BANKING & FINANCE

National, Regional Banking Conditions Detailed in Latest "ViewPoint"

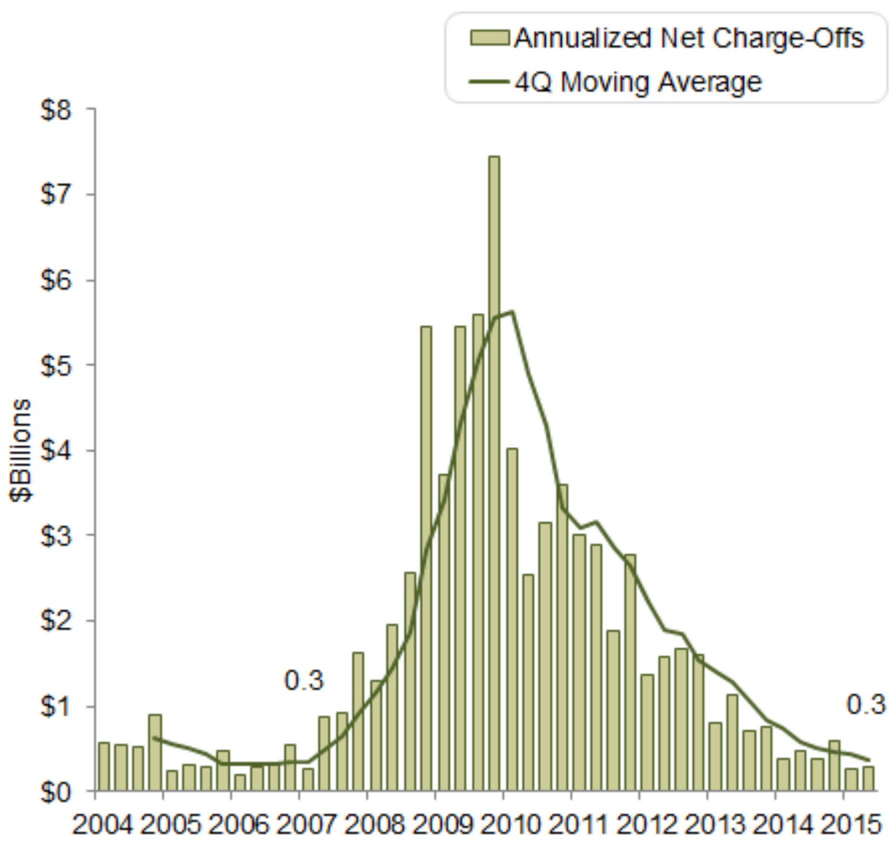
September 30, 2015

Asset Quality :: Balance Sheet Growth :: Capital :: Earnings Performance :: Liquidity :: National Banking Trends

Asset Quality

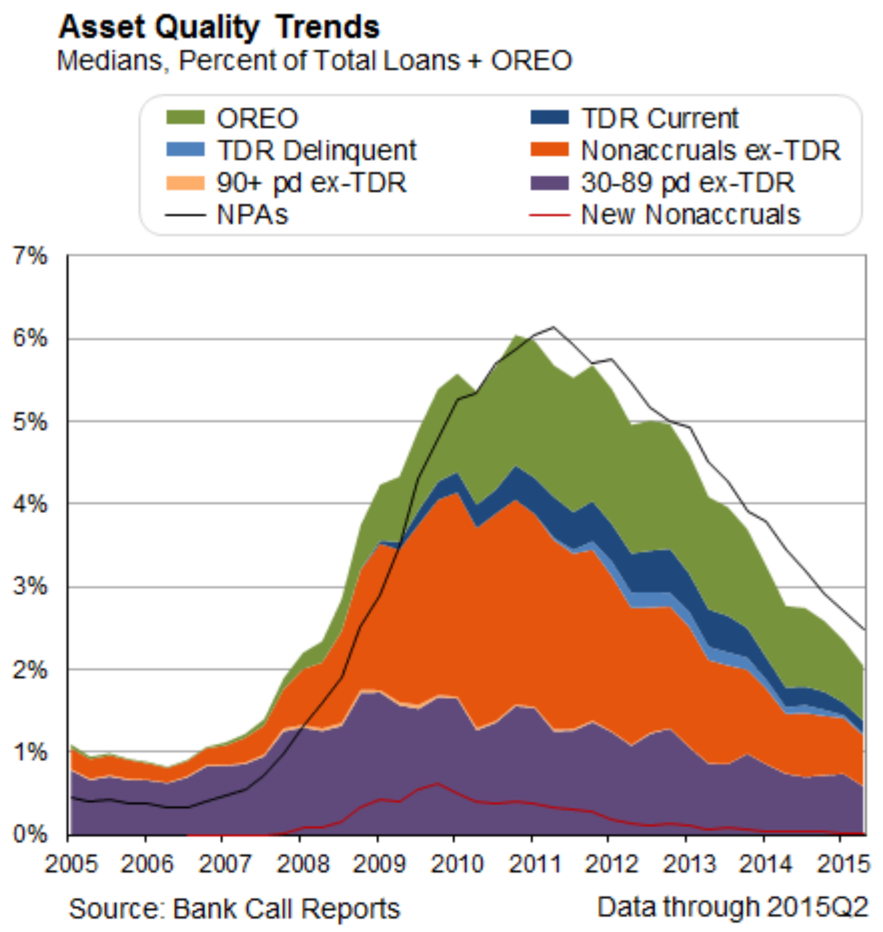
Asset quality in the second quarter is basically unchanged from the prior quarter. Noncurrent loans, as a percentage of total loans, have fallen to a precrisis level of 1.7 percent, and charge-offs have reached the same level as mid-2007 (see the chart).

