



# Third District Banking Conditions as of December 31, 2018

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



- Financial performance results for Third District community banks\* continue to demonstrate sound performance. The benign economic environment is the primary cause of the second-longest economic expansionary cycle, which began in June 2009.\*\* Sustained growth and strength within the banking sector have been the primary reasons for this economic expansion. Conditions are highlighted by the following:
  - Earnings ratios have returned to precrisis levels, driven primarily by steady loan growth, strong loan performance indicators and a lower corporate tax rate.
  - Third District asset quality metrics continue to improve as the level of noncurrent loans has 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, excess capital may provide an opportunity for continued consolidation in the industry, or it might provoke stock buybacks to help improve an institution's return on equity.

\* Community banks are defined as national, nonmember, and state member banks with less than \$10 billion in assets.

\*\* Since June 2009 through February 2019, the U.S. economy is in its second longest expansionary period, second only to the market between March 1991 through March 2001, or 120 months.

# Section 1: Executive Summary (cont'd)



- Challenges do remain for Third District bank financial performance primarily because:
  - Large banking organizations will need to comply with CECL (Current Expected Credit Loss) guidelines beginning 2020:Q1, which is just a year away. Earnings may be hindered for large banks since expected losses will need to be reported at the time of booking a loan or purchasing securities.
  - The 2017 year-end change in the tax rate for Deferred Tax Assets (DTA) and mortgage servicing rights (MSR) negatively impacted earnings at many institutions; however, earnings have rebounded in 2018 and are in line with precrisis results. Those banks with exposure to DTAs and MSRs will need to continue to reevaluate their on-balance sheet valuations to ensure they are reported correctly. As a result, some banks may need to take further losses post the assessment exercise.
  - Earnings have been augmented with nonrecurring sources of income, especially after reporting zero or negative provisions to increase overall profitability. While this strategy artificially increases earnings in the short term, this practice is not sustainable for long-term earnings growth.
  - The rise in interest rates, including nine fed funds rate increases since 2015, may impact the value of fixed-rate assets. As rates rise, the value of a bank's fixed rate assets will decline (inverse relationship). However, given the extended accommodative interest rate environment, many banks have adjusted their on- and off-balance sheet items to reduce the adverse effects of rising rates.
  - Competition for loans and deposits remains elevated within the District. It has led to a compressed net interest margin (NIM), which the median District NIM ratio is 35 basis points lower than the nation. Third District banks 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 District institutions.
  - The level of short-term assets is much lower for the District when compared with the rest of the nation. Given the increased maturity length of our District banks' loan and investment portfolios, this could increase the level of interest rate risk by increasing duration, basis, and repricing risk.
  - Reliance on noncore funding sources continues to aid in the growth of some banks' balance sheets 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 and brokered deposits) are greater than that of core deposits. Additionally, those funding sources may reprice faster than assets in an upward interest rate environment, which could negatively impact earnings.

# 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, auto loans, and student loans. Although many banks may not have significant credit concentrations, the banks that do need to be diligent when assessing areas of concentration and identified limits.
  - Management succession and strategic planning
  - Model risk management (SR 11-7 compliance)
  - Competition from FinTech firms and credit unions for loan and deposit growth
  - Pace of mergers and acquisitions may harm regional and community banks should they decide to look for new ways to find economies of scale
  - Bank Secrecy Act/Anti-Money Laundering\* (BSA/AML) compliance issues
- The number of problem banks nationwide fell by 11 banks from 71 at 2018:Q3 to 60 as of 2018:Q4. This represents the lowest number of problem banks since 2007:Q1.

\* The Bank Secrecy Act, with Anti-Money Laundering (AML) laws, were enacted to in 1970 to deter criminal activity.

# Section 2: Conditions of Third District Commercial Banks



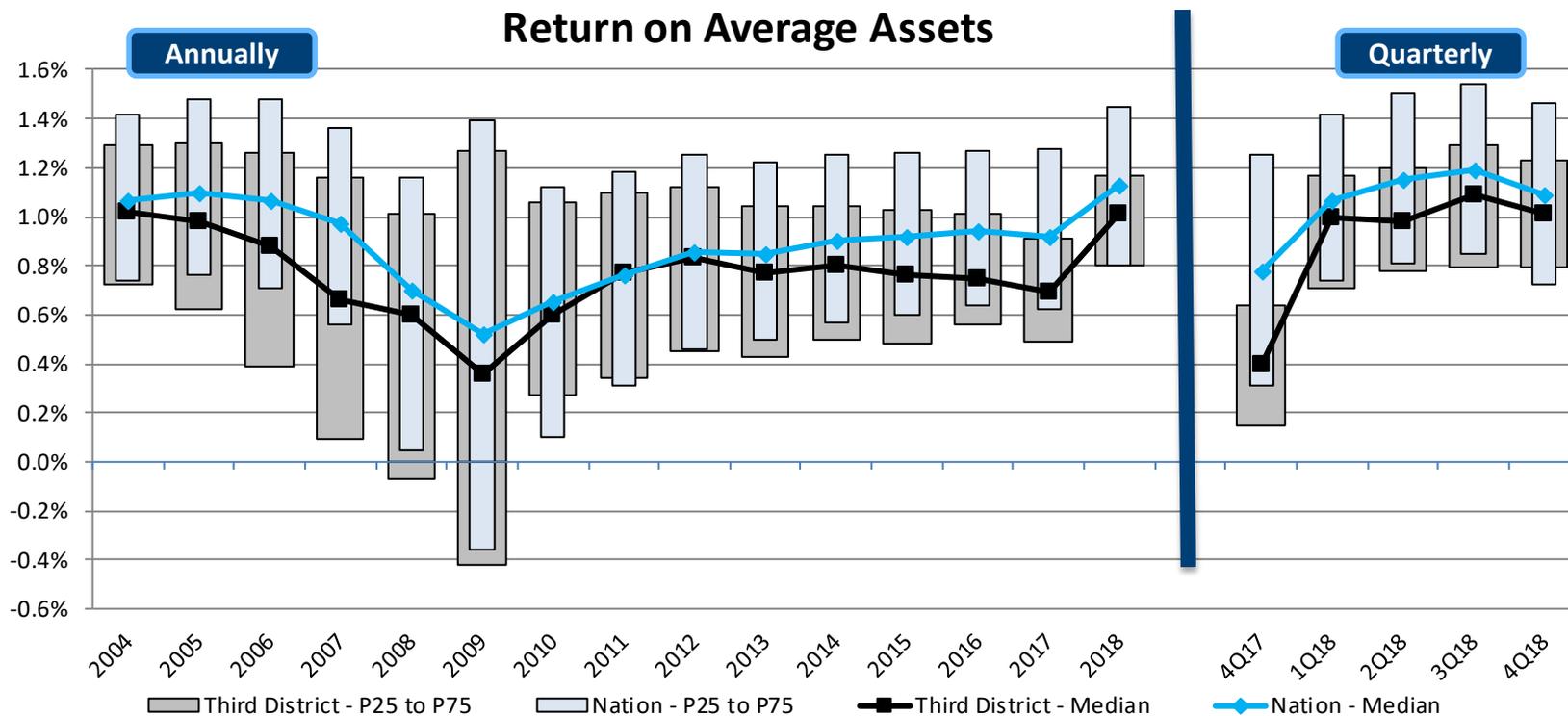
## Reporting Methodology

- 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 **95 commercial banks** within the Third District. The banks excluded from this analysis meet at least one of the following criteria as of **December 31, 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, regardless of asset size, and all national and nonmember commercial banks (CB) 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, Based on the Return on Average Assets (ROAA) Ratio



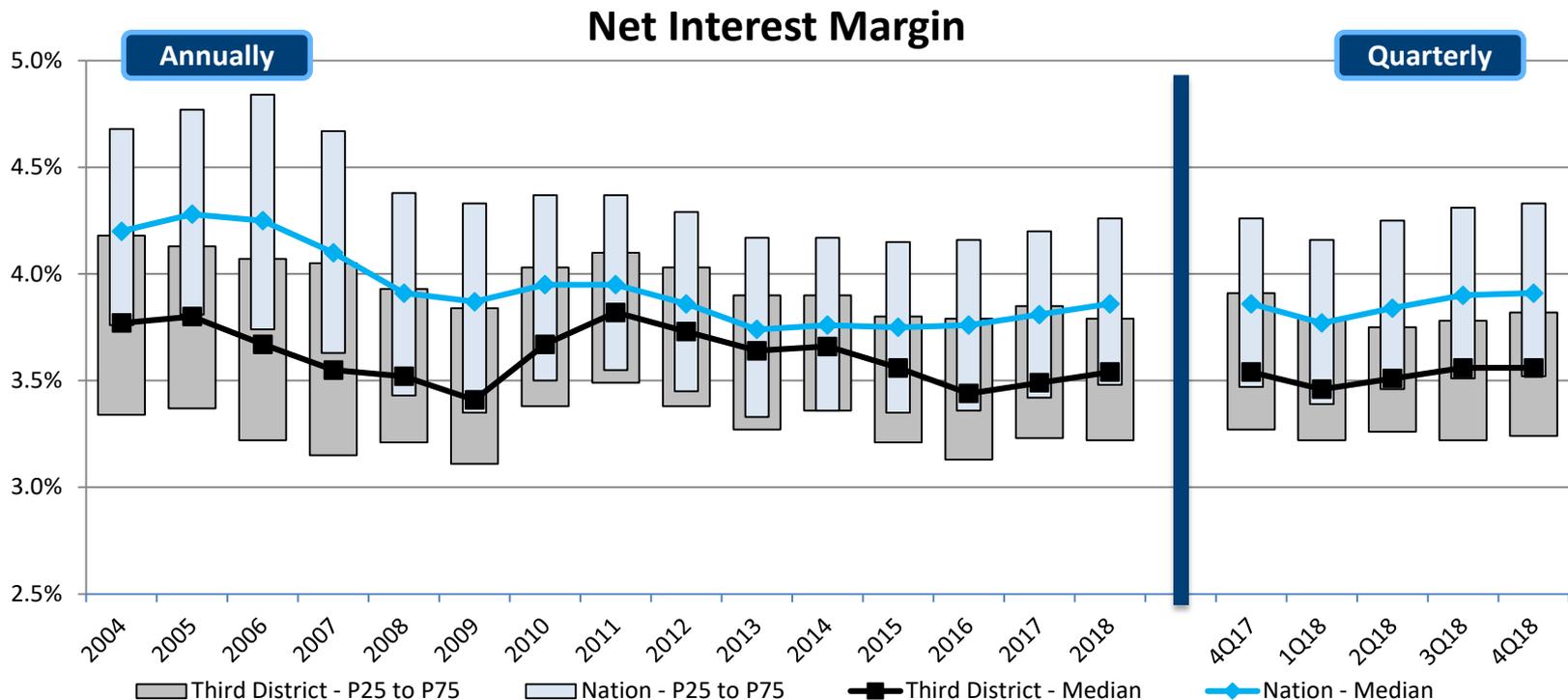
- Third District earnings continue to lag that of the nation since 2004.
- The steep decline in 2017:Q4 for the District and nation is primarily due to the change in tax law for deferred tax assets (DTA) and mortgage servicing rights (MSR).
  - Many banks had to revalue their position downward at year-end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



