Banking Brief
For Pennsylvania, New Jersey, and Delaware

Second Quarter 2014 Highlights

- *Year over year, profitability (ROA) improved at community banks. ROA is now approaching historical norms.*

- *Year over year, total loans grew at an accelerating rate at all categories of banks, but growth continued to be more modest at large organizations. Most of the loan growth at large organizations was in commercial loans. Smaller banks saw increases in all categories of loans, with commercial loans growing the fastest nationally and consumer loans leading locally.*

- *Loan quality improved year over year at all categories of banks, as both nonperforming loans and net charge-offs decreased substantially.*

- *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 nearly normal at community banks.*

- *Banks made their annual report on small business lending (see Table 9 and a summary in the "Commercial and Industrial Lending" section).*

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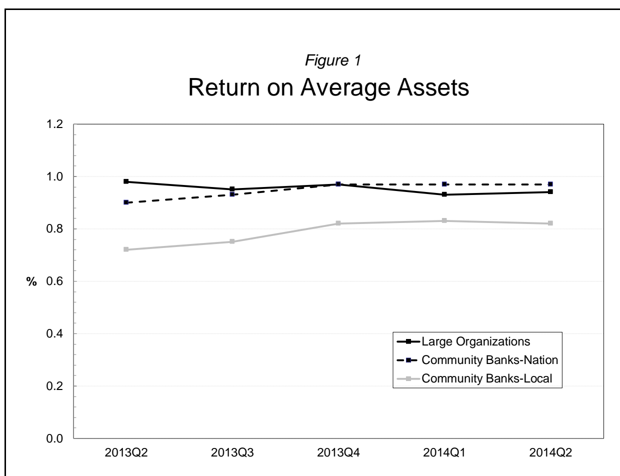
Summary Table of Bank Structure and Conditions — Second Quarter 2014

	Community Banking Organizations						*Large Organizations*			
	Nation			*Tri-State*				*Nation*		
	$ Bill	**% Change From**		**$ Bill**	**% Change From**			**$ Bill**	**% Change From**	
	14Q2	**14Q1**	**13Q2**	**14Q2**	**14Q1**	**13Q2**		**14Q2**	**14Q1**	**13Q2**
Total Assets	2,011.7	4.66	7.83	110.9	8.79	7.50	Total Assets	11,199.5	8.61	5.86
Total Loans	1,294.2	13.58	10.84	76.7	14.66	10.26	Total Loans	5,513.2	8.54	4.53
C&I	214.8	14.32	13.55	10.3	19.20	7.80	C&I	1,306.2	13.32	9.27
Real Estate	945.0	11.16	10.31	59.4	10.18	10.47	Real Estate	2,613.5	3.03	0.15
Consumer	53.5	15.63	7.28	2.9	37.68	11.93	Consumer	751.7	10.89	5.13
Total Deposits	1,665.8	0.75	6.81	90.0	1.94	4.65	Total Deposits	8,460.8	8.45	7.64
Ratios (in %)	**14Q2**	**14Q1**	**13Q2**	**14Q2**	**14Q1**	**13Q2**	**Ratios (in %)**	**14Q2**	**14Q1**	**13Q2**
Net Income/Avg. Assets (ROA)	0.97	0.97	0.90	0.82	0.83	0.72	Net Income/Avg. Assets (ROA)	0.94	0.93	0.98
Net Interest Inc./Avg. Assets (NIM)	3.38	3.37	3.35	3.19	3.18	3.22	Net Interest Inc./Avg. Assets (NIM)	2.43	2.45	2.53
Noninterest Inc./Avg. Assets	0.92	0.94	1.01	1.23	1.25	1.33	Noninterest Inc./Avg. Assets	1.66	1.71	1.89
Noninterest Exp./Avg. Assets	3.00	3.02	3.06	3.17	3.18	3.25	Noninterest Exp./Avg. Assets	2.65	2.69	2.81
Loans/Deposits	77.70	75.40	74.87	85.19	82.72	80.85	Loans/Deposits	65.16	65.15	67.10
Equity/Assets	10.94	10.78	10.69	10.18	10.10	10.04	Equity/Assets	11.05	11.04	10.96
Nonperforming Loans/Total Loans	1.51	1.68	2.09	1.40	1.53	1.98	Nonperforming Loans/Total Loans	2.48	2.74	3.48

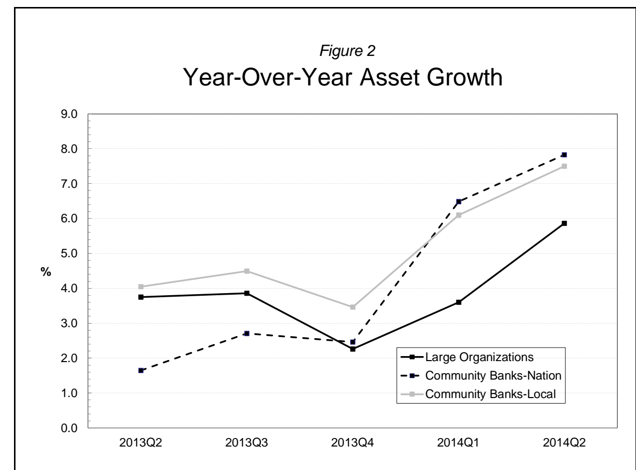
Unless otherwise noted, all data are from Federal Financial Institutions Examination Council call reports. The data are adjusted for mergers. Quarterly percentage changes are compound annualized rates except where noted. A banking organization is an independent bank or all the banks within a highest-level 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, 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 number of banking organizations in the categories are as follows: 1) community banking organizations — 164 for the tri-state area and 5,059 for the nation; 2) large banking organizations — 100 for the nation. Ratios are aggregates; that is, the numerators and denominators are summed across all banks in the group, then divided.

Second Quarter 2014

Community banks both locally and nationally reported strong results in terms of profits, loan growth, and asset quality, while large organizations were less impressive. Year over year, profitability is now around historical norms.[1] At large organizations, return on average assets (ROAA) was 0.94 percent, a decrease of 4 basis points from last year, and it was flat in the second quarter.[2] ROAA at local community banks increased 10 basis points since last year, to 0.82 percent (Figure 1).[3] At community banks nationwide, ROAA increased 7 basis points from last year.



ROAA at community banks has plateaued during the past two quarters, but other indicators show that their health continues to improve. The main reason for the higher year-over-year profitability at community banks is high asset growth, particularly loan growth (Figure 2). Loan growth at community banks both nationally and locally was more than double that of large organizations. Also, net interest margins have remained relatively stable at community banks but shrank at large organizations. While noninterest income has decreased at all categories of banks (both total and as a percent of average assets), there has been a greater decrease at large organizations. This decrease is due in part to less income from asset sales and realized gains on securities. Moreover, large organizations saw a decrease in their income from both servicing and securitizing mortgages. Finally, trading income shrank at large organizations but grew at community banks.



Profitability at area banks continued to lag other banks in the nation as it has for several quarters now (Figure 3).[4] Local banks have

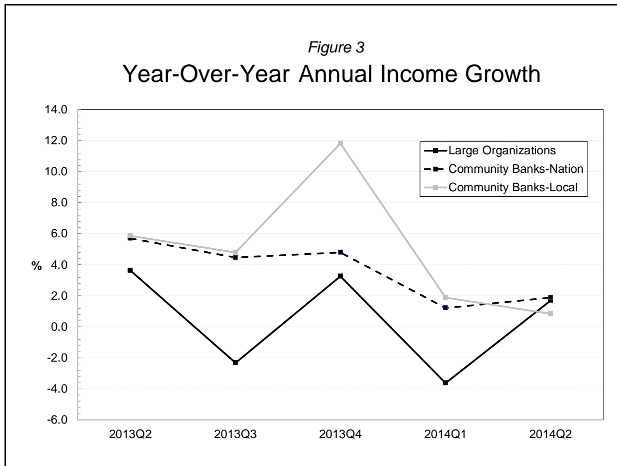
[1] The average ROAA at all commercial banks between 1934 and 2013 was 0.78 percent. In the past 20 years, this average was 1.04 percent. Source: FDIC Historical Statistics on Banking, https://www2.fdic.gov/hsob/index.asp

[2] 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 second quarter of 2013 to the second quarter of 2014. Finally, unless otherwise noted, any quarterly percentage changes are compound annual rates.

[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 ROAAs than community banks nationally most of the time. For instance, at year-end 1997, local community banks' ROAA (0.83 percent) was 13 basis points less than that of banks nationally (0.96 percent). This was actually an improvement from 1996, when community banks

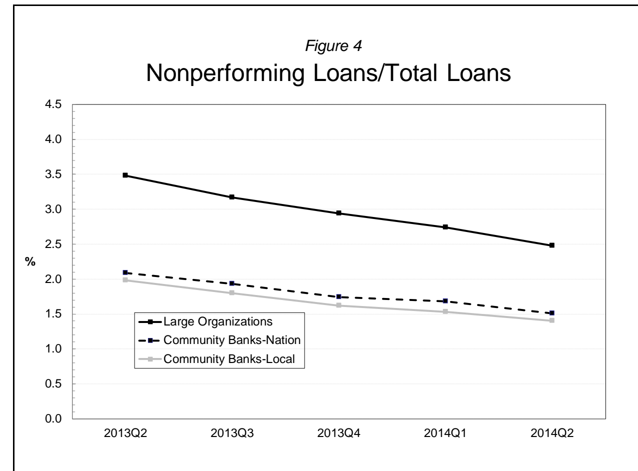
lower net interest margins due to their funding mix, which is more heavily dependent on relatively expensive nondeposit debt (see "Funding Sources" on page 15). In addition, banks in the region continued to have high expense ratios.



