BANKING BRIEF

FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

First Quarter 2014 Highlights

- *Year over year, profitability (ROA) continued to improve at community banks but was flat at large organizations. Quarterly, ROA was nearly flat in all categories of banks.*

- *Year over year, total loans grew at an accelerating rate at community banks and more modestly at large organizations. Most of the loan growth at large organizations was in commercial loans, with real estate loans continuing to shrink. Smaller banks saw an increase in all categories of loans, with commercial loans growing the fastest nationally and real estate loans leading locally.*

- *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 was particularly strong at community banks nationally, while it 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 at all categories of banks.*

- *Loan-loss coverage increased at all categories of banks despite decreases in both loan loss provisions and reserves. It is still below historical norms at large organizations but near normal at community banks.*

- *Deposit growth increased somewhat from the fourth quarter, and community banks continued to increase their reliance on nondeposit funding sources to fund their rapid loan growth.*

- *New capital regulations began to be phased in at some large organizations. Smaller banks will be subject to them next year.*

Any questions or comments should be directed to Jim DiSalvo at 215-574-3820 or at jim.disalvo@phil.frb.org. Detailed documentation on the methodology used in constructing this document, back issues, and the current issue of *Banking Brief* are available on our website at www.philadelphiafed.org/research-and-data/publications/banking-brief. To subscribe to this publication, please go to www.philadelphiafed.org/philscriber/user/dsp_content.cfm.

Summary Table of Bank Structure and Conditions — First Quarter 2014

Community Banking Organizations

	Nation $ Bill	% Change From		*Tri-State* $ Bill	% Change From	
	14Q1	**13Q4**	**13Q1**	**14Q1**	**13Q4**	**13Q1**
Total Assets	1,992.8	11.52	6.48	108.6	6.59	6.10
Total Loans	1,256.2	9.64	9.69	74.1	10.34	8.75
C&I	208.4	15.65	12.88	9.9	6.00	3.10
Real Estate	922.0	11.30	8.95	58.0	11.92	10.48
Consumer	51.7	-2.29	5.66	2.7	2.37	4.22
Total Deposits	1,666.1	12.08	6.10	89.6	5.90	4.79
Ratios (in %)	**14Q1**	**13Q4**	**13Q1**	**14Q1**	**13Q3**	**12Q4**
Net Income/Avg Assets (ROA)	0.97	0.97	0.85	0.83	0.82	0.69
Net Interest Inc/Avg Assets (NIM)	3.37	3.35	3.36	3.18	3.17	3.25
Noninterest Inc/Avg Assets	0.94	0.97	1.00	1.25	1.29	1.30
Noninterest Exp/Avg Assets	3.02	3.03	3.08	3.18	3.20	3.27
Loans/Deposits	75.40	75.82	72.93	82.72	81.87	79.71
Equity/Assets	10.78	10.63	10.85	10.10	10.02	10.20
Nonperforming Loans/Total Loans	1.68	1.73	2.34	1.52	1.61	2.12

Large Organizations

	Nation $ Bill	% Change From	
	14Q1	**13Q4**	**13Q1**
Total Assets	10,966.3	4.98	3.59
Total Loans	5,398.9	2.46	3.32
C&I	1,265.4	2.73	5.29
Real Estate	2,592.3	-1.17	-1.07
Consumer	732.4	-4.37	3.98
Total Deposits	8,287.4	3.95	5.02
Ratios (in %)	**14Q1**	**13Q4**	**13Q1**
Net Income/Avg Assets (ROA)	0.93	0.97	0.96
Net Interest Inc/Avg Assets (NIM)	2.45	2.47	2.57
Noninterest Inc/Avg Assets	1.70	1.78	1.84
Noninterest Exp/Avg Assets	2.69	2.71	2.81
Loans/Deposits	65.15	65.38	66.21
Equity/Assets	11.03	10.98	11.07
Nonperforming Loans/Total Loans	2.74	2.95	3.81

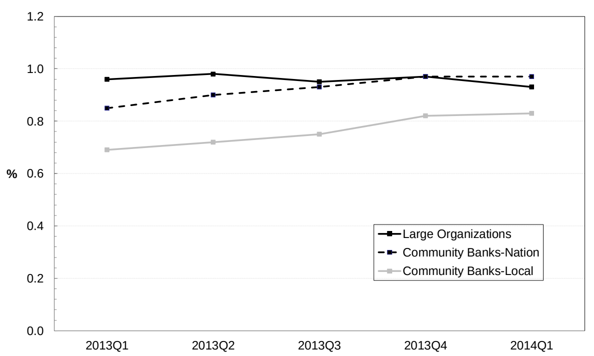
Unless otherwise noted, all data are from Federal Financial Institutions Examination Council call reports. The data are adjusted for mergers. Quarterly percentage changes are compound annualized rates except where noted. A banking organization is an independent bank or all the banks within a highest-level 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 U.S. as of December 31, 2013. 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 — 165 for the tri-state area and 5,101 for the nation; (2) large banking organizations — 101 for the nation. Ratios are aggregates; that is, the numerators and denominators are summed across all banks in the group then divided.

First Quarter 2014

Profitability at community banks continued to grow year over year, but it was practically flat at large organizations.[1] Also, growth in profitability leveled off from the fourth to the first quarter. Return on average assets (ROAA) at community banks has now nearly returned to historical norms, so some slowing in its growth is to be expected.[2] The number of firms showing positive net income increased at all categories of banks.[3] At large organizations, ROAA decreased 3 basis points from the first quarter of 2013, to 0.93 percent (Figure 1).[4] From the fourth quarter of 2013 to the first quarter of 2014, there was a decrease of 4 basis points.

Figure 1

Return on Average Assets



There are multiple reasons for the lack of growth in profits at large organizations. First, loans are not growing very rapidly, while net interest margins are shrinking. Second, noninterest income has shrunk as well. This is due to decreasing asset sales, trading income, and smaller realized gains on securities.

At community banks nationally, ROA was 0.97 percent, up 12 basis points from last year but flat from the fourth quarter. Local banks saw increases of 14 basis points for the year but only 1 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 behind other banks in the nation for several quarters now.[5] In the past, this was due to higher loan growth, which led to more loan losses and consequently more provisioning. This higher loan growth did allow local banks to overcome net interest margins that were lower than community banks nationally. However, in the first quarter, both year-to-year and quarterly loan growth at community banks nationally exceeded that of local banks in the first quarter. Local banks still had lower net interest margins due to their funding mix, which is more heavily dependent on relatively expensive nondeposit debt (see "Funding Sources" on page 14). In addition, banks in the region continued to have high expense ratios.

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

[1] Unless otherwise mentioned, all data used in this report are from Federal Financial Institutions Examination Council (FFIEC) call reports. Also, unless otherwise mentioned, all growth rates and changes in ratios or amounts are annual, that is, from the first quarter of 2013 to the first quarter of 2014. Finally, unless otherwise noted, any quarterly percentage changes are compound annual rates.

[2] 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.

[3] Out of 5,101 community banks in the national sample, 4,769 reported positive quarterly profits. This was an increase of 288 from the fourth quarter of 2013. Locally, 154 out of 165 banks reported positive profits, an increase of eight from the fourth quarter of 2013. For large organizations, 100 out of 101 were profitable, up three from the previous quarter.

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

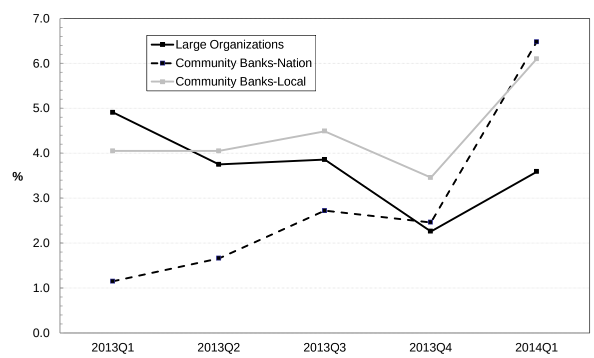
[5] This is a long-term trend. Looking back to the mid-1990s, local community banks had lower annual ROAAs than community banks nationally most of the time.

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.

Year over year, assets of community banks nationally grew nearly 6.5 percent, while asset growth at local community banks was 6.1 percent (Figure 2). At large organizations, asset growth was 3.6 percent. Quarterly growth increased substantially at all categories of banks.

