BANKING & FINANCE

National, Regional Banking Conditions Detailed in Latest "ViewPoint"

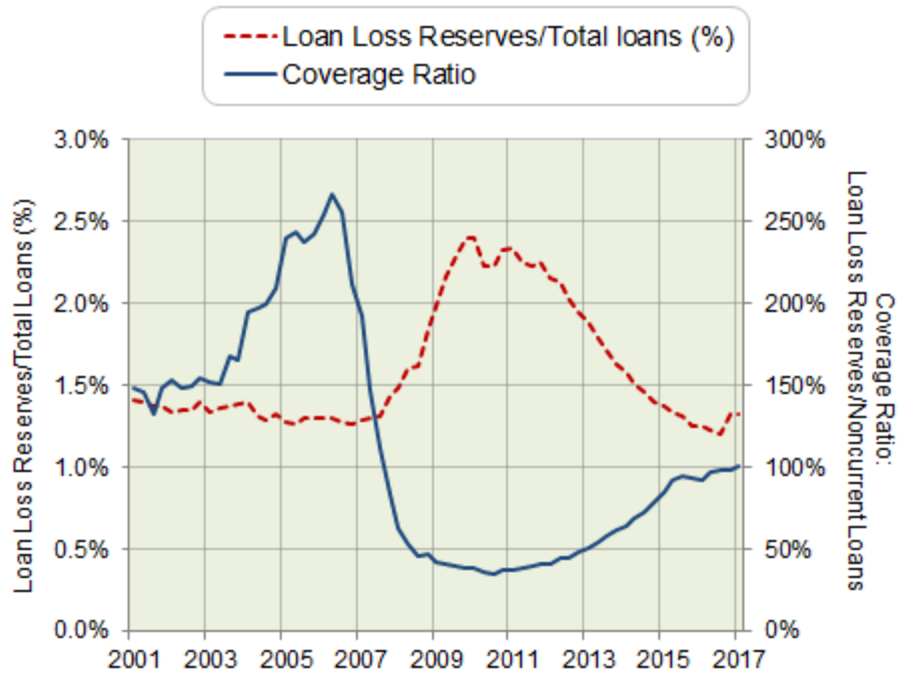
June 30, 2017

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

Asset Quality

Asset quality has remained strong for several quarters. Even as loan growth has started slowing and the business cycle appears to be maturing, delinquencies have yet to become an issue, perhaps the result of the cautious approach banks took to underwriting during the early years of the recovery. Total nonperforming assets represented less than 2 percent of total assets, the lowest level since mid-2008. Loans past days 90 or more for community banks in the Sixth District remained below 1 percent for the ninth straight quarter. Nonaccrual loans have also fallen to their lowest level in nearly 10 years. Net charge-offs, as a percentage of average loans, were 0.30 percent in the first quarter of 2017 in the Sixth District, slightly lower than banks outside the District. With nonaccrual loan balances stagnating, the coverage ratio has risen to more than 100 percent (see the chart).

Sixth District Loan Loss Reserves



Source: Bank Call Reports

Although asset quality trends remain positive, regulators still have concerns. For example, the percentage of banks exceeding supervisory guidelines on CRE continues to grow, though the number of banks exceeding the guidance is much smaller than in the run-up to the crisis. In addition, given the level of exposure to CRE, high prices, rising interest rates, and increased supply are causes for concern. Besides CRE, oil and gas and health care exposures are also being monitored. Despite the optimism expressed by shale oil producers with the increase in oil prices and lower operating costs, loan performance indicators show increased delinquency as prices started sliding below $50.

Balance Sheet Growth

Loan growth at community banks in the Sixth District was barely positive quarter over quarter, despite growing nearly 6 percent over the prior year on an aggregate basis. According to responses to the Senior Lending Officer Opinion Survey, loan demand has declined significantly across multiple lending portfolios (see the chart).

CRE is a Primary Loan Growth Driver
Year-ago difference, billions of dollars

Source: Bank Call Reports

CRE, particularly nonresidential loans, was one of the few loan categories that experienced growth over the prior quarter. Growth reached 1 percent quarter over quarter for nonresidential lending. Banks in the Southeast have a long history of CRE lending and have stepped in to provide financing as investors have decided to reduce their exposure over concerns about property values and rising cap rates. Prices are starting to fall in major markets even as prices improve in other markets. Although many banks in the Sixth District are not located in major CRE markets, the trend towards lower values will likely extend to other markets as the cycle continues to mature. These markets may experience more volatile CRE market conditions. Some banks are starting to slow their level of lending over concerns expressed by regulators about concentration levels. In the Sixth District, CRE concentration levels have drifted upwards to the point that the median level for all banks in the District is approaching precrisis levels (see the chart).

