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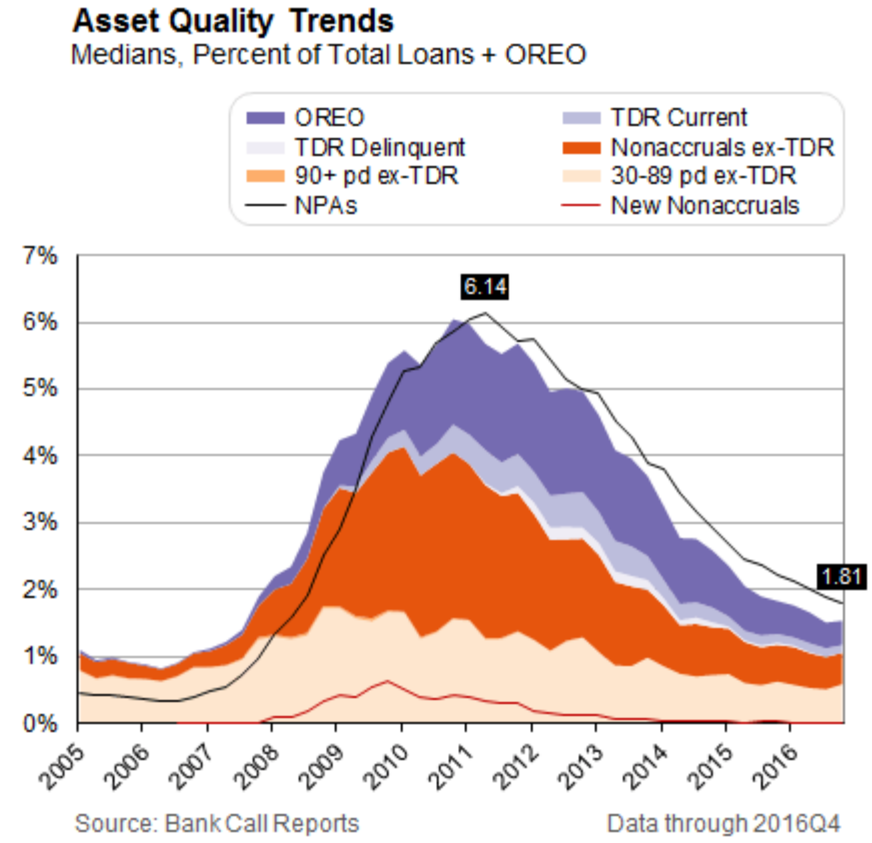
National, Regional Banking Conditions Detailed in Latest "ViewPoint"

March 30, 2017

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

Asset Quality

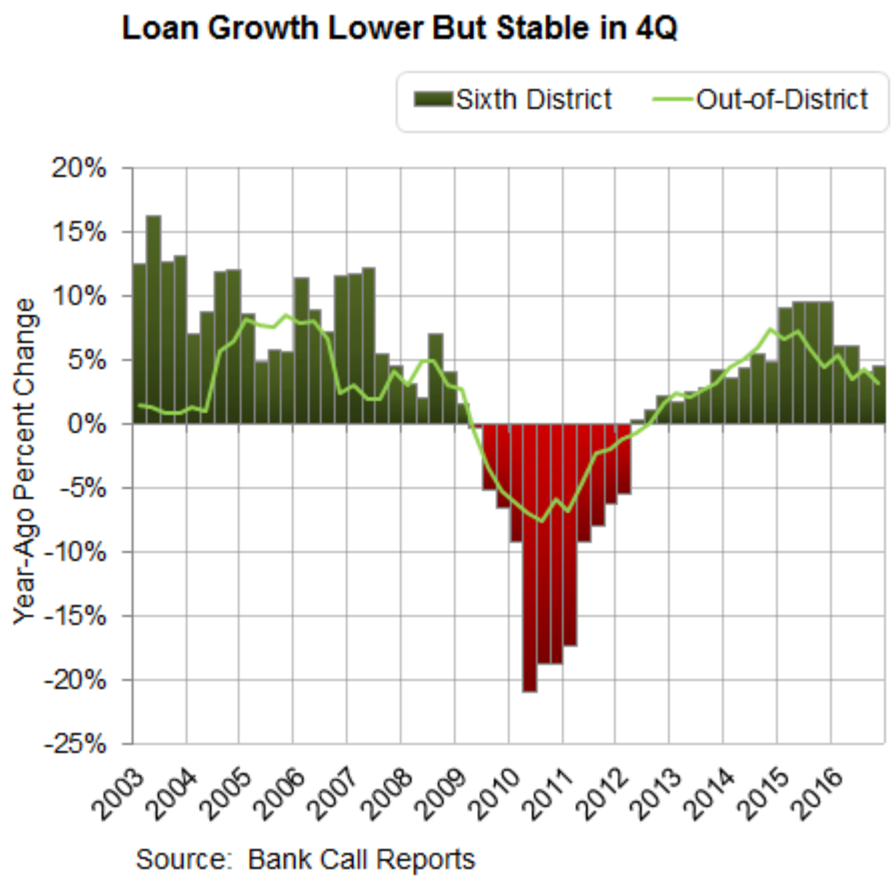
Despite examiner concerns about weaker underwriting standards—related to pricing, guarantor requirements, and loan covenants—asset quality remained little changed throughout 2016. Nonperforming loans and other real estate owned (OREO) continue to decline as a percentage of total loans and OREO from their peak in the second quarter 2011. On a median basis, less than 1 percent of loans were past days 90 or more for community banks in the Sixth District, a trend going back seven quarters (see the chart).



