



FEDERAL RESERVE BANK  
OF PHILADELPHIA

# Third District Community Banking Conditions as of June 30, 2019

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SUPERVISION, REGULATION, AND CREDIT

FEDERAL RESERVE BANK OF PHILADELPHIA





# Third District Banking Conditions

Agenda and Table of Contents			
Section 1	Executive Summary	Slides	3–7
Section 2	Commercial Bank Performance	Slides	8–28
	Earnings	Slides	8–15
	Asset Quality	Slides	16–22
	Loan Growth	Slide	23
	Capital Adequacy	Slides	24–25
	Liquidity	Slides	26–27
	Problem Banks	Slides	28

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 banking organizations\* (CBOs) continue to demonstrate solid performance. A prominent reason for this progress is primarily because of to the benign economic environment and continued strength within the banking sector. As a result, the U.S. is in the longest economic expansionary cycle in history, at 125 months,\*\* which surpassed the economic expansion between March 1991 and March 2001, or 120 months. Conditions are highlighted by the following:
  - Earnings ratios have returned to precrisis levels, driven primarily by strong loan growth and loan performance indicators, as well as the lack of or negative provision expense.
  - Third District asset quality metrics continue to improve. The level of noncurrent loans have fallen to near precrisis results.
  - Capital ratios remain well capitalized for most CBOs, as earnings have been accretive to capital. For Third District banks, however, capital ratios remain below those of the nation.
    - For some institutions, excess capital may provide the opportunity for continued consolidation in the industry, or it might provoke stock buybacks to help improve shareholder ownership.

\* Community banking organizations 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 125 months reported is inclusive through August 2019.



# Section 1

## Executive Summary (cont'd)

- Challenges do remain for Third District bank financial performance primarily because:
  - The federal funds rate, which was rising and stable as of the March Federal Open Market Committee (FOMC) meeting, was reduced by 25 basis points by the Fed on July 31, 2019. On September 18, 2019, the FOMC reduced the rate by a further 25 basis points. In light of the implications of global developments for the economic outlook as well as muted inflation pressures, the Fed's target range for the federal funds rate is now at 1.75 to 2.00 percent. The decrease in rates could put pressure on earnings if asset yields decline.
  - The 2yr–10yr spread inverted during intraday trading on August 14, 2019, as well as August 27–29. The long-term, net-negative yield will be accommodative for loan growth, while the consumer deposit account yields may decline. However, given the extended accommodative interest rate environment, many banks have adjusted their balance sheet to reduce the adverse effects of the changes in interest rates. Additionally, when the 2yr–10yr does go negative, it has been a predictor of recessions going back 40 years.
  - The current expected credit loss (CECL) standard will be implemented for the larger, publicly traded institutions at the beginning of 2020. For the smaller public business entities and privately held institutions, compliance with the CECL guidance has been delayed until 2023. This change in credit loss methodology could have a negative impact for earnings. However, with its implementation, CECL should provide an institution a larger capital buffer for charge-offs.



# Section 1

## Executive Summary (cont'd)

- Challenges do remain for Third District bank financial performance primarily because:
  - Earnings continue to be augmented with nonrecurring sources of income, especially by reporting zero or negative provisions to increase profitability. 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 has been increasing within the District. The net interest margin (NIM) has compressed 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. The deposit rates may not decline as quickly as asset yields, which would put pressure on the NIM, 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

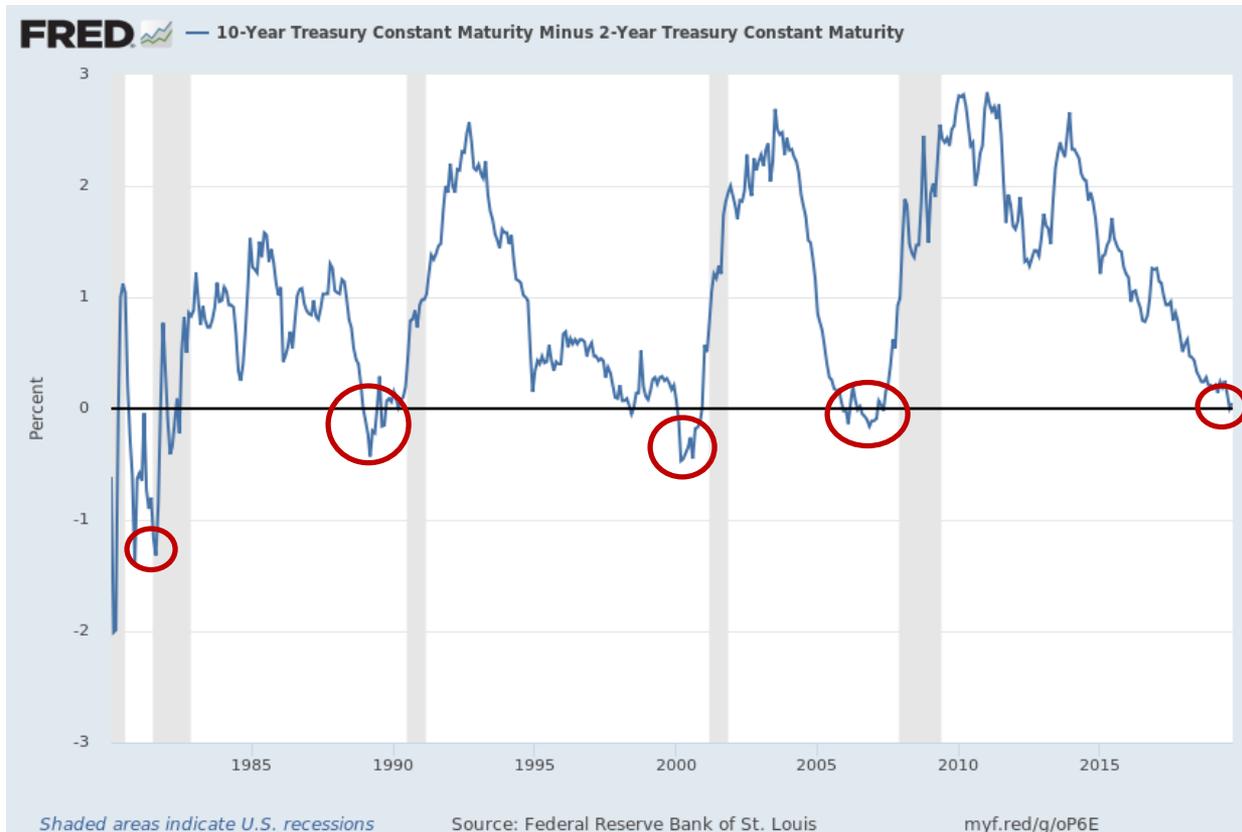
## Executive Summary (cont'd)

- 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 if 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 Bank Secrecy Act and all of the related statutes
  - Marijuana banking and the House of Representatives recently approved SAFE Banking Act on September 25
- The number of problem banks fell by four banks, from 60 at 2018:Q4 to 56 as of 2019:Q2. This represents the lowest number of problem banks since 2006, declining significantly from the peak of 888 problem banks in 2011:Q2 during the Great Recession. One bank did fail within the first six months of 2019, The Enloe State Bank in Cooper, TX.



# Will the inversion of the 2yr-10yr Treasury securities predict a recession within the next 12 to 24 months?

- Over the past 40 years, the inversion of the 2yr-10yr interest rate spread has led to a recession. The spread inverted intraday on August 14, as well as August 27, 28, and 29.
- Since August 12 to the end of September, the 2yr-10yr spread has been less than 10 basis points. As of October 3, the spread has widened to 15 basis points.





# Section 2

## Conditions of Third District Commercial Banks

### Reporting Methodology

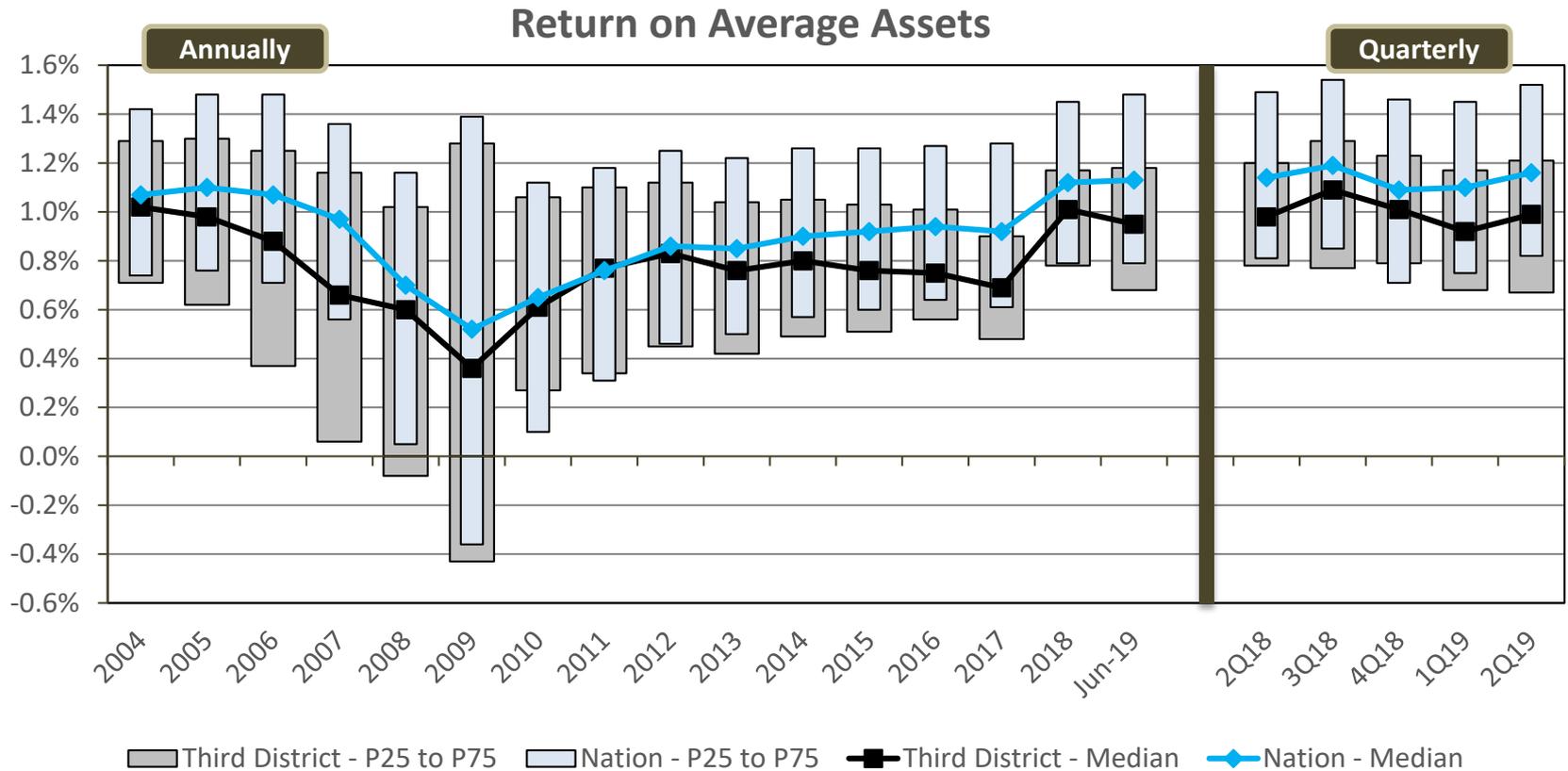
- The quarterly **Reports of Condition and Income (Call Report)** and **Uniform Bank Performance Report (UBPR)** are the primary sources of all information contained in this report unless otherwise noted.
- Slides in this section focus on trends among the **90 commercial banks** within the Third District 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, 2019**:
  - 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, national, and nonmember banks within the nation with less than \$10 billion in assets.
- 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 graph.



