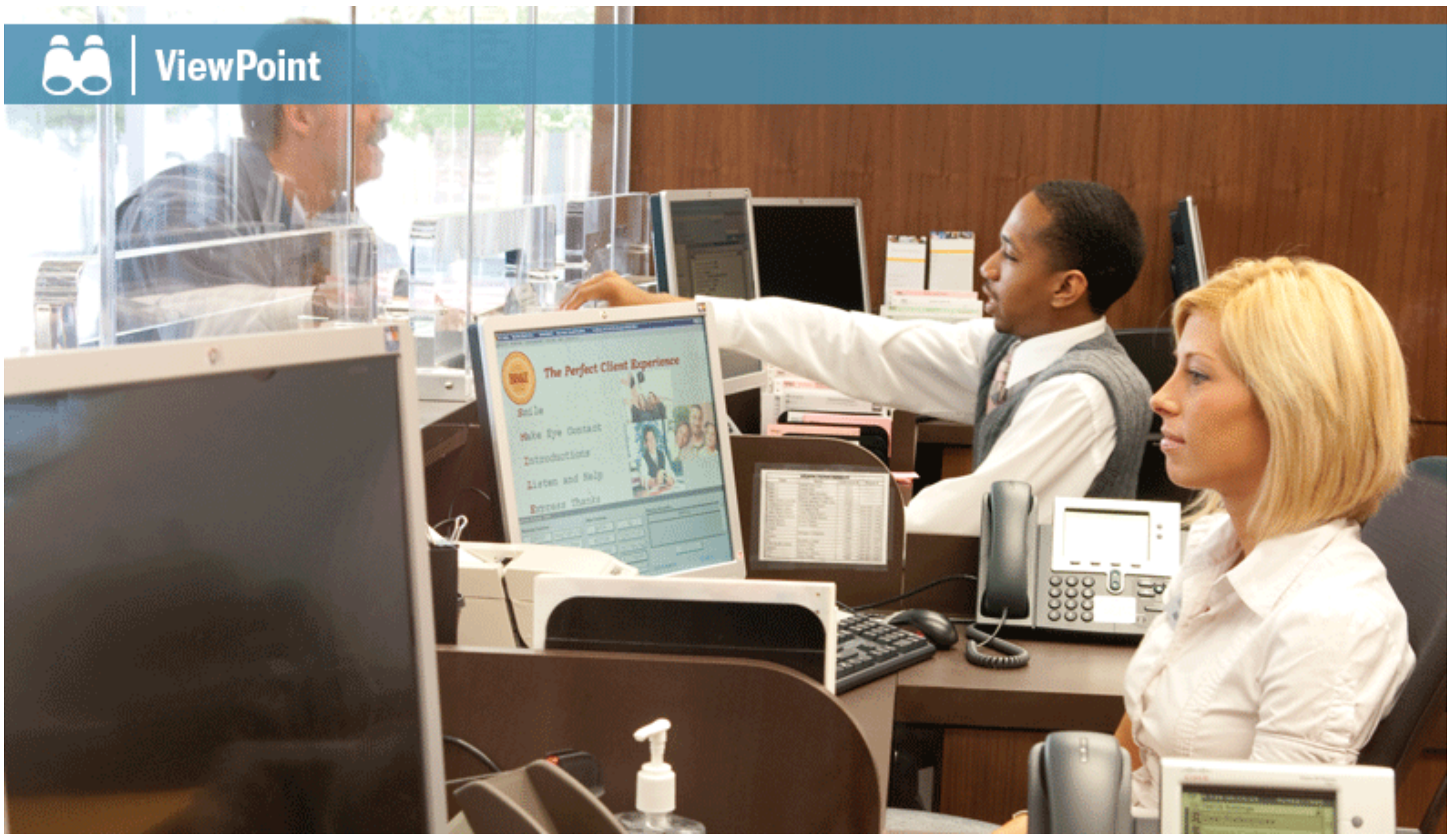
BANKING & FINANCE

National, Regional Banking Conditions Detailed in Latest "ViewPoint"