Sixth District Asset Exposures

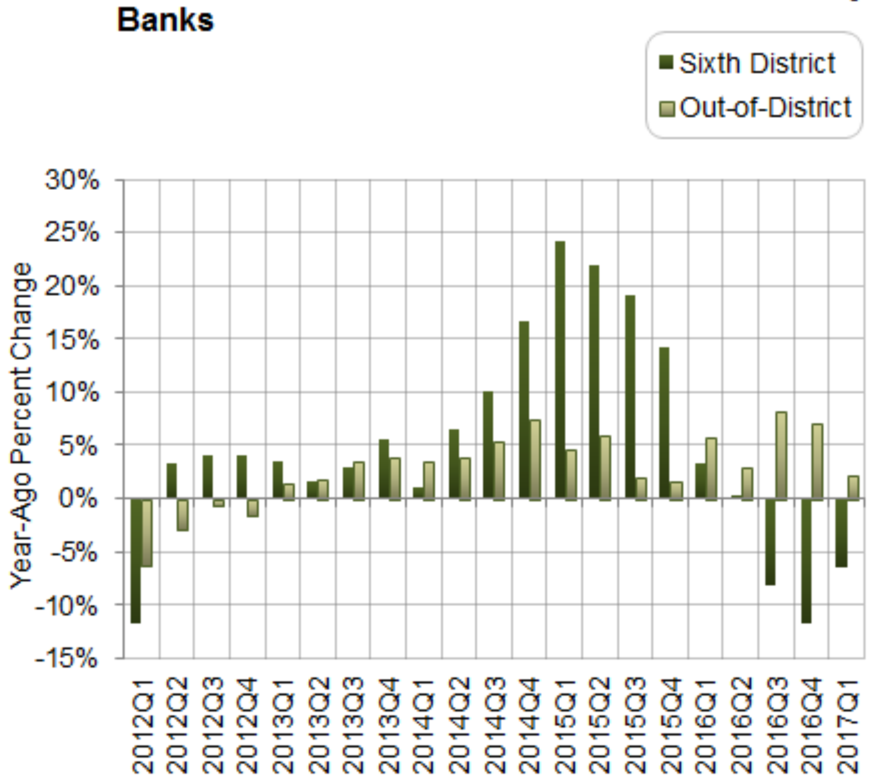
Share of Assets (%)	2017Q1	2016Q4	2016Q1	2008Q4
C&D	6.3	6.4	6.2	18.7
HELOCs	2.5	2.5	2.4	2.7
Nonresidential	22.7	22.7	22.0	19.1
Multifamily	2.4	2.4	2.4	1.7
C&I	11.1	11.2	10.9	9.0
Consumer	3.3	3.4	3.4	4.8
Residential	15.6	15.9	15.4	12.3
Total Loans	**67.5**	**68.2**	**66.2**	**71.4**
Total Securities	**19.8**	**19.7**	**20.3**	**16.7**

Source: Bank Call Reports

Unsurprisingly, residential home lending also declined from the prior quarter as mortgage rates increased. According to several metrics, underwriting for mortgages remains tighter than it was precrisis. It remains to be seen if banks will loosen underwriting in order to maintain volume. Data from CoreLogic shows that home sales drop quickly as rates move upwards (decreasing demand for purchase mortgages) and many existing homeowners already have historically low mortgage rates (decreasing demand for refinance mortgages). In fact, home equity line of credit (HELOC) originations, which increased during 2016, declined by nearly the same level as residential originations, just under 1 percent. In the Sixth District, which was severely affected by the downturn in real estate prices, HELOCs remain one of the smallest portfolios on community banks' balance sheets.

Banks have been slow to embrace HELOCs since the crisis, when, because of the extreme decline in home values, many firms had to completely write off home equity products. Other portfolios also showed weaker to negative growth in the first quarter. C&I growth was slightly negative for the quarter. C&I loans balances started declining at the end of 2016 and have continued dropping through the first quarter of 2017, possibly because of higher interest rates and tighter underwriting standards. In the consumer portfolio, loan growth declined by just over 1 percent, the second consecutive quarter lending declined. Auto loans still represent a significant portion of the consumer portfolio among Sixth District banks, although institutions have generally been backing away from such loans over the last four quarters as a result of a decline in the number of qualified buyers and a loosening of standards (see the chart).