Loan quality continued to improve, which has resulted in lower loan-loss provisions. Expense ratios also continued to decrease at all categories of banks, which contributed to increasing income.

As noted previously, the year-over-year growth in assets was fueled at community banks mainly by increases in loans as growth in banks' securities portfolios slowed; however, the opposite was true at large organizations. Loans increased 4.5 percent at large organizations, while the reported value of securities increased 6.2 percent.[5] Loans increased 10.8 percent at community banks nationally and 10.3 percent at local community banks (Figure 4). The reported value of securities increased only 3.2 percent at community banks nationally and 0.3 percent at local community banks.

At large organizations, most of the total loan growth was due to commercial and industrial (C&I) lending. There was also a lesser increase in consumer lending, while real estate loans were basically flat. At community banks, there was substantial growth in all categories of loans both nationally and locally. The main disparity in loan growth is due to real estate loans.



The main factor driving the growth of real estate loans at community banks was CRE loans, but RRE lending also showed stronger growth. With home sales sluggish during the past several years, much of the RRE market has been refinancings. These have slowed considerably, thus, dragging down the loan growth of large organizations (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 percentage point from last year to 2.48 percent (Figure 5).[6] Community banks

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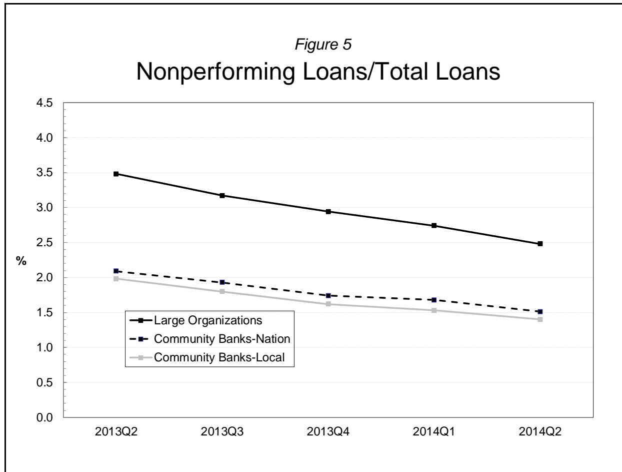
nationally had an ROAA of 0.91 percent and local banks' ROAA was 0.72 percent.

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

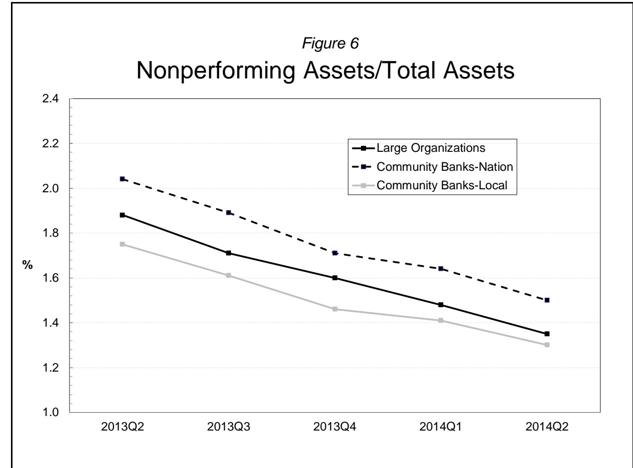
[6] For historical perspective, the average NPL ratio for all commercial banks between 2002 and 2012 was 2.52 percent. At the bottom of the last real estate cycle in 1991, this ratio stood at 3.70 percent. Source: FDIC Historical Statistics on Banking, https://www2.fdic.gov/hsob/index.asp

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

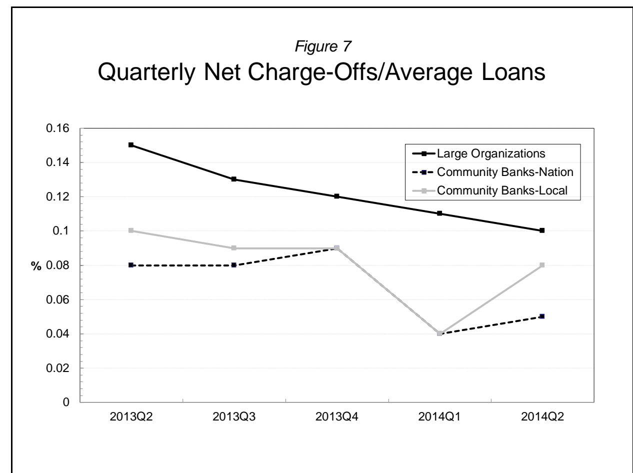


58 basis points since last year, to 1.51 percent. Locally, the NPL ratio fell by 58 basis points, to 1.40 percent.

Overall, asset quality has also improved for all categories of banks.[7] 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 8.4 percent. At community banks, the decrease was 16.4 percent nationally and 12.8 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 6).[8]



At large organizations, the NPA ratio has fallen 53 basis points in the past year, to 1.35 percent. At community banks nationally, the decrease was 54 basis points, to 1.50 percent, and locally, the NPA ratio fell 45 basis points, to 1.30 percent.



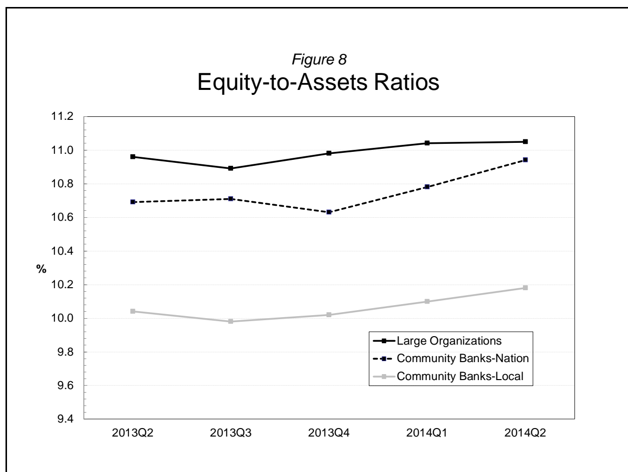
NCOs tell a similar story, with all categories of banks experiencing significant decreases. The ratio of NCOs to average loans (the NCO ratio) fell 5 basis points over the year at large organizations, to 0.10 percent (Figure 7).

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 3 basis points over the year, to 0.05 percent. At tri-state area community banks, the NCO ratio has also fallen 2 basis points over the past year,

[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, https://www2.fdic.gov/hsob/index.asp

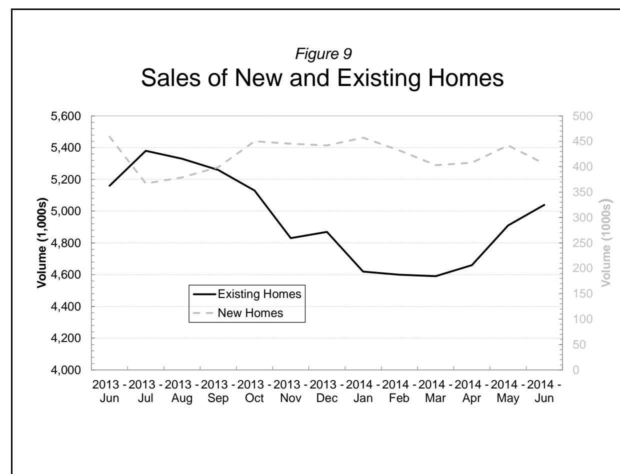
to 0.08 percent, although in both of these cases, there was a quarterly increase. Data on NCOs, particularly at community banks, tend to be very noisy.



Capital ratios, defined as the ratio of total equity to assets, increased at all categories of banks both annually and quarterly (Figure 8). There were only seven bank failures in the second quarter. Also, two banks have failed since June 30 as well. None of the failures has involved a tri-state area bank. There were 25 total failures in 2013.

Residential Real Estate Lending[9]

Nationwide, RRE markets continued their modest recovery in the second quarter, but local results were at best mixed. The Federal Reserve Board's *Beige Book,* as of July 16, 2014, 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.[10] It also reported that construction, for the most part, did not get the bump that was expected after the severe winter weather as many would-be new homebuyers fear that they will be unable to sell their existing homes.



By most measures, local real estate markets are underperforming. The *Beige Book* reported that sales of existing homes shrank slightly from last year. Northern New Jersey reported that home prices are still being restrained by a sizable backlog of foreclosed and distressed properties, and Pennsylvania reported that depressed prices continue to leave many homeowners underwater on their mortgages.

