# BANKING BRIEF

## FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

## Fourth Quarter 2014 Highlights

- *Year over year, profitability (ROA) improved at community banks. Local community banks still have a lower ROA than community banks nationwide. Profitability decreased slightly at large organizations.*

- *Year over year, total loans grew fairly rapidly at community banks, but growth was more modest at large organizations. Large organizations showed strong growth in commercial and consumer loan but less in real estate 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 nonperforming loans decreased substantially at all categories of banks. Net charge-offs also decreased at community banks but increased significantly at large organizations, driven primarily by charge-offs of consumer loans.*

- *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 strong at community banks nationally, moderate at local community banks, and continued to shrink at large organizations.*

- *Commercial real estate (CRE) lending was strong at all categories of banks, with local community banks showing the most growth and large organizations the least. Construction lending and loans on multifamily properties have shown particularly strong growth, as all categories of banks saw nonperforming loans and net charge-offs dropped substantially.*

- *Loan-loss coverage increased at all categories of banks. Loan-loss provisions and reserves decreased for local and national community banks. Large organizations saw a decrease in reserves and an increase in provisions. Loan-loss coverage is still below historical norms at large organizations but close to or at historical norms at community banks.*

Any questions or comments should be directed to James V. 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 — Fourth Quarter 2014*

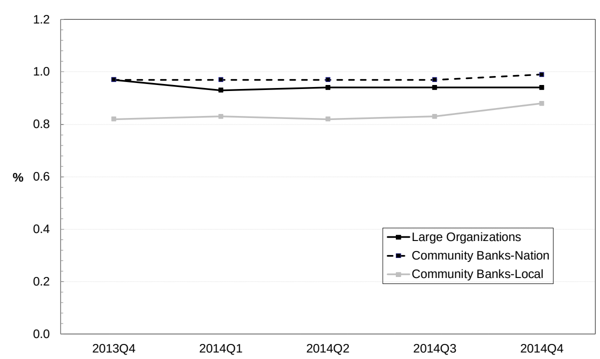
| | ***Community Banking Organizations*** | | | | | | ***Large Organizations*** | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | ***Nation*** | | | ***Tri-State*** | | | | ***Nation*** | | |
| | **$ Bill** | **% Change From** | | **$ Bill** | **% Change From** | | | **$ Bill** | **% Change From** | |
| | **14Q4** | **14Q3** | **13Q4** | **14Q4** | **14Q3** | **13Q4** | | **14Q4** | **14Q3** | **13Q4** |
| Total Assets | 2,069.7 | 9.72 | 8.00 | 115.5 | 8.68 | 8.07 | Total Assets | 11,677.4 | 9.42 | 7.20 |
| Total Loans | 1,354.5 | 11.97 | 11.66 | 81.0 | 12.51 | 11.98 | Total Loans | 5,741.8 | 14.26 | 6.34 |
| C&I | 223.9 | 15.37 | 13.70 | 10.7 | 11.45 | 10.23 | C&I | 1,350.2 | 11.11 | 9.90 |
| Real Estate | 984.1 | 10.41 | 10.84 | 62.7 | 12.26 | 11.20 | Real Estate | 2,642.0 | 0.86 | 0.52 |
| Consumer | 56.8 | 10.09 | 9.73 | 3.1 | 11.50 | 17.16 | Consumer | 866.8 | 74.72 | 17.03 |
| Total Deposits | 1,708.7 | 8.83 | 6.69 | 93.2 | 7.22 | 5.48 | Total Deposits | 8,792.6 | 9.45 | 6.67 |
| **Ratios (in %)** | **14Q4** | **14Q3** | **13Q4** | **14Q4** | **14Q3** | **13Q4** | **Ratios (in %)** | **14Q4** | **14Q3** | **13Q4** |
| Net Income/Avg. Assets (ROA) | 0.99 | 0.97 | 0.97 | 0.88 | 0.83 | 0.82 | Net Income/Avg Assets (ROA) | 0.94 | 0.94 | 0.97 |
| Net Interest Inc./Avg. Assets (NIM) | 3.37 | 3.38 | 3.35 | 3.17 | 3.15 | 3.17 | Net Interest Inc./Avg. Assets (NIM) | 2.46 | 2.41 | 2.48 |
| Noninterest Inc./Avg. Assets | 0.90 | 0.90 | 0.96 | 1.20 | 1.22 | 1.29 | Noninterest Inc./Avg. Assets | 1.67 | 1.68 | 1.78 |
| Noninterest Exp./Avg. Assets | 2.92 | 2.97 | 3.03 | 3.10 | 3.13 | 3.20 | Noninterest Exp./Avg. Assets | 2.66 | 2.61 | 2.71 |
| Loans/Deposits | 79.27 | 78.71 | 75.74 | 86.97 | 85.93 | 81.91 | Loans/Deposits | 65.30 | 64.60 | 65.51 |
| Equity/Assets | 10.98 | 11.02 | 10.64 | 10.19 | 10.18 | 10.01 | Equity/Assets | 10.92 | 10.93 | 10.96 |
| Nonperforming Loans/Total Loans | 1.23 | 1.39 | 1.73 | 1.22 | 1.30 | 1.62 | Nonperforming Loans/Total Loans | 2.13 | 2.33 | 2.95 |

Unless otherwise noted, all data are from Federal Financial Institutions Examination Council (FFIEC) 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 — 161 for the tri-state area and 4,947 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.

***Fourth Quarter 2014***

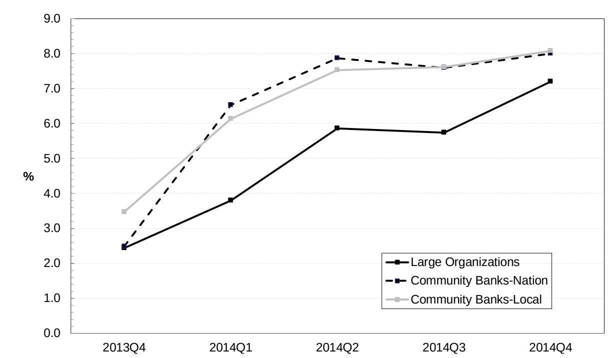
Banks in all categories continued to report fairly strong results in the fourth quarter, with all categories of banks showing increased loan growth, and higher asset quality. Large organizations lagged the community banks, but they still had fairly good results. Year over year, profitability was nearly flat at large organizations and community banks nationally, and it improved at local community banks. In large banks and community banks nationally, profitability is near historical norms.[1] Profits this quarter were virtually unchanged. At large organizations, return on average assets (ROAA) was 0.94 percent, down slightly since last year and unchanged in the quarter (Figure 1).[2] ROAA at local community banks increased 6 basis points since last year, to 0.88 percent (Figure 1).[3] At community banks nationwide, ROAA increased 2 basis points from last year to 0.99 percent.

*Figure 1*
Return on Average Assets




The factors that contributed to the relatively high profitability for the quarter were different for large organizations and community banks. Assets grew 7.2 percent year over year at large organizations, 8.07 percent at local community banks, and 8 percent at national community banks (Figure 2). The main growth in assets came from loans.

*Figure 2*
Year-Over-Year Asset Growth




Loans outstanding grew about 11.7 percent nationally and nearly 12 percent locally, while those at large organizations grew 6.3 percent (Figure 3).

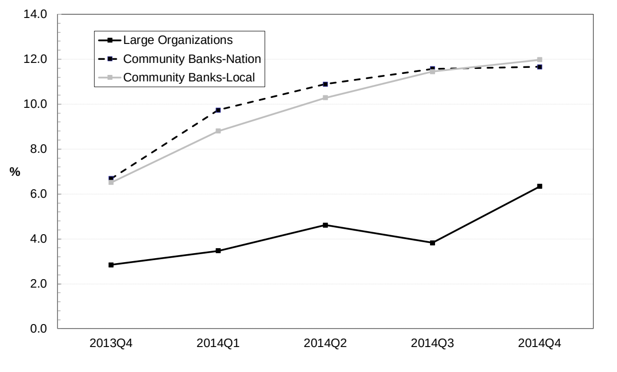
While asset growth at community banks was fueled mainly by loan growth, at large organizations, it was due to growth in securities. The market value of securities at large organizations grew nearly 10 percent from 2013, while at community banks, it grew 1.9 percent nationally and shrank 2.6 percent locally.