Auto Loan Growth Has Diminished at Community Banks

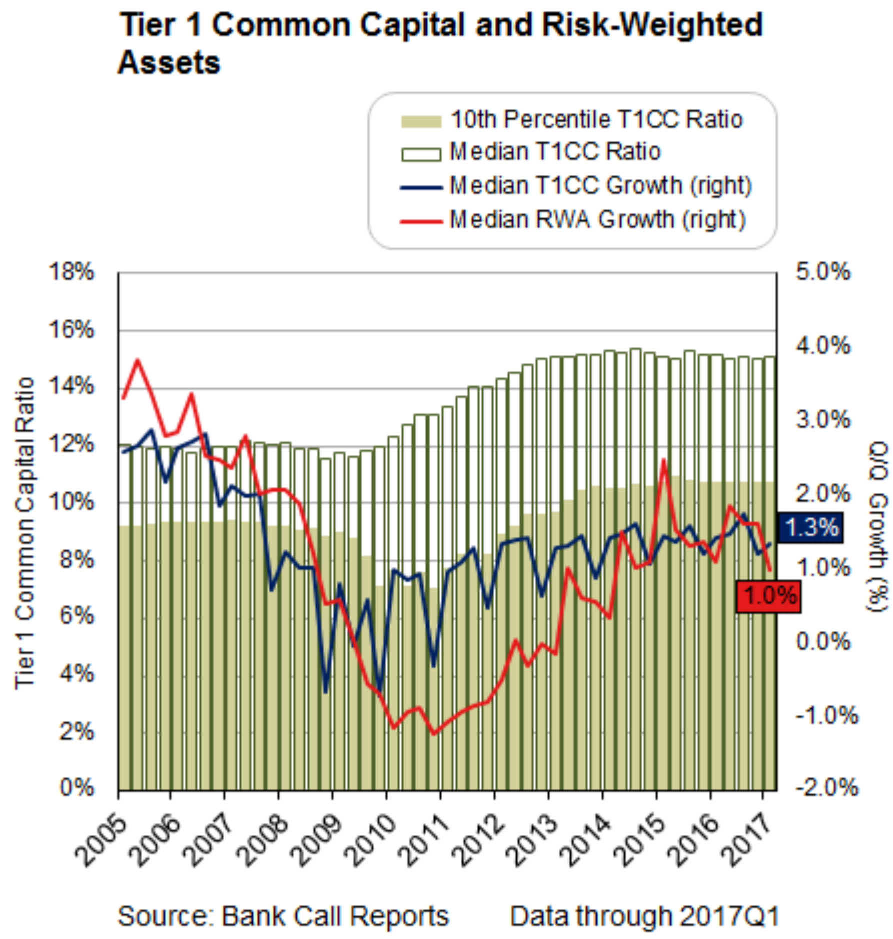


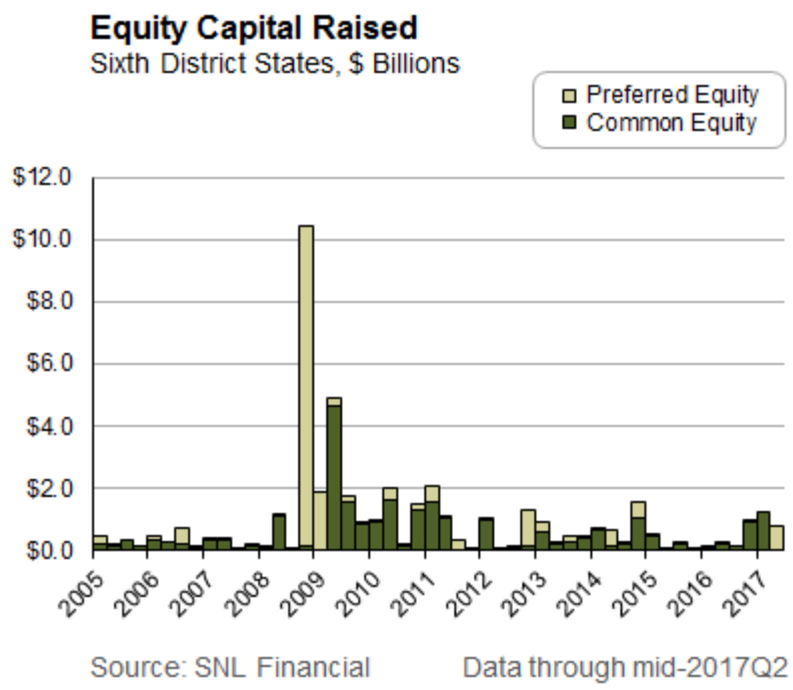
Source: Bank Call Reports

During the last four quarters, banks have gradually improved underwriting terms, requiring more of a down payment and higher credit scores.

