BANKING & FINANCE

National, Regional Banking Conditions Detailed in Latest "ViewPoint"

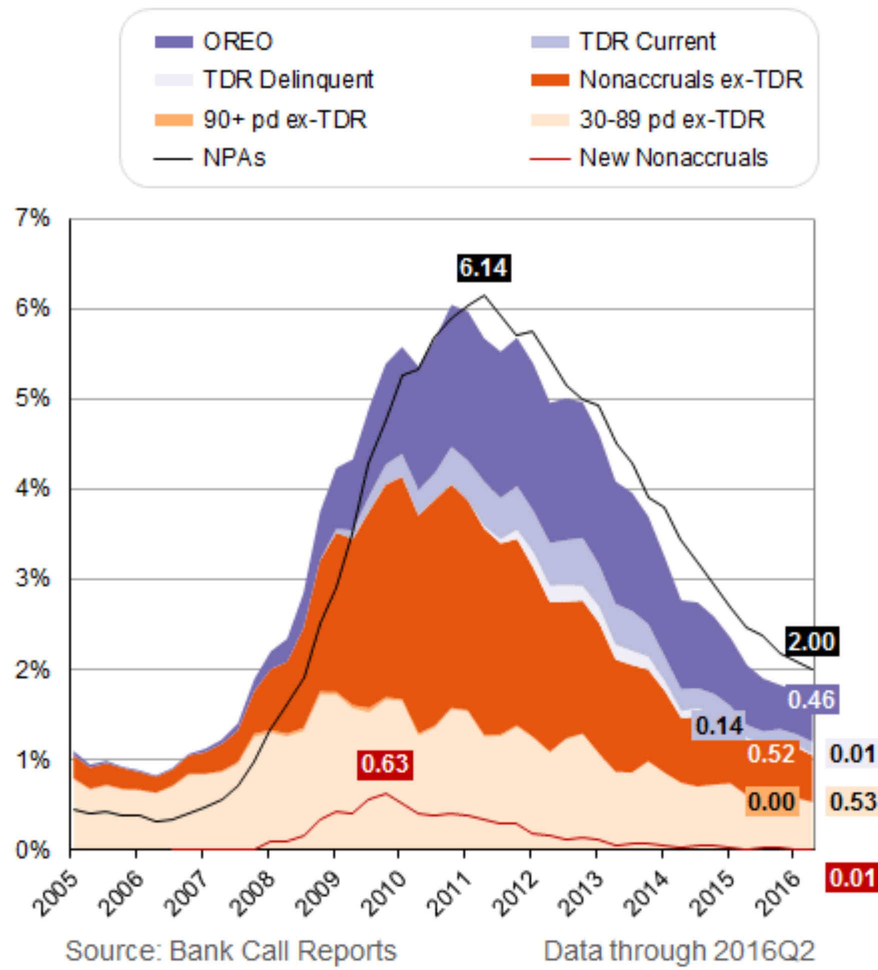
September 29, 2016

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

Asset Quality

Problem assets as a percentage of total loans have continued a downward trend and asset quality remains strong across Sixth District community banks. Steady improvement in the housing market has had a positive impact on banks' balance sheets, particularly in Florida, where distressed sales have dropped dramatically over the past year. As of the second quarter of 2016, other real estate owned (OREO) balances represented 0.45 percent of total loans plus OREO, down from 1.63 percent at its peak in the first quarter of 2011 (see the chart).