Figure 2

Year-Over-Year Asset Growth

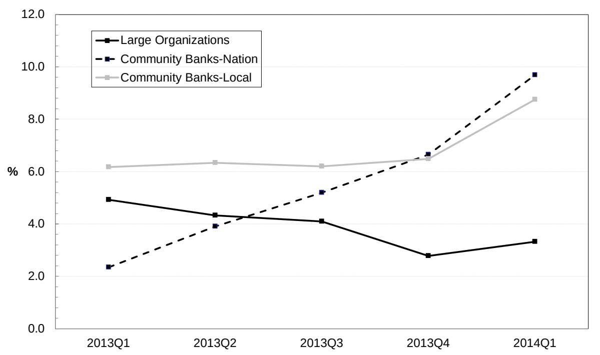


The year-over-year growth in assets was fueled mainly by increases in loans as growth in banks' securities portfolios slowed. Loans increased 3.3 percent at large organizations, 9.7 percent at community banks nationally, and 8.8 percent at local community banks (Figure 3). The reported value of securities increased only 1.1 percent at large organizations, 2.7 percent at community banks nationally, and 0.6 percent at local community banks.[6] This increase in lending is widespread, that is, not concentrated in only a few geographic regions of the country.

At large organizations, most total loan growth was due to commercial and industrial (C&I) lending, while real estate loans decreased slightly. C&I loans grew 5.3 percent, consumer loans grew 4.0 percent, and real estate lending shrank about 1.1 percent. At community banks, loans grew at different rates both nationally and locally. Nationally, C&I lending grew at a rate of 12.9 percent, real estate lending grew 8.9 percent, and even consumer lending grew at a respectable 5.7 percent. Locally, most of the growth was in real estate lending, which grew 10.5 percent, while C&I lending only grew 3.1 percent and consumer lending grew 4.2 percent.

Figure 3

Year-Over-Year Loan Growth



The main factor driving the growth of real estate loans at community banks was CRE loans, but RRE lending also showed stronger growth. Community banks both locally and nationally have a much higher percentage of their real estate loans in CRE lending, while large organizations concentrate on RRE loans (see "Residential Real Estate Lending" on page 6 and "Commercial Real Estate Lending" on page 8, and Tables 1 and 2 in the Appendix).

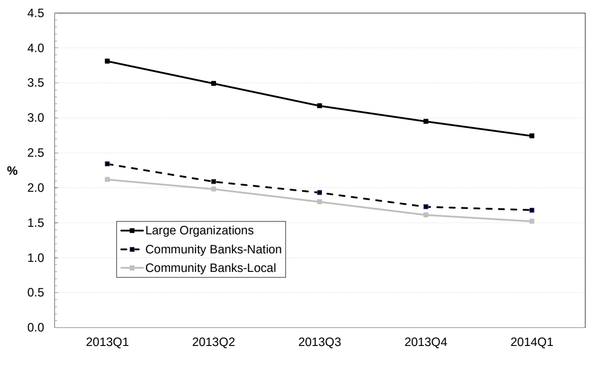
Loan quality continued to improve at all categories of banks. At large organizations, the ratio of NPLs to total loans (the NPL ratio) decreased by nearly 1.1 percentage points from last year to 2.74 percent (Figure 4).[7]

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

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

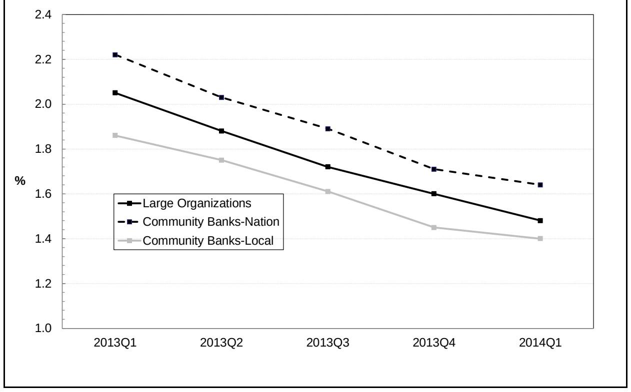
Community banks showed similar decreases, and their NPL ratios were much lower than those of large organizations to begin with. At community banks nationally, the NPL ratio has decreased 66 basis points since last year, to 1.68 percent. Locally, the NPL ratio fell by 60 basis points, to 1.52 percent.

Figure 4
Nonperforming Loans/Total Loans



Overall, asset quality has also improved at all categories of banks.[8] Foreclosed real estate, known as other real estate owned (OREO), decreased from last year at all categories of banks. At large organizations, OREO decreased by 3.1 percent. At community banks, the decrease was 15.3 percent nationally and 8.4 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).[9]

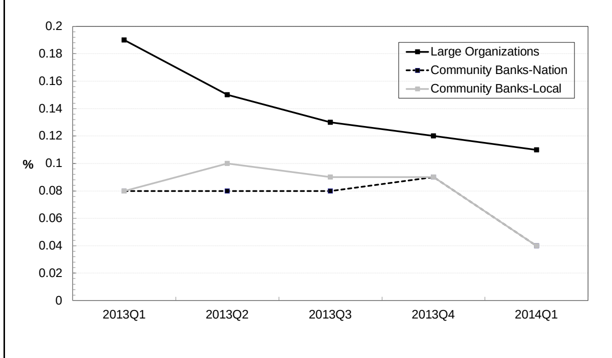
Figure 5
Nonperforming Assets/Total Assets



At large organizations, the NPA ratio has fallen 53 basis points in the past year, to 1.48 percent. At community banks nationally, the decrease was 58 basis points, to 1.64 percent, and locally the NPA ratio fell 46 basis points, to 1.40 percent.

NCOs tell a similar story, with all categories of banks experiencing significant decreases.The ratio of NCOs to average loans (the NCO ratio) fell 8 basis points over the year at large organizations, to 0.11 percent (Figure 6).

Figure 6
Quarterly Net Charge-Offs/Average Loans



Community banks both locally and nationally continued to have a lower NCO ratio than the large organizations. For community banks nationally, the NCO ratio has fallen 4 basis points over the year, to 0.04 percent. At tri-state area community banks, the NCO ratio has also fallen 4 basis points over the past year, to 0.04 percent. It is highly likely that these

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

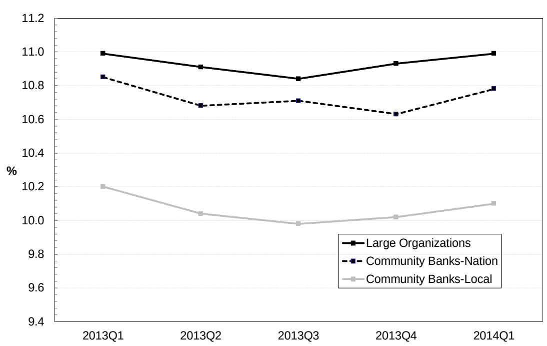
[9] Loan quality refers to NPLs only, while asset quality refers to NPAs. These are the sum of NPLs and OREO. For historical perspective, the average ratio of NPAs to total assets for all commercial banks between 2002 and 2012 was 1.56 percent. At the bottom of the last real estate cycle in 1991, this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

drops in both the NCO ratio and total NCOs at all categories of banks are at least partly due to noise in the data. Data on NCOs, particularly at community banks, tend to be very noisy.

Capital ratios, defined as the ratio of total equity to assets, were basically flat at both large organizations and community banks (Figure 7). This quarter brought the first phase of significant changes to the capital regulations (see "Regulatory Capital" on page 16). Only a small number of large institutions are affected initially, but the new regulations will apply to all banks next year.

There were only five bank failures in the first quarter. Also, one bank has failed since March 31 as well. None of the failures has involved a tri-state area bank. There were 25 total failures in 2013.