Sixth District Net Charge-Offs



Source: Bank Call Reports

Other real estate owned (OREO), as a percentage of total loans, on median basis is now on par with the first quarter of 2009, when balances first started to ramp up (see the chart).

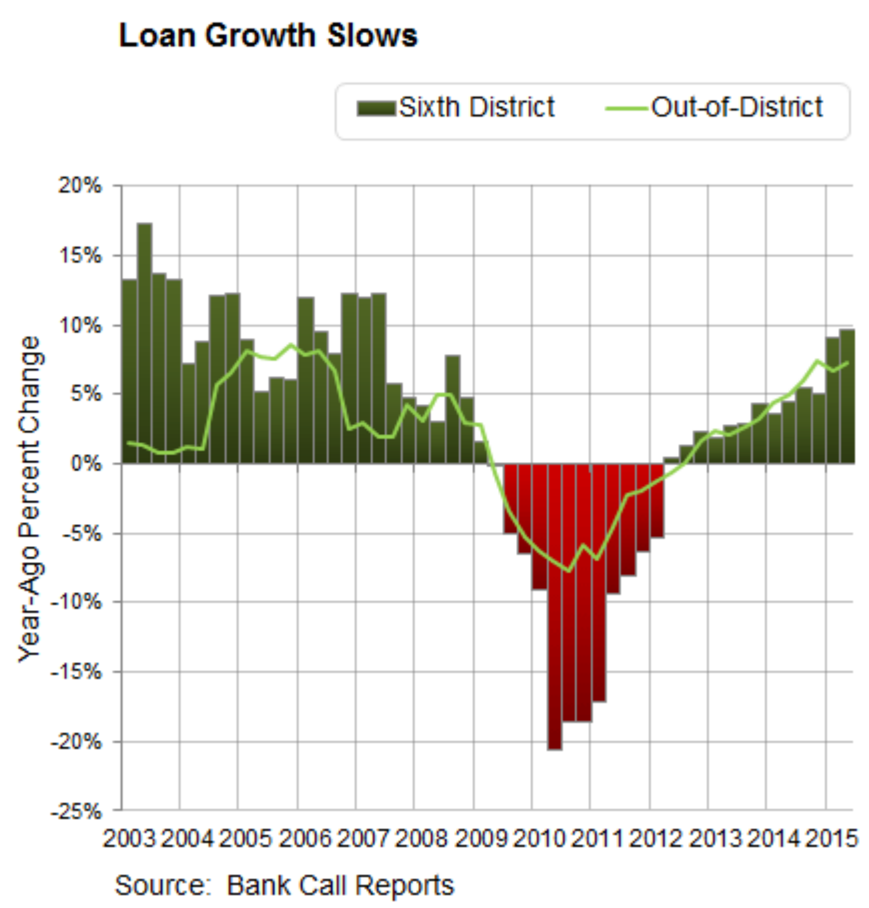


As property prices have increased, the level of losses from disposal has gradually drifted down. Even though asset quality appears to be stable, credit risk is a concern because of concessions granted as a result of competitive pressures and the potential shift in interest rates later in the year. Underwriting surveys, such as the Federal Reserve's Senior Loan Officer Opinion Survey, show that underwriting standards continue to ease across a variety of portfolios, including residential mortgages and other commercial real estate.

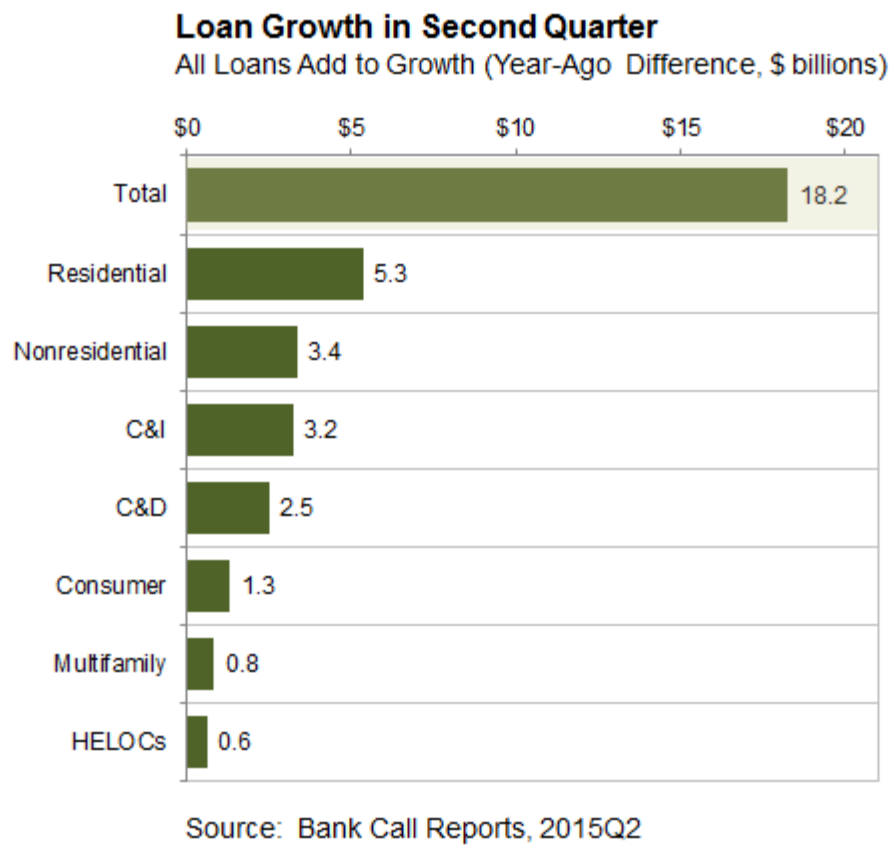
According to consumer credit data, many of the markets in the Sixth District have a lower percentage of on-time payers compared to the rest of the nation. Many of these markets also have a larger segment of subprime borrowers, which could help explain why loan growth in the Southeast was slower to recover. So although banks in the District are not reporting significant asset-quality problems, the data suggest that banks with a heavy consumer concentration in the Sixth District could suffer higher losses if a broad-based economic slowdown occurs again. Apart from concerns over loans, debt securities will need to be closely monitored for any impairment as interest rates rise.