Capital

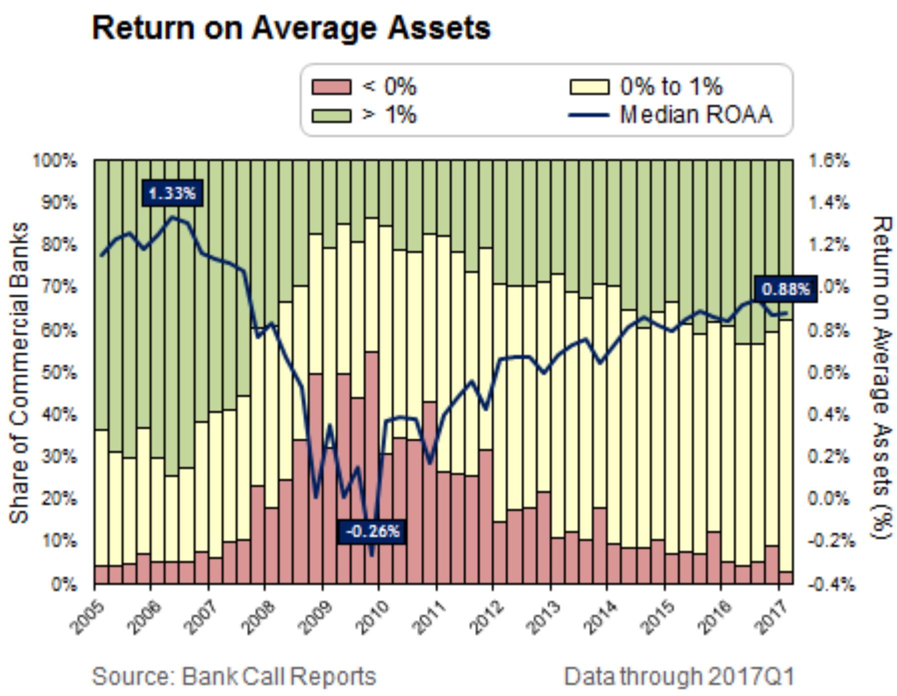
Despite an uptick in growth of risk-weighted assets, median tier 1 common capital (T1CC) ratio growth is stable. The median tier 1 common capital at community banks in the Sixth District remained at 15 percent in the first quarter 2017. Positive net income has allowed capital to keep pace with relatively slow growth in risk-weighted assets. It has also kept the tier 1 common capital ratio basically flat for the last four years. Since the crisis, most banks have not issued new stock, in order to maintain capital levels. In late 2016 and early 2017, banks began to issue more stock, in part to fund expansion primarily through business combinations (see the charts).