Asset Quality Trends
Medians, Percent of Total Loans +

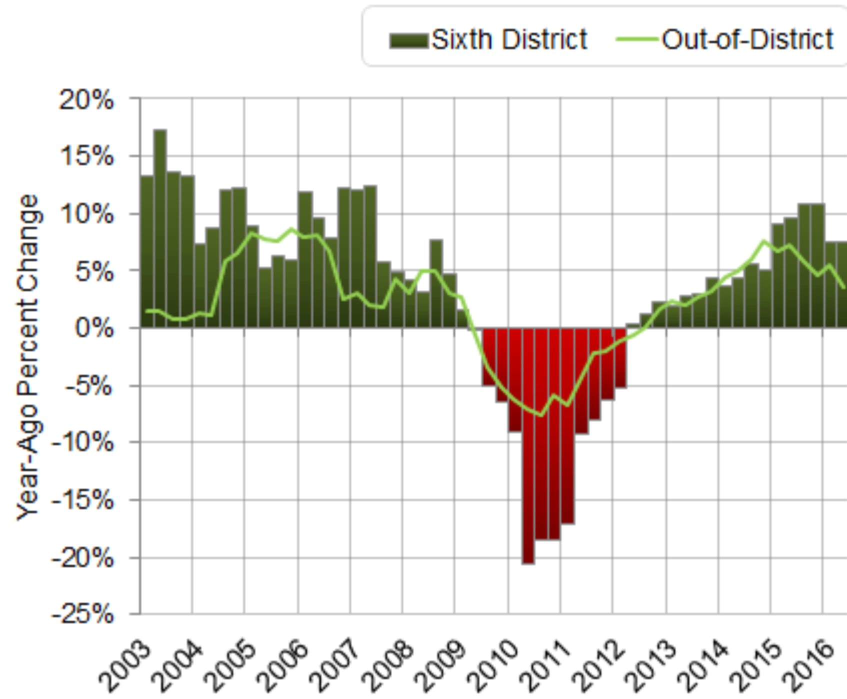


Inventory shortages have helped clear OREO properties off the balance sheet, and the steady upward pressure on home prices (up 5.3 percent from last year in Florida) has reduced the level of losses. Though the trend in asset quality remains positive, there are some concerns going into the second half of 2016. For example, community banks in energy markets like Louisiana continue to experience climbing consumer portfolio delinquencies and deteriorating conditions among CRE borrowers' financials. Problems in the real estate market will further restrict loan growth for community banks in those markets, affecting earnings growth in the short term even if delinquencies do not increase and put pressure on asset quality.

In addition, commercial bankruptcies have been trending upwards, which could indicate potential trouble with C&I loans. In comparing the growth in bankruptcies year over year using year-to-date data from June 2016 and June 2015, there has been a spike across Florida and North Georgia. The increase in the Florida panhandle is 128 percent, second only to the Middle Louisiana district. Given the level of commercial lending growth across the Sixth District, the spike is concerning given that it is unlikely all of it is connected to the change in energy prices. Currently, the coverage ratio remains roughly 100 percent. Loan charge-offs were lower during the quarter, which helped reduce the provision. The Financial Accounting Standards Board finalized and published the new standard on accounting for credit losses during the second quarter. The new guidance, known as the Current Expected Credit Loss (CECL) standard, will affect the allowance for loan loss methodology going forward. Community banks are likely to take the next few quarters preparing to adjust their allowance to be compliant with the new guidelines once they become effective.