Balance Sheet Growth

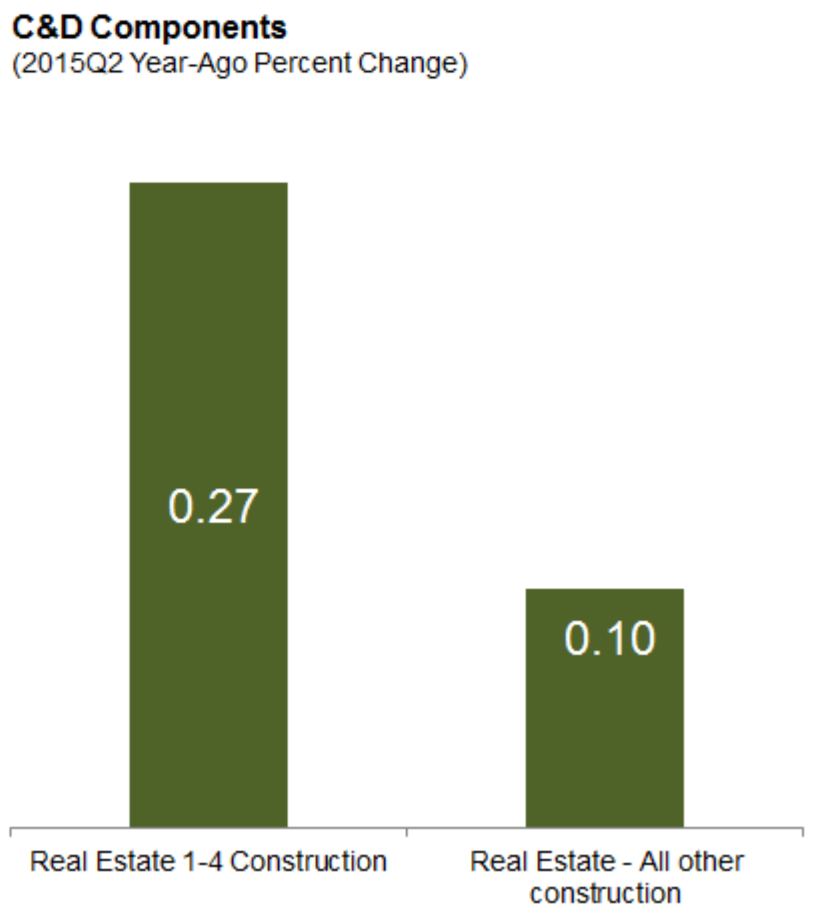
The second quarter appeared to be a positive one for community banks. Aggregate loan growth was 10 percent. However, overall annualized asset growth was negative for community banks with assets less than $1 billion, and loan growth appears to be slowing at these banks (see the chart).



One portfolio that has returned to growth, after several negative years, is the construction and development (C&D) portfolio, particularly 1–4 family developments. Before the crisis, residential C&D drove loan growth at many banks in the Sixth District. Unfortunately, the practice also was part of the reason for so many failures in the District. Now, after years of looking at a variety of "pipe farms" (see this *Community Banking Connections* article) scattered across the District, construction and development of residential properties is slowly returning. With the return to growth, banks are promising to be more careful this time. For example, in the Atlanta market, seemingly the epicenter for partially developed and then abandoned residential developments, new home starts have gradually inched upward in the past two years. In fact, as residential markets in the Sixth District continued to improve during the spring selling season, residential mortgage lending grew, leading overall loan growth at the midpoint of 2015 (see the chart).



Commercial real estate (CRE) construction has rebounded as well, though not as strongly as 1–4 family (see the chart).