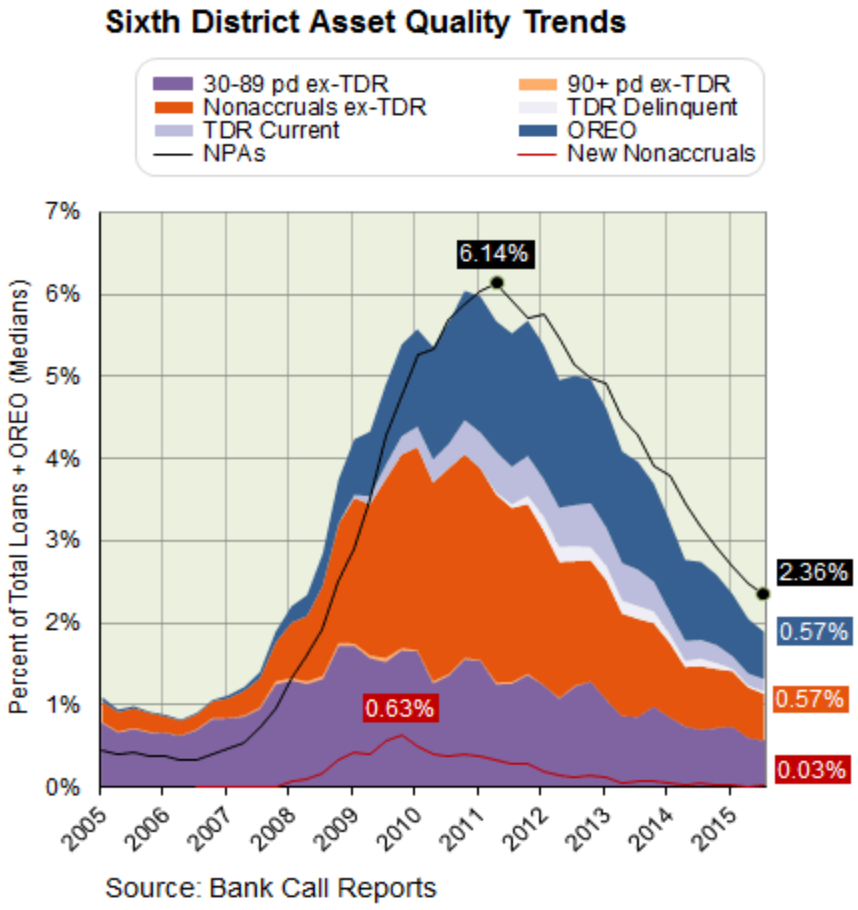
December 21, 2015



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

Asset Quality

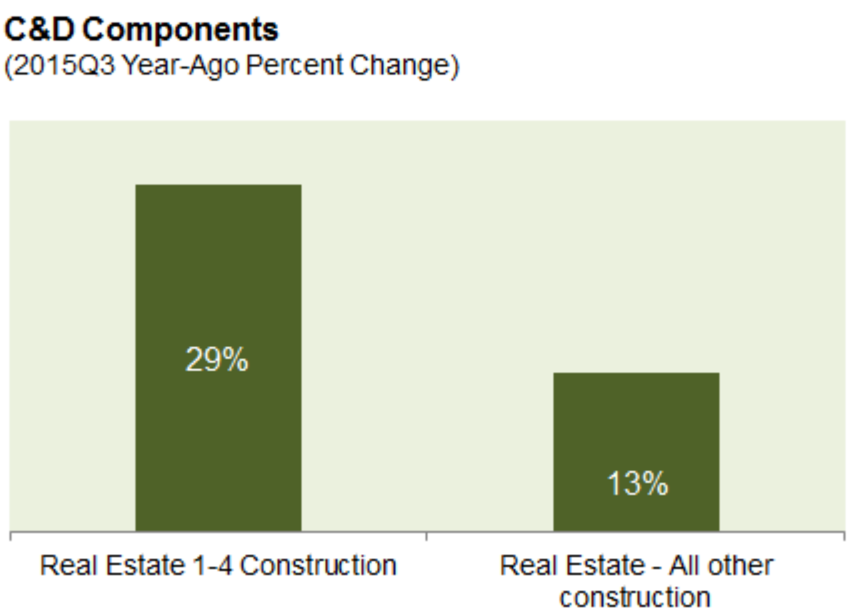
Although the data show little evidence, outside of oil-related credits, there is a growing sense that a change in the credit cycle is coming. Some of that sense of foreboding comes from the length of the current cycle. As many people have noted, 2016 will represent at least the seventh year of economic recovery, which some might consider rather late in the cycle under more normal economic conditions. Despite the improvement in credit quality, problem assets remain elevated. Prior to the crisis, nonperforming assets (NPAs) among Sixth District community banks were roughly one half of 1 percent of total loans on a median basis. As of the third quarter of 2015, NPAs are 2.36 percent, on a median basis, of total loans. In 2005, NPAs represented 0.41 percent of total loans (see the chart).



Other real estate owned (OREO) remains a significant component of problem assets on the balance sheet. Banks may still be hoping for a greater rebound prior to disposing the property under regulatory limits for holding it. Some banks view holding OREO, given the smaller incremental cost to carry the nonperforming assets, a better option than selling into markets were prices are still below the peak of 2008. Still, banks are starting to dispose of the property, likely a result of regulatory restrictions. In the Southeast, although property prices have rebounded from the bottom, a number of markets are still seeing prices well below the peak, exposing banks to the potential of more write-downs. Another positive factor is that new nonaccrual loans in the third quarter among Sixth District community banks remain extremely low, below 2008 levels.

Balance Sheet Growth

Though appearing to moderate at a national level, loan growth in the Sixth District remained strong in the third quarter. Year over year, the loan portfolio increased by roughly 10 percent. Consistent with national trends, community banks in the Sixth District have returned to real estate–related lending as markets across the Southeast improve. After shunning construction and development (C&D) loans for years following the financial crisis, community banks have once again started lending on new development. Most of the growth has been for 1-4 family developments, which does not have the same capital restrictions as other construction loans under the Basel III concept known as high volatility commercial real estate (HVCRE). Before the crisis, residential C&D drove loan growth at many banks in the Sixth District. While not as strong as 1-4 family development, other construction has increased significantly from the prior year (see the chart).



In several markets in the Sixth District, new construction for a variety of property types has been below 15-year averages for new construction compared with existing inventory. As a result, demand for properties has driven up prices leading to an increase in new projects. For example, Atlanta is one of leading markets in terms of new demand for office properties. With all of the new construction under way, there is a concern as to whether or not CRE is entering another bubble. Some of the arguments against being in a bubble include the lack of industry leverage, more muted loan-to-values (LTVs) on loan originations (in part due to HVCRE), the interest rate environment, and a higher level of regulatory oversight. However, there are some arguments for the existence of a bubble, including CMBS underwriting deteriorating and enhanced lending competition. The possibility of a bubble is a concern as Sixth District banks remain heavily exposed to CRE on median basis. The level of exposure remains on par with 2007, when many banks started to struggle with nonperforming CRE portfolios (see the table).

Sixth District Asset Exposures

Share of Assets (%)	2015Q3	2015Q2	2014Q3	2008Q4
C&D	6.0	5.8	5.5	18.9
HELOCs	2.7	2.6	2.6	2.7
Nonresidential	22.4	22.1	22.4	19.0
Multifamily	2.3	2.3	2.2	1.7
C&I	11.5	11.4	11.2	9.1
Consumer	3.6	3.5	3.4	4.7
Residential	15.1	15.0	14.3	12.3
Total Loans	**67.0**	**66.2**	**64.9**	**71.4**
Total Securities	**20.6**	**21.2**	**21.8**	**16.7**

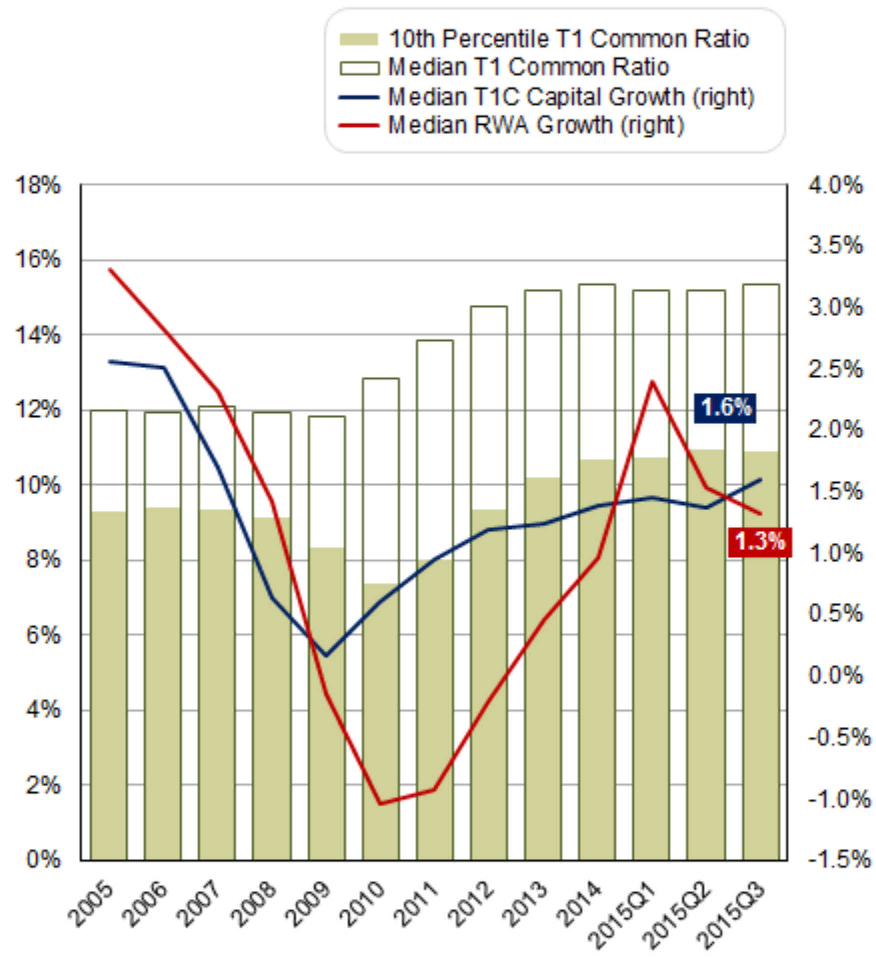
Source: Bank Call Reports

As banks turn toward more real estate–related lending, the level of growth for C&I loans has slowed. Three years ago, the C&I portfolio led loan growth at Sixth District institutions, with double digit year-over-year growth. In terms of consumer loans, the story remains focused on auto lending, as banks have drawn back from nearly every other type of consumer lending. Car sales continue to climb, with the industry on track to record one of its best sales years since 2000. As car sales have climbed, so have auto loans. Sixth District banks in particular have experienced a strong level of growth in the past two quarters, in excess of 10 percent compared with other districts' slower growth.

Capital

As of the third quarter 2015, the median tier 1 capital level remained just over 15 percent at community banks in the Sixth District (see the chart).

Capital Levels and Growth

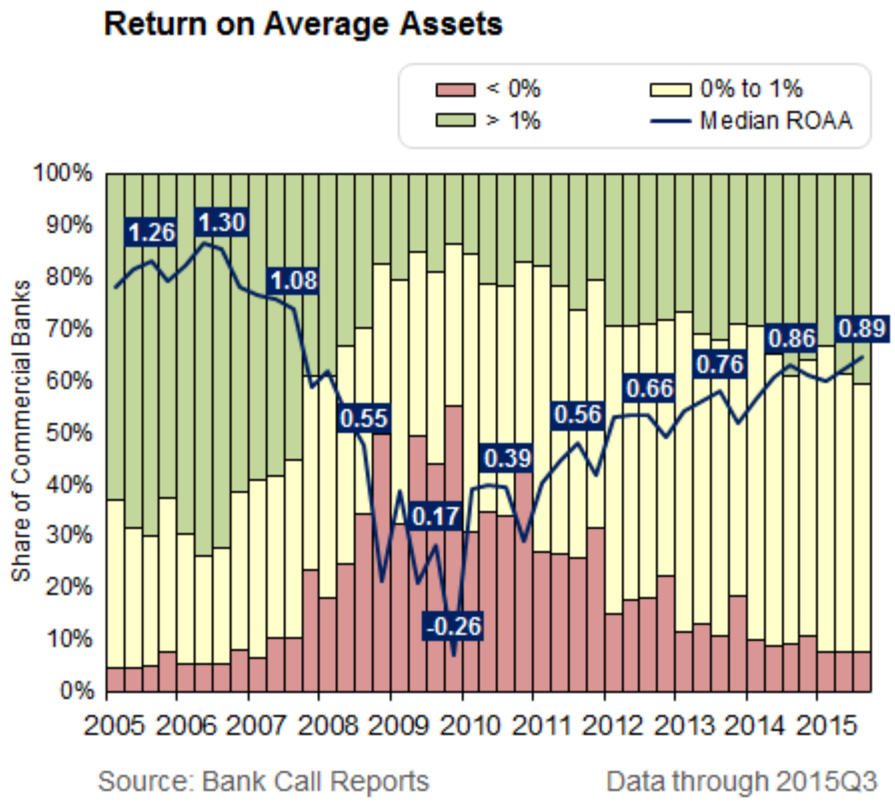


Source: Bank Call Reports

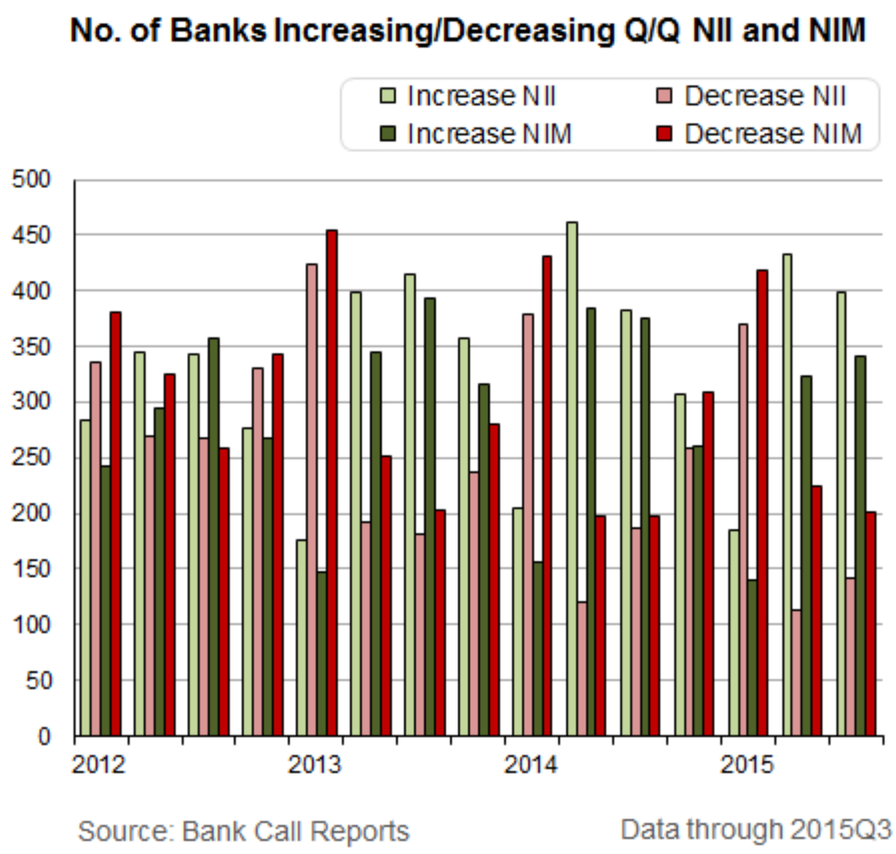
Once again, the growth in median risk-weighted assets slowed, which aids in keeping the capital ratios higher. On an aggregate basis, as a percentage of prior period capital, capital increased at community banks as a result of earnings and business combinations. Business combinations can add to the capital base as assets and liabilities are revalued. In terms on new capital rules, the Federal Reserve is in the process of developing a proposal for a long-term debt requirement that would address the estimated capital needs of each institution in a resolution scenario. This process is connected with the Financial Stability Board's proposal last year regarding Total Loss Absorbing Capacity (TLAC), which consists of regulatory capital and long-term debt that in the context of a potential resolution situation is designed to absorb losses through write-downs, forgiveness, or conversion into common equity and thereby avoid the need to use taxpayer funds to prevent systemic disruption. The capital rules would be aim at the largest institutions and should not directly affect community banks.

Earnings Performance

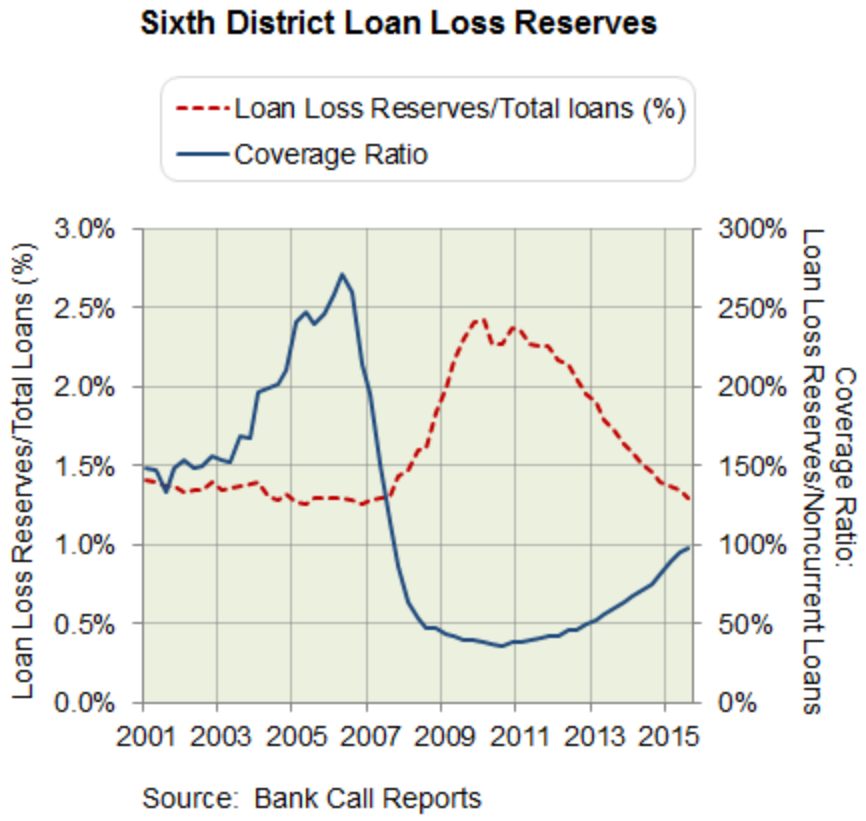
Similar to national trends, banks have been trying to improve earnings, in part by adding more risk to the balance sheet. In the third quarter of 2015, the interest rate environment continues to weigh on net interest margins. On a median basis, return on average assets (ROAA) was 0.89 percent, a 3 basis point improvement from the prior year (see the chart).



The share of unprofitable institutions has come down markedly since the recession, with only 7.5 percent of institutions being unprofitable in the quarter. On an aggregate basis, the net interest margin was 3.92 percent, a slight decline from the prior year. As higher-yielding assets have matured, banks have struggled to replace them at the same or higher interest rate. As a result, the net interest margin has been continuously squeezed since the financial crisis brought about lower rates. Net interest margin is the difference between interest earned on interest-bearing assets and interest expense on liabilities as a percentage of the average-earning assets. Throughout 2015, banks have been gradually improving their net interest income, though fewer banks were able to increase their net interest income on a quarterly basis in the third quarter (see the chart).



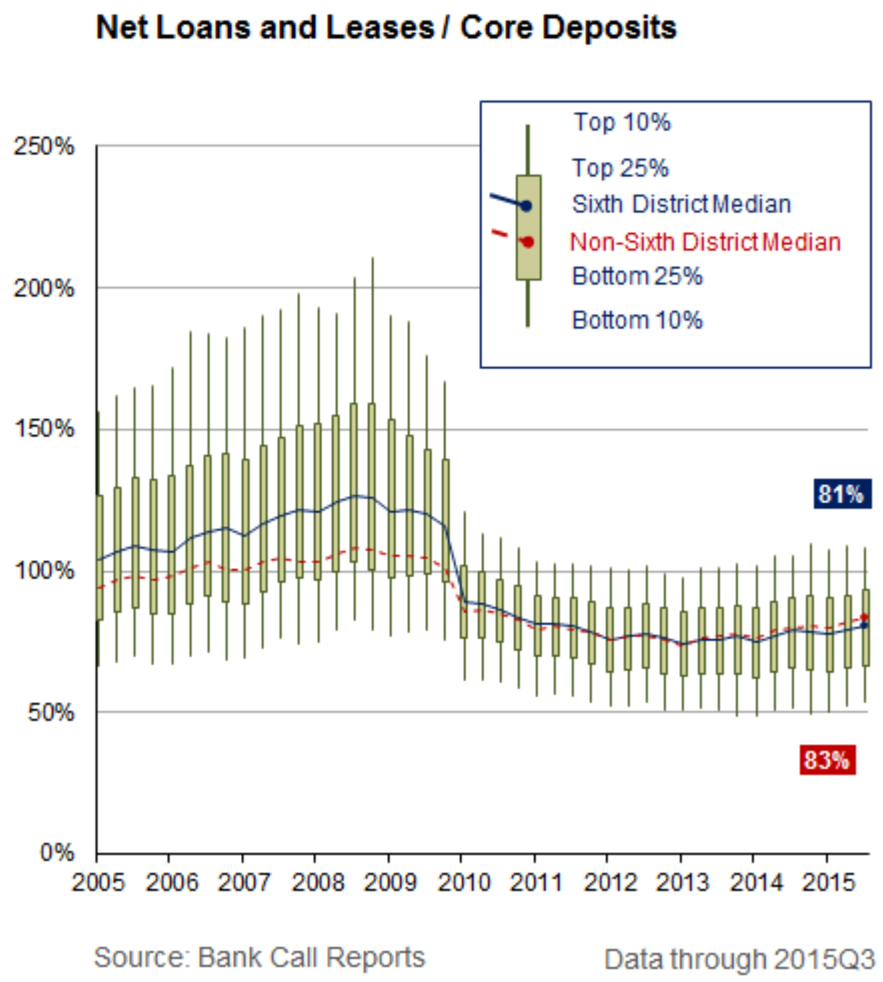
That situation could suggest banks could push farther out on the risk curves if interest rates do not increase in the fourth quarter. Provision expense remains low as there have been few asset quality problems that have emerged since the end of the financial crisis. The decline in in noncurrent loans has pushed the coverage ratio close to 100 percent, or a one-to-one basis for the allowance and noncurrent loans (see the chart).



Noninterest income continues to represent a significant component in the ROAA improvement. On an aggregate basis, the percentage of noninterest income to average assets increased 18 basis points over the same period in the prior year. An increase in mortgage production has helped push noninterest fees higher in 2015. Although cost control remains a top concern, banks have reached a point where investments in new people and technology are becoming a necessity. Part of the investment is devoted to expanding loan growth, with the aim being able to generate higher net interest margins. Another part of the investment is being devoted to compliance, primarily consumer and information technology.

Liquidity

Debate over the strength funding sources has ramped up recently just as of loan growth has started strengthening. As of the third quarter of 2015, on a median basis, the ratio of loans-to-core deposits at small community banks in the Sixth District is 75 percent and is even higher for banks with assets between $1 billion and $10 billion (see the chart).



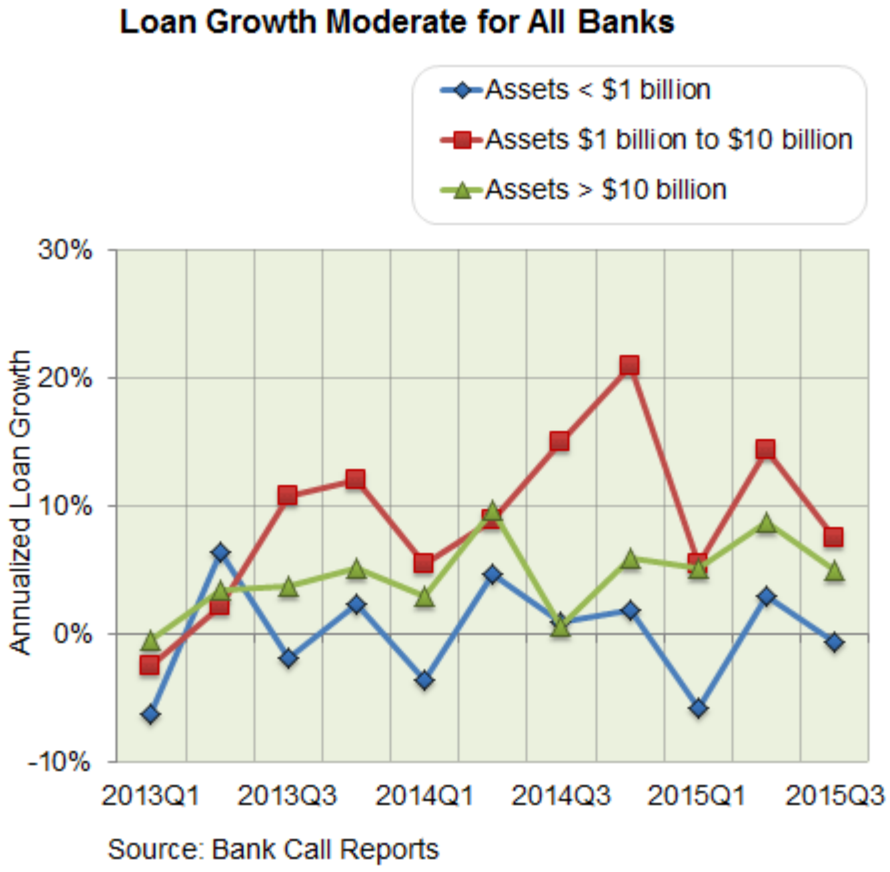
Yet the concern persists that the increases in nonmaturity deposit balances that banks have enjoyed since the recession may be unsustainable, if current economic conditions lead to an increase in interest rates. In addition, the historically high level of nonmaturity deposits, along with mismatching of maturity of assets, suggests that interest rate risk is elevated. The future stability and behavior of low-cost deposits are among the largest risk factors for interest rate risk. There is a concern that institutions may underestimate the cost to retain deposits and thus overestimate the benefits from rising rates. Given the concerns, some industry observers have suggested that it would benefit both banks and regulators to issue new guidance on deposit modeling. The guidance would help banks better understand the impact a shift in deposits will have on institutions.

