BANKING & FINANCE

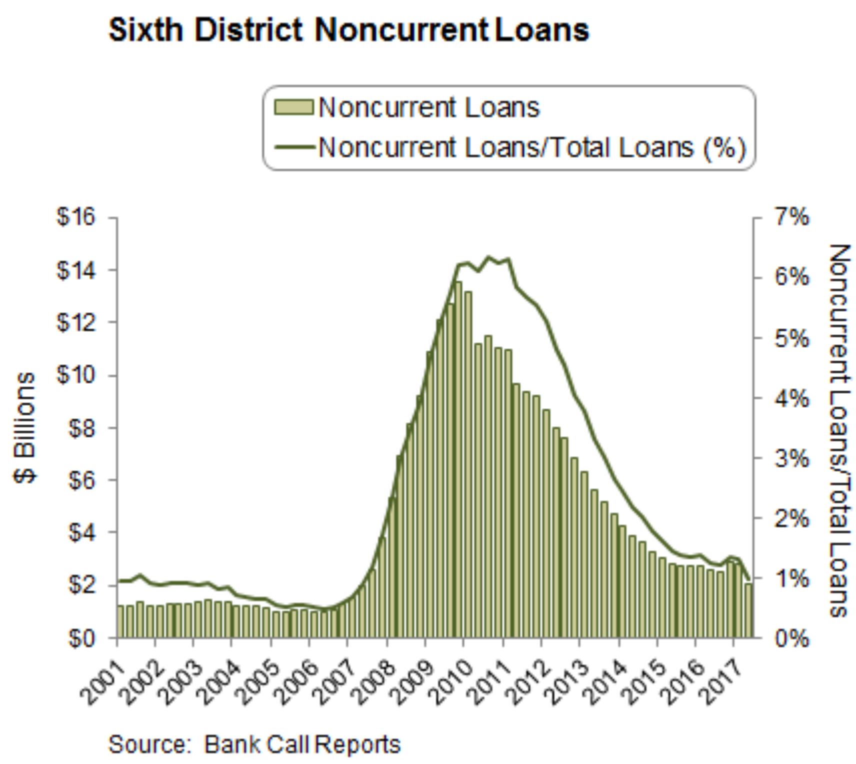
National, Regional Banking Conditions Detailed in Latest "ViewPoint"

September 29, 2017

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

Asset Quality

Asset quality remains healthy, with noncurrent loans falling to their lowest level since late 2007. Loans past due 90 days or more at community banks in the Sixth District have remained below 2 percent for 10 consecutive quarters (see the chart).