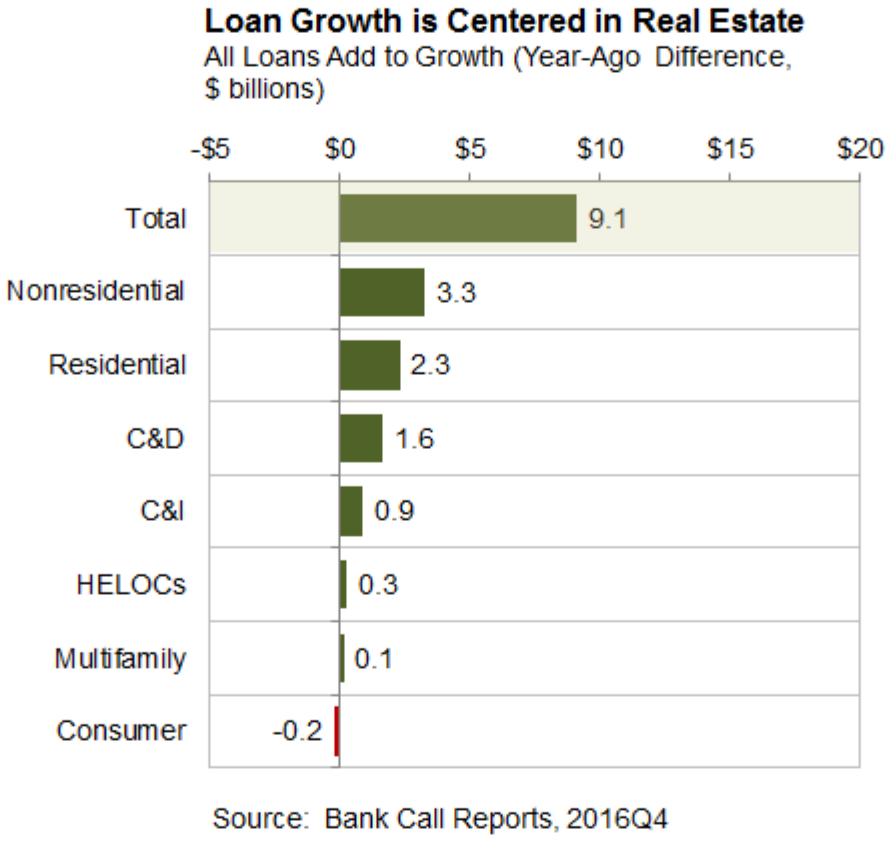
Net charge-offs as a percentage of average loans was 0.30 percent in the fourth quarter of 2016, a year-over-year decline from 2015. Continuing improvement in nonperforming loans has boosted the coverage ratio to its highest level in nearly 10 years. Although current asset quality is considered strong, concerns remain. Lower energy prices have impacted both commercial and industrial loans and some consumer credits in the western part of the District. Although the recent price rally is helpful, analysts suggest the price is still too low to make a meaningful impact on delinquent loan balances. According to some in the financial and energy industry, the price of oil would need to rise to $60 a barrel for the rally to really affect to domestic oil producers. In addition, given the level of exposure to the commercial real estate (CRE) market, high prices, increasing interest rates, and the level of new supply are all factors driving the concern about the condition of the CRE market. For months, there has been speculation that multifamily properties would peak sooner than other property types as a result of the level of construction. Yet other property types, such as office, are struggling with increased supply and lower levels of demand.

Balance Sheet Growth

Annualized loan growth was positive in the fourth quarter among Sixth District community banks (see the chart).