Sales of both new and existing homes are down from last year, though existing home sales have been increasing since March (Figure 9: Note the different scales on the left and right axes).[11] Existing home sales still haven't recovered from last winter. The percentage of delinquent mortgages decreased more than 90 basis points from a year ago, and the percentage of mortgages in foreclosure has decreased more than 80 basis points (Figure 10).

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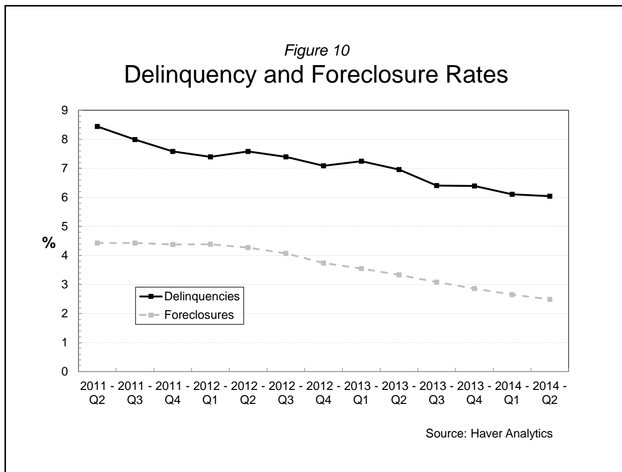
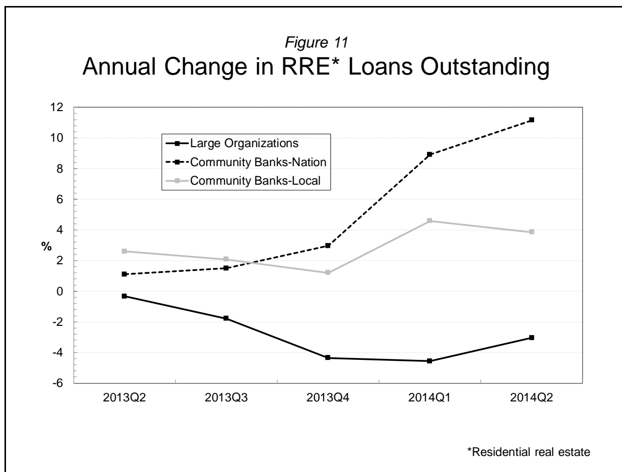
[9] See Table 1 in the Appendix for a full summary of the data used in this section.

[10] For further information, see http://www.federalreserve.gov/monetarypolicy/beigebook/files/Beigebook_20140716.pdf.

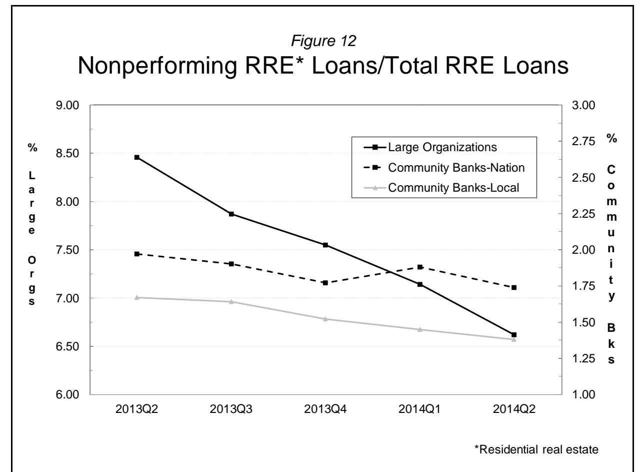
[11] Sales of existing homes dropped about 120,000 units from June 2013 to June 2014. For the entire second quarter, sales were down about 690,000 units from 2013 to 2014. New home sales also decreased by about 53,000 units from June 2013 to June 2014. For the quarter, new home sales decreased by about 86,000 units.



Total RRE loans outstanding decreased from last year as increases in lending at community banks were offset by larger decreases at the large organizations, but total RRE loans did increase from the first quarter to the second (Figure 11). From the second quarter of 2013 to the second quarter of 2014, RRE loans

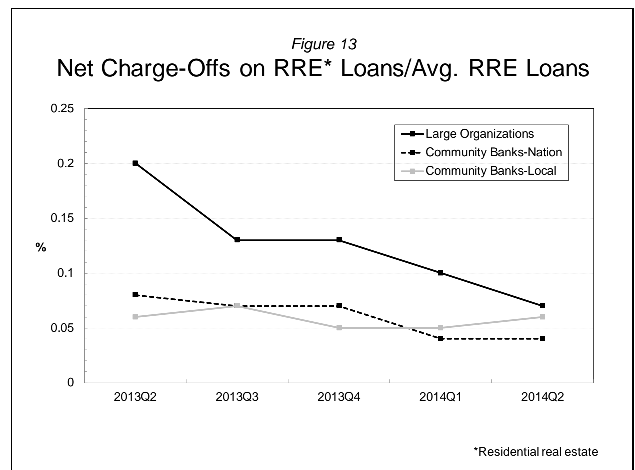


outstanding grew at a rate of 11.2 percent at community banks nationally and 3.9 percent locally. Community banks nationally and locally showed even stronger growth from the first to the second quarter. In both cases, nearly all of the growth in RRE loans was due to mortgages secured by first liens, though there was some activity in home equity lines of credit (HELOCs) as well. At large organizations, loans shrank 3.1 percent year over year, but they did grow 1.3 percent in the quarter.

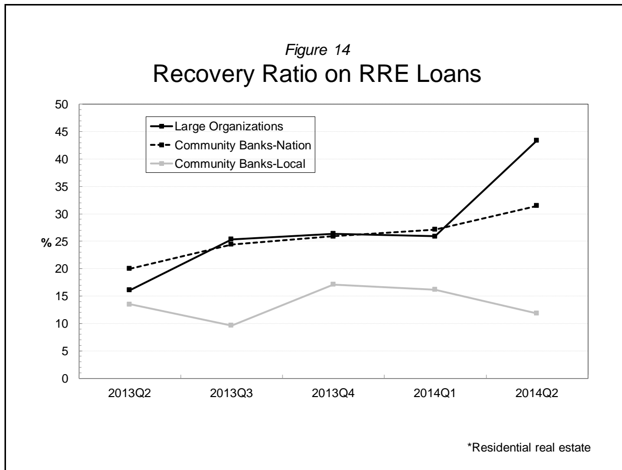


The quality of RRE loans continued to improve, but large organizations are still carrying a substantial portfolio of NPLs. The RRE NPL ratio at large banks fell nearly 2 percentage points, to 6.62 percent, in the past year (Figure 12: Note the different scales for large organizations (left y-axis) and community banks (right y-axis)). Community banks have much better RRE loan quality, with NPL ratios of 1.74 percent nationally and 1.38 percent locally. These represent drops of 23 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 decreased 13 basis points in the past year, to 0.07 percent (Figure 13).



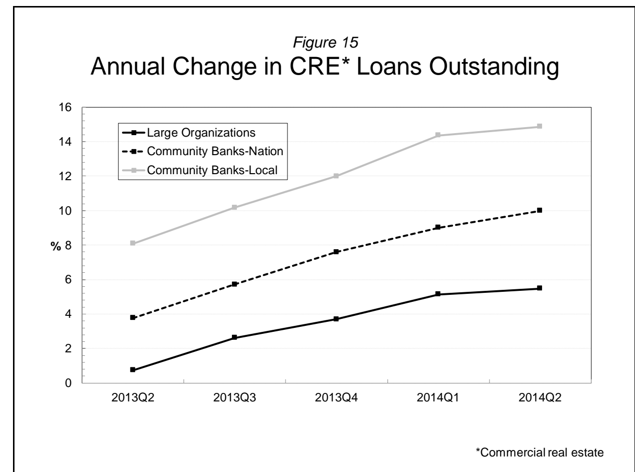
At community banks, the RRE NCO ratio decreased 4 basis points nationally in the past year, to 0.04 percent, and was flat locally at 0.06 percent. In the cases of community banks nationally and at large organizations, charge-offs decreased and recoveries increased. At local community banks, charge-offs increased slightly and recoveries decreased slightly. As a result, recovery ratios have increased at all categories of banks in the past year except local community banks (Figure 14).



Commercial Real Estate Lending[12]

Commercial real estate (CRE) market conditions improved modestly both locally and nationally. Continuing the trend of the past several quarters, the *Beige Book* reported that in most of the CRE markets nationwide, construction activity was either steady or it increased. Most of the increased activity was in multifamily properties. Construction of commercial buildings was steady in most 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. However, there was little change in construction activity, which was already at a low level. Northern New Jersey was somewhat worse off, as office vacancy rates remained high, but vacant industrial properties decreased.

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 5.5 percent at large organizations, 10.0 percent at community banks nationally, and 14.9 percent at tri-state-area community banks (Figure 15). The strongest area of growth was in loans on multifamily properties, but other areas showed solid growth as well.



