BANKING & FINANCE

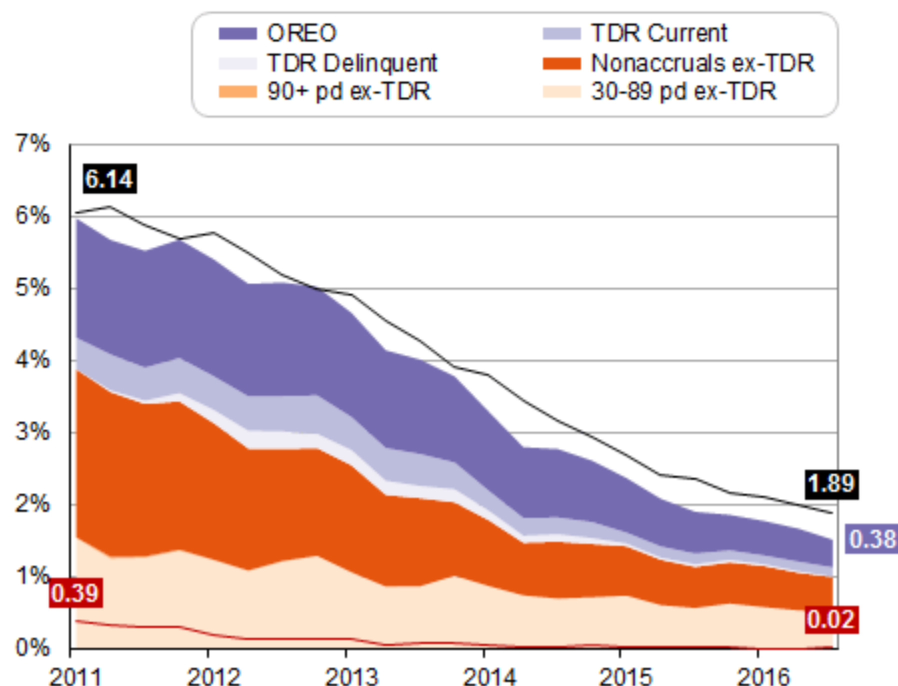
National, Regional Banking Conditions Detailed in Latest "ViewPoint"

January 5, 2017

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

Asset Quality

Asset quality remains steady at most banks across the District. Net charge-offs, as a percentage of average loans, was 0.17 percent in the third quarter of 2016, the same as the prior year. The coverage ratio is near 100 percent, the highest it's been in nine years. Nonperforming loans and other real estate owned (OREO) continue to decline as a percentage of total loans in the third quarter. The nonperforming assets represented only 1.78 percent of total loans, down 126 basis points from two years ago (see the chart).