# Earnings

## Return on Average Assets Ratio

- Third District earnings performance, based on the return on average assets (ROAA) ratio, continues to lag that of the nation since 2004; however, ROAA is now at levels prior to the Great Recession.



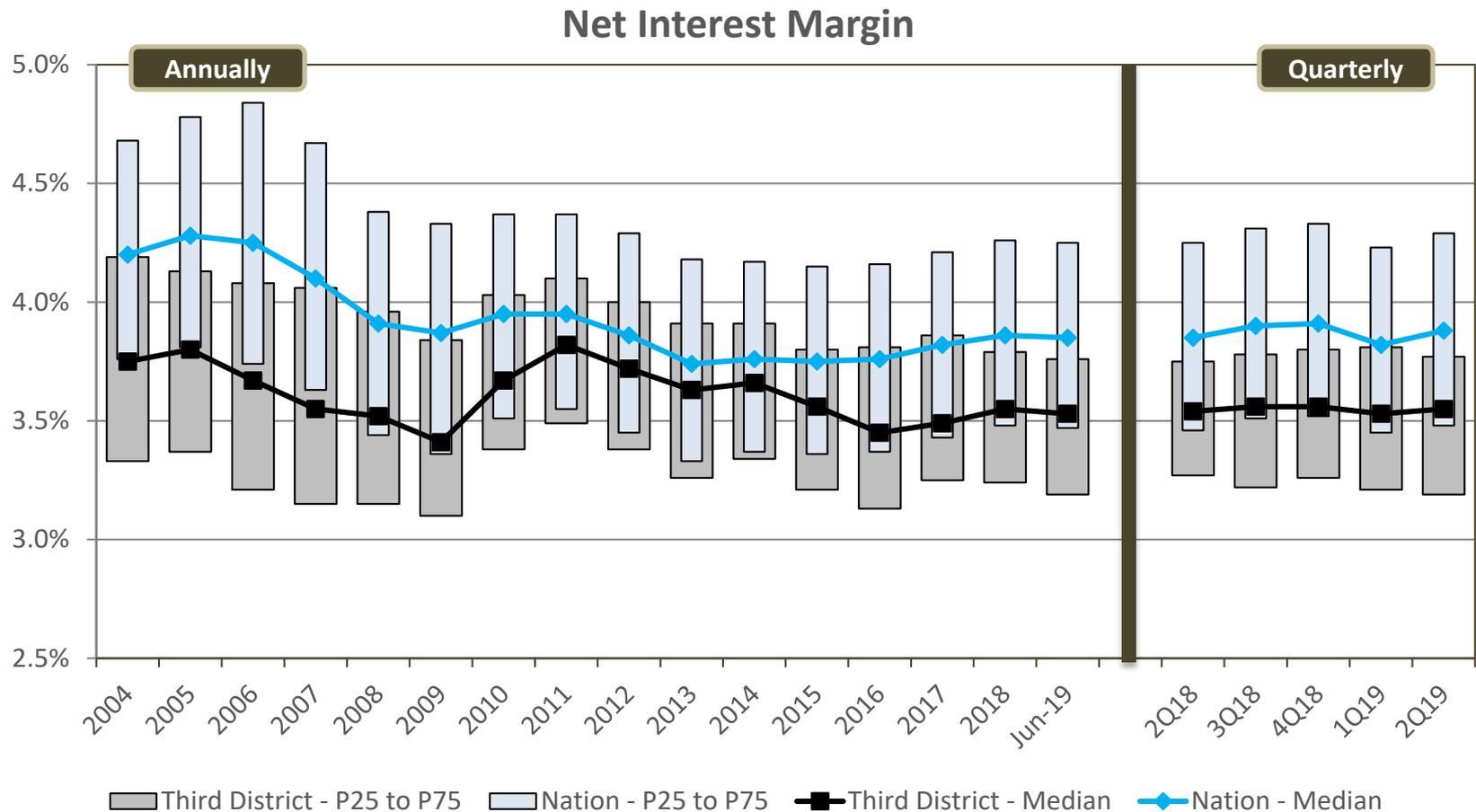
The decline in earnings as of year-end 2017 for the District and nation is primarily due to the change in tax law for deferred tax assets (DTA) and mortgage servicing rights (MSR). Many banks had to revalue their position downward at year-end 2017, which negatively impacted earnings.



# Earnings

## Net Interest Margin

- The Third District net interest margin (NIM) remains steady as of 2019:Q2; however, the NIM remains lower than that of the nation before, during, and after the Great Recession.

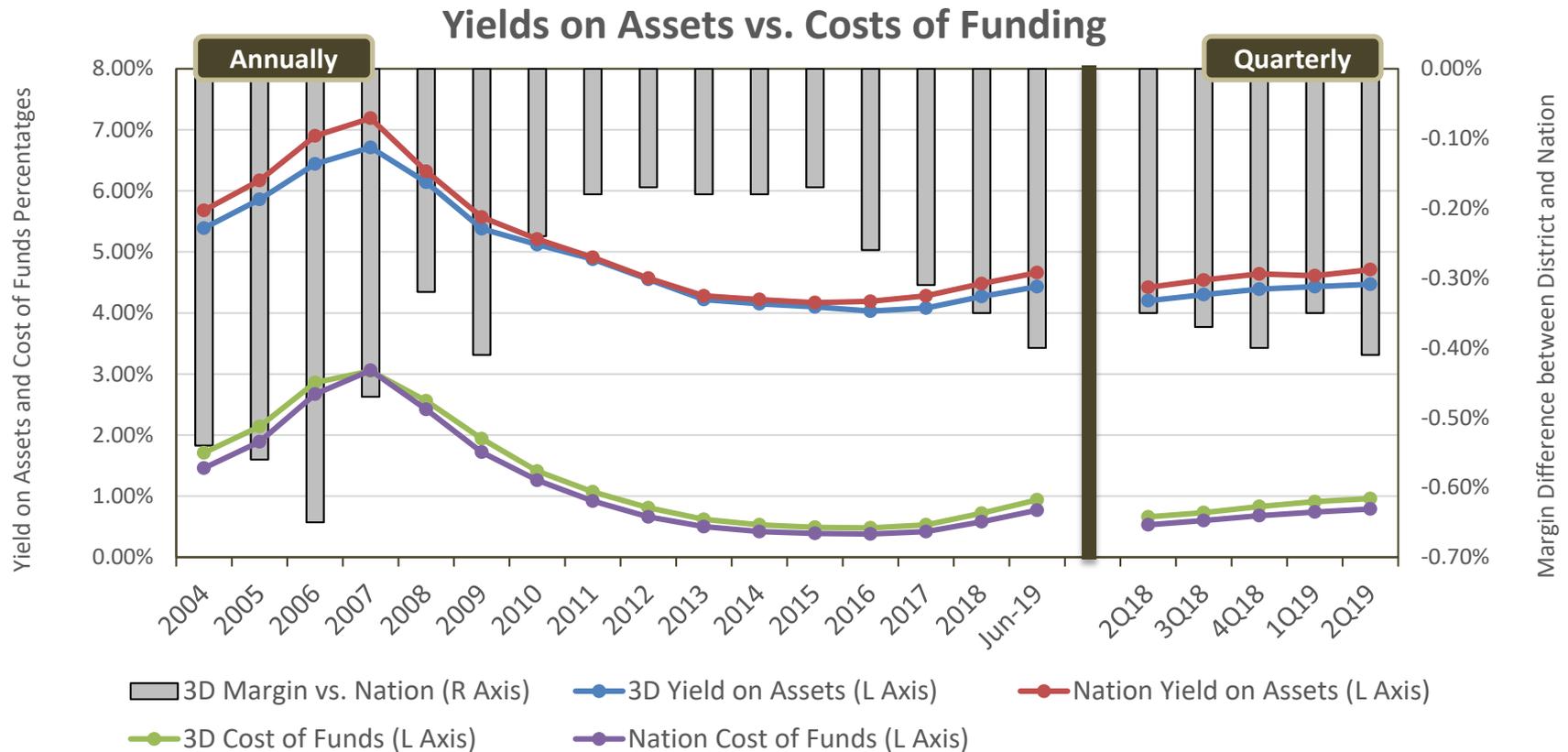




# Earnings

## Yield on Assets and Cost of Funds

- As discussed on the previous slide, the NIM has compressed considerably when compared with that of the nation. The primary reason is because of Third District CBOs maintaining a lower yield on assets and a higher cost of funds.