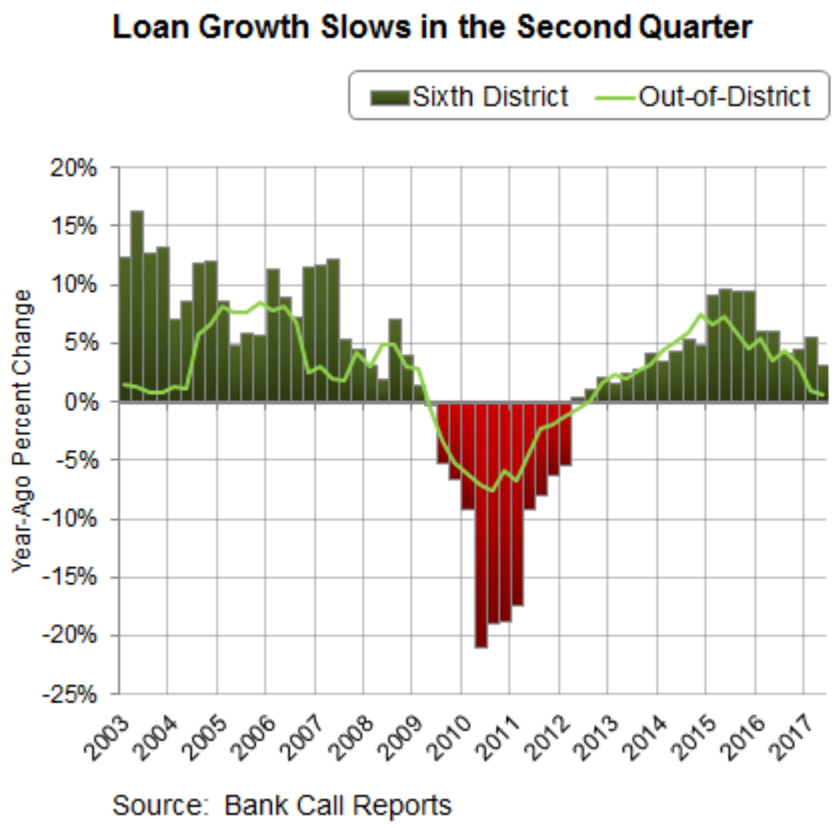


Net charge-offs, as a percentage of average loans, were 0.16 percent in the second quarter of 2017 in the Sixth District, much higher than banks outside the District but still extremely low on a historical basis. The stable asset quality has allowed institutions to improve the coverage ratio to 114 percent, on an aggregate basis, a slight decline from the prior quarter. Going into the crisis, the allowance for loan losses as a percentage of noncurrent loans was above 260 percent in June 2006 and fell to 36 percent in September 2010. So far, problems have been isolated to a relatively few institutions and a few portfolios like credit cards, autos, and energy.

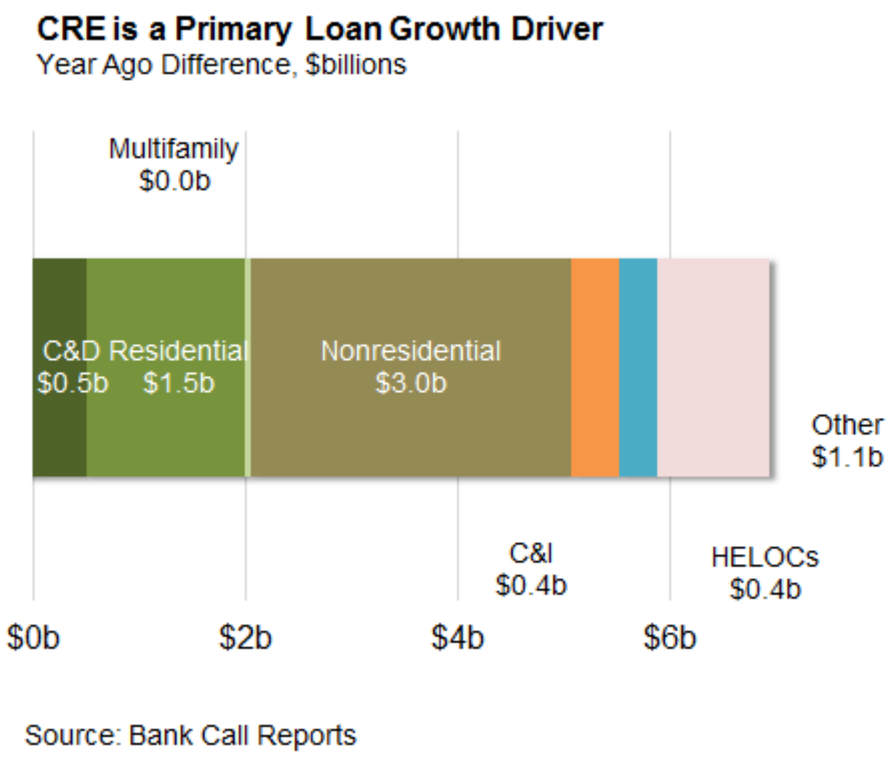
Underwriting is tightening for both CRE portfolios and consumer, outside of residential loans, with banks reporting that they've increased their minimum required credit score for credit card loans. Nationally, delinquent card balances are increasing, rising 6 percent during the last 12 months, and issuers are reporting losses and increasing their provisions, with few community banks having a sizable credit card portfolio. Regulators noted in their Shared National Credit review some concerns over underwriting and risky bank lending connected with some commercial loans, especially connected to energy exposures, which are limited to a few markets in the Sixth District.

Balance Sheet Growth

Loan growth for Sixth District community banks reached its lowest pace since the second half of 2013 (see the chart).