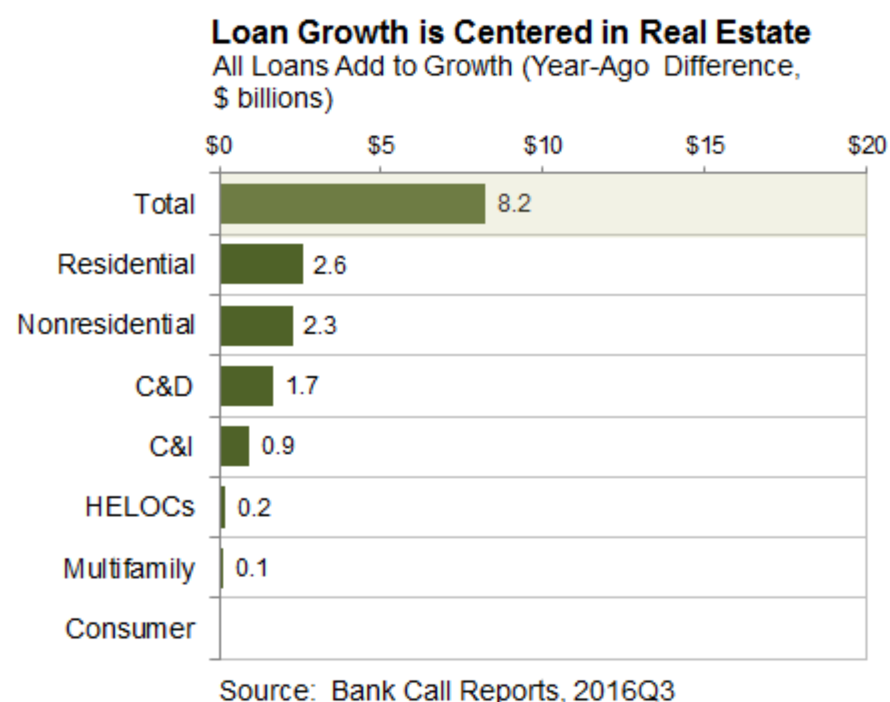


Distressed sales, including OREO, have reached their lowest point since the real estate crisis began. Inventory shortages have helped clear REO properties off the balance sheet, and the steady upward pressure on home prices has reduced the level of losses.

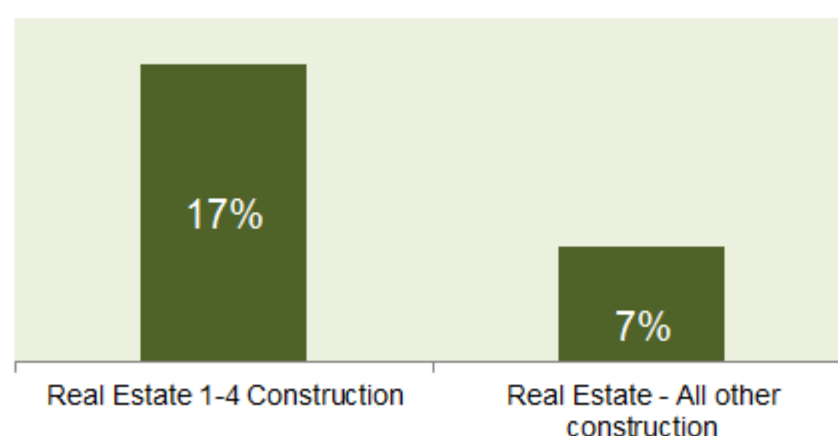
Both the C&I and CRE portfolios remain a concern. They are the only two portfolios in which nonperforming loans increased year over year. Lower energy prices continue to affect C&I loans in the western edge of the Sixth District. Recently, the rating service Fitch announced that it projects a softening of the CRE market in the coming months. Fitch's warning was directed at small and midsize banks that have the largest CRE exposure. At the same time, it's becoming increasingly challenging to refinance CRE properties as mortgages mature, forcing more properties into delinquency. It's forecasted that the inability to find financing will slow the CRE sector in the coming months, which will put pressure on prices for properties as well as community banks that have returned to CRE lending over the past year.

Balance Sheet Growth

Loan growth has slowed over the last two quarters, with annualized loan growth turning negative in the third quarter, but total volume has increased 4 percent year over year. Residential lending has recovered from the concerns raised by new regulations implemented a year-ago and had the largest volume of growth during the quarter (see the chart).



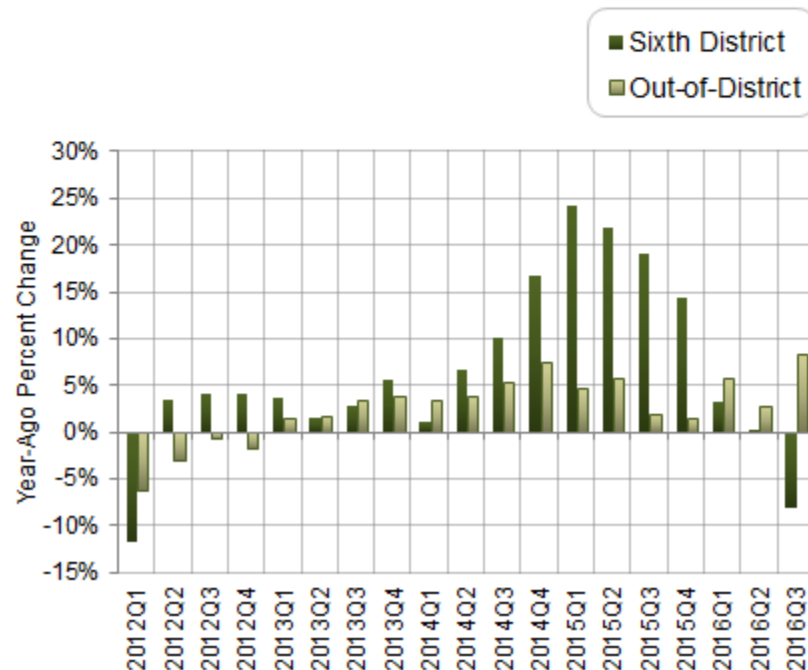
Closed-end residential loans grew 6 percent year over year. According to the October 2016 Senior Loan Officer Opinion Survey (SLOOS), mortgage underwriting remains unchanged, although new demand remains healthy. FICO scores for new originations remain above 700 across many markets. For example, in metro Atlanta, with the exception of a couple of submarkets, the average FICO was roughly 750, especially in the popular northeast corner of the market. Demand is helping spur new construction as residential construction and development (C&D) grew by 17 percent year over year (see the chart).