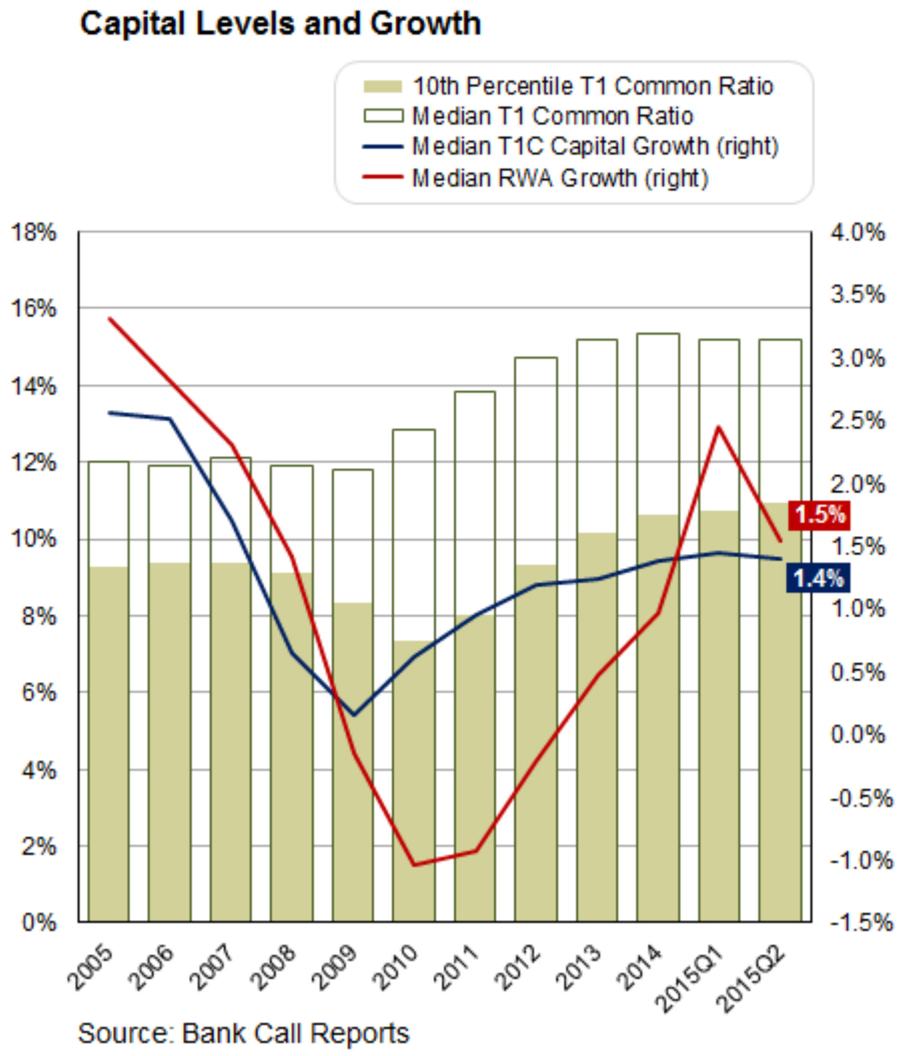


One question that may affect the strength of the construction recovery is whether banks will limit financing for projects in the future as a result of new Basel III capital requirements for high-volatility commercial real estate (HVCRE) (please see the previous "ViewPoint" article on HVCRE). There is concern from developers that the new rules will significantly hamper credit to the commercial real estate industry. They object to several conditions, including higher risk weighting and discounting of appreciated land value. Otherwise, the CRE portfolio growth is slow and steady.

Although multifamily has been the main story for a few years, there has been renewed interest in office real estate as vacancy rates have declined over the past year. In the Sixth District, Atlanta was among the top 10 markets with the most demand for office space at a time when supply is below long-term average, and Nashville is among the top markets in terms of rent growth. Consistent with national trends, commercial and industrial (C&I) loans have been a strong growth driver for several quarters among Sixth District community banks. As other portfolios have recovered, the growth in the C&I portfolio has slowed but remains stronger than before the financial crisis. In terms of consumer loans, banks seem to have focused on auto lending. Growth in auto lending in the Sixth District has outpaced other districts and seen double-digit growth in the past four quarters.

Capital

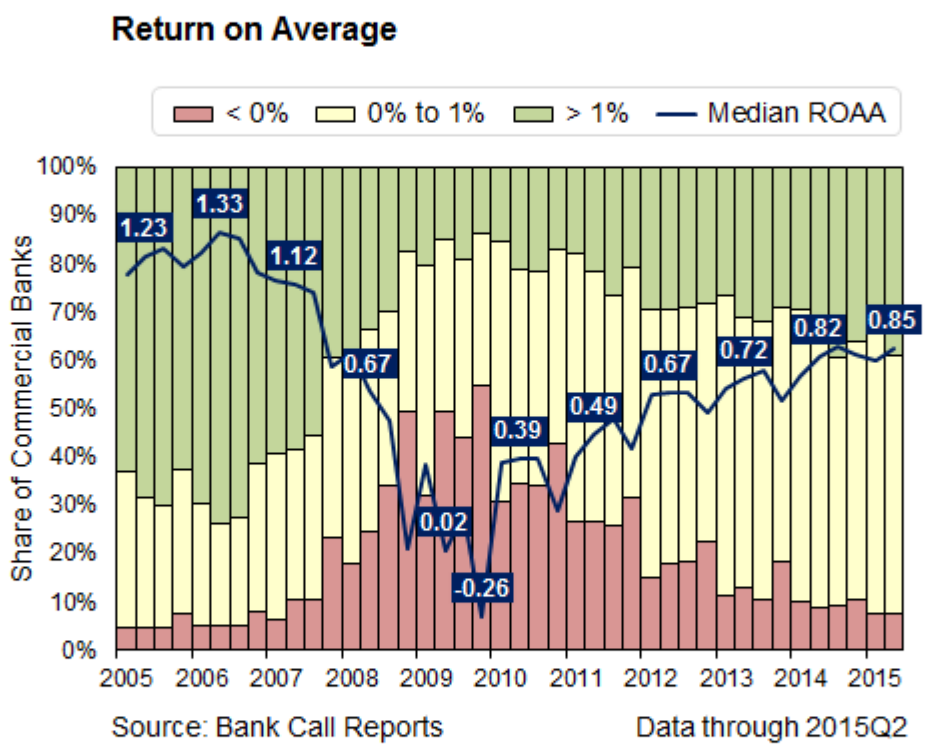
In the second quarter of reporting under recently implemented Basel III standards, community banks in the Sixth District were able to maintain the median tier 1 capital level at just over 15 percent, assisted by the lower growth in risk-weighted assets (see the chart).