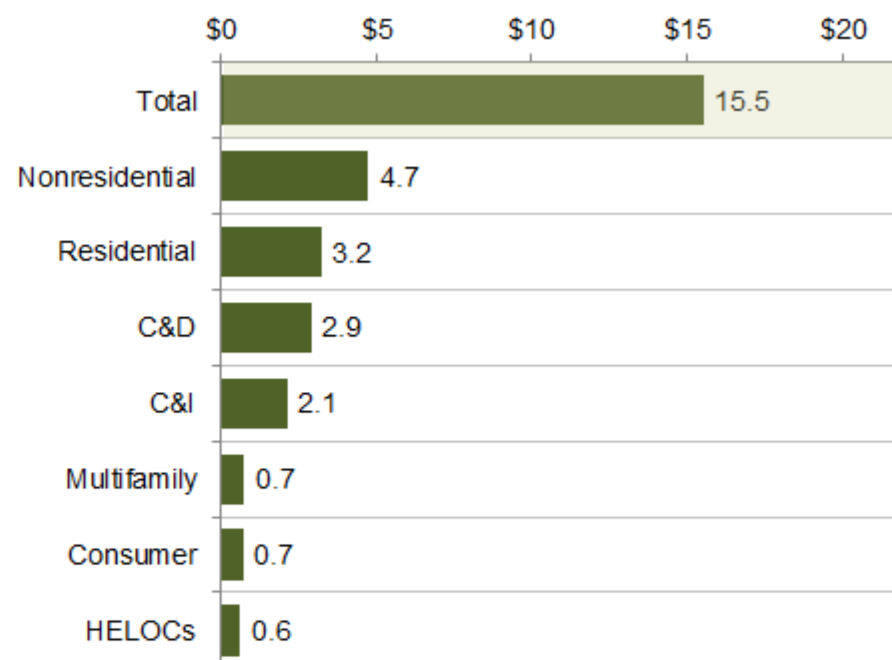
Balance Sheet Growth

Though loan growth remains strong for several portfolios, overall loan growth for banks is slowing going into the second half of 2016. Total loan growth, on an aggregate basis, in the Sixth District was flat in the second quarter compared to the prior quarter and down 200 basis points year over year (see the chart).



Source: Bank Call Reports

Construction and development (C&D) loans, along with commercial real estate (CRE) and residential mortgages continue to experience the strongest growth (see the chart).



Source: Bank Call Reports, 2015Q2

Median year-over-year growth in C&D loans was 24 percent, while commercial and industrial (C&I) loans grew 15 percent. Residential construction increased by 20 percent year over year and has achieved a growth rate of 20 percent or more in each quarter over the past year. Although residential construction levels have improved, new single family construction remains suppressed compared to historic trends, and the price points of most of what is currently being built has been concentrated in the higher end.

In Sixth District markets such as Nashville, housing starts may be hindered by declining vacant developed lot inventory levels. As of the end of the second quarter of 2016, the region had only around a 14-month supply of lots (equilibrium is typically considered between 18 to 24 months). Meanwhile, bankers in the Southeast have once again embraced CRE. CRE loan growth among Sixth District community banks continued to surge in the second quarter of 2016, with the portfolio increasing by 10 percent over the prior year. CRE remains the largest percentage of total risk-based capital for community banks in the District (see the chart).

Sixth District Asset Exposures

Share of Assets (%)	2016Q2	2016Q1	2015Q2	2008Q4
C&D	6.4	6.3	5.8	18.9
HELOCs	2.6	2.6	2.6	2.7
Nonresidential	22.4	22.0	22.1	19.0
Multifamily	2.4	2.3	2.3	1.7
C&I	11.4	11.3	11.4	9.1
Consumer	3.5	3.5	3.5	4.7
Residential	15.2	15.0	15.0	12.3
Total Loans	**67.5**	**66.4**	**66.2**	**71.4**
Total Securities	**20.1**	**20.3**	**21.2**	**16.7**

Source: Bank Call Reports

At the same time, regulators continue to express concerns over the CRE market. Cap rates in the Sixth District have reached prerecessionary lows, and any further shifts in interest rates could weaken prices in the market. Based on data from the Senior Loan Office Opinion Survey (SLOOS), loan standards in the CRE space have tightened sharply during the past year, an indication that bankers may be heeding warnings from regulators. Community banks continue to add residential mortgages to the balance sheet, growing by 3 percent on an aggregate basis, despite some banks declaring that they could no longer afford to make mortgages due to new compliance regulations. Nine months after the implementation of TILA-RESPA Integrated Disclosures (TRID), some mortgage originators are reporting mortgage origination gains of double the level of the prior year.