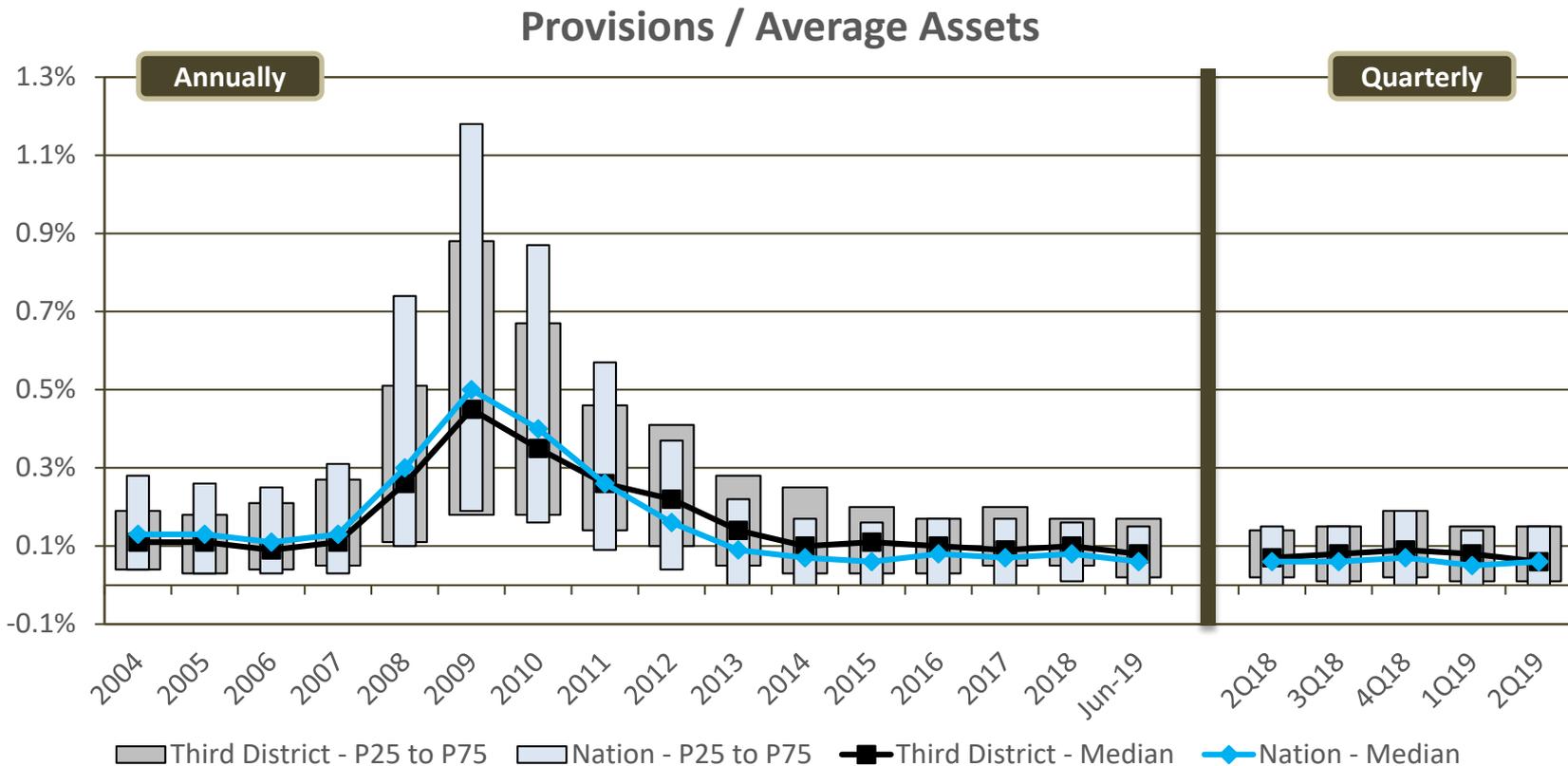




# Earnings

## Provision Expense

- The provision expense continues to trend at or below precrisis levels because of strong asset quality metrics. Consequently, the low provision expense helps augment earnings. However, if asset quality performance begins to deteriorate, CBOs may need to increase their provision expense to fund the allowance for loan and lease losses (ALLL), which could negatively impact earnings.

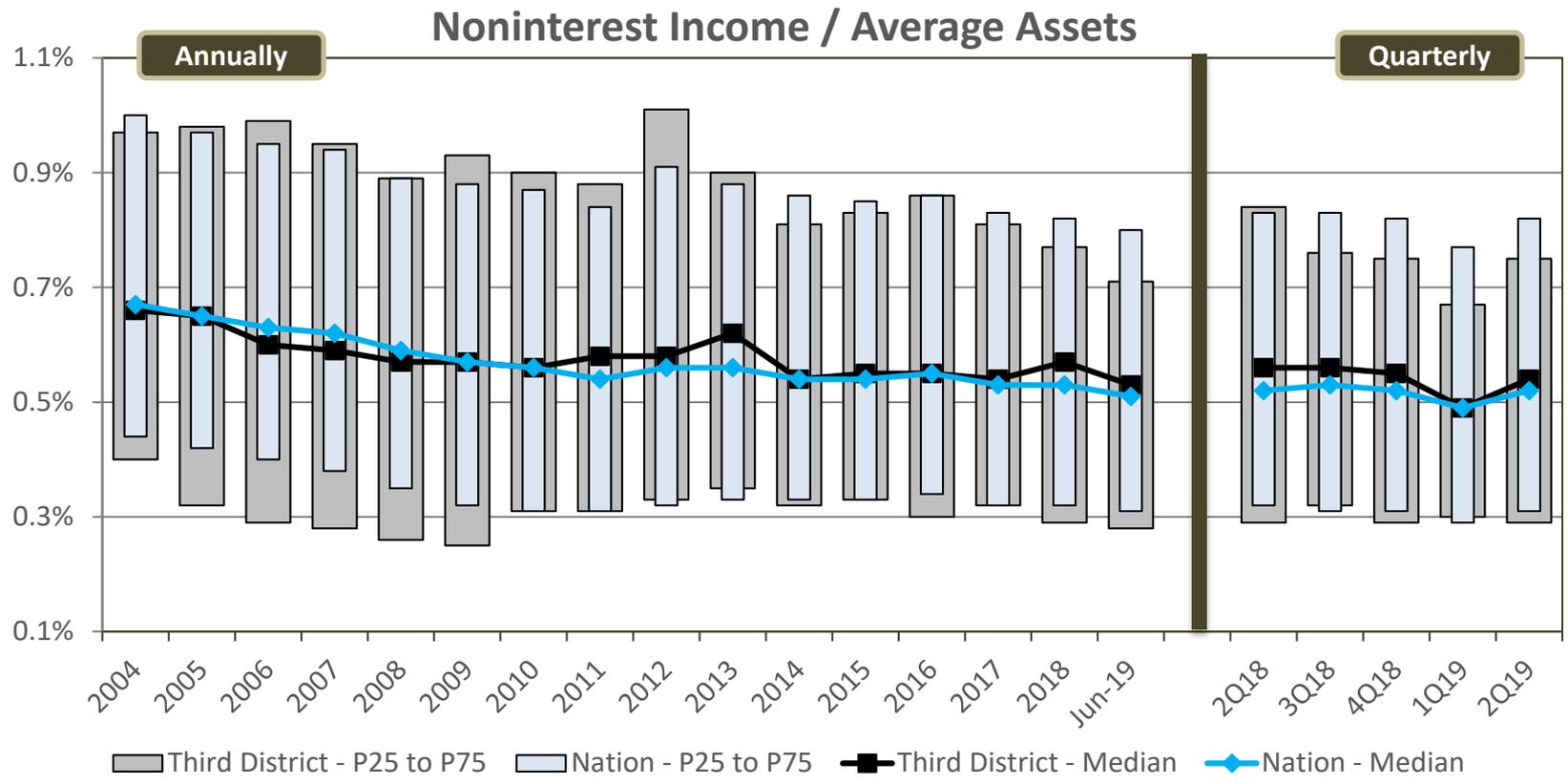




# Earnings

## 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.

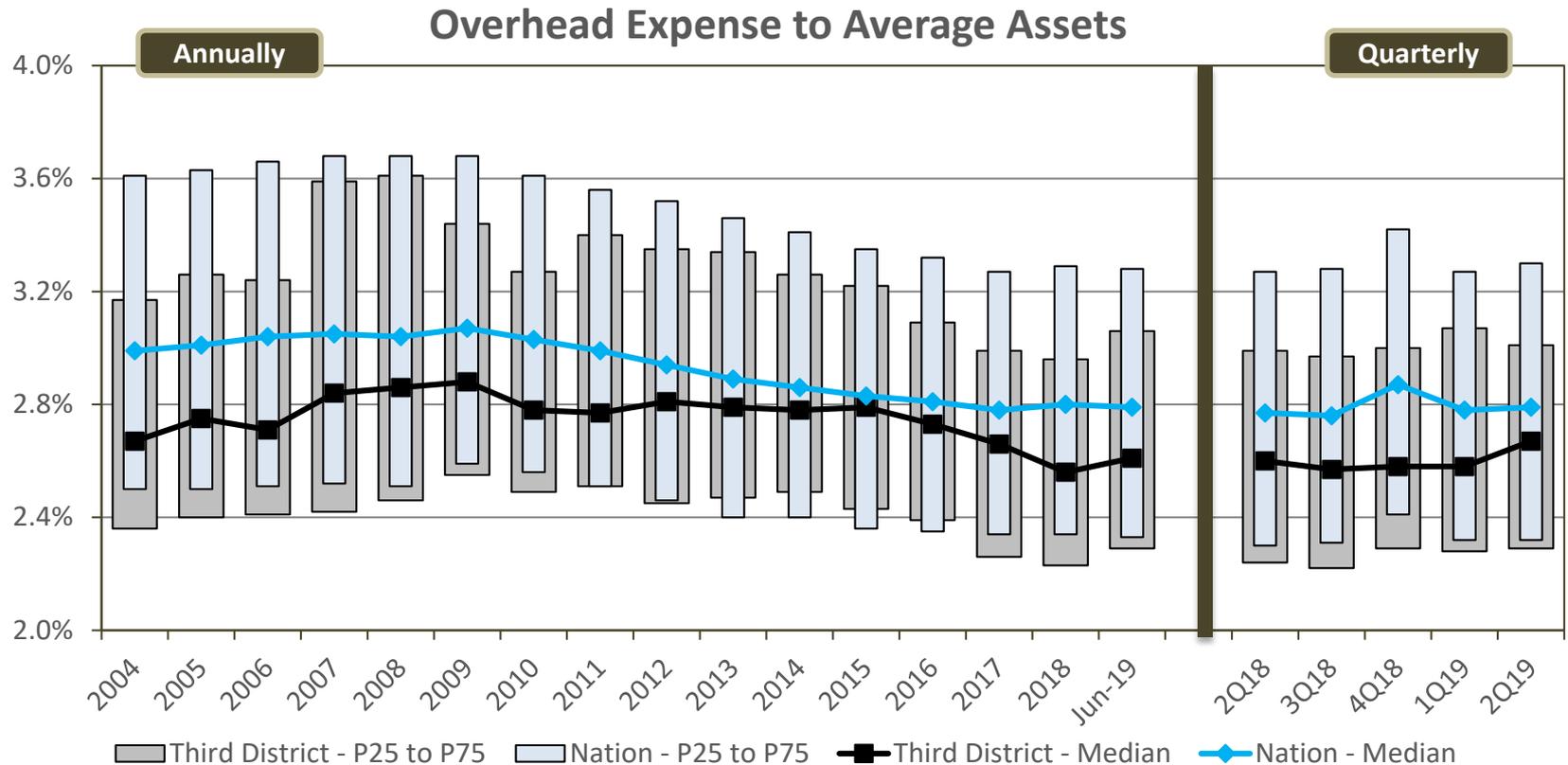




# Earnings

## Overhead Expense

- Median overhead expense has mostly decreased since 2009 for the Third District and the nation. 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, which could have a positive impact on ROAA and overall earnings.