[1] In the past 20 years, the average ROAA was 1.04 percent. Source: Federal Deposit Insurance Corporation (FDIC) Historical Statistics on Banking

[2] Unless otherwise noted, 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 annualized, that is, from the fourth quarter of 2013 to the fourth quarter of 2014. Finally, unless otherwise noted, any quarterly percentage changes are compound annualized rates.

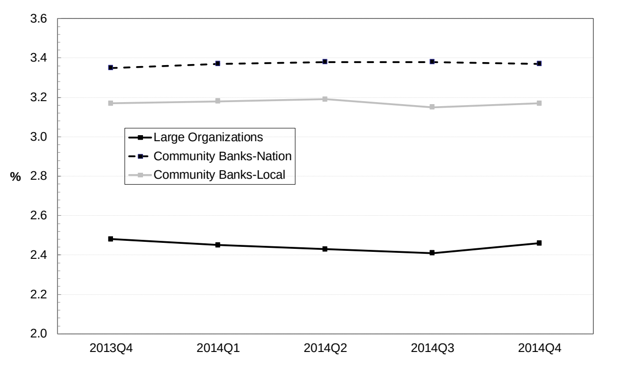
[3] See Summary Table of Bank Structure and Conditions on page 2.

*Figure 3*
Year-Over-Year Loan Growth




Community banks also had high net interest margins (NIMs) relative to large organizations. NIM at community banks nationally was 3.37 percent, a slight increase from last year (Figure 4). Locally, NIM was flat at 3.17 percent. At large organizations, NIM fell two basis points, to 2.46 percent.

*Figure 4*
Net Interest Margins

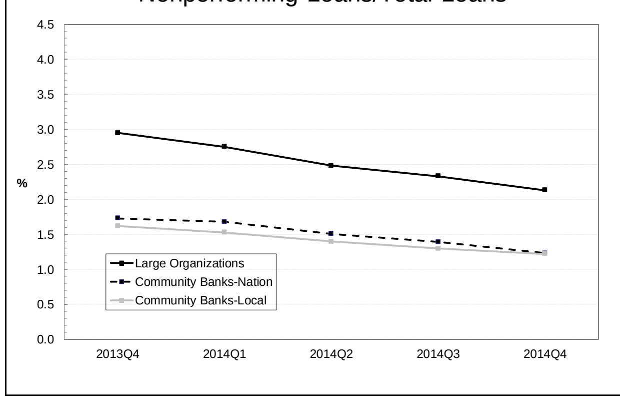



The ratio of noninterest income to average assets decreased at all categories of banks. Also, the ratio of noninterest expense to average assets decreased at all categories of banks. Net trading income increased at large organizations and community banks nationally, but local community banks reported a small net loss. Community banks saw fairly strong growth in income from asset sales, while large organizations' income from asset sales fell. All categories of banks had strong gains from loan sales, but sales of foreclosed real estate (other real estate owned — OREO) fell, particularly at large organizations. Also, all categories of banks had year-over-year increases in realized gains on securities.

Profitability at area banks continued to lag other banks in the nation as it has for several quarters (Figure 1). There are three major reasons for this. First, the high loan-to-deposit ratio at local banks shows that they have had fairly high loan growth. This means that they are carrying more loans, which leads to more loan losses, which means they have to have higher loan-loss provisions. Second, local banks have lower NIMs than community banks elsewhere because of their funding mix, which depends more heavily on relatively expensive nondeposit debt (see "Funding Sources" on page 14). A third factor affecting profitability is that banks in the region continued to have the highest expense ratios of any category of banks.

Loan quality at banks in all categories continued to improve. The ratio of nonperforming loans (NPLs) to total loans (the NPL ratio) continued to shrink substantially at all categories of banks (Figure 5). Community banks continued to have higher loan quality than large organizations, and there was little difference between local community banks and community banks nationally. Overall, asset quality has also improved for all categories of

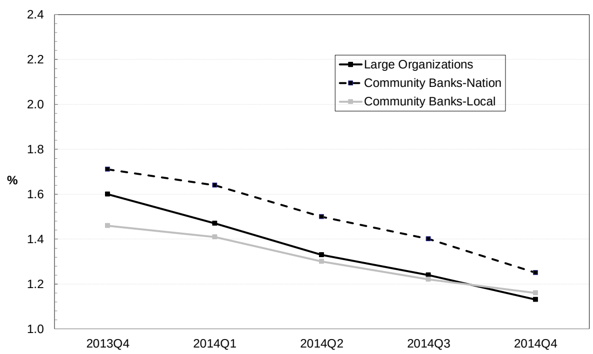
*Figure 5*
Nonperforming Loans/Total Loans



banks.[4] OREO decreased from last year at all categories of banks. At large organizations, OREO, as a percent of total assets, decreased by 6 basis points, to 0.08 percent. At community banks, the decrease was 16 basis points nationally, to 0.45 percent, and 6 basis points locally, to 0.30 percent. Total OREO decreased 26.5 percent at large organizations, 19.2 percent at community banks nationally, and 12.2 percent at community banks 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).[5]

*Figure 6*

Nonperforming Assets/Total Assets

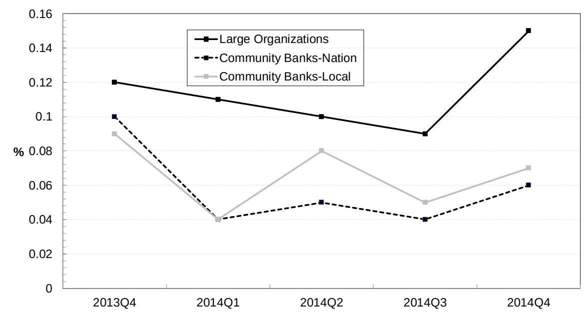



At large organizations, the NPA ratio has fallen 47 basis points in the past year, to 1.13 percent. At community banks nationally, the decrease was 46 basis points, to 1.25 percent, and locally, the NPA ratio fell 30 basis points, to 1.16 percent.

The ratio of net charge-offs (NCOs) to average loans (the NCO ratio) fell at community banks but increased at large organizations. This increase in the NCO ratio for large organizations can be attributed to an increase in NCOs on credit card and consumer loans. (See more about credit card and consumer loans in the Consumer Lending section). Additionally, all categories had an increase from the third to the fourth quarter (Figure 7).

*Figure 7*

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 0.06 percent. At tri-state area community banks, the NCO ratio has also fallen 2 basis points over the past year, to 0.07 percent. At large organizations, there was an increase of 3 basis points, to 0.15 percent. All categories of banks showed quarterly increases in charge-offs and decreases in recoveries.

Capital ratios, defined as the ratio of total equity to assets, increased at community banks and fell somewhat at large organizations (Figure 8). There were only four bank failures in the fourth quarter and an additional three so far in 2015, for a total of 21 in 2014. Only one of these was in the tri-state area. There were 25 total failures in 2013.

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

[5] 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

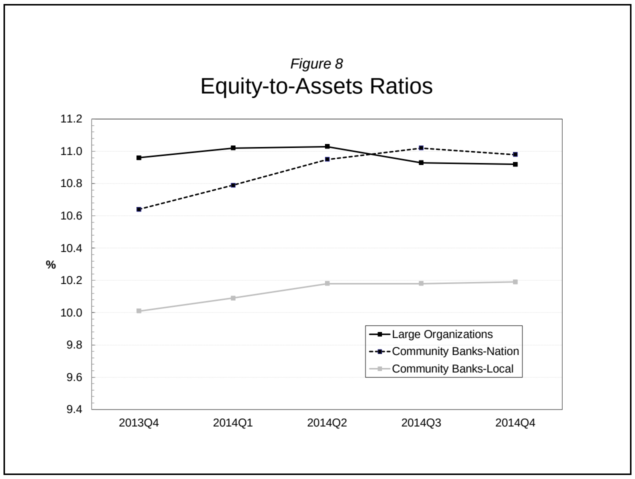



*Figure 8*
Equity-to-Assets Ratios

## ***Residential Real Estate Lending***[6]

Nationwide, RRE markets were up overall from the fourth quarter of 2013 to 2014, but the growth was very uneven. The Federal Reserve Board's *Beige Book*, as of January 14, 2015, reported that sales of both new and existing homes declined in most areas, with some areas showing a small increase.