# Third District Earnings Performance, Based on the Net Interest Margin (NIM)



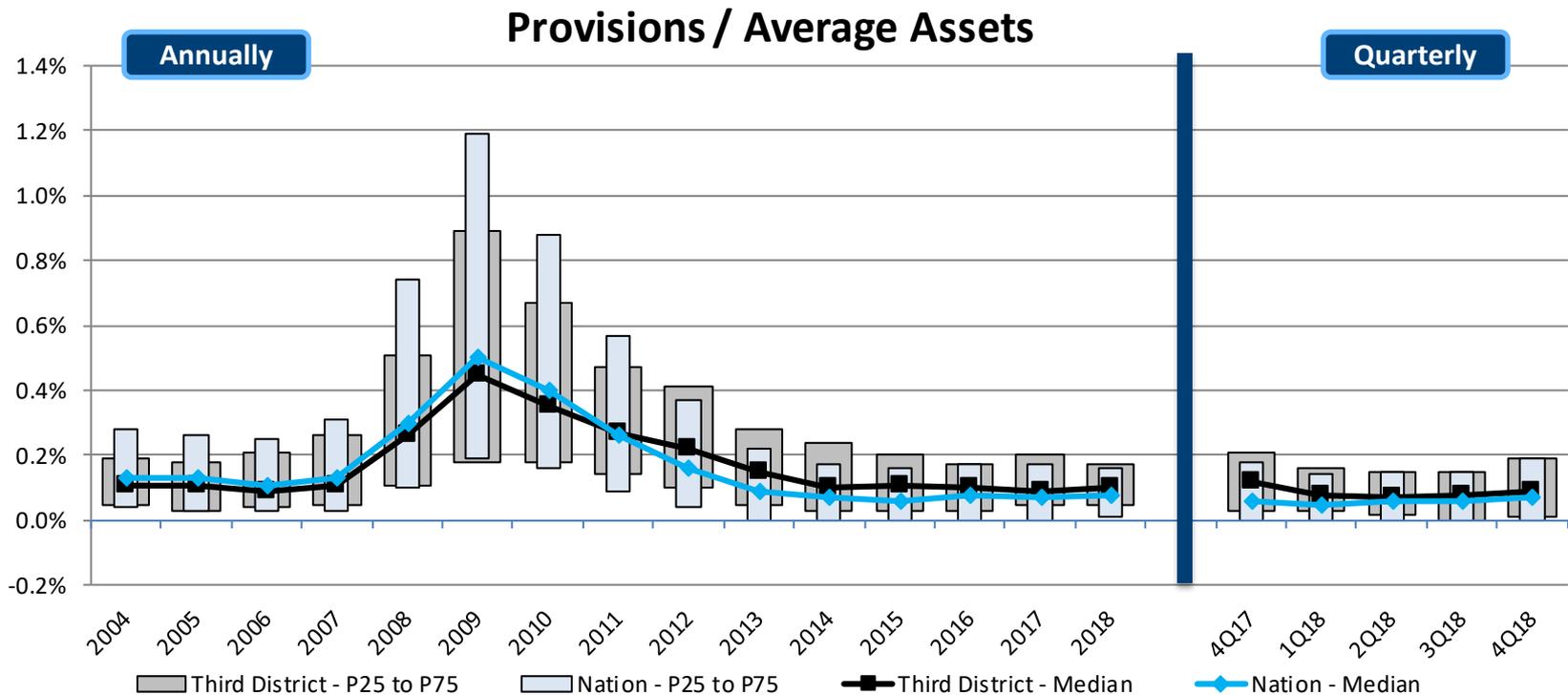
- Although the District's NIM remains steady as of 2018:Q4, it remains much lower than that of the nation before, during, and after the Great Recession.
  - This variance is a result of the Third District's lower yield on earning assets than that of the nation and the cost of funds being greater than that of the nation.
  - As of year-end 2018, the median difference between the District and the nation was 35 basis points.



# Third District Provision Expense



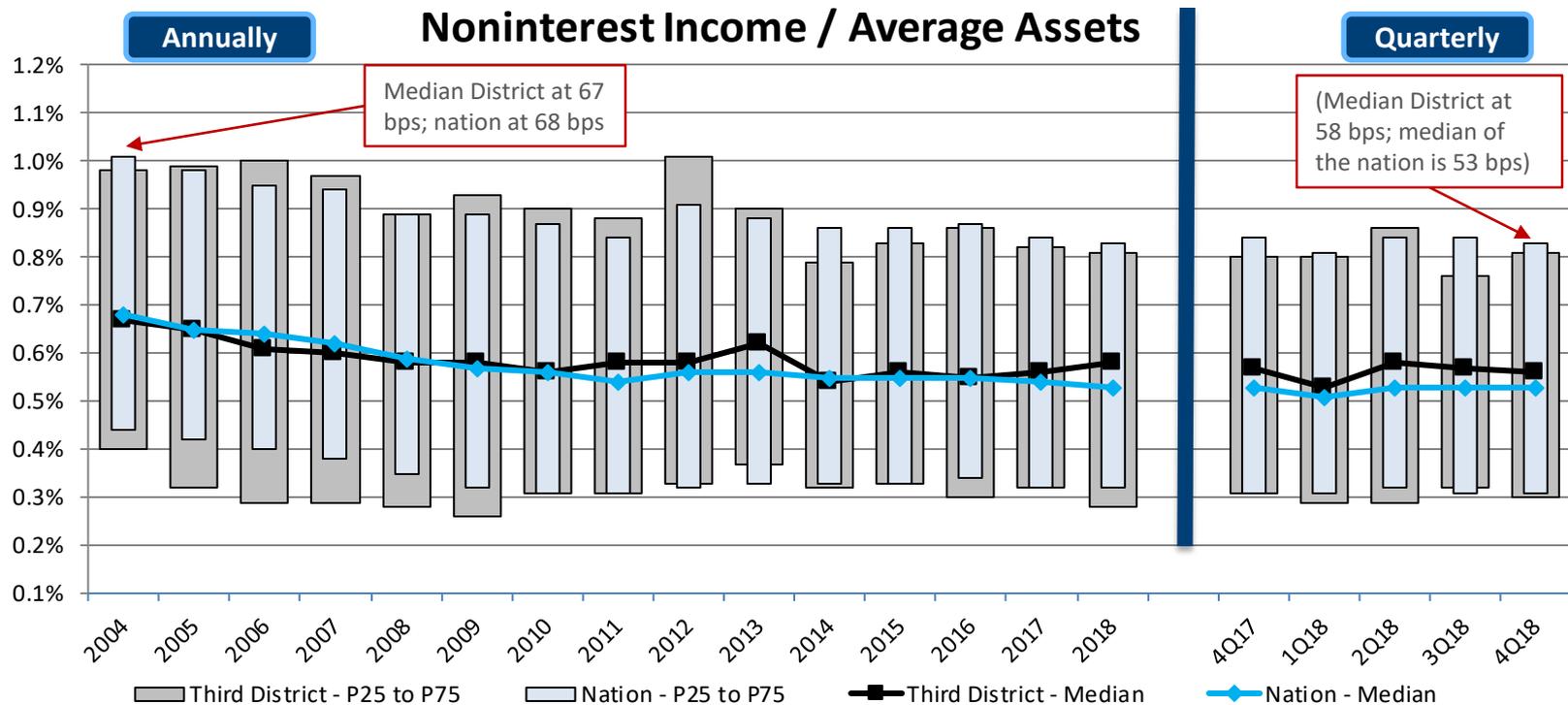
- The District's provision expense continues to trend at or below the precrisis level.
- Also, with strong asset quality performance, the low provision expense helps augment earnings on a nonrecurring basis.
  - Should asset quality performance begin to weaken, banks may need to increase their provision expense, which could lead to an increase in the allowance for loan and lease losses (ALLL) to cover potential losses. An increase in provision expense may negatively impact earnings.



# Third District Noninterest Income



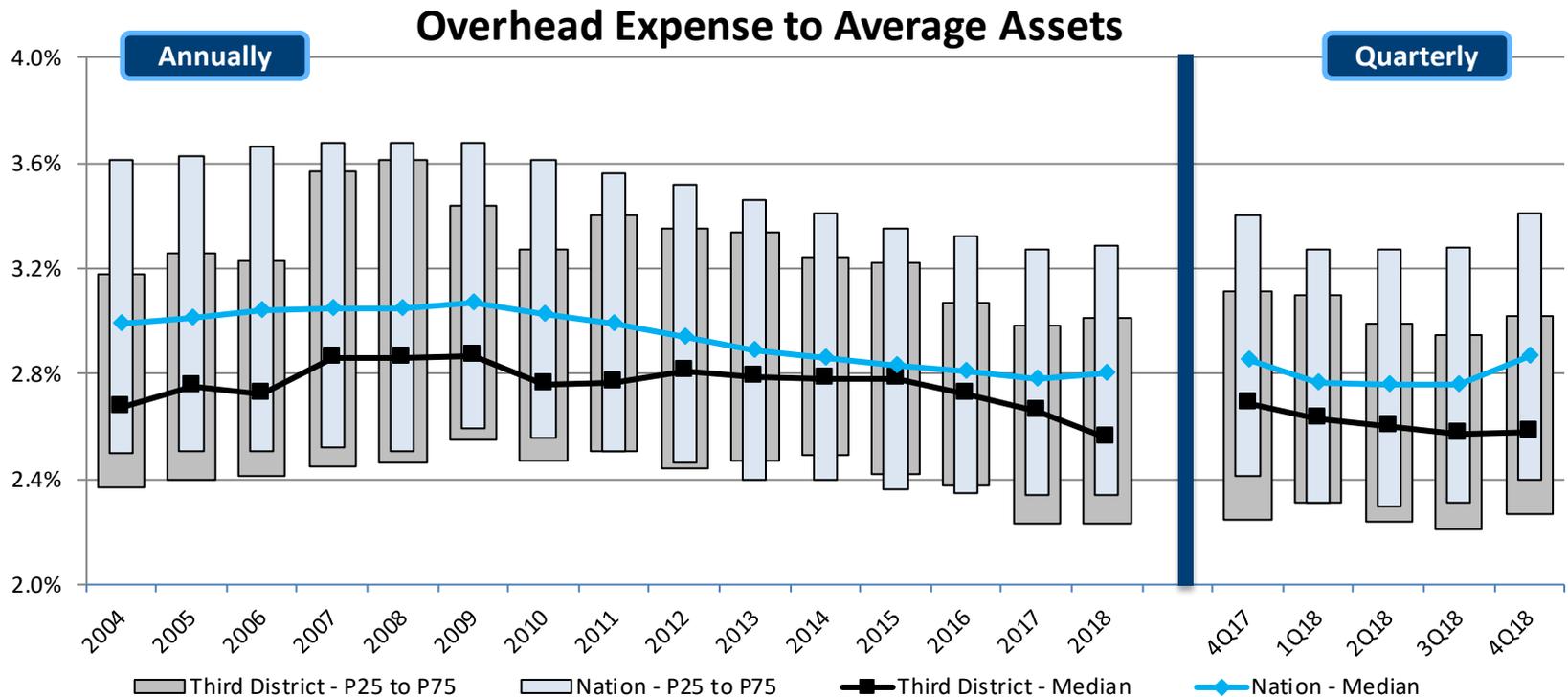
- Historically, noninterest income for the Third District has outpaced that of the nation. However, the decline in noninterest income since 2004 has placed further pressure on earnings for the District and the nation.



