# BANKING BRIEF

## FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

## Fourth Quarter Highlights

- *Year over year, profitability (ROA) continued to improve at all categories of banks. Quarterly, ROA was nearly flat everywhere except local community banks.*

- *Year over year, total loans grew at an accelerating rate at community banks and more modestly at large organizations. Most loan growth at large organizations was in commercial loans, with real estate loans continuing to shrink. Smaller banks saw increases in commercial and real estate loans, with modest growth in consumer loans.*

- *Loan quality improved year over year at all categories of banks, as both nonperforming loans and net charge-offs decreased substantially. Large organizations still lag behind community banks in loan quality.*

- *Residential real estate (RRE) loan quality improved at all categories of banks, but quality is still well below historical norms at large organizations. RRE loan growth slowed to nearly a standstill at community banks locally, grew slightly at community banks nationally, and shrank at large organizations.*

- *Commercial real estate (CRE) lending accelerated at all categories of banks, with local community banks showing the most growth and large organizations the least. Nonperforming loans and net charge-offs dropped substantially year over year at all categories of banks.*

- *Loan-loss coverage increased at all categories of banks despite decreases in both loan loss provisions and reserves. In all cases, it is still below historical norms.*

- *Deposit growth slowed somewhat from the third to the fourth quarter, and community banks are being forced to rely on more nondeposit funding sources.*

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## *Summary Table of Bank Structure and Conditions — Fourth Quarter 2013*

| | *Community Banking Organizations* | | | | | | | *Large Organizations* | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *Nation* | | | *Tri-state* | | | | *Nation* | | |
| | **$ Bill** | **% Change From** | | **$ Bill** | **% Change From** | | | **$ Bill** | **% Change From** | |
| | **13Q4** | **13Q3** | **12Q4** | **13Q4** | **13Q3** | **12Q4** | | **13Q4** | **13Q3** | **12Q4** |
| Total Assets | 1,934.9 | 8.06 | 2.98 | 106.9 | 6.05 | 3.29 | Total Assets | 10,838.1 | 3.42 | 2.17 |
| Total Loans | 1,223.1 | 11.25 | 6.62 | 72.3 | 9.51 | 6.32 | Total Loans | 5,370.2 | 3.92 | 2.78 |
| C&I | 200.4 | 16.19 | 8.65 | 9.7 | 8.96 | 3.53 | C&I | 1,257.6 | 4.22 | 6.58 |
| Real Estate | 893.5 | 10.25 | 5.92 | 56.4 | 10.40 | 7.48 | Real Estate | 2,603.9 | -0.28 | -1.48 |
| Consumer | 52.6 | 5.01 | 4.83 | 2.6 | 6.54 | 2.65 | Consumer | 740.1 | 8.06 | 2.80 |
| Total Deposits | 1,616.6 | 8.10 | 2.75 | 88.3 | 1.71 | 2.00 | Total Deposits | 8,209.9 | 6.56 | 4.05 |
| **Ratios (in %)** | **13Q4** | **13Q3** | **12Q4** | **13Q4** | **13Q3** | **12Q4** | **Ratios (in %)** | **13Q4** | **13Q3** | **12Q4** |
| Net Income/Avg. Assets (ROA) | 0.97 | 0.94 | 0.87 | 0.83 | 0.74 | 0.64 | Net Income/Avg. Assets (ROA) | 0.97 | 0.95 | 0.91 |
| Net Interest Inc./Avg. Assets (NIM) | 3.35 | 3.35 | 3.42 | 3.16 | 3.20 | 3.27 | Net Interest Inc./Avg. Assets (NIM) | 2.47 | 2.50 | 2.62 |
| Noninterest Inc./Avg. Assets | 0.97 | 1.00 | 1.00 | 1.29 | 1.30 | 1.26 | Noninterest Inc./Avg. Assets | 1.78 | 1.83 | 1.82 |
| Noninterest Exp./Avg. Assets | 3.02 | 3.04 | 3.07 | 3.19 | 3.23 | 3.24 | Noninterest Exp./Avg. Assets | 2.71 | 2.80 | 2.90 |
| Loans/Deposits | 75.66 | 75.12 | 72.91 | 81.87 | 80.37 | 78.55 | Loans/Deposits | 65.41 | 65.82 | 66.22 |
| Equity/Assets | 10.63 | 10.71 | 10.72 | 10.02 | 9.98 | 9.94 | Equity/Assets | 10.98 | 10.88 | 10.96 |
| Nonperforming Loans/Total Loans | 1.72 | 1.92 | 2.41 | 1.60 | 1.80 | 2.30 | Nonperforming Loans/Total Loans | 2.95 | 3.18 | 4.04 |

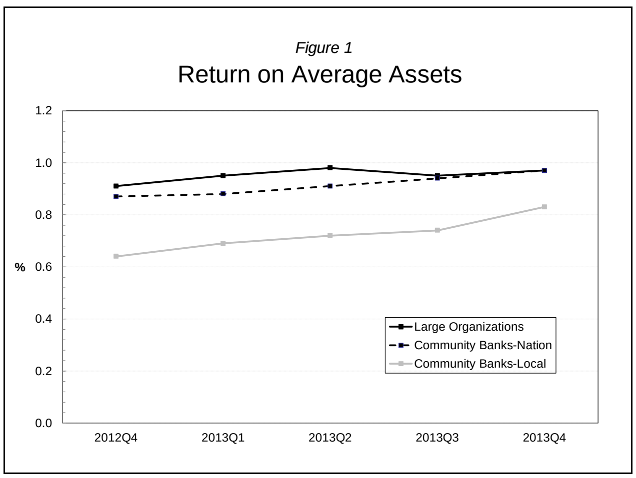
Unless otherwise noted, all data are from Federal Financial Institutions Examination Council Call Reports. The data are adjusted for mergers. Quarterly percentage changes are compound annualized rates except where noted. A banking organization is an independent bank or all the banks within a highest-level bank holding company; however, banks less than five years old and special-purpose banks such as credit card banks are excluded. The large banking organization sample is based on banking organizations with total assets at least as large as those of the 100th largest banking organization in the United States as of December 31, 2012. The community banking organization sample is based on the remaining banking organizations. Tri-state community banking organizations are those community banking organizations that are headquartered in the region. The numbers of banking organizations in the categories are as follows: (1) community banking organizations — 168 for the tri-state area and 5,139 for the nation; (2) large banking organizations — 104 for the nation. Ratios are aggregates; that is, the numerators and denominators are summed across all banks in the group then divided.

*Fourth Quarter 2013*

Profitability at all categories of banks continued its year-over-year steady growth, but growth in profitability leveled off from the second to the third quarter except at local community banks.

Profitability at all but local community banks has nearly returned to historical norms, so some slowing in its growth is to be expected.[1] In addition, the number of firms showing positive net income decreased at all categories of banks.[2]

At large organizations, ROA increased 6 basis points from the fourth quarter of 2012, to 0.97 percent (Figure 1).[3] From the third quarter of 2013 to the fourth quarter, this increase was only 2 basis points. At community banks nationally, ROA was 0.97 percent; up 10 basis points from last year but only 3 basis points from the third quarter. Local banks saw increases of 19 basis points for the year and nine for the quarter, to 0.83 percent. This ROA is substantially lower than both community banks nationally and large organizations.




While continuing to grow, profitability at area banks has lagged other banks in the nation for several quarters now.[4] This trend of lower profitability at area banks has existed for several quarters. Last quarter, this publication listed the main reason for this as higher loan growth (particularly CRE lending), leading to more losses, and therefore higher loan-loss provisioning. This is still the case. As noted in previous issues, this is largely due to higher loan growth in recent years, and loan-to-deposit ratios are significantly higher in the region than for banks nationally. Area banks earn relatively low net interest margins on these loans, in part, due to higher reliance on noncore deposits and nondeposit debt (see “Funding Sources” below). In addition, charge-offs on their relatively larger stock of loans — particularly CRE loans — are a drag on profits, and banks in the region have the highest expense ratios of any category of banks.

As has been the case for the previous several quarters, the increased profitability can be attributed primarily to the continued improvement in loan quality, which resulted in lower loan-loss provisions. Decreased expense ratios also contributed to increasing income, particularly at large organizations, while asset sales shrank except at large organizations, and trading income was down except at local community banks.

Net charge-offs (NCOs) and nonperforming loans (NPLs) dropped substantially from the

[1] The 20-year average ROA for commercial banks is 1.04 percent. Since the end of World War II, this average has been 0.81 percent.

[2] Out of 5,139 community banks in the national sample, 4,527 reported positive quarterly profits. This was a decrease of 216 from the fourth quarter of 2013. Locally, 150 out of 168 banks reported positive profits, a decrease of one from the fourth quarter of 2013. For large organizations, 99 out of 103 were profitable, down two from the previous quarter.