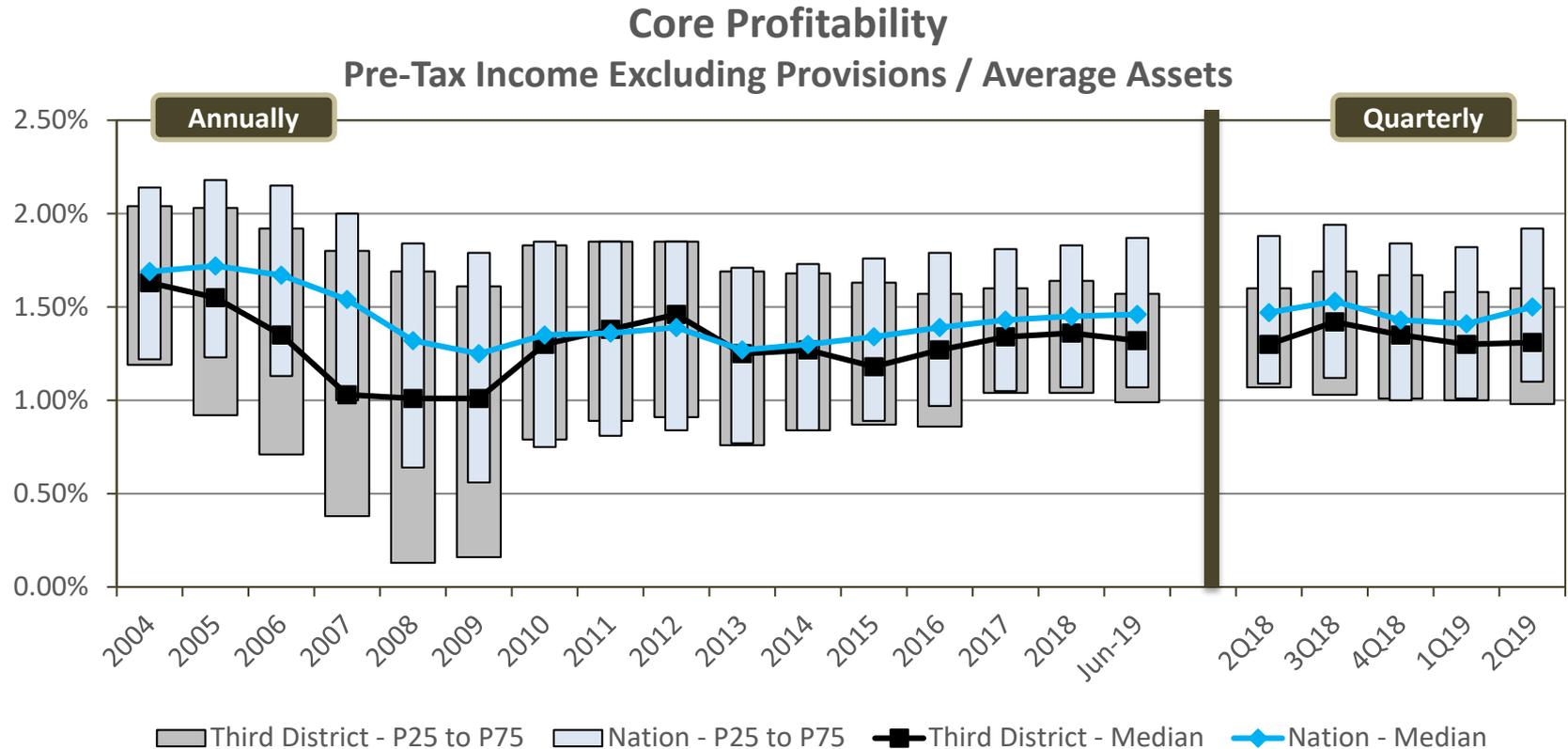




# Earnings

## Core Profitability

- For the first six months of 2019, the Third District's median core profitability fell by 4 basis points to 1.32%, while the nation increased 1 basis point to 1.46%. The lower-core profitability for the District is due primarily to a lower NIM, whereas the District's median is 32 basis points less than that of the nation's median at 2019:Q2.

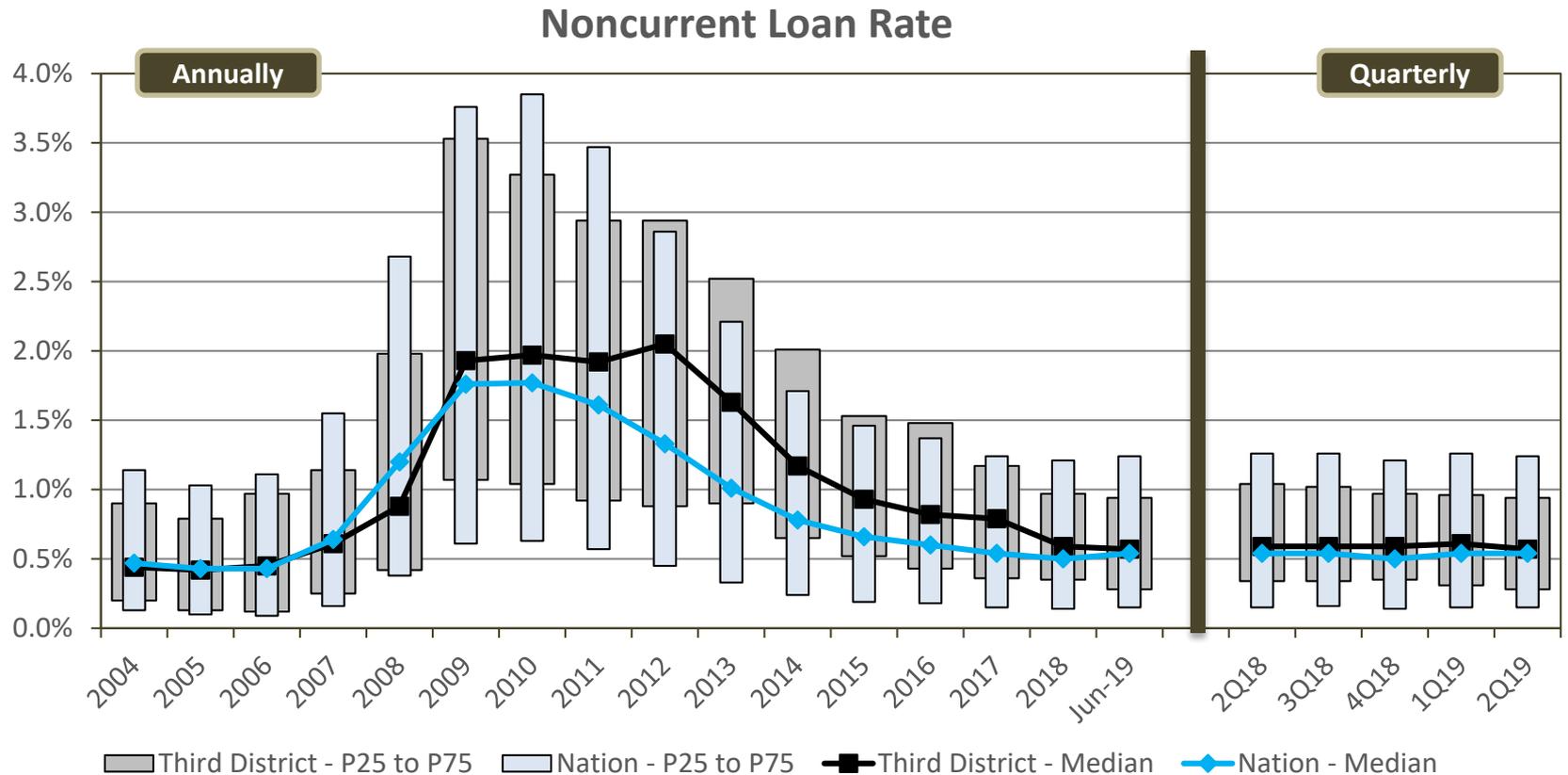




# Asset Quality

## Noncurrent Loans

- 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.