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 more than 1.1 percentage points from the first quarter of 2013, to 1.37 percent (Figure 16). The CRE NPL ratio decreased more than 1 percentage point at community banks nationally from last year to 1.80 percent and nearly 1 percentage point at community banks locally to 1.66 percent.

NCO ratios have decreased at all categories of banks as well. The NCO ratio on CRE loans

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

at large organizations decreased 6 basis points to 0.1 percent. At community banks nationally, there was a decrease of 4 basis points, to 0.04 percent, and a decrease of 3 basis points locally,

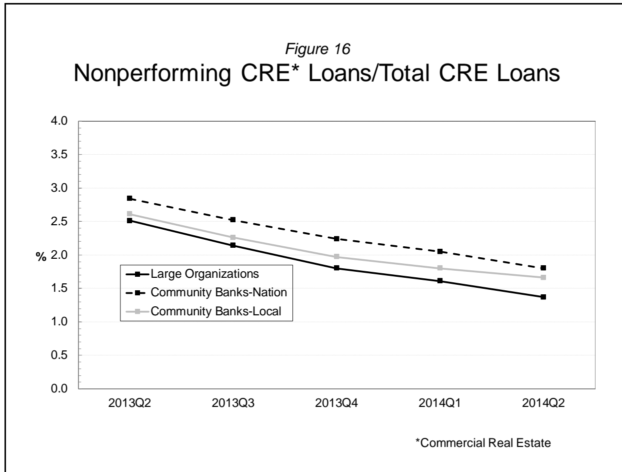


Figure 16
Nonperforming CRE* Loans/Total CRE Loans

to 0.04 percent (Figure 17). While total NPLs have been decreasing at a substantial rate, NCOs have fallen much faster. This is not due to increased recoveries.[13] Unless a substantial portion of these NPLs can become earning assets again or can be renegotiated, charge-offs

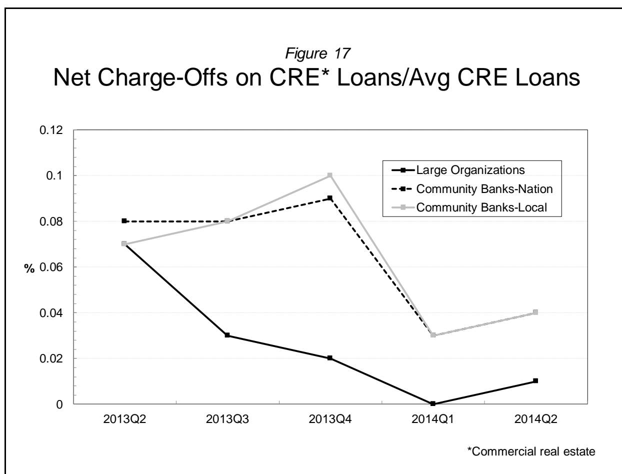


Figure 17
Net Charge-Offs on CRE* Loans/Avg CRE Loans

will likely increase in the future. This process may have already begun as NCO ratios increased slightly at all categories of banks from the first to the second quarter.

As noted previously, much of the growth in CRE lending can be attributed to growth in multifamily housing (Figure 18). All categories

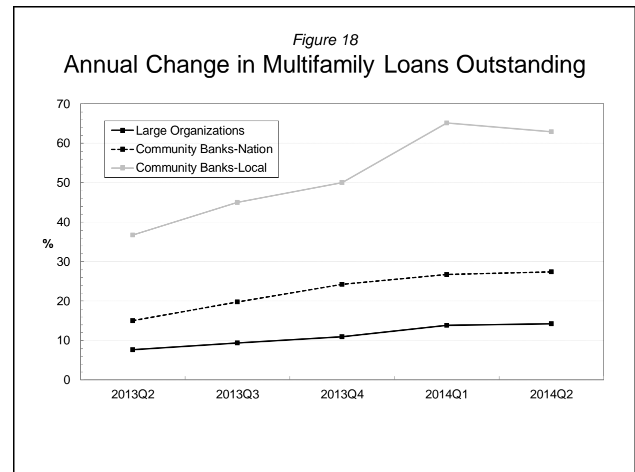


Figure 18
Annual Change in Multifamily Loans Outstanding

of banks saw double-digit growth in multifamily loans; this was especially true at local community banks, where loans outstanding have grown about 63 percent in the past year.

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 19).

Even though they have been growing at a high rate recently, multifamily loans still make

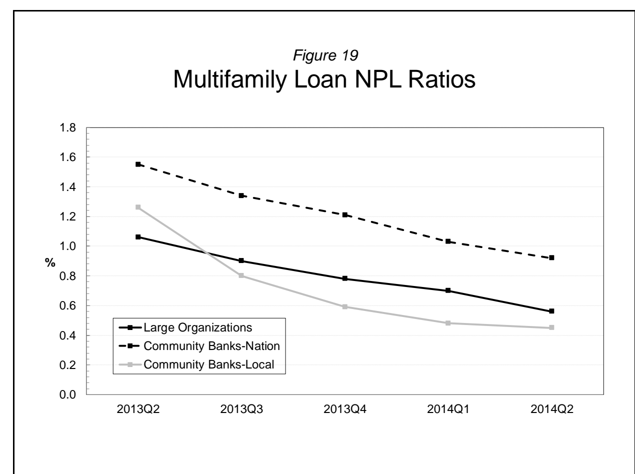
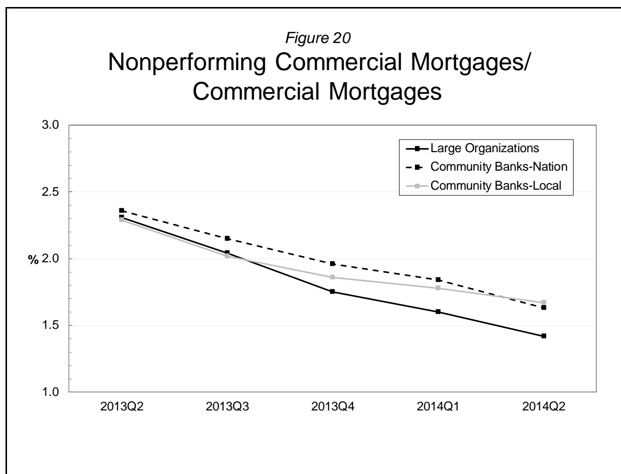


Figure 19
Multifamily Loan NPL Ratios

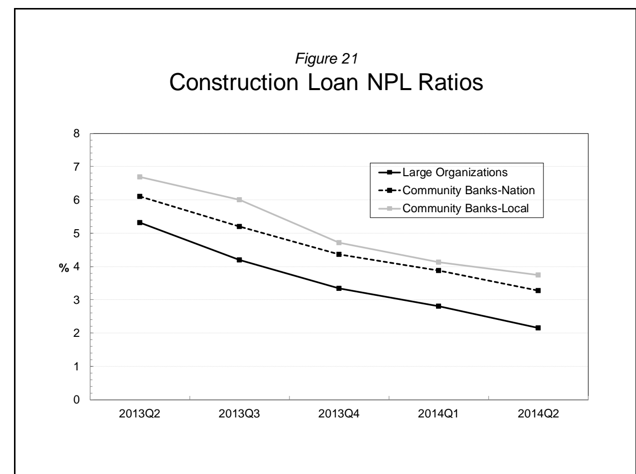
[13] Total NPLs had a year-to-year decrease of 42 percent at large organizations, 47 percent at community banks nationally, and 30 percent at local community banks. At the same time, NCOs fell 85 percent at large organizations, 47 percent at community banks nationally, and 34 percent locally.

up a small part of total CRE lending.[14] 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 89 basis points, to 1.42 percent. At community banks nationally, the ratio has decreased 73 basis points, to 1.63 percent, and at community banks, locally, the ratio has decreased 62 basis points, to 1.67 percent (Figure 20). NCOs on these loans have also dropped substantially in the past year, but all showed large quarterly increases in the second quarter.



Construction lending, which for the past several years has been a drag on CRE lending, both in terms of growth and quality, has improved dramatically in the past several quarters. In terms of growth, construction loans grew 10.0 percent at large organizations, 11.6 percent at community banks nationally, and 12.6 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 remained high. The construction loan NPL ratio for large organizations has dropped 3.25 percentage points in the past year, to 2.15 percent (Figure 21). Community banks have experienced similar drops — more than 1.8 percentage points nationally, to 3.27 percent, and nearly 3 percentage points locally, to 3.74 percent.



