



FEDERAL RESERVE BANK  
OF PHILADELPHIA

# Third District Banking Conditions as of December 31, 2019

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 banking organizations\* (CBOs) continue to demonstrate solid performance. As stated in previous reports, the benign economic environment has been the catalyst for strength within the banking sector. However, although the U.S. continues to be in the longest economic expansionary cycle in history, at 131 months,\*\* financial conditions could change in coming months as the effect of COVID-19 are realized.

As of December 31, 2019, 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, the lowest levels since 2007.
- 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 131 months reported is inclusive through February 2020.



# Section 1

## Executive Summary (cont'd)

Challenges do remain for Third District bank financial performance primarily because of the following:

- The federal funds rate was cut for the first time since 2008; in 2019, we saw three rate declines, and two rate drops in 2020:
  - 25 basis points on July 31, 2019 (range is 2.00 – 2.25 percent) to keep the U.S. economy healthy; a “midcycle adjustment,” as stated by Federal Reserve Chair Jerome Powell,
  - 25 basis points on September 18, 2019 (range is 1.75 – 2.00 percent), a result of a global economy slowdown due to uncertainty of trade wars,
  - 25 basis points on October 20, 2019 (range is from 1.50 – 1.75 percent) again due to uncertainty of the trade war and a global economic slowdown and “to provide insurance against ongoing risks,” stated Chair Powell,
  - 50 basis points on March 3, 2020 (range is from 1.00 – 1.25 percent), amid increasing unease over the global economic effects from the spreading of the coronavirus, and
  - 100 basis points on March 15, 2020 (range is 0.00 – 0.25 percent), an effective rate of 0.0 percent, amid the coronavirus pandemic and to help spur the U.S. economy.
- The five rate cuts should be accommodative for loan growth and potential new debt issuances. Interest rates on most loan types are now at historic lows, and the continued low rates should help spur spending. However, the net interest margin (NIM) will be constrained due to longer-term deposits and borrowings that will not reprice as quickly as retail deposit accounts. As a result, consumer deposit account yields may decline, leaving depositors with less interest income.



# Section 1

## Executive Summary (cont'd)

Challenges do remain for Third District bank financial performance primarily because of the following:

- In light of the implications of COVID-19, or coronavirus, the global economic outlook has declined because of the contagion caused by the virus. Managing director of the International Monetary Fund (IMF), Kristalina Georgieva, stated that global economic growth would decline by only 0.1 percent, to 3.3 percent. Some unanswered questions as to how the virus will be contained and how far it could spread.
  - According to Georgieva, the world should be concerned "about sluggish growth" impacted by uncertainty. "We are now stuck with low productivity growth, low economic growth, low interest rates and low inflation."
- The adoption of the current expected credit loss (CECL) standard is finally here for the larger, publicly traded institutions and will be reported on the March 31, 2020, call report. For the smaller public business entities and privately held institutions, compliance with the CECL guidance has been delayed until 2023.



# Section 1

## Executive Summary (cont'd)

Safety and soundness challenges do remain for Third District bank financial performance primarily because:

- Earnings continue to be augmented with nonrecurring sources of income, including provision expense. The strength of asset quality metrics have allowed many banks to scale back their provisions; however, the practice is not sustainable for long-term earnings growth.
- Competition for loans and deposits continues to be strong within the District, as evidenced by the difference of the yield on assets as compared with the cost of deposits. As of 2019:Q4, the median difference for the asset yields and funding costs has expanded to 46 basis points when compared with the nation, an increase of 7 basis points from 2018:Q4. This difference has an immediate impact on the NIM, as it continues to compress within the District.
- 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 could have negative implications on interest income margins.
- "Labor markets remained excessively tight throughout the District, and wages continued growing moderately," according to the January 15, 2020 Beige Book for the Third District. "While contacts describe increased wage pressure, they continued to report slight employment increases. Overall, price pressures remained modest. The firms' outlook for growth over the next six months remained positive, though cautious, and broadened further among nonmanufacturing firms." Additionally, the manufacturing sector expects an easing of activity over the next few months based on the potential for new shipments and orders, as they continue to edge lower.



# Section 1

## Executive Summary (cont'd)

Qualitative and/or operational risks include:

- Cybersecurity
- Credit concentrations – Commercial Real Estate (CRE) (Refer to SR Letters 07-1 and SR 15-17)
- Leveraged lending
- 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
- Marijuana banking and related businesses

The number of problem banks fell by nine banks year-over-year, from 60 in 2018:Q4 to 51 as of 2019:Q4. 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. Four banks failed in 2019, including: The Enloe State Bank in Cooper, TX; Louisa Community Bank in Louisa, KY (Q4); Resolute Bank in Maumee, OH (Q4); City National Bank of New Jersey in Newark, NJ. Additionally, two banks failed already in 2020, Ericson State Bank in Ericson, NE and First State Bank, based in Barboursville, WV.



# 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 **86 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, 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.

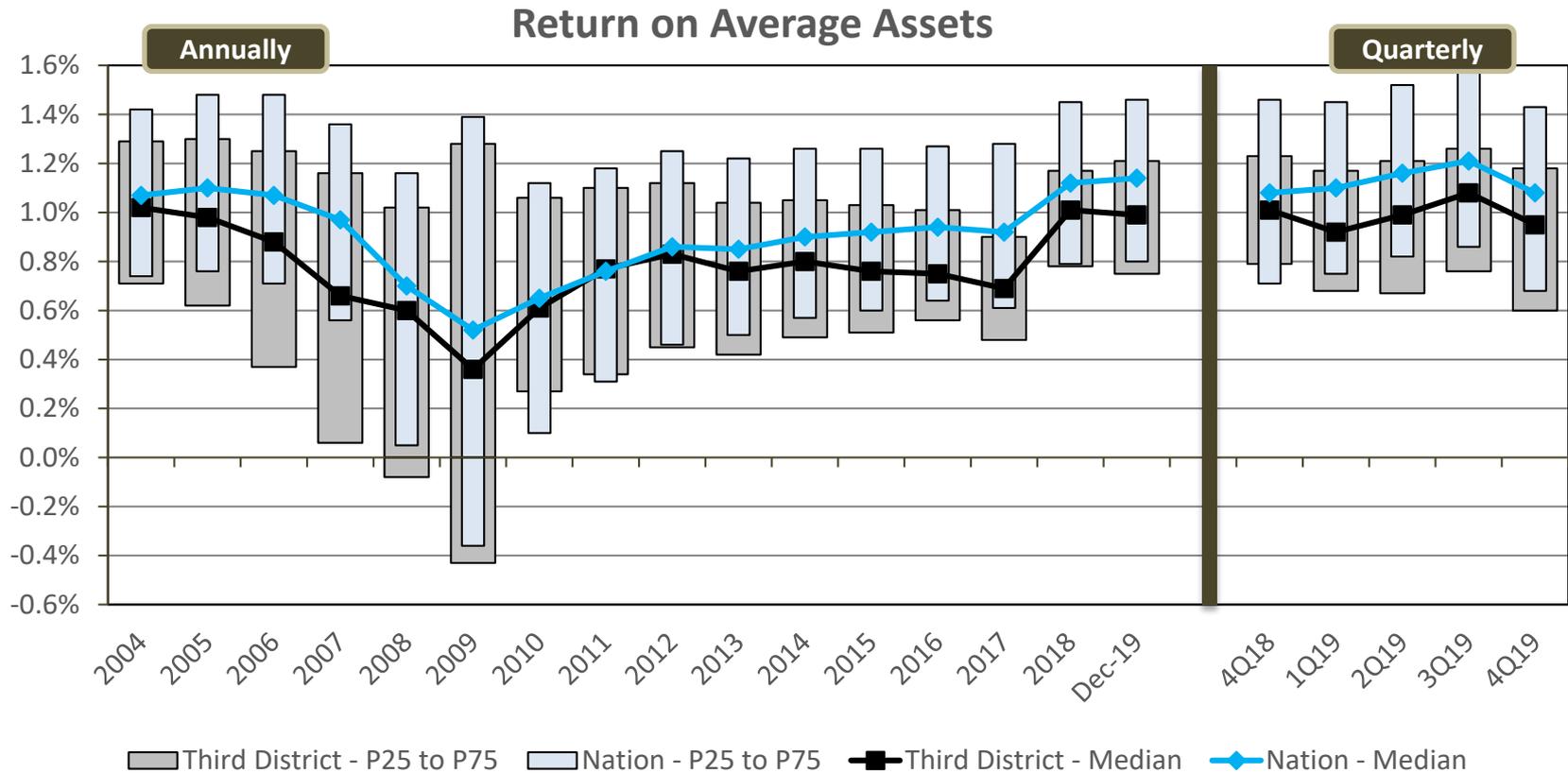
- The line graphs represent the median for the District and the nation, whereas the bar graphs represent the range of results from the 25th through the 75th percentiles for the data included in each graph.



# Earnings

## Return on Average Assets Ratio

Third District earnings performance, based on the return on average assets (ROAA) ratio, is at levels not seen since 2004 when the median ROAA was 1.02 percent; however, it continues to lag that of the nation.