Philadelphia and North Jersey lagged the rest of the nation, reporting minimal growth in both new and existing home sales.[7] The *Beige Book* did report that contract signings in the Philadelphia area were up in December after slow sales in October and November. The *Beige Book* also reported decreases in residential construction in the region, and this was the case in much of the country as well.

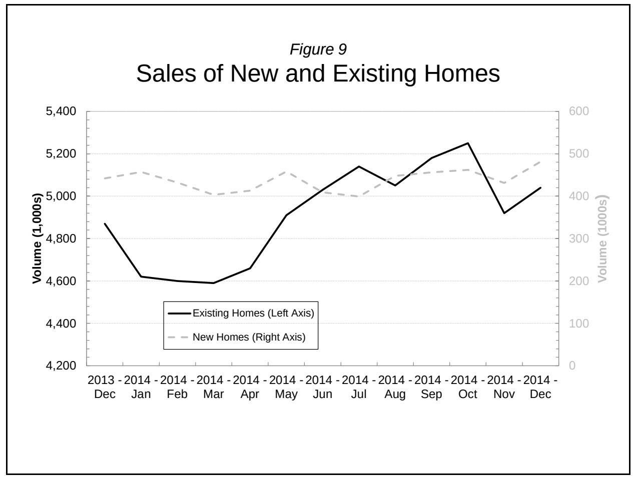



*Figure 9*
Sales of New and Existing Homes

Sales of both new and existing homes have increased somewhat from last year (Figure 9: Note the different scales on the left and right y-axes).[8] The percentage of both delinquent mortgages and mortgages in foreclosure has decreased steadily for several years (Figure 10).

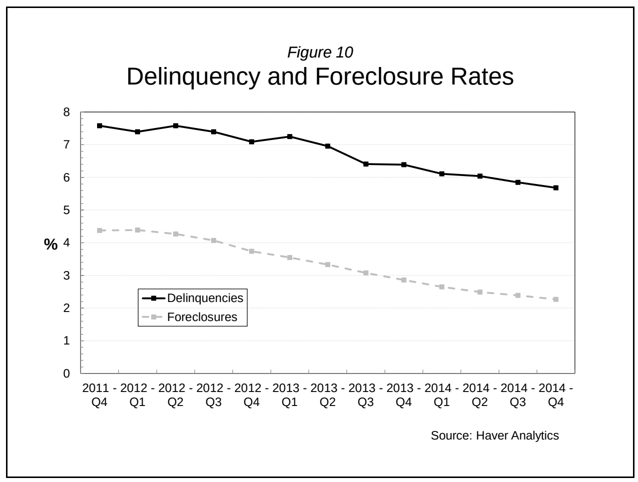



*Figure 10*
Delinquency and Foreclosure Rates

Lending at community banks continued to strengthen (Figure 11). Total RRE loans at community banks nationally and locally have increased year over year. Total RRE loans have been decreasing for the past year at large organizations. From the fourth quarter of 2013

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

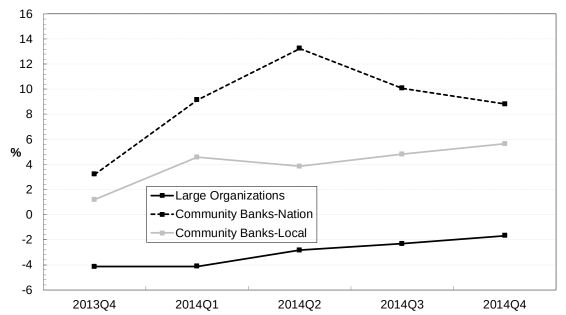
[7] For further information, see http://www.federalreserve.gov/monetarypolicy/beigebook/files/BeigeBook_20150114.pdf.

[8] Sales of existing homes increased by about 140,000 units from December 2013 to December 2014. For the entire fourth quarter, existing home sales are up strongly. New home sales increased by about 39,000 units from December 2013 to December 2014. For the quarter, new home sales increased by about 43,000 units.

to the fourth quarter of 2014, RRE loans outstanding grew at a rate of 11.7 percent at community banks nationally and

*Figure 11*

Annual Change in RRE* Loans Outstanding



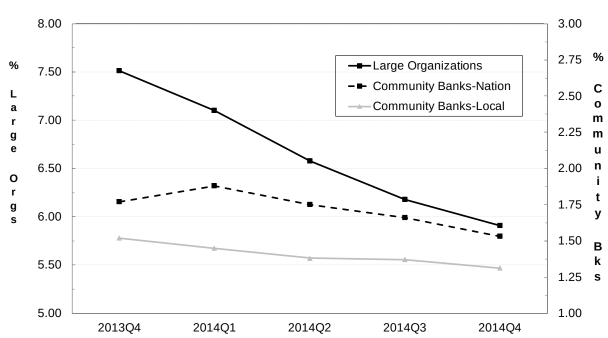

*Residential real estate

5.7 percent locally. Large organizations, by contrast, had a 1.7 percent drop in RRE loans. Most of the increase in lending at community banks both nationally and locally has been in mortgages secured by first liens, though home equity lines of credit (HELOCs) at those institutions continued to increase as well.

The quality of RRE loans continued to improve at all categories, but large organizations are still carrying a substantial portfolio of NPLs. The RRE NPL ratio at large banks fell 1.6 percentage points, to 5.91 percent, in the past year (Figure 12: Note the different scales for large organizations [left y-axis] and

*Figure 12*

Nonperforming RRE* Loans/Total RRE Loans



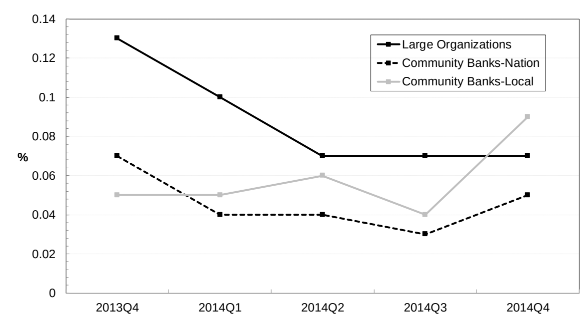

*Residential real estate

community banks [right y-axis]). Community banks have much better RRE loan quality, with NPL ratios of 1.53 percent nationally and 1.31 percent locally. These represent drops of 34 and 21 basis points, respectively, in the past year.

The improvement in loan quality is also reflected in the RRE NCO ratio. At large organizations, this ratio decreased 6 basis points in the past year, to 0.07 percent (Figure 13). At community banks, the RRE NCO ratio decreased 2 basis points nationally in the past year, to 0.05 percent, and it increased 4 points locally, to 0.09 percent. Community banks both locally and nationally had quarterly increases in their RRE NCO ratios. At large organizations,

*Figure 13*

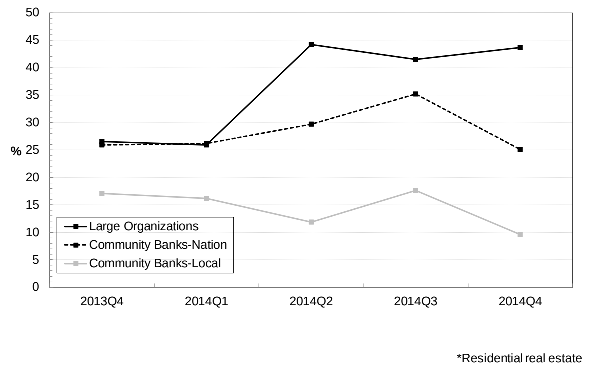
Net Charge-Offs on RRE* Loans/Avg. RRE Loans




*Residential real estate

charge-offs are down and recoveries are up. At community banks nationally, both charge-offs and recoveries fell somewhat. Locally, charge-offs increased and recoveries declined. As a result, while recovery ratios continued to increase at large organizations, they have decreased at community banks in the past year (Figure 14).