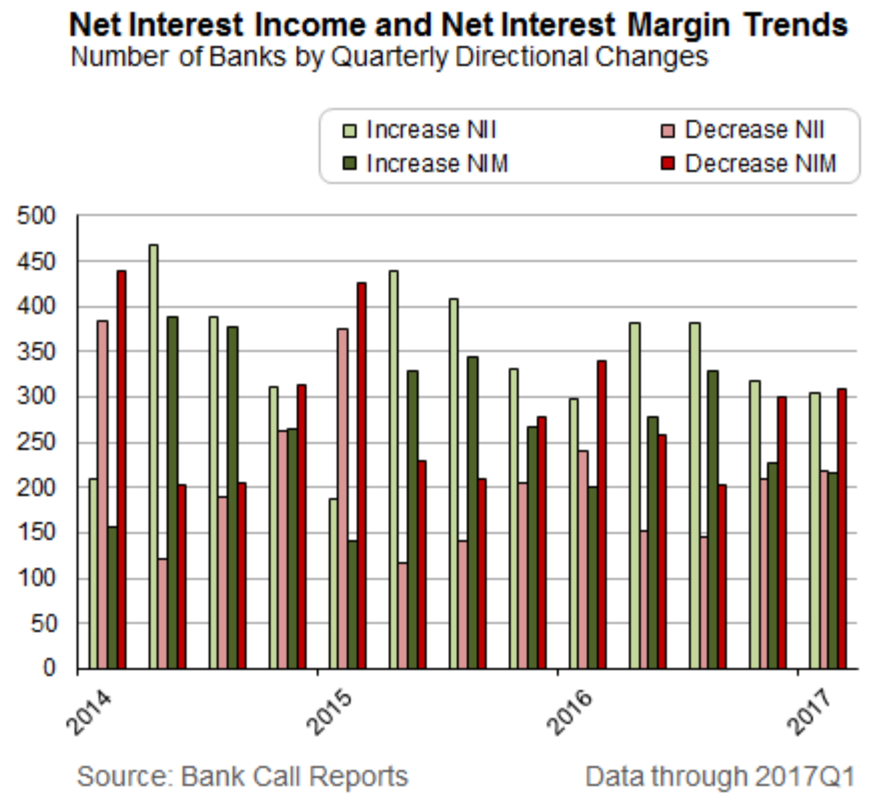


Earnings Performance

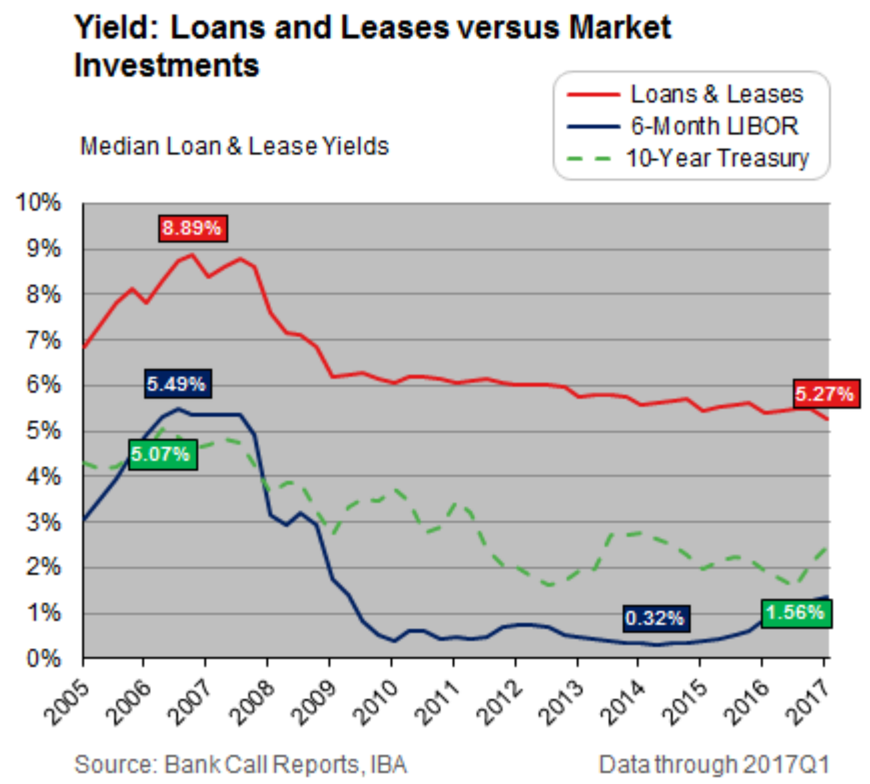
Sixth District community banks experienced a slight improvement on their return on average assets (ROAA) from the prior year, increasing to 0.88 percent during the first quarter of 2017 (see the chart).



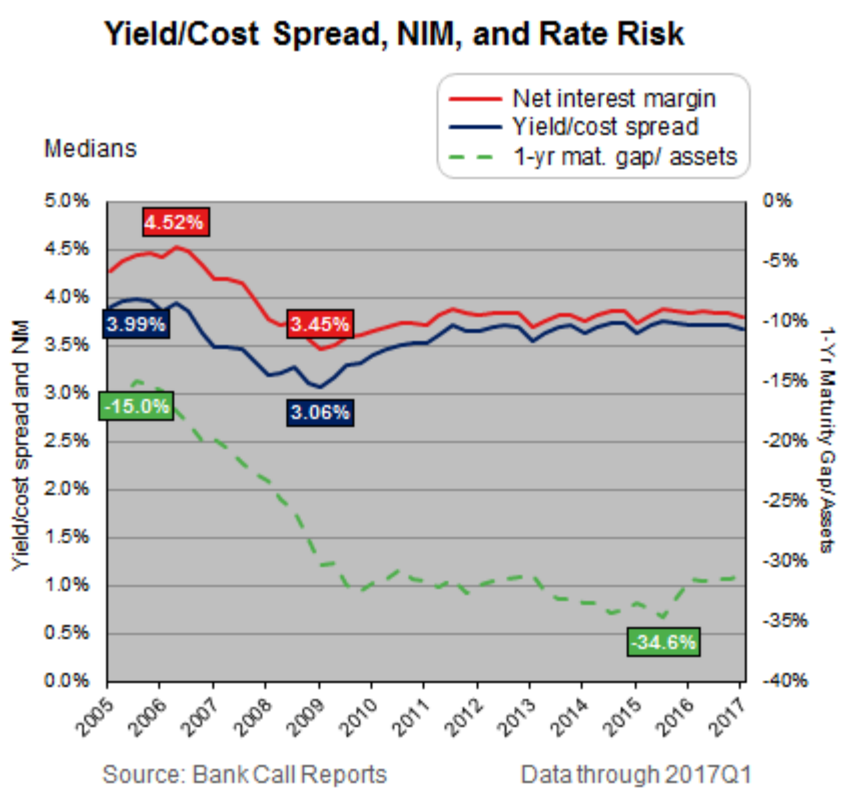
The median net interest margin (NIM) in the first quarter was 3.77 percent, a decline of 5 basis points from the prior year. Another fed funds interest rate hike occurred during the quarter. However, more banks are reporting a gradual decrease in their net interest income (see the chart).



Part of the reason is that yields on loans dipped slightly year over year (see the chart).