Commercial and Industrial Lending[15]

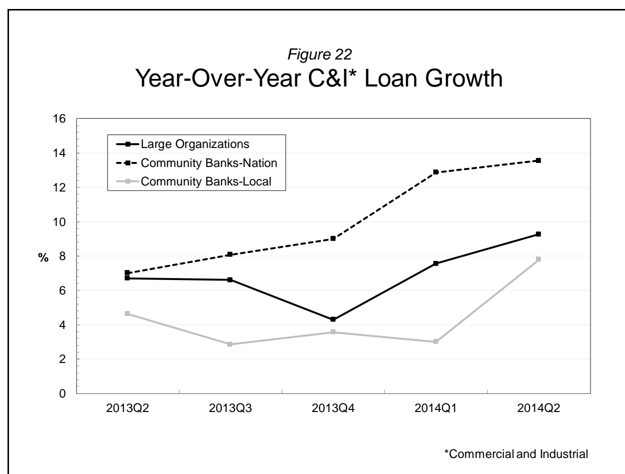
C&I lending continued to grow at a good pace at community banks and at large organizations. Growth at local community banks still lags other categories of banks, but it more than doubled in the second quarter. At large organizations, C&I loans grew 9.3 percent in the past year (Figure 22 and Table 3 in the Appendix). At community banks, C&I lending grew 13.6 percent nationally and 7.8 percent locally. Growth at community banks nationally

[14] At large organizations, 68.3 percent of CRE loans are commercial mortgages, 17.8 percent are multifamily loans, and 13.9 percent are construction loans. At community banks nationally, 73.9 percent of CRE loans are commercial mortgages, 11.2 percent are multifamily loans, and 15.0 percent are construction loans. At local community banks, 72.9 percent of CRE loans are commercial mortgages, 17.2 percent are multifamily loans, and 9.9 percent are construction loans.

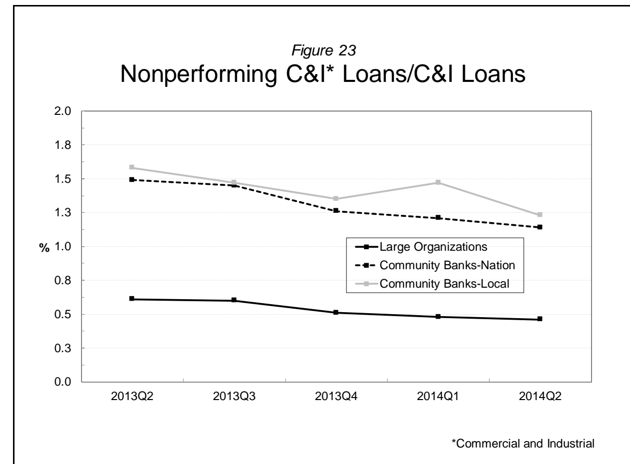
[15] See Table 3 in the Appendix for a full summary of the data used in this section.

has been increasing every quarter for the past year.

The Federal Reserve Board's *Senior Loan Officer Opinion Survey* for July 2014 reported that loan demand had for the most part increased significantly, with most respondents reporting an increase in demand.[16] This was true regardless of firm size. On the supply side, a small percentage of responding firms reported that they had eased standards on C&I loans. A larger percentage of firms reported that they had eased loan terms on all sizes of firms, including reducing the cost of credit lines, decreasing the use of interest rate floors, easing loan covenants, and reducing risk premiums. These developments continue trends of easing both standards and terms that began several quarters ago. 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.



Loan quality remained high at all categories of banks (Figure 23). At large organizations, the NPL ratio has fallen 15 basis points in the past year, to 0.46 percent. Quality is somewhat worse at community banks, with NPL ratios of 1.14 nationally and 1.23 locally. Again, both of these ratios fell substantially in the past year.



In addition to data on all C&I loans, the June Call Report annually contains data on the level of small business lending activity.[17] Overall, results were mixed. Community banks for the most part reported modest increases in small business lending from last year, both in real estate and C&I loans. Large organizations reported decreases in real estate lending and, at best, small increases in C&I lending.

Overall, growth in small business loans lagged overall growth in CRE and C&I loans.[18]

[16] For further information, see http://www.federalreserve.gov/boarddocs/SnLoanSurvey/201408/default.htm.

[17] See Table 9 for a full summary of the data used in this paragraph. It should be noted that the title "small business lending" is somewhat of a misnomer because banks report all commercial loans and CRE loans with original amounts less than $100,000, $250,000, and $1 million regardless of the size of the borrower.

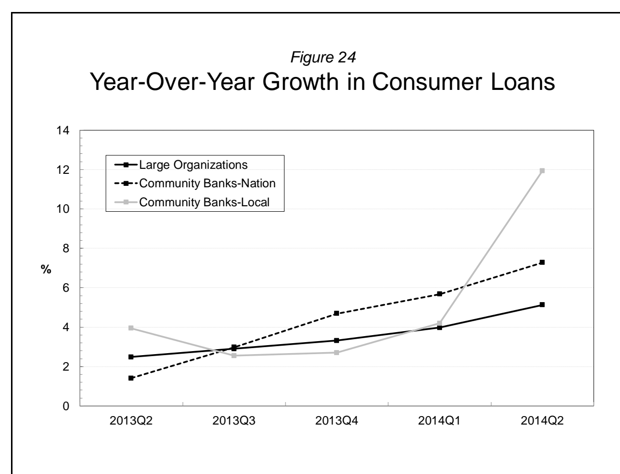
[18] Total outstanding CRE loans in amounts less than $1 million grew 1.5 percent at large organizations, 6.0 percent at community banks nationally, and 6.8 percent at community banks locally.[18] Overall annual growth numbers for CRE lending were 5.5 percent for large organizations, 10.0 percent for community banks nationally, and 14.9 percent for community banks locally. C&I loans less than $1 million grew 1.8 percent at large organizations, 6.8 percent at community banks nationally, and 5.0 percent at local community banks. Overall growth numbers on C&I loans were 9.3 percent for large organizations, 13.6 percent at community banks nationally, and 7.8 percent at community banks locally.

Thus, there is some discrepancy between total CRE and C&I lending and that of small businesses. Some of this can be explained by the data in the *Senior Loan Officer Opinion Survey.* Several quarters before, banks were slower to reduce their standards and terms on small businesses than on large and medium-sized firms, and these are generally stricter for small businesses.

Breaking down the nationwide and local community bank samples into subgroups based on size shows that all of the growth in both CRE and C&I lending (overall and to small businesses) was at the largest of the community banks. These numbers actually shrank at the smallest institutions and were flat at the medium-sized organizations. Moreover, nearly all of the discrepancy in total lending versus small business lending was at these larger institutions.[19]

Consumer Lending[20]

Overall, consumer lending continued to strengthen in the first quarter, with strong growth and relatively few quality problems. Large organizations conduct the vast majority of consumer lending. Their consumer lending grew about 5.1 percent year over year (Figure 24). At community banks nationally, consumer lending grew 7.3 percent, while at community banks locally, consumer lending grew 11.9 percent. At least part of this may be pent up demand from the unusually severe winter experienced in most of the country. At large organizations, auto loans, "other revolving credit" (i.e., revolving credit not due to credit cards), and installment loans grew.[21] At community banks both locally and nationally, growth was in "other revolving credit," with some growth in auto loans and installment loans.



NPL ratios on consumer loans have been low: 0.89 percent for large organizations, 0.83 percent for community banks nationally, and 0.47 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

[19] Community banks were broken down into three categories: less than $150 million in assets, assets between $150 million and $1 billion, and more than $1 billion. Total CRE loans in the first group shrank 8.3 percent since last year, while small business CRE loans shrank 9.8 percent. Total C&I loans in this group shrank 7.1 percent, and small business C&I loans shrank 7.7 percent. In the second group, total CRE loans were basically flat, growing 1.4 percent, while small business CRE loans grew 0.1 percent. Total C&I loans grew 2.9 percent, while small business C&I loans grew 3.0 percent. In the largest group, total CRE loans grew 23.2 percent, while small business loans grew 17.4 percent. C&I loans grew 27.2 percent, while small business C&I loans grew 18.7 percent. The numbers for local community banks were similar.

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

[21] 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.

are often a total loss.[22] NCO ratios were basically flat at large organizations, falling 1 basis point to 0.45 percent (Figure 25). At community banks nationally, the results were the same, with the NCO ratio falling 1 basis point to 0.13 percent. At local community banks, the NCO ratio doubled, to 0.20 percent. There was a similarly large quarterly increase. However, this may be noise in the data as NCOs tend to have considerable variability.

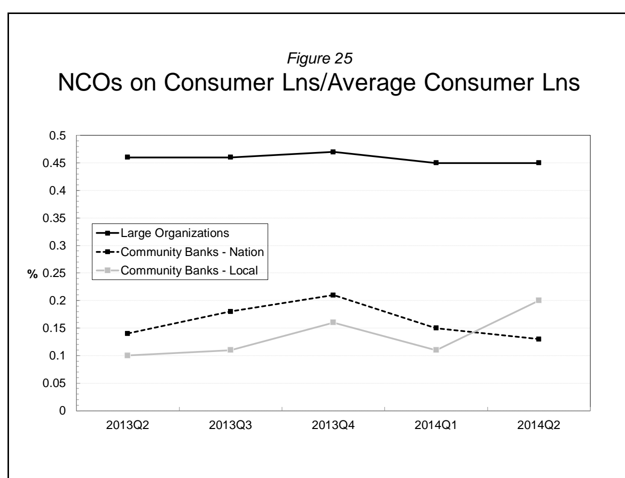


Figure 25
NCOs on Consumer Lns/Average Consumer Lns

Provisioning and Reserves[23]

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.[24] 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 nearly 1.1 percentage points, to 2.21 percent, at large organizations. At community banks nationally, the ratio has decreased 94 basis points, to 2.57 percent, and it fell 52 basis points, to 4.99 percent, at local community banks (Figure 26).[25] Community banks did have substantial quarterly increases, however. It should be noted that in each category this ratio is somewhat bumpy, rising in some quarters and falling in others.