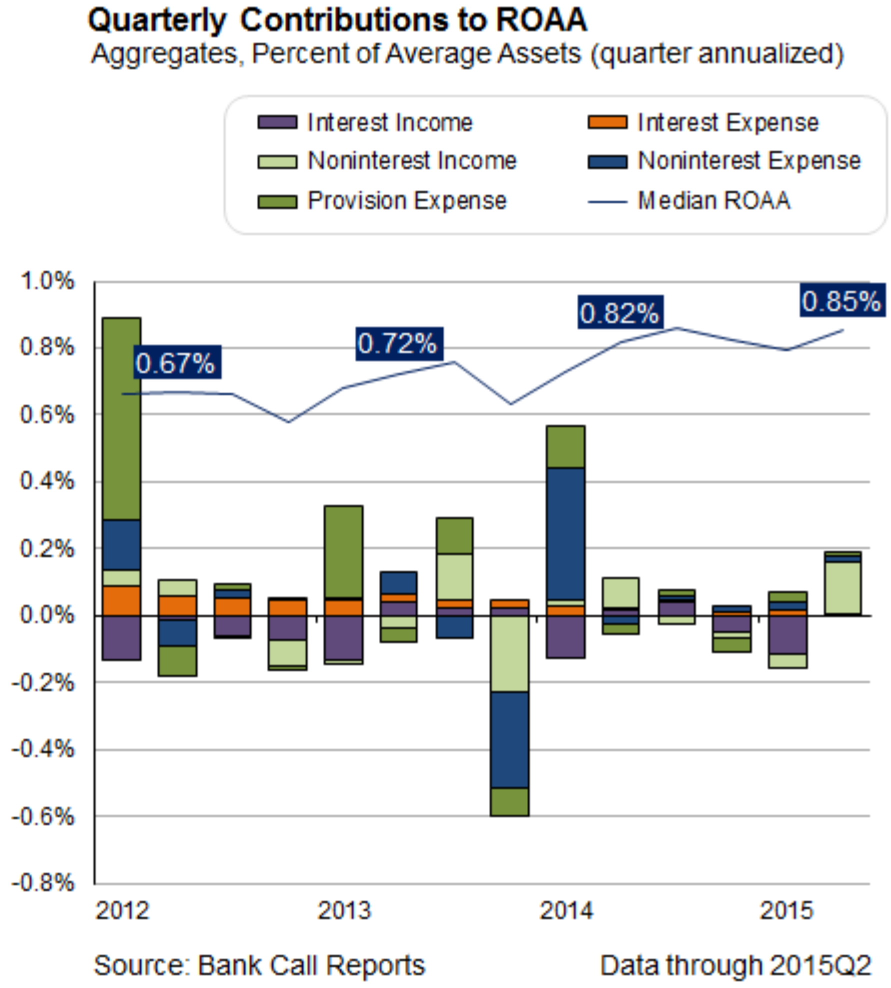
On a median basis, risk-weighted assets increased by 1.5 percent, 100 basis points lower than the prior quarter when new risk weights took effect under Basel III. Earnings were the primary driver of increases in the capital base. In addition, some additional capital was issued to maintain or improve current capital ratios.

Earnings Performance

Earnings are once again adding significantly to capital. On a median basis, return on average assets (ROAA) was 0.85 percent, a 3 basis point improvement from the prior year. A third of the community banks now have a ROAA above 1 percent compared with 75 percent of the banks prior to the crisis (see the chart).



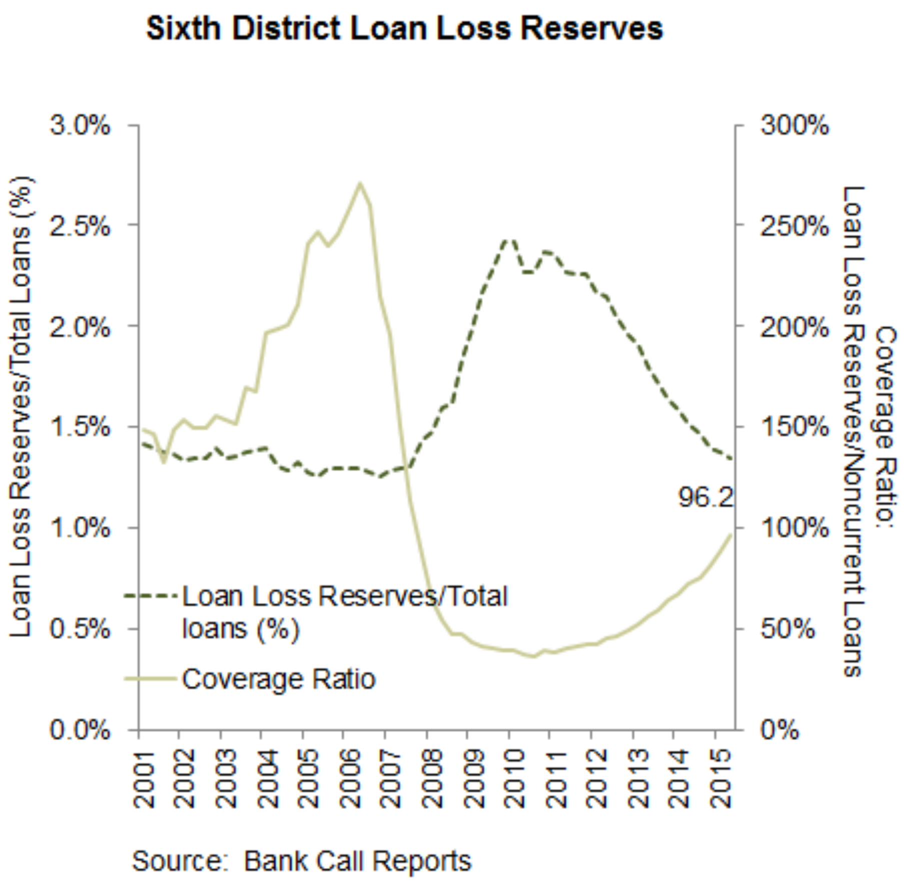
Although the earnings story continues to be positive in the second quarter, many community banks in the Sixth District continue to search for sustainable ways to generate targeted rates of return. Even as banks have added new loans, the median net interest margin has remained stable around 3.82 percent. Noninterest income continues to represent a significant component in the ROAA improvement (see the chart).