Over the past year, more banks have shifted lending into commercial real estate (CRE), slowing growth in other portfolios. In aggregate, CRE concentrations at commercial banks headquartered in the Sixth District have continued to drift upward but remain well below prerecession peaks. Multifamily lending has really grown over the past three years and although it represents a small share of total bank lending, it has become a more significant sector of concentration among banks in the Sixth District. Construction and development loans for CRE continue to grow, but growth rates remain in the single digits. Regulators are urging more caution with CRE loans, particularly in the multifamily sector, with the agencies releasing new statements about CRE loans. Loan standards in the CRE space have tightened sharply over the past year, an indication that bankers may sense the danger. As other portfolios, such as CRE, have started to grow again, banks have been able to reduce their reliance on consumer lending.

Coming out of the crisis, the auto portfolio was one of the only consumer portfolios in which banks were able to achieve growth.

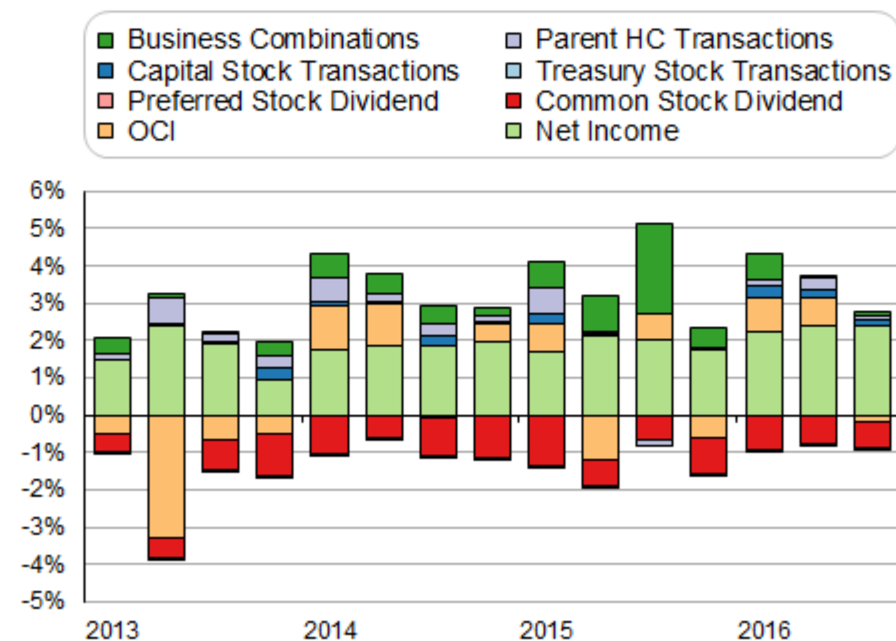
However, the re-emergence of captive finance companies and a greater push by credit unions quickly reduced the margins on the portfolio. Underwriting standards had declined as banks allowed loan-to-value ratios to increase and extended the number of months for repayment terms (in some cases as long as 84 months for new cars). In the second quarter of 2016, Experian reported that the average loan term for loans to subprime borrowers is now nearly six years on new cars. Subprime borrowers are the primary buyers currently, as prime and super prime borrowers are shifting more to leasing as prices increase. Auto loan growth in the Sixth District turned negative during the quarter (see the chart).