Figure 7
Equity-to-Assets Ratios

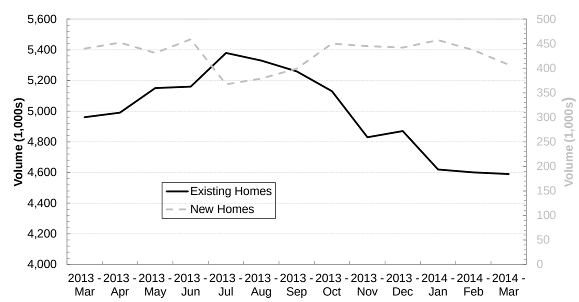


Residential Real Estate Lending[10]

The nationwide and local RRE markets continued their modest recovery in the first quarter, although the unusually severe winter in much of the country appears to have hampered growth. As of April 16, 2014, the Federal Reserve Board's *Beige Book* reported that sales of existing homes increased moderately in some Federal Reserve Districts but not in others. Philadelphia and North Jersey reported slower growth than the rest of the nation.[11] It also reported that construction, for the most part, was severely affected by the winter weather. However, many builders are anticipating large increases in activity due to pent-up demand.

By most measures, local real estate markets are underperforming. The *Beige Book* reported that sales of existing homes shrank slightly (except along the New Jersey shore) from last year, but construction is up. Northern New Jersey reported that home prices are still being restrained by a sizable backlog of foreclosed and distressed properties.

Figure 8
Sales of New and Existing Homes



Sales of both new and existing homes are down from last year, and existing home sales have been declining for three quarters (Figure 8: Note the different scales on the left and right axes).[12] The severe winter weather clearly affected new home sales, which were rising until winter set in. The percentage of delinquent mortgages decreased nearly 1.2 percentage points from a year ago, and the percentage of

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

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

[12] Sales of existing homes dropped about 340,000 units from March 2013 to March 2014. For the entire first quarter, sales were down about 970,000 units from 2013 to 2014. New home sales also decreased by about 33,000 units from March 2013 to March 2014. For the quarter, new home sales decreased by about 40,000 units.

mortgages in foreclosure has decreased 90 basis points (Figure 9).

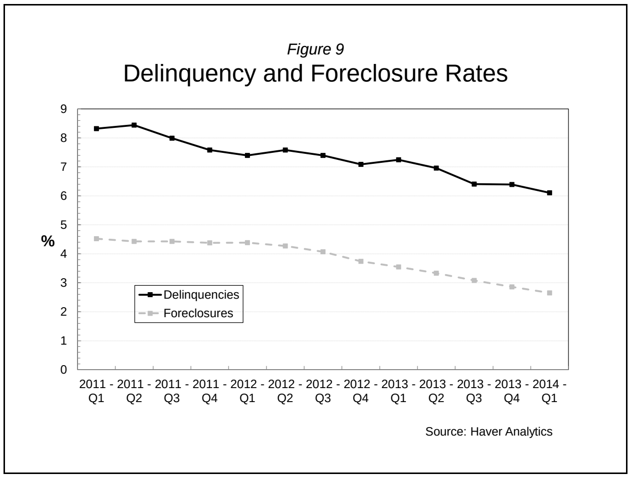


Figure 9
Delinquency and Foreclosure Rates

Total RRE loans outstanding decreased from last year as increases in lending at community banks were offset by larger decreases at the large organizations (Figure 10). In sum, RRE loans declined over the last year. From the first quarter of 2013 to the first quarter of 2014, RRE loans outstanding grew at a rate of 8.9 percent at community banks nationally and 4.6 percent

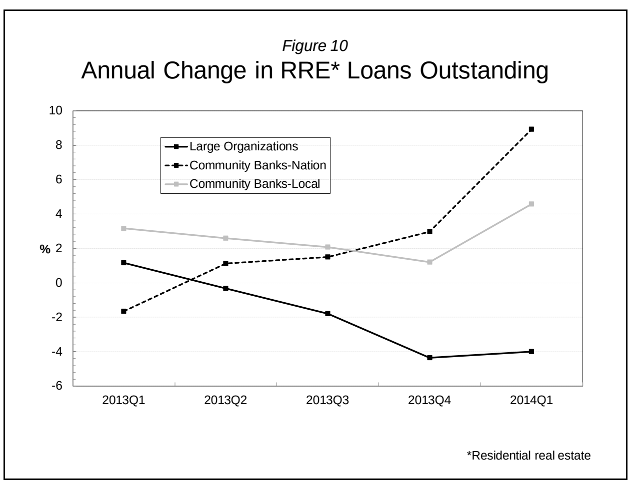


Figure 10
Annual Change in RRE* Loans Outstanding

locally. Community banks nationally and locally showed even stronger growth from the fourth to the first quarter. In both cases, nearly all of the growth in RRE loans was due to mortgages secured by first liens. At large organizations, loans shrank 4.6 percent year over year and 4.0 percent in the quarter.

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 1.9 percentage points, to 7.14 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

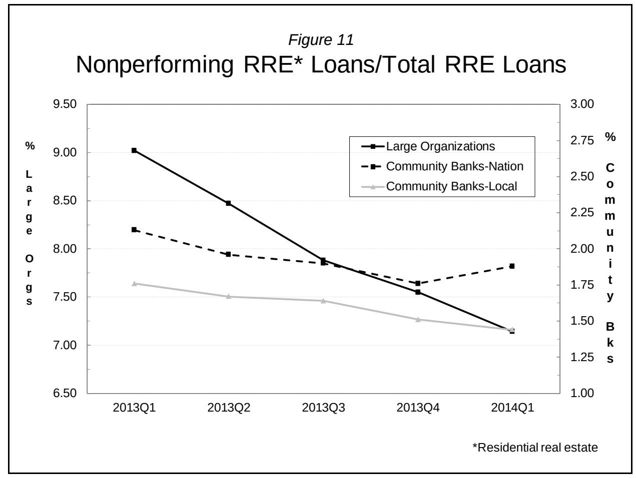


Figure 11
Nonperforming RRE* Loans/Total RRE Loans

much better RRE loan quality, with NPL ratios of 1.88 percent nationally and 1.44 percent locally. These represent drops of 26 and 32 basis points, respectively, in the past year, but community banks nationally did show an

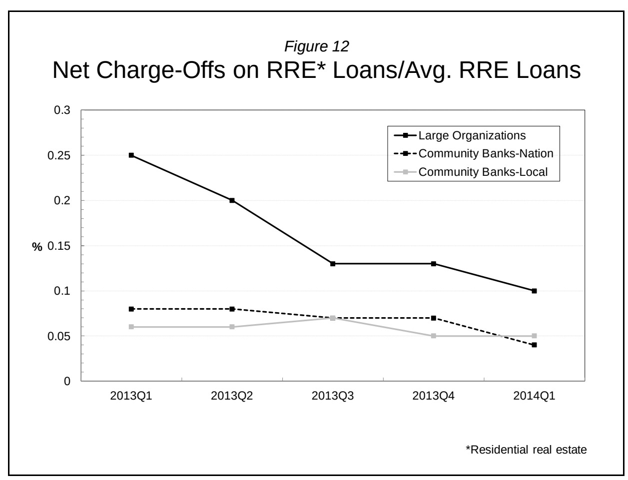


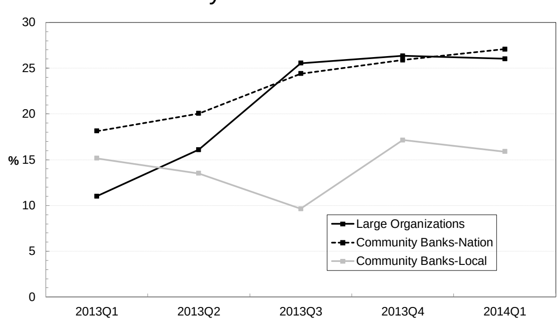
Figure 12
Net Charge-Offs on RRE* Loans/Avg. RRE Loans

increase of 11 basis points from the fourth to the first quarter.

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 15 basis points, to 0.10 percent in the past year (Figure 12).

At community banks, the RRE NCO ratio has decreased 4 basis points nationally in the past year, to 0.04 percent, and fell 1 basis point locally at 0.05 percent. In the cases of community banks both nationally and locally, charge-offs and recoveries both decreased. At large organizations, charge-offs decreased, and recoveries increased. Recovery ratios have increased at all categories of banks in the past year (Figure 13).

