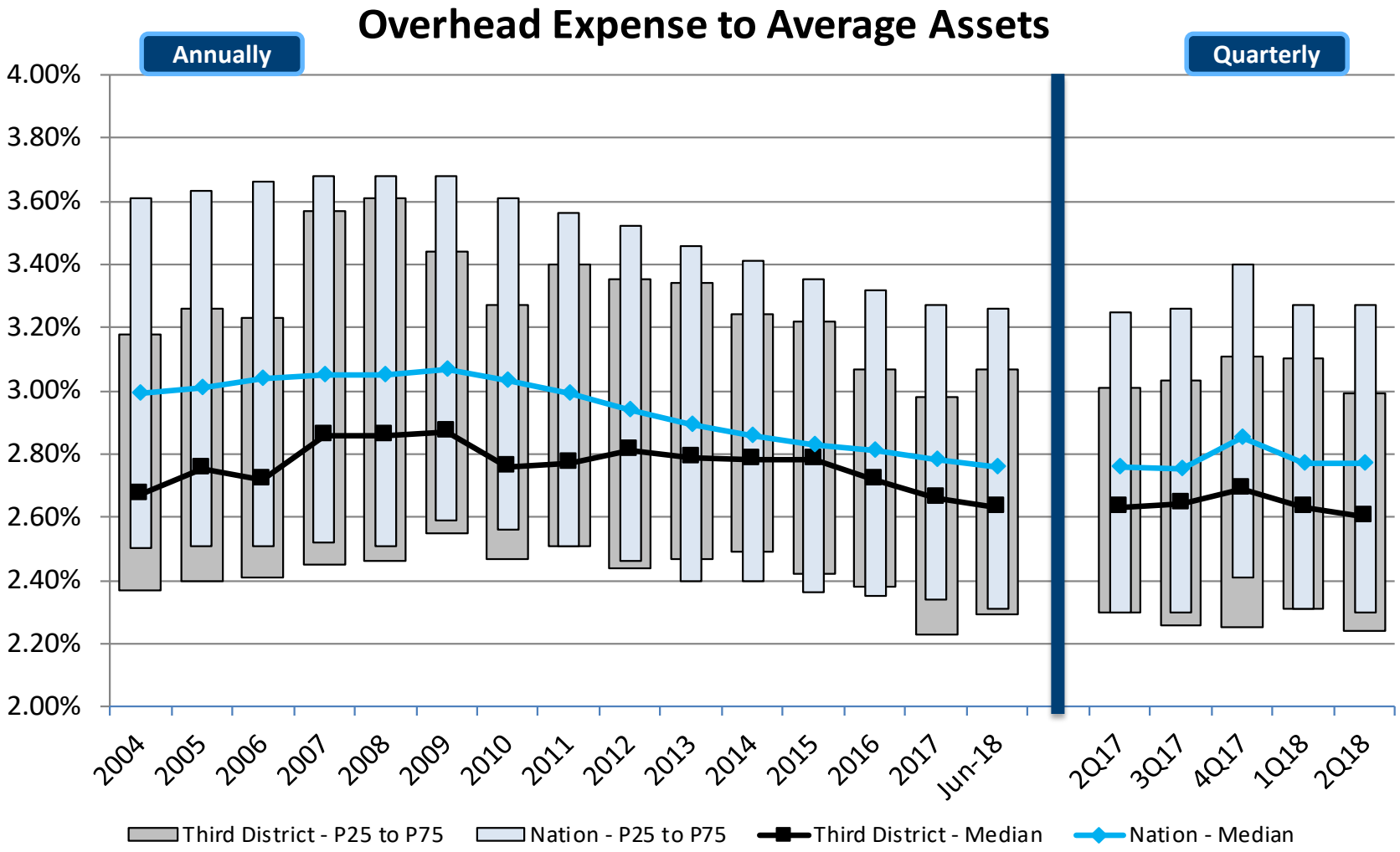
The provision expense continues to trend at or below precrisis levels, which is roughly 7 basis points. Consequently, the low provision expense helps augment earnings, while asset quality performance indicators remain strong. However, should asset quality performance begin to worsen within the current credit cycle, banks may need to increase their provision expense and allowance for loan and lease losses (ALLL), which could negatively impact earnings.



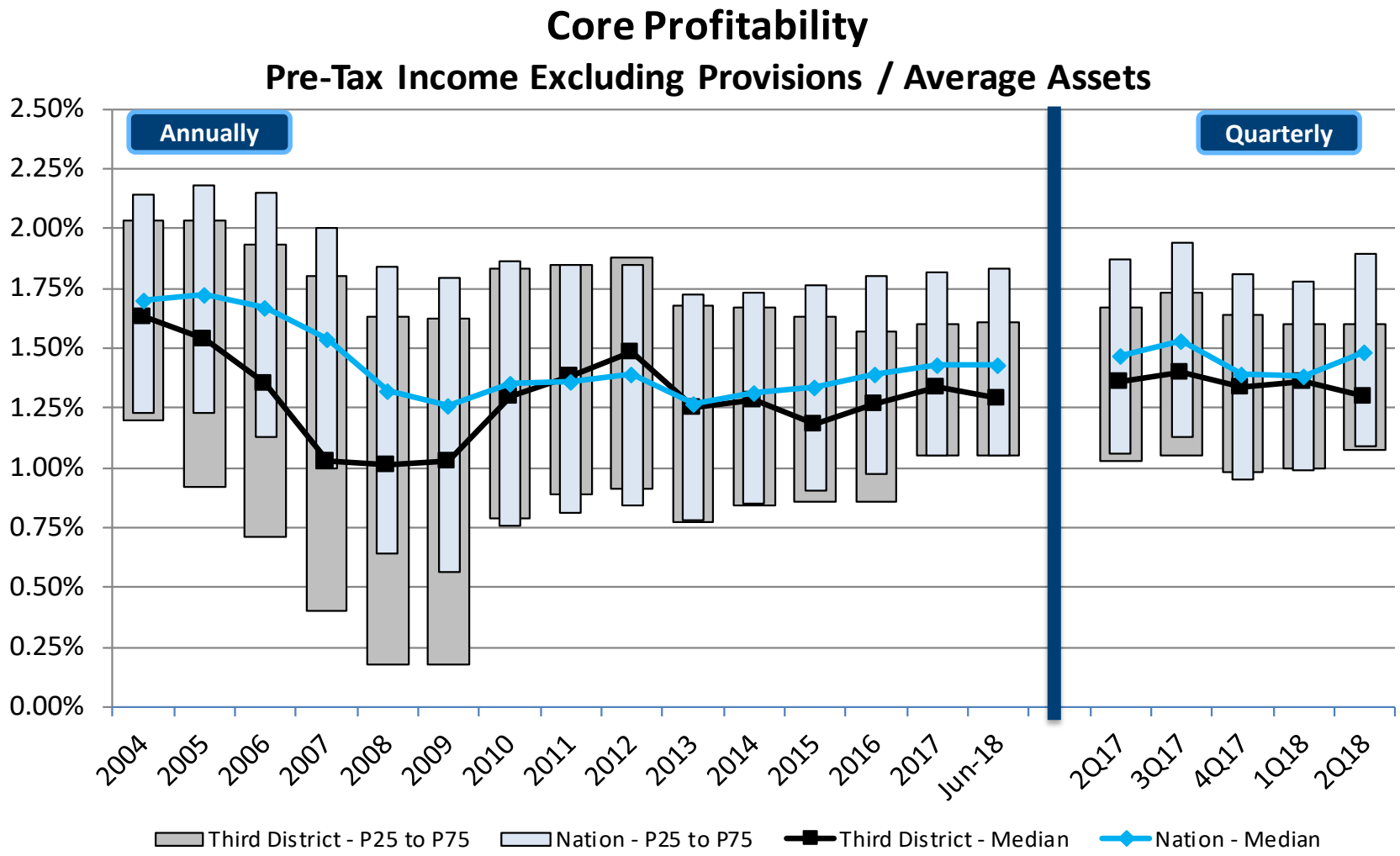
Historically, noninterest income for the Third District has outpaced that of the nation. However, the decline in noninterest income since 2004 has placed further pressure on earnings for the District and the nation.