Given the current market composition, banks are increasingly pulling back on auto lending, as the level of competition has led to very narrow spreads and auto sales decline. Some banks have started selling their portfolios into conduits and moving the portfolios off the balance sheet. Meanwhile, another source of growth coming out of the crisis—C&I loans—has also slowed.

Capital

Given the current operating environment, capital has not been a significant issue for community banks in the Sixth District (see the chart).

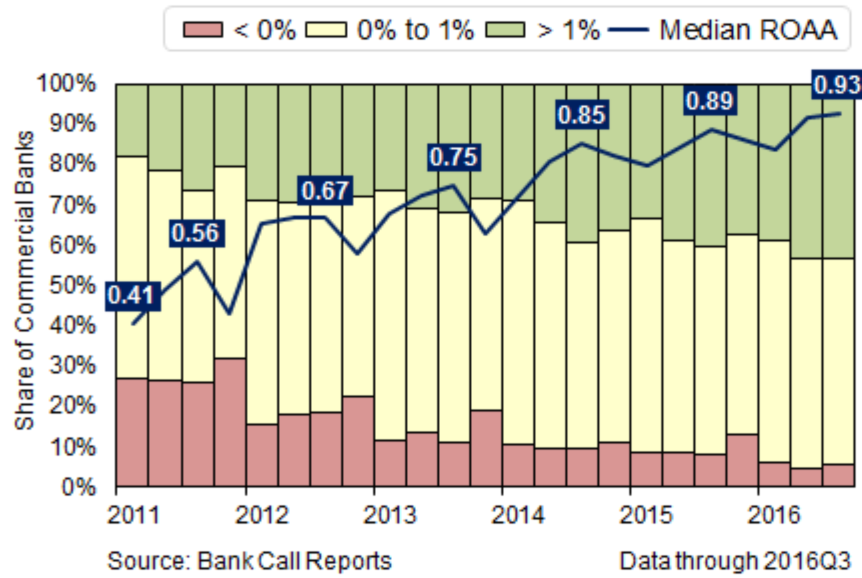


Banks have maintained their capital levels across multiple quarters. The median common tier 1 capital ratio was over 15 percent and has been since the implementation of Basel III. For the quarter, growth in capital was slightly higher than the growth in risk-weighted assets, pushing the ratio slightly higher than the previous quarter. Net income is still a primary driver of capital growth.