# Third District Overhead Expense



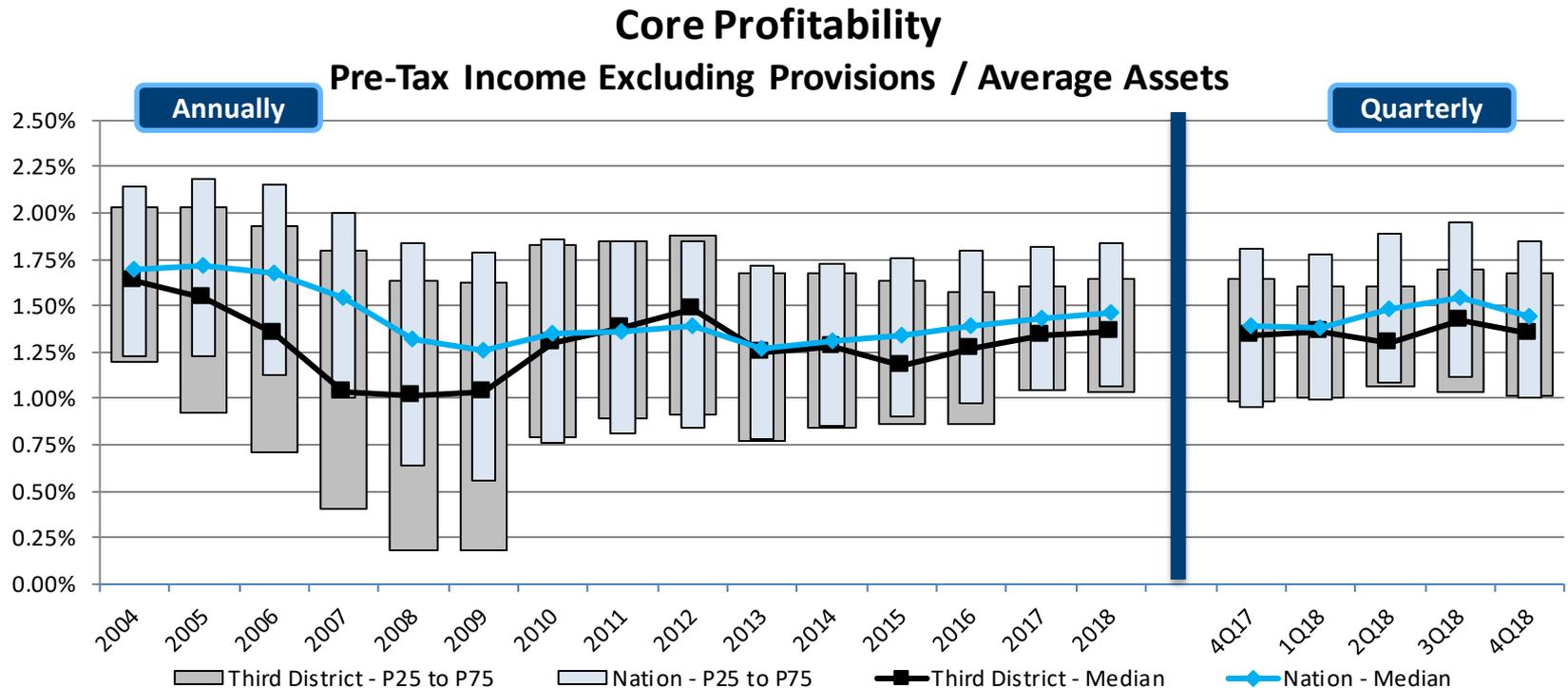
- Median overhead expense has decreased in the nation since 2010 and in the Third District since 2015.
  - However, it may be a sign that banks are trying to run their institutions in an increasingly lean manner, which could lead to other issues (lack of expenditure into operations, training, information technology).
  - As a result, the institutions that can control their expenses could have a positive impact on ROAA and overall earnings.



# Third District Core Profitability



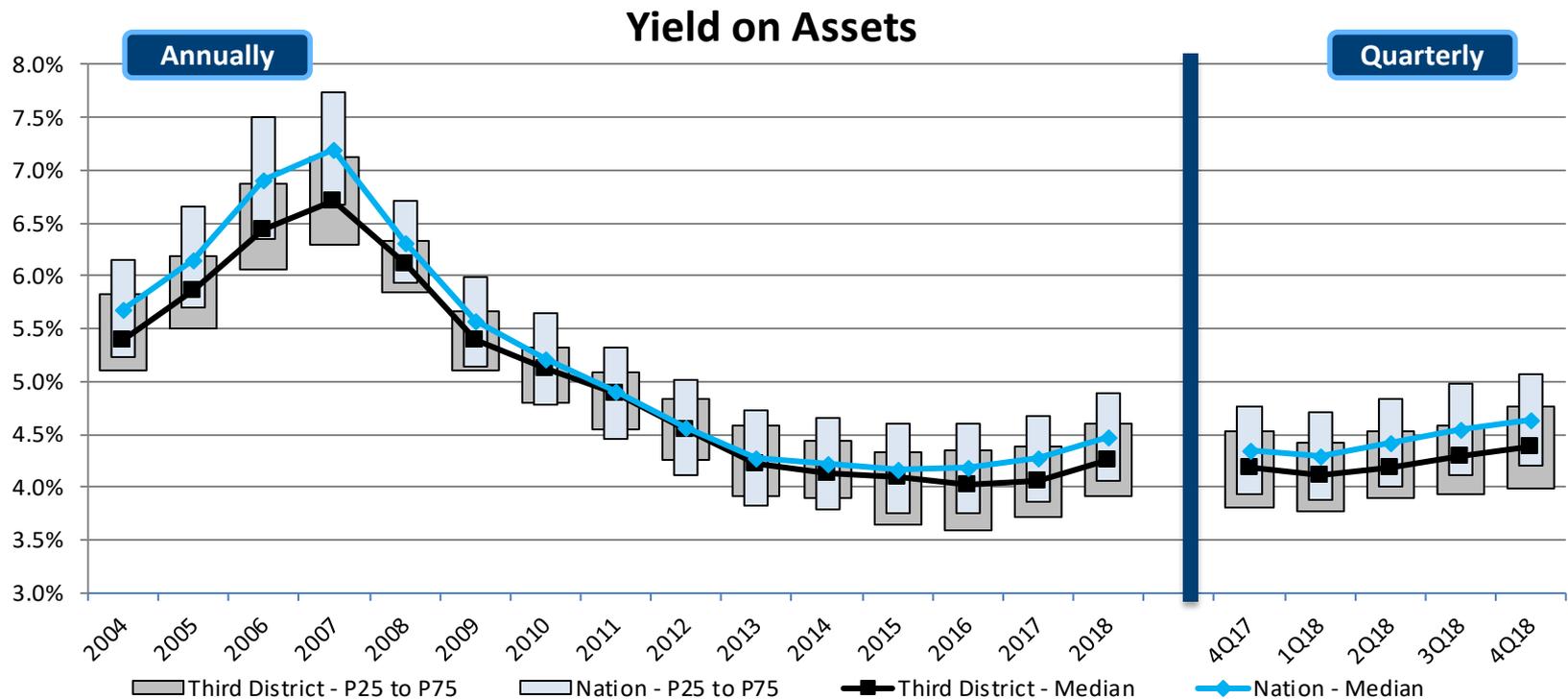
- At year-end 2018, the Third District's median core profitability increased by 2 basis points to 1.36%, while the nation increased 3 basis points to 1.46% year-over-year.
  - The lower-core profitability for the District is due primarily to a lower NIM when compared with the nation. The lower NIM is somewhat mitigated by the higher noninterest income and lower overhead expenses within the District.