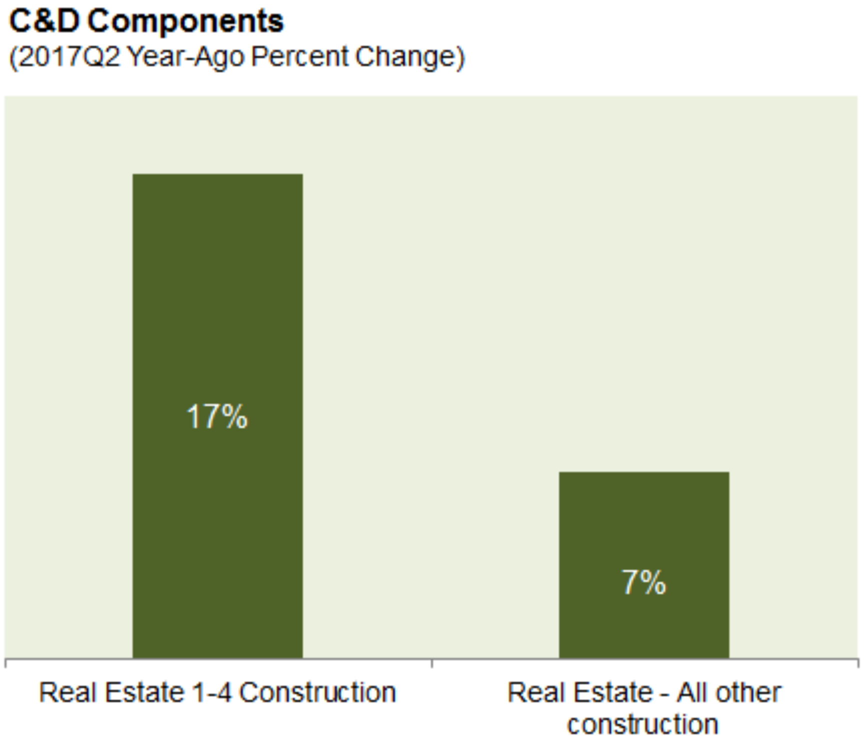


CRE was the primary growth driver during the quarter. In the Sixth District, CRE concentration levels have slowly risen to the point where the median level for all banks in the District is approaching precrisis levels. Given the importance of CRE in the Southeast, banks are monitoring conditions in both the retail and multifamily property sectors (see the chart).



Conditions in the retail sector are a source of concern. With national retailers' quickening pace of store closings, these formerly fully leased spaces now have vacancies that might cause property owners trouble with cash flow in the coming months. Multifamily lending increased nearly 1 percent year over year, which was much weaker than banks outside the District. For multifamily, lenders and investors have concerns that range from the level of supply to slowing rent growth to rising operating costs in certain markets, such as Miami.

Residential lending is behind only CRE in terms of the greatest growth during the quarter. In the last [Senior Loan Officer Opinion Survey](#) (SLOOS), banks report that demand for the types of mortgages that most consumers would use was flat to declining as mortgage rates start to slowly climb. Despite the improvement in housing prices, banks in the District are still not adding large exposures to the balance sheet, likely because of the number of write-offs that occurred during the crisis. The portfolio grew 5 percent year over year, but balances in the portfolio are much lower than prior to the crisis. In some markets in the District, there is a concern about affordability and the potential that prices could correct, causing a decline in value. Lending for construction and development projects remains positive. Most of the new lending is going to new home construction (see the chart).