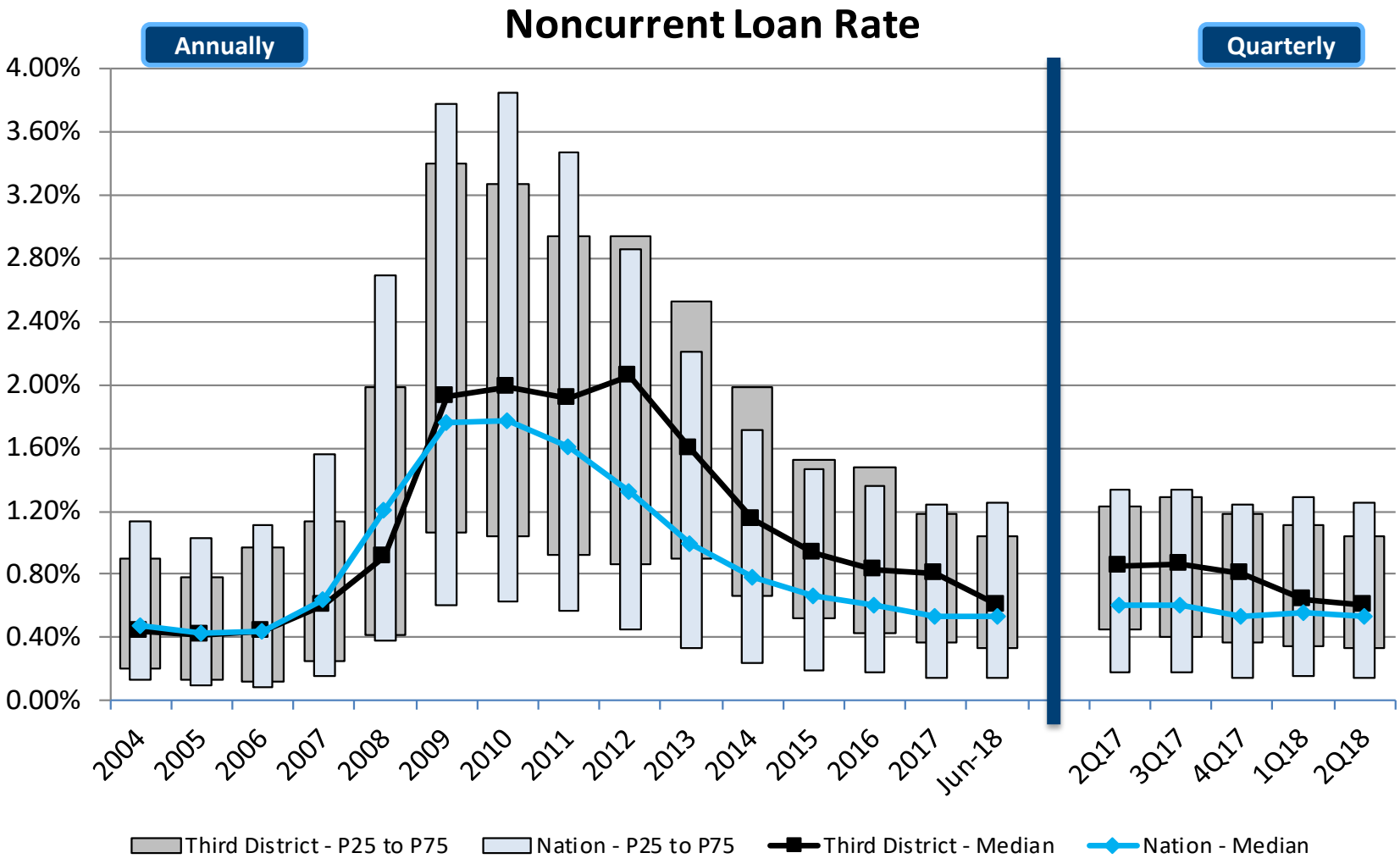
Median overhead expense has decreased in the nation since 2010 and in the Third District since 2015. However, it may be a sign that banks are trying to run their institutions in an increasingly lean manner so they can control their expenses to have a positive impact on ROAA and overall earnings.



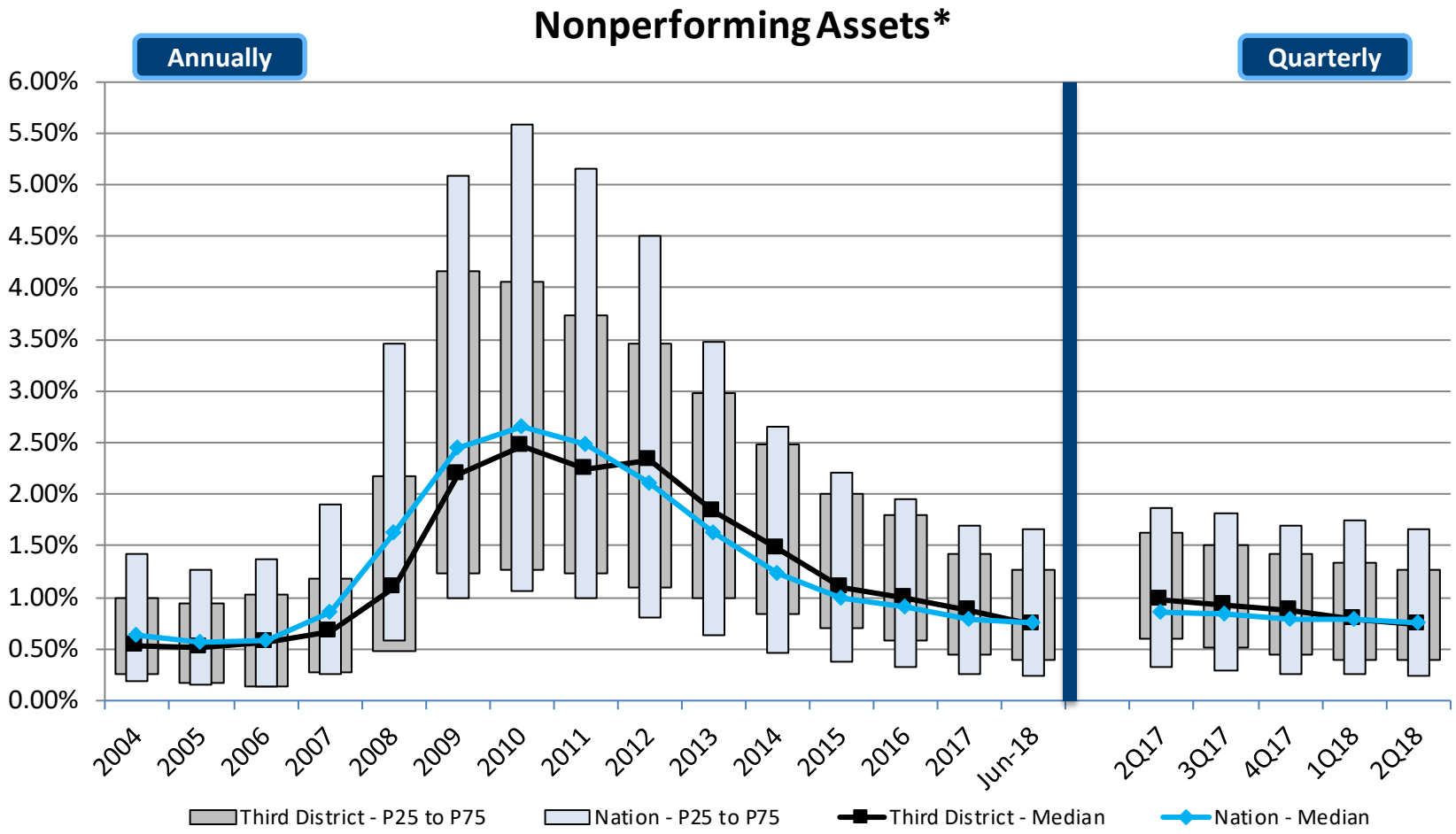
As of 2018:Q2, the Third District's median core profitability fell by 6 basis points to 1.30%, while the nation increased 10 basis points to 1.48%. The lower-core profitability for the District is due primarily to a lower NIM, whereas the District's median is 25 basis points less than that of the nation's median.



Asset quality metrics continue to improve, as the noncurrent loan ratio continues to decline. Additionally, in recent quarters, the District's noncurrent loan rate has declined to more closely align with the nation.