Figure 13
Recovery Ratio on RRE Loans



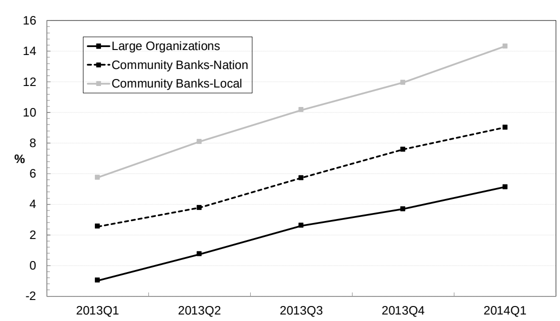
*Residential real estate

Commercial Real Estate Lending[13]

Commercial real estate (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, but with increases in commercial construction in some areas. Demand for leased commercial space picked up in many areas. Most areas reported that the severe winter weather had a negative impact on CRE lending in the beginning of the year. For the most part, in the Philadelphia district, there was modest growth in commercial leasing activity, particularly at commercial warehouses. North Jersey was somewhat worse off, with little growth in leases and construction limited to renovations and improvements on existing properties due to a continued backlog of foreclosed properties. Also, vacancy rates remain high.

CRE lending results improved in the first quarter, with both loan growth and quality and growth 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 5.1 percent at large organizations, 9.0 percent at community banks nationally, and 14.3 percent at tri-state-area community banks (Figure 14). The strongest area of growth was in loans on multifamily properties, but other areas showed solid growth as well.

Figure 14
Annual Change in CRE* Loans Outstanding



*Commercial real estate

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 1.4 percentage points from the first quarter of 2013, to 1.61 percent (Figure 15). The CRE NPL ratio decreased nearly 1.1 percentage points at community banks nationally from last year, to 2.05 percent, and nearly 1 percentage point at community banks locally, to 1.80 percent.

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

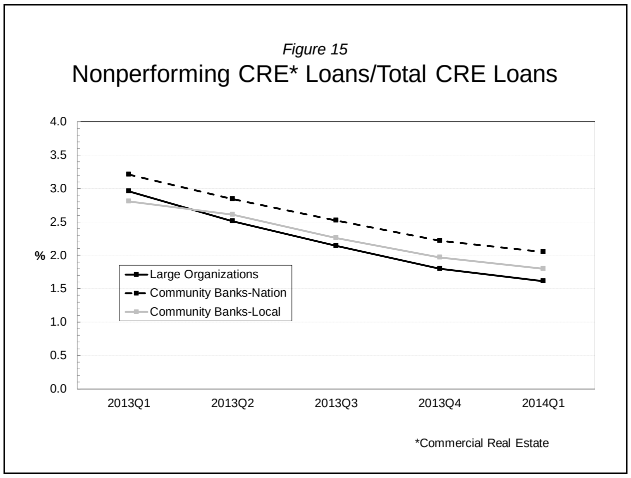


Figure 15
Nonperforming CRE* Loans/Total CRE Loans

NCO ratios have decreased at all categories of banks as well. As of March 31, the NCO ratio on CRE loans at large organizations decreased more than 8 basis points, to near zero. At community banks nationally, there was a decrease of 6 basis points, to 0.03 percent, and a decrease of 7 basis points locally, to 0.03 percent (Figure 16). It is difficult to see

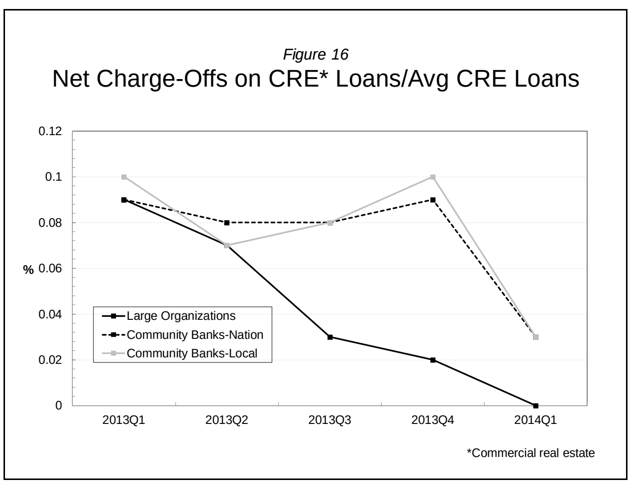


Figure 16
Net Charge-Offs on CRE* Loans/Avg CRE Loans

how these low NCO ratios can be sustained. While total NPLs have been decreasing at a substantial rate, NCOs have fallen much faster. This is not due to increased recoveries.[14] Either the banks believe that a substantial portion of their NPLs can become earning assets again or they will have increased charge-offs in the future.

As noted previously, much of the growth in CRE lending can be attributed to loans on multifamily housing (Figure 17). Community banks in general saw double-digit growth in multifamily loans; this was especially true at local community banks, where loans outstanding have grown more than 65 percent in the past year. Growth at large organizations wasn't as great but is still fairly strong.

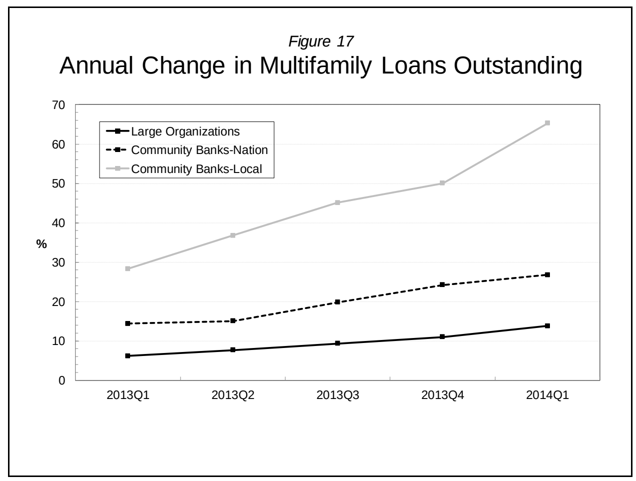


Figure 17
Annual Change in Multifamily Loans Outstanding

This growth in multifamily housing is concentrated in two areas. First, there has been a lot of construction and conversions in New Jersey, particularly northern New Jersey. There is also substantial conversion activity in the Philadelphia and northern New Jersey areas, where, according to the last several *Beige Books*, 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, but they are well below those for all CRE loans (Figure 18).

[14] Total NPLs had a year-to-year decrease of 43 percent at large organizations, 30 percent at community banks nationally, and 27 percent at local community banks. At the same time, NCOs fell 94 percent at large organizations, 61 percent at community banks nationally, and 64 percent locally.

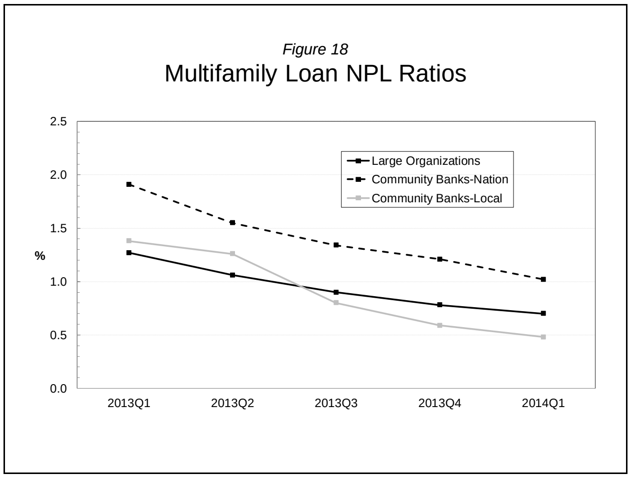


Figure 18
Multifamily Loan NPL Ratios

Even though they have been growing at a high rate recently, multifamily loans still make up a small part of total CRE lending.[15] 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. Commercial mortgage quality has improved significantly in the past year. At large organizations, the NPL has decreased 94 basis points, to 1.60 percent. At community banks nationally, the ratio has decreased 77 basis points, to 1.84 percent, and at community banks locally, the ratio has decreased 58 basis points, to 1.78 percent (Figure 19). NCOs on these loans have also dropped substantially in the last year.