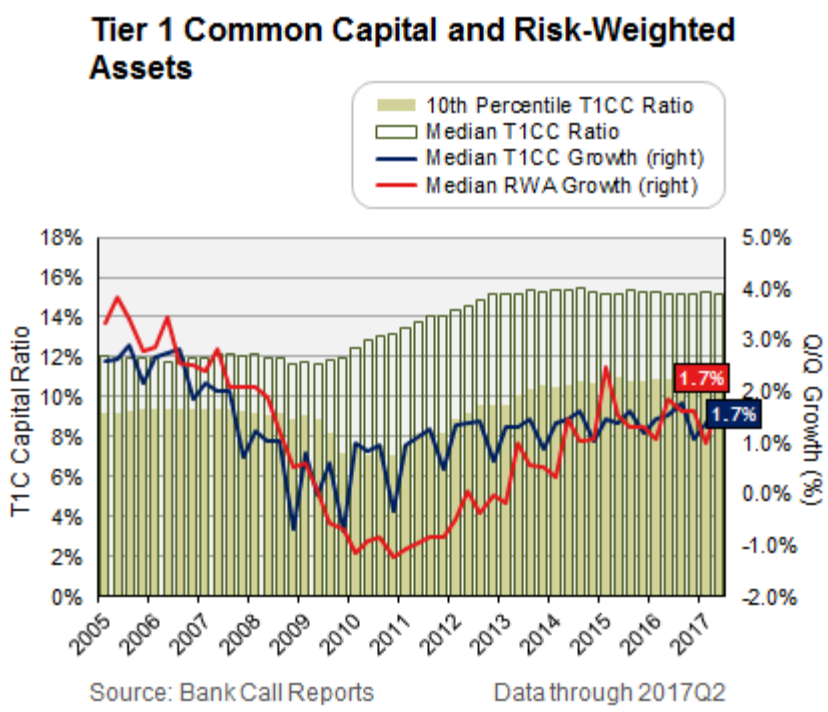
Industry analysts expect housing starts to increase because of the extreme shortage in supply and what they perceive as an increase in demand. Still, slowing demand along with increasing building and development costs could have a significant impact on new housing starts in the second half of the year.

Commercial and industrial (C&I) lending has been slowing for the last 18 months, with growth barely positive year over year. Banks are also reporting weaker demand for C&I. The auto industry suppliers in the District, as well as some oil and gas operations, have slowed production, which may be causing some of the weaker demand.

In the consumer portfolio, loan growth declined by just over 2 percent, the third consecutive quarter that consumer lending has declined. Auto loans represent the largest portion of the consumer portfolio for most Sixth District banks. In the most recent SLOOS, more institutions are indicating that underwriting standards for car loans are tightening. At the same time, demand for new cars continues to cool. There are concerns about the impact that lower demand will have on prices. Already, some captured finance companies and other big auto lenders are cutting back leasing to avoid being stuck with a glut of vehicles at depressed prices should loans start to go delinquent.

Capital

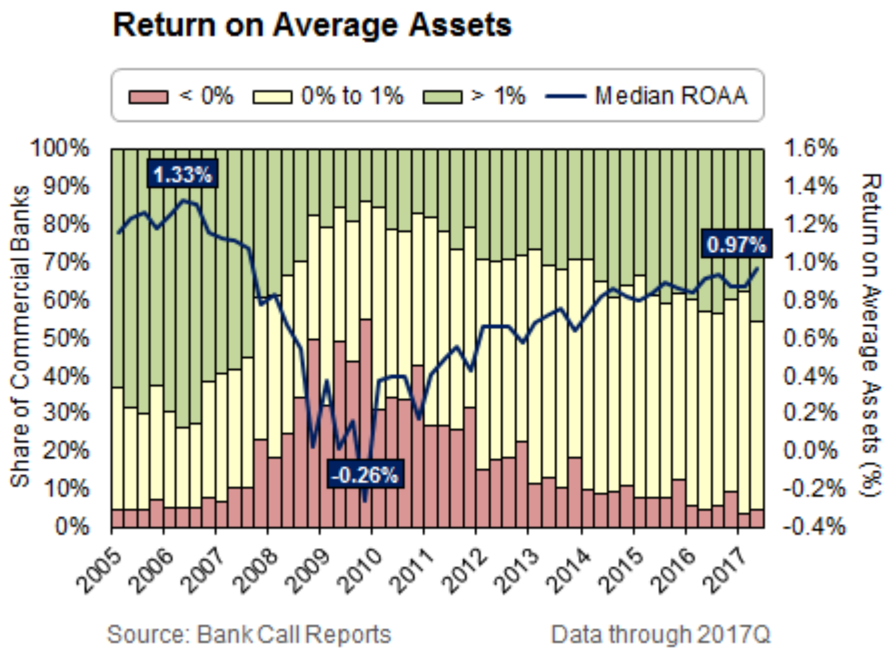
As profitability has improved and loan growth has slowed, capital levels remained stable for most community banks across the Sixth District. The median tier 1 common capital ratio held steady at 15 percent in the second quarter 2017 (see the chart).