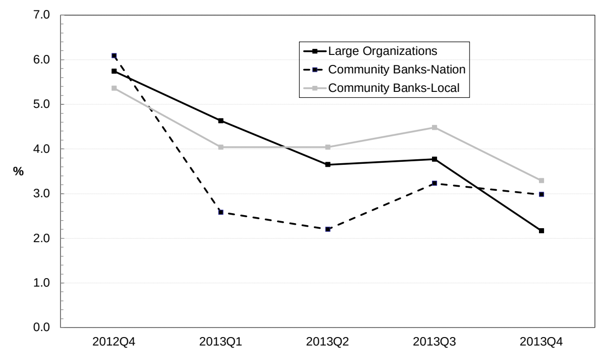
[3] See Summary Table of Bank Structure and Conditions on page 2.

[4] This is a long-term trend. Looking back to the mid-1990s, local community banks had lower annual ROAs than community banks nationally most of the time. This is likely due to the fact that the tri-state area’s economy generally lags the rest of the nation.

fourth quarter of 2012, although NCOs have remained flat during the past few quarters at community banks both locally and nationally. Both loan-loss provisions and reserves continued to drop as well (see “Provisioning and Reserves” that follows). This allowed community banks to show increases in profits from last year despite falling net interest margins.

*Figure 2*

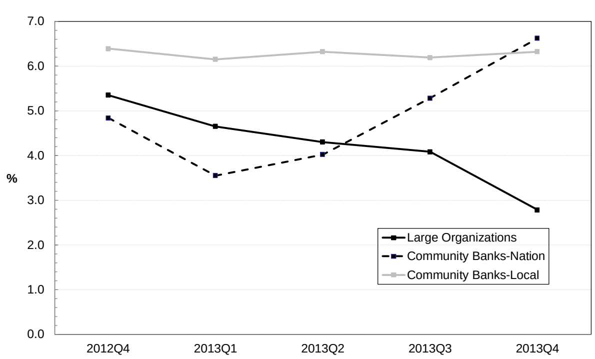
Year-Over-Year Asset Growth




Year over year, assets of community banks nationally grew slightly less than 3.0 percent, while asset growth at local community banks was 3.3 percent (Figure 2). At large organizations, asset growth was 2.2 percent. Quarterly growth increased at all categories of banks.

*Figure 3*

Year-Over-Year Loan Growth




The year-over-year growth in assets was fueled mainly by increases in loans as growth in banks’ securities portfolios slowed. Loans increased 2.8 percent at large organizations, 6.6 percent at community banks nationally, and 6.3 percent at local community banks (Figure 3). The reported value of securities increased only 2.3 percent at community banks nationally, 3.3 percent at local community banks, and decreased 1.9 percent at large organizations.[5] This increase in lending is widespread, that is, not concentrated in only a few geographic regions of the country.

At large organizations, most of the total loan growth was due to commercial and industrial (C&I) lending, while real estate loans decreased. C&I loans grew nearly 6.6 percent, consumer loans grew 2.8 percent, and real estate lending shrank 1.5 percent. At community banks, C&I lending grew at a rate of 8.7 percent nationally and 3.5 percent locally, but real estate and consumer lending picked up as well.

The main factor driving the growth of real estate loans was CRE loans, as RRE lending grew modestly at best at community banks and shrank at large organizations. Community banks both locally and nationally have a much higher percentage of their real estate loans in CRE lending, while large organizations concentrate heavily on RRE loans (see the “Residential Real Estate Lending” and “Commercial Real Estate Lending” sections that follow, and Tables 1 and 2 in the Appendix).

Loan quality continued to improve at all categories of banks. At large organizations, the ratio of NPLs to total loans (the NPL ratio) decreased by 1.1 percentage points from last year to 2.95 percent (Figure 4).[6] Community

[5] Reported value is the sum of the market value of available-for-sale securities and the book value of held-to-maturity securities.

[6] For historical perspective, the average NPL ratio for all commercial banks between 2002 and 2012 was 2.52 percent. At the bottom of the last real estate cycle, in 1991, this ratio stood at 3.70 percent. Source: FDIC

banks showed similar decreases, and their NPL ratios were much lower than those of large organizations to begin with. At community banks nationally, the NPL ratio has decreased 69 basis points since last year, to 1.72 percent. Locally, the NPL ratio fell by 70 basis points, to 1.60 percent.

Overall, asset quality has also improved at all categories of banks.[7] Foreclosed real estate,

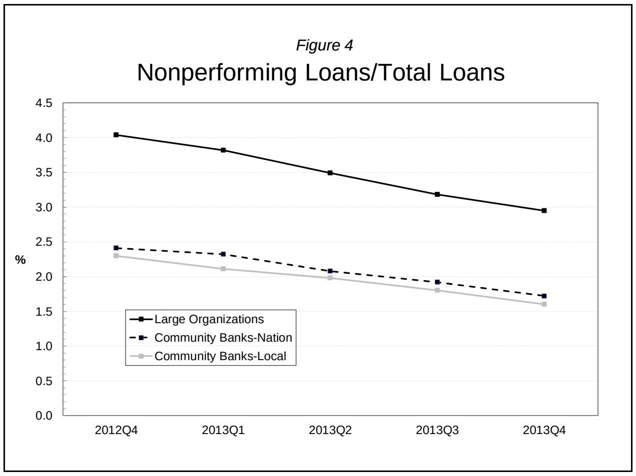



*Figure 4*
Nonperforming Loans/Total Loans

known as other real estate owned (OREO), fell substantially from last year at all categories of banks. At large organizations, OREO decreased by 11.3 percent. At community banks, the decrease was 19.4 percent nationally and 16.6 percent locally. Combining the decrease in OREO with improved loan quality, the ratio of nonperforming assets (NPAs) to total assets has fallen at all three categories of banks in the past year (Figure 5).[8]

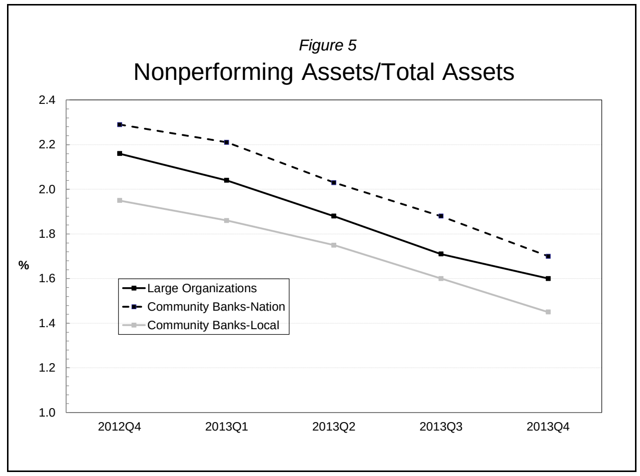



*Figure 5*
Nonperforming Assets/Total Assets

At large organizations, the NPA ratio has fallen 56 basis points in the past year, to 1.60 percent. At community banks nationally, the decrease was 59 basis points, to 1.70 percent, and locally the NPA ratio fell 50 basis points, to 1.45 percent.

NCOs tell a similar story, with all categories of banks experiencing significant decreases.

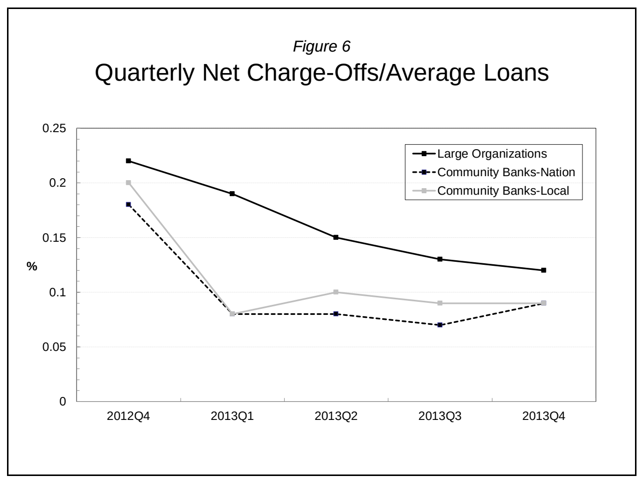



*Figure 6*
Quarterly Net Charge-Offs/Average Loans

The ratio of NCOs to average loans (the NCO ratio) fell 10 basis points during the year at large organizations, to 0.12 percent (Figure 6).

Community banks both locally and nationally continued to have a lower NCO ratio than large organizations. For community banks nationally, the NCO ratio has fallen 9 basis points during the year, to 0.09 percent. At tri-

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Historical Statistics on Banking, http://www2.fdic.gov/hsob/index.asp.