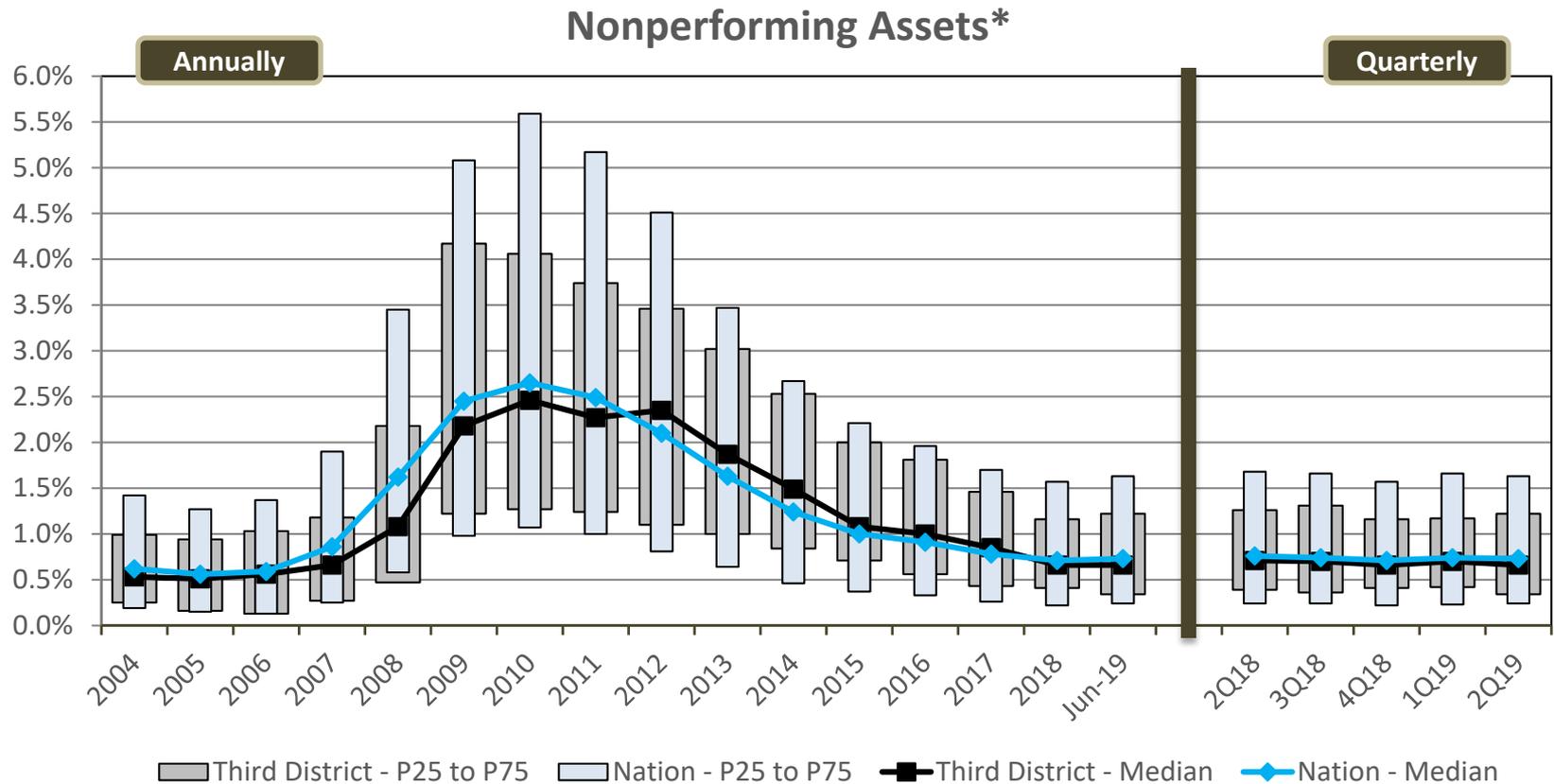




# Asset Quality

## Nonperforming Assets

- Additionally, the Third District's median level of nonperforming assets has been decreasing since 2012. The District now better aligns itself with the nation as the level of other real estate owned continues to decline.



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

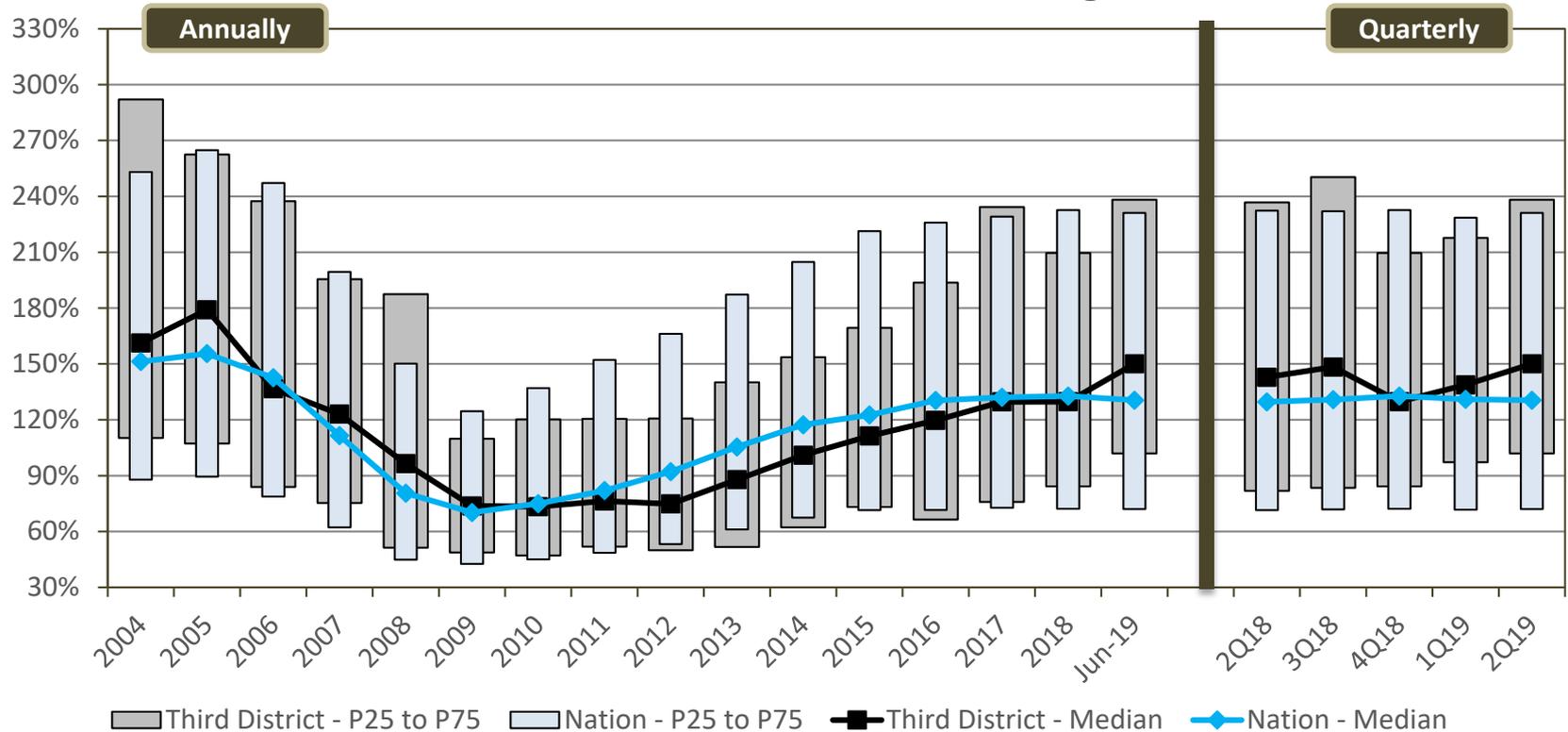


# Asset Quality

## The ALLL Reserve Coverage Ratio

- The ALLL reserve coverage ratio for both District and nation CBOs continues to improve because of strong asset quality metrics. As we discussed on a prior slide, the coverage ratio did not increase due to provision expense; rather, it is due to a lower amount of noncurrent loans.

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



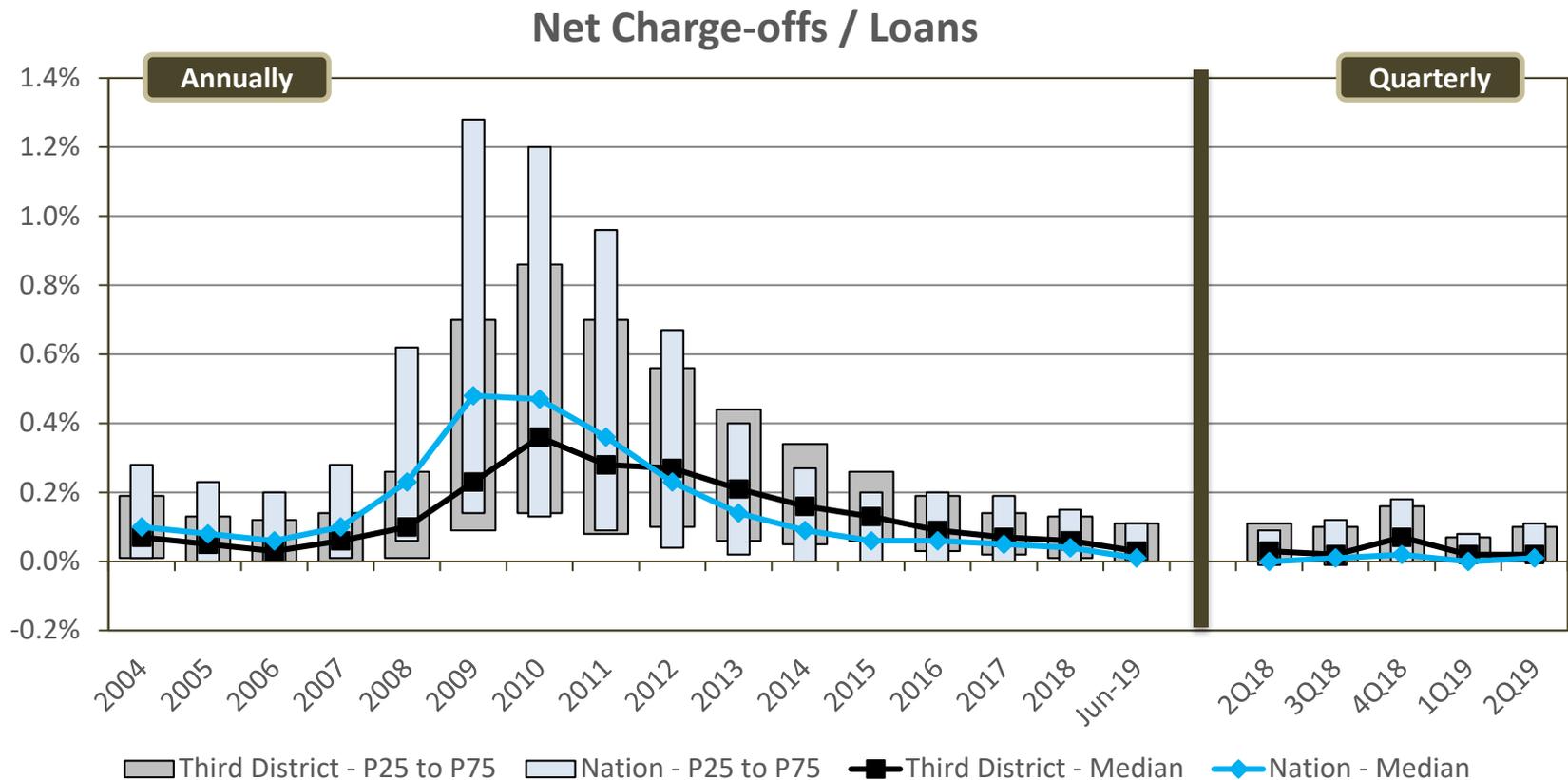
\* The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.