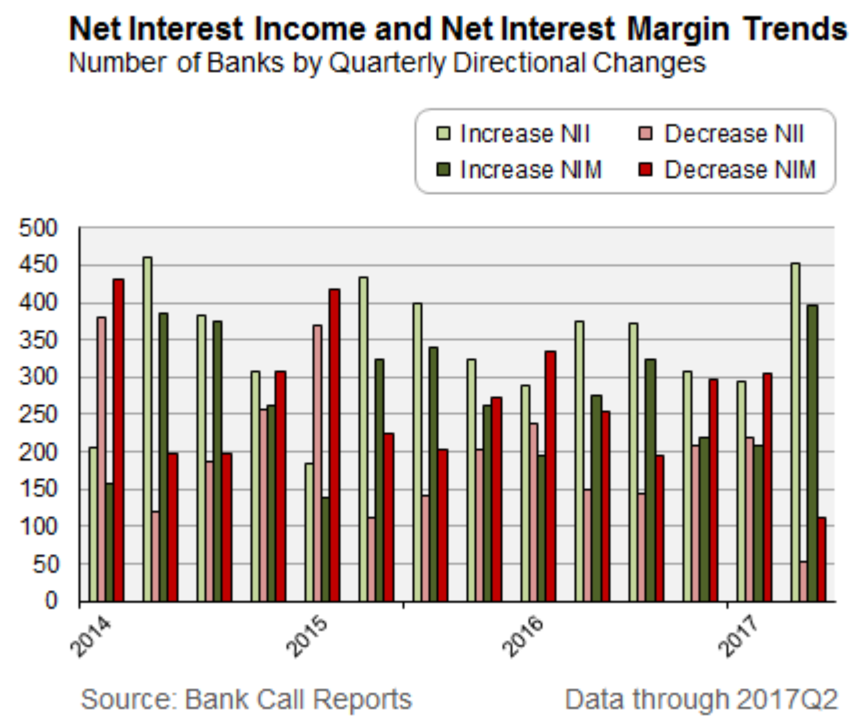
The ratio has remained around 15 percent since the second half of 2012 with little fluctuation over the last five years. The growth in risk-weighted assets was slightly higher than the prior quarter but remained below 2 percent. Positive net income has allowed capital to keep pace with the growth in risk-weighted assets. Several changes have either been proposed or have been finalized that could have an impact on capital ratios. One change that has been finalized is the Financial Accounting Standards Board's new lease accounting guidance, which will place operating leases on the balance sheet with an offsetting liability. The new standard could lower capital ratios, but the impact is not expected to be significant. One proposal the agencies are considering is replacing the complex treatment of high volatility commercial real estate (HVCRE) with a more straightforward treatment for acquisition, development, and construction loans. Currently, HVCRE is risk weighted at 150 percent.

Earnings Performance

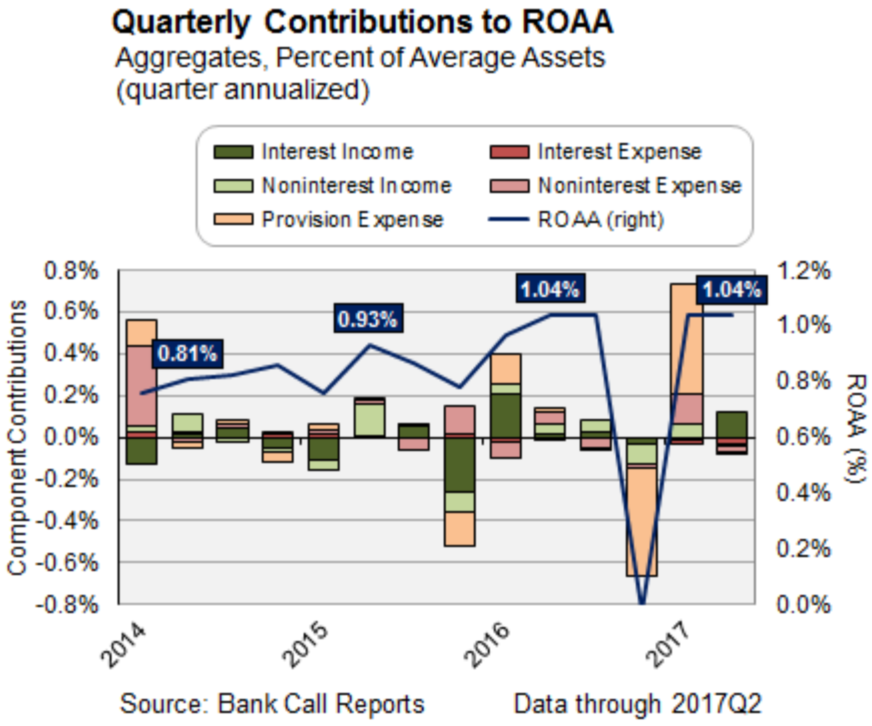
Earnings improved significantly in the second quarter for community banks in the Sixth District as the March increase in interest rates was being priced into new loan originations and renewals. Return on average assets (ROAA) was 0.97 percent on a median basis, the highest ROAA has been in nearly 10 years, consistent with banks on a national basis (see the chart).