*Figure 14*
Recovery Ratio on RRE Loans

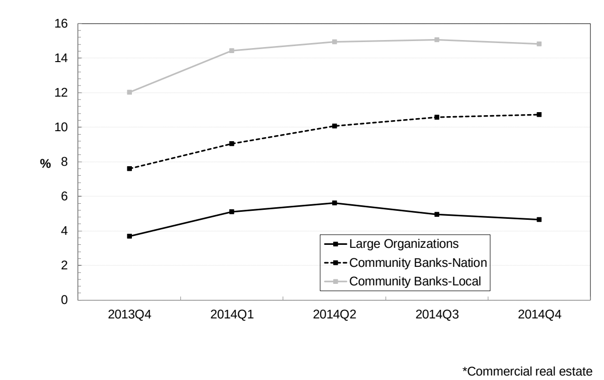



## ***Commercial Real Estate Lending***[9]

While the RRE markets continued to be sluggish, commercial real estate (CRE) market conditions continued to strengthen both locally and nationally. The *Beige Book* reported that, in most of the CRE markets nationwide, construction activity has increased. Most of the increased activity was in multifamily properties, with more than half of the districts also reporting increasing construction for manufacturing. Demand for leased commercial space picked up in many areas. The Philadelphia district reported generally worse performance than the rest of the country, with construction activity virtually unchanged and only slight growth in leasing activity. Much of the leasing of office space was due to companies shifting offices rather than an expansion of leasing. Northern New Jersey, which has lagged Philadelphia, reported a slight pickup in both construction and leasing, but both remain at fairly low levels.

CRE lending results were fairly strong among all categories of banks, with both loan growth and quality improving. Loan growth was especially strong at local community banks. Year over year, CRE loans outstanding grew at a rate of 4.7 percent at large organizations, 10.7 percent at community banks nationally, and 14.8 percent at tri-state area community banks (Figure 15). The strongest area of growth at community banks was in loans on multifamily properties, with construction lending increasing

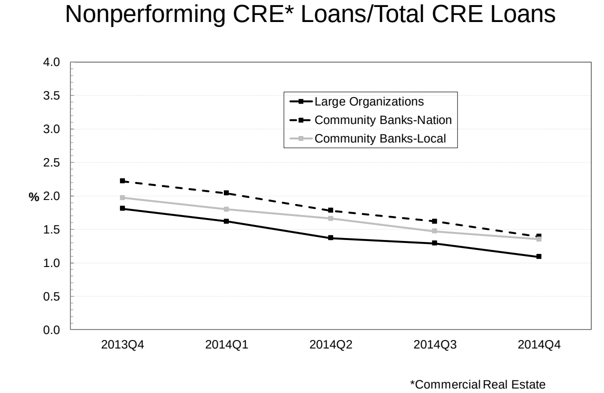
*Figure 15*
Annual Change in CRE* Loans Outstanding




at double-digit rates as well. Construction lending and multifamily properties were also the main contributors to growth at large organizations, although growth in multifamily properties did slow somewhat.

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 72 basis points from the fourth quarter of 2013, to 1.09 percent (Figure 16). The

*Figure 16*
Nonperforming CRE* Loans/Total CRE Loans



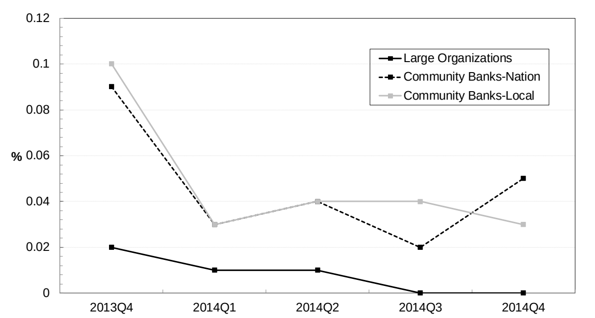

CRE NPL ratio decreased by 83 basis points from last year at community banks nationally, to

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

1.39 percent, and 62 basis points at community banks locally, to 1.35 percent.

NCO ratios have decreased at all categories of banks as well. The NCO ratio on CRE loans at large organizations decreased 2 basis points, to less than 0.01 percent (Figure 17). At community banks, nationally there was a decrease of 4 basis points, to 0.05 percent, and a

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

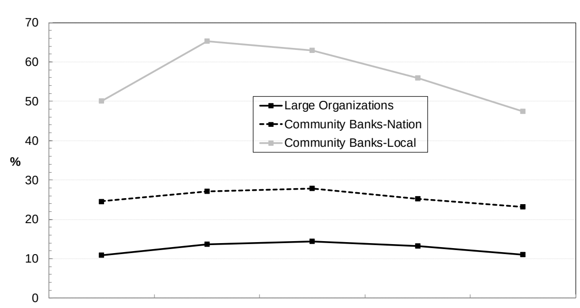



*Commercial real estate

decrease of 7 basis points locally, to 0.03 percent. Total NCOs on CRE loans grew 3 basis points at community banks nationally in the fourth quarter, to 0.05.

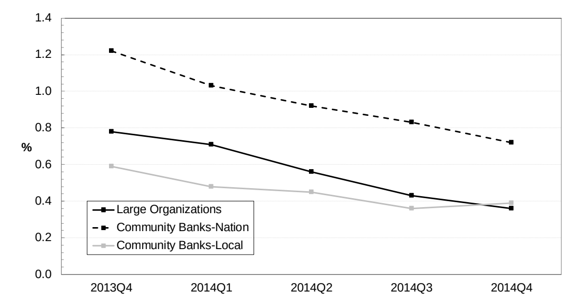
As noted previously, much of the growth in CRE lending can be attributed to growth in multifamily housing (Figure 18). All categories of banks saw double-digit growth in multifamily

*Figure 18*
Annual Change in Multifamily Loans Outstanding




loans; this was especially true at local community banks. Multifamily loans grew 11.1 percent at large organizations, 23.1 percent at community banks nationally, and 47.4 percent at community banks locally.

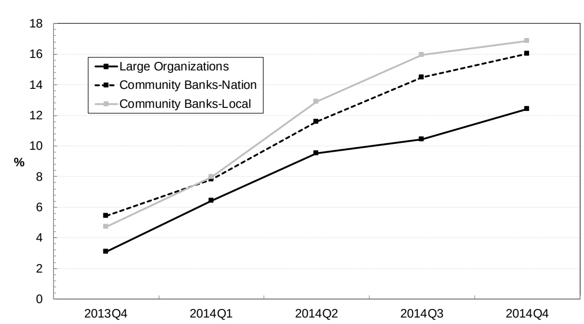
*Figure 19*
Multifamily Loan NPL Ratios




In spite of the high growth, multifamily loan quality has not been adversely affected, as NPL ratios at all categories have been falling for more than a year, and they are below those for all CRE loans (Figure 19).

After shrinking for several years, construction lending is now growing at double-digit rates at all categories of banks, and this growth has accelerated in each of the past five quarters (Figure 20).

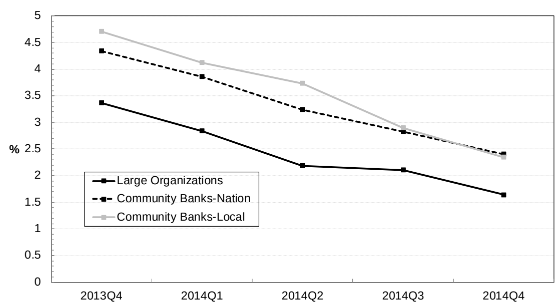
*Figure 20*
Annual Change in Construction Loans Outstanding




The quality of construction loan portfolios has improved substantially as well, but it is still the riskiest type of CRE lending. The construction loan NPL ratio for large organizations has dropped 1.73 percentage points in the past year, to 1.64 percent (Figure 21). Community banks have experienced similar drops — more than 1.9 percentage points nationally, to 2.40 percent, and nearly 1.4 percentage points locally, to 2.34 percent.