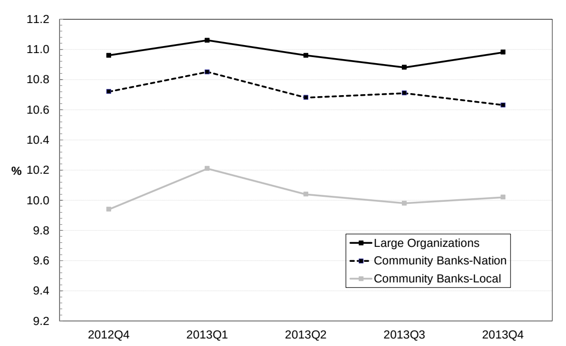
[7] Asset quality refers to nonperforming assets. These are defined as NPLs plus other real estate owned (OREO).

[8] Loan quality refers to NPLs only, while asset quality refers to NPAs. These are the sum of NPLs and OREO. For historical perspective, the average ratio of NPAs to total assets for all commercial banks between 2002 and 2012 was 1.56 percent. At the bottom of the last real estate cycle in 1991, this ratio stood at 3.02 percent. Source: FDIC Historical Statistics on Banking, http://www2.fdic.gov/hsob/index.asp.

state area community banks, the NCO ratio has fallen 11 basis points over the past year, to 0.09 percent. It should be noted that total NCOs showed substantial quarterly increases at community banks nationally and locally. Gross charge-offs fell at all categories of banks from last year, while recoveries increased slightly at all categories of banks.

Capital ratios, defined as the ratio of total equity to assets, were basically flat at all types of institutions (Figure 7).

*Figure 7*
Equity-to-Assets Ratios



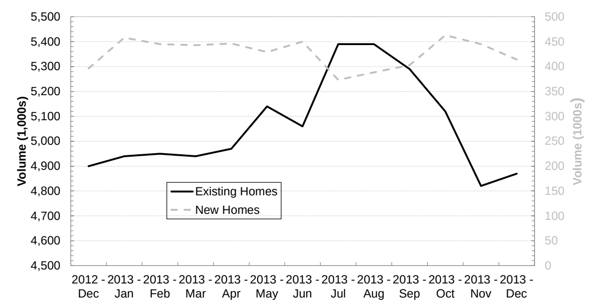

There were only two bank failures in the fourth quarter, bringing the 2013 total to 25, as compared with 51 for all of 2012. None of the failures involved a tri-state area bank.

## ***Residential Real Estate Lending***[9]

The nationwide and local RRE markets continued their modest, if somewhat sputtering, recovery in the fourth quarter, with about half of the areas reporting increased activity from last year. The Federal Reserve Board's *Beige Book*, as of January 15, 2014, reported that sales of existing homes increased moderately in most Federal Reserve Districts, but the Philadelphia and North Jersey metro areas reported slower growth.[10] It also reported that construction, for the most part, improved across the country, and much of this increase was in apartment buildings.

By most measures, local real estate markets continued to improve in the third quarter. In the Philadelphia region, the *Beige Book* reported that sales of existing homes shrank slightly from last year, but construction is up. The New York region (including northern New Jersey) reported the same but also noted that home prices are still being restrained by a sizable backlog of foreclosed and distressed properties.

*Figure 8*
Sales of New and Existing Homes



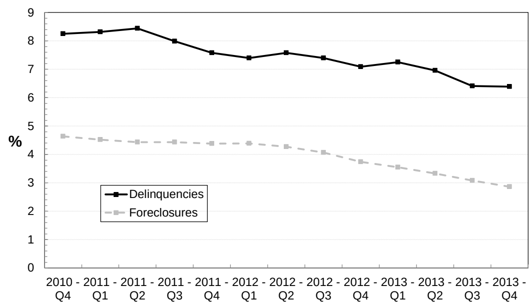

New home sales have increased since the fourth quarter of 2012, and also increased from the end of the third quarter of 2013 (Figure 8: Note the different scales on the left and right axes).

Sales of existing homes, however, are down for both the year and the quarter after growing for the first half of 2013. The percentage of delinquent mortgages decreased 70 basis points from a year ago, and the percentage of mortgages in foreclosure has decreased 88 basis points (Figure 9).

[9] See Table 1 in the Appendix for a full summary of the data used in this section.

[10] For further information, see http://www.federalreserve.gov/monetarypolicy/beigebook/files/Beigebook_20140115.pdf.

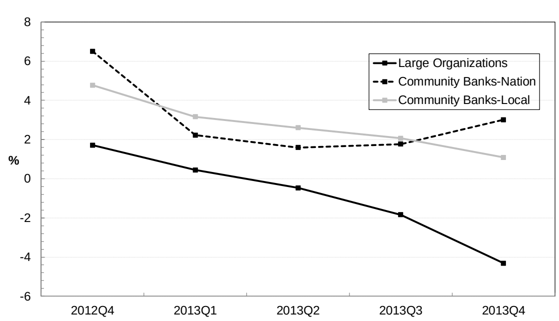
*Figure 9*
Delinquency and Foreclosure Rates




Source: Haver Analytics

RRE loans outstanding showed little year-over-year growth at community banks nationally and locally and shrank at large organizations (Figure 10). From the fourth quarter of 2012 to the fourth quarter of 2013, RRE loans outstanding grew at a rate of 3.0 percent at community banks nationally and 1.1 percent locally. Community banks nationally showed somewhat stronger growth from the third quarter to the fourth. At large organizations, loans shrank 4.3 percent year over year and 4.1 percent in the fourth quarter.

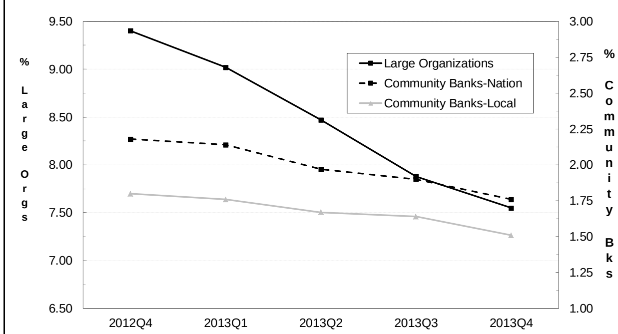
*Figure 10*
Annual Change in RRE* Loans Outstanding




*Residential real estate

The quality of RRE loans continued to improve, but large organizations are still carrying a substantial portfolio of NPLs. The RRE NPL ratio at large banks fell more than 1.8 percentage points, to 7.55 percent, in the last year [Figure 11: Note the different scales for large organizations (left y-axis) and community banks (right y-axis).] Community banks have much better RRE loan quality, with NPL ratios

*Figure 11*
Nonperforming RRE* Loans/Total RRE Loans

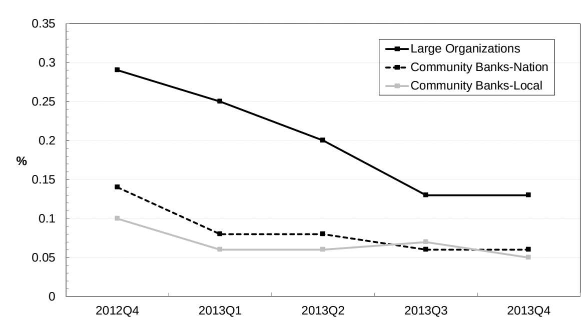



*Residential real estate

of 1.76 percent nationally and 1.51 percent locally. These represent drops of 42 and 29 basis points, respectively, in the past year.

The improvement in loan quality at large organizations is also reflected in the RRE NCO ratio. At large organizations, this ratio fell for the fourth consecutive quarter, decreasing 16 basis points, to 0.13 percent in the past year (Figure 12).

*Figure 12*
Net Charge-Offs on RRE* Loans/Avg. RRE Loans




*Residential real estate

At community banks, the RRE NCO ratio decreased 8 basis points nationally, to 0.06 percent, and fell 5 basis points locally, to 0.05 percent. At both large organizations and community banks nationally, charge-offs decreased and recoveries increased. At local

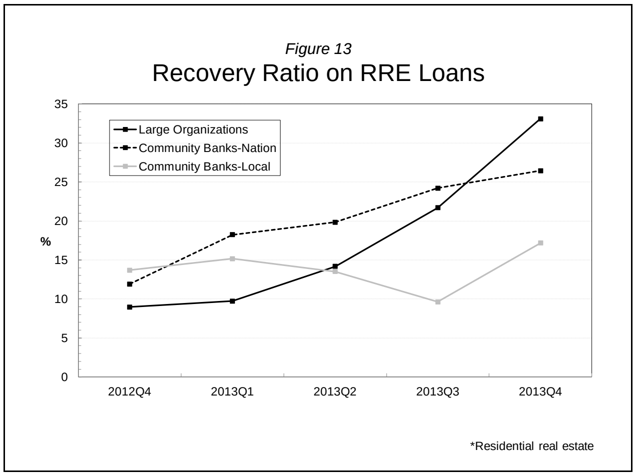



*Figure 13*
Recovery Ratio on RRE Loans

community banks, charge-offs decreased but so did recoveries. Recovery ratios have increased at all categories of banks in the past year (Figure 13).