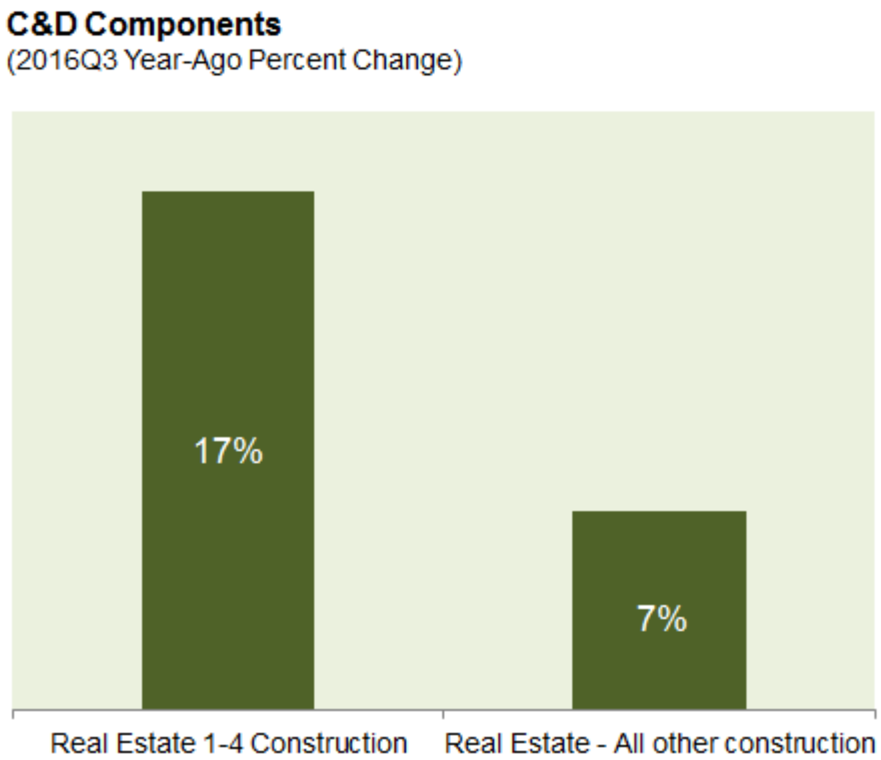


Commercial real estate (CRE) continued to drive loan growth in the fourth quarter (see the chart).



Many banks in the Southeast have an affinity for CRE lending and are finding some additional loan growth opportunities as some investors have decided to reduce their exposure over concerns about the CRE business cycle. Some banks are reporting that yields have improved on CRE loans, perhaps as a result of less direct competition. Yet, CRE lending in the Sixth District is moving away from multifamily properties, such as apartments, toward other property types over concerns that supply may now be exceeding demand. Growth in multifamily loans was flat year over year. Among the cities that may be reaching a saturation point of apartments are Nashville and Atlanta, cities that both show a high percentage of construction compared with existing stock. To give an example, according to market watcher Haddow & Co., the Atlanta market has more than 40 apartment projects under construction and another 36 projects proposed.

Closed-end residential loans followed CRE closely, growing by 5 percent year over year in the fourth quarter. Closed-end residential loans have been a greater source of loan growth during the last five quarters, especially when rates dipped during the summer, but rising interest rates may cause a shift in loan demand in 2017. Already there are signs that fewer borrowers want to refinance their mortgages, as the Mortgage Bankers Association of America's (MBA) refinance index reported a decline in refinance activity at the end of the fourth quarter. Home equity products, such as home equity lines of credit, may instead be a source of growth. Construction lending in the district is also skewing more towards residential projects than commercial (see the chart).

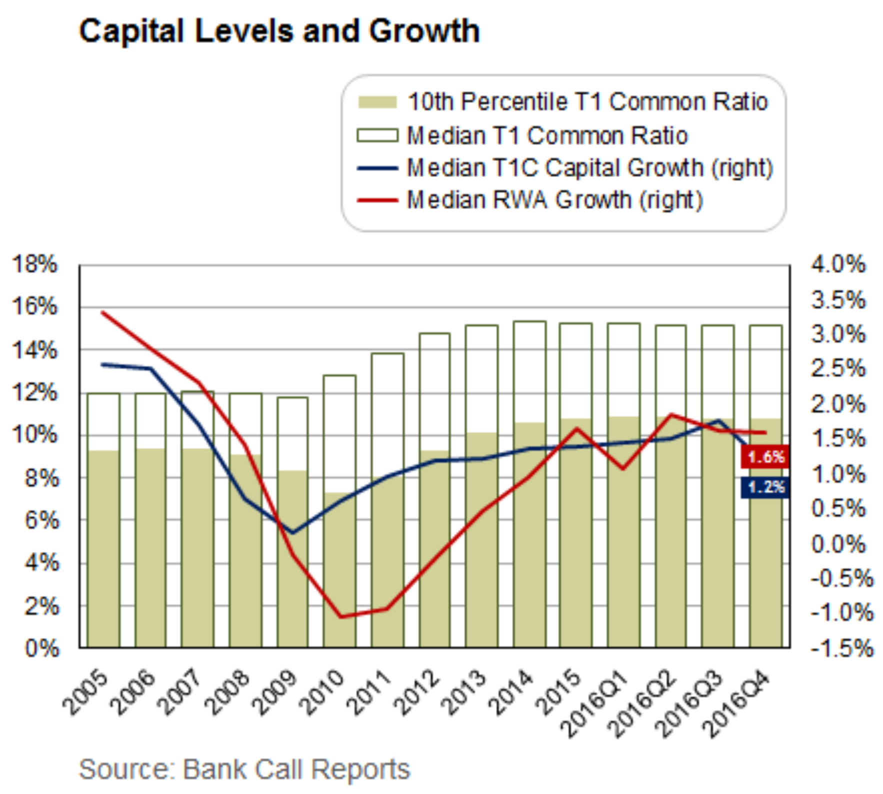


Residential construction continued its strong growth at community banks in the District during the fourth quarter, up 17 percent year over year. Across the Sixth District, current housing conditions, including increased demand and lower inventories, have spurred construction and driven home prices higher. Georgia, Louisiana, and Tennessee are among the 14 states across the nation to reach new home price highs in late 2016, according to CoreLogic. In terms of slower growing portfolios, banks in the Sixth District appear to be signaling that the aggressive pursuit of commercial and industrial (C&I) loan growth has come to an end, with growth during the quarter declining to just over 2 percent.