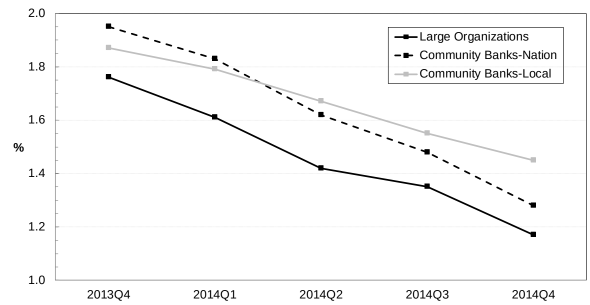
By far, the largest share of CRE lending is in commercial mortgages.[10] Since CRE lending is the largest part of community banks' loan

*Figure 21*
Construction Loan NPL Ratios




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 69 basis points, to 1.18 percent. At community banks nationally, the ratio has decreased 67 basis points, to 1.28 percent, and at community banks locally, the ratio has decreased 42 basis points, to 1.45 percent (Figure 22). NCOs on these loans have also dropped substantially in the past year. While this is also the weakest growing

*Figure 22*
Nonperforming Commercial Mortgages/ Commercial Mortgages




segment, at community banks, there has still been substantial growth, with a growth rate of about 7.9 percent nationally and 8.3 percent locally. Growth at large organizations has been more sluggish at about 1.6 percent, but this is a less important market to them.

***<u>Commercial & Industrial Lending</u>***[11]

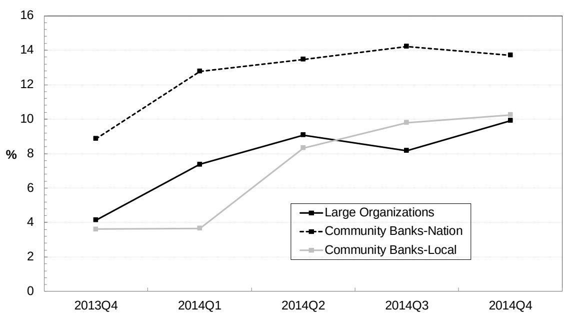
C&I lending continued to grow at a good pace at all categories of banks, with community banks having a bit higher growth than large organizations. At large organizations, C&I loans grew 9.9 percent in the past year (Figure 23 and Table 3 in the Appendix). At community banks, C&I lending grew 13.7 percent nationally and 10.2 percent locally.

[10] At large organizations, 67.5 percent of CRE loans are commercial mortgages, 18.1 percent are multifamily loans, and 14.4 percent are construction loans. At community banks nationally, 72.8 percent of CRE loans are commercial mortgages, 11.7 percent are multifamily loans, and 15.5 percent are construction loans. At local community banks, 71.1 percent of CRE loans are commercial mortgages, 18.5 percent are multifamily loans, and 10.3 percent are construction loans.

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

*Figure 23*

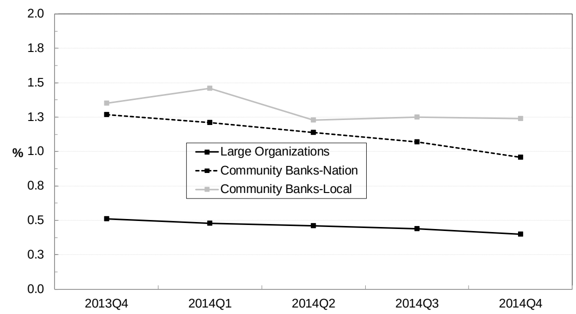
Year-Over-Year C&I* Loan Growth




*Commercial and Industrial

*Figure 24*

Nonperforming C&I* Loans/C&I Loans




*Commercial and Industrial

The Federal Reserve Board's *Senior Loan Officer Opinion Survey* for January 2015 reported that conditions were basically unchanged from the October survey. Loan demand continued to increase somewhat, with most banks reporting a small increase in demand and a small fraction of respondents reporting a strong increase in demand.[12] The increase in demand was nearly all from medium- and large-sized firms, with demand from small firms unchanged. On the supply side, there was little change in lending standards. Only a few banks reported easing spreads, interest rate floors, and cost of credit lines.

Loan quality remained high at all categories of banks (Figure 24). At large organizations, the NPL ratio has fallen 11 basis points in the past year, to 0.40 percent. Quality is somewhat worse at community banks, with NPL ratios of 0.96 percent nationally and 1.24 percent locally. Both of these ratios fell substantially in the past year.

## ***Consumer Lending***[13]

Consumer lending strengthened substantially in the fourth quarter, with all but community banks nationally reporting double-digit growth and no category experiencing quality problems. Large organizations conduct the vast majority of consumer lending. Their consumer lending grew about 17.0 percent year over year (Figure 25). At community banks nationally, consumer lending grew 9.7 percent, while at community banks locally, consumer lending grew 17.2 percent. At large organizations, credit card loans grew substantially at 40.85 percent to make up 40.28 percent of consumer loans, auto loans grew at a modest pace, and installment loans shrank.[14] Growth in "other revolving credit" was the largest at community banks both locally and nationally at 10.37 percent and 5.85 percent, respectively. Auto loans as a percentage of consumer loans grew slightly at all categories of banks. Large organizations saw a 1.94 percent

[12] For further information, see http://www.federalreserve.gov/boarddocs/snloansurvey/201502/fullreport.pdf.

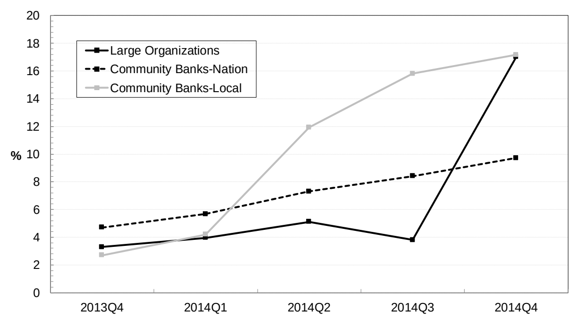
[13] See Table 4 in the Appendix for a full summary of the data used in this section.

[14] 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.

increase. Community banks nationally saw a 2.85 percent increase. Local community banks saw a 1.49 percent increase. There was little or no growth in installment loans.

*Figure 25*

Year-Over-Year Growth in Consumer Loans

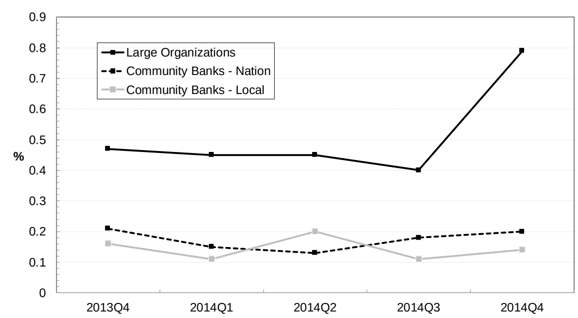



NPL ratios on consumer loans have been low: 0.85 percent for large organizations, 0.73 percent for community banks nationally, and 0.41 percent for tri-state area community banks.

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.[15] On that measure, quality of consumer loans worsened. NCO ratios increased 34 basis points from last year at large organizations, to 0.79 percent (Figure 26). At community banks, the NCO was basically flat nationally at 0.20 percent and increased 3 basis points locally, to 0.14 percent. All categories of banks saw their NCO ratios rise during the fourth quarter. The increasing NCO ratio at large organization can be attributed to increasing NCOs on credit cards and a slight increase in NCOs for C&I loans. Credit card NCOs as a percentage average credit card loans increased 98 basis points, from 0.89 percent to 1.87 percent. In comparison, community banks nationally had a 10 basis point increase in credit card NCOs, to 0.80 percent of average credit card loans. Local community banks had a 13 basis point increase in credit card NCOs, to 0.69 percent.