## ***Commercial Real Estate Lending***[11]

CRE market conditions improved modestly both locally and nationally. The *Beige Book* reported that most CRE markets nationwide continued to show increases in construction, particularly multifamily properties. Demand for leased commercial space picked up in many areas. For the most part, in the Third District (Philadelphia region), there was modest growth in commercial leasing activity, particularly at commercial warehouses. Construction in the region was unchanged from last year. North Jersey was somewhat worse off, with little growth in leases and construction limited to renovations and improvements on existing properties. Also, vacancy rates remain high.

CRE lending results improved in the third quarter, with both loan growth and quality improving at all categories of banks. Loan growth was especially strong at local community banks. Year over year, CRE loans outstanding grew at a rate of 3.6 percent at large organizations, 7.6 percent at community banks

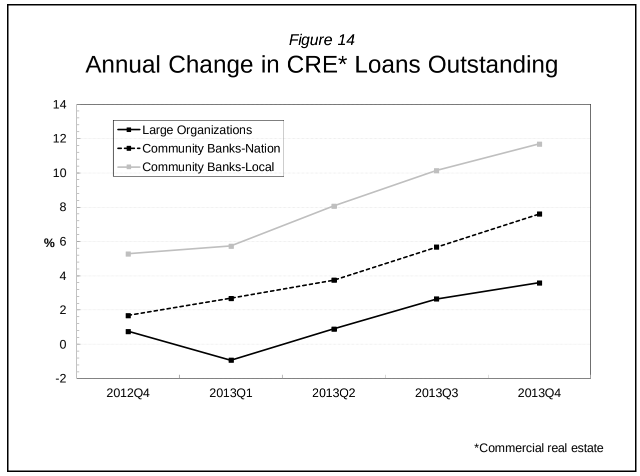



*Figure 14*
Annual Change in CRE* Loans Outstanding

nationally, and 11.7 percent at tri-state area community banks (Figure 14). Much of this growth can be attributed to loans on multifamily properties; however, construction lending continued to be weak (see below).

The quality of CRE loans improved at all categories of banks and in each category of CRE loans. At large organizations, the CRE NPL ratio decreased nearly 1.5 percentage points from the fourth quarter of 2012, to 1.80 percent (Figure 15). At community banks nationally, the CRE NPL ratio decreased nearly 1.2 percentage points from last year, to 2.23 percent and at community banks locally, the ratio

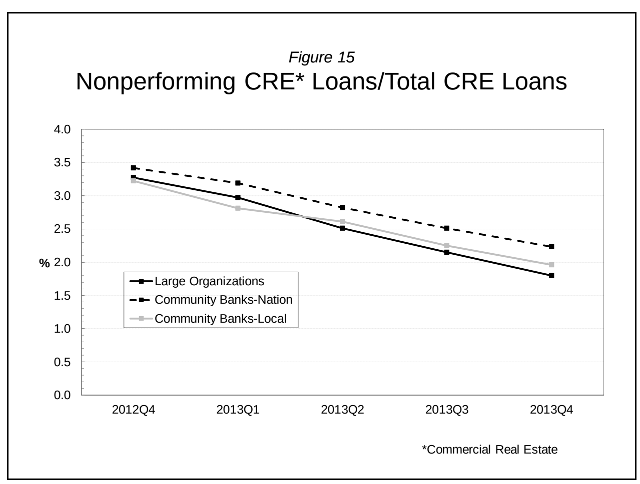


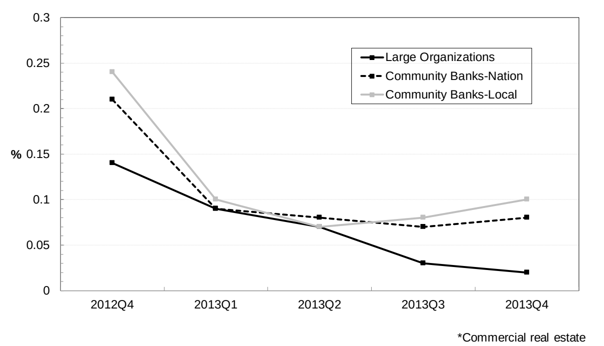

*Figure 15*
Nonperforming CRE* Loans/Total CRE Loans

[11] See Table 2 in the Appendix for a full summary of the data used in this section.

dropped nearly 1.3 percentage points, to 1.96 percent.

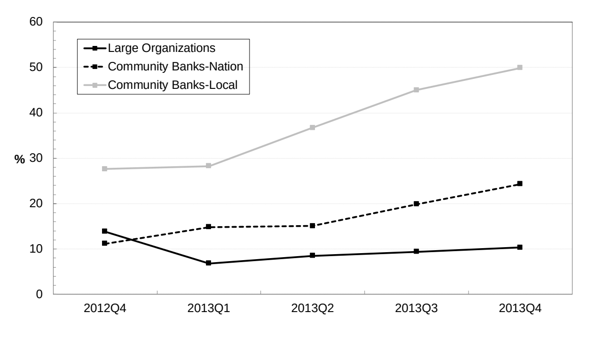
NCO ratios have decreased at all categories of banks as well. Since last year, the CRE NCO ratio at large organizations has decreased by 12 basis points, to 0.02 percent (Figure 16). At community banks nationally, there was a decrease of 13 basis points, to 0.08 percent; locally the ratio decreased 14 basis points, to 0.10 percent. Community banks both locally and nationally saw slight increases in this ratio from the third quarter to the fourth.

*Figure 16*
Net Charge-Offs on CRE* Loans/Avg CRE Loans




As previously noted, much of the growth in CRE lending can be attributed to loans on multifamily housing, and growth is accelerating (Figure 17). Community banks in general saw double-digit growth in multifamily loans. This

*Figure 17*
Annual Change in Multifamily Loans Outstanding

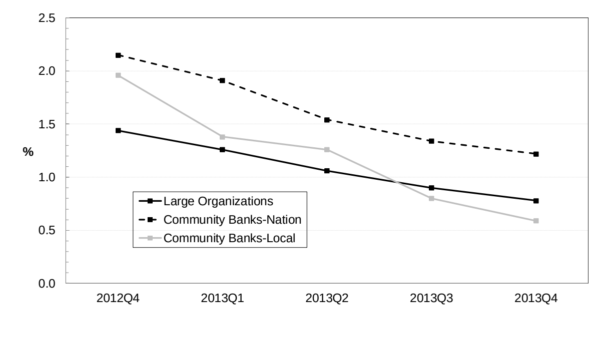



was especially true at local community banks, where loans outstanding have grown nearly 50 percent in the past year. Growth at large organizations wasn't as large, but it was still fairly strong.

This growth in multifamily housing is concentrated in two areas. First, there has been a lot of construction and conversion activity in New Jersey, particularly northern New Jersey. There is also substantial conversion activity in the Philadelphia area, where, similar to northern New Jersey, excess office space is being converted into multifamily housing.

In spite of the high growth, loan quality hasn't been adversely affected, as NPL ratios at all categories are not only falling they are well below those for all CRE loans (Figure 18).

*Figure 18*
Multifamily Loan NPL Ratios




Even though they have been growing at a high rate recently, multifamily loans still make up a small part of total CRE lending.[12] By far, the largest share of CRE lending is in commercial mortgages.

Since CRE lending is the largest part of community banks' loan portfolios, the quality of their commercial mortgage portfolios has a significant role in determining the health of those banks.

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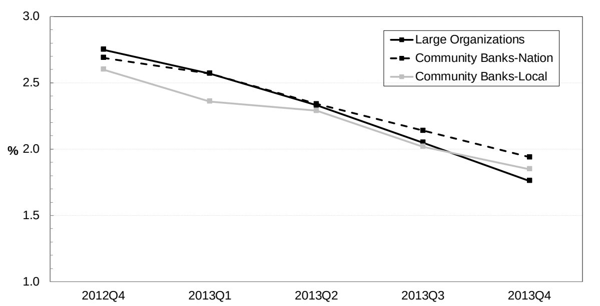
[12] At local community banks, 75.4 percent of CRE loans are commercial mortgages, 14.5 percent are multifamily loans, and 10.1 percent are construction loans.

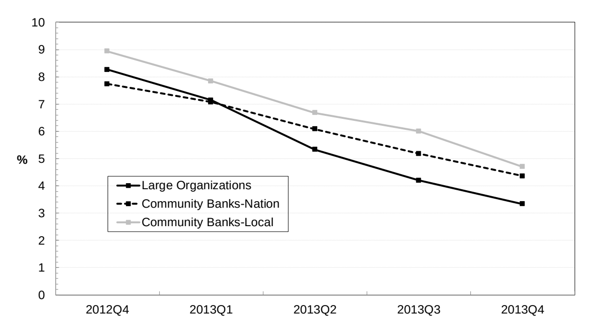
Commercial mortgage quality has improved significantly in the past year, and it continued to improve in the fourth quarter. At large organizations, the NPL has decreased 99 basis points, to 1.76 percent. At community banks nationally, the ratio has decreased 75 basis points, to 1.94 percent, and at community banks locally, the ratio has decreased 75 basis points, to 1.85 percent (Figure 19). NCOs on these loans have also dropped substantially.