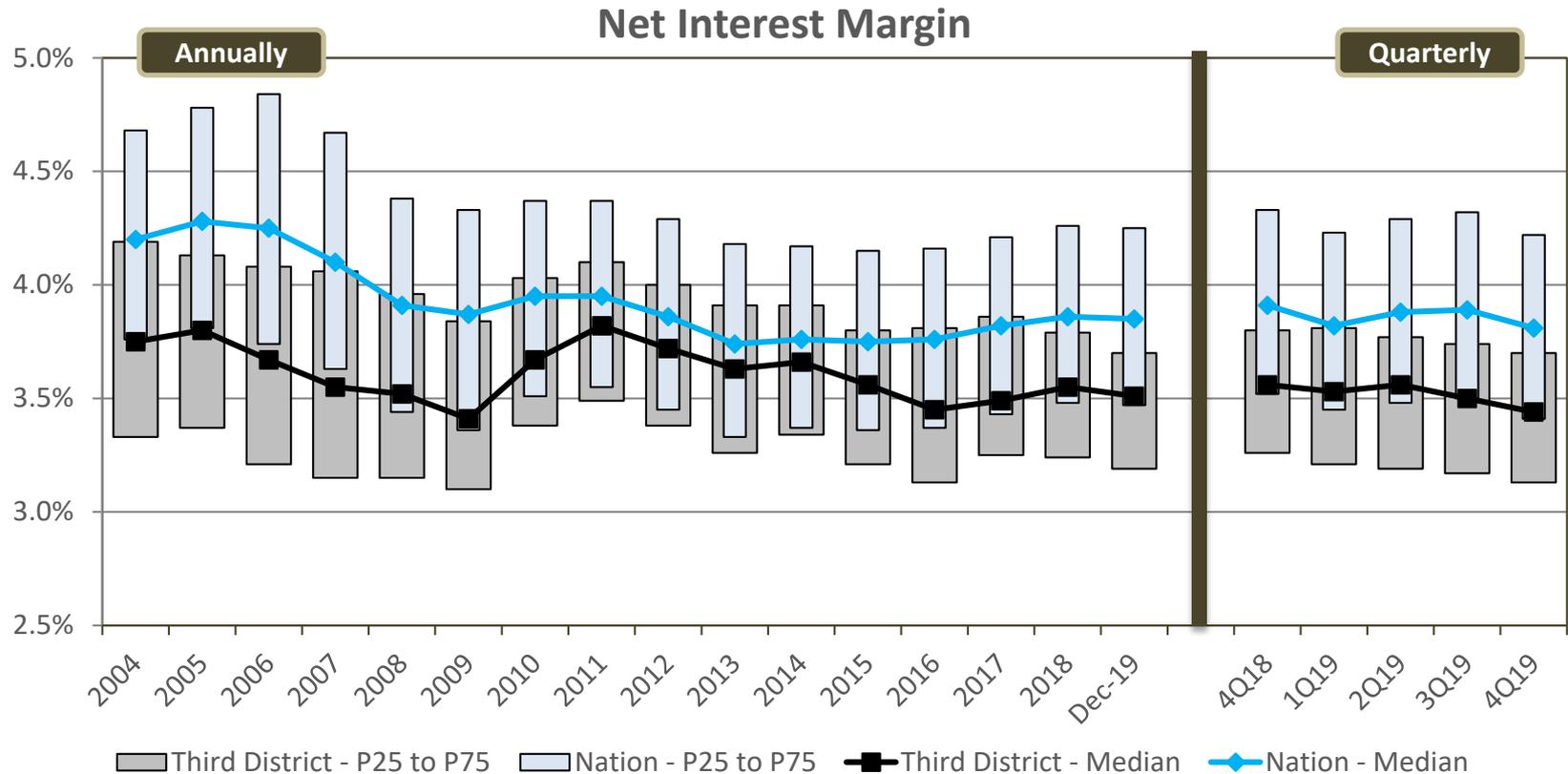
The decline in earnings as of year-end 2017 for the District and nation is primarily due to the change in tax law for deferred tax assets (DTA) and mortgage servicing rights (MSR). Many banks had to revalue their position downward at year-end 2017, which negatively impacted earnings.



# Earnings

## Net Interest Margin

The Third District net interest margin (NIM) has fallen throughout 2019 because of the 75 basis point decrease in the fed funds rate; additionally, the NIM remains lower than that of the nation before, during, and after the Great Recession.

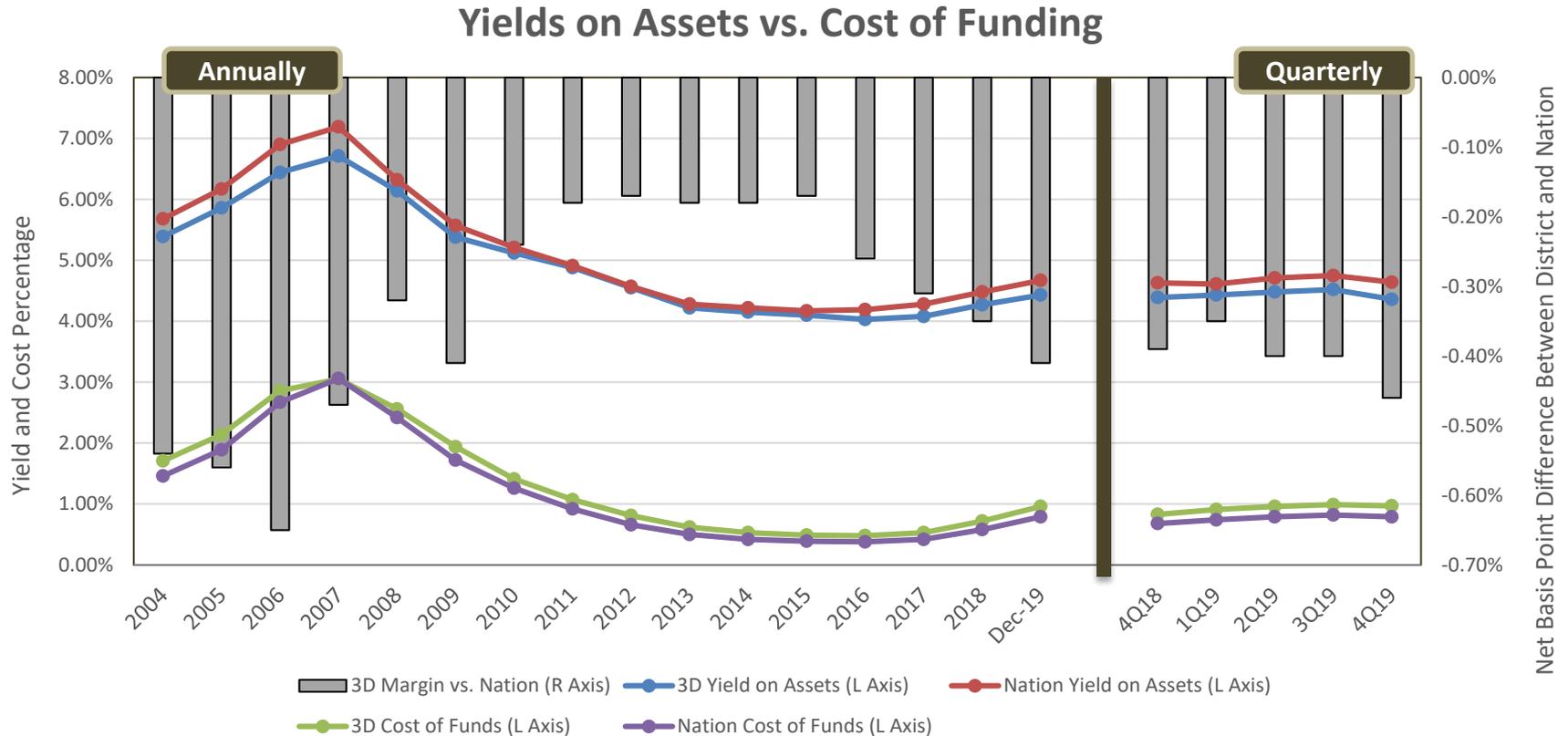




# Earnings

## 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 Third District CBOs maintain a lower yield on assets and a higher cost of funds. The primary drivers are the asset and deposit mix as well as by a highly competitive rate environment for both loans and deposits.



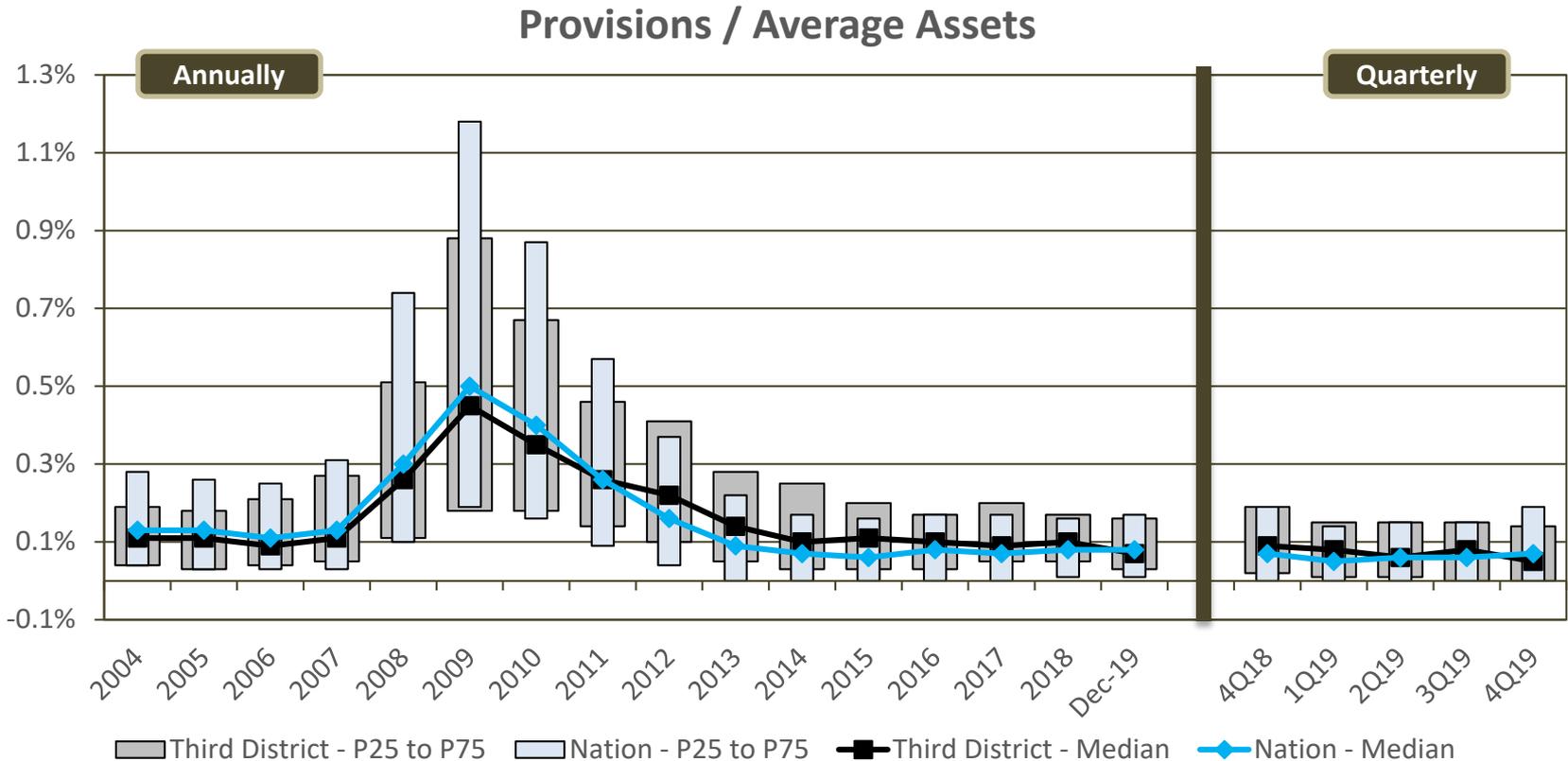
Net Basis Point Difference Between District and Nation



# Earnings

## Provision Expense

The provision expense continues to trend at or below precrisis levels, primarily because of strong asset quality metrics. Consequently, the low provision expense has helped augment earnings. 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 in the future.

