Third District Banking Conditions as of September 30, 2016

PREPARED BY THE RISK ANALYTICS & SURVEILLANCE UNIT
SUPERVISION, REGULATION, AND CREDIT

FEDERAL RESERVE BANK OF PHILADELPHIA
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For any questions about this presentation, please contact Christopher Hahne at 215-574-6406 or christopher.hahne@phil.frb.org.
Section 1: Executive Summary

- Challenges remain for Third District bank financial performance primarily due to the following:
  1. Core earnings remain a challenge in the low interest rate environment. Third District banks maintain a lower yield on assets and a higher cost of funds when compared with the nation.
  2. There is increased competition for loans and deposits.
  3. The lower amount of core earnings are offset with nonrecurring items, such as the sale of loans and securities and/or reporting zero or negative provisions.
- Capital ratios continue to increase mostly as a result of earnings accretion; however, capital ratios remain below the nation.
- Third District and national asset quality metrics continue to improve as the level of noncurrent loans declined to 2008 levels.
- Third District banks’ reliance on noncore funding sources continues to outpace the industry as core deposit competition persists.
- Interest rate risk remains fairly elevated throughout the banking industry; however, many banks have adjusted their balance sheet to reduce adverse effects of rising rates.
- The number of problem banks fell by 15 banks to 132 as of 3Q2016. This represents the lowest number of problem banks in more than seven years, declining significantly from the peak of 888 problem banks in 1Q2011. Two banks failed during 3Q2016, although neither were Third District institutions.
- Qualitative and/or operational risks that remain on the risk radar include:
  1. Commercial Real Estate (CRE) concentrations and the management of the portfolio (Refer to SR Letters 07-1 and SR 15-17)
  2. Cybersecurity
  3. Model risk management (SR 11-7 compliance)
Section 2: Conditions of Third District Commercial Banks

Reporting Methodology

- The quarterly *Reports of Condition and Income (Call Report)* and *Uniform Bank Performance Report (UBPR)* are the primary sources of all information contained in this report unless otherwise noted.

- Slides in this section focus on trends among the **107 commercial banks** within the Third District and state member, national, and nonmember commercial banks (CBs). The banks excluded from this analysis meet at least one of the following criteria as of **September 30, 2016**:  
  - Institutions with total assets > $10 billion  
  - Credit card banks (credit card loans and receivables > 50% net loans and credit card receivables)  
  - Trust banks (income from fiduciary activities > 30% of interest + noninterest income)  
  - Banks with loans to depository institutions > 30% of net loans

- **All Third District state member banks (SMBs) are included in the Third District calculations.**

- The **nation** consists of all SMBs within the nation, regardless of asset size, and all national and nonmember banks with aggregate assets of less than $10 billion.

- This report uses the **median, the 25th, and the 75th percentiles** to compare Third District and national ratios.
  - The line graphs represent the median for the District and the nation, whereas the bar graphs represent the range of results from the 25th through the 75th percentiles for the data included in each of the graphs.
Third District earnings performance, as defined by the return on average assets (ROAA) ratio, continues to lag the nation since 2004.
The Third District net interest margin (NIM) continues to compress as of 3Q2016. This decline is a result of the Third District’s yield on earning assets being below that of the nation and the cost of funds being greater than that of the nation.
The provision expense continues to trend around or below precrisis levels. Although the low provision figures currently help augment earnings, this trend will not be sustainable if a collapse in the credit cycle occurs.
Historically, noninterest income for the Third District outpaced the nation. However, the decline in noninterest income since 2004 has placed further pressure on earnings for both the District and the nation.
Median overhead expense has decreased in the nation since 2010, while it continues to moderate within the District. The lower overhead costs generate a positive impact on ROAA.
Core profitability continues to rise nationally, while the Third District remains well below precrisis levels.
The continued low interest rate environment and overall loan composition suppresses the yield on assets within the District.