On an aggregate basis, the percentage of noninterest income to average assets increased 10 basis points over the same period in the prior year. Overdraft fees are a key component of noninterest income and continue to be a significant source of revenue. While the Call Report does not necessarily break out overdraft fees, the Federal Deposit Insurance Corporation recently published data showing that overdraft fees account for roughly 5 percent of banks' total noninterest income nationally. For some banks, the overdraft fees represented more than 30 percent of total fee income.

Expense control remains a top priority, and expanding loan growth is expected to generate higher net interest margins. For most community banks in the District, the efficiency ratio declined in the second quarter, in part the result of an increase in revenue and in part of additional cost cutting. Banks are looking at all areas of their businesses for additional savings. Expense reduction plans at large banks that may trickle down to community banks include strategies such as eliminating voicemail. At some point, banks will need additional expenses as they look to improve their cybersecurity programs or add more risk management expertise.

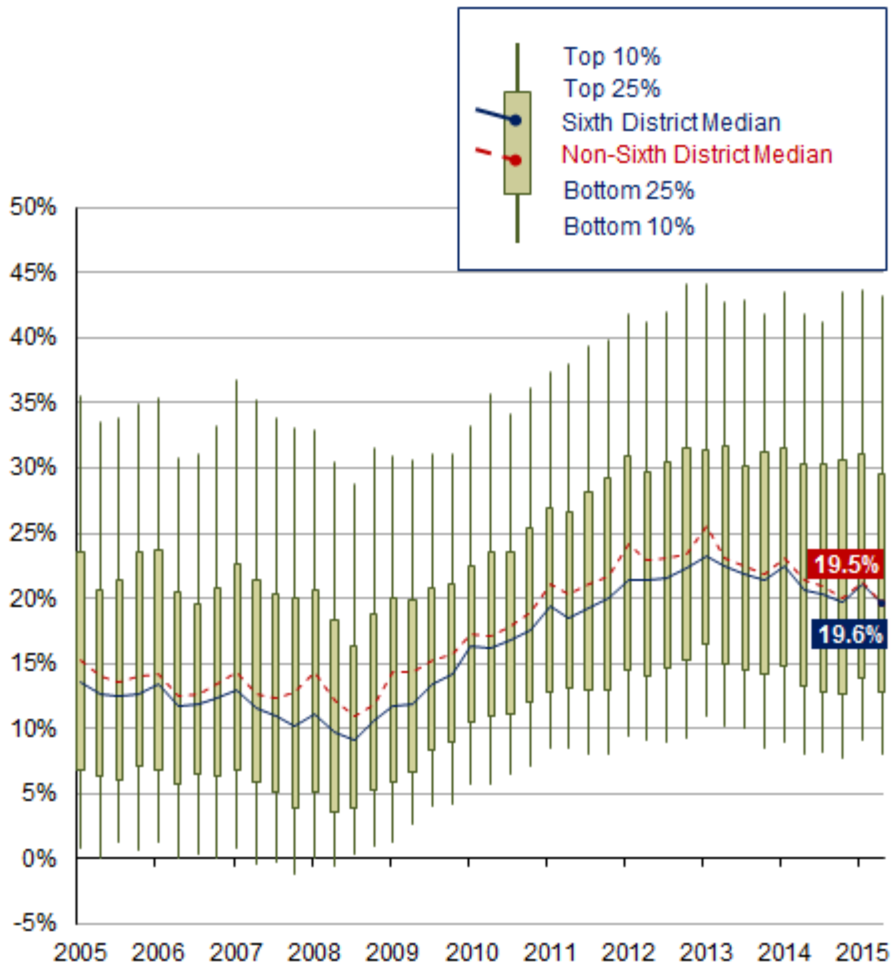
One expense that has increased is provision expense, which grew by 12 percent over the prior year. The increases in the provision expense have helped push the coverage level up from its bottom in 2010 of 38 percent to 96 percent, its highest level in seven years (see the chart).



Liquidity

Balance sheet liquidity is stable. The median on-hand liquidity ratio for the Sixth District has hovered around 20 percent for several quarters and is line with the median for banks outside the District (see the chart).