*Figure 26*

NCOs on Consumer Lns/Average Consumer Lns




## ***Provisioning and Reserves***[16]

The large drops in both NPLs and NCOs have allowed banks to continue to reduce their loan-loss provisions and reserves. Loan-loss reserves continued to fall at all categories of banks, both overall and as a percent of assets.[17] As a percent of assets, loan-loss reserves fell 12 basis points at large organizations, to 0.70

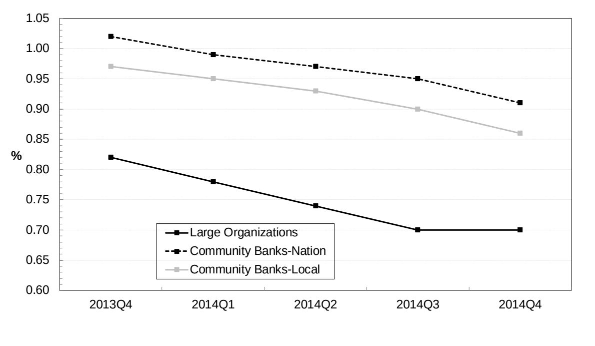
[15] The breakdown of consumer loans is as follows. Large organizations: credit cards, 40.3 percent; other revolving credit, 6.6 percent; auto loans, 34.3 percent; other consumer loans, 18.9 percent. Community banks nationally: credit cards, 3.0 percent; other revolving credit, 5.7 percent; auto loans, 45.5 percent; other consumer loans, 46.9 percent. Local community banks: credit cards, 1.6 percent; other revolving credit, 23.4 percent; auto loans, 34.3 percent; other consumer loans, 40.7 percent. Figures may not equal 100 percent due to rounding.

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

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

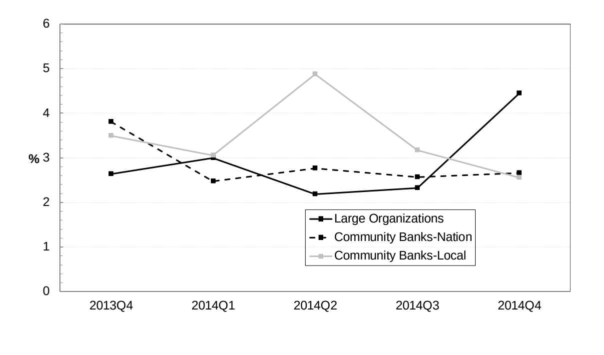
percent; 11 points at community banks nationwide, to 0.91 percent; and 11 basis points at local community banks, to 0.86 percent (Figure 27).

*Figure 27*
Loan-Loss Reserves/Assets




Loan loss provisions as a percent of operating income fell at community banks, but they increased substantially at large organizations (Figure 28).[18] The ratio of loan-loss provision to operating income increased 1.8

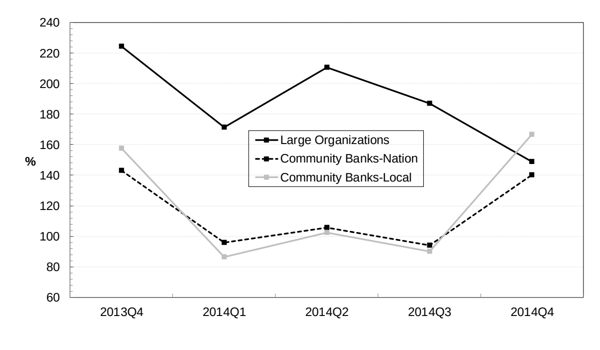
*Figure 28*
Loan-Loss Provision/Operating Income




percentage points at large organizations, to 4.45 percent. At community banks nationally, the ratio has decreased 1.15 percentage points, to 2.66 percent, and at local community banks, it fell 94 basis points, to 2.56 percent.[19]

In previous quarters, the falling loan-loss provisions and consequent decreases in reserves could be justified as a reaction to improving loan quality. However, the ratio of NCOs to loan-loss provision (Figure 29) is now well above the historical norm.[20] At large organizations, this ratio has decreased 75.7 percentage points in the past year and 38.2 percent in the fourth quarter, to 148.8 percent. At community banks nationally, the ratio has fallen 3.1 percentage points in the past year, to 140.1 percent, but it increased 46 percentage

*Figure 29*
Net Charge-offs/Loan-Loss Provision




points from the third to the fourth quarter. Locally, this ratio increased 9.2 percentage points in the past year and 76.7 percentage points in the fourth quarter, to 166.8 percent.

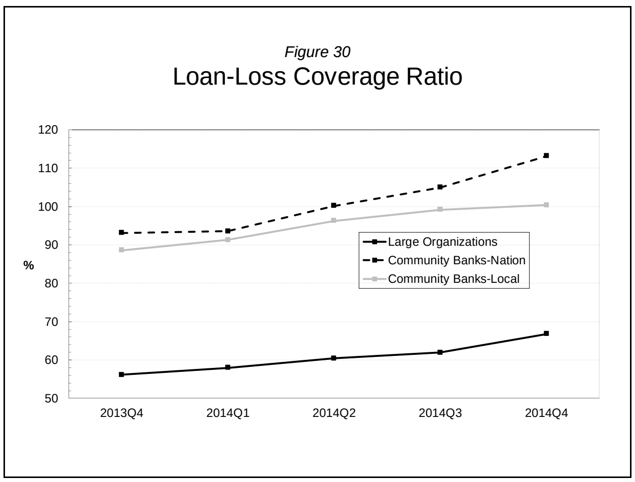
---

[18] Operating income is defined as the sum of net interest income and noninterest income.

[19] 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

[20] 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

Loan-loss coverage continued to improve at all categories of banks.[21] At community banks, it is now above the historical average nationally and near it locally, but at large organizations, it remains well outside of historical norms. For the first time in several years, community banks now have sufficient reserves for all of their NPLs. At large organizations, loan-loss coverage increased about 10.7 percentage points from last year, to 66.8 percent (Figure 30). The loan-loss coverage ratio at community banks nationally has increased more than 20 percentage points in the past year, to 113.2 percent. Locally, loan-loss coverage increased almost 12 percentage points, to 100.4 percent.




## ***Securities***[22]

The market value of securities increased substantially in the past year at large organizations, but community banks' portfolios were less successful. As noted previously, much of the asset growth at large organizations was in securities, which gained 10.0 percent in value.[23] At community banks nationally, there was a small year-over-year increase (1.9 percent) in the market value of their securities portfolios. Locally, securities portfolios decreased by about 2.6 percent. Community banks locally had a small quarterly decrease in their securities portfolios, while those nationally showed a small increase.

All categories of banks saw both quarterly and annual increases in realized gains on securities.[24] Large organizations posted gains of approximately $570.5 million. Community banks nationally reported a realized gain of $131.1 million in the quarter. Local community banks reported a realized gain of about $17.4 million.

## ***Funding Sources***[25]

Year-over-year deposit growth was relatively strong across all categories of banks

[21] 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

[22] 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.

[23] 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.

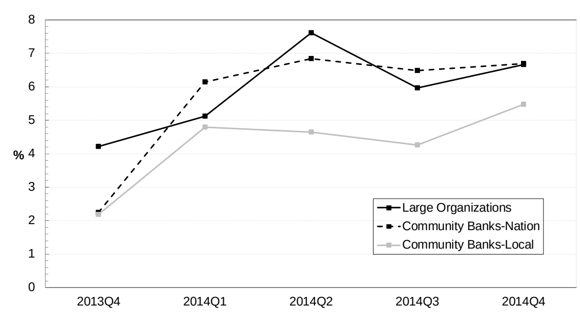
[24] Realized and unrealized gains and losses are net positions. Thus, the tri-state area sample can have larger gains or losses than the national sample, even though the tri-state sample is a subset of the national sample.

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

(Figure 31), but deposit growth at community banks is not keeping pace with loan growth. Deposit growth was fairly consistent across banks and account types, with all categories of banks seeing transaction and savings accounts rise, and time deposits fall.

Reliance on brokered deposits continued to increase at all categories of banks. At large organizations, brokered deposits as a percent of total deposits have increased 10 basis points from last year. At community banks nationally, this ratio has increased 44 basis points in the

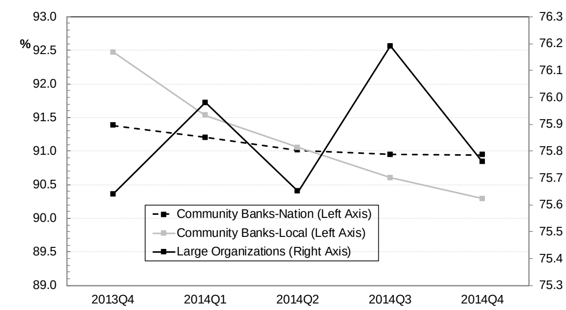
*Figure 31*
Year-Over-Year Growth in Deposits




past year. At local community banks, brokered deposits as a percent of total deposits are up 1.8 percentage points in the past year.