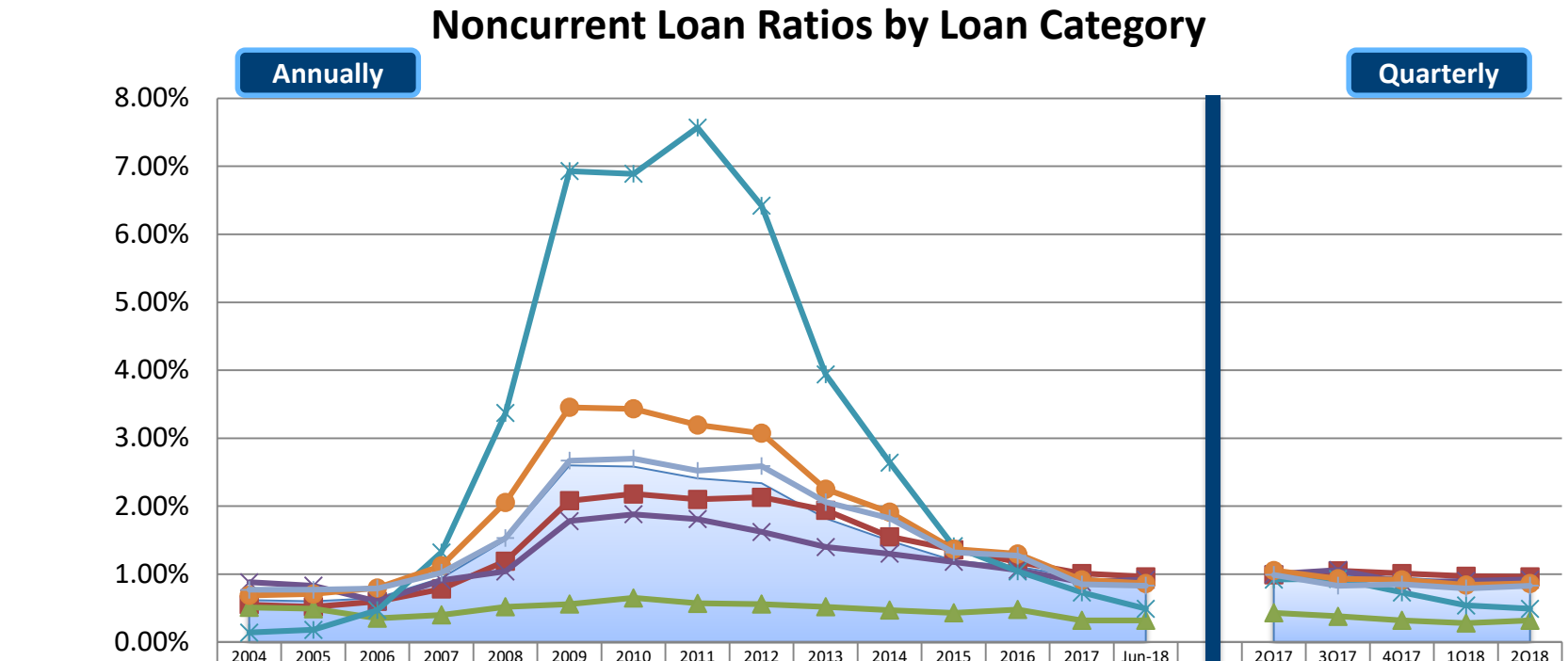


Additionally, the Third District's median level of nonperforming assets has been decreasing since 2012, and now the District better aligns itself with the nation.



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

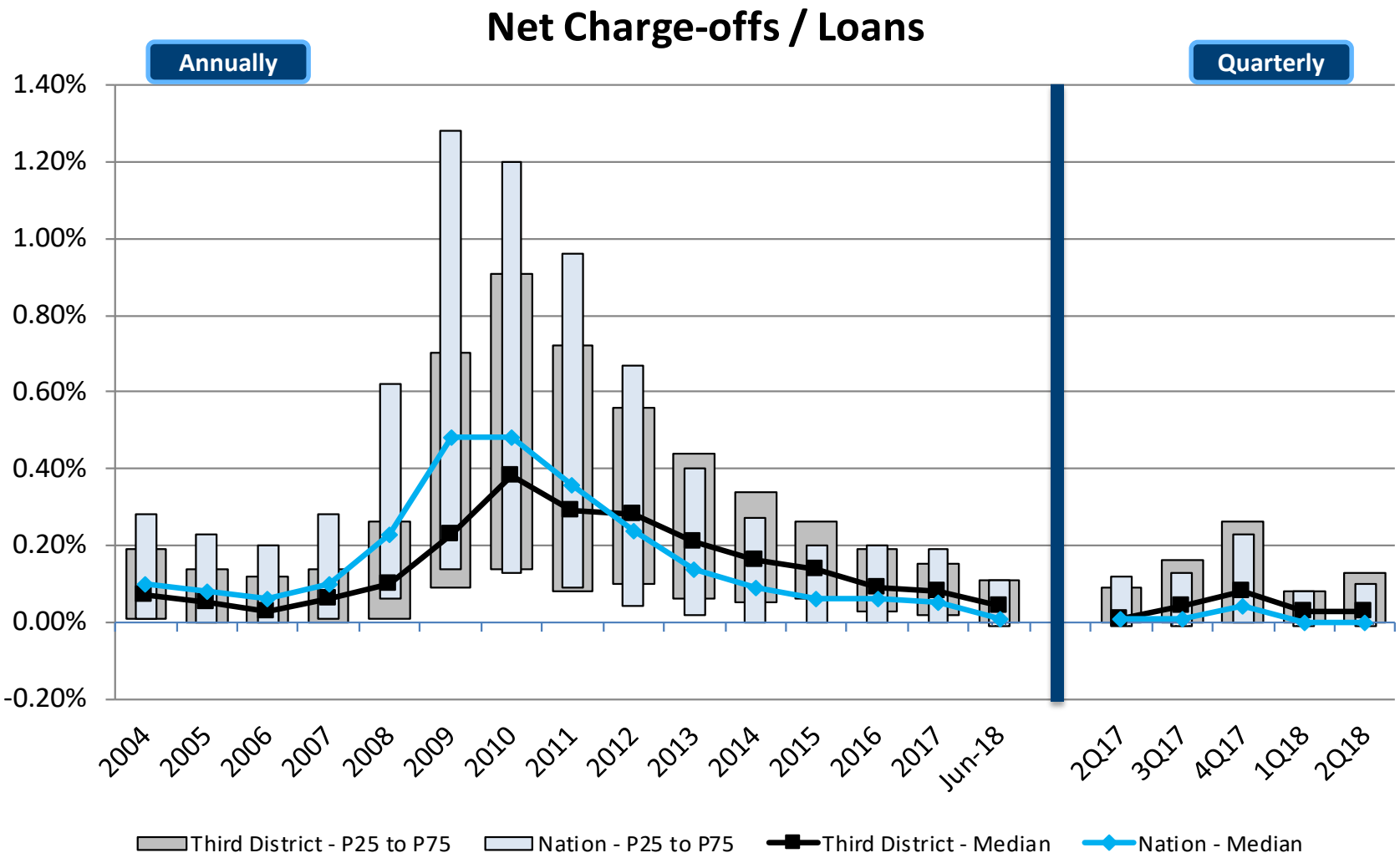
Third District loan performance continues to show ongoing improvement among the principal loan categories, which are near or below 2006–2007 metrics.