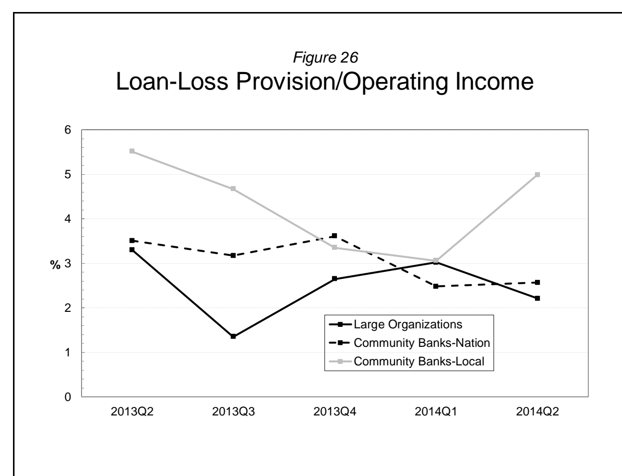


Figure 26
Loan-Loss Provision/Operating Income

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 rose somewhat both nationally and locally, but it is still comparable

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[22] The breakdown of consumer loans is as follows. Large organizations: credit cards, 31.7 percent; other revolving credit, 7.2 percent; auto loans, 37.8 percent; other consumer loans, 23.2 percent. Community banks nationally: credit cards, 3.1 percent; other revolving credit, 5.3 percent; auto loans, 44.8 percent; other consumer loans, 46.6 percent. Local community banks: credit cards, 1.8 percent; other revolving credit, 19.9 percent; auto loans, 35.0 percent; other consumer loans, 43.2 percent. Figures may not equal 100 percent due to rounding.

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

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

[25] 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, https://www2.fdic.gov/hsob/index.asp

with the historical norm. At large organizations, this ratio continued to be well over this norm (Figure 27).[26]

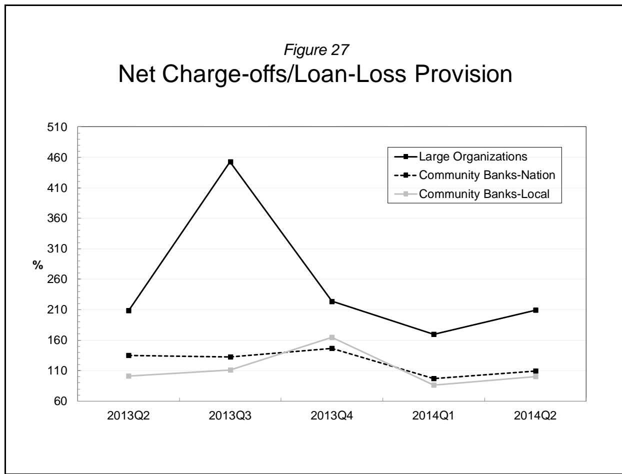


Figure 27
Net Charge-offs/Loan-Loss Provision

Large organizations saw this ratio basically remain flat since last year at 208 percent, although it did increase 39 percentage points in the second quarter. At community banks, the ratios are somewhat lower, and they have improved from last year. The NCOs to loan-loss provision ratio has decreased about 25 percentage points, to 109.6 percent, at community banks nationally. At local community banks, the ratio decreased about 2 percentage points, to 100.0. All community banks had quarterly increases in this ratio, however.

The decrease in provisioning has resulted in a drop in overall reserves, particularly at large organizations. Total loan-loss reserves fell 4.6 percent at community banks nationally, approximately 3.8 percent at local community banks, and almost 17 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 28). At large organizations, the ratio has fallen 20 basis points since last year, to 0.74 percent. At community banks, the drop was 13 basis points nationally and 11 basis points locally.

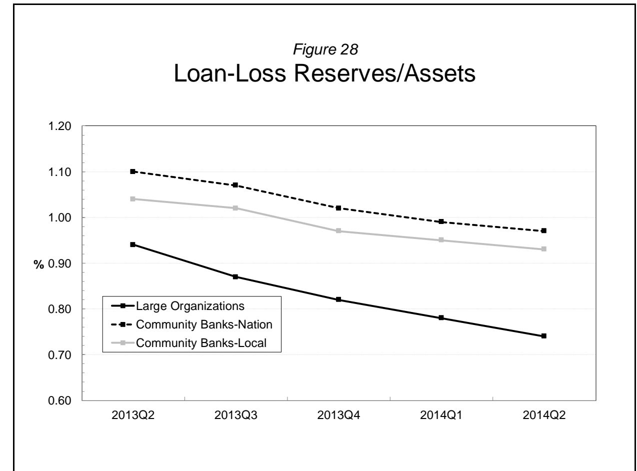


Figure 28
Loan-Loss Reserves/Assets

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 6 percentage points from last year, to 60.6 percent (Figure 29). It has been increasing for more than a year now.

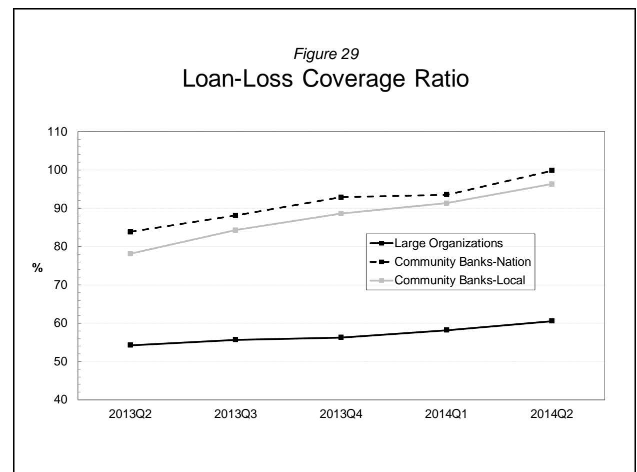


Figure 29
Loan-Loss Coverage Ratio

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 more

[26] 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, https://www2.fdic.gov/hsob/index.asp

than 16 percentage points in the past year, to 99.9 percent. Locally, loan-loss coverage increased more than 18 percentage points, to 96.3 percent.[27]

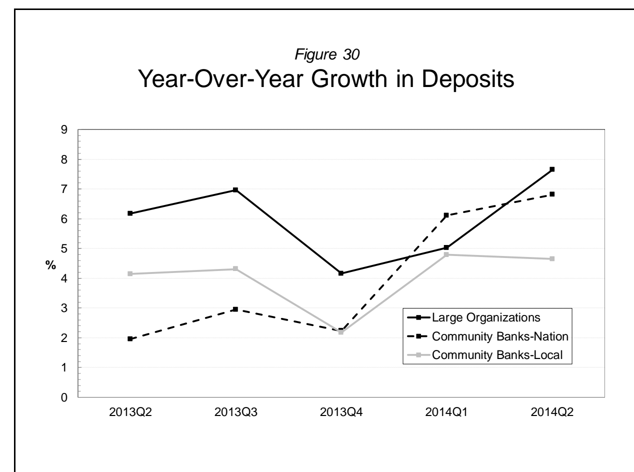
Securities[28]

Community banks nationally, saw small year-over-year increases (3.3 percent) in the market value of their securities portfolios. Locally, securities portfolios were basically flat. Large organizations had a somewhat larger gain in value (6.5 percent).[29]

Community banks saw quarterly increases in realized gains on securities, but year-over-year realized gains dropped.[30] Large organizations had both quarterly and annual drops. Large organizations posted gains of approximately $569 million. Community banks nationally reported a realized gain of $124.3 million in the quarter. Local community banks reported a realized gain of about $12.8 million.

Funding Sources[31]

Year-over-year deposit growth was relatively strong across all categories of banks (Figure 30), though it did slow somewhat locally. 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.



Reliance on brokered deposits has grown somewhat at all categories of banks. At large organizations, brokered deposits as a percent of total deposits have increased 23 basis points from last year. At community banks nationally, this ratio has increased 37 basis points in the past year. At local community banks, brokered deposits as a percent of total deposits are up 1.55 percentage points in the past year. Except at local community banks, there was little change in the quarter.

Core deposits grew at a slower pace than overall deposit growth at all categories of banks and actually had quarterly decreases at community banks.[32] Core deposit growth has

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[27] 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, https://www2.fdic.gov/hsob/index.asp

[28] 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.

[29] 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.

[30] 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.

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

[32] 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

been slow for at least the past year at all categories of banks and that is partially responsible for declining net interest margins. Their share of total deposits has decreased at all categories of banks in the past year (Figure 31: Note the different scales for community banks and large organizations). 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.