At the same time, larger banks have reported selling off some of their riskier C&I loans in a bid to protect their balance sheets from a possible downturn in credit quality. Growth in the consumer portfolio came to a halt, turning negative in the fourth quarter. While auto loans still represent a large portion of the consumer portfolio, Sixth District banks continued to reduce auto lending in the fourth quarter, as the quality of buyers declined and the spreads narrowed due to competition. Going into 2017, slower growth could continue, according to the January 2017 Senior Loan Officer Opinion Survey (SLOOS), in which banks reported that they expect to see tightening underwriting standards on some loan types, including CRE.

Capital

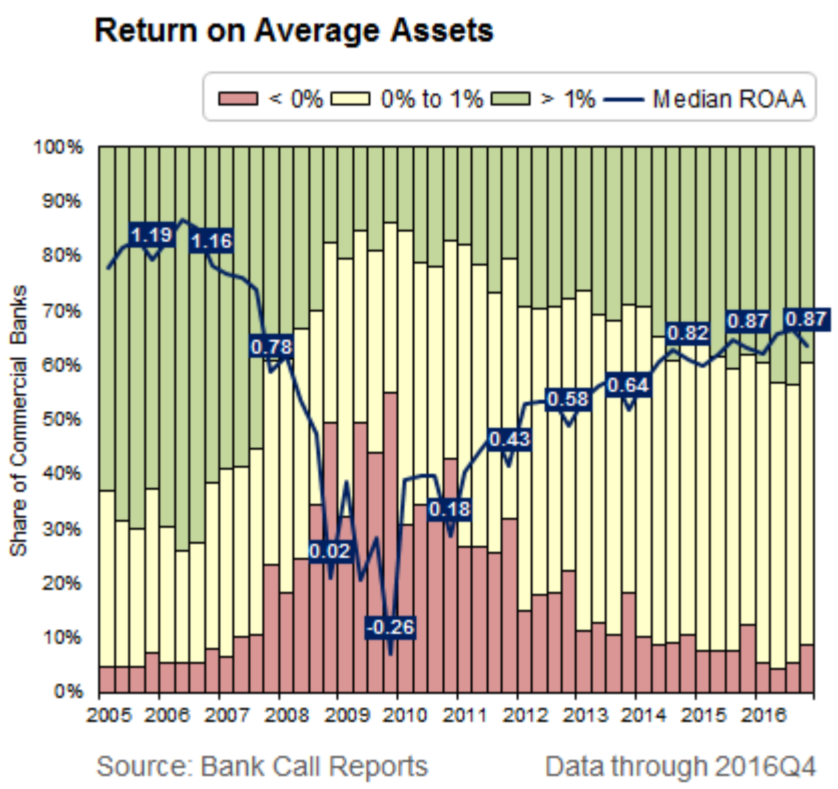
As of the fourth quarter 2016, the median tier 1 common capital ratio at community banks in the Sixth District was above 15 percent (see the chart).



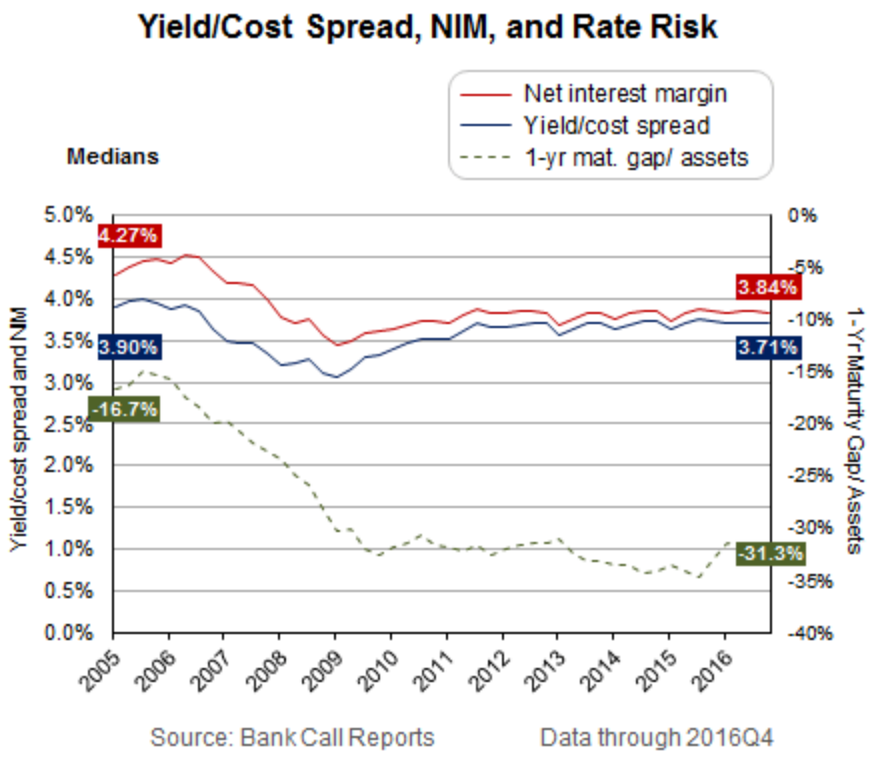
The ratio has remained around 15 percent since the implementation of Basel III capital rules. Positive earnings, good asset quality, and slower dividend growth have helped banks maintain capital levels. Business combinations remain a contributor to healthier capital, but not to the same extent as during the crisis. Risk-weighted asset growth has also been relatively slow given the increases in loan growth. Banks have improved their ability to risk-weight assets and are showing a preference for portfolios with lower risk weights.