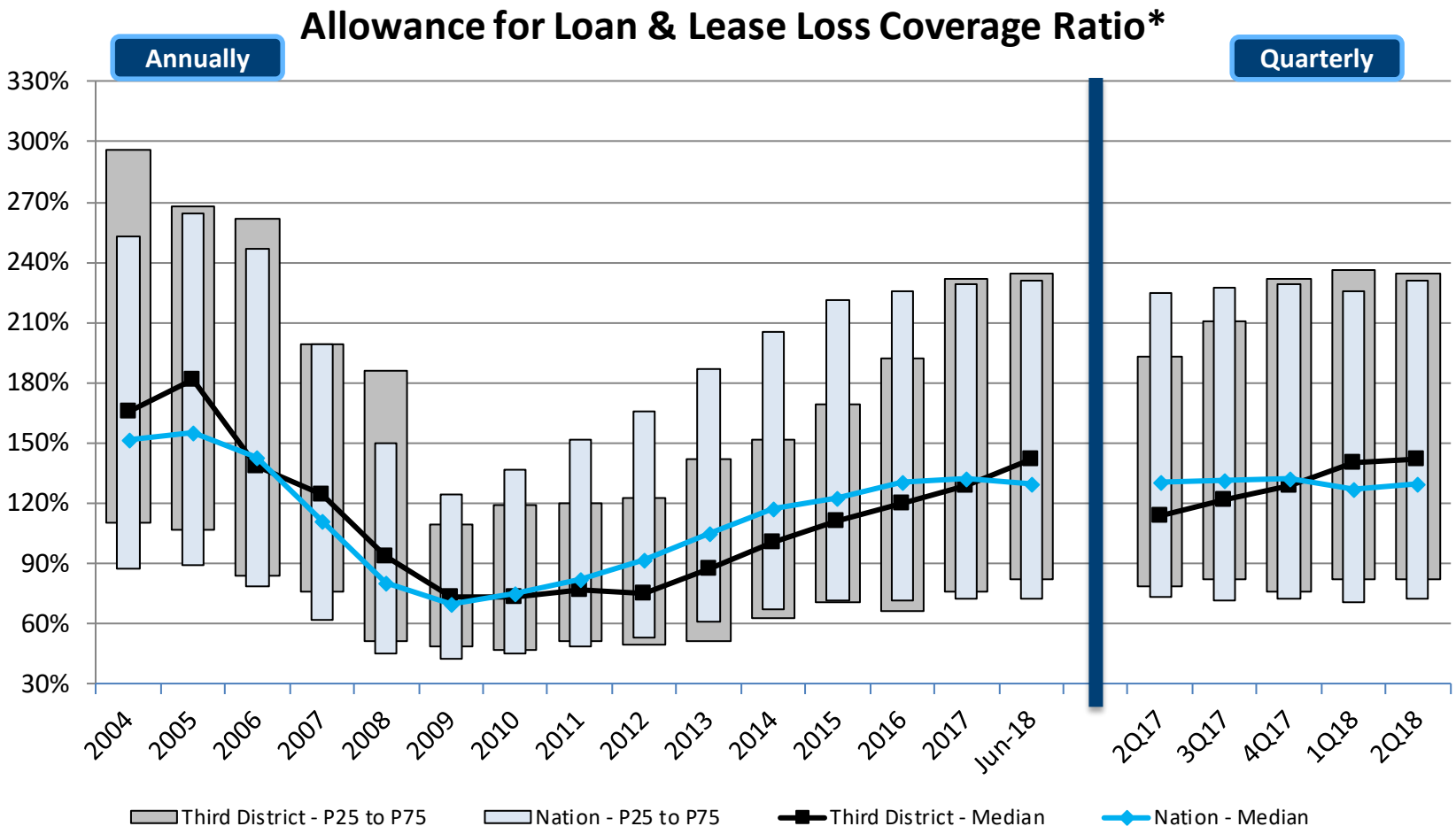
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Jun-18	2Q17	3Q17	4Q17	1Q18	2Q18
All Loan	0.62%	0.60%	0.65%	0.94%	1.50%	2.60%	2.58%	2.41%	2.34%	1.82%	1.49%	1.20%	1.11%	0.95%	0.87%	1.00%	0.99%	0.95%	0.89%	0.87%
Single & Multifamily	0.55%	0.52%	0.60%	0.78%	1.19%	2.08%	2.18%	2.10%	2.13%	1.94%	1.55%	1.36%	1.18%	1.01%	0.96%	0.99%	1.05%	1.01%	0.97%	0.96%
Consumer	0.51%	0.49%	0.35%	0.40%	0.52%	0.56%	0.65%	0.57%	0.56%	0.52%	0.47%	0.43%	0.48%	0.32%	0.32%	0.43%	0.38%	0.32%	0.28%	0.32%
C&I	0.88%	0.83%	0.60%	0.91%	1.04%	1.78%	1.88%	1.81%	1.62%	1.40%	1.30%	1.18%	1.06%	0.88%	0.92%	1.00%	1.06%	0.88%	0.90%	0.92%
C&LD	0.14%	0.18%	0.47%	1.32%	3.37%	6.93%	6.89%	7.57%	6.42%	3.94%	2.64%	1.41%	1.04%	0.73%	0.49%	0.92%	0.93%	0.73%	0.54%	0.49%
CRE (Total)	0.69%	0.71%	0.80%	1.12%	2.05%	3.45%	3.43%	3.19%	3.07%	2.25%	1.91%	1.37%	1.30%	0.92%	0.86%	1.05%	0.93%	0.92%	0.84%	0.86%
Nonfrm Nonres	0.77%	0.77%	0.79%	1.02%	1.53%	2.67%	2.70%	2.52%	2.59%	2.06%	1.82%	1.32%	1.27%	0.85%	0.83%	0.99%	0.83%	0.85%	0.79%	0.83%

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 steadily since 2010 and are now below precrisis loss levels for both the District and nation.

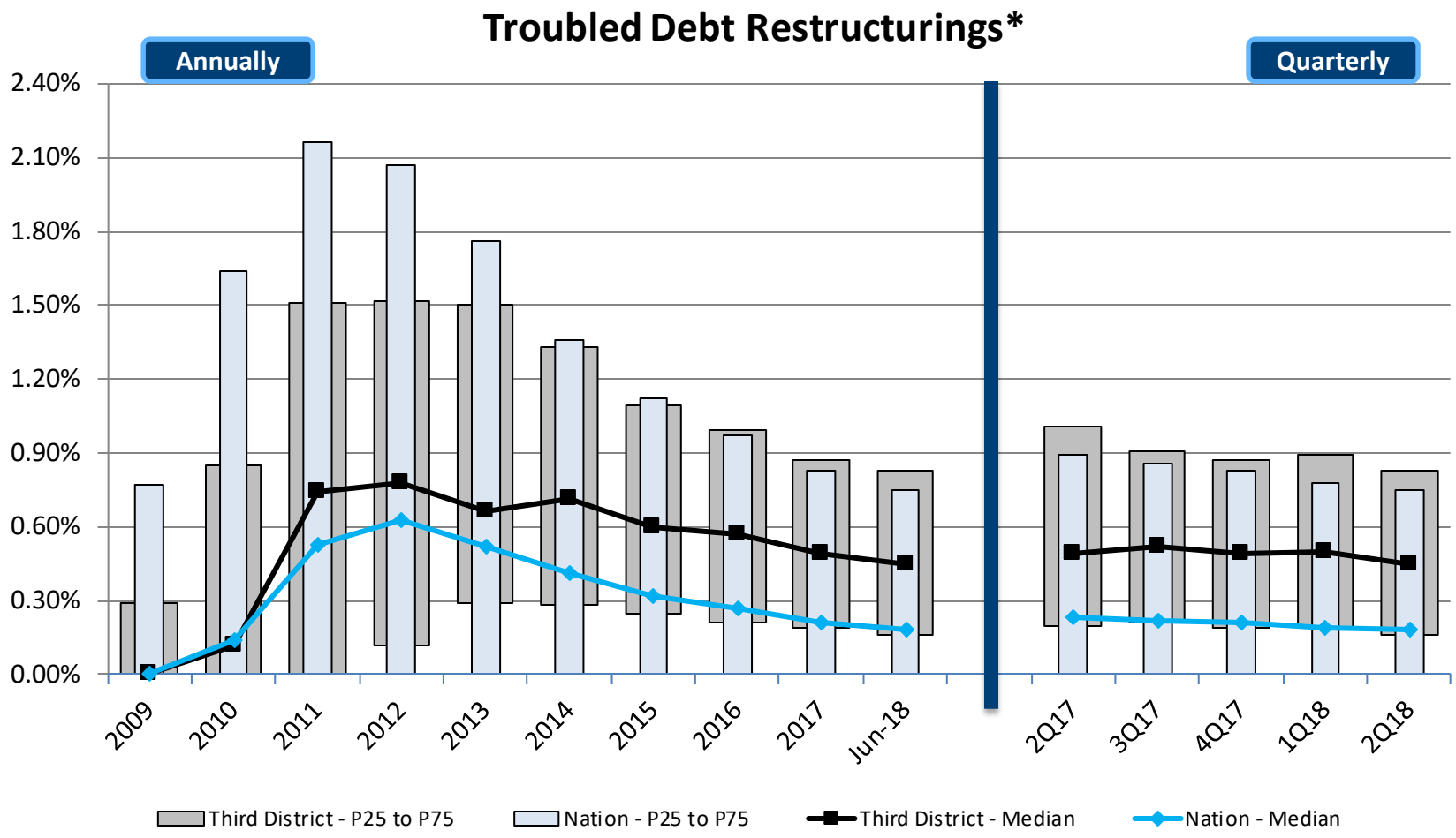


The allowance for loan and lease losses (ALLL) reserve coverage ratio for both the District and nation continues to improve because of improved asset quality metrics, and not by increased provision expense.