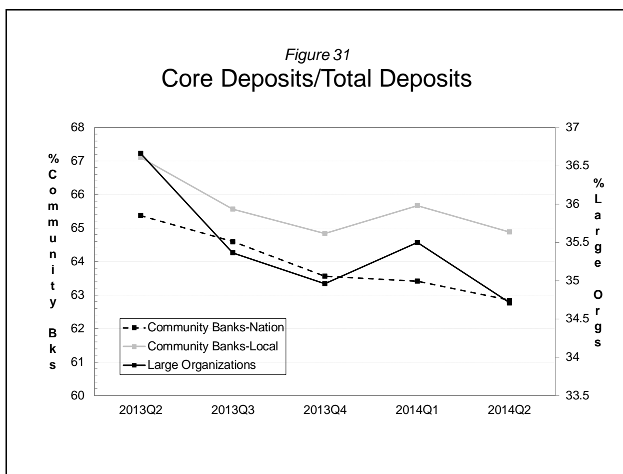

Figure 31
Core Deposits/Total Deposits

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 substantially for the past several quarters at community banks both nationally and locally (Figure 32).[33] Nondeposit debt funding increased 20.1 percent at community banks nationally and 49.1 percent locally, with even larger quarterly increases. Large organizations saw much more modest increases in nondeposit debt funding. For large organizations, nondeposit debt grew 1.1 percent from the second quarter of 2013, and 8.3 percent from the first quarter of 2014.

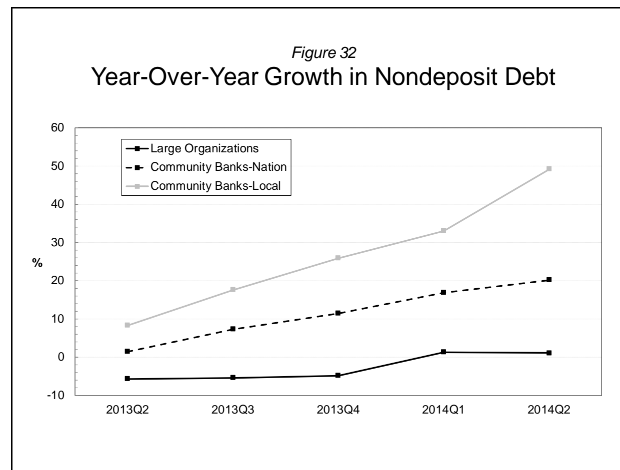

Figure 32
Year-Over-Year Growth in Nondeposit Debt

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 33).[34] This holds true for nondeposit funding as well.

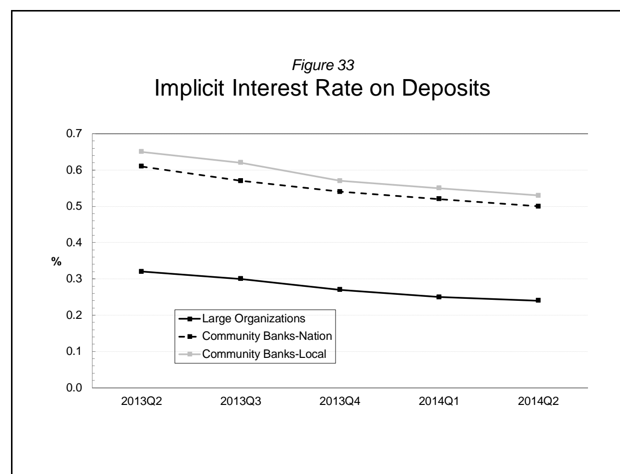

Figure 33
Implicit Interest Rate on Deposits

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was -0.1 percent at large organizations, 2.7 percent at community banks nationally, and 2.4 percent at community banks locally.

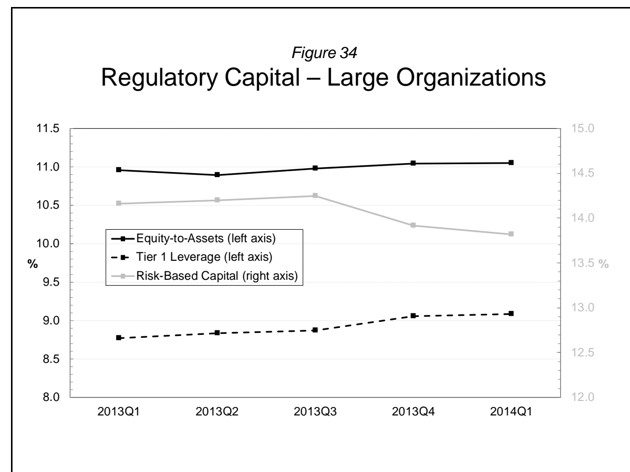
[33] Nondeposit funding consists of fed funds purchased, securities sold under agreements to repurchase (repos), subordinated debt, Federal Home Loan Bank (FHLB) advances, and other borrowings.

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

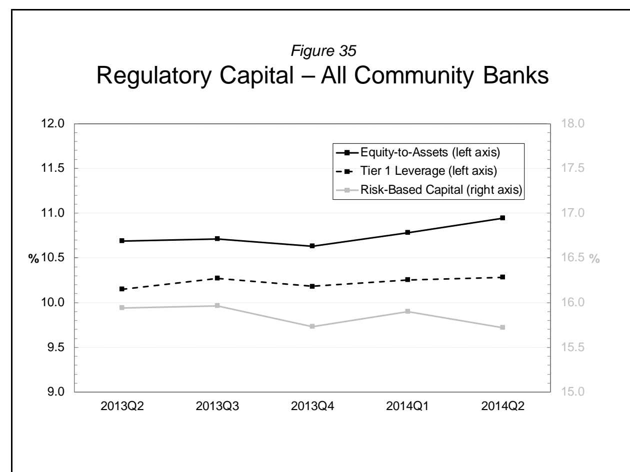
Regulatory Capital[35]

Last quarter brought the first phase of the new capital standards intended to implement the Basel III accords for certain large banks.[36] All other banks will become subject to the new regulation beginning January 1, 2015.

As noted previously, the only class of institutions affected by the new regulations until next year was the large organizations, specifically their tier 1 leverage and risk-based capital ratios. Thus, the first quarter and second quarter ratios are not directly comparable with those of previous quarters (the first and second quarter numbers are comparable, however). The one ratio whose definition did not change, the equity-to-assets ratio, was relatively stable, with a year-over-year increase of 9 basis points and a quarterly increase of 1 basis point, to 11.05 percent (Figure 34: Note the different scales on the left and right axes). The quarterly changes in the other ratios were relatively small, with a 3 basis point increase in the tier 1 leverage ratio, to 9.09 percent, and a 10 point decrease in the risk-based capital ratio, to 13.82 percent.



Community banks nationally had equity-to-assets and tier 1 leverage ratios increasing and risk-based capital ratios falling. Since last year, the equity-to-assets ratio at community banks nationally decreased 25 basis points, the tier 1 leverage ratio increased 13 basis points, and the risk-based capital ratio decreased 22 basis points (Figure 35: Note the different scales on the left and right axes).



At local community banks year over year, the equity-to-assets ratio has risen 14 basis points, to 10.18 percent; the tier 1 leverage ratio increased 3 basis points, to 9.65 percent; the risk-based capital ratio was unchanged at 14.42 percent (Figure 36: Note the different scales on the left and right axes).

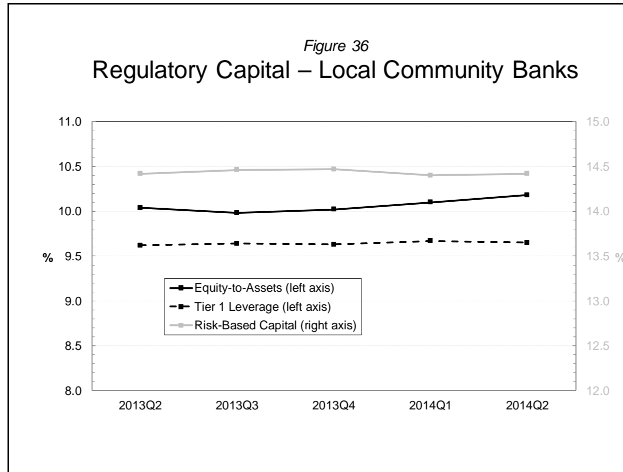
Reversing a trend over the past several quarters, all categories of banks except local

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

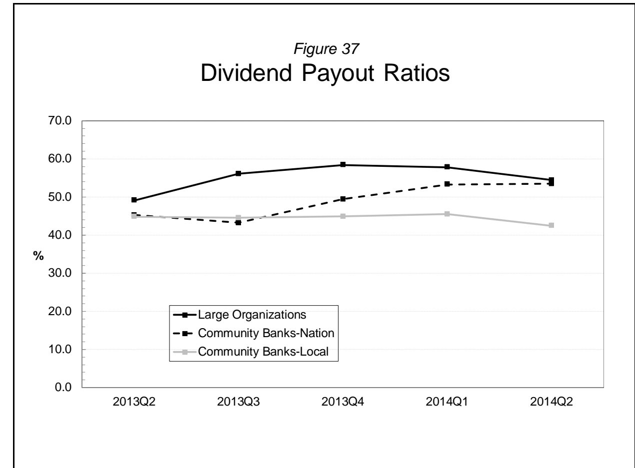
[36] The banking organizations currently affected are JPMorgan Chase & Co., Bank of America Corp., Citigroup, Wells Fargo & Co., Goldman Sachs Group, Morgan Stanley, Bank of New York Mellon Corp., U.S. Bancorp, PNC Financial Services Group, Capital One Financial Corp., HSBC North America Holdings, State Street Corp., TD Bank US Holding Company, Union BanCal Corp., and Northern Trust Corp. These institutions are known as "core" banking organizations because they have either $250 billion or more in assets or at least $10 billion in on-balance sheet foreign exposures. See last quarter's *Banking Brief* for a summary of the new regulation.

community banks had substantial unrealized gains on securities.