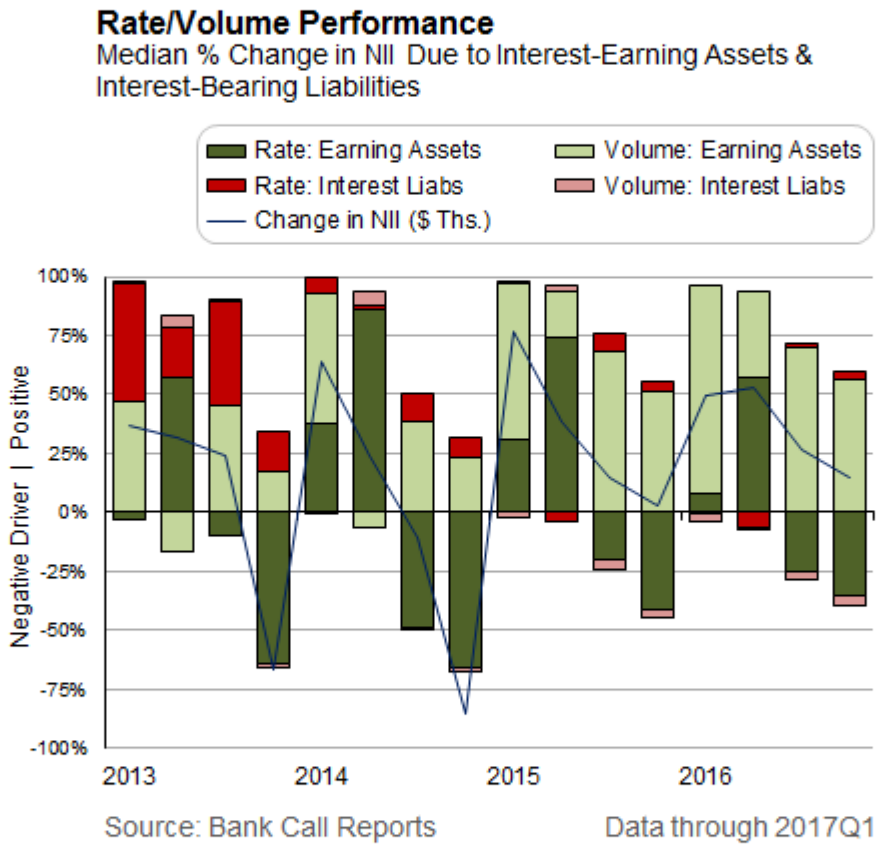
Another reason could be lower demand for loans in a rising rate environment. Community banks are expected to benefit from some recovery of their NIM in the medium to longer term, especially with two more increases expected in 2017 (see the chart).



Some banks are still trying to reposition themselves for the anticipated additional interest rate increases. In the short term, roughly half of the community banks in the District are reporting more pressure on their NIM, despite a decrease in the percentage of banks reporting a negative ROAA. Bank earnings benefited from higher noninterest income and lower provision and other noninterest expense, leading to a 7 basis point year-over-year improvement in income. Banks are hopeful that the prospect of reforming Dodd-Frank will bring changes to the Durbin Amendment, which could increase interchange fees. Since the Dodd-Frank limits went into place, the average interchange fee per exempt transaction has been steadily declining, according to data from the Federal Reserve Board. The provision for loan losses decreased slightly year over year on an aggregate basis, as nonperforming loans remain at historic lows. The efficiency ratio continued to fall as firms closely managed expenses. Full-time equivalent employees at community banks also continued to decline, despite increases in compliance requirements.

Liquidity

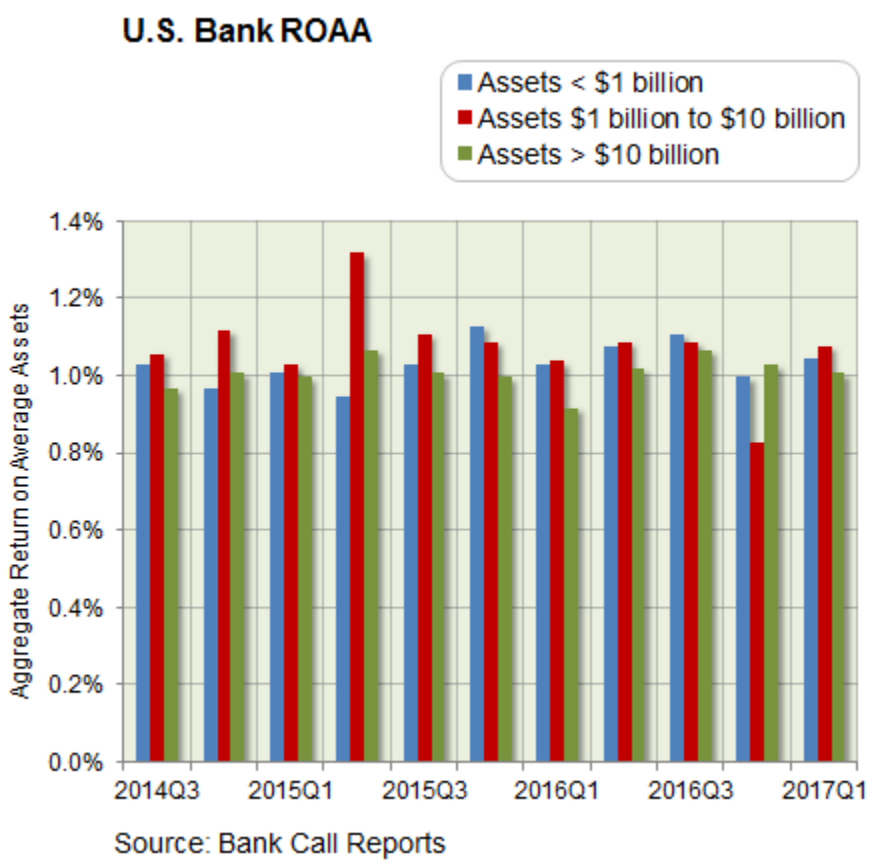
Liquidity on hand improved slightly during the quarter. One of the key risks for banks in the Sixth District is deposit mix migration. Through the first quarter of 2017, banks continued to attract near record levels of deposits. As rates rise, it is unclear how deposits will behave. Since the financial crisis, smaller banks in the Sixth District have seen shifts towards more transactional accounts and away from time accounts. Based on first quarter call report data, the repricing of interest bearing liabilities was a positive driver for improving the net interest margin (see the chart).