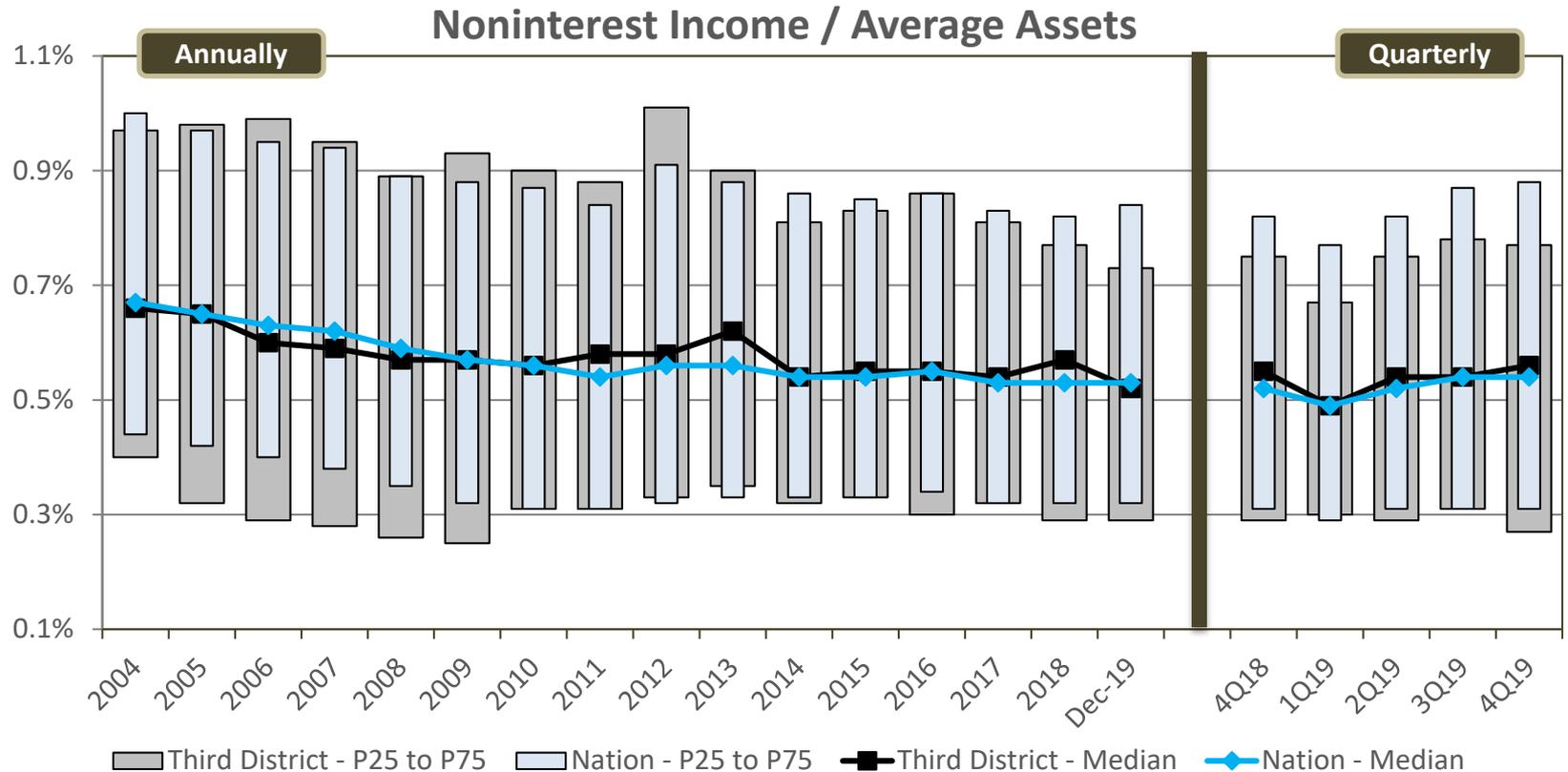




# Earnings

## Noninterest Income

Historically, noninterest income for the Third District has outpaced that of the nation. However, in more recent quarters, the nation has surpassed the District, placing further pressure on earnings.

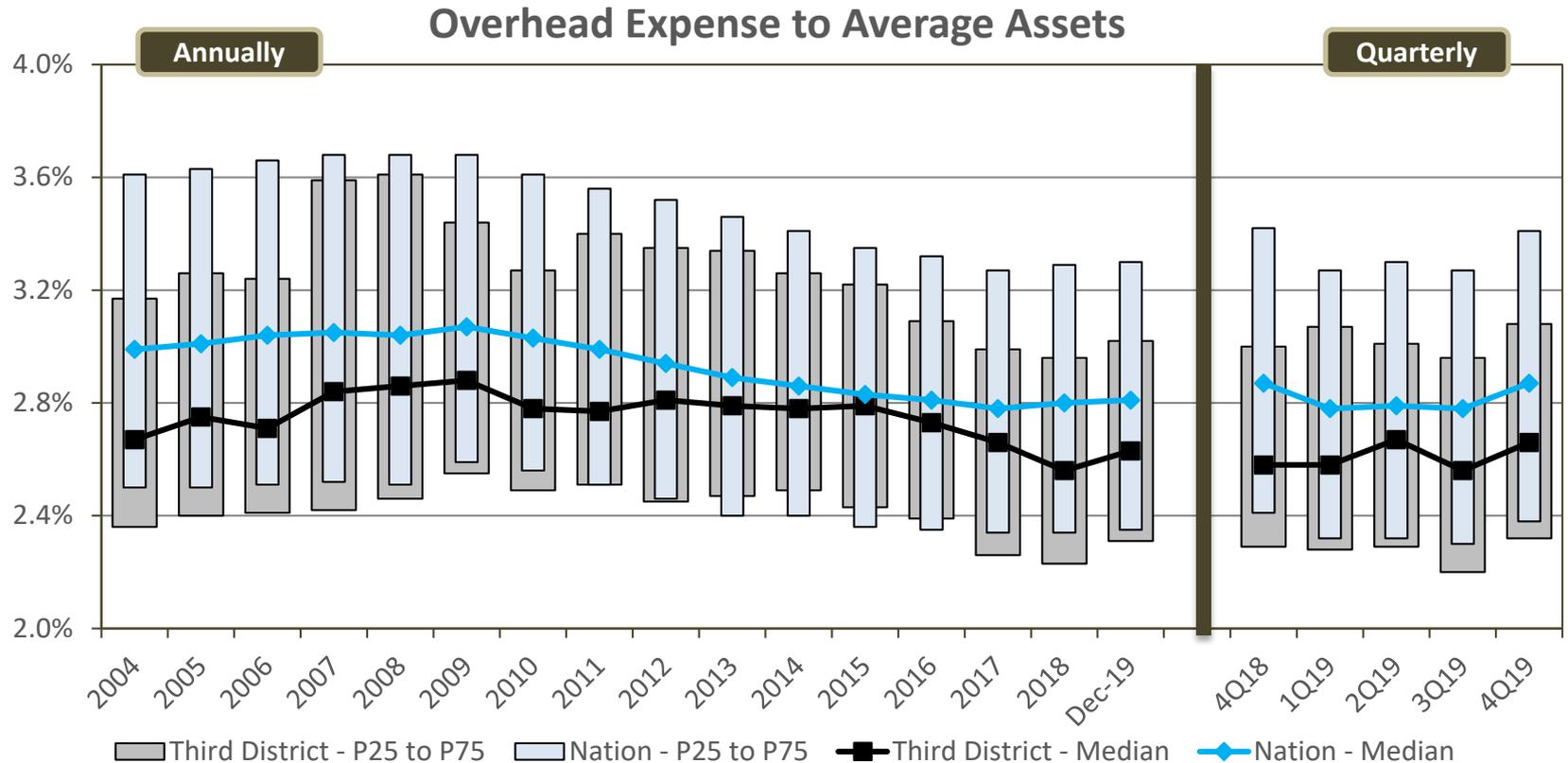




# Earnings

## 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 overall earnings.

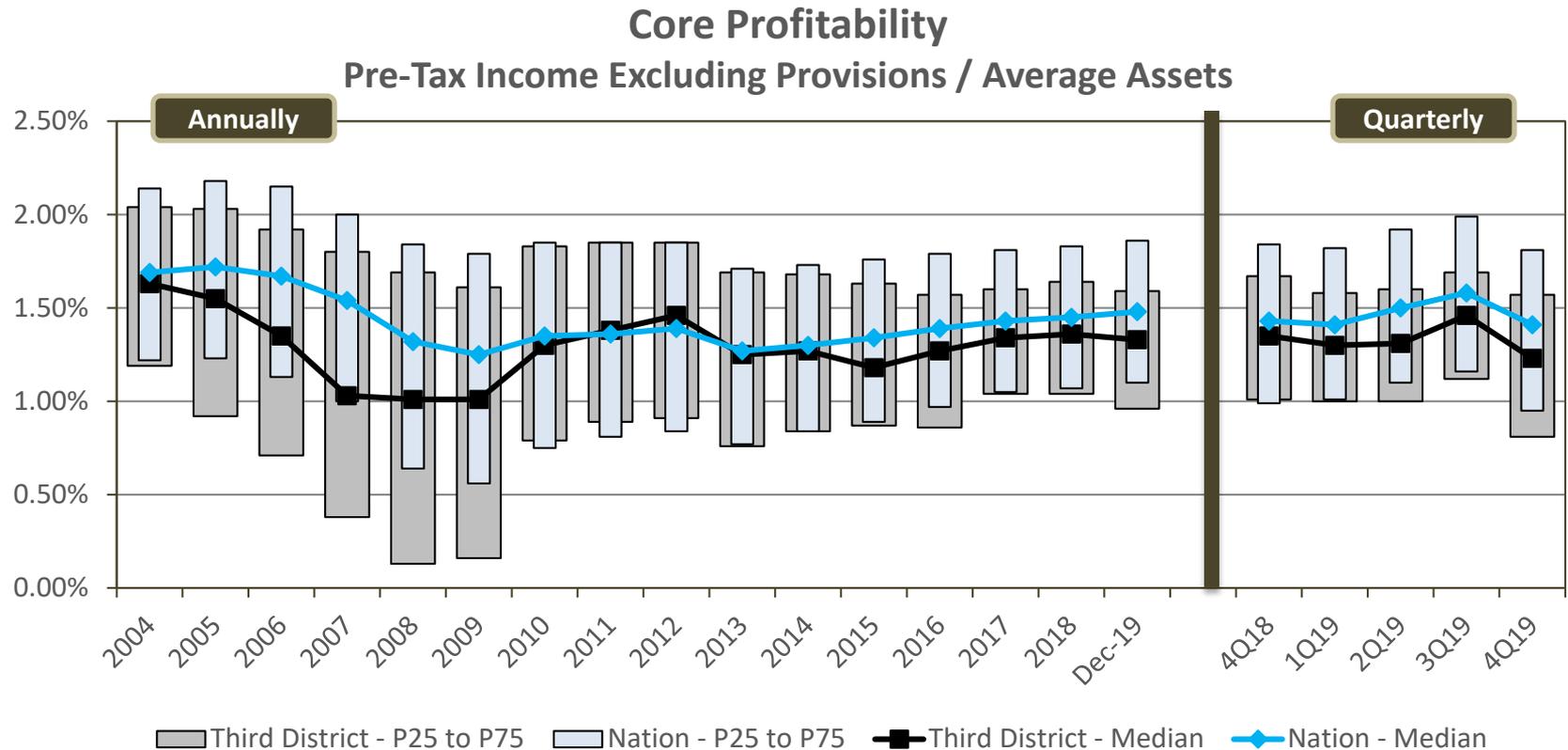




# Earnings

## Core Profitability

As of 2019:Q4, the Third District's median core profitability fell by 3 basis points year-over-year to 1.33 percent, while the nation increased 3 basis point to 1.48 percent. The lower-core profitability for the District is due primarily to a lower NIM, whereas the District's median is 34 basis points less than that of the nation's median as of 2019:Q4.