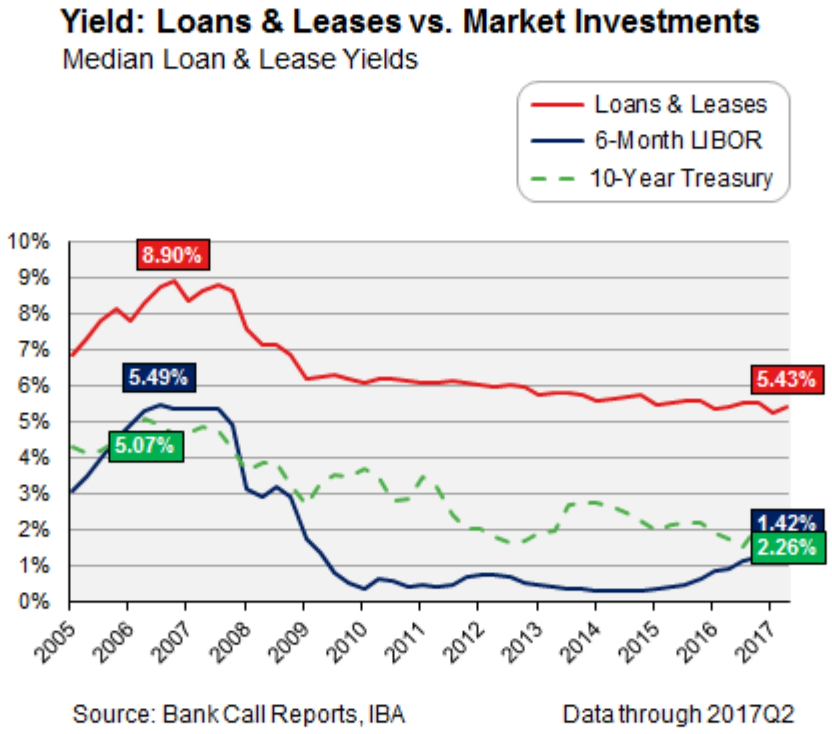
Earnings were driven by an improving NIM, which increased 11 basis points (bps) from the prior quarter on a median basis (see the chart).



The overwhelming number of banks experienced an increase in interest income, with an increase in rate being the primary reason for the improvement as the pace of new volume growth slowed (see the chart).



Loan yield increased 15 bps over the prior quarter but remained lower than the prior year (see the chart).