Core deposits grew at about the same rate as total deposits at large organizations, but a little slower at community banks both nationally and locally.[26] Core deposits as a percent of total deposits has decreased slightly at community banks in the past year, and it was nearly unchanged at large organizations (Figure 32: Note the different scales for community banks

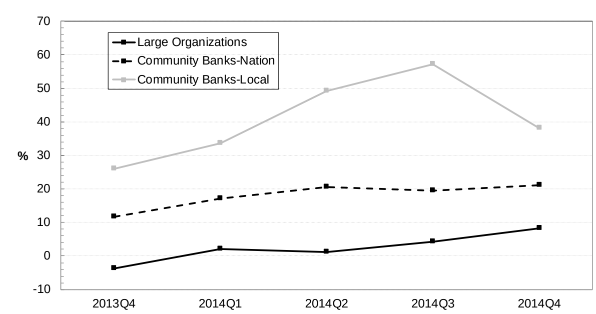
*Figure 32*
Core Deposits/Total Deposits




and large organizations). Local community banks have a much lower ratio than do those nationally.

The slower growth in deposits in general and core funding in particular has forced banks, especially community banks, to seek more expensive types of funding in the form of nondeposit debt. Nondeposit debt funding has been increasing substantially for the past several quarters at community banks both nationally and locally (Figure 33).[27]

*Figure 33*
Year-Over-Year Growth in Nondeposit Debt

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[26] Core deposits are defined as the sum of transaction accounts, money market accounts, other savings deposits, and time deposits of less than $250,000, less all brokered deposits.

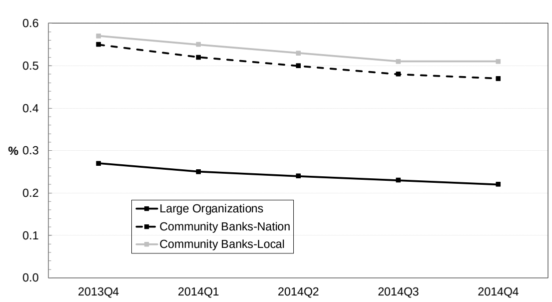
[27] Nondeposit funding consists of fed funds purchased, securities sold under agreements to repurchase (repos), subordinated debt, Federal Home Loan Bank (FHLB) advances, and other borrowings.

Nondeposit debt funding increased 21.0 percent at community banks nationally and 38.2 percent locally. Large organizations saw more modest increases in nondeposit debt funding. For large organizations, nondeposit debt grew 8.2 percent from the fourth quarter of 2013. Nondeposit debt as a share of assets is about 8.7 percent for large organizations compared with 5.7 percent for community banks nationally and 8.2 percent locally. Community banks nationally have higher core deposits, at 90.94 percent of total deposits, and lower debt funding, at 5.69 percent of assets. Local community banks have 90.29 percent core deposits and 8.21 percent debt funding as a percent of assets. Large organizations have 75.76 percent of deposits as core deposits and 8.68 percent of their assets are debt funding. The combination of higher core deposits and lower debt funding compared with large organizations is a major factor in explaining why community banks nationally have higher net interest margins than local banks and community banks in general have higher margins than large organizations.

Large organizations continue to have a substantial funding price 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

*Figure 34*

Implicit Interest Rate on Deposits



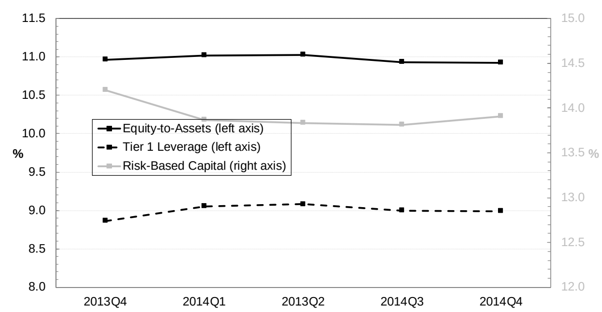

banks, but large organizations pay only a fraction of what community banks pay both nationally and locally (Figure 34).[28] This holds true for nondeposit funding as well.

## ***Regulatory Capital***[29]

Because of the new capital standards intended to implement the Basel III accords that were implemented for certain large banks in the first quarter of 2014, annual changes in tier 1 leverage and risk-based capital are not directly comparable.[30] The one ratio whose definition did not change, the equity-to-assets ratio, was

*Figure 35*

Regulatory Capital – Large Organizations

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

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

[30] 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. All other banks will be subject to the new regulations beginning January 1, 2015. See *Banking Brief* for the first quarter of 2014 for a summary of the new regulation.

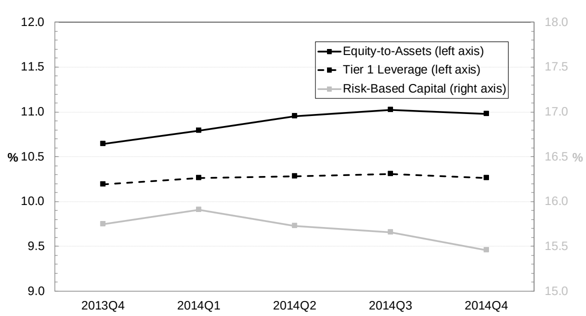
relatively stable year over year, falling 4 basis points to 10.92 percent. This represents a quarterly drop of 1 basis point (Figure 35: Note the different scales on the left and right y-axes). The tier 1 leverage ratio was flat in the quarter, falling 1 basis point, to 8.99 percent, and the risk-based capital ratio increased by 10 basis points, to 13.91 percent.

At community banks nationally, equity-to-assets and tier 1 leverage ratios increased slightly from last year, while the risk-based capital ratio decreased. The equity-to-assets ratio at community banks nationally increased 34 basis points, to 10.98 percent, but fell 3 points in the fourth quarter. The tier 1 leverage ratio increased 7 basis points, to 10.26 percent, but fell 5 points in the quarter. The risk-based capital ratio decreased 29 basis points, to 15.46 percent (Figure 36: Note the different scales on the left and right y-axes). This was a drop of 20 basis points in the fourth quarter.

At local community banks year over year, the equity-to-assets ratio has risen 18 basis points, to 10.19 percent; the tier 1 leverage ratio decreased 12 basis points, to 9.51 percent; and the risk-based capital ratio decreased 29 basis points, to 14.17 percent (Figure 37: Note the different scales on the left and right y-axes). The equity-to-assets and tier 1 leverage ratios were unchanged in the fourth quarter, and the risk-based capital ratio fell 5 basis points.

*Figure 36*

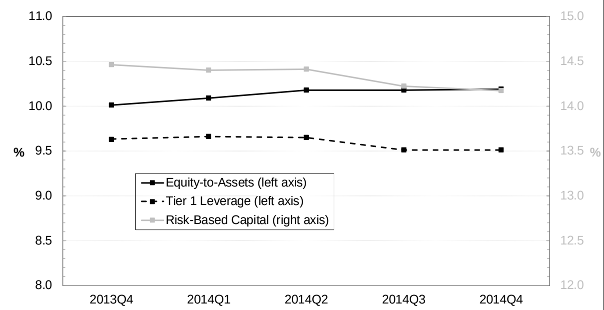
Regulatory Capital – All Community Banks




All categories of banks had large unrealized gains on securities in the fourth quarter. 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.