# Third District Yield on Assets



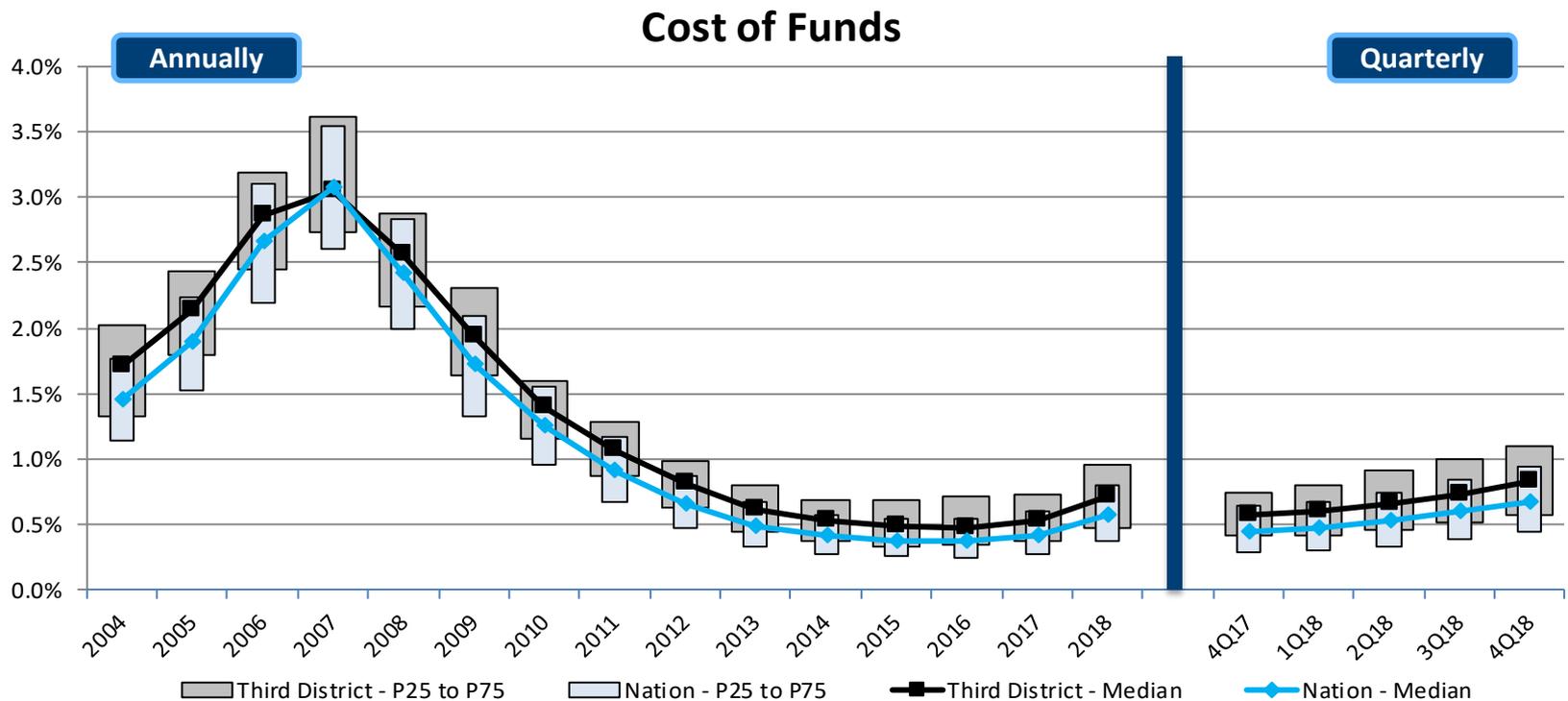
- The yield on assets within the Third District are constrained by:
  - The current interest rate environment;
  - The concentration and composition of retail and commercial real estate (CRE) loans at lower asset yields; and
  - The overall heightened competition for loans.



# Third District Cost of Funds



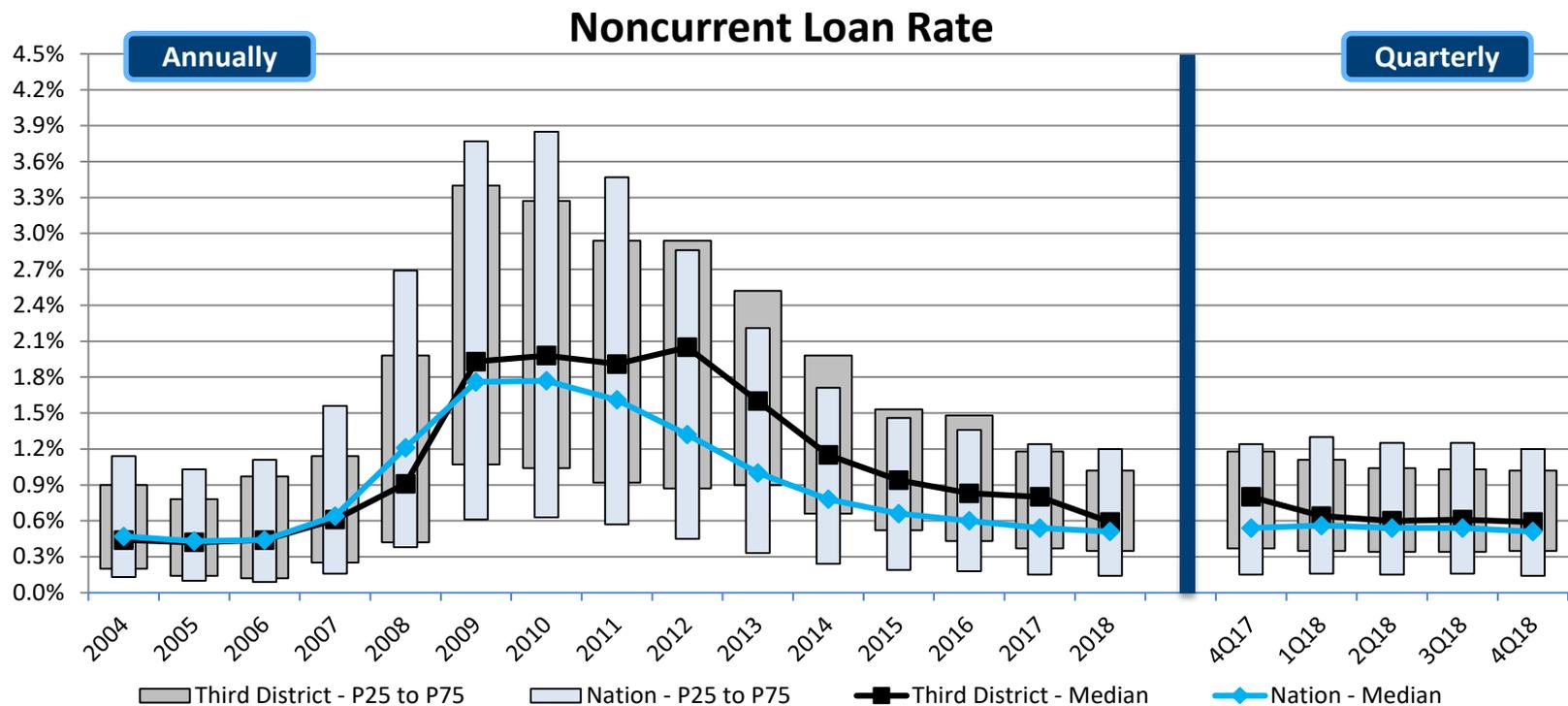
- Although many banks in the nation are able to better manage their cost of funds, the Third District's ability to reduce interest expense costs is hindered based on deposit competition and the reliance on noncore funding sources.
  - These types of liquidity sources (FHLB borrowings, brokered deposits, CDs > \$250K, etc.) are more expensive than most core deposits and can increase a bank's liquidity risk profile.



# Third District Noncurrent Loans



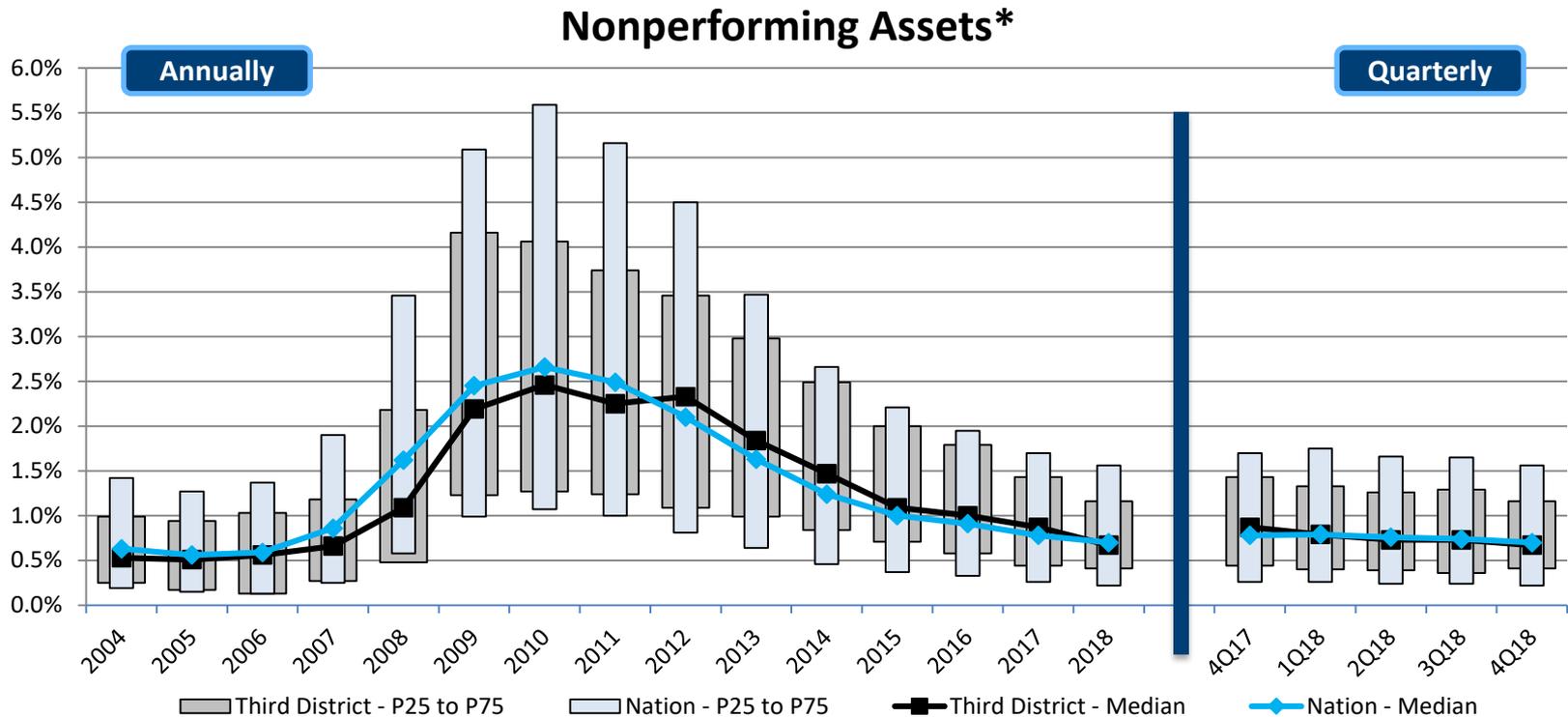
- Asset quality metrics continue to improve as the noncurrent loan ratio continues to decline.
  - In recent quarters, the District’s noncurrent loan rate has declined to more closely align with the nation.