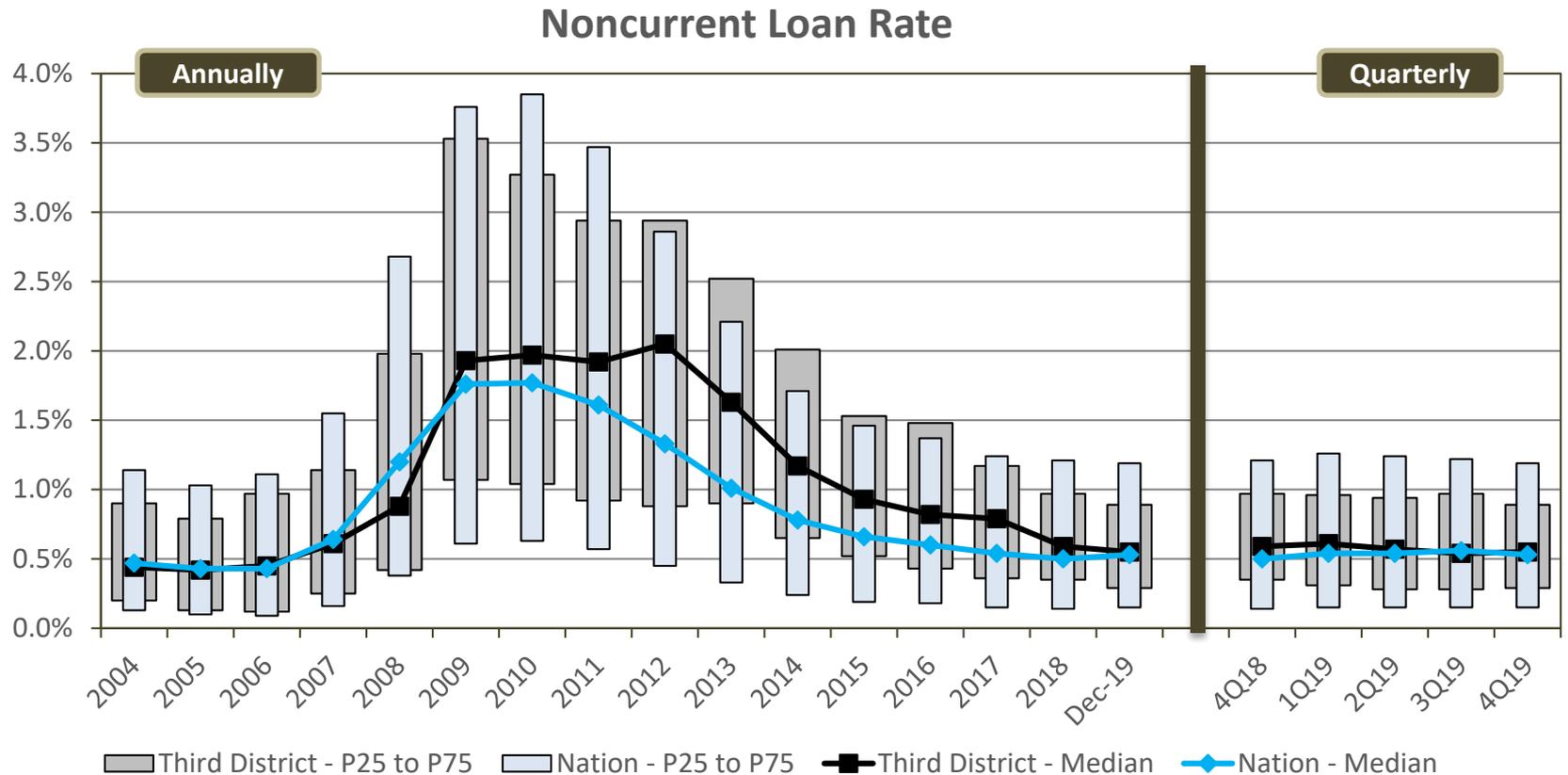




# Asset Quality

## 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 that the nation.



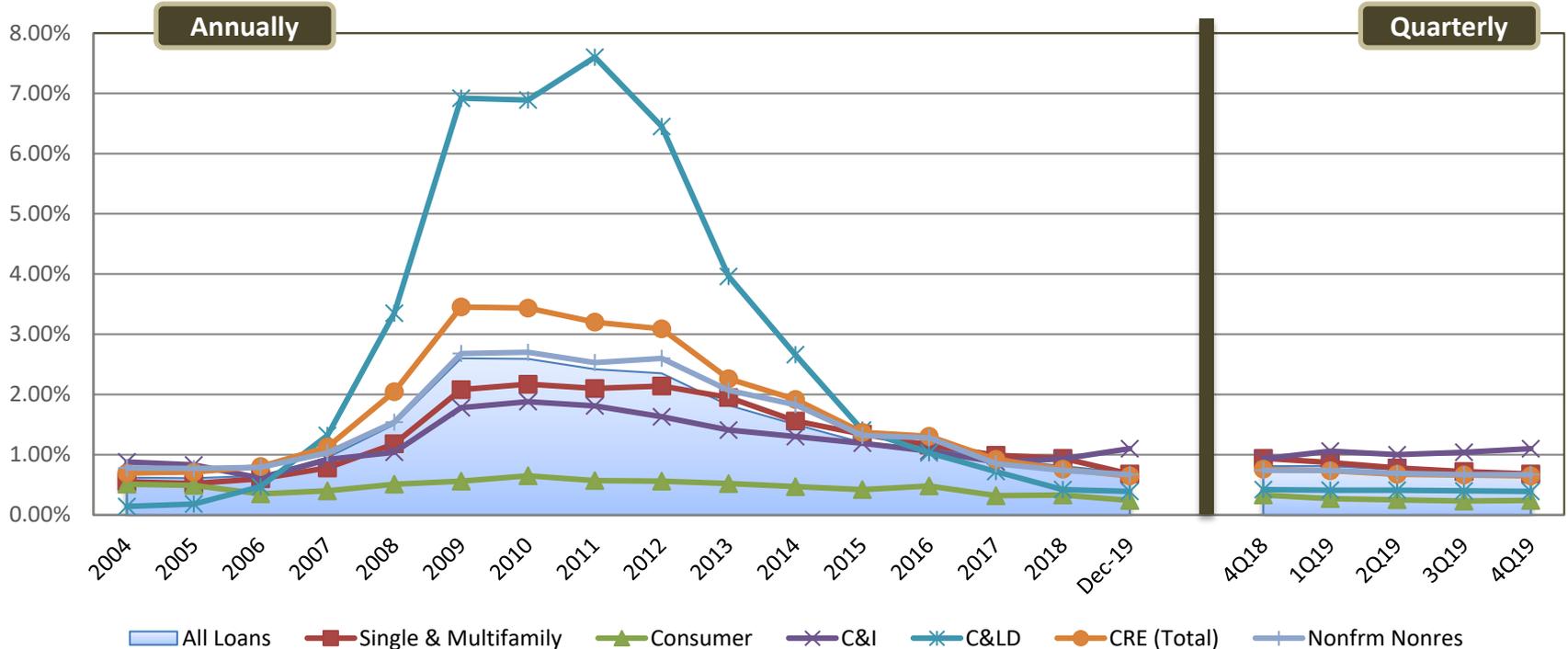


# Asset Quality

## Noncurrent Loans by Category

Third District loan performance continues to show ongoing improvement among the principal loan categories, which are near or below 2006–2007 metrics. However, there was a small uptick in noncurrent loans as of 2019:Q4 for commercial and industrial loans.