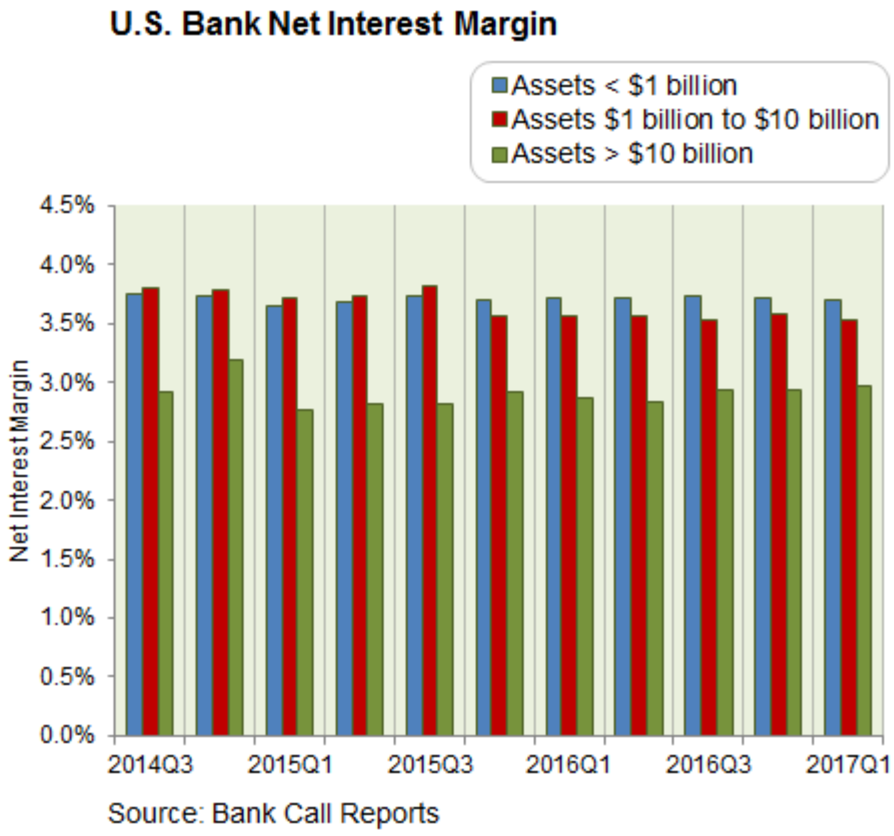
However, some bank executives and bank analysts do not believe banks will be able to hold deposit rates at existing levels in the digital age. They believe both money markets and large banks operating under new liquidity rules will quickly push rates higher in order to attract much needed deposits. Although many institutions have modeled different scenarios, the model assumptions have yet to be fully tested and well understood because of the inherent difficulties in assessing deposit stability.

National Banking Trends

Return on average assets rebounded in the first quarter of 2017 after dipping at year-end (see the chart).