Earnings Performance

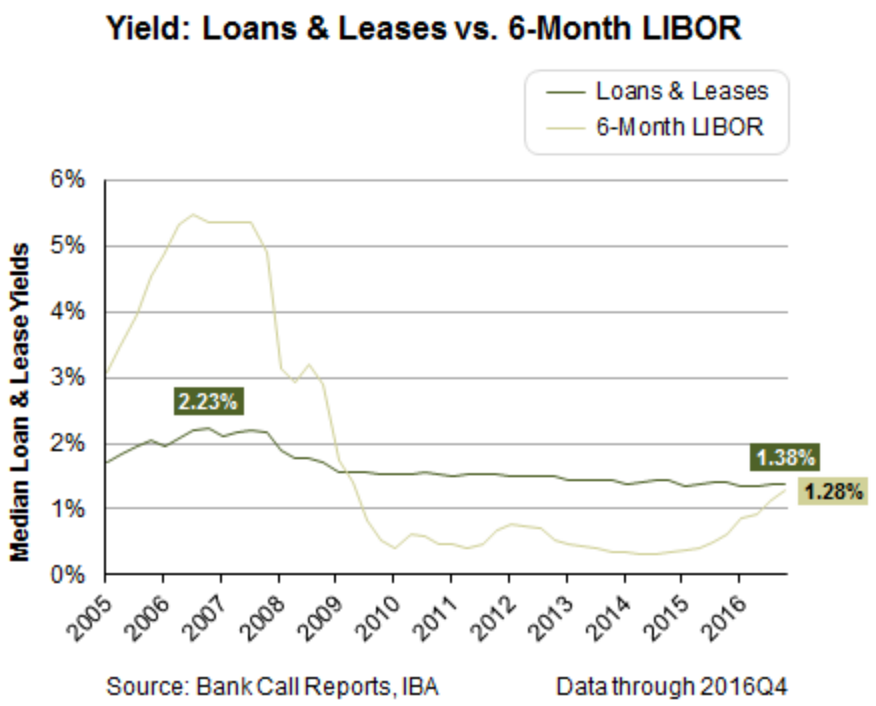
The return on average assets (ROAA) was flat year over year on a median basis for community banks in the Sixth District. ROAA in the fourth quarter was 0.87 percent, a dip of 6 basis points from the prior quarter (see the chart).



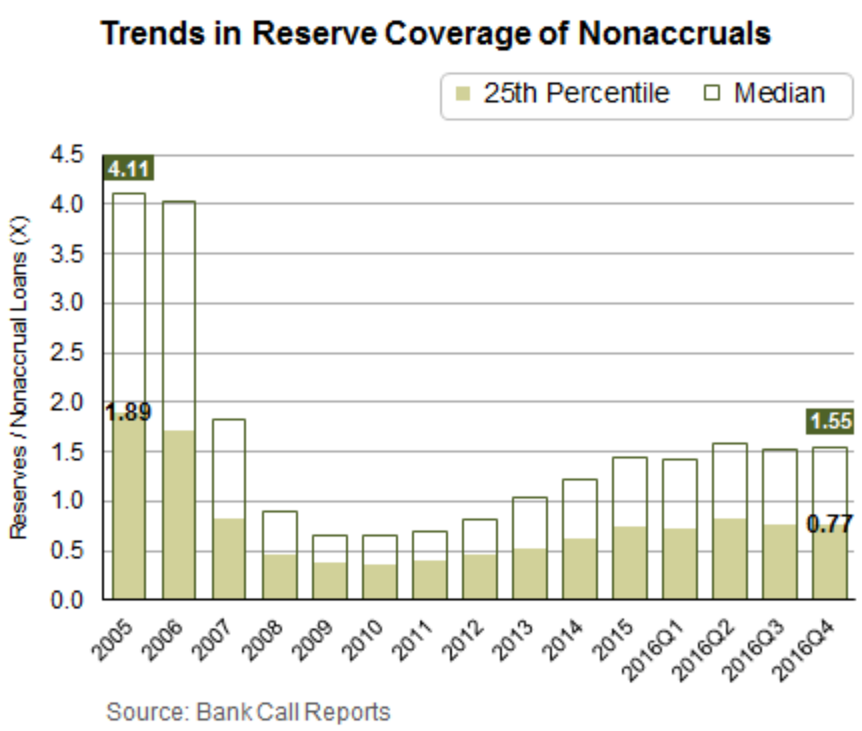
Once again, there was a slight increase in the percentage of banks with a negative ROAA, the second increase in 2016 and the first time the level increased two consecutive quarters since 2012. The median net interest margin (NIM) in the fourth quarter was 3.84 percent (see the chart).