### Noncurrent Loan Ratios by Loan Category



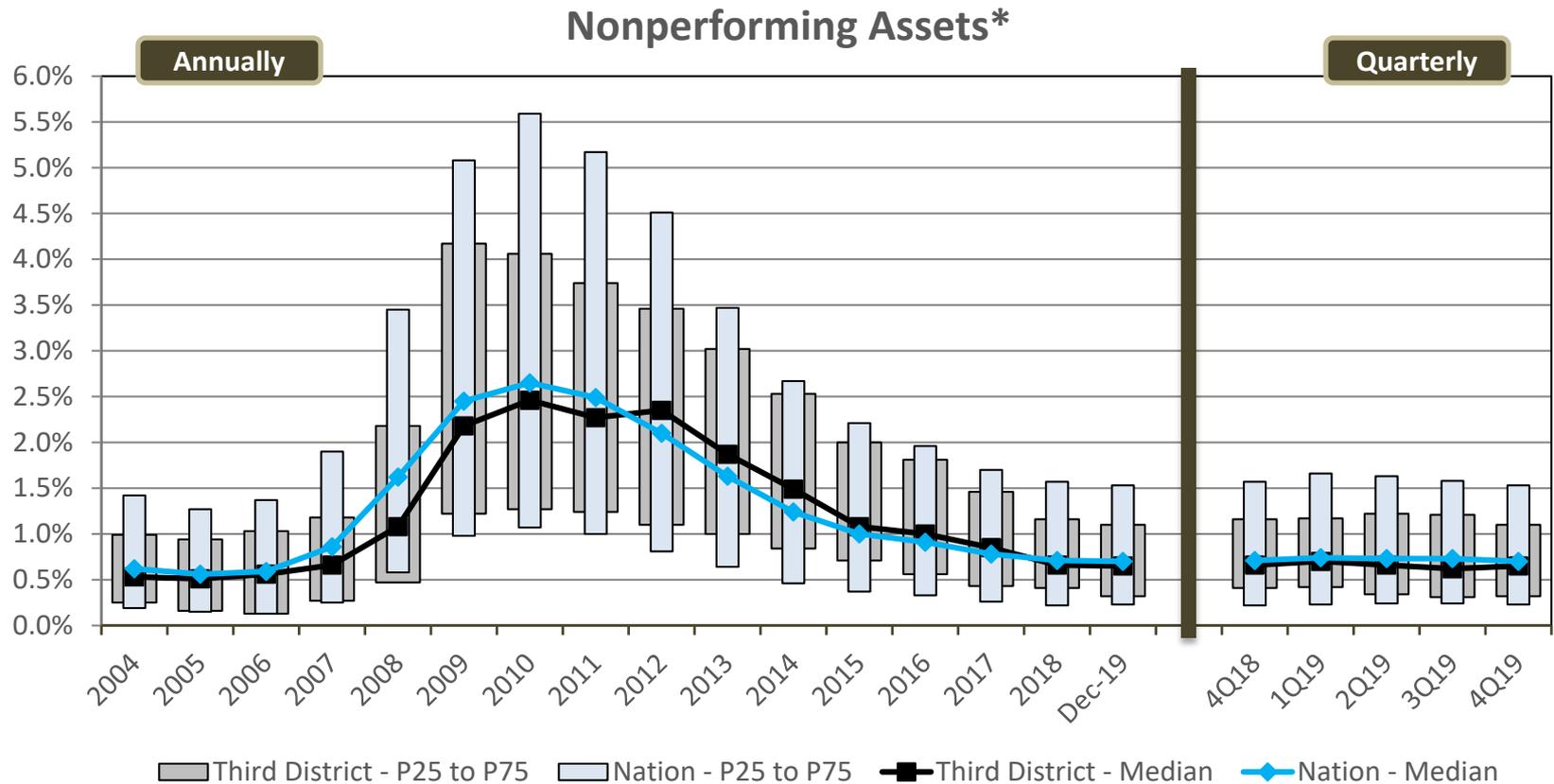
This chart uses a **10% capped mean, or winsorized mean**, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on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



# Asset Quality

## Nonperforming Assets

Additionally, the Third District's median level of nonperforming assets has been decreasing since 2012. The decline is primarily due to the lower level of other real estate owned (OREO) within the District as compared with the nation.



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

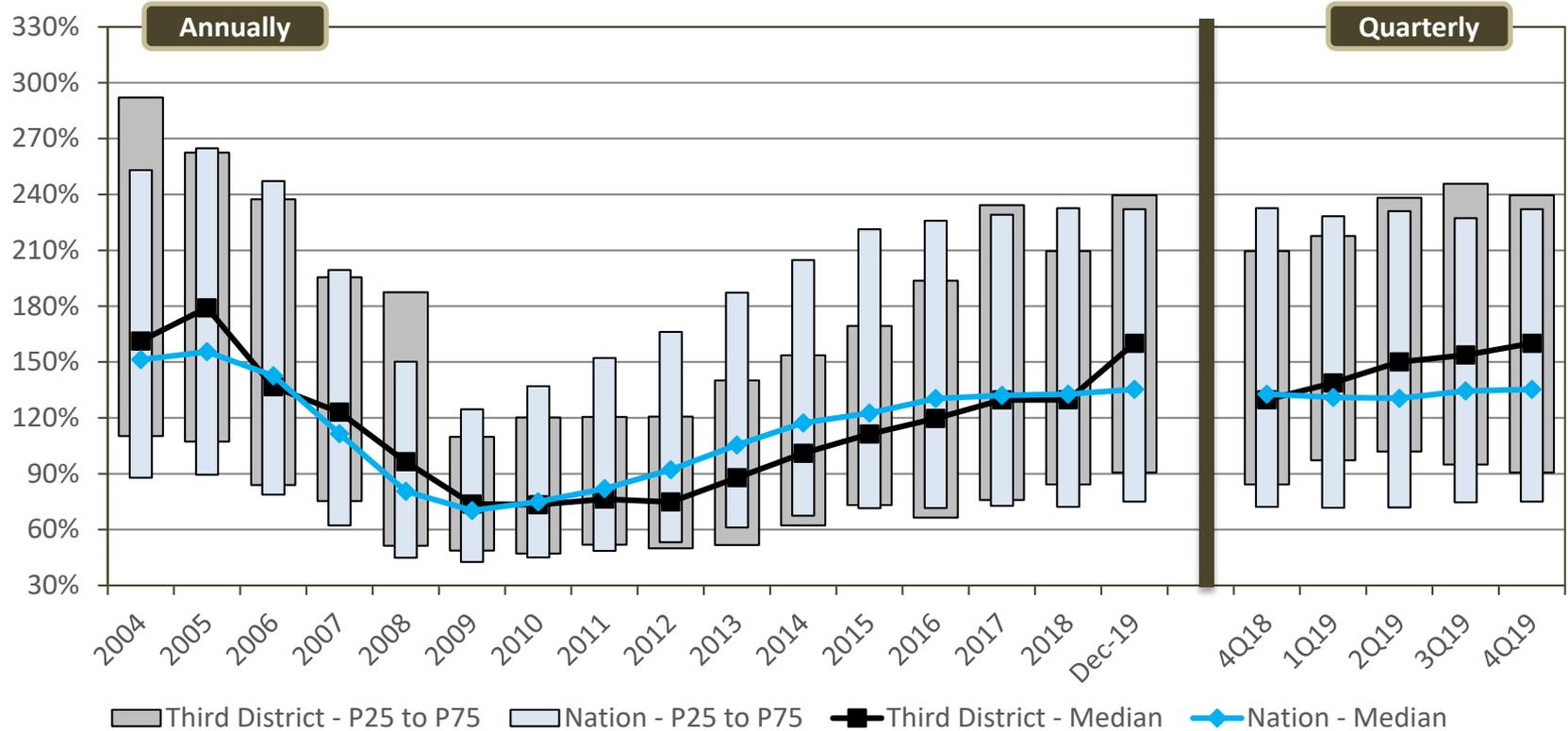


# Asset Quality

## The ALLL Reserve Coverage Ratio

The ALLL reserve coverage ratio for both District and national CBOs continues to improve, principally the result of strong asset quality metrics. As we discussed on slide 12, the coverage ratio did not increase because of provision expense; rather it is due to a lower amount of noncurrent loans.

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



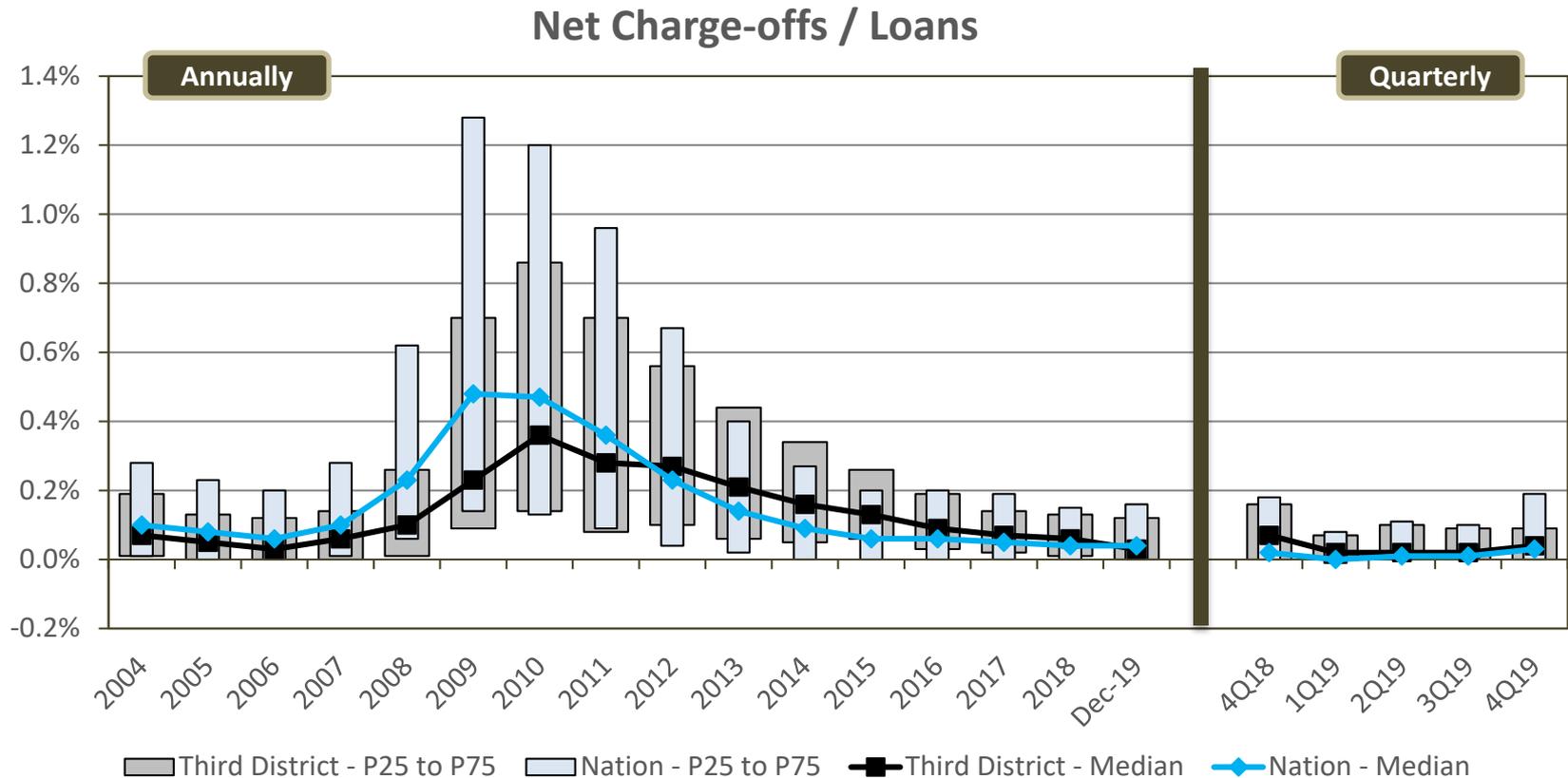
\* The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.