*Figure 19*
Nonperforming Commercial Mortgages/ Commercial Mortgages




Construction lending continues to be a drag on CRE loan quality. Although the quality of construction loan portfolios has improved substantially in the past year or two, particularly at large organizations, NPL ratios remain high. The construction loan NPL ratio for large organizations has dropped more than 4.9 percentage points in the last year, to 3.33 percent (Figure 20). Community banks have experienced similar drops — nearly 3.4 points nationally and more than 4.2 points locally.

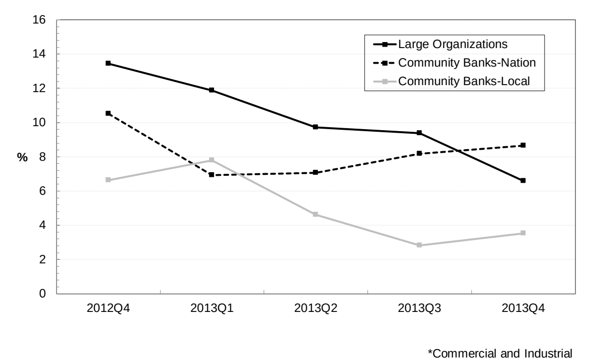
*Figure 20*
Construction Loan NPL Ratios




## ***Commercial & Industrial Lending***[13]

C&I lending continued to grow at a good pace at community banks, but it has been slowing somewhat at large organizations. At large organizations, C&I loans grew 6.6 percent in the past year (see Figure 21 below and Table 3 in the Appendix). Both the annual and quarterly growth rates at these organizations have slowed for each of the past four quarters. At community banks, C&I lending grew 8.7 percent nationally and 3.5 percent locally. Locally, quarterly growth (up 9.0 percent) was strong after several quarters of reduced C&I lending.

*Figure 21*
Year-Over-Year C&I* Loan Growth




The Federal Reserve Board's *Senior Loan Officer Opinion Survey* for January 2014 reported that loan demand had for the most part increased modestly.[14] This was true regardless of firm size. On the supply side, most firms reported they had eased their lending standards

[13] See Table 3 in the Appendix for a full summary of the data used in this section.

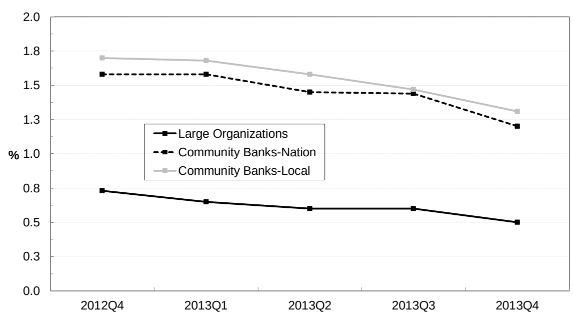
[14] For further information, see http://www.federalreserve.gov/boarddocs/snloansurvey/201402/fullreport.pdf.

for large- and medium-size firms, and had left standards unchanged for small borrowers. The main reason cited for easing standards was increased competition, and about one-quarter of respondents indicated they had eased standards because of an increased tolerance for risk.

Regardless of the easing of standards, loan quality remained high at all categories of banks (Figure 22). At large organizations, the NPL ratio has fallen 23 basis points in the past year, to 0.50 percent. Quality is somewhat worse at community banks, with NPL ratios of 1.20 nationally and 1.31 locally. Again, both of these ratios fell substantially in the past year.

*Figure 22*

Nonperforming C&I* Loans/C&I Loans



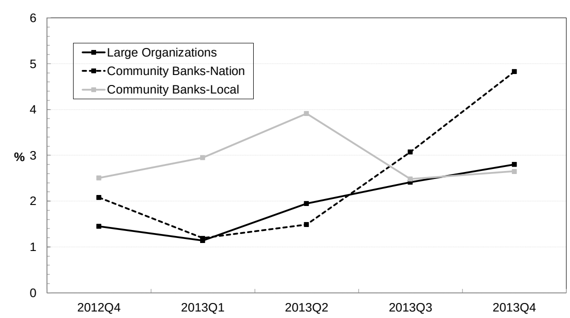

*Commercial and Industrial

## ***Consumer Lending***[15]

Overall, consumer lending continued to grow weakly in the fourth quarter, and there were relatively few quality problems. Large organizations conduct the vast majority of consumer lending. Their consumer lending increased slightly, growing about 2.8 percent year over year (Figure 23). At community banks nationally, consumer lending grew 4.8 percent, while at community banks locally, consumer lending grew 2.7 percent. In all categories of banks, consumer loans grew at a higher rate from last quarter than year over year. For large organizations the main area of growth in consumer lending was auto loans, with nearly every other category of loan either remaining flat or shrinking.[16] At community banks both locally and nationally, growth was in other revolving credit (i.e., revolving credit not due to credit cards).

*Figure 23*

Year-Over-Year Growth in Consumer Loans




NPL ratios on consumer loans have been low: 1.05 percent for large organizations, 0.85 percent for community banks nationally, and 0.52 percent for tri-state area community banks.

The most reliable measure of quality for consumer loans is NCOs. Many consumer loans — particularly at large organizations — are lines of credit with flexible repayment schedules, so NPLs are difficult to calculate. Also, except for automobiles, items purchased with consumer loans are difficult to repossess and resell, so when consumer loans go bad they are often a total loss.[17] NCO ratios fell

[15] See Table 4 in the Appendix for a full summary of the data used in this section.

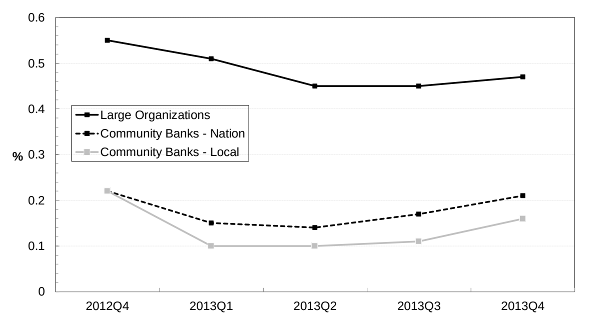
[16] Consumer loans can be divided into four components: credit cards, other revolving credit, auto loans, and other consumer loans. The fourth category is basically amortizing personal loans for things other than buying an automobile.

[17] The breakdown of consumer loans is as follows: At large organizations — credit cards, 33.5 percent; other revolving credit, 7.0 percent; auto loans, 36.6 percent; other consumer loans, 23.0 percent; at community banks nationally — credit cards, 3.3 percent; other revolving credit, 4.6 percent; auto loans, 44.6 percent; other

somewhat at large organizations and local community banks year over year, and they were basically flat at community banks nationally (Figure 24). For large organizations, the ratio fell 8 basis points, to 0.47 percent. For local community banks, the ratio fell 1 basis point, to 0.21 percent nationally, and locally the ratio fell 6 basis points, to 0.16 percent.

*Figure 24*

NCOs on Consumer Lns/Average Consumer Lns



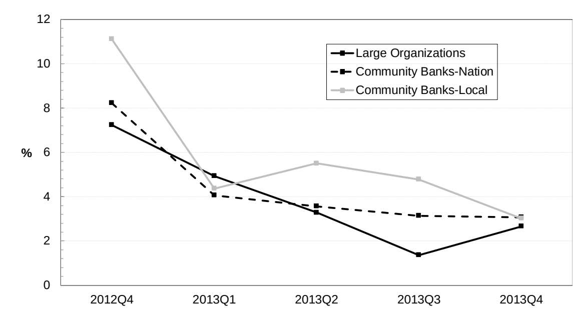

## ***Provisioning and Reserves***[18]

Banks continued to ease up on their provisioning and reserves in response to falling NPLs and charge-offs. At large organizations, loan-loss reserves have fallen more than 18 percent in the past year.[19] At community banks, loan-loss reserves have fallen by more than 6 percent nationally and nearly 5 percent locally. Loan-loss provisions also have decreased substantially, both overall and as a percentage of operating income. Over the past year, quarterly loan-loss provisions were down more than 64 percent at large organizations, 62 percent at community banks nationally, and 73 percent at local community banks.

The ratio of loan-loss provisions to operating income fell 4.6 percentage points, to 2.66 percent, at large organizations; decreased 5.2 percentage points, to 3.07 percent, at community banks nationally; and fell 8.2 percentage points, to 3.01 percent, at local community banks (Figure 25).[20] It should be noted that in each category this ratio is somewhat bumpy, rising in some quarters and falling in others. However, the overall trend is downward at all categories of banks.