# Asset Quality

## Net Charge-off Rates

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

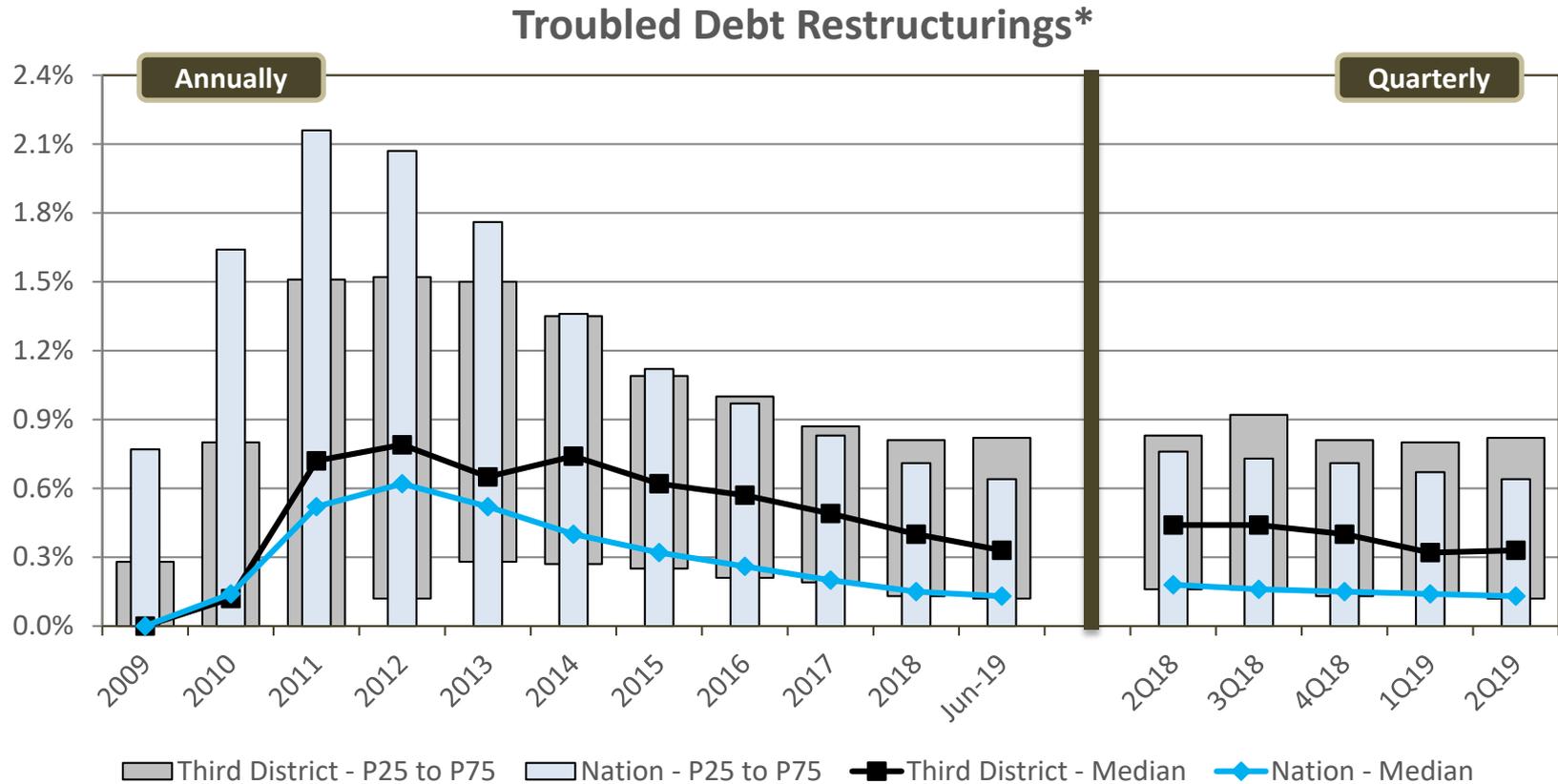




# Asset Quality

## Troubled Debt Restructurings

- Third District troubled debt restructurings are declining; 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.

\*\* Under the new standard, a holding company will recognize the entire gain, if any, and derecognize the OREO at the time of sale if the transaction meets the requirements of FASB Topic 606 and its five criteria.

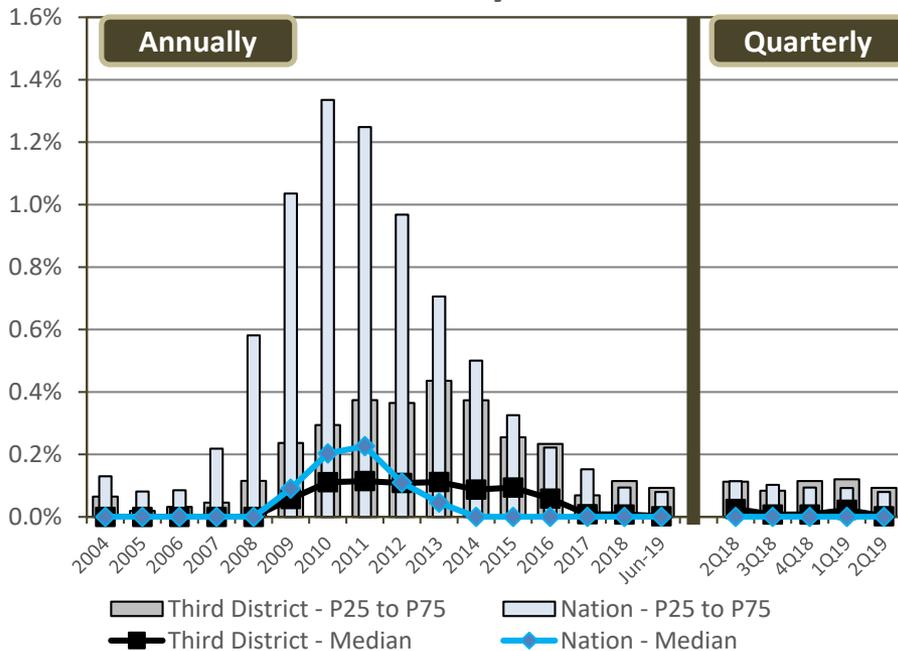


# Asset Quality

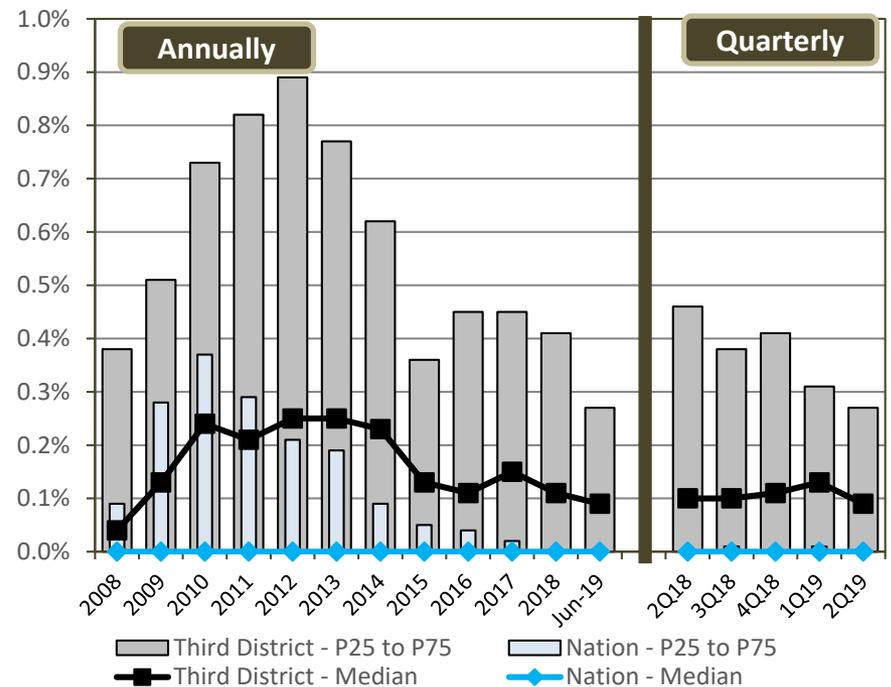
## Other Real Estate Owned (OREO) and Foreclosures

- One- to four-family 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. Pennsylvania, Delaware, and New Jersey, are all judicial foreclosure states that can extend the foreclosure process.

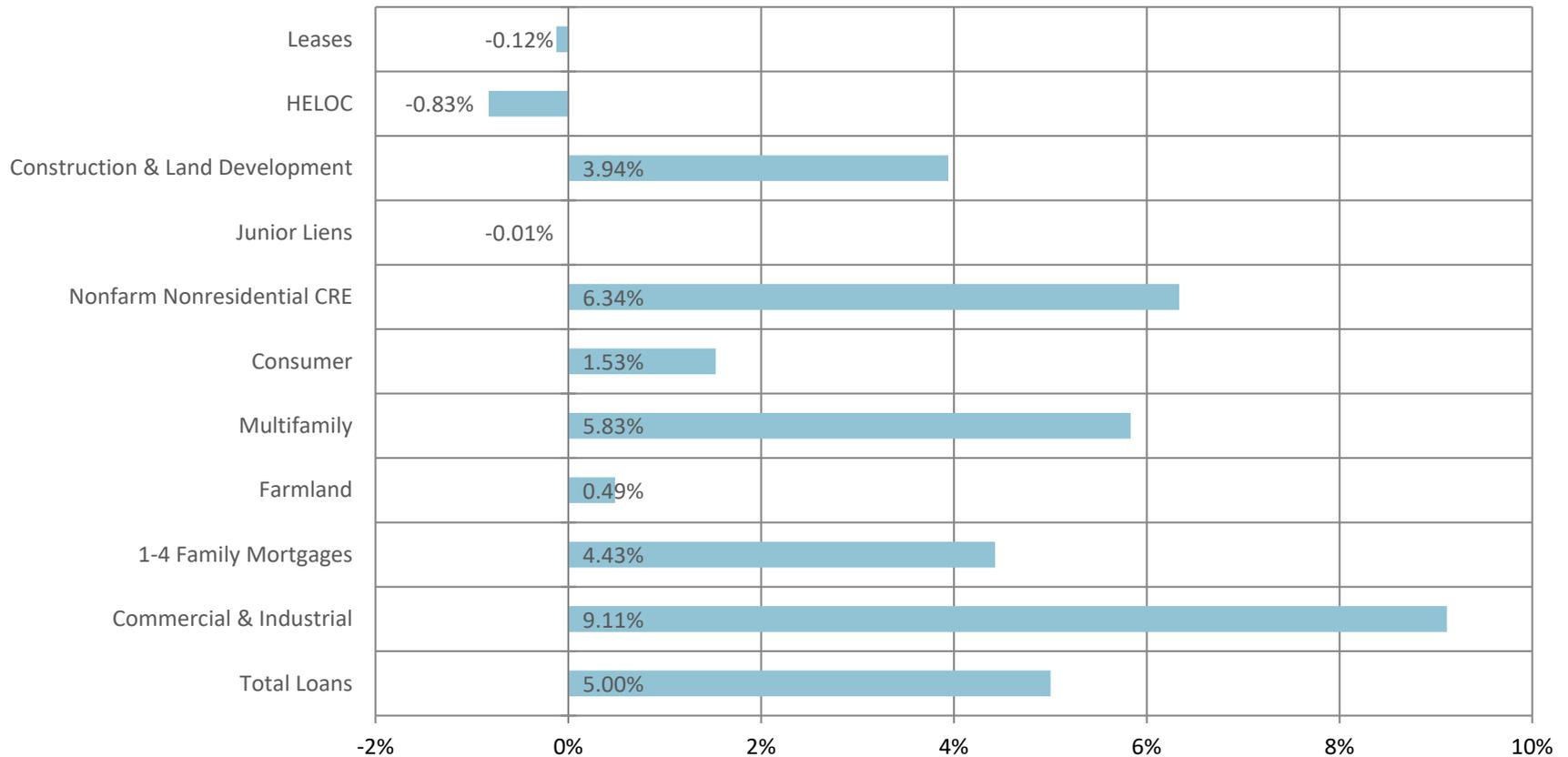
\*\*\* Under the FASB's new revenue recognition standard (Topic 606), a bank or holding company will recognize the entire gain, if any, and derecognize the OREO at the time of sale if the transaction meets the requirements of FASB Topic 606 and its five criteria.