# 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.

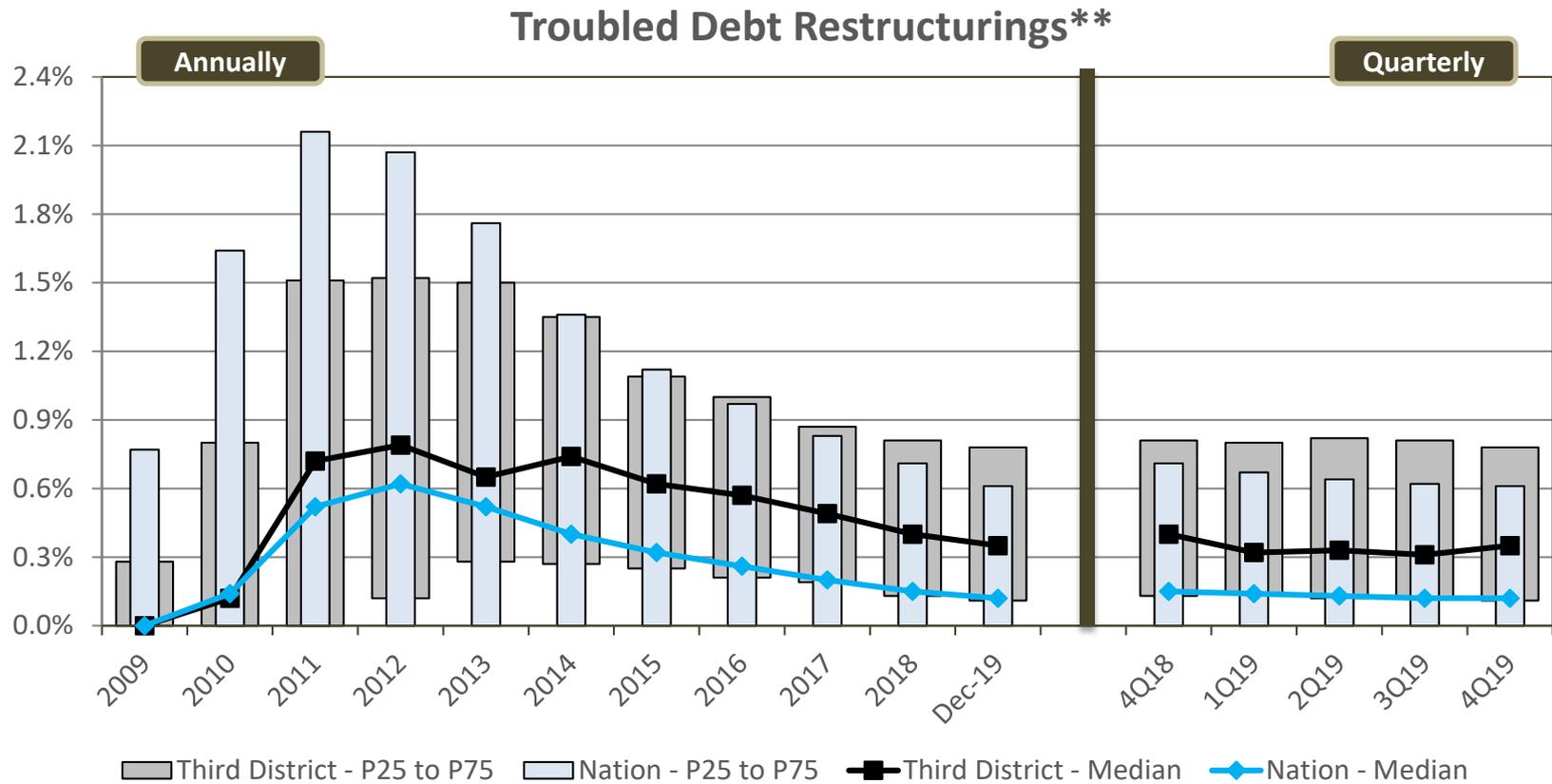




# Asset Quality

## 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.

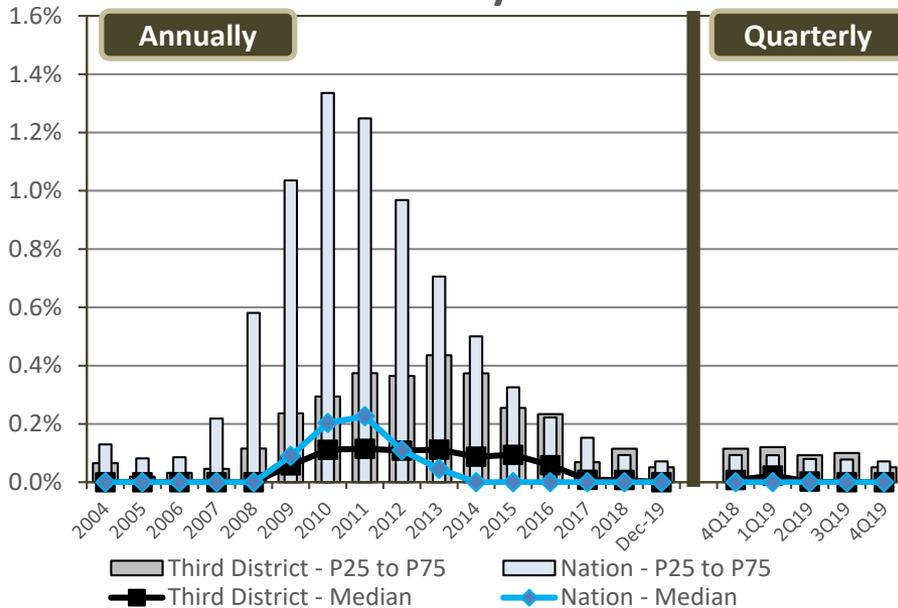


# Asset Quality

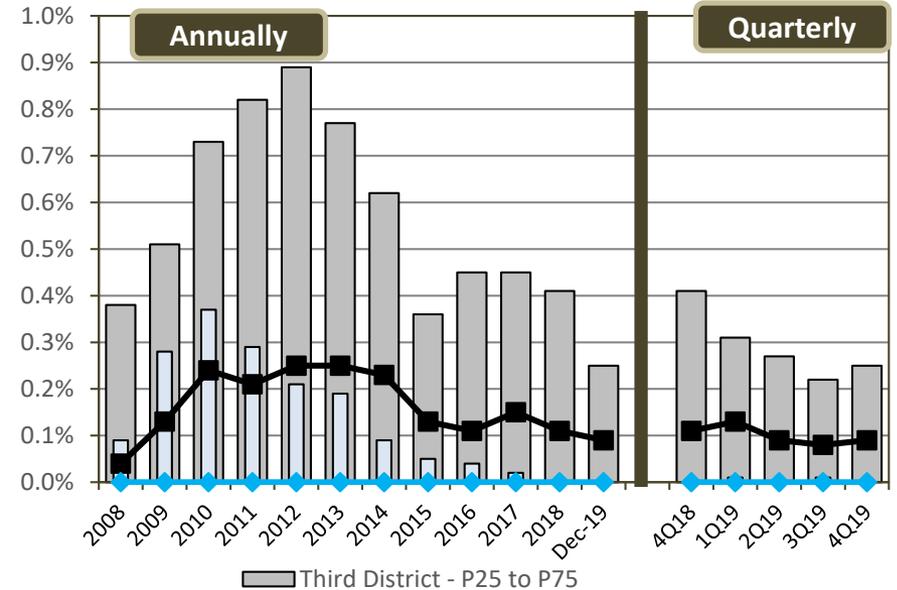
## OREO and Foreclosures

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.

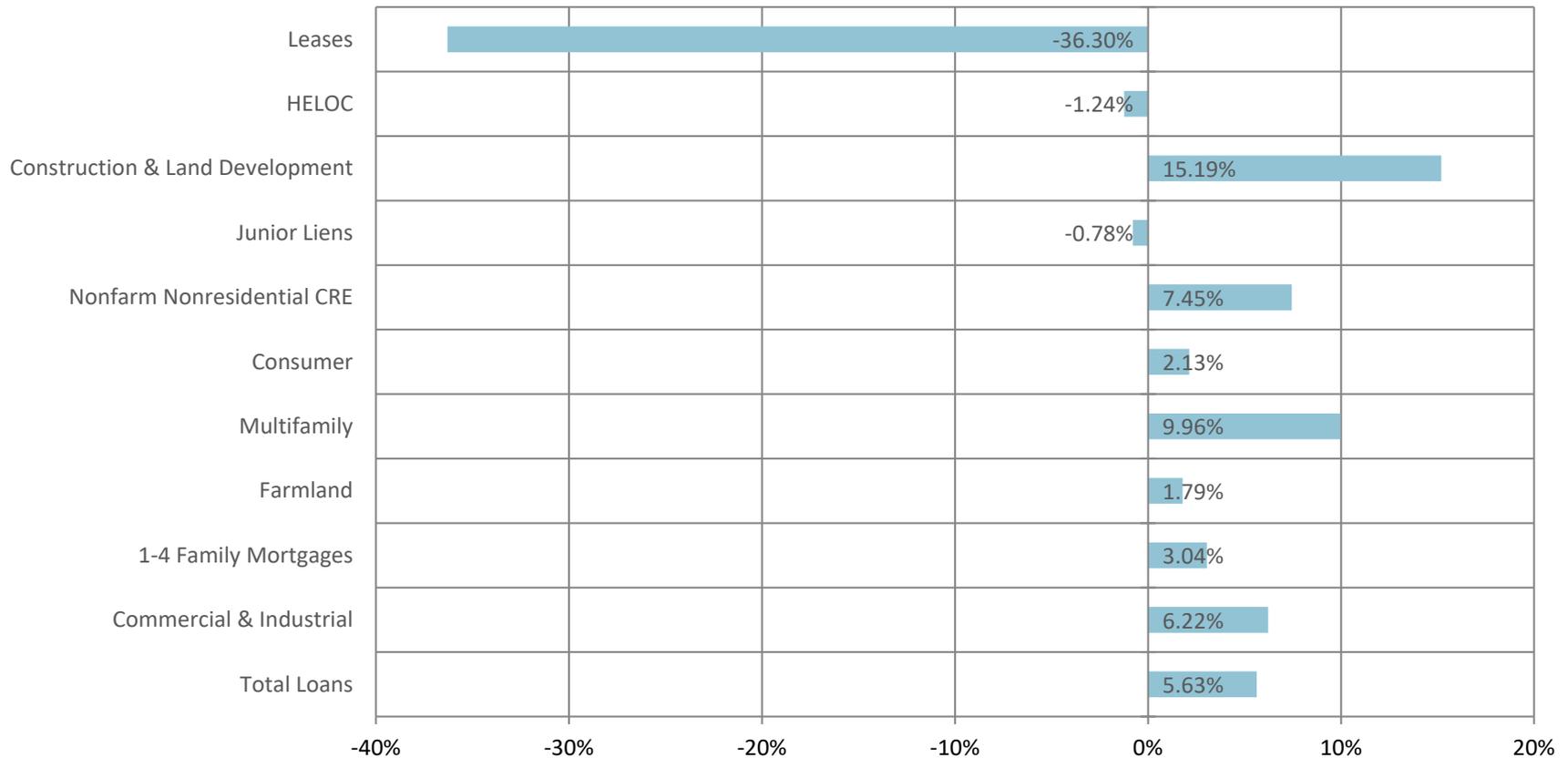
\*\*\* Under the FASB's new revenue recognition standard (Topic 606), a bank or holding company will recognize the entire gain, if any, and derecognize the OREO at the time of sale if the transaction meets the requirements of FASB Topic 606 and its five criteria.