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

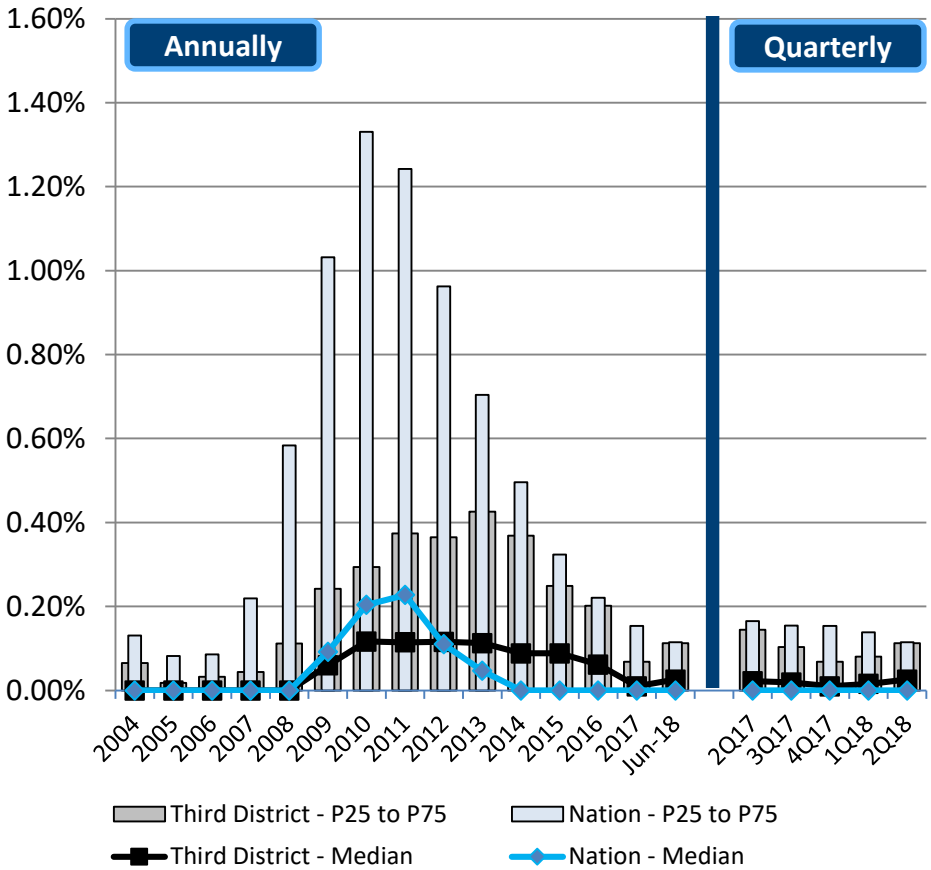
Third District troubled debt restructurings remained stable; however, the metrics remain elevated when compared with the nation.



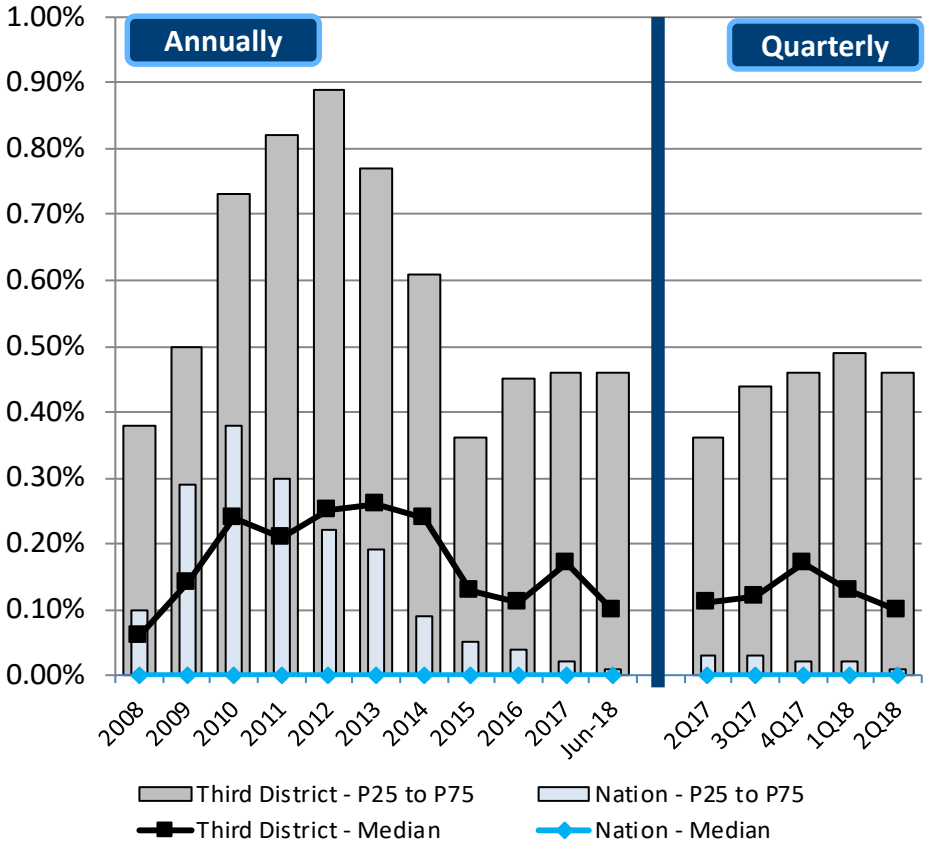
* Troubled debt restructurings (TDRs) were not included on the Call Report until the March 2009 reporting period.