Many Third District institutions have less potential to increase interest income due to loan composition (primarily retail and CRE), strong competition, and the type of loan in other areas of the nation (e.g., agricultural and farm loans).
Most banks are able to reduce their cost of funds within the current interest rate environment.

Many Third District banks rely on higher-cost noncore funding sources to fund balance sheet growth and for liquidity purposes. As a result, the District’s funding costs are greater than that of the nation.
Although the noncurrent loan rate remains stable, the District’s median result remains above that of the nation since 2009.
Third District nonperforming assets remain stable, but the District’s median remains slightly above that of the nation.

* NPAs (nonperforming assets) are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans)
Third District loan performance shows significant performance improvement among the principal loan categories. Total CRE loan delinquency remains the highest category.

This chart uses a **10% capped mean, or winsorized mean**, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on the calculated average by “capping” values of the upper and lower 5% bounds of institutional data reported.
Third District net charge-off rates have steadily declined since 2010 and are in line with precrisis levels.
The allowance for loan and lease losses (ALLL) reserve coverage ratio continues to improve due to improved asset quality metrics, not by increased provision expense.

* The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.
Third District troubled debt restructurings remained stable but remain elevated compared with the nation.

* Troubled debt restructurings (TDRs) were not included on the Call Report until the March 2009 reporting period.
One- to four-family OREO continues to decrease, but the Third District trails in the foreclosure process due to the judicial foreclosure process in PA, DE, and NJ.

1-4 Family OREO*

- As a percentage of one- to four-family loans.

** Loans in the process of foreclosure were not included in the Call Report until the March 2008 reporting period. New Jersey, Pennsylvania, and Delaware are all judicial foreclosure states that can extend the foreclosure process.

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Third District commercial bank median loan growth* in most categories year over year was positive; loan contraction continues in the junior lien loan category.

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<th>Loan Category</th>
<th>Growth (%)</th>
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<tbody>
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<td>Leases</td>
<td>10.49%</td>
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<tr>
<td>HELOC</td>
<td>7.78%</td>
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<tr>
<td>Construction &amp; Land Development</td>
<td>18.71%</td>
</tr>
<tr>
<td>Junior Liens</td>
<td>-6.90%</td>
</tr>
<tr>
<td>Nonfarm Nonresidential CRE</td>
<td>7.19%</td>
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<tr>
<td>Consumer</td>
<td>0.39%</td>
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<tr>
<td>Multifamily</td>
<td>16.17%</td>
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<tr>
<td>Farmland</td>
<td>4.22%</td>
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<tr>
<td>1-4 Family Mortgages</td>
<td>5.47%</td>
</tr>
<tr>
<td>Commercial &amp; Industrial</td>
<td>6.29%</td>
</tr>
<tr>
<td>Total Loans</td>
<td>7.27%</td>
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* This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 4.
Capital ratios have increased postcrisis; however, Third District capital levels have flattened since 2011 and remain below the nation.
Median dividend payments in the Third district have increased and may outpace the nation in 2016.

* Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout (DPO) ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income as dividends in 2014.
Third District banks hold fewer short-term investments compared with the nation. Additionally, the District is growing its loan portfolio, which may increase duration and interest rate risk.

Short-Term Investments / Assets*

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

Loans / Assets

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Third District banks’ reliance on noncore funding sources to fund balance sheet growth continues to outpace that of the nation.

**Net Noncore Funding Dependence**

*Net noncore funding dependence measures the degree to which banks fund longer-term assets with noncore funding sources.*

In 2010, the FDIC increased the insurance limit from $100,000 to the current $250,000 threshold.
Problem banks within the nation fell by 15 to 132 as of 3Q2016. Two banks failed within the quarter that were not within the Third District.

Source: FDIC; problem banks are defined as having a CAMELS composite rating of 4 or 5. CAMELS is an acronym for the components assessed at a safety and soundness examination. The components are Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk.