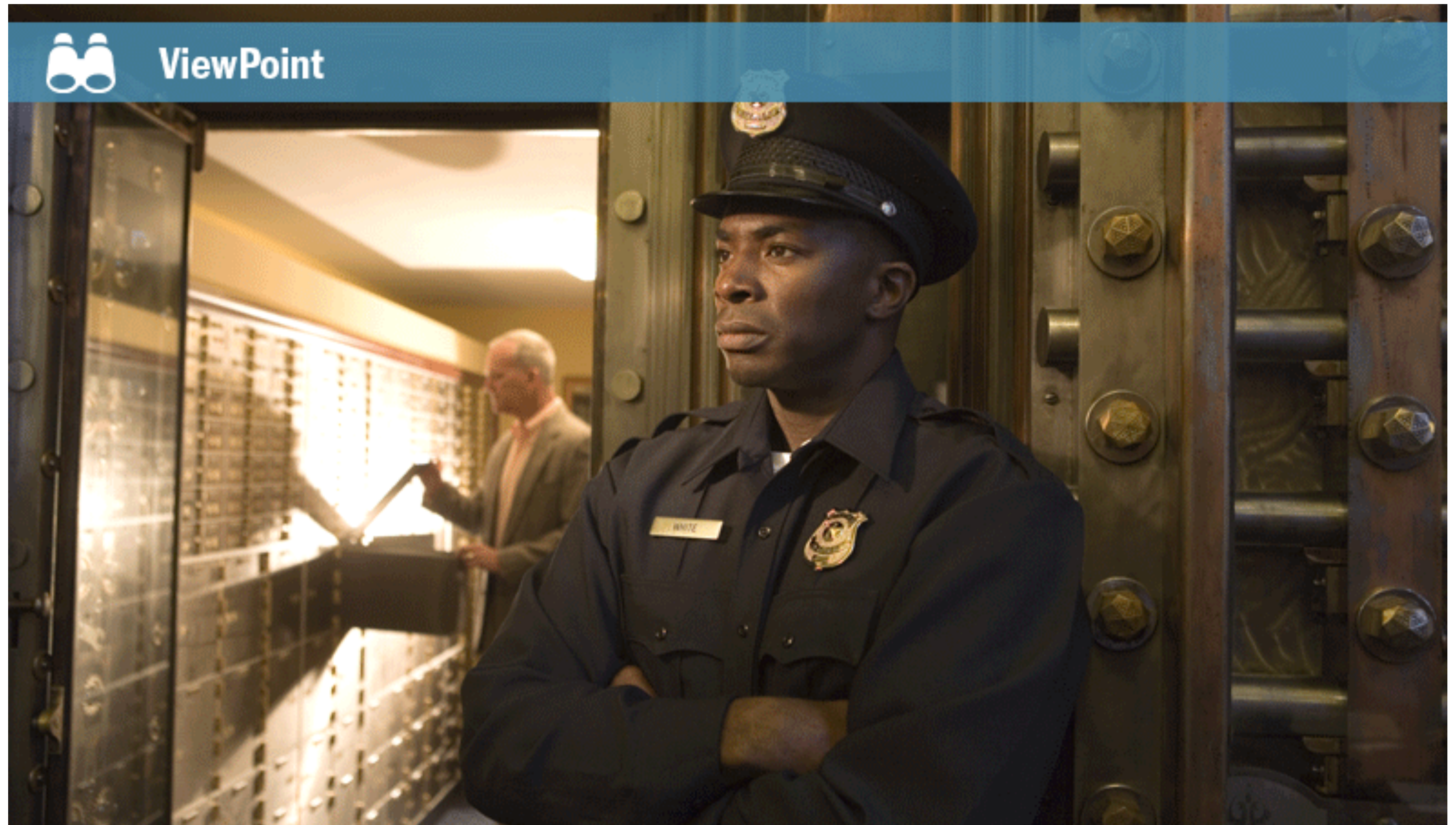
BANKING & FINANCE

National, Regional Banking Conditions Detailed in Latest "ViewPoint"

March 31, 2016

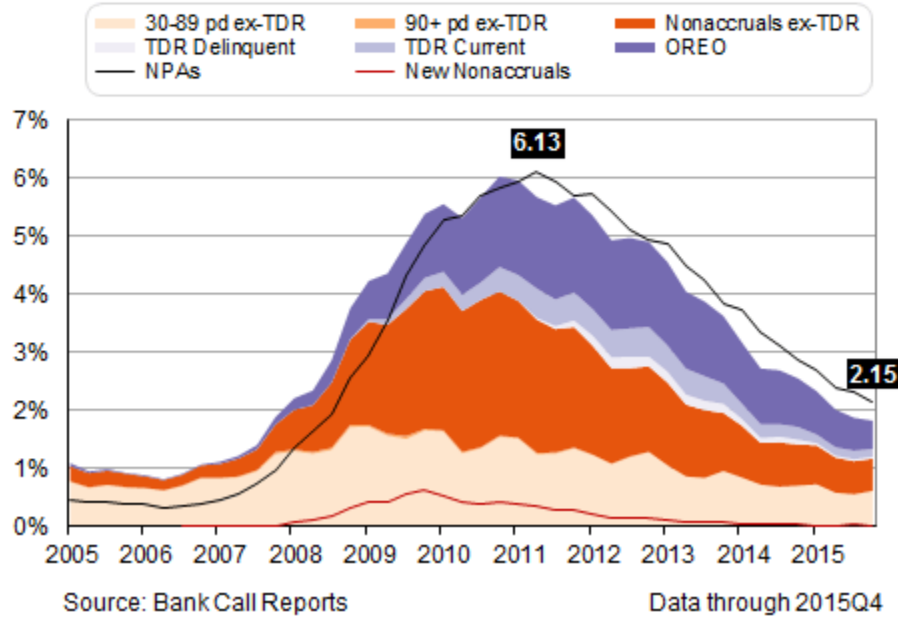


Asset Quality :: Balance Sheet Growth :: Capital :: Earnings Performance :: Liquidity :: National Banking Trends

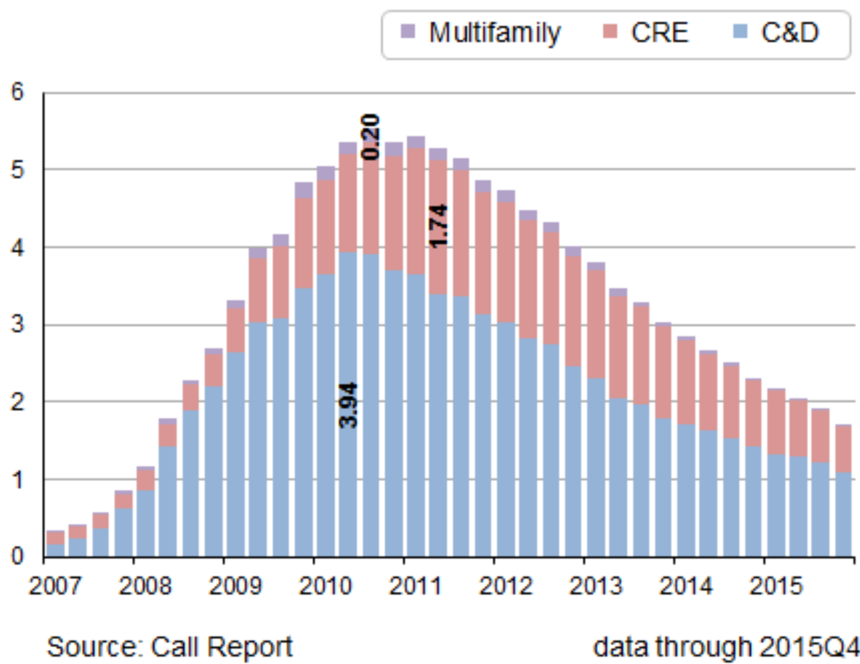
Asset Quality

Although the latest Senior Loan Officer Opinion Survey may be signaling a shift, some 2015 surveys of credit quality and underwriting indicated that banks had reported loosening their standards. Underwriting standards across all banks nationally had declined to the point that—as a result of intense competition for loans—they were on par with 2005–07 levels. Looser underwriting standards make asset quality problems more likely when economic conditions shift.

Some of that sense of foreboding comes from the length of the current cycle and some from problems being faced by energy-producing companies and related industries. In isolating the commercial and industrial (C&I) portfolio (where energy loans are usually reported), nonperforming loans are still declining on an aggregate basis. Data on business bankruptcy filings though have risen on a year-ago basis for the first time since just following the end of the last recession in energy-producing markets. As of the fourth quarter charge-offs among Sixth District community banks remain low. However, they have climbed slightly during the past two quarter-ends. Nonperforming assets (NPAs) among Sixth District community banks are 2.15 percent, on a median basis, of total loans (see the chart).

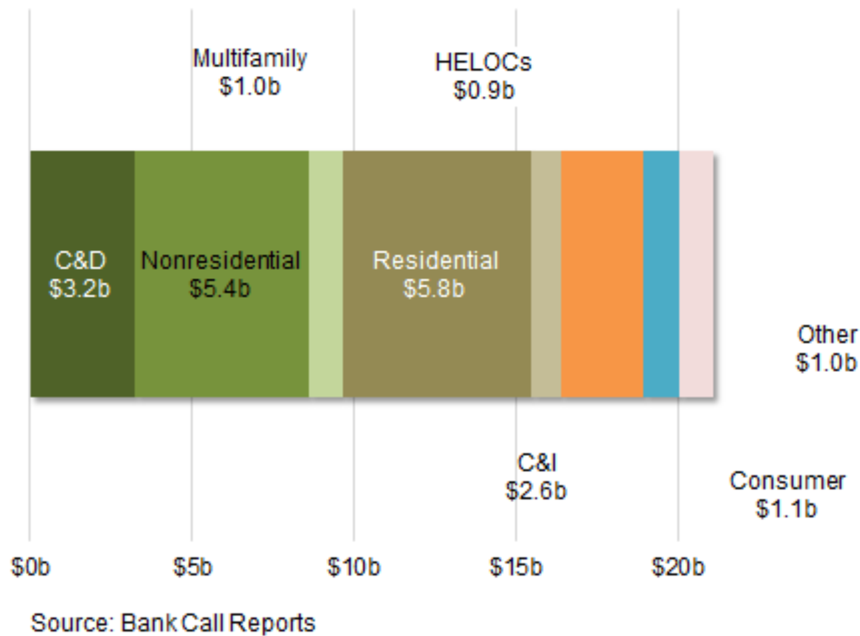


NPAs are at their lowest level in seven years. The only category with a slight increase were loans past due 30–89 days, which could represent one missed payment. Other real estate owned (OREO) remains the largest component of problem assets. The level is trending downward as banks are disposing of the property (see the chart).



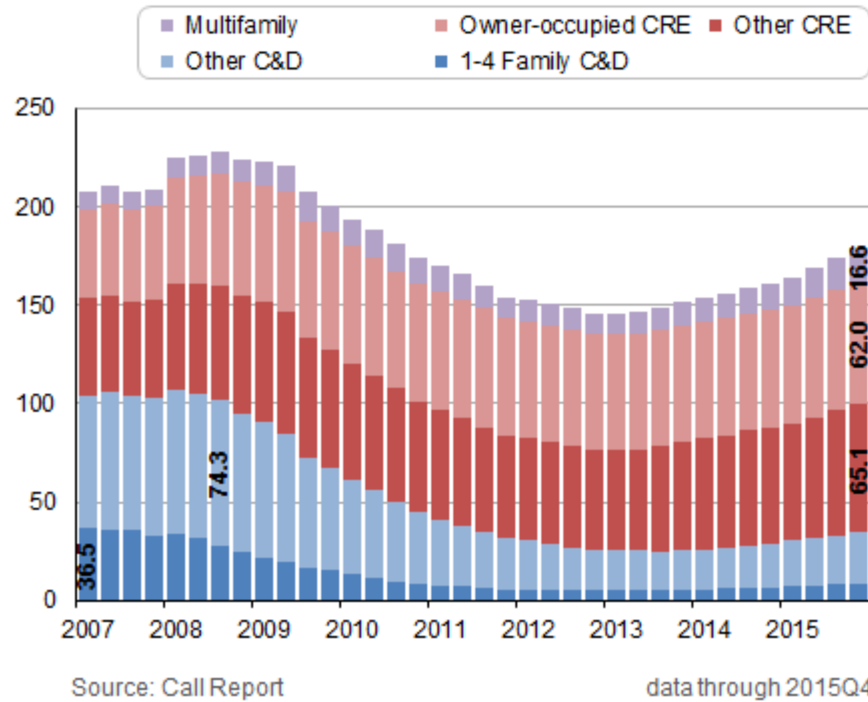
Balance Sheet Growth

Loan growth accelerated into the double digits in the fourth quarter on an aggregate basis. Community banks in the Sixth District have returned to real estate development related lending as markets across the Southeast improve (see the chart).



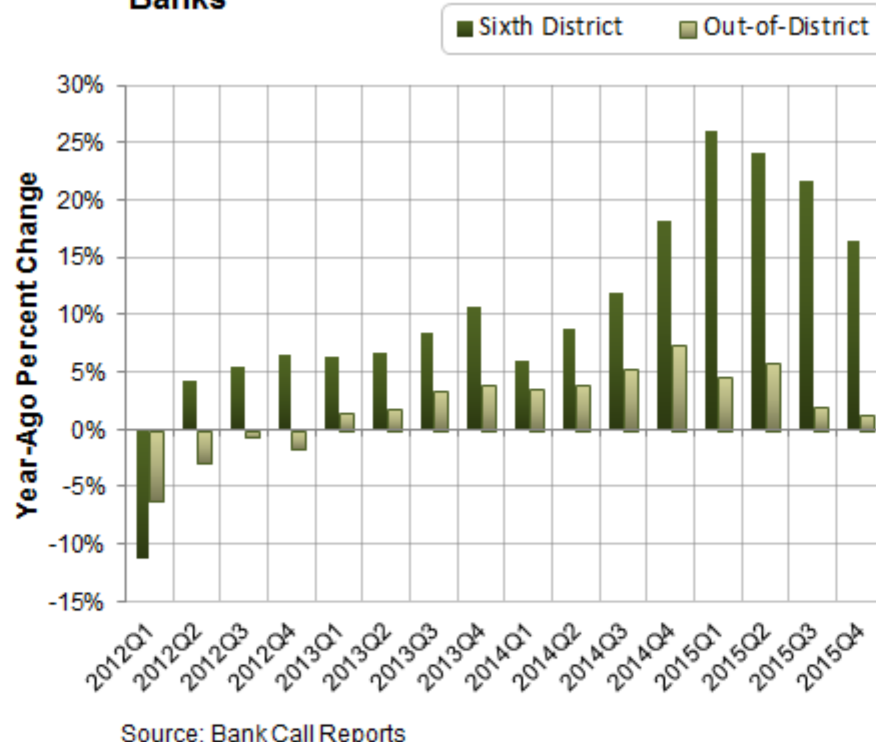
Many Sixth District institutions are reporting significant growth in construction and development (C&D) over the past couple of

years. As recently as the fourth quarter of 2013, C&D lending was still shrinking. In the fourth quarter of 2015, however, C&D lending grew almost 10 percent on a median basis. Only growth in commercial and industrial (C&I) loans was stronger. Consistent with national trends, property valuations are outpacing economic growth due to strong investor demand. Some Sixth District markets and CRE asset classes (multifamily, office and retail) have surpassed peak valuation levels observed in 2007–08. Some of the valuation growth in CRE is the result of purchases using foreign capital (see the chart).



In the Atlanta market, foreign capital purchases skyrocketed from 5 percent in 2014 to almost 20 percent in 2015, according to estimates. This trend is repeating itself in a number of the Sixth District markets and beyond. Banks have questioned the potential impact of foreign investment on local CRE prices and the subsequent issues for appraisal values used in loan underwriting. The concern is that if there is a notable reduction in the level of foreign capital in the market, it could negatively impact market valuations quickly. In terms of C&I lending, demand is reported to be weakening according to recent surveys, with indications of stronger demand declining to its lowest levels in nearly five years. Loan growth among 1-4 family mortgages has remained steady, at about 5 percent, on median basis across 2015.

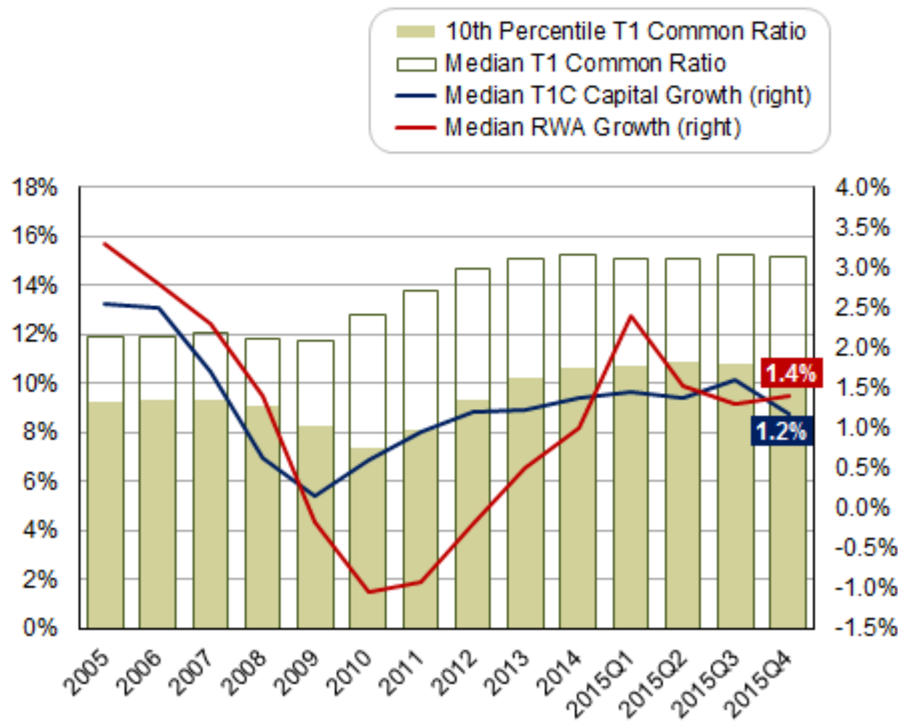
There was some concern about the impact the new mortgage disclosure rules (known as TILA-RESPA Integrated Disclosure, or TRID) would have on 1-4 family loan growth. The new rules became effective early in the fourth quarter of 2015 and implemented certain lending disclosures. Though possibly slowing business operations, the new rules don't appear to have had a significant impact on the level of mortgage lending. Home prices across the Sixth District remain affordable, with the exception of Miami. Atlanta's price growth is not making most of the market unaffordable, and prices in the Tampa market have returned to their long-term averages. After dropping sharply in the Sixth District during and after the financial crisis, homeownership levels are starting to recover but progress varies by state. In terms of improvement in homeownership rates among Sixth District states, Alabama posted the largest year-ago increase followed by Georgia. Florida was flat and Louisiana, Mississippi, and Tennessee saw declines. Consumer loan growth remains around 1 percent as the portfolio is less of a priority for many community banks. Auto loans now make up half of the overall consumer portfolio. Banks currently provide a fifth of all auto loans, aimed almost exclusively at prime and super-prime borrowers. However, since the second quarter, the level of growth has been moderating (see the chart).



Finance companies and credit unions have ramped up low interest rate loans and are attracting a larger portion of the car-buying consumers.

Capital

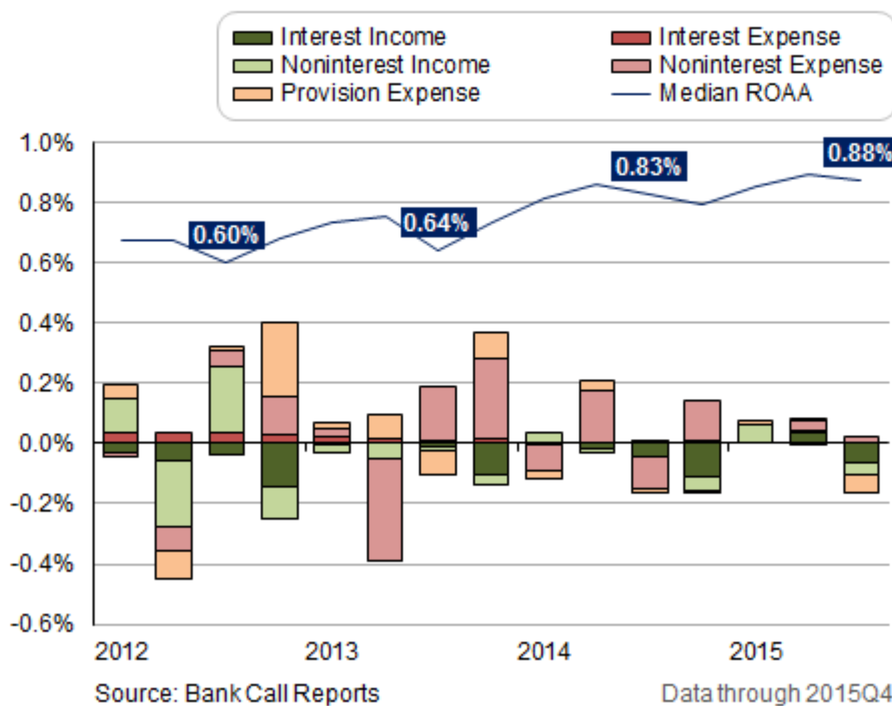
Capital levels remained healthy among Sixth District community in the last quarter of 2015. The median common tier 1 capital was just over 15 percent at community banks in the Sixth District. The growth in capital and risk-weighted assets were at the same level, keeping the ratio stable for the quarter (see the chart).



Net income is the primary driver of capital growth during the quarter, along with transactions with parent companies. As part of the Basel III rules, the Federal Reserve has developed a proposal to institute a countercyclical capital buffer that would be used to boost capital during times of economic stress. The proposed buffer applies in general to banking organizations with more than $250 billion in assets. The Federal Reserve acknowledged in the proposal that as a result of the fact that the buffer can float, it's expected to moderate fluctuations in the supply of credit over time. The agencies also voted to keep the buffer at zero for now. Currently, banks with assets above $250 billion in assets have a tier 1 common ratio of 12.5 percent, so even lifting the buffer is not expected to have a significant impact on large-bank activities.

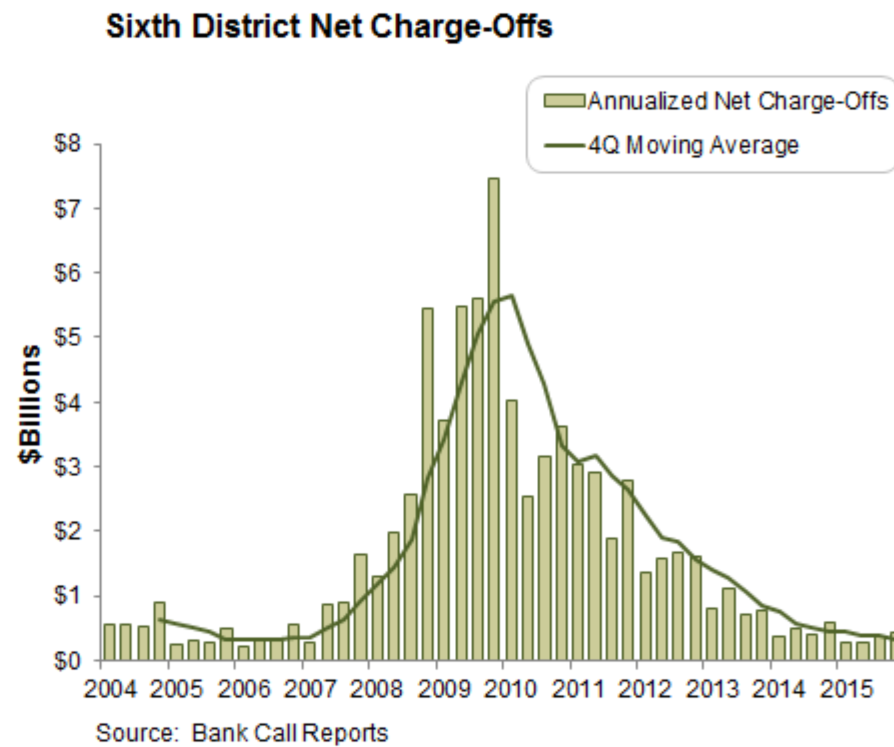
Earnings Performance

On a median basis, return on average assets (ROAA) was 0.88 percent in 2015Q4, a 5 basis point (bp) improvement from the prior year but a 2 bp decline from the prior quarter (see the chart).



The share of unprofitable institutions has come down markedly since the recession, with only 11 percent of institutions being unprofitable in the quarter, on par with the prior year. Banks have gradually improved their net interest income by adding longer maturing loans and securities to the balance sheet. In addition, interest expense continued to decline in the fourth quarter on a median basis. Many banks actively monitored their portfolios throughout 2015 for interest rate risk in anticipation of the rate hike that occurred in the fourth quarter. Even with the interest rate hike late in the quarter, slightly more community banks in the Sixth District had a declining net interest margin (NIM) than had an increasing NIM. As short-term interest rates have been pushed upwards, long-term rates have yet to adjust, which means at least another quarter of NIM compression for community banks.

Since the increase in Fed Funds rate, long-term rates have surprisingly declined. With the potential for more short-term rate increases in 2016, banks will have to manage the balance sheet to avoid further margin compression if long-term rates do not increase in parallel. Loan charge-offs have increased in the last two quarters, prompting some banks to increase their provision expense (see the chart).



Community and regional banks in the Sixth District along the Gulf Coast have some energy exposure, which is prompting some of the increase in provision expense. Although some banks are monitoring their level of provision expense more closely, it remains historically low as there have been only isolated asset quality problems during the last three years. The decline in noncurrent loans has pushed the coverage ratio over 100 percent for the first time since the third quarter 2007. Noninterest income has helped stabilize earnings, increasing 18 percent on an aggregate year-ago basis. Asset sales continue to push increases, although mortgage production continues to drive more fee revenue. After five years of tight cost controls, noninterest expense is no longer trending down, an indication that banks may have reached bottom on their expense containment.

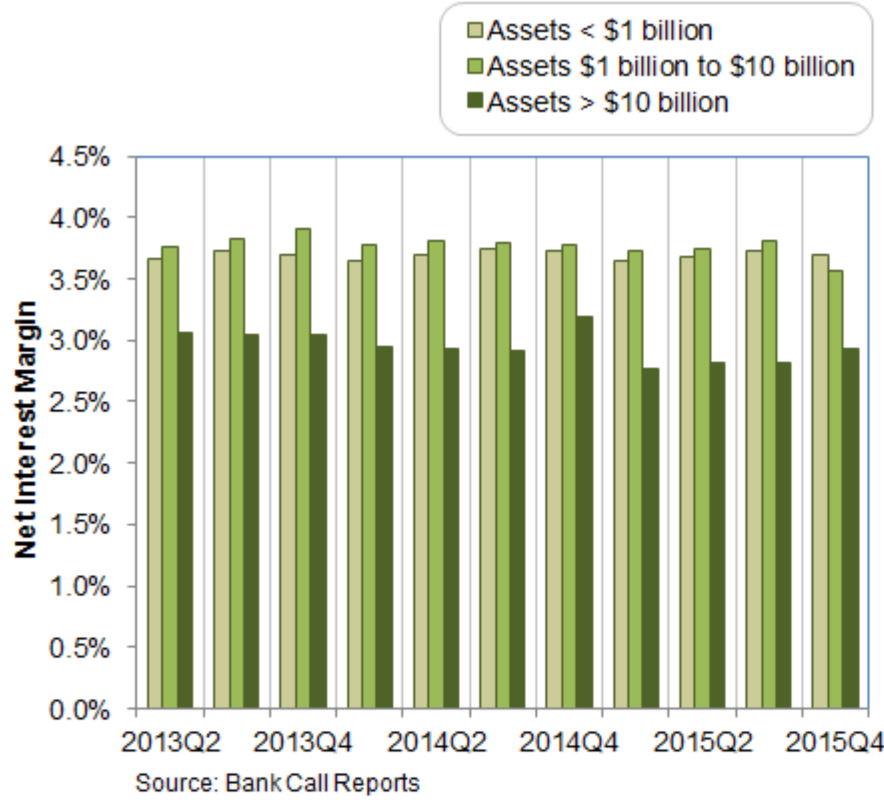
Liquidity

The increase in interest rates occurred late in the fourth quarter and, based on the decline in interest expense, banks have not yet increased rates on deposit accounts. The impact of higher rates on deposits remains uncertain. The rise of mobile banking during the past decade has had a significant effect on the way people use banking services today. Given all the change, it may be difficult for banks to model customer behavior based on past rate increases. Even with the recent loan growth, the current core deposits-to-loans ratio among community banks in the Sixth District is 68 percent, on par with banks out of district. Reliance on noncore deposit funding has declined to just 1.8 percent on a median basis. Banks may soon be scrambling to increase noncore funding if there is a significant shift in deposits. In addition, recent discussions about negative rates could, at some point, put additional pressure on banks' liquidity.

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.

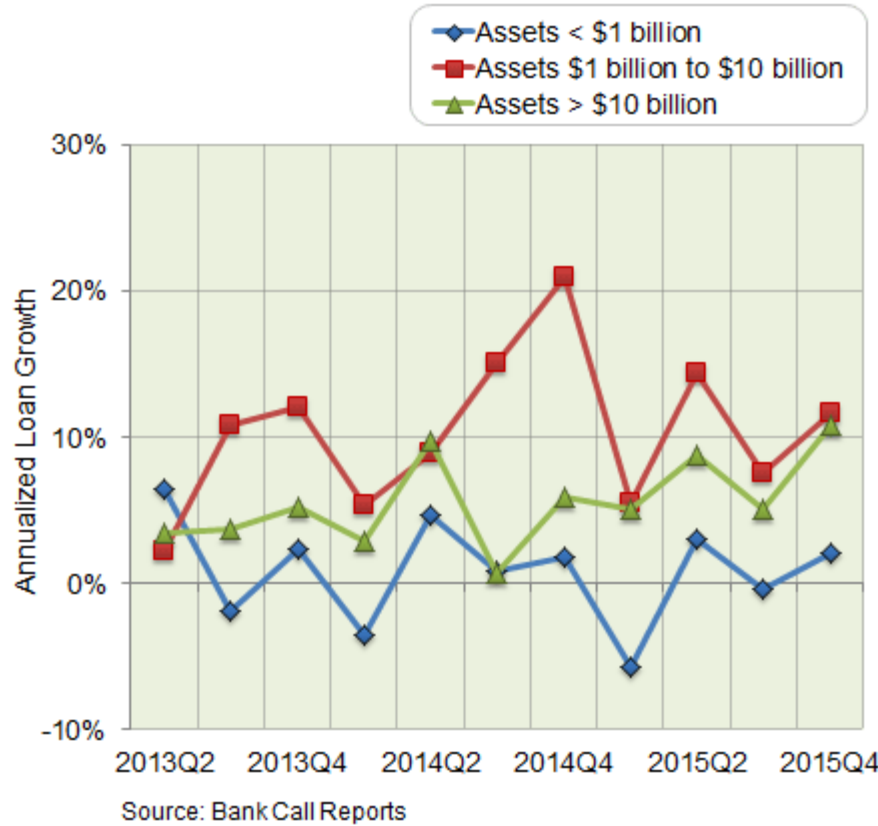
National Banking Trends

With the low interest rate environment that has existed since the financial crisis, banks hope that the recent move to normalize interest rates will lead to an improvement in overall earnings. The December 2015 rate increase came too late in the quarter to have a significant impact on the net interest margin. The net interest margin actually declined for banks with assets below $10 billion in the fourth quarter, and the return on average assets (ROAA) increased slightly (see the chart).

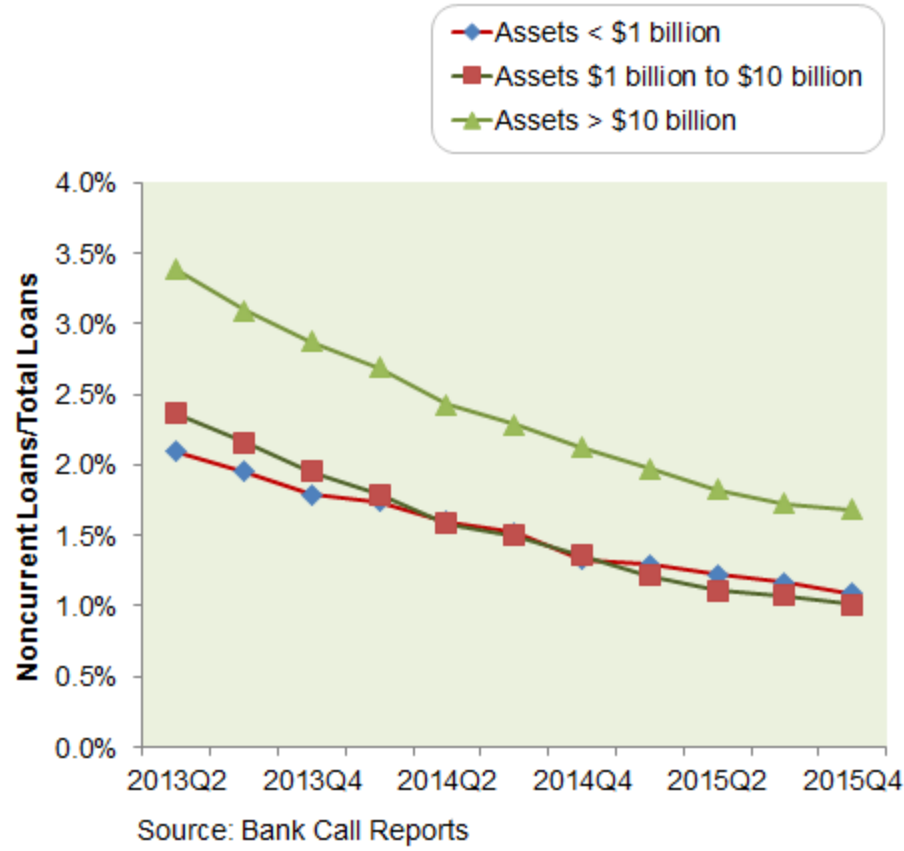


Banks remain under pressure to keep costs down with net interest margins remaining so tight, but they are finding that they can no longer easily reduce costs and that some expenses will actually need to increase. Provision expense will likely be among the expenses banks will increase during the next year. Though asset quality has been a back-burner issue for the past three years, with the focus for many banks on interest rates, banks and regulators are becoming more concerned that the credit cycle is about to change.

The long-term low interest rate environment has provided obstacles to revenue growth for many banks. Banks have responded to the competitive environment by easing their credit underwriting standards, during the past couple of years, primarily in their pricing, in order to attract business. The pace of lending continues to be strong, with an annualized loan growth of 12 percent for banks with assets between $1 billion and $10 billion. Growth has been much more uneven for banks with assets less than $1 billion (see the chart).



At the same time, there has been rapid price appreciation in certain real estate markets, similar to conditions prior to the financial crisis, and a strong level of commercial and industrial (C&I) lending related to the energy sector. Both real estate and C&I credits pose a higher risk for potential losses at the current point in the credit cycle (see the chart).



Based on fourth quarter data from the call reports, CRE concentrations—although below peak levels from 2007–08—they remain elevated with banks just over $1 billion ($1 billion to $5 billion) in size having the highest concentration. However, there are signs of valuation pressures in some CRE markets across the nation, which has renewed concerns among regulators—so much so, in fact, that the banking agencies issued a statement in December that calls for sensible risk-management practices regarding CRE in light of recent growth. The banking agencies' statement reinforces existing guidance for commercial real estate risk management—in particular, the guidance on concentrations issued in December 2006.

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