On Hand Liquidity Ratio



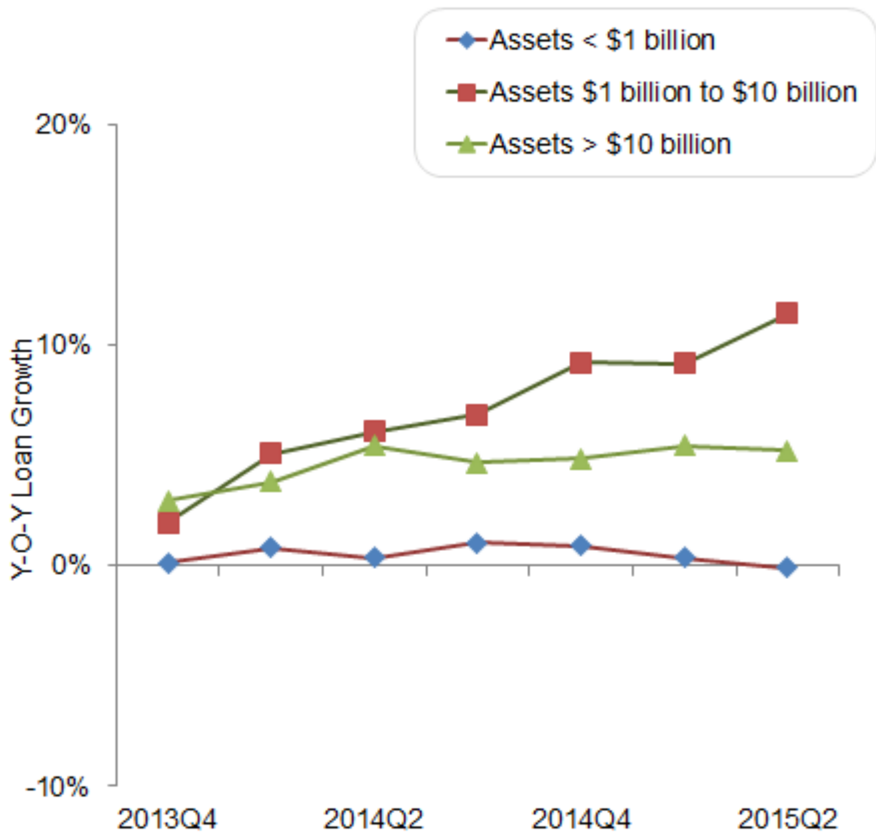
Source: Bank Call Reports Data through 2015Q2

On a median basis, the ratio of loans-to-core deposits at small community banks is 75 percent and is even higher for banks with assets between $1 billion and $10 billion. Net noncore funding remains low compared with levels going into the crisis. Debate over the strength of funding sources has ramped up lately just as loan growth has begun to increase. Talk of a potential rate increase, changes in liquidity requirements for large banks, and a strong stock market could all pose threats to community banks' deposit base. Yet, based on data from the Call Report, deposit growth has remained fairly steady since the beginning of 2015, though growing at a slower pace than in prior years. The type of deposits that are growing is shifting, with more money being put into transactional accounts rather than short-term certificates of deposits. Depositors, such as local companies, remain cautious and are taking a wait-and-see approach before committing to changes in strategies that may reduce balances. With interest rates still low, businesses at least appear more willing to borrow than draw down on deposit balances.

National Banking Trends

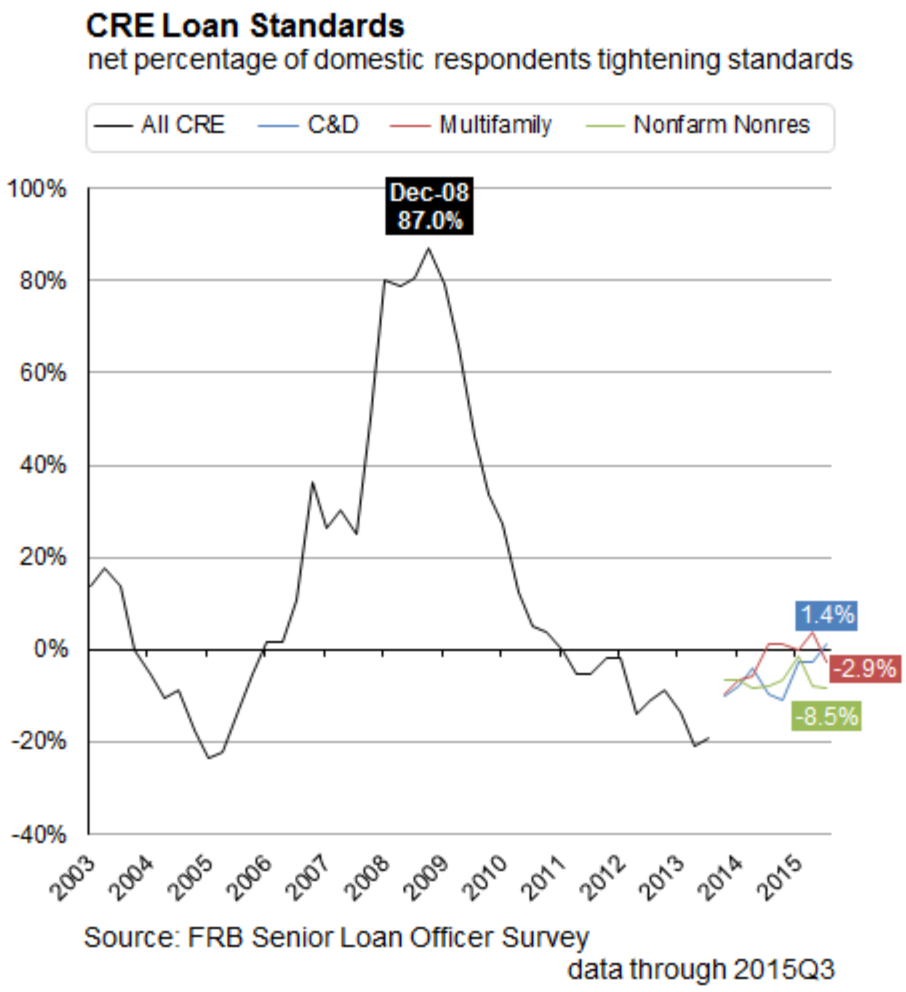
Recent unemployment reports, along with a stock market near its record high, brought more optimism to the banking industry in the second quarter. Overall, lending activity continues to recover and is nearing prerecession peaks. Though growth has been volatile, banks with assets above $1 billion have had consistent positive growth (see the chart).