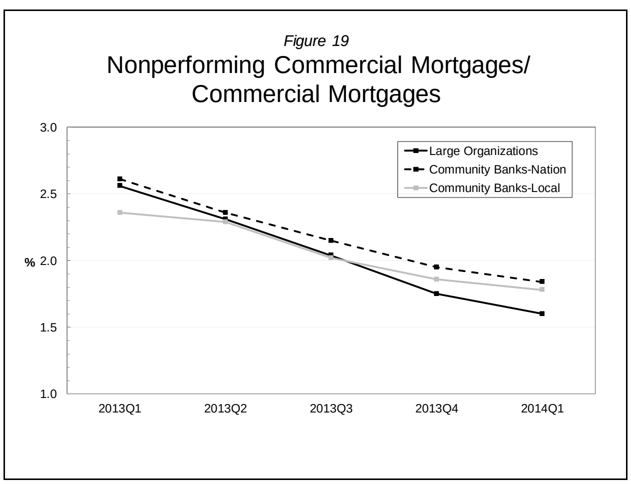


Figure 19
Nonperforming Commercial Mortgages/
Commercial Mortgages

Construction lending, which for the past several years has been a drag of CRE lending, both in terms of growth and quality, has improved dramatically in the past quarter. In terms of growth, construction loans grew 6.4 percent at large organizations, 7.8 percent at community banks nationally, and 7.7 percent at local community banks. The quality of construction loan portfolios has improved substantially as well, but it is still the weakest of the categories of CRE loans as NPL ratios have remained high. The construction loan NPL ratio for large organizations has dropped 4.3 percentage points in the last year, to 2.81 percent (Figure 20). Community banks have experienced similar drops — nearly 3.2 points nationally, to 3.86 percent, and 3.7 points locally, to 4.12 percent.

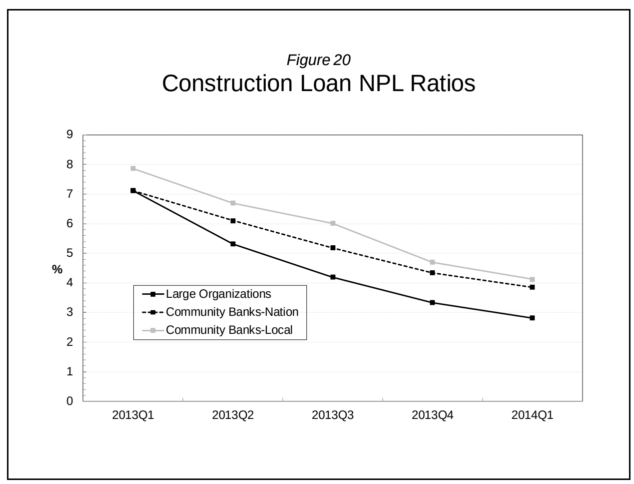


Figure 20
Construction Loan NPL Ratios

Commercial & Industrial Lending[16]

C&I lending continued to grow at a good pace at community banks nationally and at large organizations, but growth has been more modest

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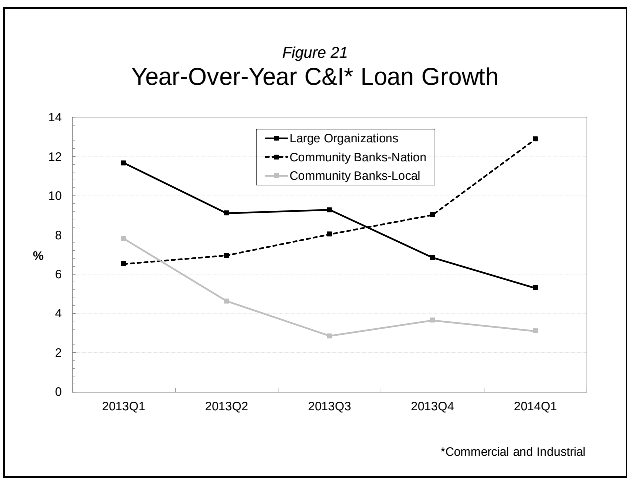
[15] At local community banks, 73.8 percent of CRE loans are commercial mortgages, 16.5 percent are multifamily loans, and 9.7 percent are construction loans.

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

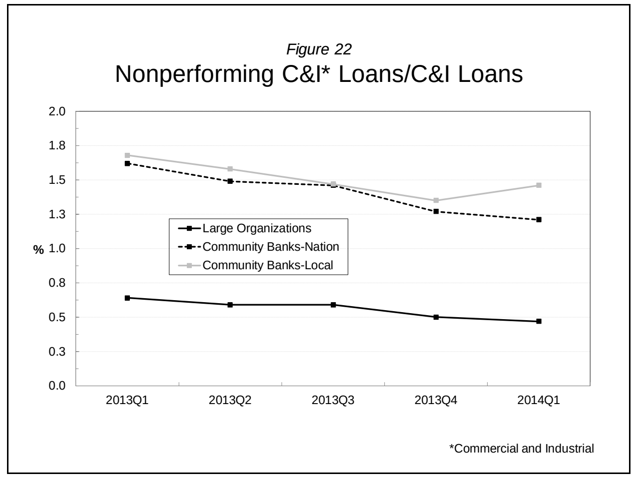
at local community banks. At large organizations, C&I loans grew 5.3 percent in the past year (Figure 21 and Table 3 in the Appendix). Both the annual and quarterly growth rates at these organizations have slowed for each of the past four quarters. At community banks, C&I lending grew 12.9 percent nationally and 3.1 percent locally. Growth at community banks nationally has been increasing every quarter for the past year.

The Federal Reserve Board's *Senior Loan Officer Opinion Survey* for April 2014 reported that loan demand had for the most part increased modestly, with slightly more respondents reporting an increase in demand than those reporting weaker demand.[17] This was true regardless of firm size. On the supply side, most firms reported they had eased loan terms on all sizes of firms, including reducing the cost of credit lines, decreasing use of interest rate floors, easing loan covenants, and reducing risk



premiums. The main reason cited for easing standards was increased competition from both banks and nonbank lenders. A much smaller percentage of lenders reported easing standards due to a more favorable economic outlook.

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 17 basis points in the past year, to 0.47 percent. Quality is somewhat worse at community banks, with NPL ratios of 1.21 nationally and 1.46 locally. Again, both of these ratios fell substantially in the past year, but the ratio at local banks increased 11 basis points from the fourth to the first quarter.

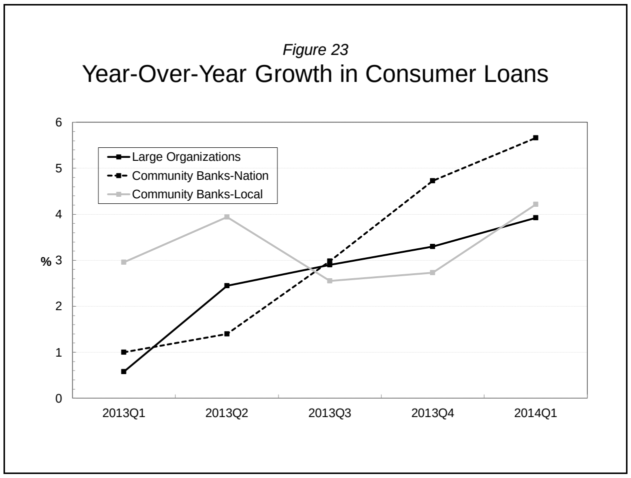


Consumer Lending[18]

Overall, consumer lending continued to strengthen in the first quarter, with modest growth and relatively few quality problems. Large organizations conduct the vast majority of consumer lending. Their consumer lending grew about 4.0 percent year over year (Figure 23). At community banks nationally, consumer lending grew 5.7 percent, while at community banks locally, consumer lending grew 4.2 percent. At both large organizations and community banks nationally, consumer loans shrank from the fourth to the first quarter. This may be seasonal, however, with both the end of the holiday season and the severe winter hampering consumer purchases. At large organizations, the main area of growth in consumer lending was in auto loans, with nearly every other category of

[17] For further information, see http://www.federalreserve.gov/boarddocs/snloansurvey/201405/default.htm.

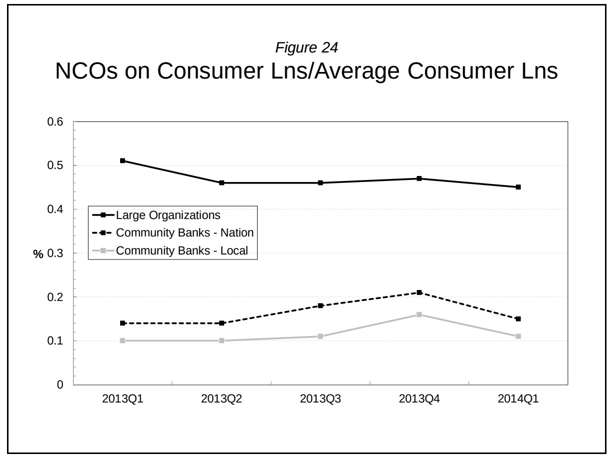
[18] See Table 4 in the Appendix for a full summary of the data used in this section.



loan flat or shrinking.[19] At community banks locally and nationally, growth was in "other revolving credit (i.e., revolving credit not due to credit cards)." Nationally, growth was in credit card loans.

NPL ratios on consumer loans have been low: 1.00 percent for large organizations, 0.91 percent for community banks nationally, and 0.51 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.[20] NCO ratios fell somewhat at large organizations, and they were basically flat at community banks both nationally and locally (Figure 24). For large organizations, the ratio fell 6 basis points, to 0.45 percent. For community banks, the ratio rose 1 basis point, to 0.15 percent nationally, and locally the ratio rose 1 basis point, to 0.11 percent.



Provisioning and Reserves[21]

Banks continued to ease up on their provisioning and reserves in response to falling NPLs and charge-offs. Loan loss reserves have fallen substantially in the past year at all categories of banks.[22] Loan-loss provisions also have decreased substantially, both overall and as a percentage of operating income.

The ratio of loan-loss provision to operating income fell almost 1.9 percentage points, to 3.03 percent, at large organizations, although it has increased over the past several quarters. At community banks nationally, the ratio has decreased nearly 1.6 percentage points, to 2.47

[19] 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.

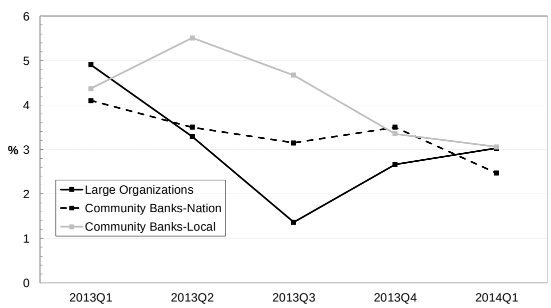
[20] The breakdown of consumer loans is as follows: At large organizations — credit cards, 33.5 percent; other revolving credit, 7.0 percent; auto loans, 36.6 percent; other consumer loans, 23.0 percent; at community banks nationally — credit cards, 3.3 percent; other revolving credit, 4.6 percent; auto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

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

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

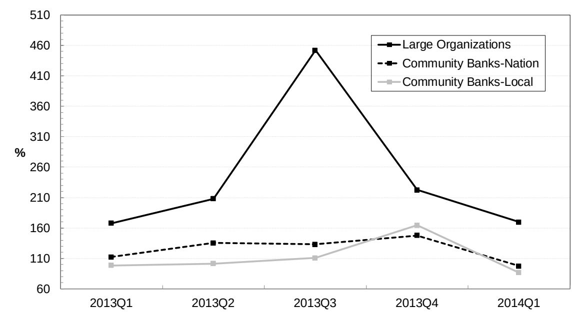
percent, and it fell 1.3 percentage points, to 3.06 percent, at local community banks (Figure 25).[23] It should be noted that in each category this ratio is somewhat bumpy, rising in some quarters and falling in others. However, the overall trend is downward at all categories of banks.

Figure 25
Loan-Loss Provision/Operating Income



As noted previously, the falling loan-loss provisions and consequent decreases in reserves can be justified as a reaction to improving loan quality. At community banks, the ratio of NCOs to loan-loss provision was within or below historical norms for the first time in a while, but it remains high at large organizations (Figure 26).[24]

Figure 26
Net Charge-Offs/Loan-Loss Provision



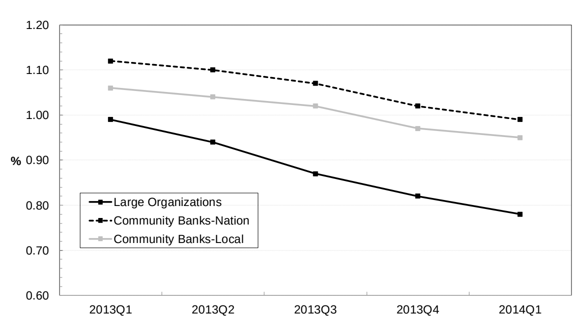
Large organizations saw this ratio basically stay flat, increasing from 168 percent to 169 percent since last year, although it has been dropping for the past three quarters. At community banks, the ratios are somewhat lower, and they have improved both from last year and from the fourth quarter. The NCOs to loan-loss provision ratio has decreased about 15 percentage points, to 97.1 percent, at community banks nationally. At local community banks, the ratio decreased about 12 percentage points, to 86.5. All community banks had large quarterly decreases in this ratio as well.

The decrease in provisioning has resulted in a drop in overall reserves, particularly at large organizations. Total loan-loss reserves fell 5.5 percent at community banks nationally, approximately 4.5 percent at local community banks, and almost 18 percent at large organizations. As a percent of total assets, reserves have decreased from last year in all categories of banks, though the drop was smaller at community banks (Figure 27). At large organizations, the ratio has fallen 21 basis points since last year, to 0.78 percent. At community banks, the drop was 13 basis points nationally and 11 basis points locally.

[23] 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.

[24] 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.

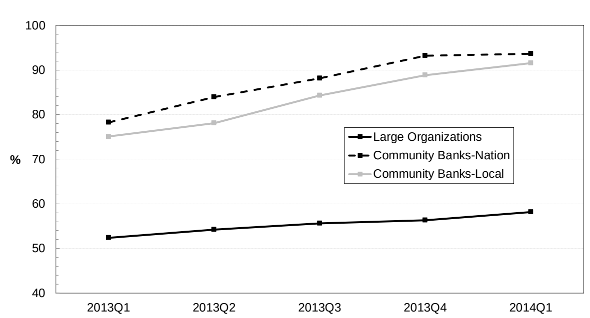
Figure 27
Loan-Loss Reserves/Assets



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 more than 5 percentage points from last year, to 58.1 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

Figure 28
Loan-Loss Coverage Ratio



community banks nationally has increased over 15 percentage points in the past year, to 93.7 percent. Locally, loan-loss coverage increased over 16 percentage points, to 91.6 percent.[25]

Securities[26]

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 somewhat larger gain in value.[27]

All categories of banks saw increases in realized gains on securities.[28] Large organizations posted gains of approximately $586 million. Community banks nationally reported a realized gain of $110.3 million in the quarter. Local community banks reported a realized gain of about $15.4 million.

Funding Sources[29]

Year-over-year deposit growth was relatively strong across 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.

[25] 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.

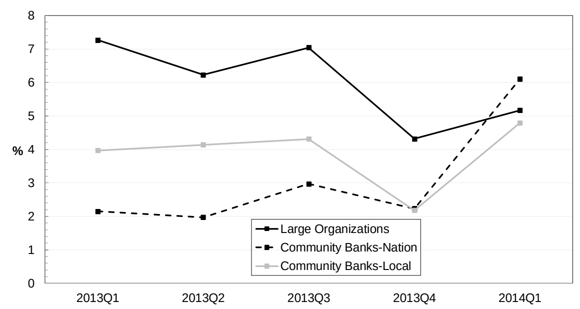
[26] See Table 6 in the Appendix for a full summary of the data used in this section. The figure for percent of assets uses the value of securities as reported on the banks' balance sheet. Securities there are reported at book value if they are held to maturity and at market value if they are available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

[27] 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.

[28] 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.

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

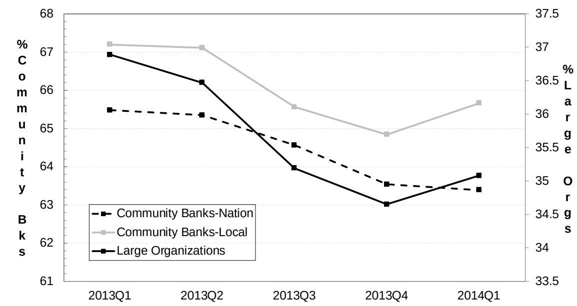
Figure 29
Year-Over-Year Growth in Deposits



Reliance on brokered deposits has grown somewhat at all categories of banks. At large organizations, brokered deposits have increased 14.6 percent from last year, but the quarterly increase was only 1.7 percent. Their share of total deposits has risen from 5.4 to 5.9 percent since last year. At community banks nationally, brokered deposits have decreased 16.3 percent in the past year and 29.6 percent in the first quarter. Their share of total deposits increased from 3.4 to 3.7 percent since last year. At local community banks, brokered deposits are up 126.1 percent in the past year with a quarterly increase of 32.8 percent. Their share of total deposits has increased in the last year by over 1 percentage point, to 5.0 percent.

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 at community banks and not at all at large organizations.[30] Core deposit growth has been slow for at least the past year at all categories of banks, and that is partially due to declining net interest margins. 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

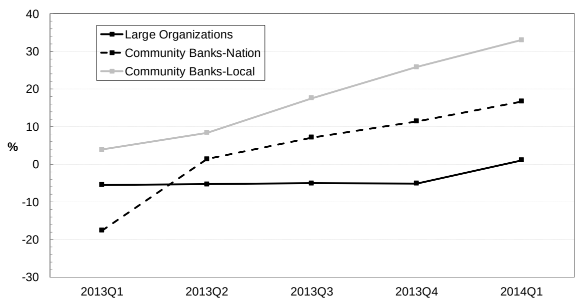


The slow growth in core funding has forced banks, especially community banks, to seek more expensive types of funding in the form of nondeposit debt. Again, this will negatively impact net interest margins. Nondeposit debt funding has been increasing in the past several quarters at community banks both nationally and locally (Figure 31).[31] However, nondeposit debt shrank nationally in the first quarter and was only a fraction of its annual growth rate at local banks (9.8 percent quarterly and 33.1 percent annually). Large organizations saw a fairly large quarterly increase in nondeposit debt funding, but the annual increase was very small. For large organizations, nondeposit debt grew 1.1 percent from the first quarter of 2013 and 18.7 percent from the fourth quarter of 2013.

[30] 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. Year-over-year growth in core deposits was -0.1 percent at large organizations, 2.7 percent at community banks nationally, and 2.4 percent at community banks locally.

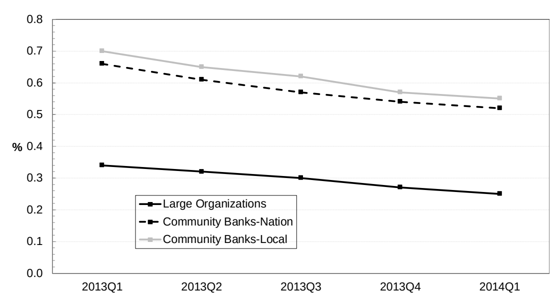
[31] Nondeposit funding consists of fed funds purchased, securities sold under agreements to repurchase (repos), subordinated debt, FHLB advances, and other borrowings.

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 community banks pay both nationally and locally (Figure 32).[32] This holds true for nondeposit funding as well.

Figure 32
Implicit Interest Rate on Deposits



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

Regulatory Capital[33]

The first quarter brought the first phase of the new capital standards intended to implement the Basel III accords. This is an international agreement among banking regulators to harmonize their capital standards and other regulations. The phase implemented this quarter applies only to what are known as "core" banking organizations and their subsidiaries.[34] All other banks will become subject to the new regulation beginning January 1, 2015. Although the initial phase includes only 15 organizations, their assets represent about 65 percent of the total assets of all banks in the sample.

The new rule introduces a new level of capital, called "common equity tier 1," changes the definitions of tier 1 and risk-based capital, changes the risk weights on the denominator of the capital ratios, and has stricter definitions of what an "adequately capitalized" or "well-capitalized" institution is, as well as higher minima for corrective action.[35]

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

[34] "Core" banking organizations are those that have either $250 billion or more in assets or at least $10 billion in on-balance sheet foreign exposures. The banking organizations currently affected are JPMorgan Chase & Co., Bank of America Corp., Citigroup, Wells Fargo & Co., Goldman Sachs Group, Morgan Stanley, Bank of New York Mellon Corp., U.S. Bancorp, PNC Financial Services Group, Capital One Financial Corp., HSBC North America Holdings, State Street Corp., TD Bank US Holding Company, Union BanCal Corp., and Northern Trust Corp.

[35] For a full summary of the regulation, see the Federal Reserve Bank of Philadelphia's *Banking Legislation and Policy*, Second Quarter 2013, at http://www.phil.frb.org/research-and-data/publications/banking-legislation-and-policy/2013/blpq213.pdf. The FDIC has also published two guides for community banks: http://www.fdic.gov/regulations/capital/Community_Bank_Guide.pdf and http://www.fdic.gov/regulations/capital/Community_Bank_Guide_Expanded.pdf.

Common equity tier 1 capital is a more basic measure of capital than the current tier 1. It includes only common stock, surplus, retained earnings, some minority interest stock and perpetual preferred stock, and some accumulated other comprehensive income (AOCI), less most goodwill and unrealized gains on securities, cash flow hedges, tax-deferred assets, and mortgage servicing assets.

In most cases, it probably won't be different from (the new definition of) tier 1 capital. The main difference between common equity tier 1 and the current definition of tier 1 is the inclusion and calculation of AOCI (especially for large organizations) and the treatment of unrealized gains and losses (i.e., how much has to be deducted).

Total risk-based capital adds tier 2 capital to tier 1. Tier 2 capital mainly adds subordinated debt to tier 1. It also includes loan-loss reserves (up to 1.25 percent of risk-weighted assets) plus instruments such as trust-preferred securities not included in tier 1. The main difference between the current and new rule is the treatment of trust-preferred securities and minority interest.[36]

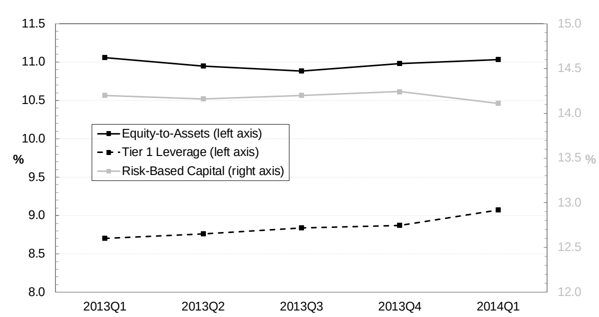
Risk-adjusted assets (the denominator in the risk-based capital ratio) are also changed by the rule. The main change is that all unsecured past-due loans are now weighted at 150 percent rather than at the weight the loan would normally be assigned, and some other items such as mortgage servicing rights receive higher risk weights depending on their volatility, rather than a single weight for all items in a category.

The net result of these changes is that more volatile items receive less weight in the numerator and more weight in the denominator. This should reduce the risk-based capital and tier 1 leverage ratios of institutions carrying more of these types of instruments, but it should increase those ratios of institutions carrying less of them.

[36] Minority interest in unconsolidated subsidiaries (i.e., the bank's ownership of shares in an organization that is not reported as a subsidiary).

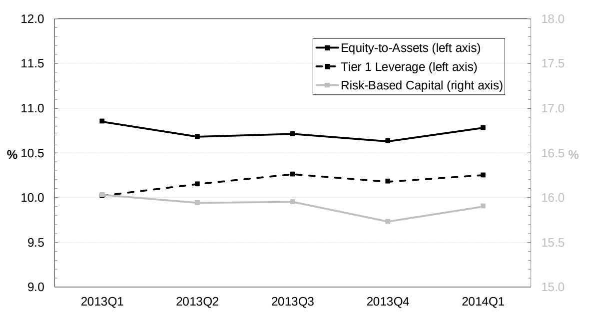
As previously noted, the only class of institutions affected by the new regulations this quarter was the large organizations, specifically their tier 1 leverage and risk-based capital ratios. Thus, the first quarter ratios are not directly comparable with those of previous quarters. However, the data for large organizations excluding the 15 "core" organizations show that tier 1 leverage ratios had a year-over-year increase of 12 basis points, to 9.91 percent, but the risk-based capital ratio decreased by more than a percentage point, from 14.41 to 13.35 percent. The one ratio whose definition did not change, the equity to assets ratio, was relatively stable, with a year-over-year decrease of 3 basis points and a quarterly increase of 5 basis points (Figure 33: Note the different scales on the left and right axes). This number includes all large organizations.