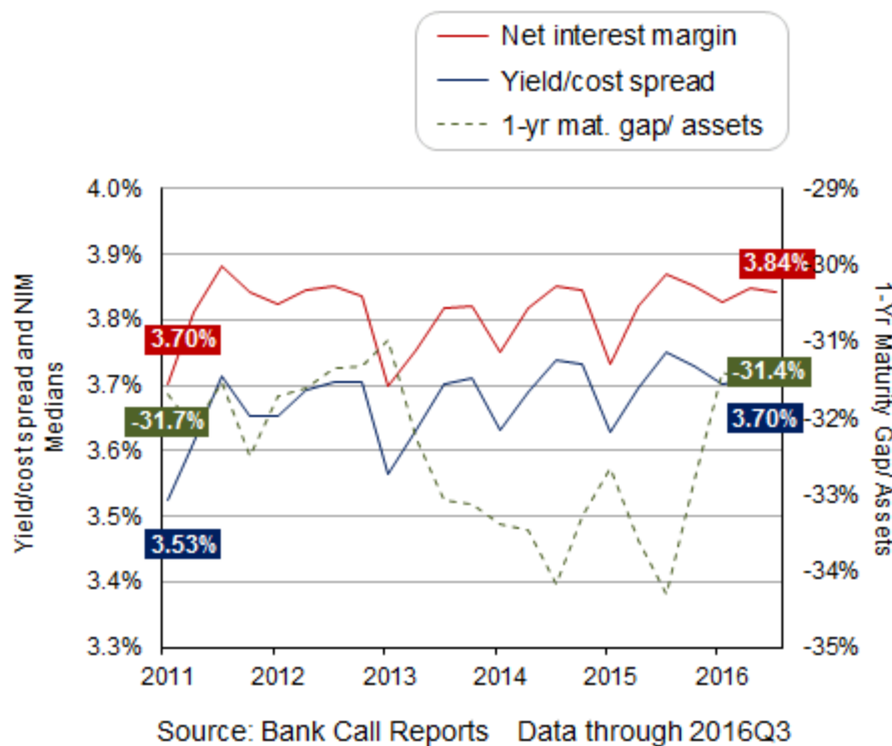
Earnings Performance

Earnings continue to improve even as the net interest margin (NIM) remains flat. On a median basis, ROAA for Sixth District community banks continued to increase. ROAA improved by 4 basis points from the prior year to 0.93 percent, its highest level in

nine years (see the chart).



There was a slight increase in the percentage of banks with a negative ROAA, but it remains far below the peak of 54 percent from 2009. The median NIM in the third quarter was 3.84 percent, slightly down year over year (see the chart).

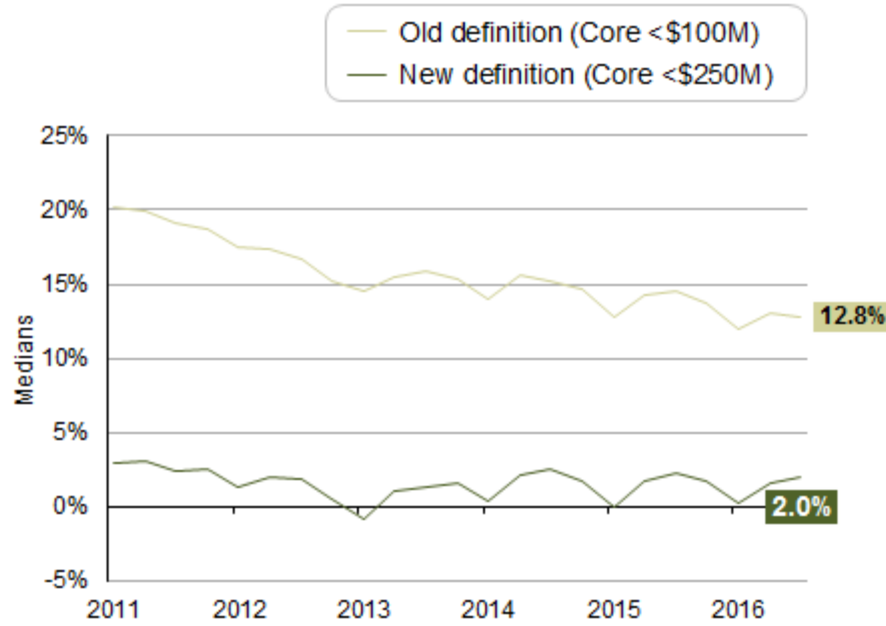


Changes in NIM have been relatively minor for the past five years. Banks have been hopeful the rates would normalize as the unemployment rate declined. Institutions continue to position themselves for an increase in interest rates by shortening the duration of some of their assets, putting further pressure on the margin. The rate on earning assets drove the net margin during the quarter as rates have pushed higher going into the fall after declining due to global turmoil following the Brexit vote in June.

Noninterest income increased by 5 percent on an aggregate basis, driven by other noninterest income. Service fees on deposits, large component of noninterest income, declined year over year. The decline could be the result of media coverage of inappropriate account openings and closer inspections of accounts by depositors. Provision for loan losses increased slightly year over year but remained stable from the prior quarter. Although the provision level has increased from the post-crisis bottom, it remains near historic lows. As the balance sheet has expanded, the efficiency ratio has steadily declined over the three quarters in 2016 and is 200 basis points lower year over year. The level of staffing has remained constant, which suggests that banks have reached a floor in terms of cost cutting.

Liquidity

Overall, liquidity at community banks in the Sixth District has remained little changed in the third quarter from the prior year. The Sixth District's median on hand liquidity ratio is slowly declining but remains above its precrisis levels. Net noncore dependence is close to its postcrisis low point (see the chart).