Loan Growth Weakening for Small Community Banks

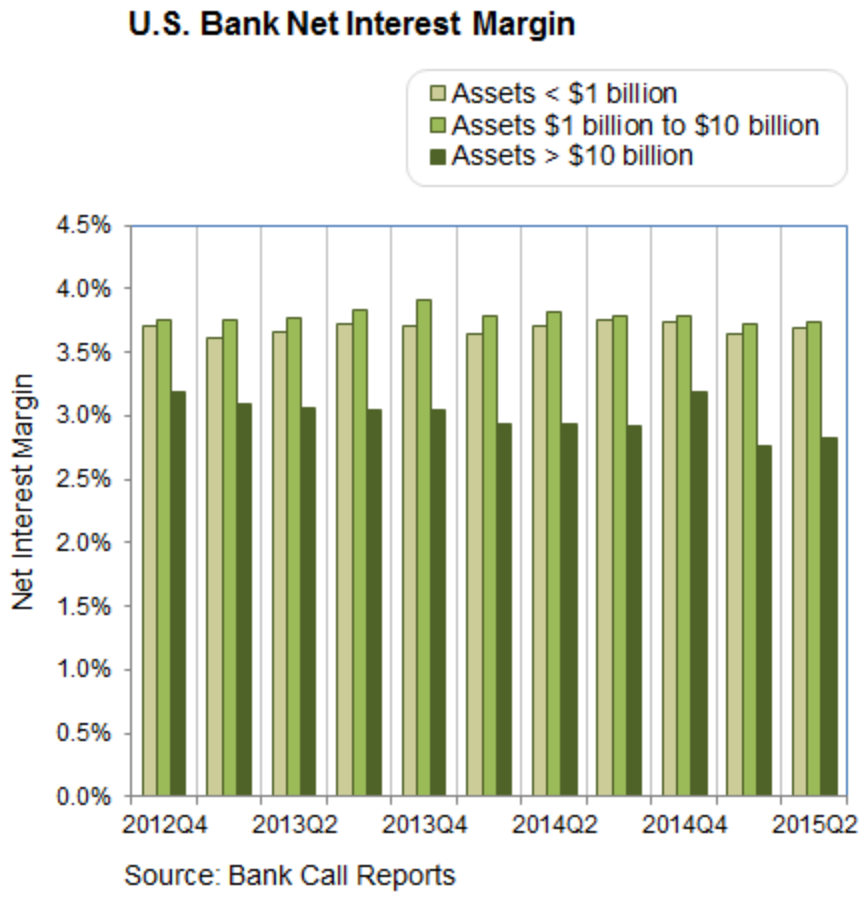


Source: Bank Call Reports

In the second quarter, smaller banks saw a lower level of growth. Commercial and industrial (C&I) is one of two lending categories that has fully recovered. For all institutions, C&I loan growth remains robust and accounts for the largest increase in loan levels during the past two years. However, commercial real estate is making a strong comeback, especially the construction and development (C&D) and multifamily portfolios (see the chart).



Even the level of consumer lending has increased during the prior year, although the rate of increase has slowed since August of last year, when it peaked. The return of loan growth has yet to have a significant impact on banks' net interest margins (NIM), which have remained relatively unchanged from the prior year (see the chart).



Controlling costs, especially funding costs, remains a key strategy for banks to remain profitable. Delinquency rates continue to trend downward, with noncurrent loans (as a percentage of total loans) just over 1 percent for community banks. Still, credit risk is perceived as increasing as a result of competitive pressures and the current interest rate environment. For example, the latest Senior Loan Officer Opinion Survey (SLOOS) reports that although banks have made no changes in standards and terms for most consumer loans during the past three months, they have eased lending standards on residential mortgages and some types of commercial real estate.

In addition to concerns about an increase in credit risk, given the length of time that rates have remained low, banks have increased their risk to rising interest rates as they have been chasing greater yields for the past few years. Debate over the strength of loan growth and funding sources has been ramping up lately, just as it appears an interest rate increase seems more likely. The question about when deposits will flee has been lingering for the past three years, which is a key question as banks have started to grow again.

For more detailed information on banking trends in the Sixth District, see the Federal Reserve Bank of Atlanta's Regional Economics Information Network web page. The Federal Reserve Bank of Atlanta also produces a variety of publications dealing with other economic and financial topics. These materials appeal to a wide range of readers, including bankers, businesspeople, economists, students, and economics teachers.