One reason for the decline in ROAA is a decline of 3 basis points in NIM, despite two rate increases in 13 months. This result is in contrast to the outcome following an increase in rates at the end of 2015. In that quarter, NIM increased 1 basis point over the prior year on a median basis. In the short term, banks are trying to maintain deposits and, as a result, are raising their deposit rates prior to benefiting from higher loan rates. The median yield on loans in the District generally declined throughout 2016, ending slightly below the year-end 2015 level (see the chart).



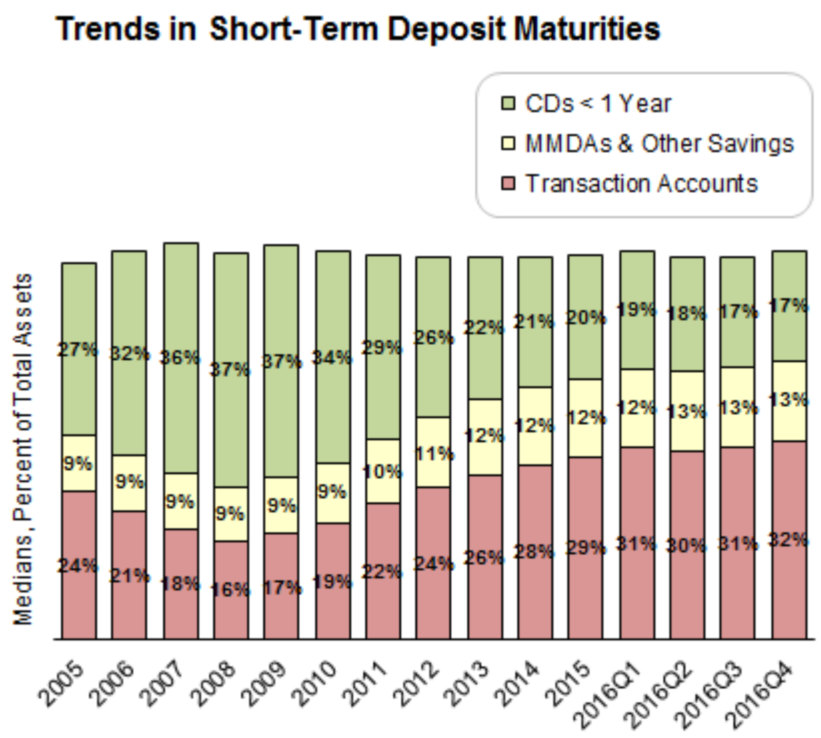
In addition, banks continue to position themselves for additional interest rates increases. Community banks in the Sixth District improved noninterest income by 12 percent on an aggregate basis at the end of 2016 over the prior year. Service fees on deposits and other noninterest income, which includes ATM fees, drove the increases. Fees for trust services also provided a boost to earnings at year-end. Provision for loan losses increased slightly year over year on an aggregate basis. On a median basis, the coverage ratio is 1.55 percent, more than twice the level it was during the financial crisis as nonperforming loans remain near historic lows (see the chart).



The efficiency ratio, which generally increases at year-end, was nearly 200 basis points lower than the prior year for smaller community banks as they continue to closely manage expenses.

Liquidity

Like asset quality, liquidity in the community banks of the Sixth District remained strong as of the fourth quarter. For banks in the District with assets under $1 billion, the loan-to-deposit ratio exceeds 75 percent, and for larger community banks the ratio is higher. Although the median on hand liquidity ratio for community banks in the District has fallen to its lowest level in five years, it remains well above its precrisis levels (see the chart).