One- to four-family 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*



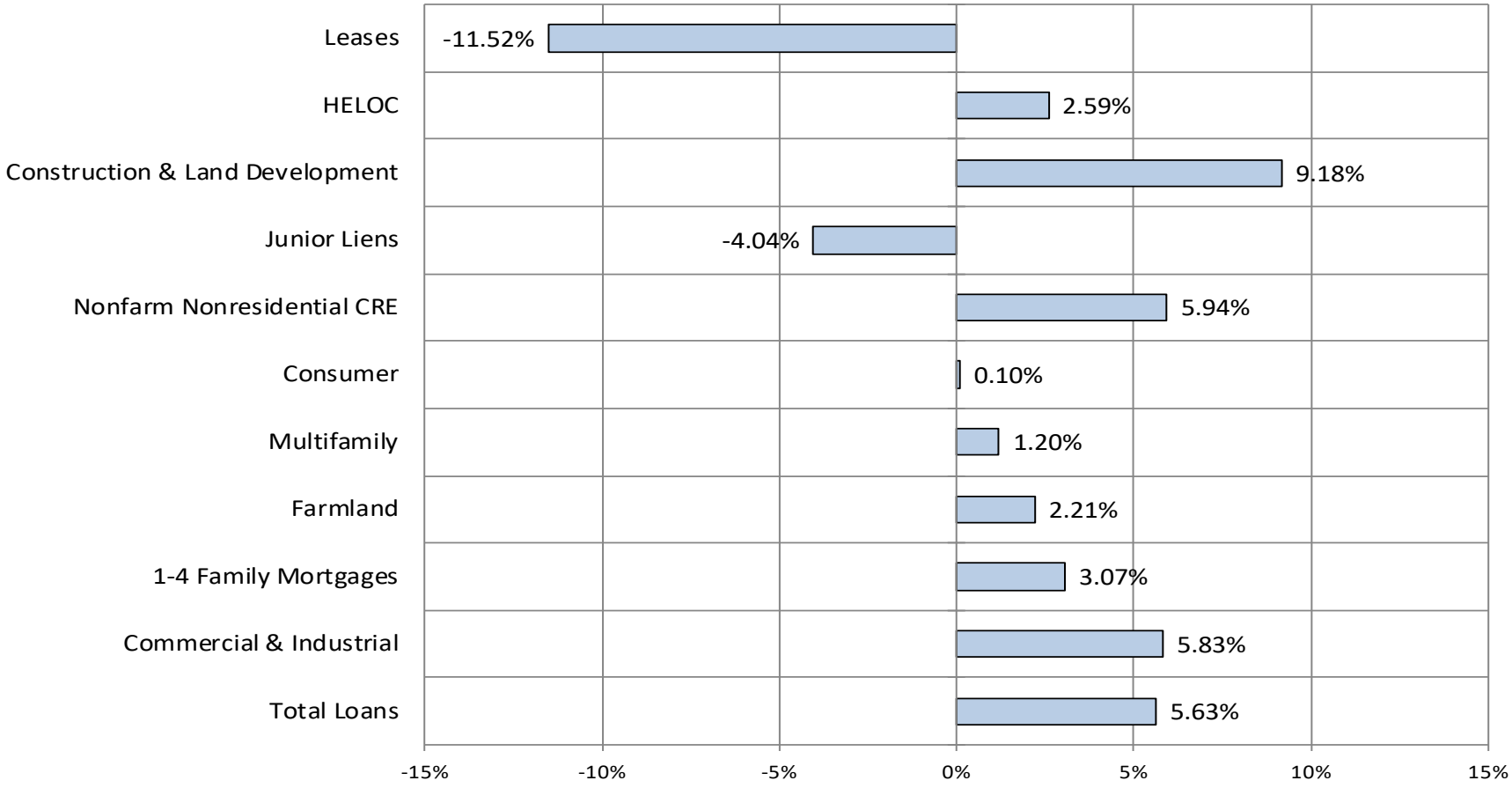
Loans in Process of Foreclosure**



* As a percentage of one- to four-family loans.

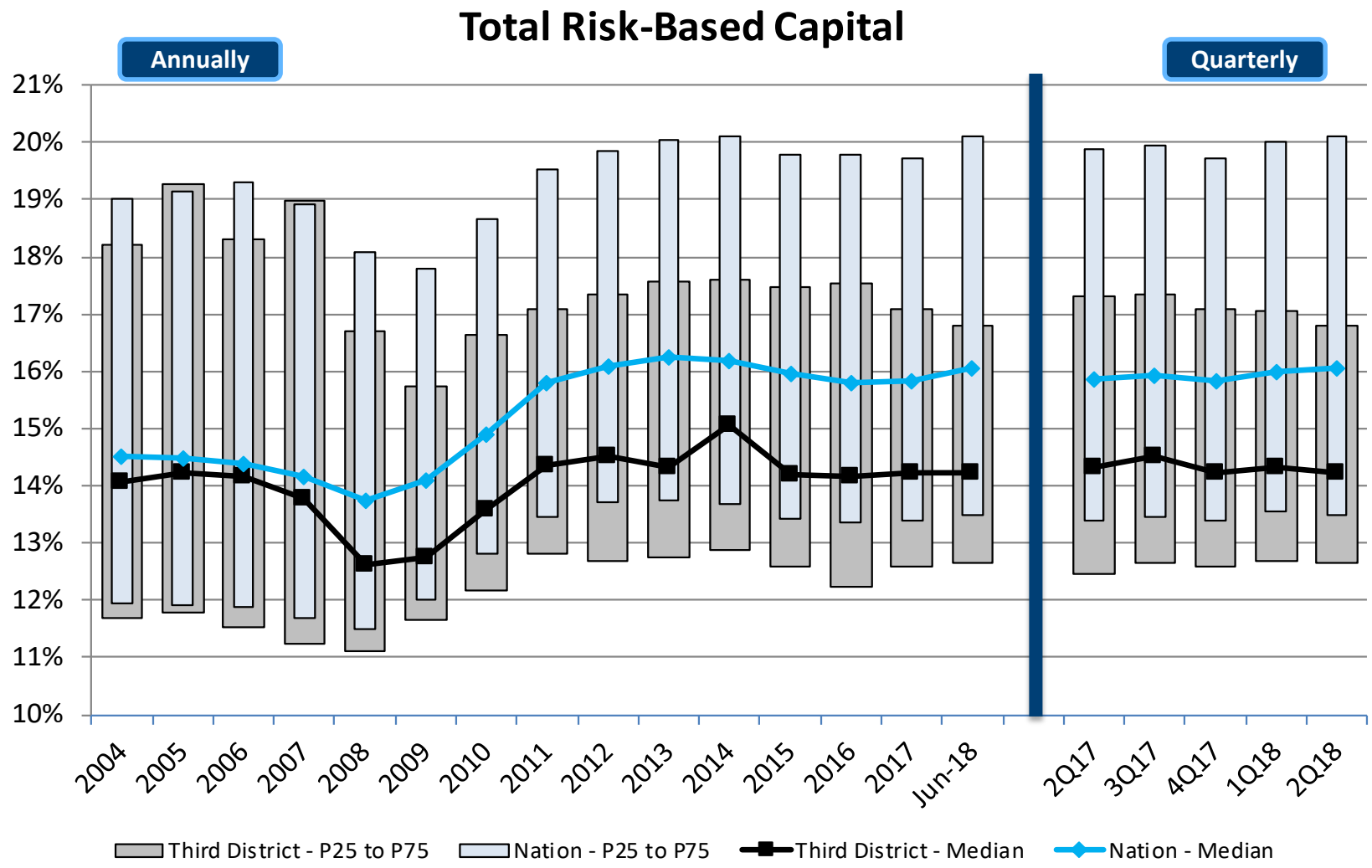
** Loans in the process of foreclosure were not included in the Call Report until the March 2008 reporting period. New Jersey, Pennsylvania, and Delaware are all judicial foreclosure states that can extend the foreclosure process.

Third District community 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.