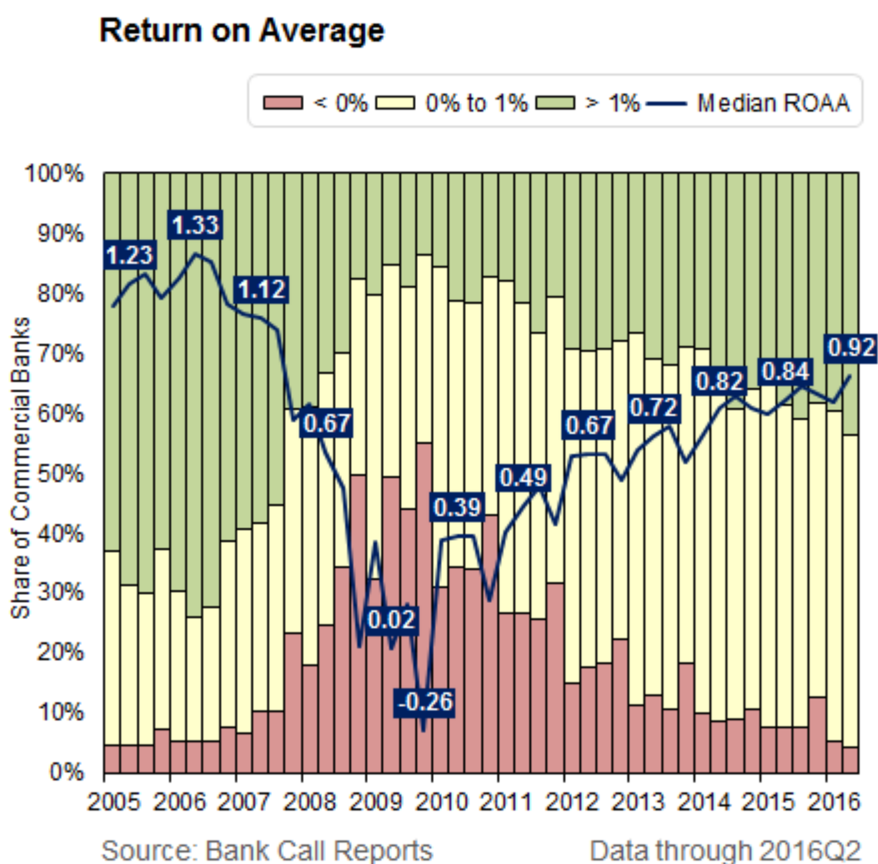
C&I loan growth slowed to 6 percent in the second quarter, 400 basis points lower year over year, continuing a trend of single-digit growth that stretches over four quarters. A slowdown in C&I had been expected as banks shifted back to more traditional CRE lending, especially in Sixth District markets where energy is a large component of the local market economy. Part of the slowdown also comes from a lack of demand for C&I loans, as small business owners are reporting no real enthusiasm for expansion or new capital expenditures, according to the National Federation of Independent Business. Roughly half of the responding banks in the July SLOOS reported that demand had softened for C&I loans. Aggregate consumer loan growth was 6 percent year over year as auto loan growth slowed dramatically from 2015 levels. Auto loans are about the only source of consumer loan growth for banks over the last five years, outside of mortgages. Auto sales have slowed over the summer, which has also weakened demand for auto loans.

Capital

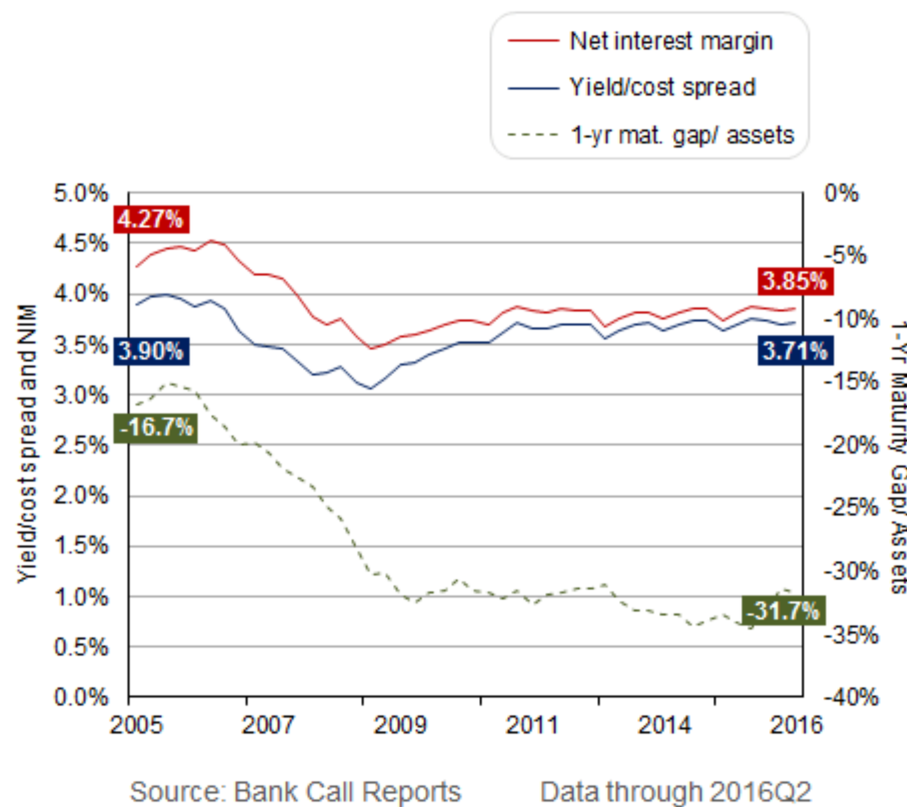
Banks have been able to maintain higher capital levels across multiple quarters, partly the result of low levels of asset quality problems. The median tier 1 common ratio remains strong but dipped slightly in the current quarter as growth in risk-weighted assets outpaced that of tier 1 capital. Most banks are well above the minimum capital requirements. Growth in risk-weighted assets was 1.9 percent, 40 basis points more than the growth in medium tier 1 capital. Growth in capital was driven by net income and other comprehensive income, which more than offset the impact of common dividend distributions.

Earnings Performance

Although economic conditions have affected banks in the Sixth District, annualized median return on average assets (ROAA) was at 0.92 percent in the second quarter, sustaining the improvement in earnings that community banks have achieved since the depths of the financial crisis (see the chart).



A greater number of banks, 43 percent, have ROAAs that exceeded 1 percent, the highest level since 2007. On the flip side, less than 5 percent of the community banks in the Sixth District had negative earnings, the lowest level in 11 years. The increase in interest rates in December 2015 has yet to have a significant impact on the net interest margin. The median net interest margin in the second quarter was 3.85 percent, slightly down from the prior year-end, but up 2 basis points year over year (see the chart).

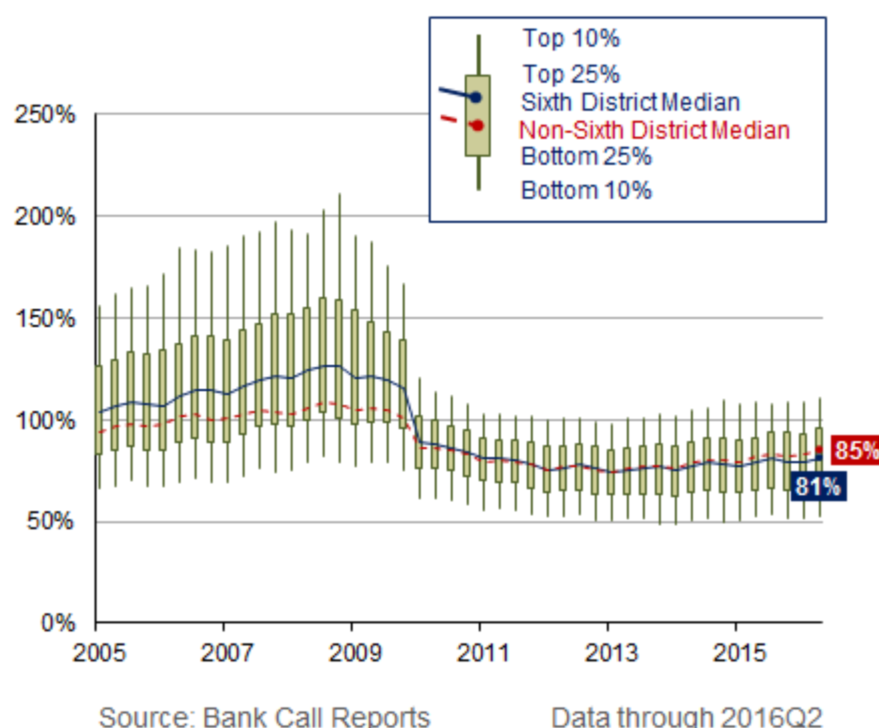


Over the past couple of years, some banks had decided to forgo short-term earnings opportunities to position themselves for a time when rates would increase. However, global events such as Brexit in June, which helped push Treasury rates to their lowest levels in four years during the quarter, has left banks wondering if rates will ever return to normal. Still, the margin appears to have stabilized during the past year, fluctuating quarter to quarter by 2 or 3 basis points. The median yield on the banks' largest asset class—loans and leases—remained steady at 1.36 percent.

Despite weaker growth in the first half 2016 and an uncertain interest rate future, the outlook for earnings appears to be improving for community banks in the Sixth District. Major contributors included an increase in noninterest income and decreases in noninterest expense and provisions. Provision expense is increasing in energy markets but remains low across the majority of community banks, reflecting the low levels of nonaccrual loans and charge-offs. As banks continue to operate in a low yield environment and comply with new regulations, noninterest income from sales of other assets and fees will continue to grow in importance.

Liquidity

Banks continue to have stable liquidity. Beginning in the first quarter of 2014, loan growth began to consistently outperform core deposit growth on a quarterly basis, which continues to occur. Core deposits continue to grow slowly and as such, core support remains robust at 81 percent in the Sixth District, just below the national median (see the chart).



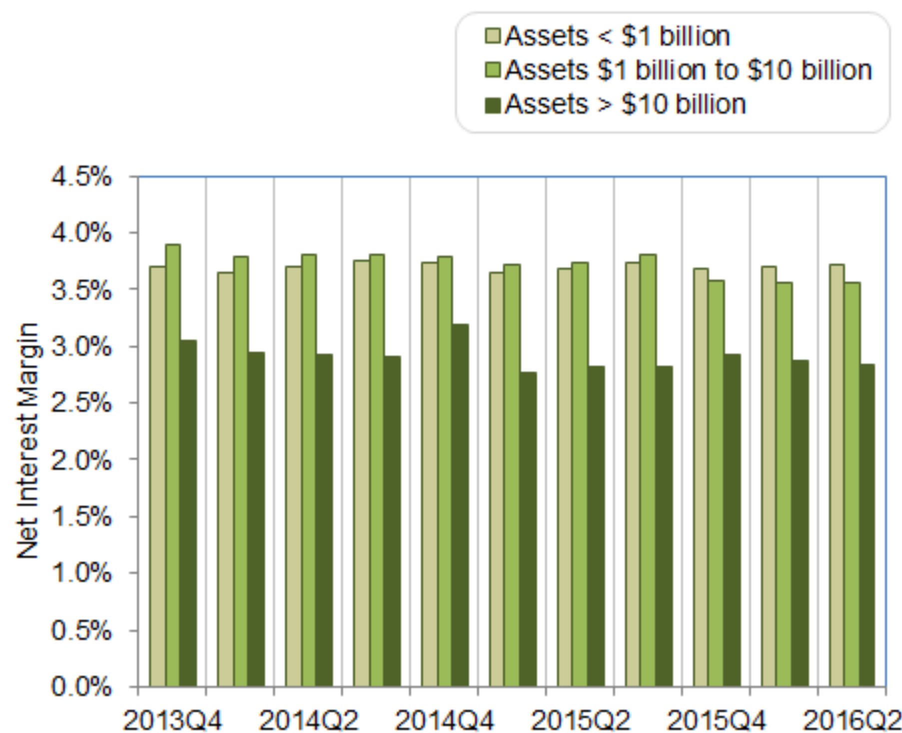
The median net noncore funding dependence ratio, under the current definition, continues to exhibit a low dependence on noncore liabilities. Noncore funding has remained far below the heights reached during the financial crisis, even with the recent spike in loan growth. The Sixth District's median on-hand liquidity ratio remains stable and has kept pace with the non-District peer. With the improvement in loan growth and slowing of deposit growth, banks are starting to seek funding from other sources. One option more frequently used is subordinated debt, which can be a very attractive to some boards and a relatively inexpensive alternative to either raising capital or seeking new depositors. So far, new issuances of subordinated debt appear to be small in the Sixth District.

As of the second quarter, year-over-year growth of subordinated debt was 12 percent at the holding company level in the Sixth District, tripling the growth rate from the prior year (the growth includes all holding companies within the District that file the Y9C form). Even a bank with assets greater than $1 billion within the District experienced an oversubscription of a recent offering, which speaks to the popularity of subordinated debt with investors. Limiting the analysis to holding companies with assets between $1 billion and $10 billion, the growth is even more dramatic at 102 percent.

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.