# Third District Nonperforming Assets



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



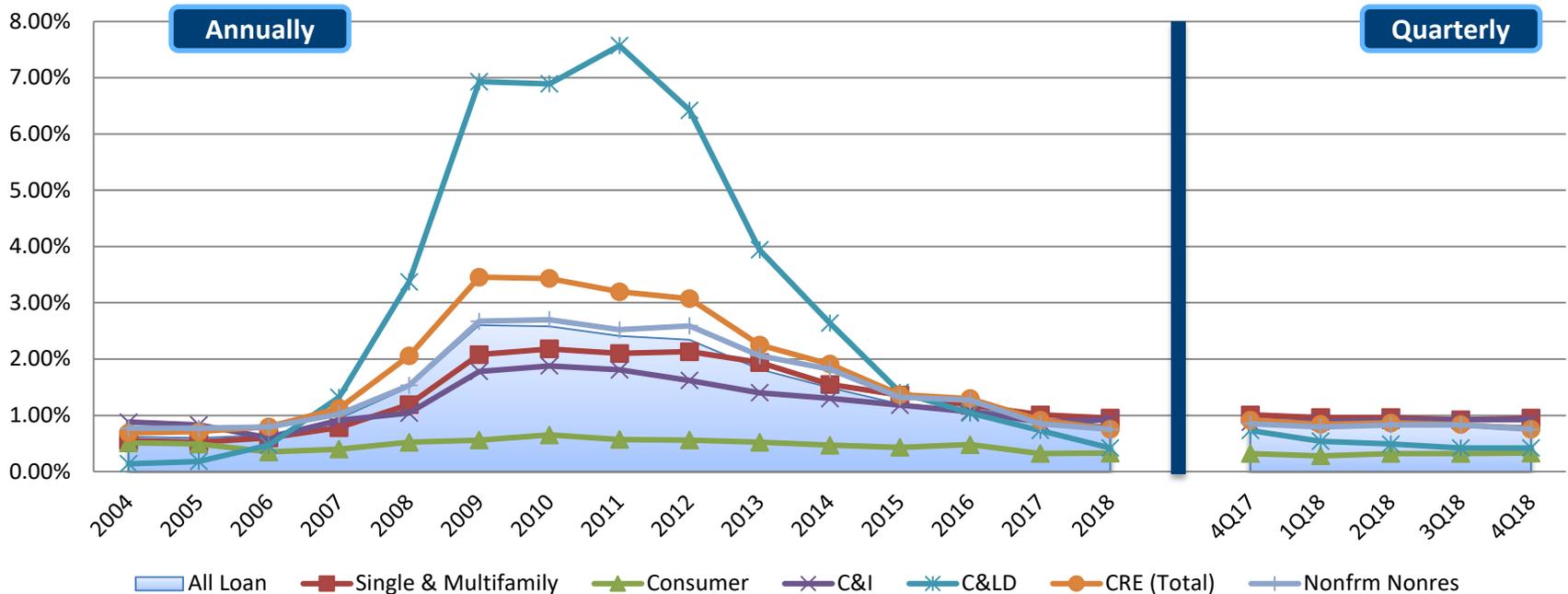
\* Nonperforming assets are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans)

# Third District Loan Performance



- Loan performance continues to show ongoing improvement among the principal loan categories, which are near or below precrisis metrics.

## Noncurrent Loan Ratios by Loan Category

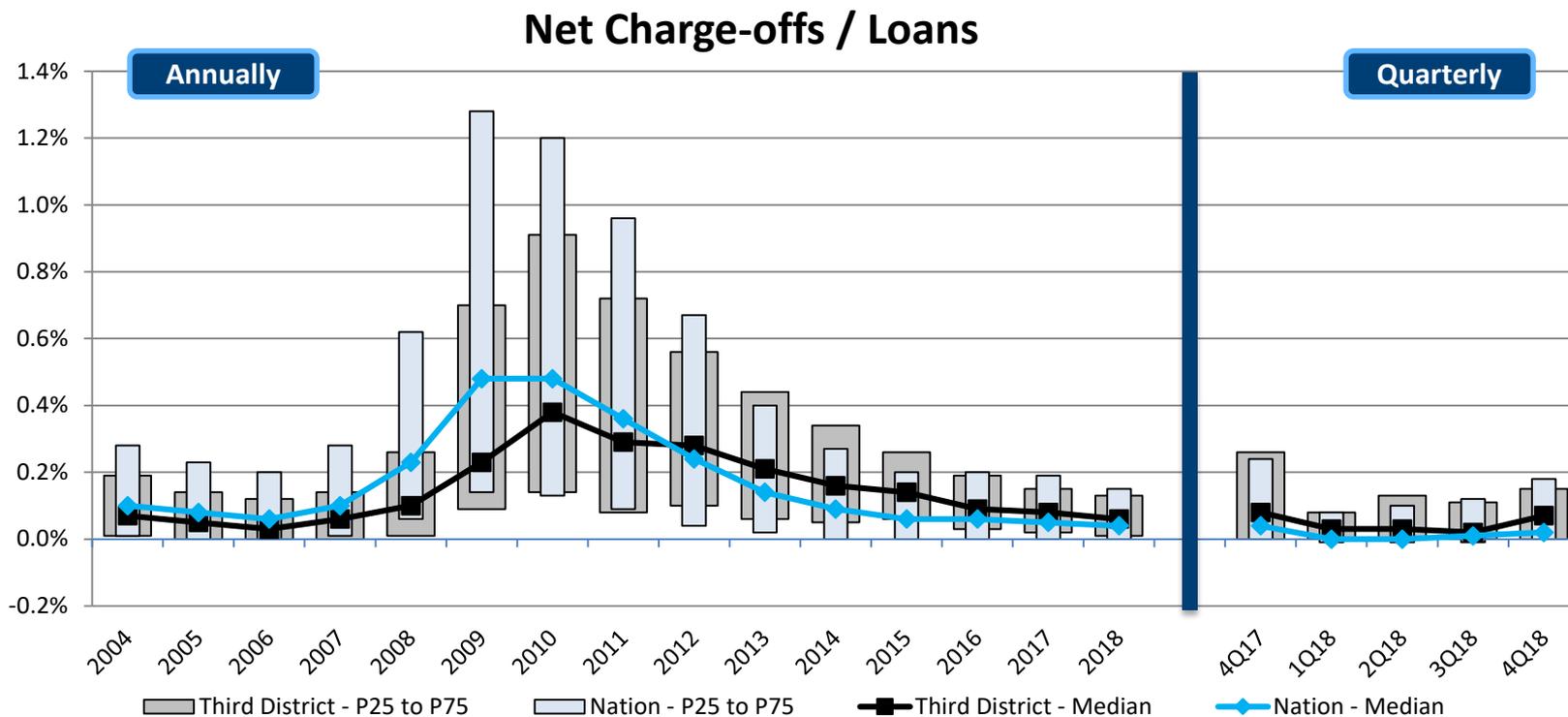


This chart uses a **10% capped mean, or winsorized mean**, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on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

# Third District Net Charge-off Rates



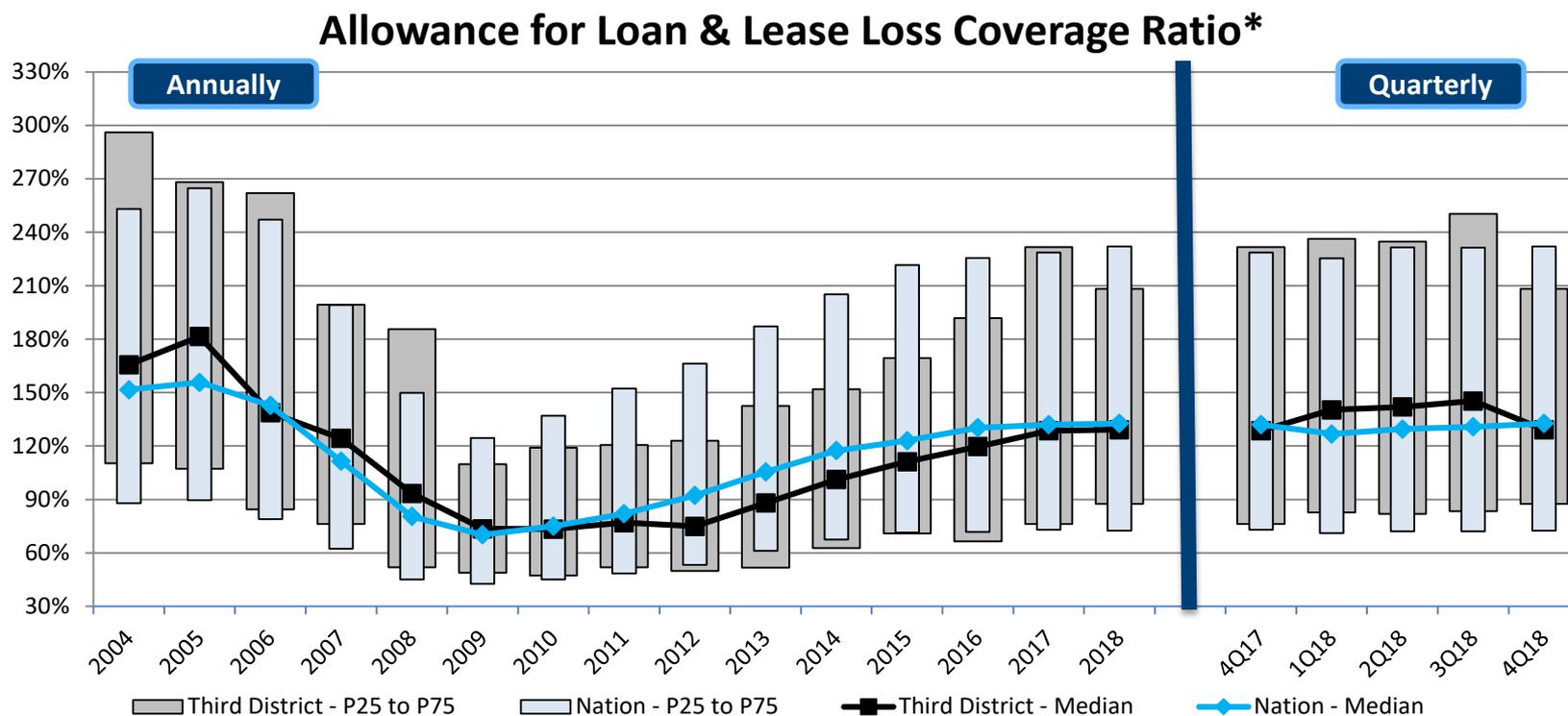
- The net charge-off rates have declined steadily since 2010 and are now below precrisis loss levels for both the District and the nation.