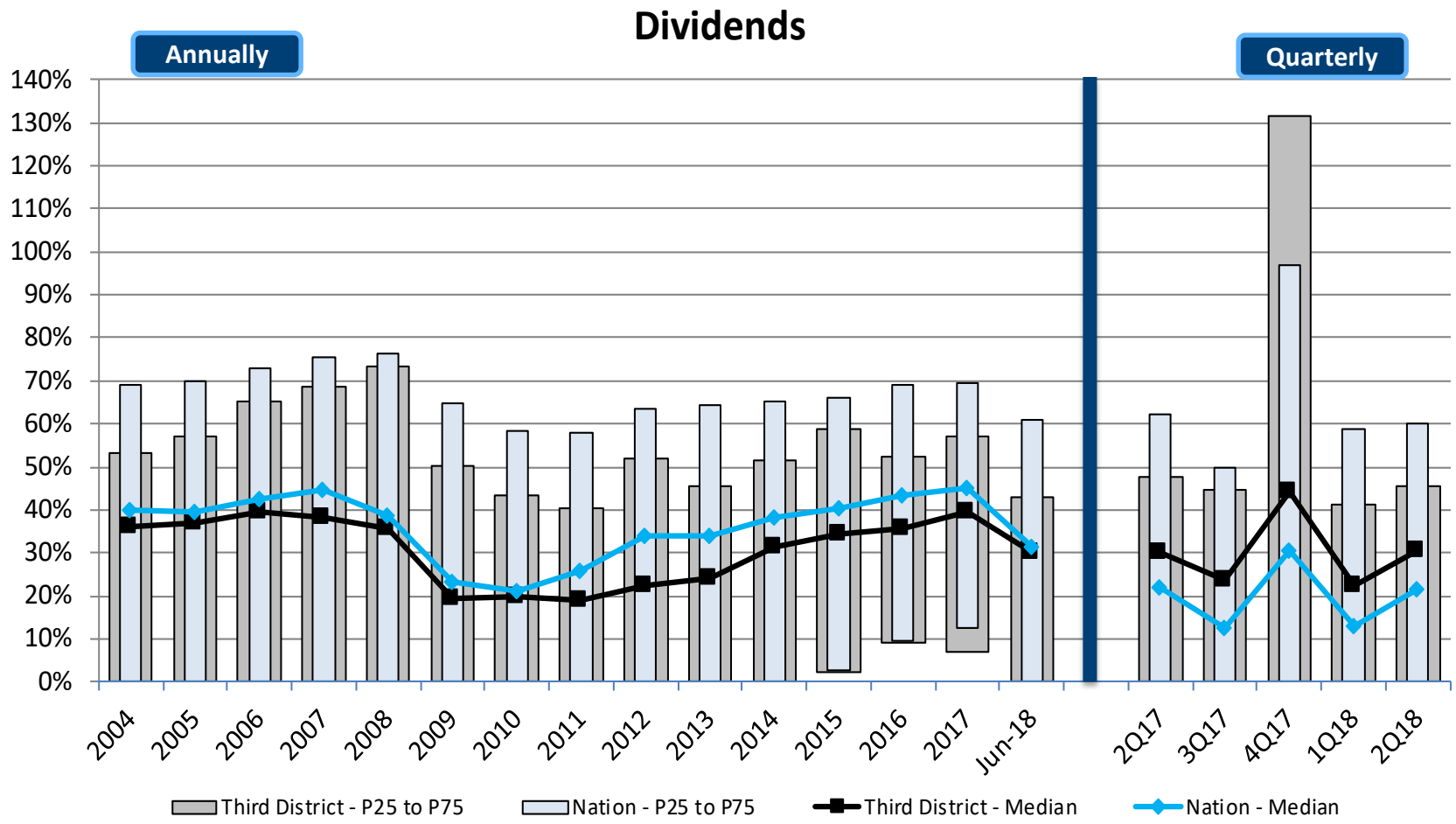


* This report shows the median year-over-year percentage loan growth for Third District community banks that meet the community bank definition on Slide 7.

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.



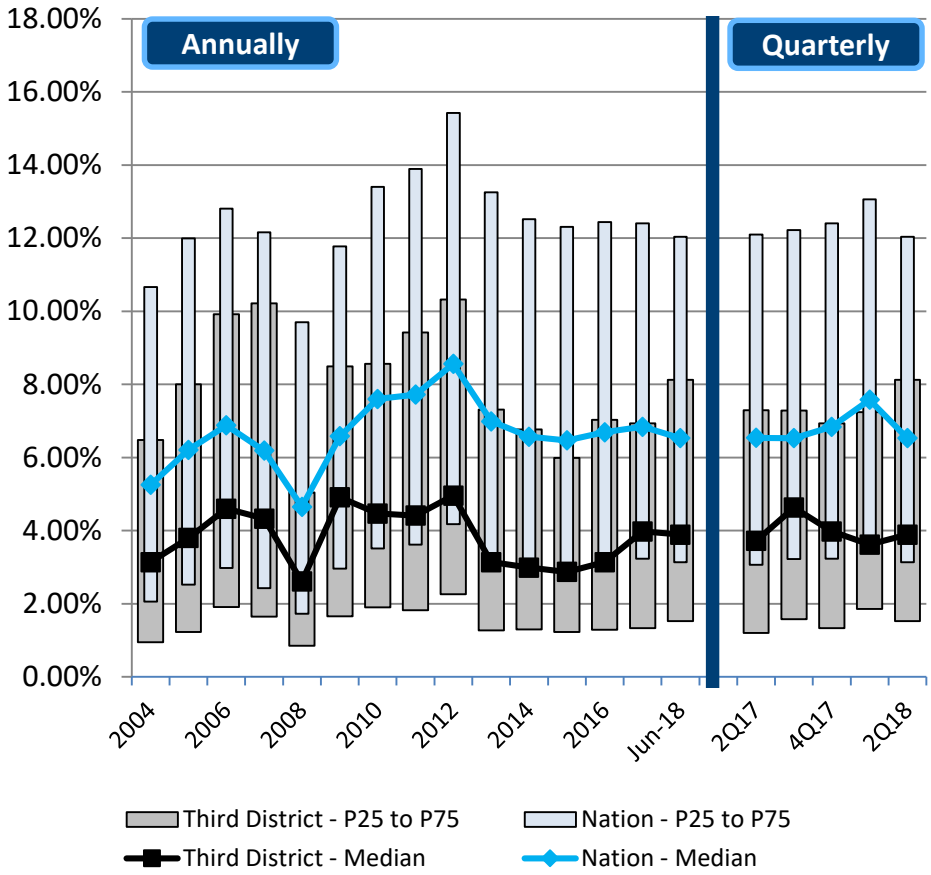
As of 2018:Q2, median dividend payments* in the Third District increased and are comparable to precrisis levels. The spike in 2017:Q4 was primarily due to the revaluation of DTAs, which negatively impacted earnings (denominator), while the dividend amounts did not change significantly (numerator).



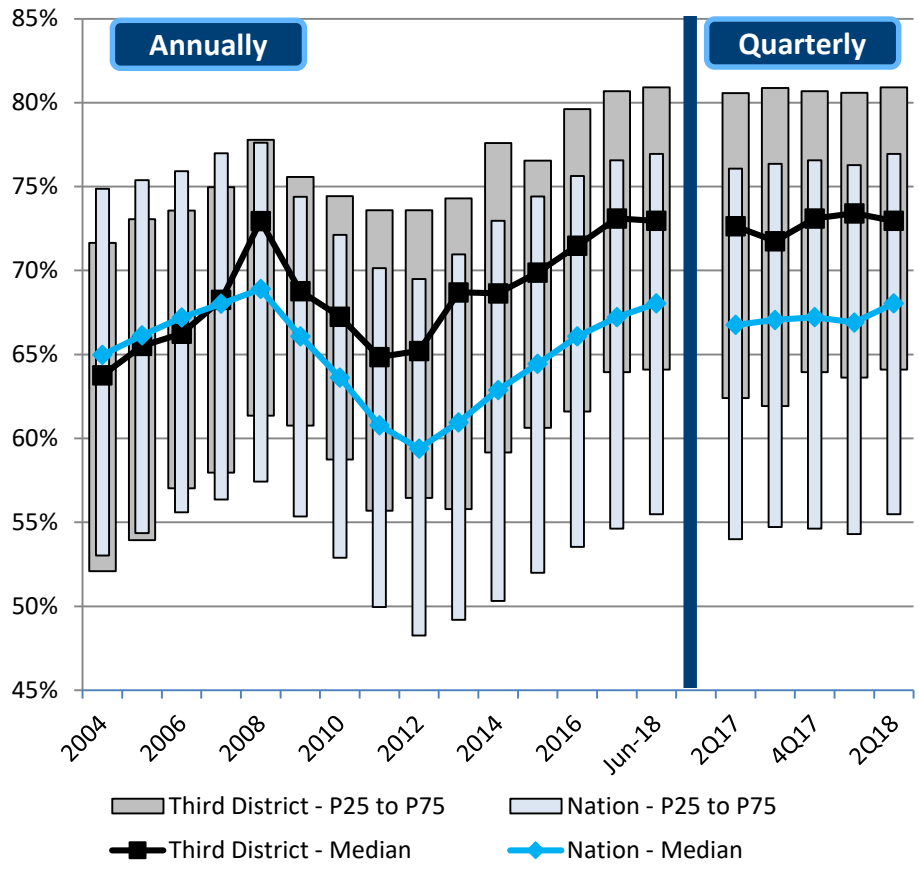
* Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout (DPO) ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income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

Third District banks hold fewer short-term investments compared with that of the nation. Rather, District institutions have decided to grow their loan portfolio. This strategy may increase duration and interest rate risk depending on the specific loan type.