*Figure 37*

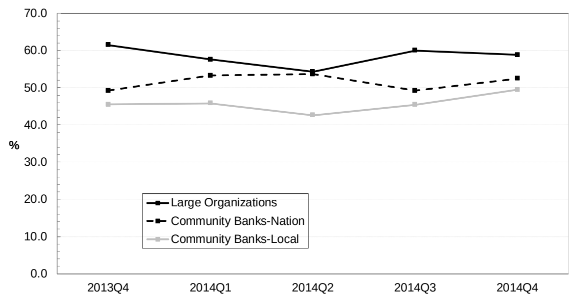
Regulatory Capital – Local Community Banks



The percentage of community banks and large organizations paying dividends on their stock has increased in the past year. Dividend payout ratios rose year over year at community banks nationally and locally. Dividend payout ratios fell slightly at large organizations (Figure 38).[31]

*Figure 38*

Dividend Payout Ratios




[31] 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 | -1.7% | 5.7% | 11.7% |
| RRE NPLs | -22.7% | -9.1% | -3.3% |
| RRE NCOs | -47.6% | 80.2% | -22.4% |
| | | | |
| 2. Shares | | | |
| RRE Loans/Total Loans | 28.9% | 28.2% | 25.1% |
| RRE NPLs/Total NPLs | 80.0% | 30.3% | 31.2% |
| RRE NCOs/Total NCOs | 14.1% | 36.9% | 18.9% |
| | | | |
| 3. Performance Ratios | | | |
| RRE NPLs/Total RRE Loans | 5.91% | 1.31% | 1.53% |
| RRE NCOs/Avg. RRE Loans | 0.07% | 0.09% | 0.05% |
| | | | |
| 4. Outstandings ($ millions) | | | |
| Total RRE Loans | 1,657,340.1 | 22,844.6 | 339,992.3 |
| RRE NPLs | 97,913.0 | 299.4 | 5,201.5 |
| RRE NCOs | 1,168.2 | 19.5 | 153.4 |

***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 | 4.7% | 14.8% | 10.7% |
| CRE NPLs | -37.0% | -21.7% | -30.8% |
| CRE NCOs | -94.0% | -62.9% | -45.8% |
| | | | |
| 2. Shares | | | |
| CRE Loans/Total Loans | 15.6% | 48.2% | 43.0% |
| CRE NPLs/Total NPLs | 8.0% | 53.2% | 48.5% |
| CRE NCOs/Total NCOs | 0.1% | 21.4% | 31.6% |
| | | | |
| 3. Performance Ratios | | | |
| CRE NPLs/Total CRE Loans | 1.09% | 1.35% | 1.39% |
| CRE NCOs/Avg. CRE Loans | <0.01% | 0.03% | 0.05% |
| | | | |
| 4. Outstandings ($ millions) | | | |
| Total CRE Loans | 897,964.3 | 39,030.6 | 582,970.0 |
| CRE NPLs | 9,971.6 | 525.6 | 8,098.7 |
| CRE NCOs | 9.0 | 11.3 | 256.8 |

***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 | 9.9% | 10.2% | 13.7% |
| C&I NPLs | -14.9% | 1.4% | -13.5% |
| C&I NCOs | 31.9% | -9.3% | -10.7% |
| | | | |
| 2. Shares | | | |
| C&I Loans/Total Loans | 23.5% | 13.2% | 16.5% |
| C&I NPLs/Total NPLs | 4.4% | 13.5% | 12.9% |
| C&I NCOs/Total NCOs | 11.1% | 33.4% | 40.4% |
| | | | |
| 3. Performance Ratios | | | |
| C&I NPLs/Total C&I Loans | 0.40% | 1.24% | 0.96% |
| C&I NCOs/Avg. C&I Loans | 0.07% | 0.17% | 0.16% |
| | | | |
| 4. Outstandings ($ millions) | | | |
| Total C&I Loans | 1,350,173.4 | 10,730.7 | 223,901.4 |
| C&I NPLs | 5,371.5 | 133.3 | 2,160.4 |
| C&I NCOs | 922.5 | 17.7 | 328.2 |

***Table 4 — Summary of Consumer Lending***

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| 1. Year-Over-Year Growth | | | |
| Total Consumer Loans | 17.0% | 17.2% | 9.7% |
| Consumer NPLs | -5.5% | -6.3% | -6.6% |
| Consumer NCOs | 78.5% | -2.3% | -0.1% |
| | | | |
| 2. Shares | | | |
| Consumer Loans/Total Loans | 15.1% | 3.8% | 4.2% |
| Consumer NPLs/Total NPLs | 6.0% | 1.3% | 2.5% |
| Consumer NCOs/Total NCOs | 72.3% | 7.6% | 13.2% |
| | | | |
| 3. Performance Ratios | | | |
| Cons NPLs/Total Cons. Loans | 0.85% | 0.41% | 0.73% |
| Cons NCOs/Avg. Cons. Loans | 0.79% | 0.14% | 0.20% |
| | | | |
| 4. Outstandings ($ millions) | | | |
| Total Consumer Loans | 866,795.5 | 3,090.1 | 56,815.5 |
| Consumer NPLs | 7,337.0 | 12.8 | 415.6 |
| Consumer NCOs | 6,042.0 | 4.0 | 107.0 |

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

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| Loan-Loss Reserve ($ millions) | 81,798.3 | 991.4 | 18,887.1 |
| Change from Last Quarter | 7.9% | -8.6% | -7.4% |
| Change from Last Year | -8.6% | -4.5% | -3.6% |
| Net Charge-Offs/LL Provision | 148.8% | 166.8% | 140.1% |
| LL Provision/Operating Inc. | 4.45% | 2.56% | 2.66% |
| Loan-Loss Coverage Ratio | 66.8% | 100.4% | 113.2% |

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

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| Securities/Assets | 20.7% | 19.3% | 21.8% |
| Market Value ($ millions) | 2,422,694.7 | 22,290.2 | 452,596.2 |
| Change from Last Quarter | 10.8% | -1.9% | 0.4% |
| Change from Last Year | 10.0% | -2.6% | 1.9% |
| Realized Gain/Loss | 570.5 | 17.4 | 131.1 |
| Pct. of Average Securities | 0.02% | 0.08% | 0.03% |
| Market Value/Book Value | 101.2% | 100.9% | 101.0% |

### *Table 7 — Structure of Liabilities*

| | Large Organizations | Community Banks | |
|---|---|---|---|
| | Nation | Tri-State Area | Nation |
| Deposits ($ millions) | 8,792,633.7 | 93,175.8 | 1,708,718.1 |
| Pct. of Assets | 75.3% | 80.7% | 82.6% |
| Change from Last Quarter | 9.4% | 7.2% | 8.8% |
| Change from Last Year | 6.7% | 5.5% | 6.7% |
| Core Deposits/Deposits | 75.8% | 90.3% | 90.9% |
| Implicit Rate on Deposits | 0.22% | 0.51% | 0.47% |
| Nondeposit Debt ($ millions) | 1,013,560.2 | 9,482.9 | 117,708.1 |
| Pct. of Assets | 8.7% | 8.2% | 5.7% |
| Change from Last Quarter | 5.8% | 24.9% | 27.7% |
| Change from Last Year | 8.2% | 38.2% | 21.0% |
| Implicit Rate on Debt | 1.20% | 1.38% | 1.46% |

*Table 8 — Capitalization Measures*

| | Large Organizations | Community Banks | |
|---|---|---|---|
| Ratios | Nation | Tri-State Area | Nation |
| Total Equity/Total Assets | 10.92% | 10.19% | 10.98% |
| Change from Last Qtr. (basis pts.) | -1 | 1 | -4 |
| Change from Last Yr. (basis pts.) | -4 | 18 | 34 |
| Tier 1 Leverage Ratio | 8.99% | 9.51% | 10.26% |
| Change from Last Qtr. (basis pts.) | -1 | 0 | -5 |
| Change from Last Yr. (basis pts.) | 13 | -12 | 7 |
| Risk-Based Capital Ratio | 13.91% | 14.17% | 15.46% |
| Change from Last Qtr. (basis pts.) | 10 | -5 | -20 |
| Change from Last Yr. (basis pts.) | -29 | -29 | -29 |

* 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 16.

***A Note to Our Readers***

Beginning with the first quarter 2015 edition, there will be substantial changes to *Banking Brief*. The tables in the back and some charts will be placed on the Bank’s website — available about 50–60 days from the end of the quarter, but there will be no extensive accompanying text. Instead, there will be an article on some aspect of bank performance published semiannually in the *Business Review*. The topics covered will change with each issue. These changes will allow us to provide more in-depth analysis of current and future industry trends while still supplying our readers with the same data at the same time. We welcome any questions, comments, or suggestions. Any comments can be sent to James V. DiSalvo, banking structure specialist, at jim.disalvo@phil.frb.org.