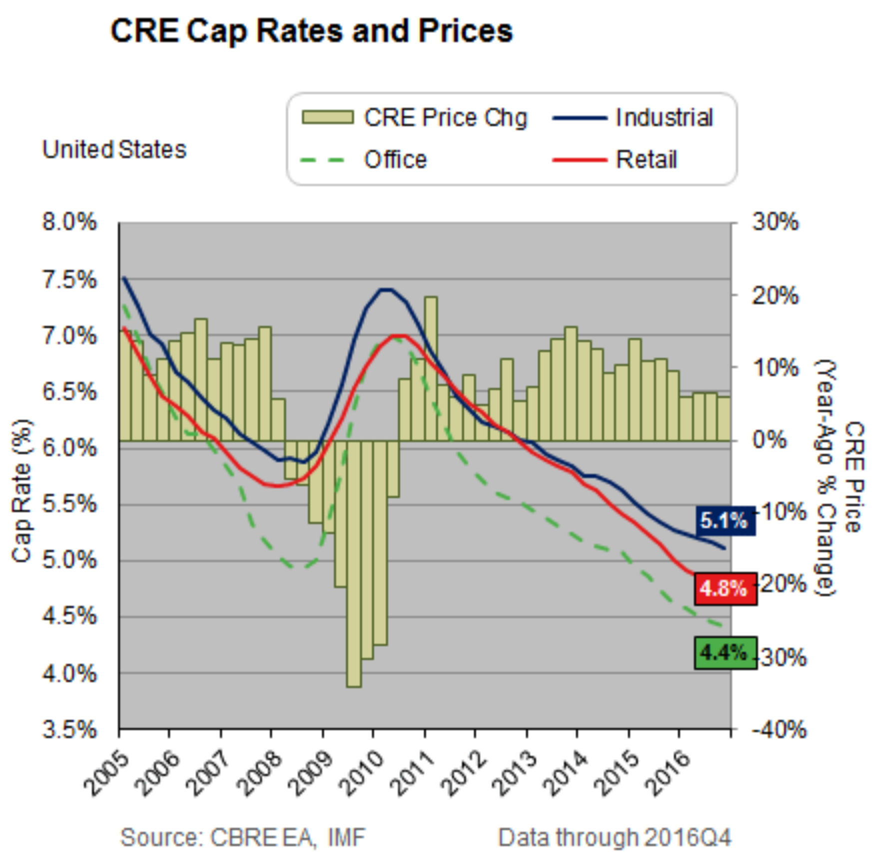


Many expect that 2017 might be the year banks experience some recovery of their net interest margin (NIM) (see the chart).



The Federal Reserve raised the fed funds interest rate on March 15, the second rate hike in the last six months, to a range between 0.75 and 1 percent. Financial markets anticipate that the Federal Open Market Committee will vote for two more increases in 2017, which is expected to help banks' NIM to rebound. Yields on loans started to increase in 2016. Banks are trying to wait to raise deposit rates until adjustable rate loans reset.

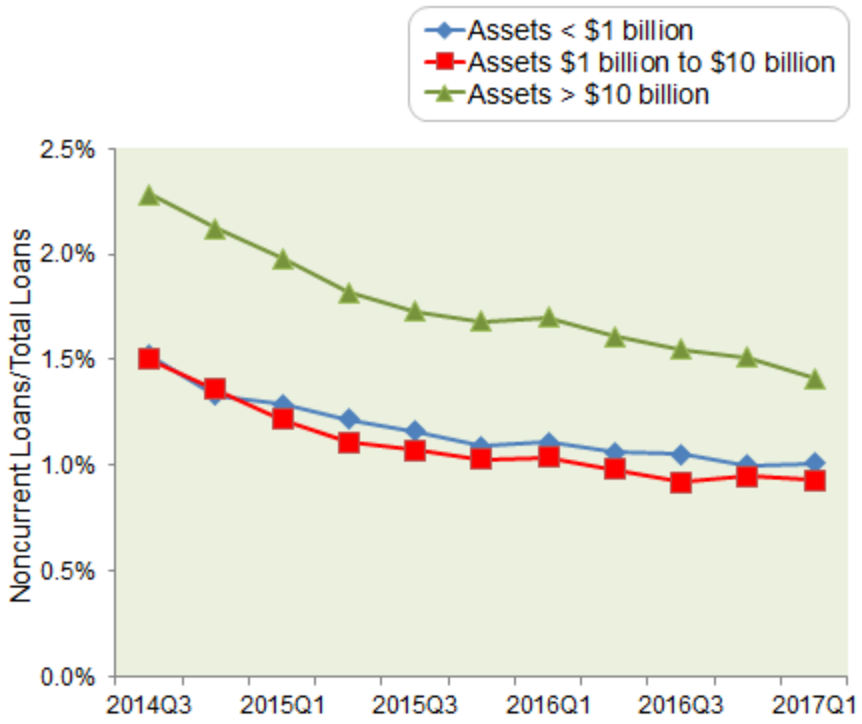
Loan growth for community banks turned negative in the first quarter of 2017, despite surveys showing a high level of confidence in the economy. Commercial and industrial (C&I) loan balances have been declining since the end of 2016 and dropped sharply through the first quarter of 2017. Interest rates and underwriting standards have been discussed as potential causes though it seems that neither should hamper lending to the degree seen since the beginning of the year, if confidence is as strong as implied in a variety of reports. According to the latest Senior Loan Officer Opinion Survey, banks reported tightening most credit policies on commercial real estate (CRE) loans over the past year. Reasons cited included prices and vacancy rates. CoStar reports that CRE prices are starting to fall in major markets even as prices improve in other markets. The divergence in pricing trends suggests a maturing market cycle, especially for higher-value properties in major markets that were the first to recover from the crisis. This development is a cause for concern as it affects the value of collateral for existing CRE loans (see the chart).



Some banks have significant concentrations in CRE retail property, exposing them to potential losses if the market continues to turn. In addition, banks have generally been backing away from car loans over the last four quarters as it became harder to find qualified buyers and loan terms became extremely loose, especially for some prime borrowers.

Although loan growth declined in the first quarter, asset quality remains strong. Noncurrent loans continue to hover around 1 percent of total loans, basically unchanged from the prior quarter, representing a decline of 11 basis points year over year (see the chart).

Noncurrent Loans Remain Low



Source: Bank Call Reports

Net charge-offs declined for the first time in four quarters as banks started tightening their credit terms, especially on consumer and CRE loans.