*Figure 25*

Loan-Loss Provision/Operating Income




As noted above, the falling loan-loss provisions and consequent decreases in reserves can be justified as a reaction to improving loan quality, but at the same time, all the measures of coverage against losses remain outside of historical norms. At all categories of banks, the ratio of NCOs to loan-loss provisions is more

consumer loans, 47.5 percent; and at local community banks — credit cards, 2.1 percent; other revolving credit, 15.4 percent; auto loans, 36.9 percent; other consumer loans, 45.6 percent. Figures may not equal 100 due to rounding.

[18] See Table 5 in the Appendix for a full summary of the data used in this section.

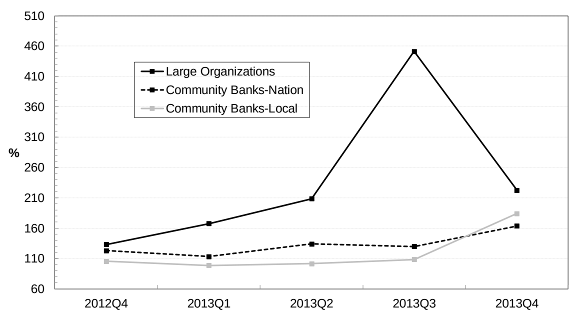
[19] As reported here, loan-loss reserves are the balance-sheet item and loan-loss provisions are from the income statement.

[20] Operating income is defined as the sum of net interest income and noninterest income. For historical perspective, the average ratio of loan-loss provision to operating income for all commercial banks between 2002 and 2012 was 14.57 percent. At the bottom of the last real estate cycle in 1991, this ratio was 18.9 percent. Source: FDIC Historical Statistics on Banking, http://www2.fdic.gov/hsob/index.asp.

than 100 percent and, except at large organizations, continued to increase (Figure 26).[21]

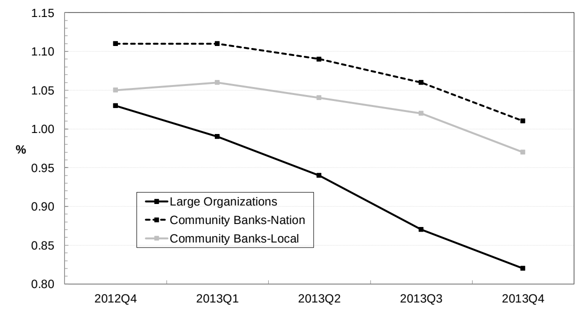
Large organizations saw this ratio fall from 451 to 223 percent. This is an improvement but still very high by historical standards. At community banks, the ratios are somewhat lower, but they also have increased in the past year. The NCOs to loan-loss provision ratio has increased more than 40 percentage points, to 163.6 percent, at community banks nationally. At local community banks, the ratio increased more than 78 percentage points, to 184.0. All community banks had large quarterly increases in this ratio as well.

*Figure 26*
Net Charge-offs/Loan-Loss Provision



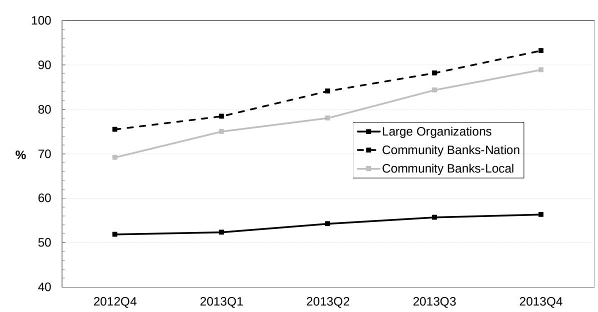

The decrease in provisioning has resulted in a drop in overall reserves, particularly at large organizations. Total loan-loss reserves fell more than 6 percent at community banks nationally, approximately 5 percent at local community banks, and nearly 19 percent at large organizations. As a percent of total assets, reserves have decreased from last year in all categories of banks, although the drop was smaller at community banks (Figure 27). At large organizations, the ratio has fallen 21 basis points since last year, to 0.82 percent. At community banks, the drop was 10 basis points nationally and 8 basis points locally.

*Figure 27*
Loan-Loss Reserves/Assets




In spite of falling reserves and provisioning, loan-loss coverage continued to improve at all categories of banks. However, it still remains well outside of historical norms. At large organizations, loan-loss coverage increased a little less than 5 percentage points from last year, to 56.3 percent (Figure 28). It has been increasing for the past year now. The situation has been somewhat better at community banks, and it continued to improve there as well. The loan-loss coverage ratio at community banks nationally has increased nearly 18 percentage points in the past year, to 93.3 percent. Locally,

*Figure 28*
Loan-Loss Coverage Ratio




[21] For historical perspective, the average ratio of NCOs to loan-loss provision for all commercial banks between 2002 and 2012 was 102.50 percent. At the bottom of the last real estate cycle in 1991, this ratio was 95.8 percent. Source: FDIC Historical Statistics on Banking, http://www2.fdic.gov/hsob/index.asp.

loan-loss coverage increased more than 19 percentage points, to 88.9 percent.[22]

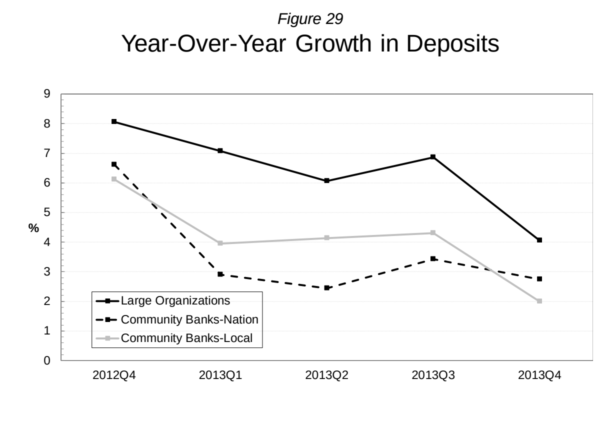
## ***Securities***[23]

Community banks, both locally and nationally, saw small year-over-year increases in the market value of their securities portfolios, while large organizations had a small loss in value. Although large organizations' portfolios lost value from last year, they had a relatively large increase in value from the third quarter to the fourth.[24]

All categories of banks saw small realized gains on securities.[25] Large organizations posted gains of approximately $438 million. Community banks nationally reported a realized gain of $4.1 million in the fourth quarter after reporting a loss in the previous last quarter. Local community banks reported a realized gain of about $9.2 million, an increase from the third quarter. Except at local community banks, these figures are down substantially from last year.

## ***Funding Sources***[26]

Year-over-year deposit growth was modest at all categories of banks (Figure 29). Deposit growth was fairly consistent across banks and account types, with all categories of banks seeing increases in transaction and savings accounts and decreases in time deposits. Large organizations also had increases in foreign deposits.




Reliance on brokered deposits has grown somewhat at large organizations and local community banks, particularly in the past quarter or two. At large organizations, brokered deposits have increased 17.5 percent from last year with a similar quarterly increase. Their share of total deposits has risen from 5.2 to 5.9 percent since last year. At community banks nationally, brokered deposits have decreased 11.1 percent in the past year but increased 10.1 percent in the third quarter. However, their share of total deposits decreased from 4.3 to 3.7 percent since last year. At local community banks, brokered deposits are up more than 14.4 percent in the past year with a quarterly increase of 14.9 percent. Their share of total deposits has increased in the last year by about 44 basis points, to 4.1 percent.

---

[22] The loan-loss coverage ratio is defined as the ratio of loan-loss reserves to NPLs. For historical perspective, the average loan-loss coverage ratio for all commercial banks between 2002 and 2012 was 108.03 percent. At the bottom of the last real estate cycle, in 1991, this ratio stood at 72.6 percent. Source: FDIC Historical Statistics on Banking, http://www2.fdic.gov/hsob/index.asp.

[23] See Table 6 in the Appendix for a full summary of the data used in this section. The figure for percent of assets uses the value of securities as reported on the banks' balance sheet. Securities there are reported at book value if they are held to maturity and at market value if they are available for sale.

[24] Changes in market value can be indicative of either increases in the value of securities that were already owned or increases due to purchases or sales of securities.

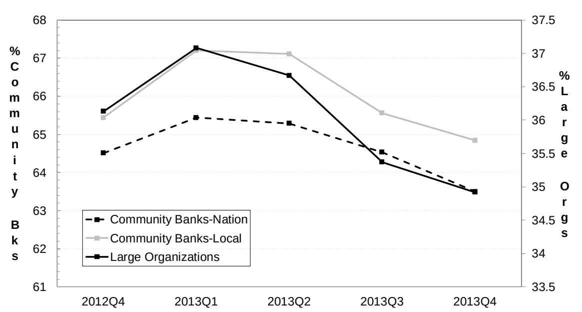
[25] Realized and unrealized gains and losses are net positions. Thus, the tri-state area sample can have larger gains or losses than the national sample, even though the tri-state sample is a subset of the national sample.