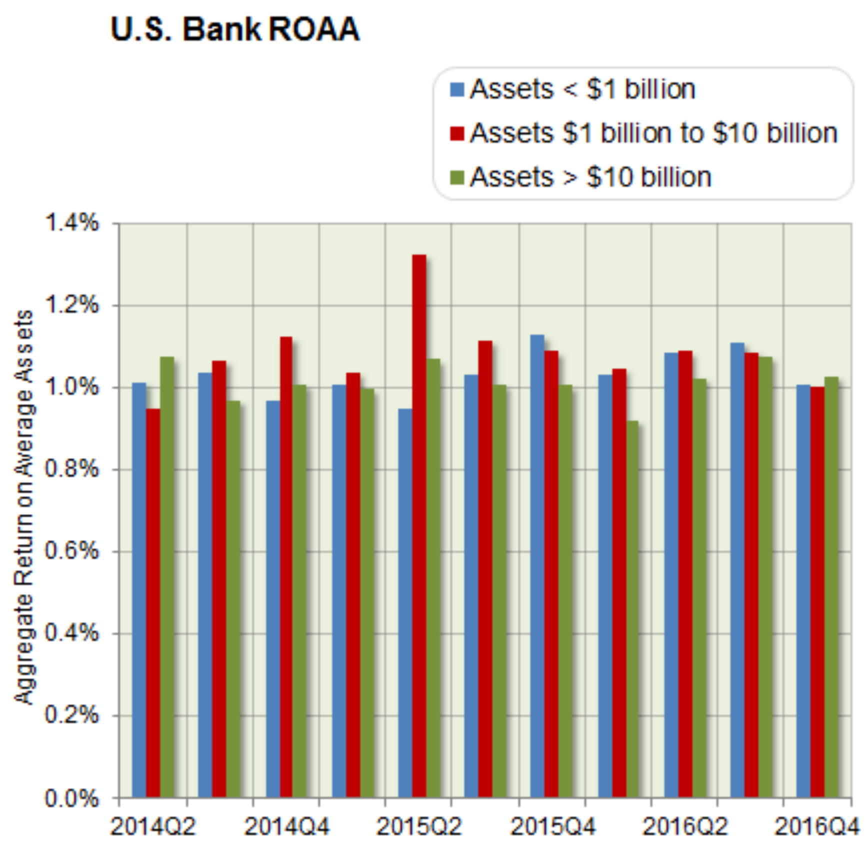


Source: Bank Call Reports

Currently, analysts believe that banks in faster-growing regions, such as some in the Sixth District, will have more difficulty creating a lag between rate increases and raising deposit rates. With interest rates gradually increasing, it is expected that banks will more actively seek to attract and retain deposits by raising deposit rates. However, since raising deposit rates also increases the cost of funds, banks may look to shift their deposit mix. During the past 10 years, short-term time deposits have fallen from 37 percent of total assets, on a median basis, to 17 percent as of the fourth quarter.

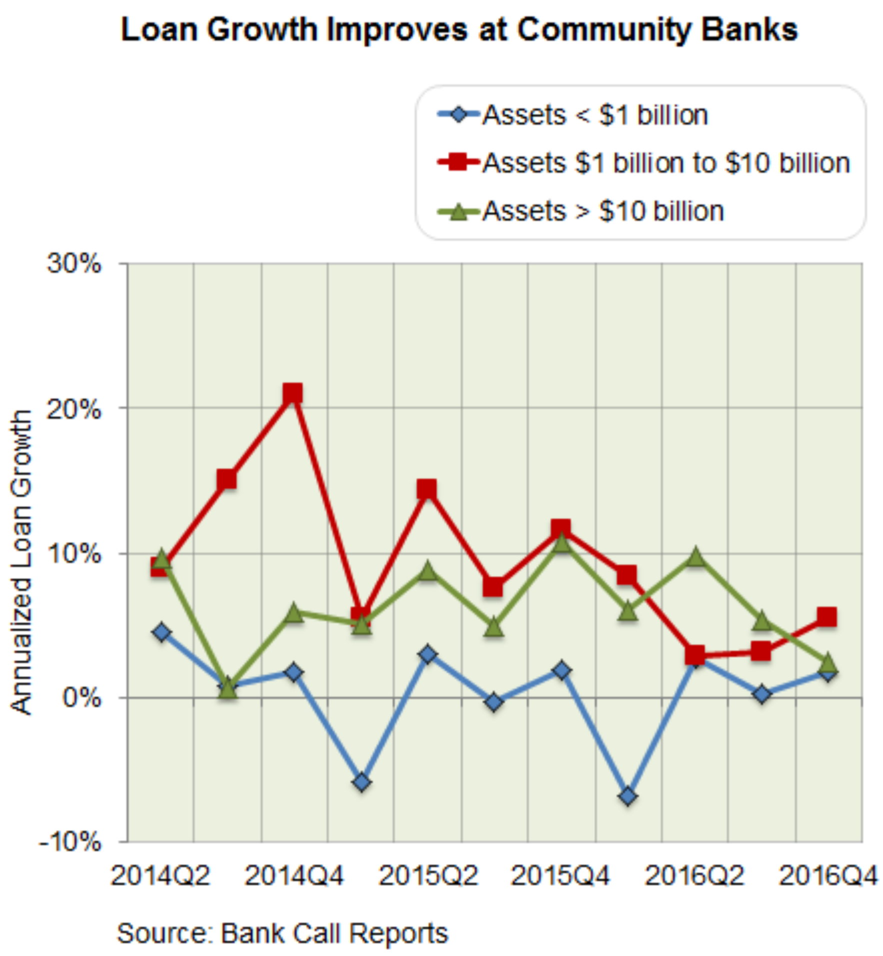
National Banking Trends

Return on average assets (ROAA) was stable year over year, as the net interest margin remained the same and the efficiency ratio continued to decline for banks overall though smaller banks are facing increasing costs (see the chart).