# Loan Growth

## Third District Commercial Bank Median Loan Growth\*

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



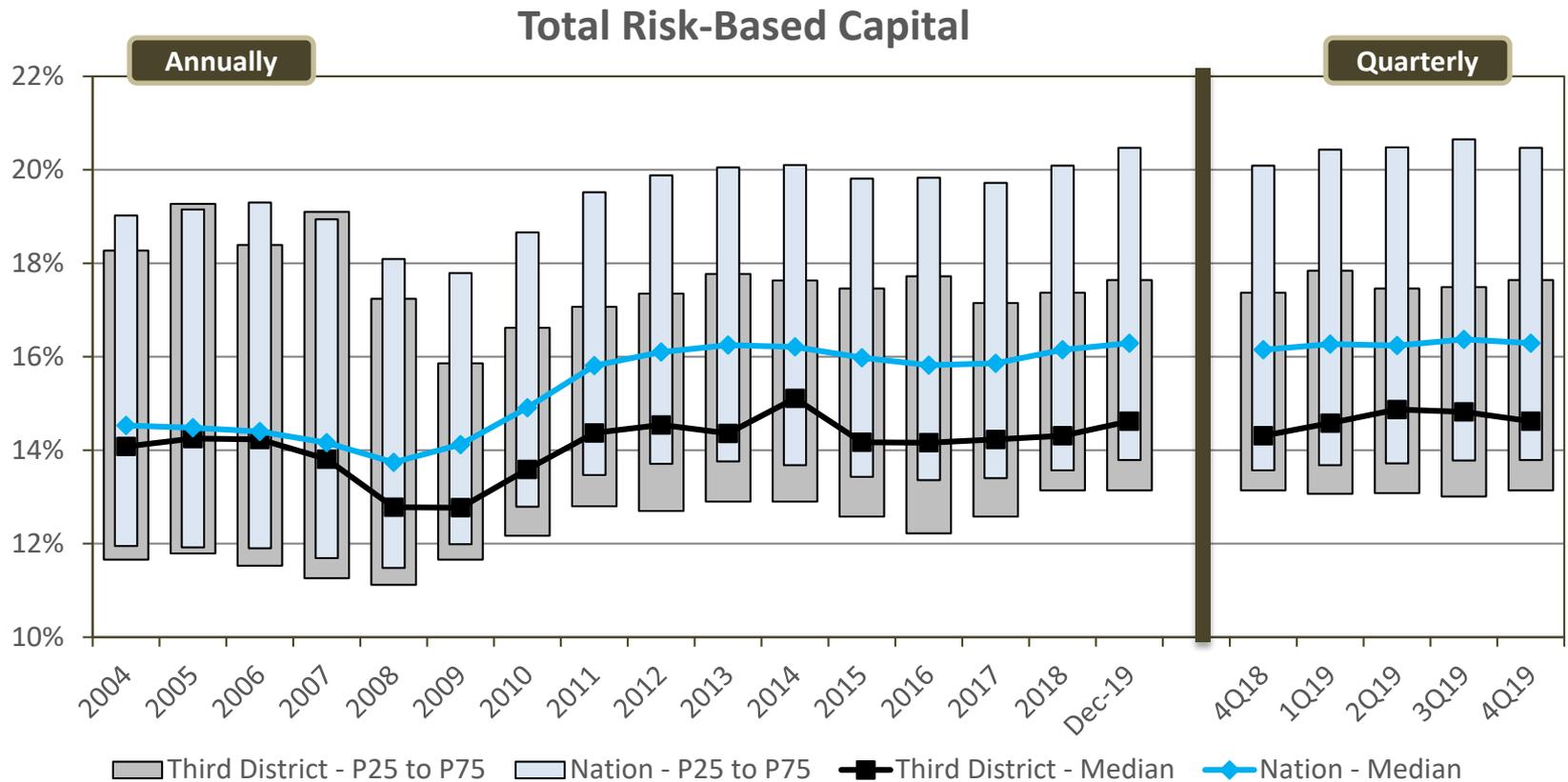
\* This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the community bank definition on Slide 8.



# Capital Adequacy

## Total Risk-Based Capital Ratio

Although capital ratios have increased postcrisis, Third District total risk-based capital (RBC) levels have mostly flattened since 2011. The total RBC ratio also remains well below the level of the nation, a difference of 167 basis points at 2019:Q4. Much of this can be attributed to Third District CBOs having a larger concentration of CRE loans, which require a higher amount of capital.

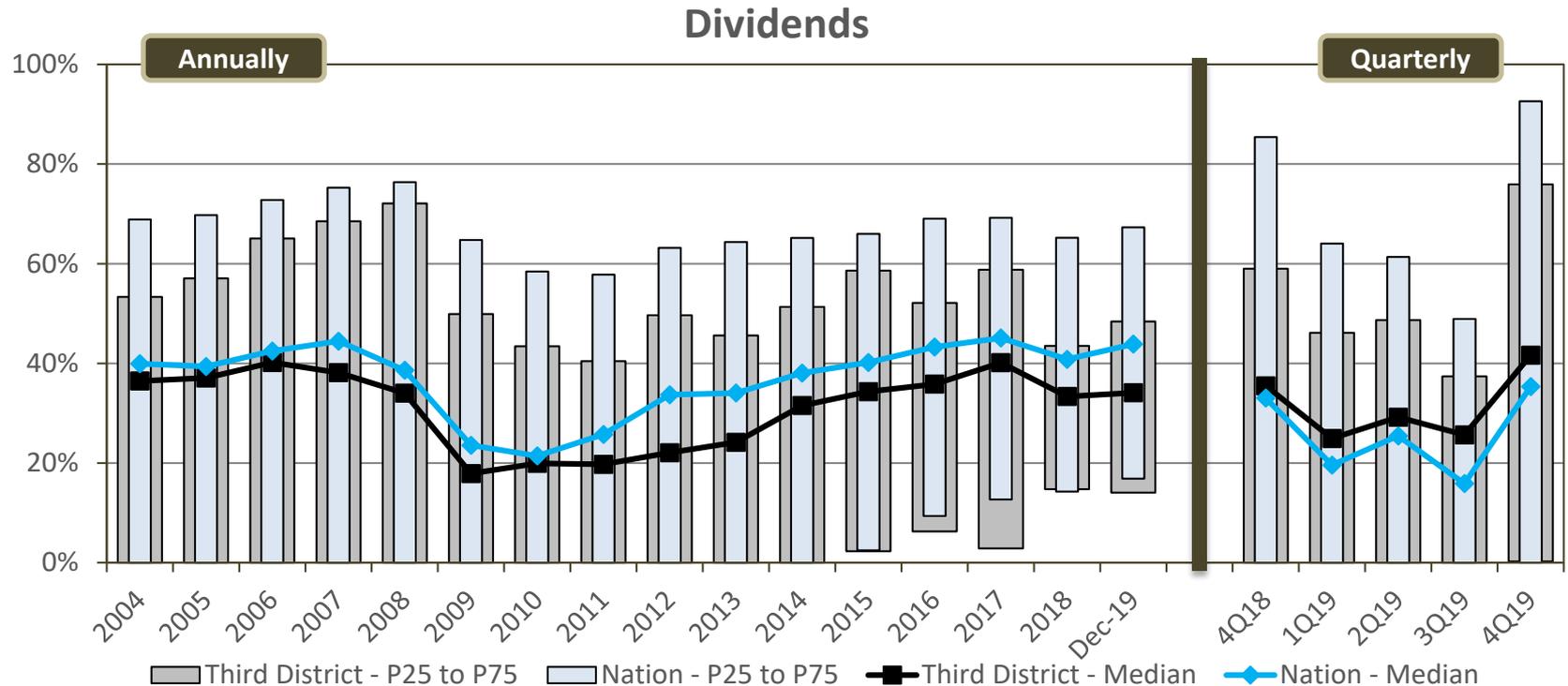




# Capital Adequacy

## Dividend Payments\*

As of 2019:Q4, median dividend payments\* in the Third District increased and are comparable to precrisis levels. The higher level of dividends 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.