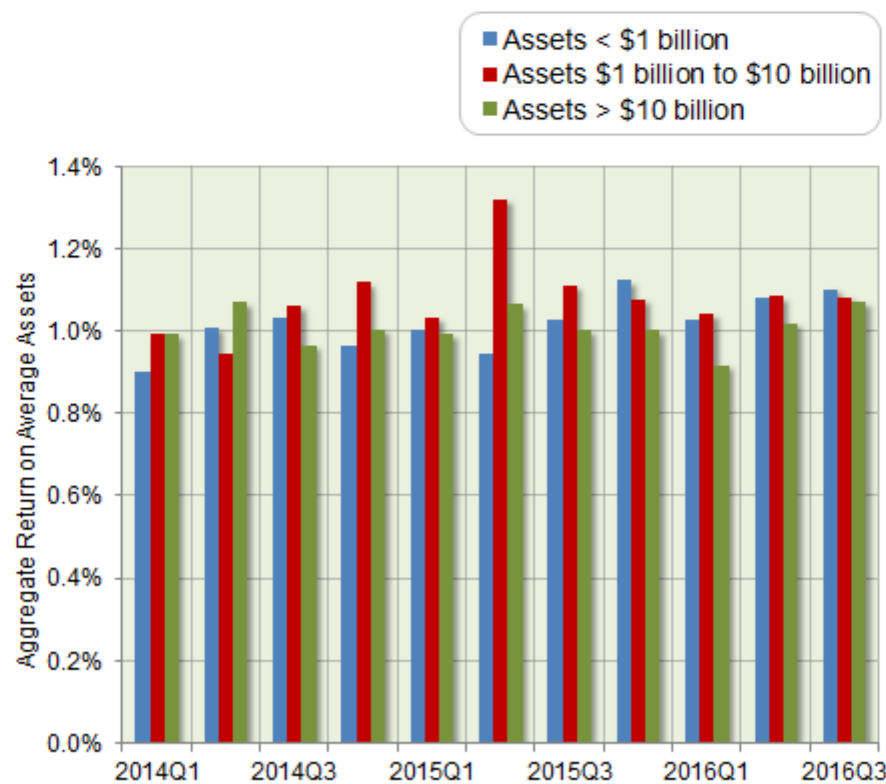
In the third quarter, core deposits continued to provide the primarily support to loans, at 81 percent deposits-to-loans. At community banks in the Sixth District, deposits increased by 3 percent in aggregate.

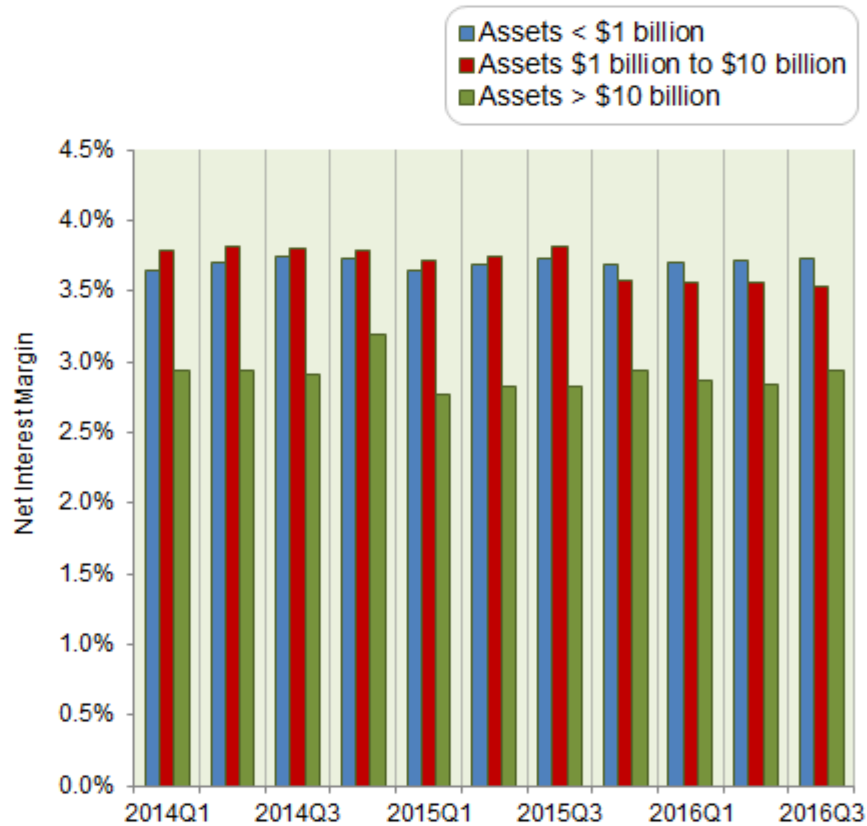
According to several surveys, corporations are hoarding cash and have limited their capital expenditures. Large depositors continue to flock to the largest banks. Year over year, deposits at banks with $50 billion or more in assets have grown by nearly 8 percent, according to third quarter 2016 Call Report data. Depositors are starting to realize that their operational/nonoperational deposits have different levels of value to them and can parse those out depending on their needs. Although the largest banks have long held a majority of the deposits nationally, their focus on deposit growth in response to the crisis and new regulations is putting added pressure on community banks to grow their deposit base. The gap in technology and public interfaces with websites is likely to continue provide an advantage to large banks, especially attracting new deposits from young adults just entering the workforce.