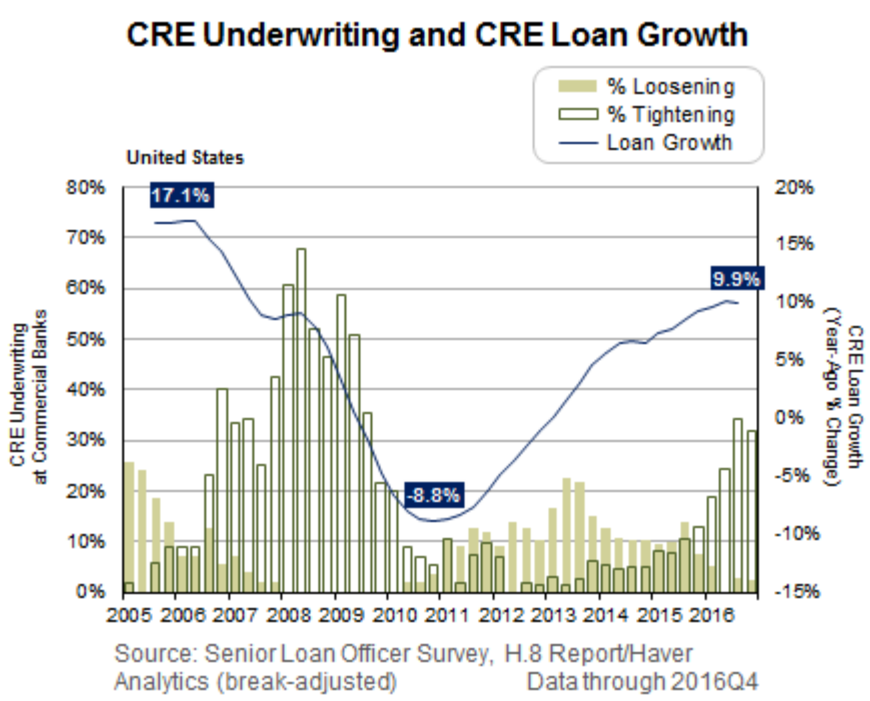
Source: Bank Call Reports

Noninterest income, as a percentage of total revenue, has remained unchanged for community banks year over year even as it has declined for all commercial banks. Despite reporting flat earnings in the fourth quarter, commercial banks ended 2016 more optimistic than when the year began as loan growth improved. In the fourth quarter, the Federal Reserve raised interest rates for the second time since the financial crisis. The new administration has ordered a review of the Dodd-Frank Act and other postcrisis financial system regulation by the executive agencies to determine a plan to replace the legislation with new financial services regulation. Those two events have brightened the outlook for banks in the market. Although loan growth declined in the fourth quarter of 2016 for large banks, banks with assets below $10 billion showed improved loan growth for the first time in a year (see the chart).



Improving loan growth was little reflected in the latest Senior Loan Officer Opinion Survey, which showed a tightening of credit standards for both commercial and industrial (C&I) loans and commercial real estate (CRE) loans. Credit standards for consumers remained basically unchanged from the prior survey. In terms of loan demand, small businesses have yet to show an increase in demand despite the recent National Federation of Independent Business survey that showed an increase in small business confidence. However, Experian points out that utilization rates among small businesses credit lines remain below 40 percent, so businesses don't necessarily need to apply for more credit.

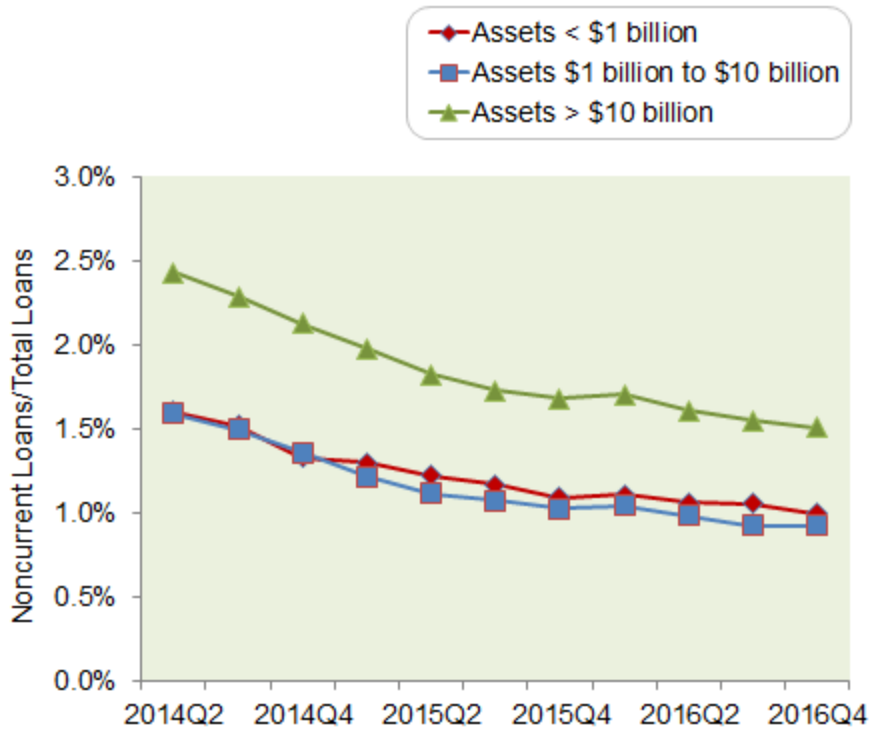
Banks may have tightened CRE underwriting standards because of concerns about the market. Several analysts continue to express concern that the sector is either at or near its peak for this cycle. High prices, increasing interest rates, and the level of new supply are all factors driving the concern about the condition of the CRE market (see the chart).



For months, there has been speculation that multifamily properties would peak sooner than other property types in various markets because of the level of construction.

Asset quality remains good for most banks. Nonperforming loans in banks with assets below $10 billion have fallen below 1 percent (see the chart).

Noncurrent Loans Stable



Source: Bank Call Reports

The pace of improving nonperforming rates slowed throughout 2016, as nonperforming loans have fallen below historical average levels. Delinquency among small oil producers, which drove some of the increases in nonperforming loans in 2015, is falling as oil prices recover and production costs decline.