Short-Term Investments / Assets*

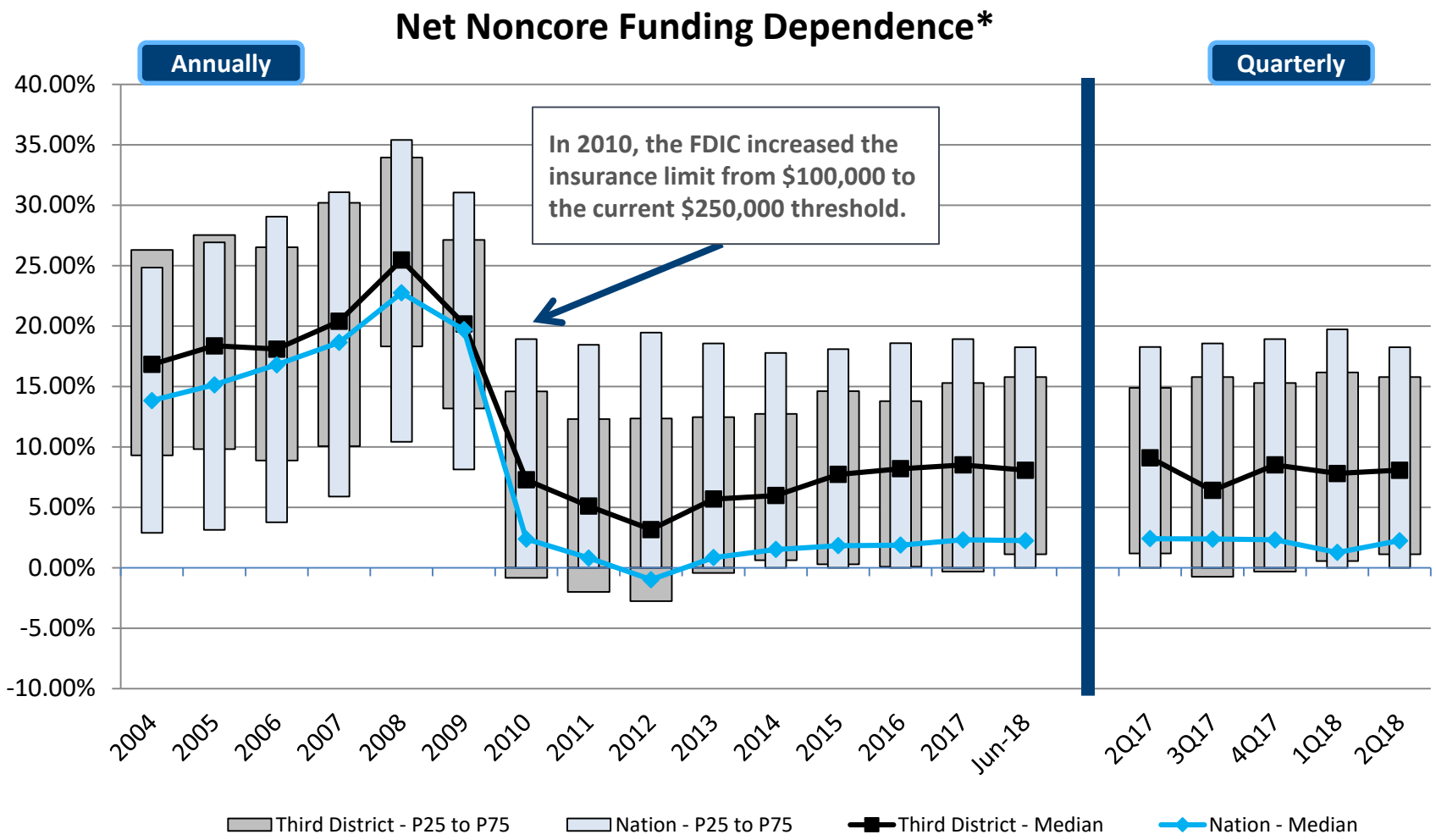


Loans / Assets



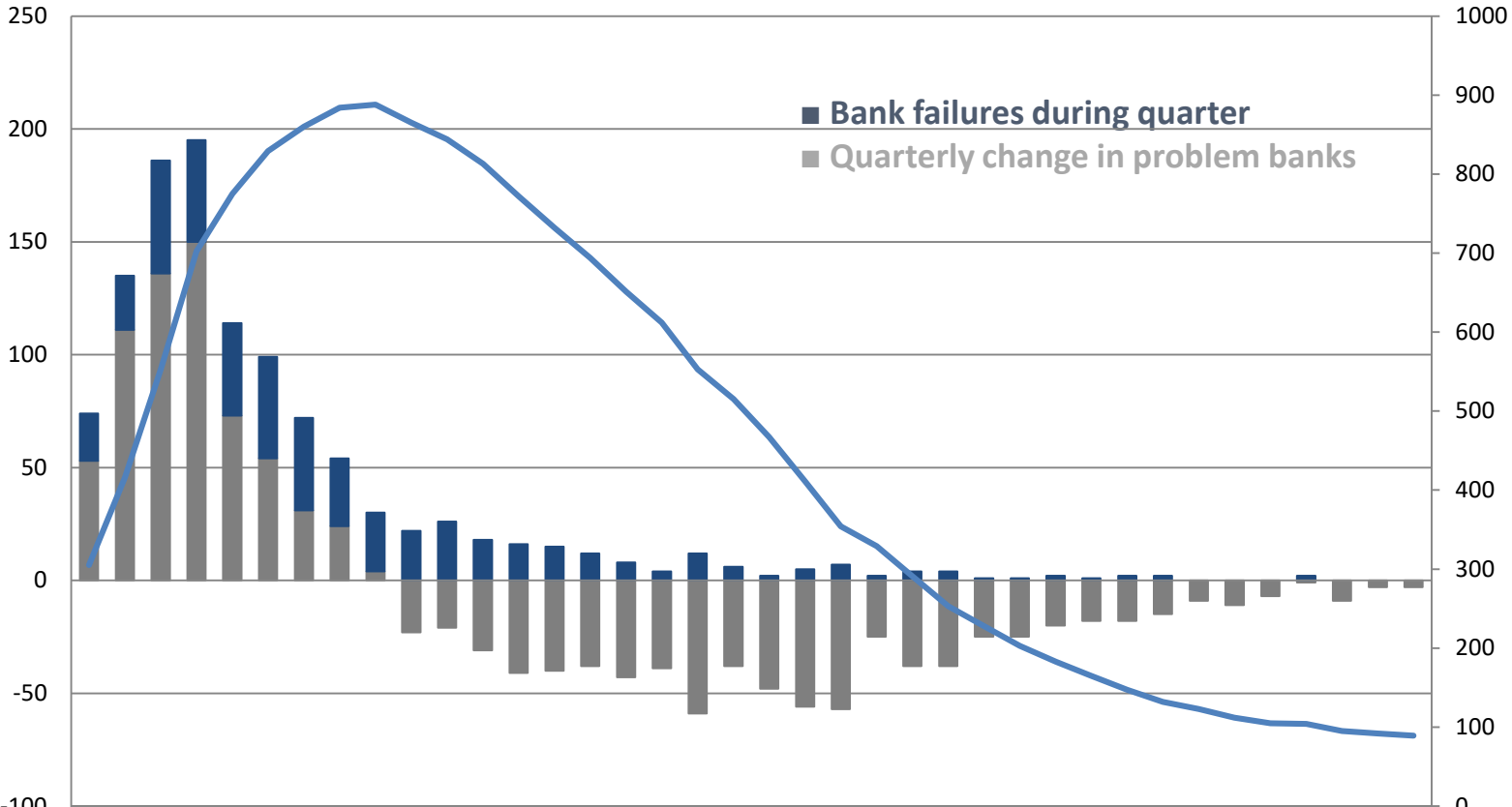
* Short-term investments equals the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

Many Third District banks depend heavily on noncore funding sources to fund balance sheet growth. As a result, Third District exposure to these noncore sources of funding continues to outpace that of the nation.



* 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 6 to 89 as of 2018:Q4 from 95 at 2017:Q4. This represents the smallest number of problem banks since 2008:Q1. Additionally, no banks failed within the first six months of 2018.



	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18
Failures (L)	21	24	50	45	41	45	41	30	26	22	26	18	16	15	12	8	4	12	6	2	5	7	2	4	4	1	1	2	1	2	2	0	0	0	2	0	0	0
Δ Problems (L axis)	53	111	136	150	73	54	31	24	4	-23	-21	-31	-41	-40	-38	-43	-39	-59	-38	-48	-56	-57	-25	-38	-38	-25	-25	-20	-18	-18	-15	-9	-11	-7	-1	-9	-3	-3
Problem Bks (R axis)	305	416	552	702	775	829	860	884	888	865	844	813	772	732	694	651	612	553	515	467	411	354	329	291	253	228	203	183	165	147	132	123	112	105	104	95	92	89

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.