Figure 33
Regulatory Capital – Large Organizations



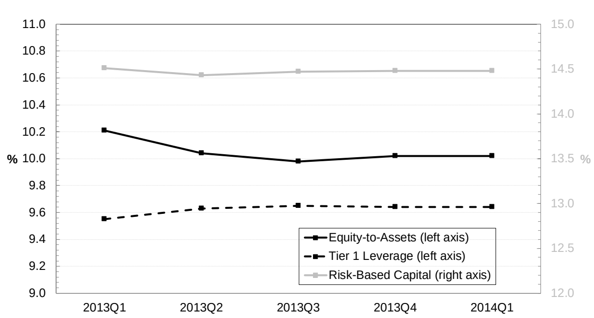
Community banks nationally had equity-to-assets and risk-based capital ratios falling and tier 1 leverage ratios increasing. Since last year, the equity-to-assets ratio at community banks nationally decreased 7 basis points, the tier 1 leverage ratio increased 23 basis points, and the risk-based capital ratio decreased 13 basis points (Figure 34: Note the different scales on the left and right axes).

Figure 34
Regulatory Capital – All Community Banks



At local community banks, year over year, the equity-to-assets ratio has fallen 10 basis points, the tier 1 leverage ratio increased by 13 basis points, and the risk-based capital ratio decreased 11 basis points (Figure 35: Note the different scales on the left and right axes).

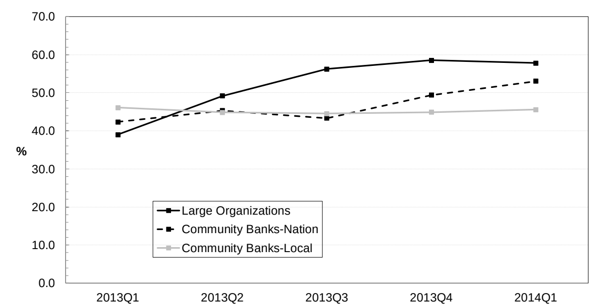
Figure 35
Regulatory Capital – Local Community Banks



As has been the case for the previous several quarters, 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.

Large organizations saw increases in preferred stock, surplus, and retained earnings, while common stock decreased. Community banks nationally had decreases in both common and preferred stock, and these were offset by increases in surplus and retained earnings. Local community banks had increases in common stock, surplus and retained earnings, and a decrease in preferred stock. The percentage of institutions paying dividends on their stock has increased at all categories of banks in the past year, and the dividend payout ratios at all categories except local community banks has risen substantially year over year (Figure 36).[37]

Figure 36
Dividend Payout Ratios



[37] 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	-4.6%	4.6%	8.9%
RRE NPLs	-24.4%	-14.5%	-4.1%
RRE NCOs	-61.5%	-26.2%	-47.3%
2. Shares			
RRE Lns/Total Lns	30.5%	29.6%	25.4%
RRE NPLs/Total NPLs	79.5%	28.0%	28.3%
RRE NCOs/Total NCOs	29.7%	31.7%	24.9%
3. Performance Ratios			
RRE NPLs/Total RRE Lns	7.14%	1.44%	1.88%
RRE NCOs/Avg RRE Lns	0.1%	0.05%	0.04%
4. Outstandings ($ millions)			
Total RRE Lns	1,646,811.5	21,971.8	318,549.5
RRE NPLs	117,638.0	316.1	5,981.6
RRE NCOs	1,675.6	9.9	124.2

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	5.1%	14.3%	9.0%
CRE NPLs	-42.9%	-27.0%	-30.5%
CRE NCOs	-94.2%	-64.2%	-60.8%
2. Shares			
CRE Lns/Total Lns	15.9%	47.5%	43.4%
CRE NPLs/Total NPLs	9.3%	56.0%	52.9%
CRE NCOs/Total NCOs	0.7%	32.8%	33.3%
3. Performance Ratios			
CRE NPLs/Total CRE Lns	1.61%	1.80%	2.05%
CRE NCOs/Avg CRE Lns	<0.01%	0.03%	0.03%
4. Outstandings ($ millions)			
Total CRE Lns	859,822.1	35,201.1	545,692.9
CRE NPLs	13,815.2	632.5	11,167.5
CRE NCOs	41.8	10.2	166.1

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	5.3%	3.1%	12.9%
C&I NPLs	-22.4%	-10.3%	-15.7%
C&I NCOs	-32.7%	-5.7%	-19.4%
2. Shares			
C&I Lns/Total Lns	23.4%	13.3%	16.6%
C&I NPLs/Total NPLs	4.1%	12.8%	11.9%
C&I NCOs/Total NCOs	9.8%	25.6%	44.9%
3. Performance Ratios			
C&I NPLs/Total C&I Lns	0.47%	1.46%	1.21%
C&I NCOs/Avg C&I Lns	0.04%	0.08%	0.11%
4. Outstandings ($ millions)			
Total C&I Lns	1,265,430.1	9,870.3	208,384.8
C&I NPLs	6,007.4	144.3	2,518.5
C&I NCOs	553.7	8.0	223.8

Table 4 – Summary of Consumer Lending

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
1. Year-Over-Year Growth			
Total Consumer Loans	4.0%	4.2%	5.7%
Consumer NPLs	-7.5%	9.3%	34.5%
Consumer NCOs	-10.4%	7.7%	6.7%
2. Shares			
Consumer Lns/Total Lns	13.6%	3.6%	4.1%
Consumer NPLs/Total NPLs	4.9%	1.2%	2.2%
Consumer NCOs/Total NCOs	57.3%	9.1%	15.3%
3. Performance Ratios			
Cons NPLs/Total Cons Lns	0.99%	0.51%	0.91%
Cons NCOs/Avg Cons Lns	0.45%	0.11%	0.15%
4. Outstandings ($ millions)			
Total Consumer Lns	732,383.6	2,653.7	51,748.9
Consumer NPLs	7,225.0	13.4	472.6
Consumer NCOs	3,231.2	2.8	76.2

Table 5 – Provision for Loan Losses and Loan-Loss Reserves

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Loan-Loss Reserve ($ millions)	86,008.2	1,034.3	19,782.3
Change from Last Quarter	-12.6%	-0.8%	-1.3%
Change from Last Year	-17.6%	-4.5%	-5.5%
Net Charge-Offs/LL Provision	169.8%	86.6%	97.2%
LL Provision/Operating Inc.	3.03%	3.06%	2.47%
Loan-Loss Coverage Ratio	58.1%	91.6%	93.7%

Table 6 – Summary of Securities Portfolios

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Securities/Assets	20.4%	20.6%	22.9%
Market Value ($ millions)	2,238,620.0	22,394.5	456.511.8
Change from Last Quarter	7.6%	-8.5%	6.6%
Change from Last Year	0.9%	0.3%	2.3%
Realized Gain/Loss ($ millions)	586.0	15.4	110.3
Pct of Average Securities	0.03%	0.07%	0.02%
Market Value/Book Value	100.19%	99.61%	99.72%

Table 7 – Structure of Liabilities

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Deposits ($ millions)	8,287,422.4	89,614.7	1,666,078.7
Pct of Assets	75.6%	82.5%	83.6%
Change from Last Quarter	4.0%	5.9%	12.1%
Change from Last Year	5.0%	4.8%	6.1%
Core Deposits/Deposits	35.3%	65.7%	63.4%
Implicit Rate on Deposits	0.25%	0.55%	0.52%
Nondeposit Debt ($ millions)	963,539.2	6,991.1	97,428.3
Pct of Assets	8.8%	6.4%	4.9%
Change from Last Quarter	19.2%	9.8%	-9.7%
Change from Last Year	1.3%	33.1%	16.8%
Implicit Rate on Debt	1.36%	1.66%	1.71%

Table 8 – Capitalization Measures

	Large Organizations	Community Banks	
Ratios	Nation	Tri-State Area	Nation
Total Equity/Total Assets	11.03%	10.10%	10.78%
Change fr Last Qtr (basis pts)	5	8	15
Change fr Last Yr (basis pts)	-3	-10	-7
Tier 1 Leverage Ratio	9.07%*	9.67%	10.25%
Change fr Last Qtr (basis pts)	20	4	7
Change fr Last Yr (basis pts)	33	13	23
Risk-Based Capital Ratio	14.11%*	14.40%	15.90%
Change fr Last Qtr (basis pts)	-13	-7	17
Change fr Last Yr (basis pts)	-9	-11	-13

* The definition of these items was changed for several of the largest organizations, and the new numbers are not directly comparable with the same ratio in previous quarters. See "Regulatory Capital" on page 16.