# Third District Allowance for Loan and Lease Losses (ALLL) Coverage Ratio



- The reserve coverage ratio for both the District and the nation continues to improve primarily because of improved asset quality metrics, and not by increased provision expense.

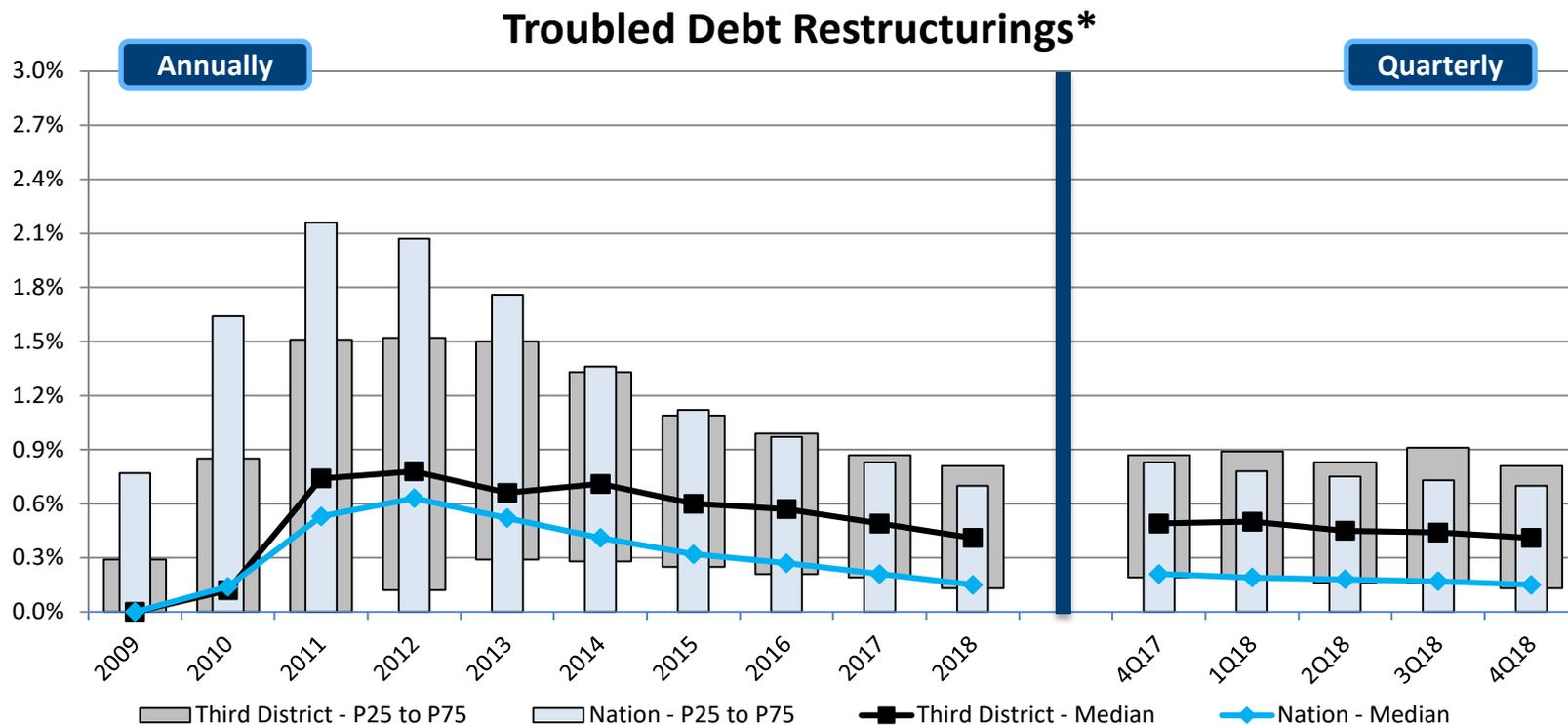


\* The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.

# Third District Troubled Debt Restructurings



- Troubled debt restructurings\* remain stable for both the District and the nation, with a decreasing trend since 2012. However, the District metrics remain elevated when compared with the nation.



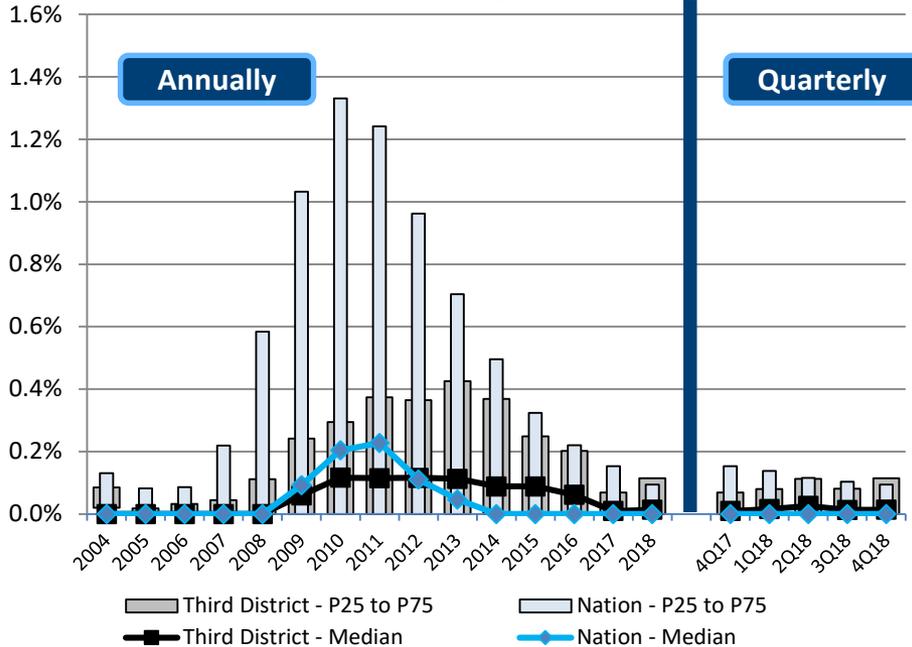
\* Troubled debt restructurings were not included on the Call Report until the March 2009 reporting period.

# Third District OREO and Foreclosures

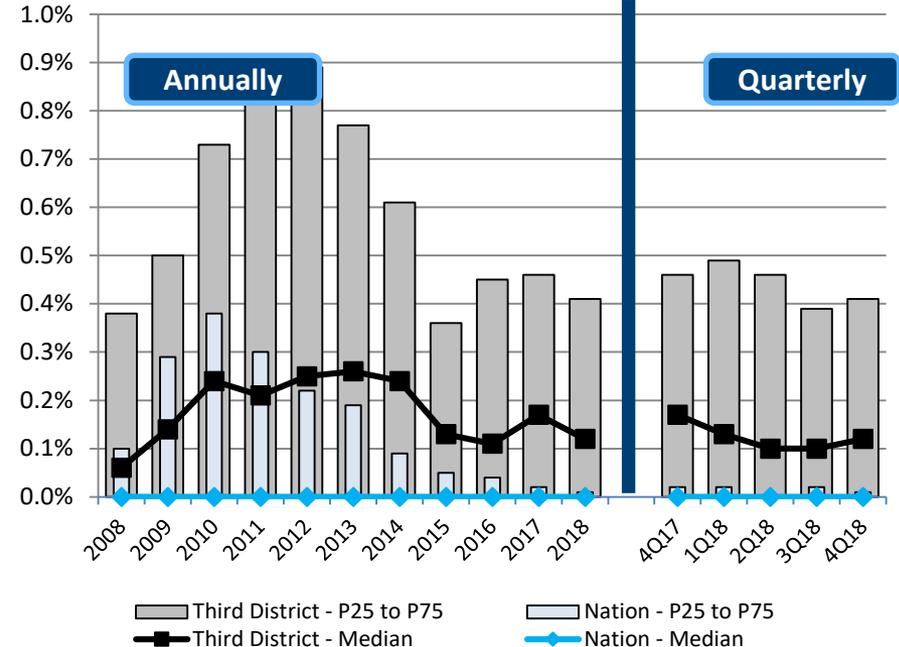


- One- to four-family other real estate owned (OREO) continues to decrease; however, the Third District continues to trail in the foreclosure process because of the judicial foreclosure process in Pennsylvania, Delaware, and New Jersey.

### 1-4 Family OREO\*



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



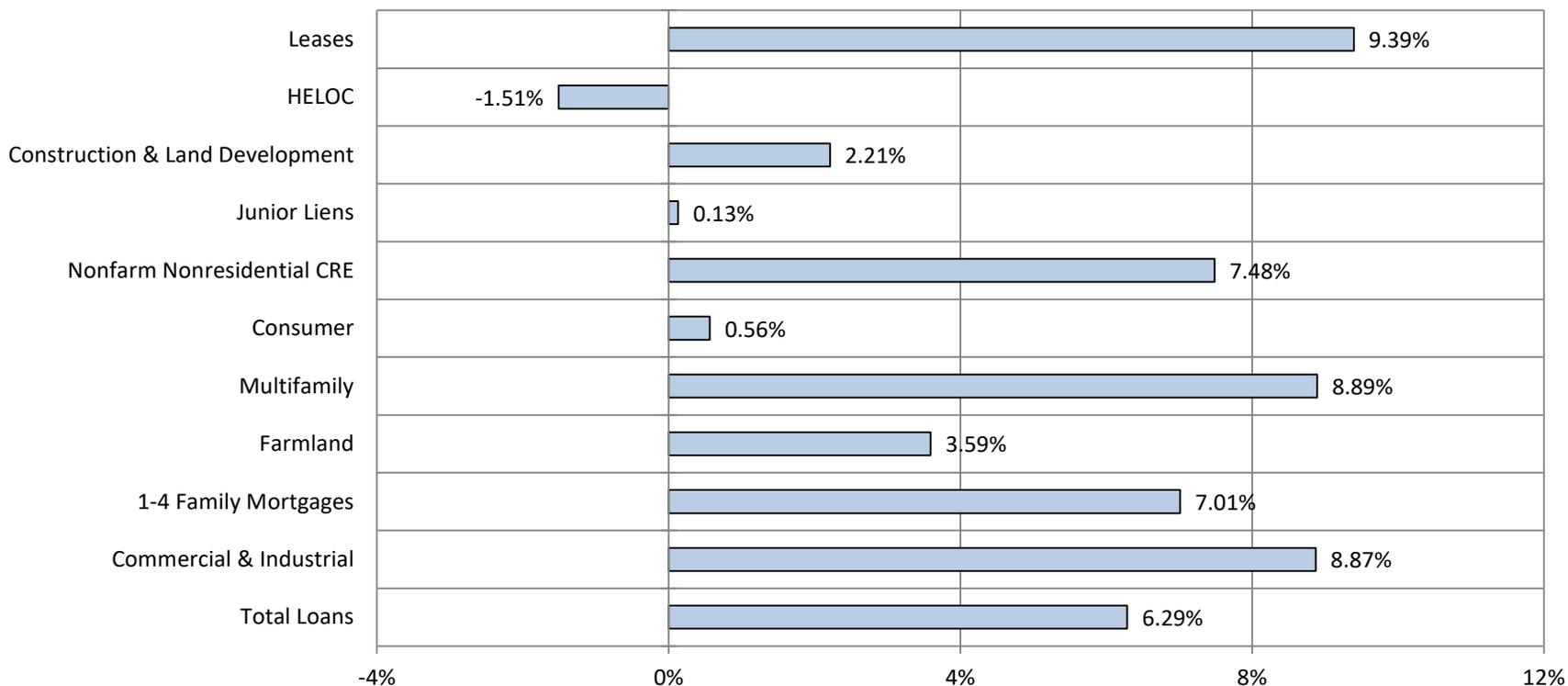
\* As a percentage of one- to four-family loans.