One unknown factor that could also affect community banks is how the new Federal Reserve liquidity coverage ratio, which requires banks to hold high-quality liquid assets to cover projected deposit losses over 30 days, will influence deposit movement and possibly the fee structure. Many businesses have large sums on hand, and opportunities to profitably invest it appear scarce. However, large banks subject to the rule are indicating that they don't want certain kinds of deposits, judging them costly to keep. Though there are some alternatives to keeping large deposit balances, such as U.S. Treasuries and money-market funds, business could also look for new deposit products from smaller institutions.

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.

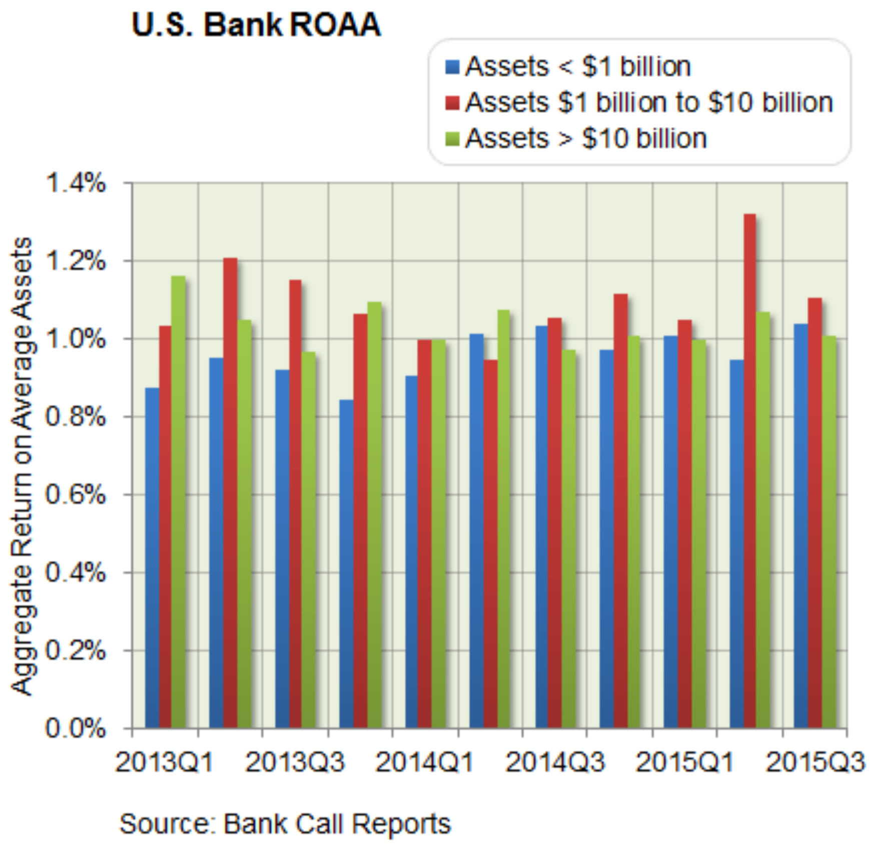
National Banking Trends

At the end of the third quarter, bank lending is growing at a middling pace, primarily on the strength of increased consumer spending and an improving real estate market (see the chart).



The improvement in the real estate market is helping to drive refinancing. According to Black Knight Financial Services, there was a 26 percent decline in the number of underwater borrowers through the first half of 2015, providing more homeowners with equity that they can tap. Many of those homeowners with equity are choosing cash-out refinancing of their first lien rather than using home equity lines of credit, a product that has lagged since the financial crisis. Also in the third quarter, community banks report that demand for commercial real estate (CRE) has increased. Since the second quarter of 2013, CRE balances at banks have steadily grown after a gradual decline following the crisis. Though lending in real estate has improved, lending in other portfolios has slowed. To help continue asset growth levels, most community banks are exploring new business. At the same time as banks try to expand their portfolios, competition among banks for all types of loans has increased, which has put pressure on underwriting.

As banks increasingly focus on increasing the size of the balance sheet and improving earnings, they are adding more risk to their balance sheets. Net interest margins continue to be compressed in the current interest rate environment. Banks are under pressure to keep costs down with net interest margins remaining so tight, but they are finding that they can no longer easily reduce costs, and some costs will need to increase. For example, although problem assets have fallen to 2008 levels, some banks are reaching a point at which they need to increase their provision expenses. Already, the downward trend in commercial and industrial (C&I) delinquencies appears to have come to a halt. In addition, banks continue to report that regulatory costs are increasing. With the low interest rate environment that has existed for the last five years, banks had hoped that noninterest income would help boost return on average assets (ROAA) (see the chart).



One of the positive noninterest income categories has been mortgage fees. However, most banks have seen little growth in noninterest income over the years, with most growth coming from gains from asset sales rather than higher fees.