# Loan Growth

## Third District Commercial Bank Median Loan Growth\*

- Third District commercial bank median loan growth\* in most categories year-over-year was positive; loan contraction continues to occur in the junior lien, HELOC, and leases categories.



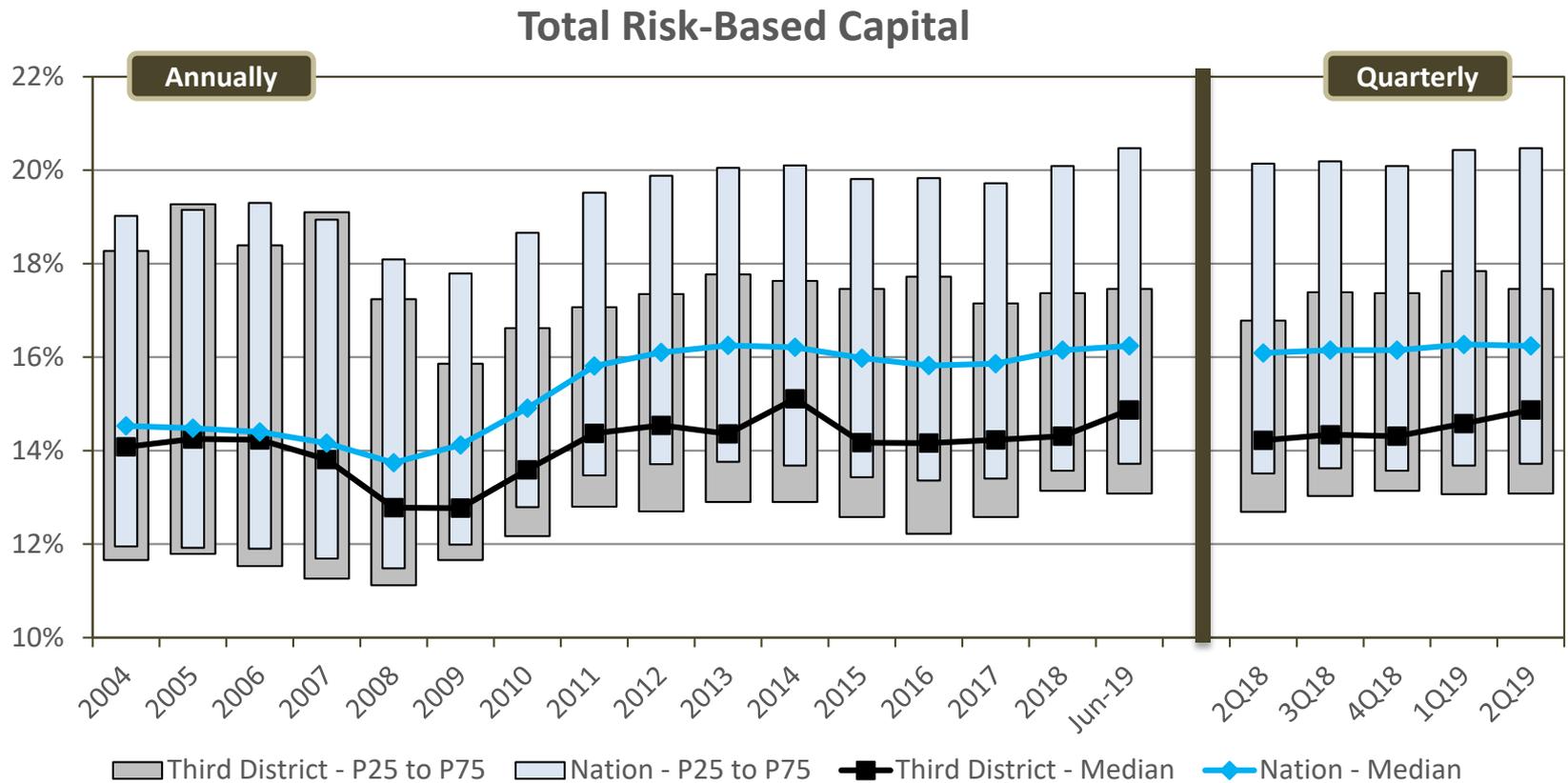
\* This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the community bank definition on Slide 8.



# Capital Adequacy

## Total Risk-Based Capital Ratio

- Although capital ratios have increased postcrisis, Third District total risk-based capital levels have mostly flattened since 2011 while continuously remaining well below the level of the nation. Much of this can be attributed to Third District CBOs having a larger concentration of CRE loans, which require a higher amount of capital.

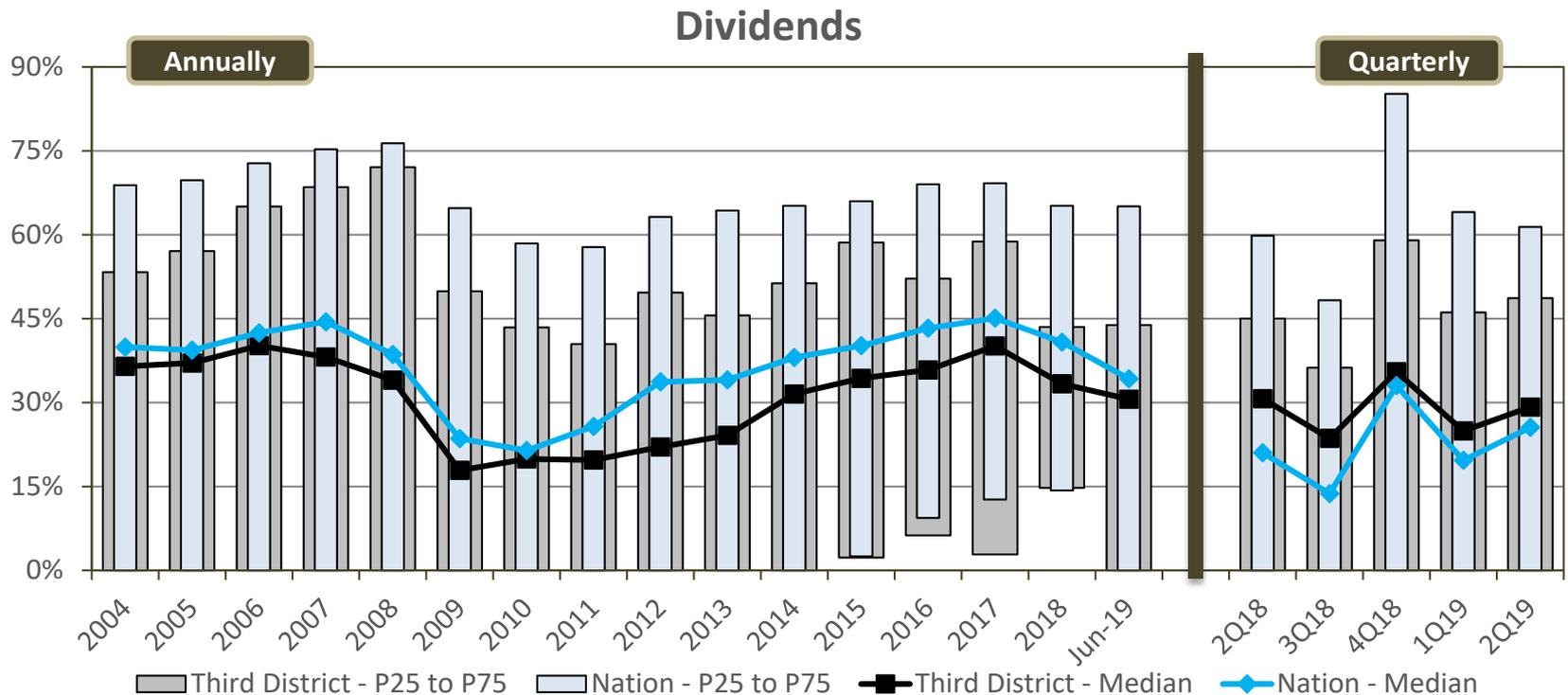




# Capital Adequacy

## Dividend Payments\*

- As of 2019:Q2, median dividend payments\* in the Third District increased and are comparable to precrisis levels. The higher level reported at year-end 2017 was primarily because of the revaluation of DTAs and MSRs, which negatively impacted earnings (denominator). Overall, 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.