\*\* 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 loan categories, year-over-year loan growth was positive
- Loan contraction continues in the leases and junior lien loan categories.

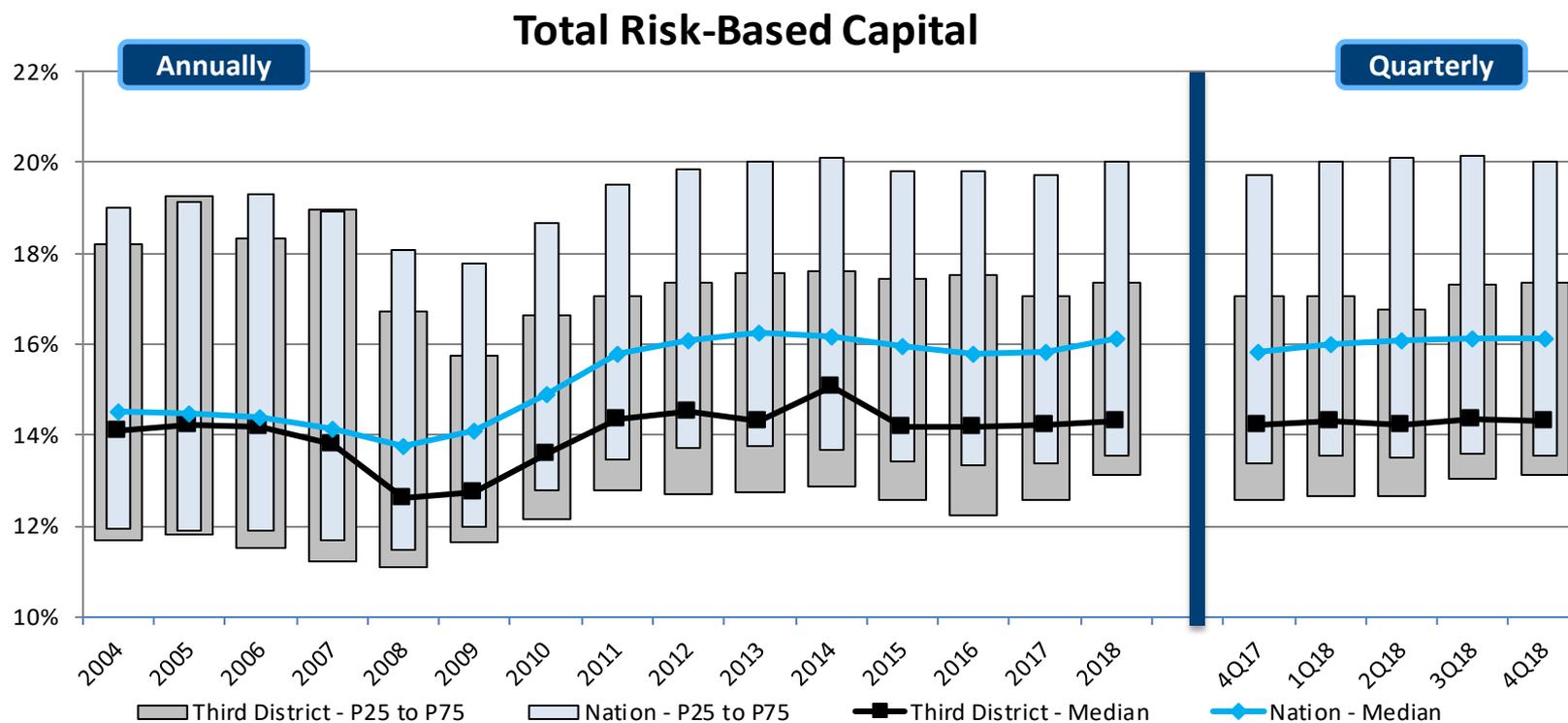


\* This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 6.

# Third District Total Risk-Based Capital Ratio



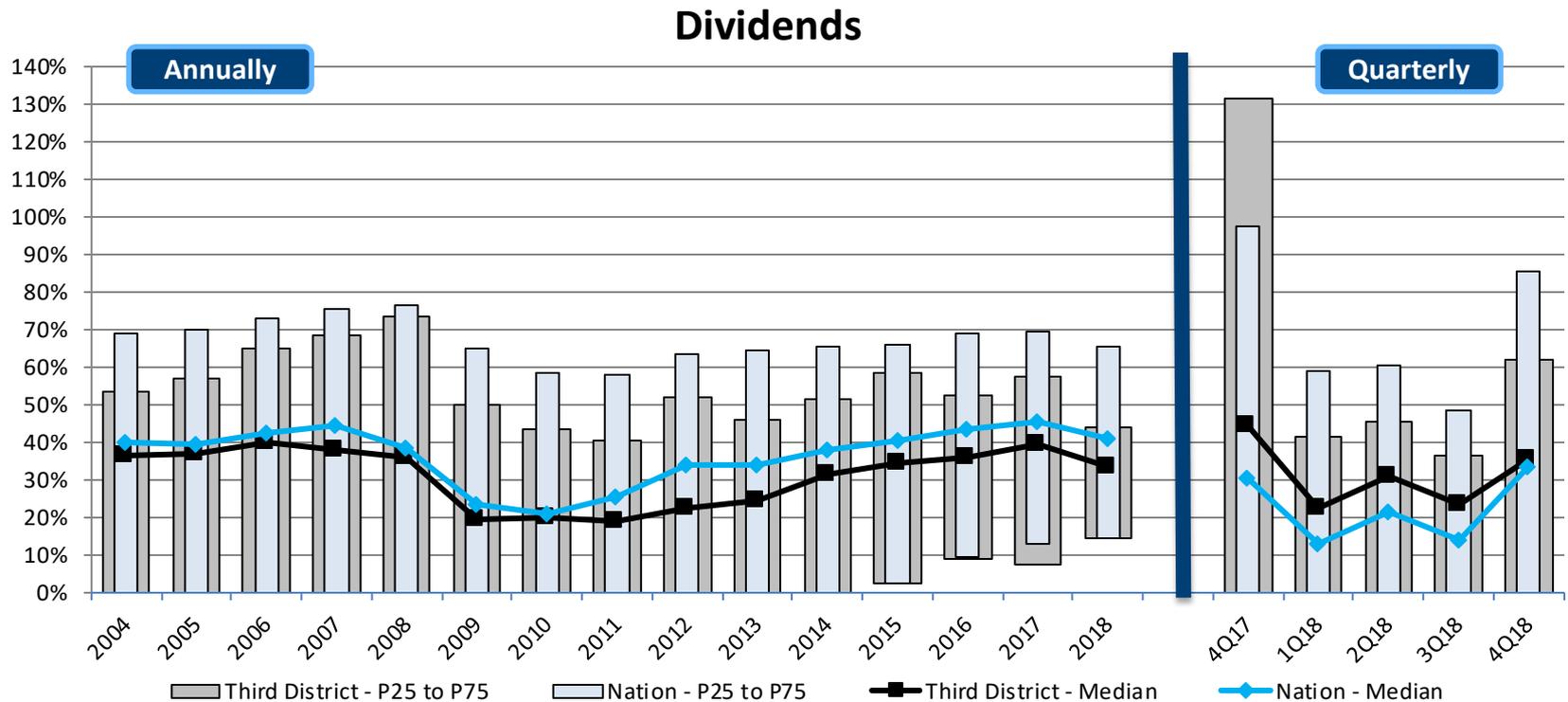
- Although capital ratios have increased from postcrisis levels, District total risk-based capital levels have flattened since 2011 and the ratio remains well below those of the nation.



# Third District Dividends



- As of 2018:Q4, 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).