For more detailed information on economic 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

Banking conditions in the third quarter of 2016 are mixed as earnings improved, loan growth slowed, and nonperforming assets remained at historic lows. Return on average assets (ROAA) improved by 6 basis points year over year, as the net interest margin improved (see the chart) and the efficiency ratio declined to its lowest level since the first quarter of 2010.

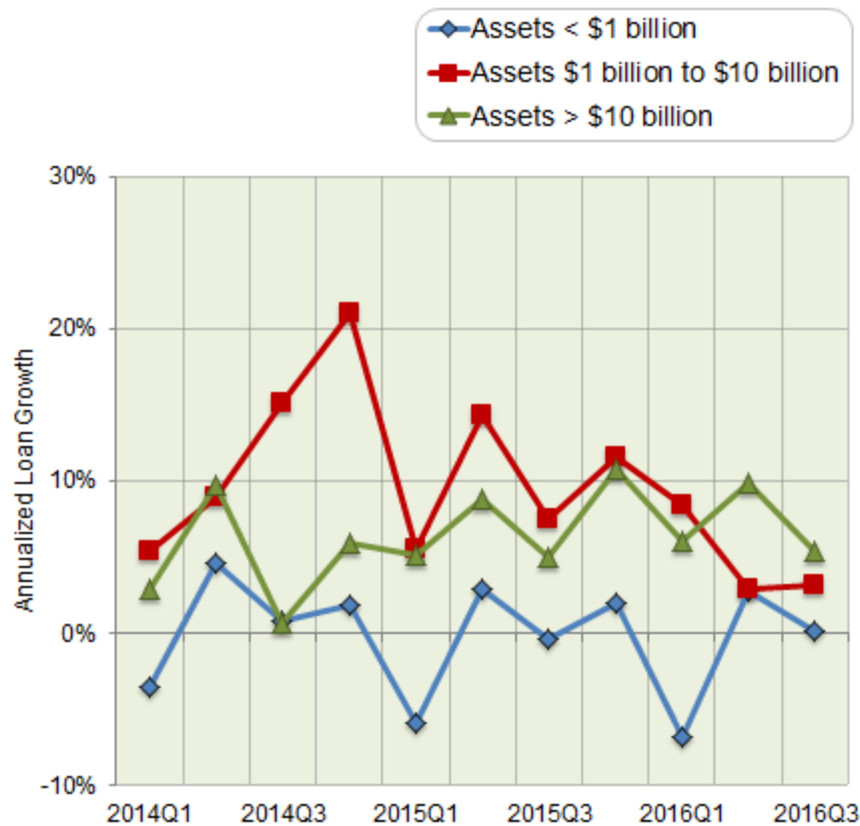




Fee income has become national news over questions about sales tactics. Noninterest income, as a percentage of total revenue, declined for the fifth straight quarter as interest income has ticked upward.