[26] See Table 7 in the Appendix for a full summary of the data used in this section.

The reliance on brokered deposits is reflected in the slow growth of core deposits as a fraction of total deposits. Core deposits grew at a slower pace than overall deposit growth.[27] Core deposits are the least expensive and most stable form of funding for banks, so this slowdown in growth could adversely affect interest margins going forward. Their share of total deposits has decreased at all categories of banks in the past year (Figure 30). Also, note that local community banks have a much lower ratio than those nationally. This partially explains the disparity in net interest margins in the table on page 2.

*Figure 30*

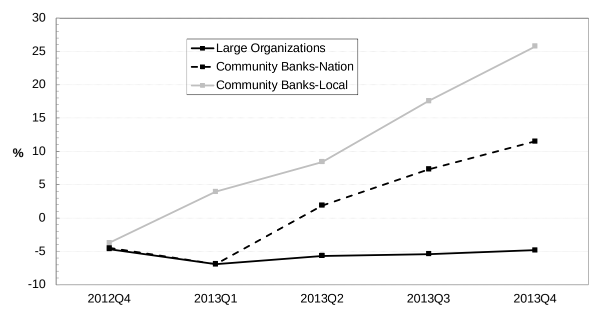
Core Deposits/Total Deposits




The slow growth in core funding has forced banks, especially community banks, to seek more expensive types of funding in the form of nondeposit debt. Nondeposit debt funding has been increasing for the past several quarters at community banks both nationally and locally (Figure 31).[28] The year-over-year increases grew substantially from last quarter, and at community banks locally the quarterly increase was quadruple the annual increase (104.8 percent quarterly and 25.7 percent annually). Community banks nationwide also had large quarterly and annual increases (20.5 percent quarterly and 11.5 percent annually). Large organizations have not had to seek out nondeposit funding. For large organizations, nondeposit debt fell 4.9 percent from the fourth quarter of 2012, and 9.7 percent from the third quarter of 2013.

*Figure 31*

Year-Over-Year Growth in Nondeposit Debt



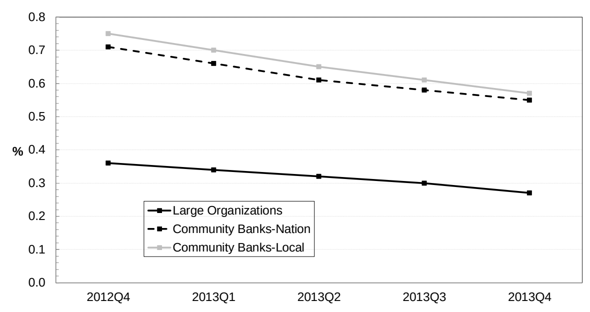

Large organizations continue to have a funding advantage over community banks in terms of both deposits and nondeposit funding. The implicit interest rate on deposits continued to fall at all categories of banks, but large organizations pay only a fraction of what both national and local community banks pay (Figure 32).[29] This holds true for nondeposit funding as well.

[27] Core deposits are defined as total domestic deposits less the sum of brokered deposits in denominations of less than \$100,000, and all deposits in denominations greater than \$100,000.

[28] Nondeposit funding consists of fed funds purchased, securities sold under agreements to repurchase (repos), subordinated debt, Federal Home Loan Bank advances, and other borrowings.

[29] The implicit interest is computed by dividing the annualized interest paid by the average total balance.

*Figure 32*
Implicit Interest Rate on Deposits

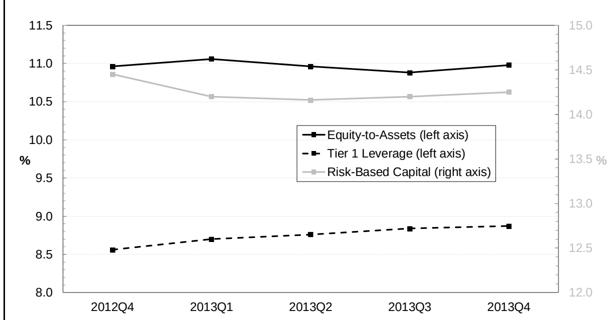



## ***Regulatory Capital***[30]

Both large organizations and community banks are meeting regulatory capital standards, for the most part, but capitalization decreased in the fourth quarter. Of the 103 large organizations in the sample, 102 had equity-to-assets ratios of at least 6 percent, and 99 had equity-to-assets ratios of more than 7 percent.[31] At community banks nationally, 97.1 percent of the institutions had equity-to-assets ratios of at least 6 percent, and 94.6 percent of those banks had ratios of at least 7 percent. However, the number of institutions with ratios above 7 percent decreased by 14 since the third quarter. Locally, 94 percent (158 out of 168) of the institutions had a capital ratio of at least 6 percent, and 91.1 percent (153) had an equity-to-assets ratio of at least 7 percent. These local numbers were unchanged since last quarter. Overall capitalizations are still above historical averages.

Year over year, at large organizations capitalization was a mixed bag, with equity-to-assets ratios flat, risk-based capital ratios falling, and tier 1 leverage ratios rising. Regardless, capitalization remained somewhat higher than historical norms.[32] Year over year, the equity-to-assets ratio at large organizations has fallen 2 basis points, the risk-based capital ratio has decreased 20 basis points, and the tier 1 leverage ratio has increased 31 basis points (Figure 33: Note the different scales on the left and right axes).[33] From the third quarter to the fourth, all of these ratios rose slightly.

*Figure 33*
Regulatory Capital – Large Organizations




Community banks nationally had equity-to-assets and risk-based capital ratios falling and tier 1 leverage ratios increasing. Since last year, the equity-to-assets ratio at national community banks has decreased 9 basis points, the risk-

[30] See Table 8 in the Appendix for a full summary of the data used in this section.

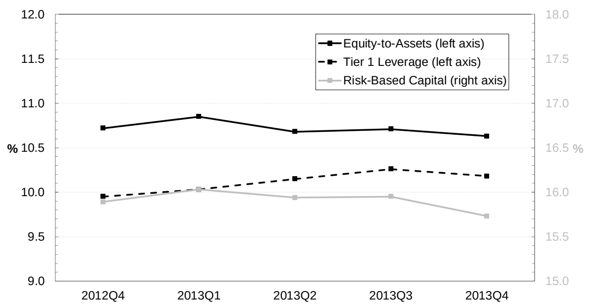
[31] Regulation Y defines capital in terms of zones. Institutions in Zone 1 have tier 1 capital-to-assets ratios above 7 percent, those in Zone 2 are between 6 and 7 percent, and those in Zone 3 have ratios below 6 percent. An institution is considered well capitalized if it is in Zone 1 or 2 and undercapitalized if it is in Zone 3. While total equity capital and tier 1 capital are not identical, in most cases they are close proxies. For further information on capital guidelines, see http://www.federalreserve.gov/bankinforeg/reglisting.htm#Y.

[32] The average ratio of total equity to total assets at all commercial banks from 2002 to 2012 was 10.22 percent. Source: FDIC Historical Statistics on Banking, http://www2.fdic.gov/hsob/index.asp.

[33] Tier 1 leverage and risk-based capital are the two main ratios regulators use to determine if a bank is adequately capitalized. For further information, see the Call Report instructions at http://www.ffiec.gov/forms031.htm.

based capital ratio has decreased 16 basis points, and the tier 1 leverage ratio has increased 23 basis points (Figure 34: Note the different

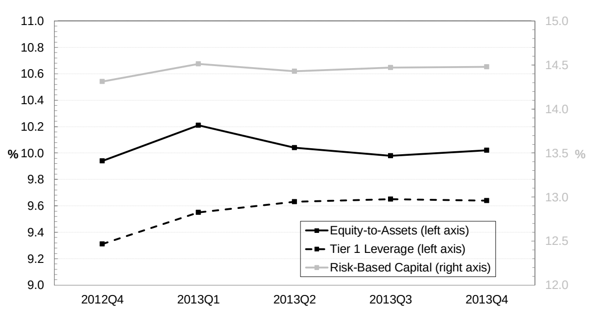
*Figure 34*
Regulatory Capital – All Community Banks




scales on the left and right axes). All of these measures decreased from the third to the fourth quarter.

At local community banks, year over year, the equity-to-assets ratio has risen 8 basis points, the risk-based capital ratio has increased 17 basis points, and the tier 1 leverage ratio increased by 33 basis points (Figure 35: Note the different scales on the left and right axes).