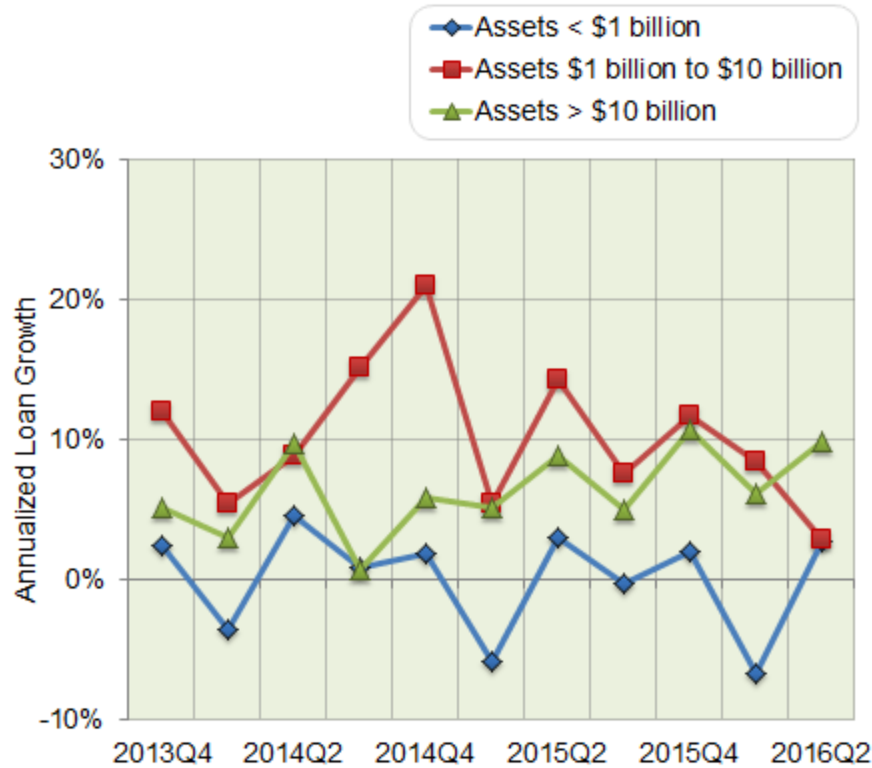
National Banking Trends

The slower growth since the financial crisis has affected the banking sector with lower interest rates, narrow margins, and moderate loan growth. Net interest (NIM) margins have remained stable, even with the 25 basis point increase in short-term rates that occurred in the fourth quarter of 2015 (see the chart).



Even without an expanding NIM, aggregate return on average assets (ROAA) bounced back from the prior quarter, especially for large banks. For the first time in over a year, banks of all sizes had an aggregate ROAA above 1 percent. Increases in fee income and other noninterest income helped ROAA continue to improve during the quarter. In addition, higher deposit levels, compared to precrisis, continue to keep interest expense at historically low levels.

Part of the reason that the NIM has flattened is that during the past four quarters, banks with assets between $1 billion and $10 billion have experienced declining loan growth while other banks have experienced extremely volatile growth, up and down quarter-to-quarter (see the chart).



Many banks, especially in the Southeast, have shifted away from a heavy emphasis in commercial and industrial (C&I) loan growth back to a more traditional commercial real estate (CRE) sector strategy. However, more caution is being urged with CRE loans, particularly in the multifamily sector, with the agencies releasing statements about CRE loans. Multifamily lending has really grown during the past three years, and although it represents a small share of total bank lending, it has become a significant sector of concentration (25 percent or more of capital). In the July 2016 Senior Loan Officer Opinion Survey (SLOOS), banks reported that underwriting standards on CRE loans tightened during the second quarter, and demand for CRE loans remains positive. Financing CRE loans has become more complicated as new risk-retention rules are slowing new issuances in the commercial mortgage-backed securities (CMBS) market. For example, August year-to-date nonagency CMBS issuance is down 50 percent from one year earlier, according to SIFMA. Banks that issue CMBS securities are viewed by some in the market as having an advantage, given their large balance sheets and the amount of risk that needs to be retained.

Even with the slower growth and concerns surrounding CRE concentration, there has not been a significant increase in noncurrent loans. The ratio of noncurrent loans to total loans remains below 2 percent on an aggregate basis. For larger community banks—those between $1 billion and $10 billion in total assets—the ratio decreased below 1 percent. The ratio remains extremely low and far below the levels experienced during the crisis.

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