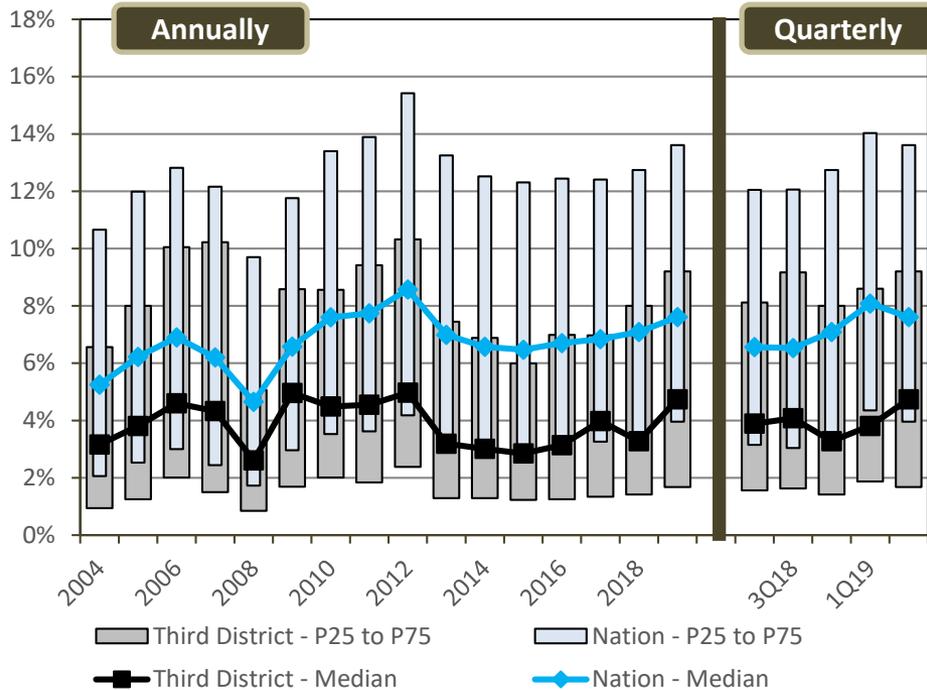


# Liquidity

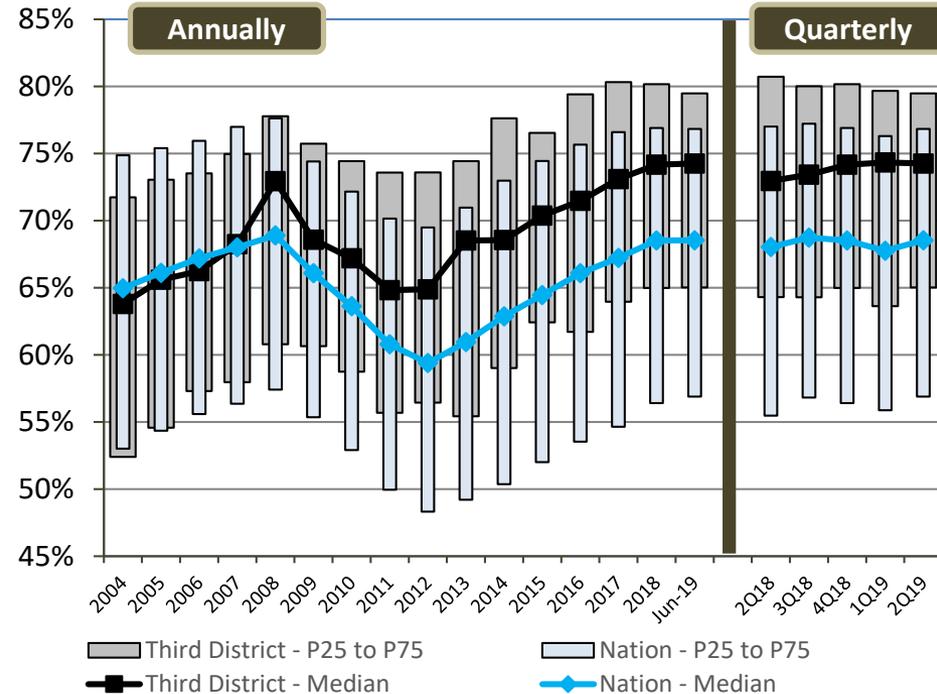
## Short-Term Investments and Loans to Assets

- Third District banks hold fewer short-term investments compared with that of 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



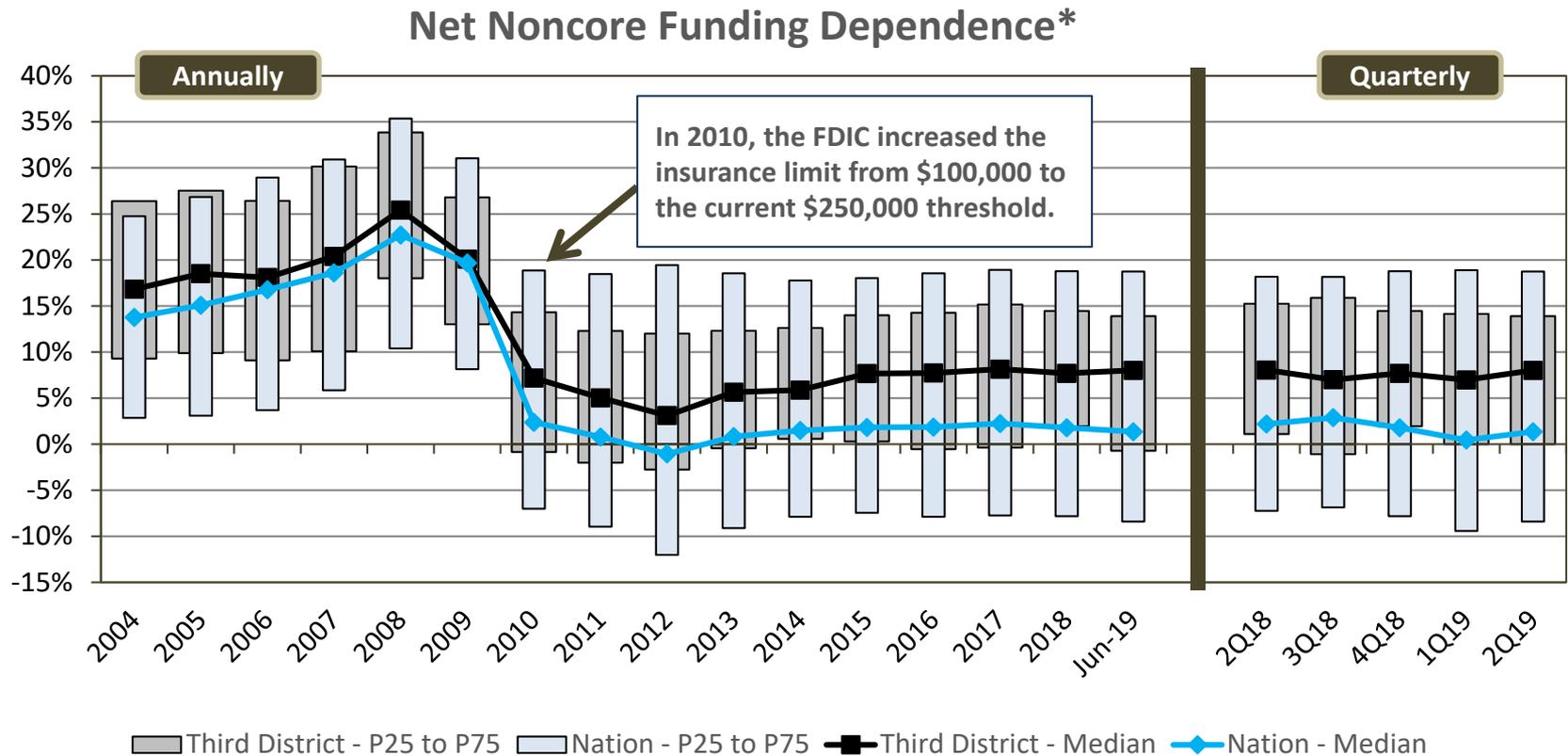
\* Short-term investments equals the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.



# Liquidity

## Noncore Funding Dependence Ratio

- 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.

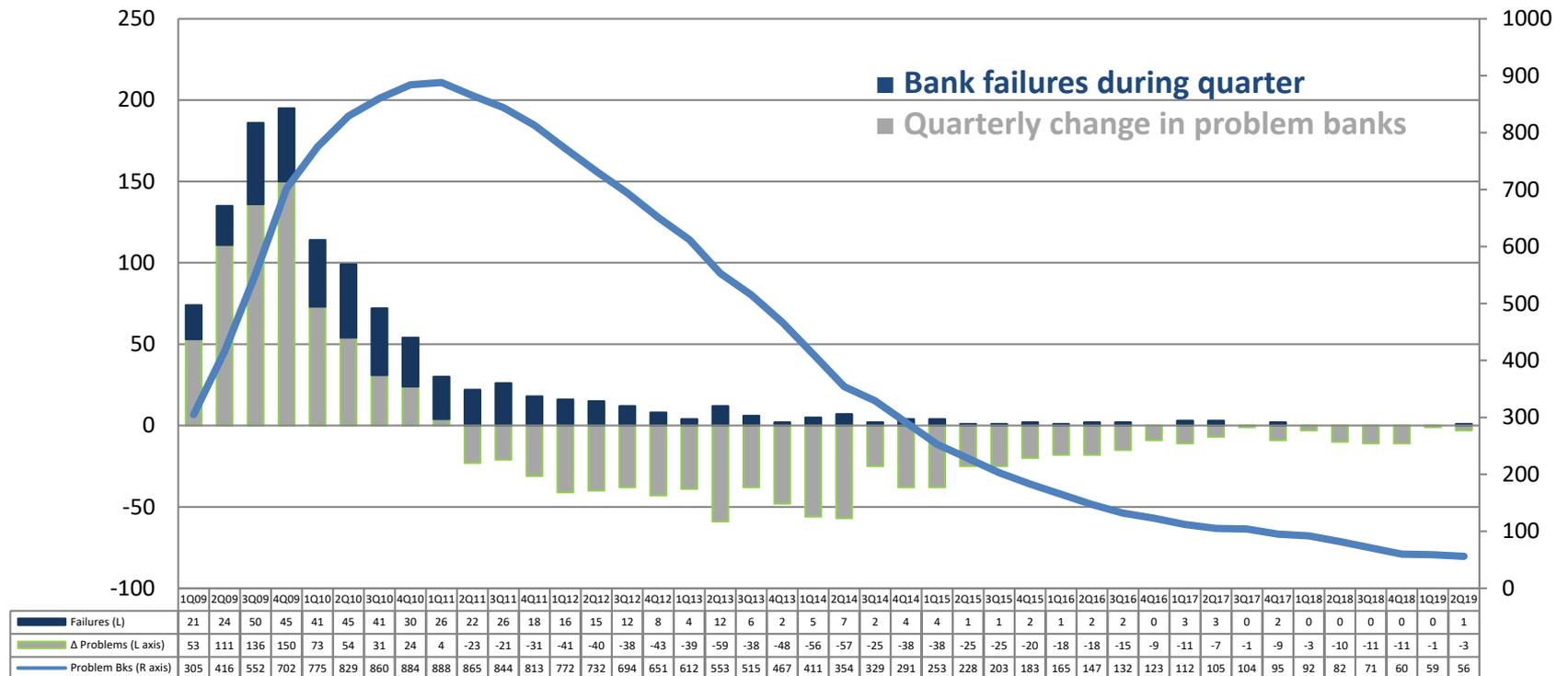


\* Net noncore funding dependence measures the degree to which banks fund longer-term assets with noncore funding sources.



# Problem Banks

- Problem banks within the nation fell by 4 to 56 as of 2019:Q2, from 60 at 2018:Q4, and from 95 at 2017:Q4. This represents the smallest number of problem banks since 2008:Q1.
- One bank did fail within the first six months of 2019, The Enloe State Bank in Cooper, TX.



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.