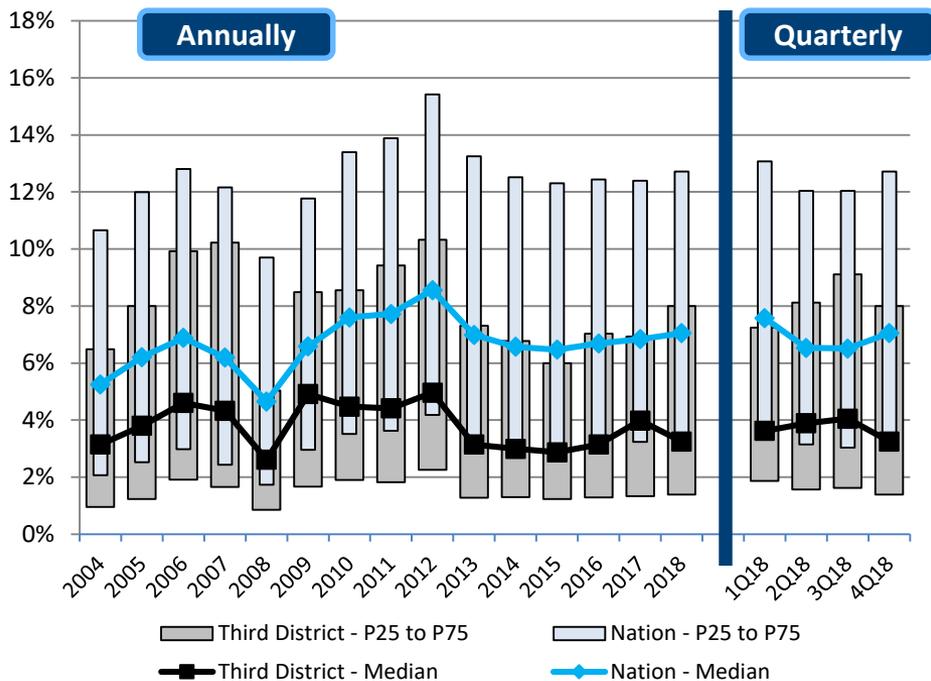
\* Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout (DPO) ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income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

# Third District Short-Term Investments and Loans-to-Assets

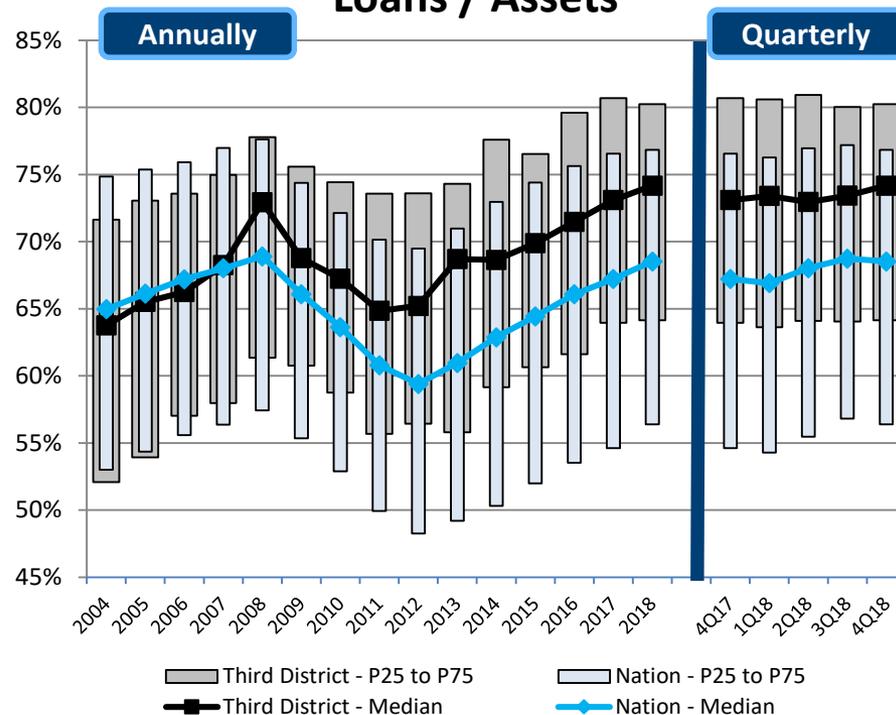


- Third District banks hold fewer short-term investments compared with the nation.
- Rather, Third District institutions have decided to grow their loan portfolio. This strategy may increase duration and interest rate risk depending on the specific loan type.

## Short-Term Investments / Assets\*



## Loans / Assets

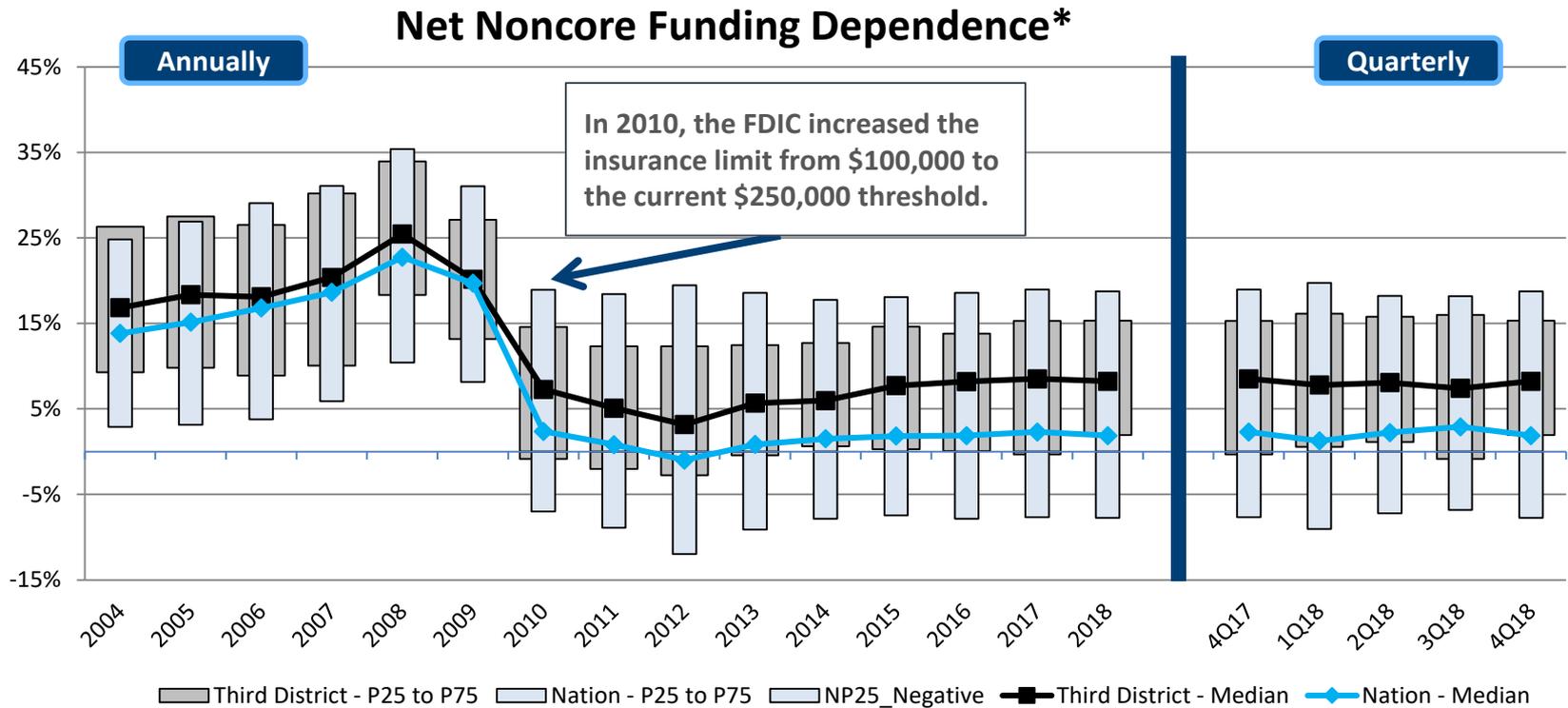


\* Short-term investments equal the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

# Third District Net Noncore Funding Dependence



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

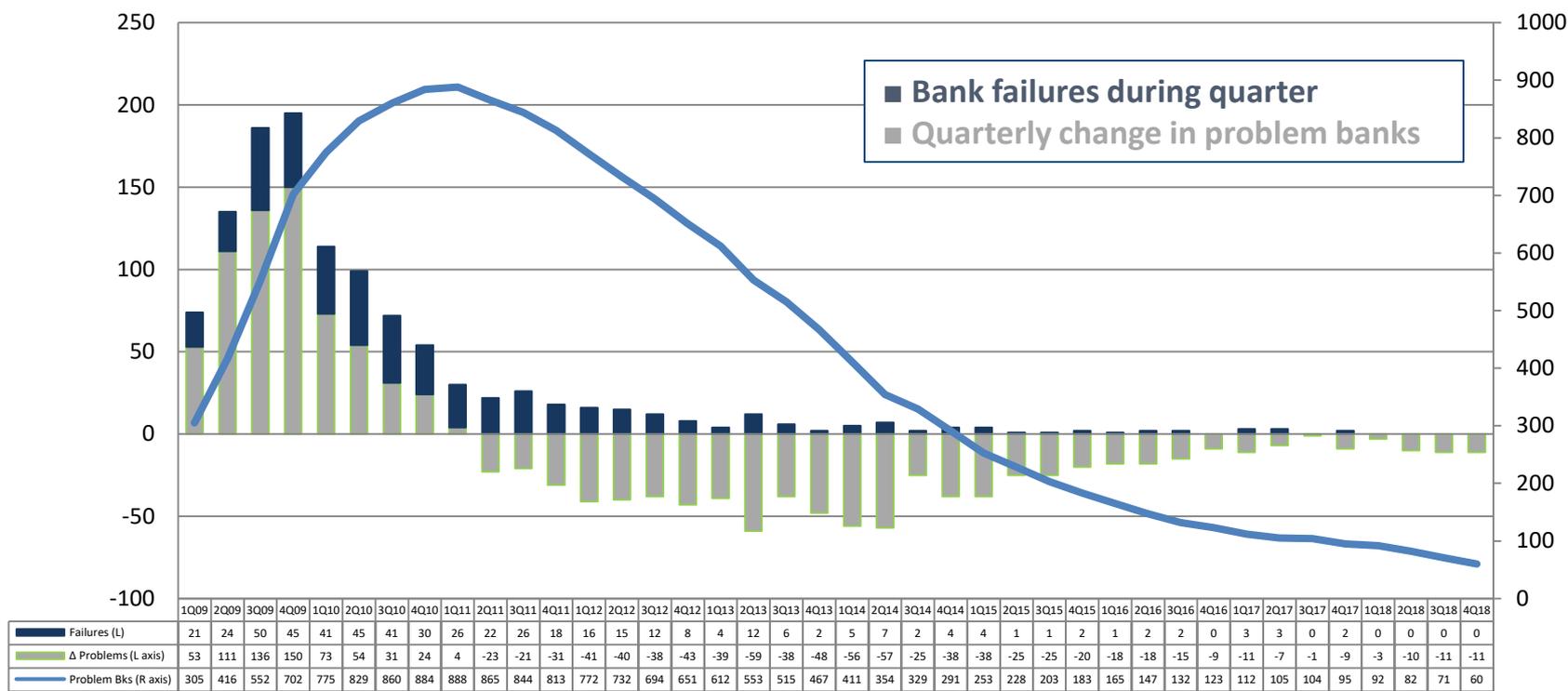


\* Net noncore funding dependence measures the degree to which banks fund longer-term assets with noncore funding sources.

# Problem Banks



- Nationwide, the number of banks on the FDIC’s Problem Bank List declined from 71 to 60 at year-end 2018, the fewest since 2007:Q1.
- Additionally, no banks failed in 2018.



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.