Large organizations saw increases in common stock preferred stock, surplus, and retained earnings. Community banks nationally had decreases in both common and preferred stock, and these were offset by increases in surplus, retained earnings, and accumulated other income. Local community banks had increases in common stock, preferred stock, surplus, and retained earnings.



The percentage of community banks paying dividends on their stock has increased slightly in the past year, while that of large organizations has fallen. Dividend payout ratios rose year over year at large organizations and community banks nationally and fell at local community banks (Figure 37).[37]



[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	-3.1%	3.9%	11.2%
RRE NPLs	-24.2%	-13.8%	-1.5%
RRE NCOs	-65.7%	8.2%	-41.3%
2. Shares			
RRE Loans/Total Loans	30.0%	29.0%	25.3%
RRE NPLs/Total NPLs	80.0%	28.6%	29.2%
RRE NCOs/Total NCOs	22.5%	22.8%	22.4%
3. Performance Ratios			
RRE NPLs/Total RRE Loans	6.62%	1.38%	1.74%
RRE NCOs/Avg. RRE Loans	0.07%	0.06%	0.04%
4. Outstandings ($ millions)			
Total RRE Loans	1,652,930.6	22,219.8	327,969.6
RRE NPLs	109,344.7	307.5	5,717.8
RRE NCOs	1,182.8	13.9	135.0

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	5.5%	14.9%	10.0%
CRE NPLs	-42.4%	-26.8%	-30.3%
CRE NCOs	-85.3%	-34.3%	-47.0%
2. Shares			
CRE Loans/Total Loans	15.8%	47.4%	43.1%
CRE NPLs/Total NPLs	8.7%	56.4%	51.3%
CRE NCOs/Total NCOs	1.6%	22.9%	36.0%
3. Performance Ratios			
CRE NPLs/Total CRE Loans	1.37%	1.66%	1.80%
CRE NCOs/Avg. CRE Loans	0.01%	0.04%	0.04%
4. Outstandings ($ millions)			
Total CRE Loans	872,990.5	36,363.3	557,633.6
CRE NPLs	11,954.7	605.2	10,019.6
CRE NCOs	82.3	14.0	217.3

Table 3 — Summary of Commercial and Industrial Lending

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
1. Year-Over-Year Growth			
Total C&I Loans	9.3%	7.8%	13.6%
C&I NPLs	-17.0%	-16.1%	-13.2%
C&I NCOs	-26.1%	7.2%	-24.7%
2. Shares			
C&I Loans/Total Loans	23.7%	13.4%	16.6%
C&I NPLs/Total NPLs	4.4%	11.8%	12.5%
C&I NCOs/Total NCOs	10.2%	49.9%	40.5%
3. Performance Ratios			
C&I NPLs/Total C&I Loans	0.46%	1.23%	1.14%
C&I NCOs/Avg. C&I Loans	0.04%	0.31%	0.12%
4. Outstandings ($ millions)			
Total C&I Loans	1,306,249.3	10,305.0	214,771.6
C&I NPLs	6,014.3	126.7	2,442.2
C&I NCOs	536.9	30.5	244.8

Table 4 — Summary of Consumer Lending

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
1. Year-Over-Year Growth			
Total Consumer Loans	5.1%	11.9%	7.3%
Consumer NPLs	-11.9%	12.2%	28.5%
Consumer NCOs	2.9%	111.6%	-2.8%
2. Shares			
Consumer Loans/Total Loans	13.6%	3.8%	4.1%
Consumer NPLs/Total NPLs	4.9%	1.3%	2.3%
Consumer NCOs/Total NCOs	63.1%	8.6%	11.2%
3. Performance Ratios			
Cons NPLs/Total Cons Loans	0.89%	0.47%	0.83%
Cons NCOs/Avg. Cons Loans	0.45%	0.20%	0.13%
4. Outstandings ($ millions)			
Total Consumer Loans	751,692.0	2,873.7	53,541.1
Consumer NPLs	6,698.1	13.4	441.8
Consumer NCOs	3,317.6	5.2	67.6

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

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Loan-Loss Reserve ($ millions)	82,813.2	1,034.2	19,524.2
Change from Last Quarter	-14.2%	-0.1%	-4.4%
Change from Last Year	-16.9%	-3.8%	-4.6%
Net Charge-Offs/LL Provision	208.8%	100.0%	109.6%
LL Provision/Operating Inc.	2.21%	4.99%	2.57%
Loan-Loss Coverage Ratio	60.6%	96.3%	99.9%

Table 6 — Summary of Securities Portfolios

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Securities/Assets	20.5%	20.2%	22.7%
Market Value ($ millions)	2,301,082.0	22,422.8	457.507.3
Change from Last Quarter	11.6%	0.5%	1.2%
Change from Last Year	6.5%	0.5%	3.3%
Realized Gain/Loss	569.2	12.8	124.3
Pct. of Average Securities	0.03%	0.06%	0.03%
Market Value/Book Value	101.06%	100.49%	100.56%

Table 7 — Structure of Liabilities

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Deposits ($ millions)	8,460,776.0	90,045.8	1,665,762.3
Pct. of Assets	75.6%	81.2%	82.8%
Change from Last Quarter	8.5%	1.9%	0.8%
Change from Last Year	7.6%	4.7%	6.8%
Core Deposits/Deposits	34.7%	64.9%	62.8%
Implicit Rate on Deposits	0.24%	0.53%	0.50%
Nondeposit Debt ($ millions)	983,035.3	8,496.5	110,502.0
Pct. of Assets	8.8%	7.7%	5.5%
Change from Last Quarter	8.3%	118.2%	66.5%
Change from Last Year	1.1%	49.1%	20.1%
Implicit Rate on Debt	1.29%	1.55%	1.63%

Table 8 — Capitalization Measures

	Large Organizations	Community Banks	
Ratios	Nation	Tri-State Area	Nation
Total Equity/Total Assets	11.05%	10.18%	10.94%
Change fr Last Qtr. (basis pts)	1	8	16
Change fr Last Yr. (basis pts)	9	14	25
Tier 1 Leverage Ratio	9.09%*	9.65%	10.28%
Change fr Last Qtr. (basis pts)	3	-2	3
Change fr Last Yr. (basis pts)	32	3	13
Risk-Based Capital Ratio	13.82%*	14.43%	15.72%
Change fr Last Qtr. (basis pts)	-10	3	-18
Change fr Last Yr. (basis pts)	-34	1	-22

* The definition of these items was changed in the first quarter of 2014 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 17.

*Table 9 — Annual Report of Small Business Lending***

	Large Organizations		Community Banks			
	Nation		Tri-State Area		Nation	
Commercial Real Estate	Number	Amount	Number	Amount	Number	Amount
<$100,000	79,272	595,990.8	11,330	26,525.1	250,964	411,984.3
Change from 2013	-9.7%	2.6%	0.7%	7.7%	-3.2%	-7.5%
$100,000–$250,000	134,950	16,975.3	12,517	1,564.1	210,751	27,120.8
Change from 2013	-7.5%	-6.2%	3.4%	1.4%	0.9%	0.5%
$250,000–$1 million	231,124	92,641.0	17,692	7,191.3	279,121	111,986.2
Change from 2013	-4.6%	-3.9%	5.8%	5.0%	3.0%	2.3%
C&I Loans						
<$100,000	7,276,450	96,746.7	43,313	1,274.1	1,125,246	31,790.8
Change from 2013	3.3%	2.5%	2.1%	5.0%	3.3%	10.3%
$100,000–$250,000	243,128	23,702.9	9,586	948.5	204,619	20,679.8
Change from 2013	-0.9%	0.0%	5.5%	5.3%	4.3%	4.2%
$250,000–$1 million	202,600	62,062.9	9,206	2,448.3	169,852	49,094.8
Change from 2013	-1.8%	1.5%	-10.0%	4.9%	4.5%	5.7%

** The number of loans is the number of loans reported; amounts are in $ millions. Starting from 2011, banks are required to report loans that are outstanding as of June 30 of the current year. As a result, loans originated after June 30, 2013, and paid off before June 30, 2014, are not included in the reported number. Conversely, loans originated before June 30, 2013, and still outstanding will be counted. This applies to both the number of loans made and the amount outstanding. As before, the "Amount" columns represent the outstanding balance on the loans rather than the original principal.