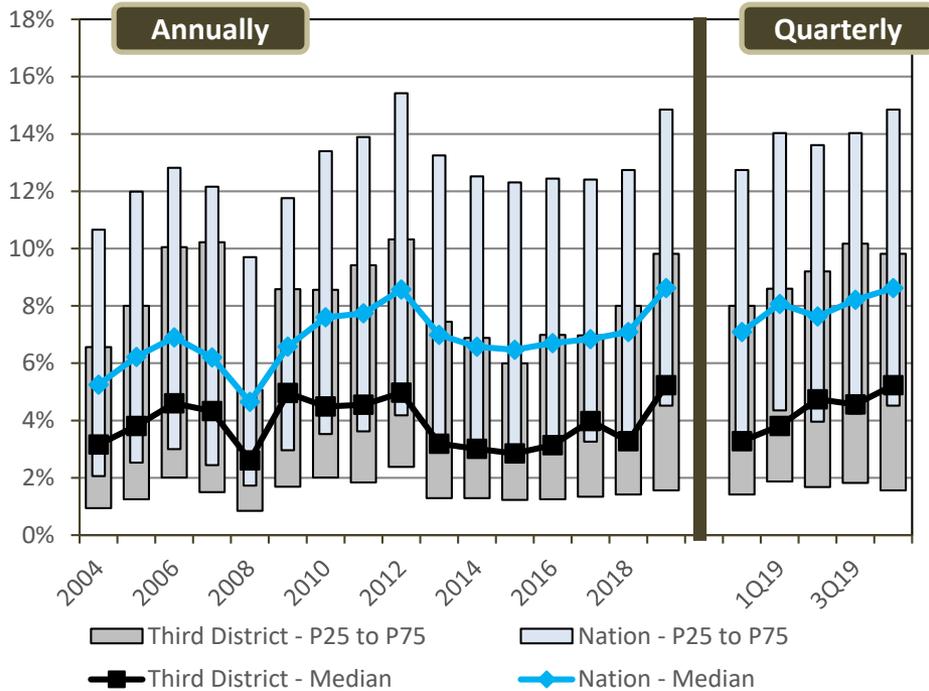


# Liquidity

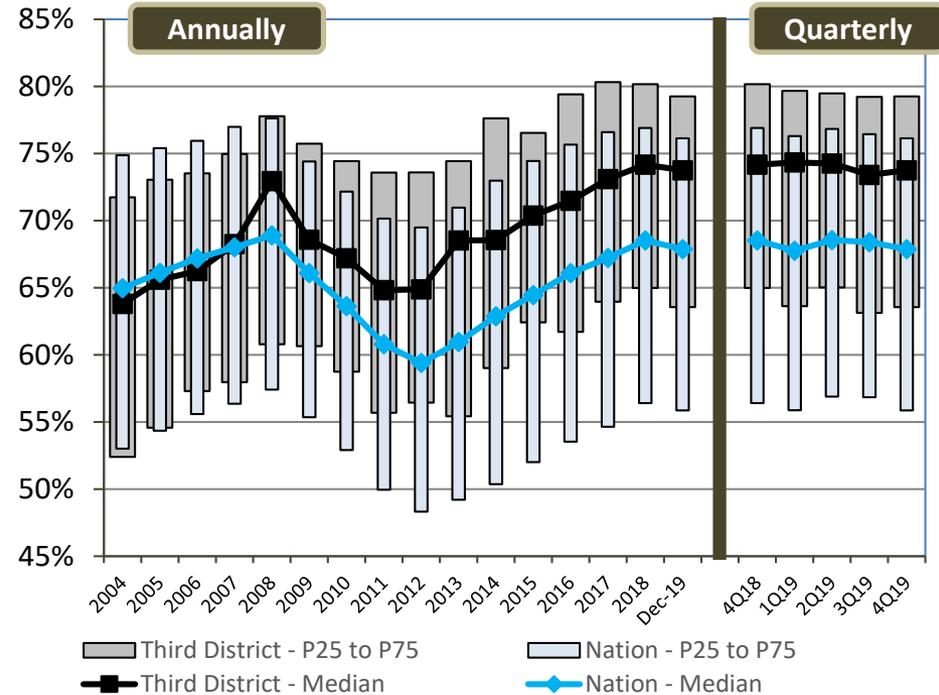
## Short-Term Investments and Loans to Assets

Third District banks hold a much greater percentage of loans to assets as compared with the nation. The liquidity of a loan is only as strong as its market value relative to its book value. If a bank must sell assets at a steep discount to meet its obligations, it may be experiencing a liquidity problem. Additionally, Third District institutions maintain a lower level of short-term assets. In terms of sensitivity, having more long-term loans and investments may increase duration and interest rate risk depending on the specific loan type.

### Short-Term Investments / Assets\*



### Loans / Assets



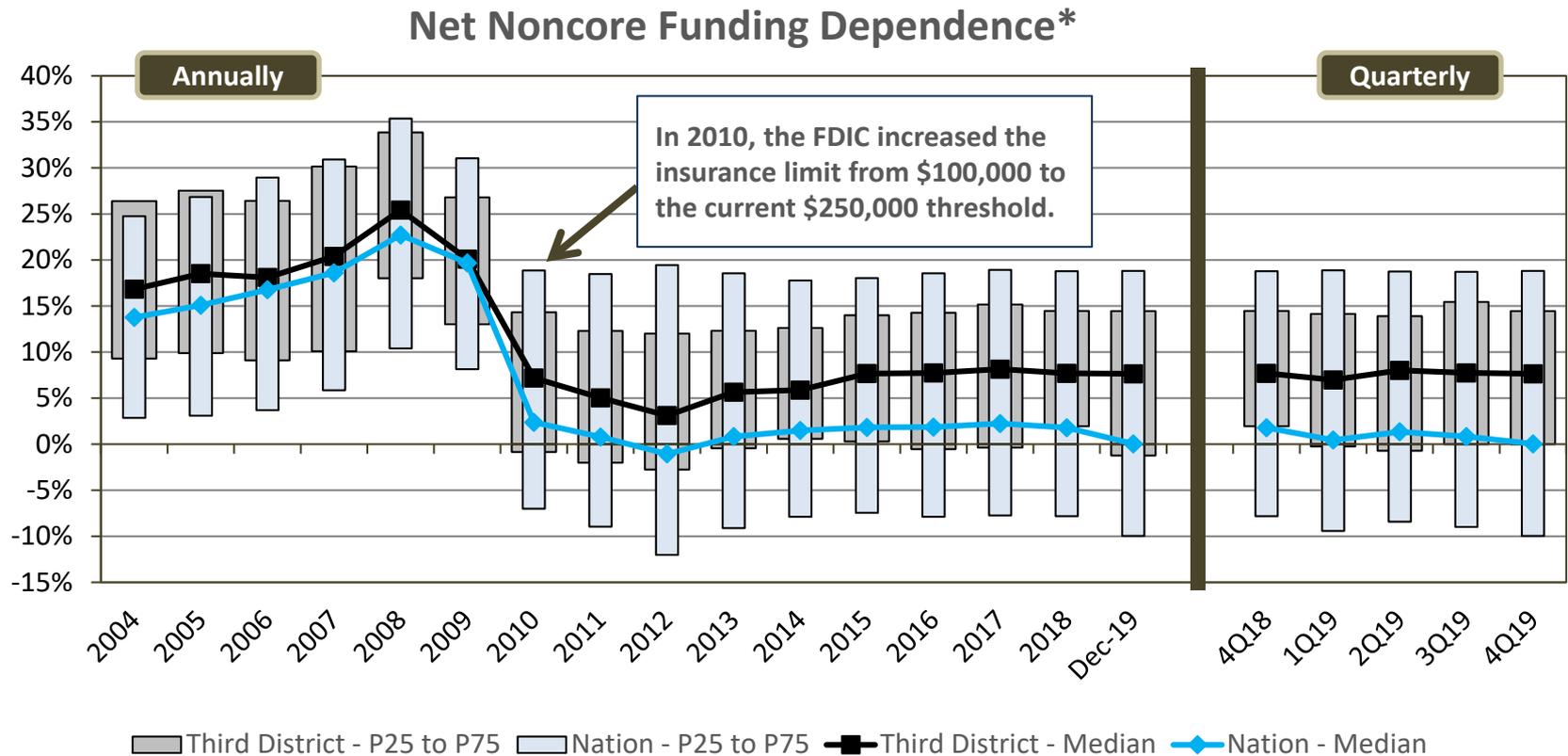
\* Short-term investments equals the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.



# Liquidity

## Noncore Funding Dependence Ratio

Many Third District banks depend heavily on noncore funding sources to fund balance sheet growth given the increased competition for deposits. 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.

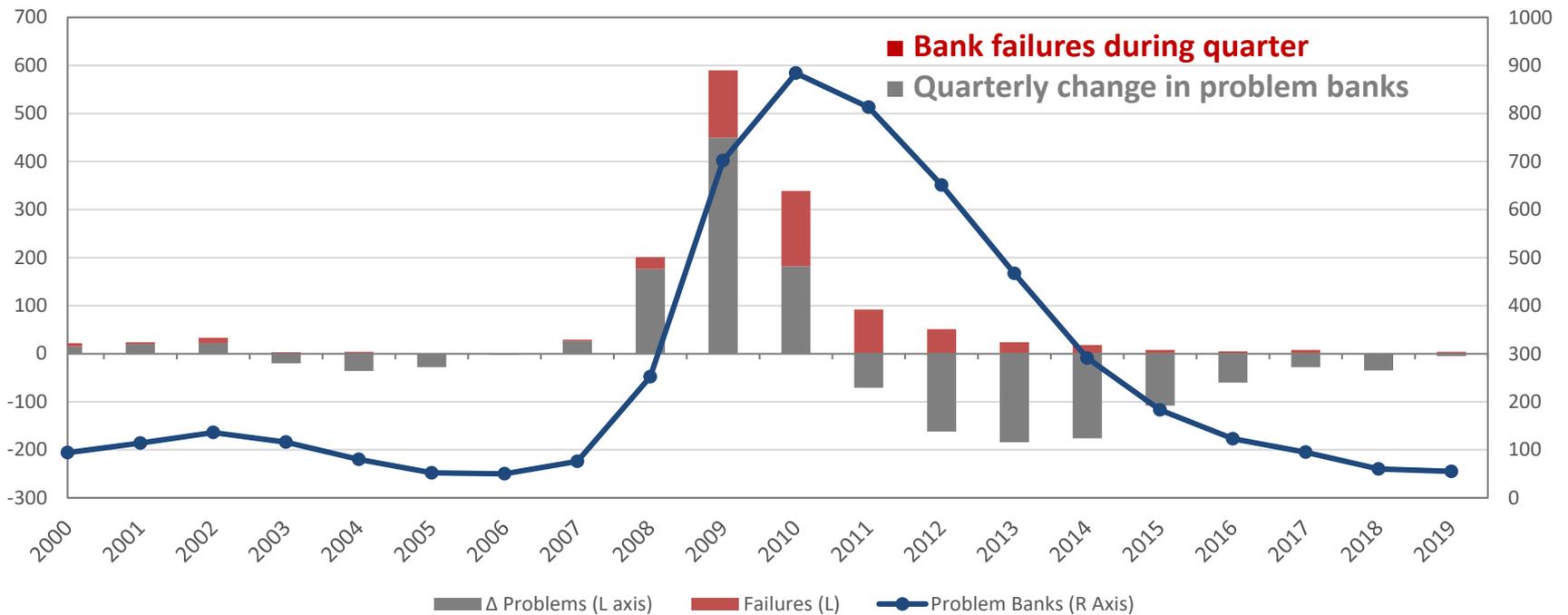


# Problem Banks

Problem banks within the nation fell by 9 year-over-year to 51 as of 2019:Q4. This represents the smallest number of problem banks since 2006.

Four banks failed within 2019, including the Enloe State Bank in Cooper, TX; Louisa Community Bank in Louisa, KY; Resolute Bank in Maumee, OH; and City National Bank of New Jersey in Newark, NJ.

Two banks failed already in 2020, Ericson State Bank in Ericson, NE; First State Bank, based in Barboursville, WV.



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. The 20-year high of problem institutions reached 888 as of 2011:Q1.