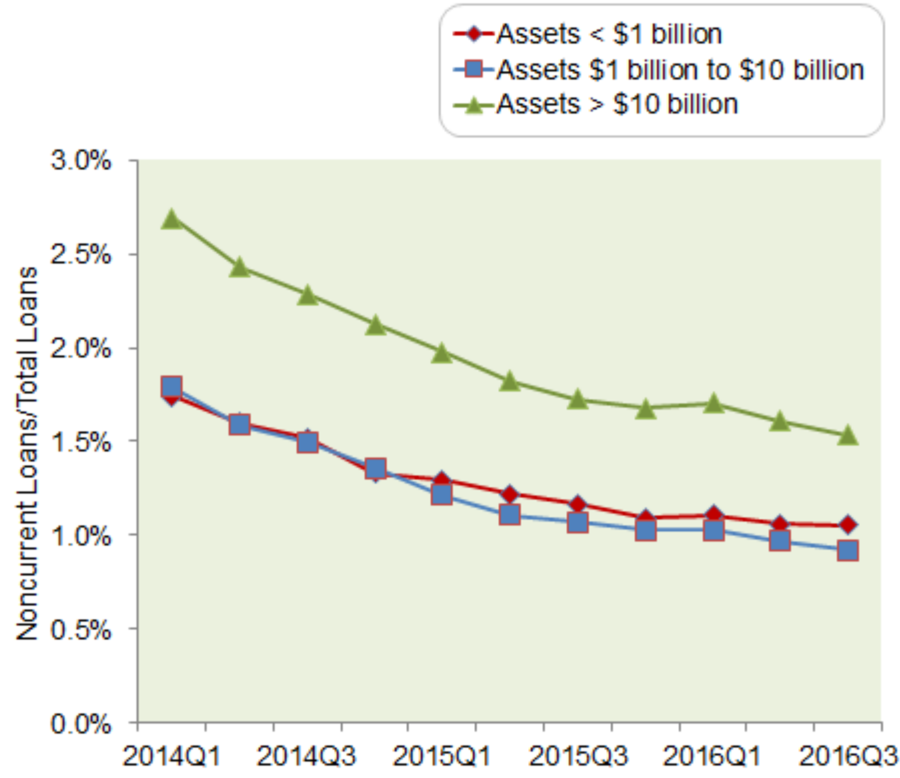
A few years ago, banks were openly discussing the need to improve fee income. After spiking up during the crisis, the level of fees has fallen back to precrisis levels. Fees on deposit accounts represented roughly 14 percent of noninterest income during the first half of 2016. Now, at least publicly, banks are discussing a shift in strategy to lower fees.

Loan growth across banks of all sizes lost momentum and slowed to lowest annualized growth rate since the third quarter of 2015 (see the chart).



Residential loan growth slowed among commercial banks as nonbanks originated more mortgages for the first time during the third quarter of 2016. Many analysts continue to express concerns about the mortgage financing market and are looking at tighter underwriting standards and increased regulations as sources of the lackluster growth. Indications from a variety of sources, including analysis from the Mortgage Bankers Association, are that underwriting on residential housing remains stronger than precrisis levels.

However, it's difficult to judge the direct impact of regulations in the current residential market or what the size the impact of regulations is having on mortgage availability. Banks have also been shifting to more commercial real estate lending in recent quarters, especially in the Southeast, as lenders have shifted away from a heavy emphasis in commercial and industrial (C&I) loan growth. Nonperforming loans now represent less than 1.5 percent of total loans (see the chart).



Although nonperforming loans continue to decline overall, some weaknesses can be observed in the consumer portfolio. Data from various regulatory reports shows that while overall credit card delinquency rates remain at 10-year lows, the trend has been higher over the past several quarters. TransUnion reports that delinquencies on credit card balances have risen by double digits in several oil rich states, including Oklahoma and Texas. Perhaps somewhat surprising, delinquencies are increasing faster on newly issued cards, suggesting standards have declined over the past two years.

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