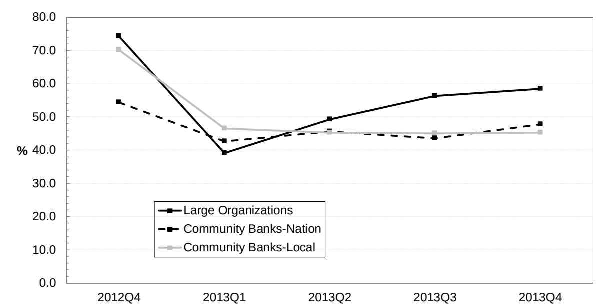
*Figure 35*
Regulatory Capital – Local Community Banks




As was the case last quarter, all categories had substantial unrealized losses on securities, mainly on cash flow hedges. Cash flow hedges are not reported as ordinary income but are reported in the capital accounts.

All categories of banks also had declining levels of both common and preferred stock. These were offset by increases in surplus and retained earnings. The percentage of institutions paying dividends on their stock has increased at all categories of banks, and the dividend payout ratios at all categories except national community banks has fallen substantially year over year, but rose slightly from the third quarter except at local community banks (Figure 36).[34]

*Figure 36*
Dividend Payout Ratios




[34] The dividend payout ratio is defined as the ratio of dividends paid on common and preferred stock to net income.

***Appendix – Data Tables for Each Section***

***Table 1 - Summary of Residential Real Estate Lending***

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| 1. Year-Over-Year Growth | | | |
| Total RRE Loans | -4.3% | 1.1% | 3.0% |
| RRE NPLs | -23.1% | -14.8% | -16.7% |
| RRE NCOs | -56.3% | -47.1% | -53.4% |
| | | | |
| 2. Shares | | | |
| RRE Lns/Total Lns | 31.0% | 29.9% | 25.1% |
| RRE NPLs/Total NPLs | 79.5% | 28.2% | 25.7% |
| RRE NCOs/Total NCOs | 33.6% | 17.0% | 18.8% |
| | | | |
| 3. Performance Ratios | | | |
| RRE NPLs/Total RRE Lns | 7.55% | 1.51% | 1.76% |
| RRE NCOs/Avg RRE Lns | 0.13% | 0.05% | 0.06% |
| | | | |
| 4. Outstandings ($millions) | | | |
| Total RRE Lns | 1,664,383.7 | 21,623.3 | 307,130.0 |
| RRE NPLs | 125,736.2 | 327.1 | 5,410.4 |
| RRE NCOs | 2.202.9 | 10.8 | 193.5 |

***Table 2 - Summary of Commercial Real Estate Lending***

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| 1. Year-Over-Year Growth | | | |
| Total CRE Loans | 3.6% | 11.7% | 7.6% |
| CRE NPLs | -43.0% | -31.9% | -29.9% |
| CRE NCOs | -87.3% | -57.2% | -57.4% |
| | | | |
| 2. Shares | | | |
| CRE Lns/Total Lns | 15.9% | 47.0% | 43.3% |
| CRE NPLs/Total NPLs | 9.7% | 57.4% | 56.0% |
| CRE NCOs/Total NCOs | 2.2% | 48.6% | 41.7% |
| | | | |
| 3. Performance Ratios | | | |
| CRE NPLs/Total CRE Lns | 1.80% | 1.96% | 2.23% |
| CRE NCOs/Avg CRE Lns | 0.02% | 0.10% | 0.08% |
| | | | |
| 4. Outstandings ($millions) | | | |
| Total CRE Lns | 855,264.2 | 33,960.5 | 529,108.8 |
| CRE NPLs | 15,387.8 | 665.7 | 11,779.1 |
| CRE NCOs | 141.3 | 30.9 | 428.2 |

## *Table 3 - Summary of Commercial & Industrial Lending*

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| 1. Year-Over-Year Growth | | | |
| Total C&I Loans | 6.6% | 3.5% | 8.7% |
| C&I NPLs | -26.6% | -20.3% | -17.7% |
| C&I NCOs | -3.3% | -36.8% | -37.1% |
| | | | |
| 2. Shares | | | |
| C&I Lns/Total Lns | 23.4% | 13.5% | 16.4% |
| C&I NPLs/Total NPLs | 4.0% | 11.0% | 11.4% |
| C&I NCOs/Total NCOs | 10.8% | 30.0% | 32.9% |
| | | | |
| 3. Performance Ratios | | | |
| C&I NPLs/Total C&I Lns | 0.50% | 1.31% | 1.20% |
| C&I NCOs/Avg C&I Lns | 0.06% | 0.20% | 0.18% |
| | | | |
| 4. Outstandings ($millions) | | | |
| Total C&I Lns | 1,257,558.4 | 9,727.9 | 200,350.4 |
| C&I NPLs | 6,350.4 | 127.3 | 2,403.2 |
| C&I NCOs | 706.6 | 19.1 | 338.0 |

## *Table 4 - Summary of Consumer Lending*

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| 1. Year-Over-Year Growth | | | |
| Total Consumer Loans | 2.8% | 2.7% | 4.8% |
| Consumer NPLs | -6.3% | 3.0% | 19.9% |
| Consumer NCOs | -13.3% | -24.0% | -2.5% |
| | | | |
| 2. Shares | | | |
| Consumer Lns/Total Lns | 13.8% | 3.7% | 4.3% |
| Consumer NPLs/Total NPLs | 4.9% | 1.2% | 2.1% |
| Consumer NCOs/Total NCOs | 51.6% | 6.5% | 10.3% |
| | | | |
| 3. Performance Ratios | | | |
| Cons NPLs/Total Cons Lns | 1.05% | 0.52% | 0.85% |
| Cons NCOs/Avg Cons Lns | 0.47% | 0.16% | 0.21% |
| | | | |
| 4. Outstandings ($millions) | | | |
| Total Consumer Lns | 740,057.0 | 2,638.2 | 52,579.5 |
| Consumer NPLs | 7,761.2 | 13.6 | 448.1 |
| Consumer NCOs | 3,385.2 | 4.1 | 106.2 |

### *Table 5 - Provision for Loan Losses and Loan-Loss Reserves*

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| Loan-Loss Reserve ($millions) | 89,109.8 | 1,031.7 | 19,602.5 |
| Change from Last Quarter | -19.3% | -13.8% | -10.8% |
| Change from Last Year | -18.8% | -4.7% | -6.2% |
| Net Charge-Offs/LL Provision | 222.6% | 184.0% | 163.6% |
| LL Provision/Operating Inc. | 2.66% | 3.01% | 3.07% |
| Loan-Loss Coverage Ratio | 56.3% | 89.0% | 93.3% |

### *Table 6 - Summary of Securities Portfolios*

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| Securities/Assets | 20.4% | 21.5% | 23.1% |
| Market Value ($millions) | 2,201,432.2 | 22,897.5 | 446,010.9 |
| Change from Last Quarter | 7.4% | 0.2% | 1.4% |
| Change from Last Year | -2.3% | 2.8% | 1.8% |
| Realized Gain/Loss | 437.8 | 9.2 | 4.1 |
| Pct of Average Securities | 0.02 | 0.04 | 0.00 |
| Market Value/Book Value | 99.6% | 98.6% | 98.8% |

### *Table 7 - Structure of Liabilities*

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| Deposits ($millions) | 8,209,894.2 | 88,339.4 | 1,026,569.0 |
| Pct of Assets | 75.8% | 82.7% | 83.6% |
| Change from Last Quarter | 6.6% | 1.7% | 8.10% |
| Change from Last Year | 4.1% | 2.0% | 2.75% |
| Core Deposits/Deposits | 34.9% | 64.8% | 63.5% |
| Implicit Rate on Deposits | 0.27% | 0.57% | 0.55% |
| Nondeposit Debt ($millions) | 923,287.2 | 6,829.5 | 98,807.7 |
| Pct of Assets | 8.5% | 6.4% | 5.1% |
| Change from Last Quarter | -9.7% | 104.8% | 20.5% |
| Change from Last Year | -4.9% | 25.7% | 11.5% |
| Implicit Rate on Debt | 1.40% | 1.78% | 1.79% |

***Table 8 - Capitalization Measures***

| | Large Organizations | Community Banks | |
|---|---|---|---|
| Ratios | Nation | Tri-State Area | Nation |
| Total Equity/Total Assets | 10.98% | 10.02% | 10.63% |
| Change fr Last Qtr (basis pts) | 10 | 4 | -8 |
| Change fr Last Yr (basis pts) | 2 | 8 | -9 |
| Tier 1 Leverage Ratio | 8.87% | 9.64% | 10.18% |
| Change fr Last Qtr (basis pts) | 3 | -1 | -8 |
| Change fr Last Yr (basis pts) | 31 | 33 | 23 |
| Risk-Based Capital Ratio | 14.25% | 14.48% | 15.73% |
| Change fr Last Qtr (basis pts) | -5 | 1 | -22 |
| Change fr Last Yr (basis pts) | -20 | 17 | -16 |