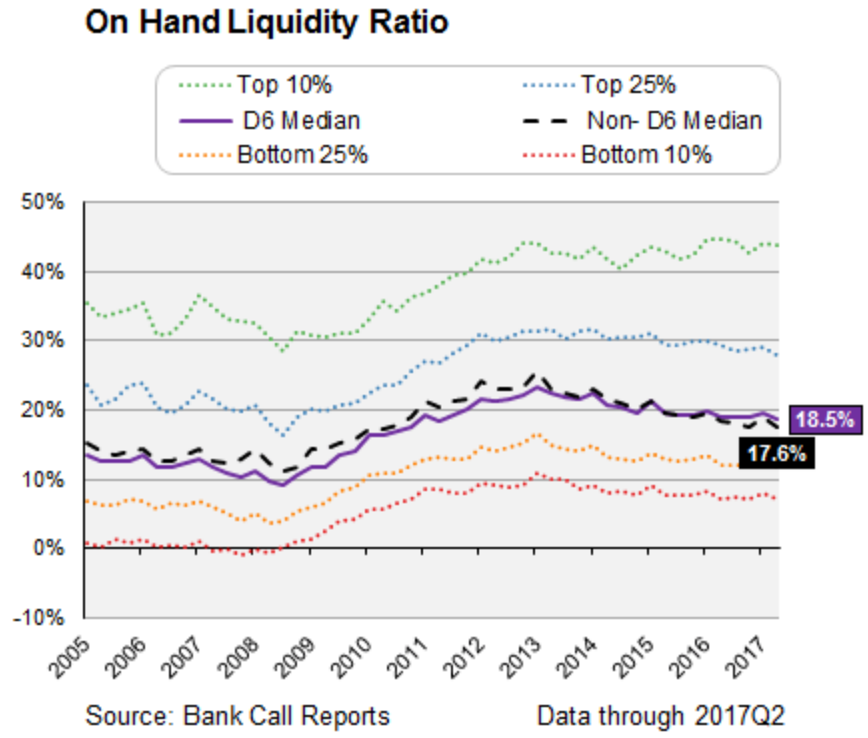


Treasury rates on the 10-year note dipped in the second quarter but remain higher than at the end of each quarter in 2016. Consistent with banks at the national level, community banks in the District have generally been able to hold off on rate increases for retail deposit accounts, which limited the negative impact on NIM. The longer that banks can avoid raising rates on deposits, the quicker banks are likely to experience a normalized margin. Some senior bank executives and bank analysts don't believe the banks will be able to hold deposit rates at existing levels as long as they would like in the digital age. They believe both money markets and large banks operating under new liquidity rules will push rates higher more quickly than other banks would like so they can attract much-needed deposits.

Noninterest income declined slightly as a percentage of total revenue as interest income improved and refinancing slowed. The provision for loan losses remains at historic lows, although delinquencies are starting to move upward for some portfolios. The efficiency ratio continues to decline as revenues improve and banks have addressed most of their lingering problem assets.

Liquidity

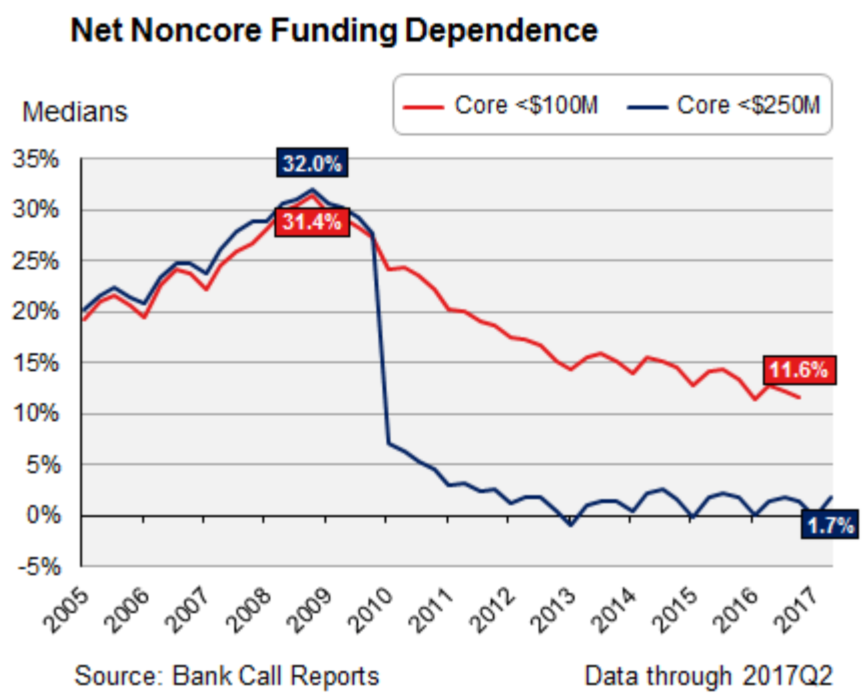
Liquidity in the Sixth District, remains strong relative to prerecessionary levels (see the chart).



Liquidity on hand, including fed funds and marketable securities, as a percentage of total liabilities declined slightly during the quarter. Despite the decline, the ratio is still over 500 bps above precrisis levels. The median ratio of loans to deposits remains below 100 percent despite a higher level of loan growth in recent quarters. Since the financial crisis, smaller banks in the Sixth District have seen shifts towards more transactional accounts and away from time accounts.

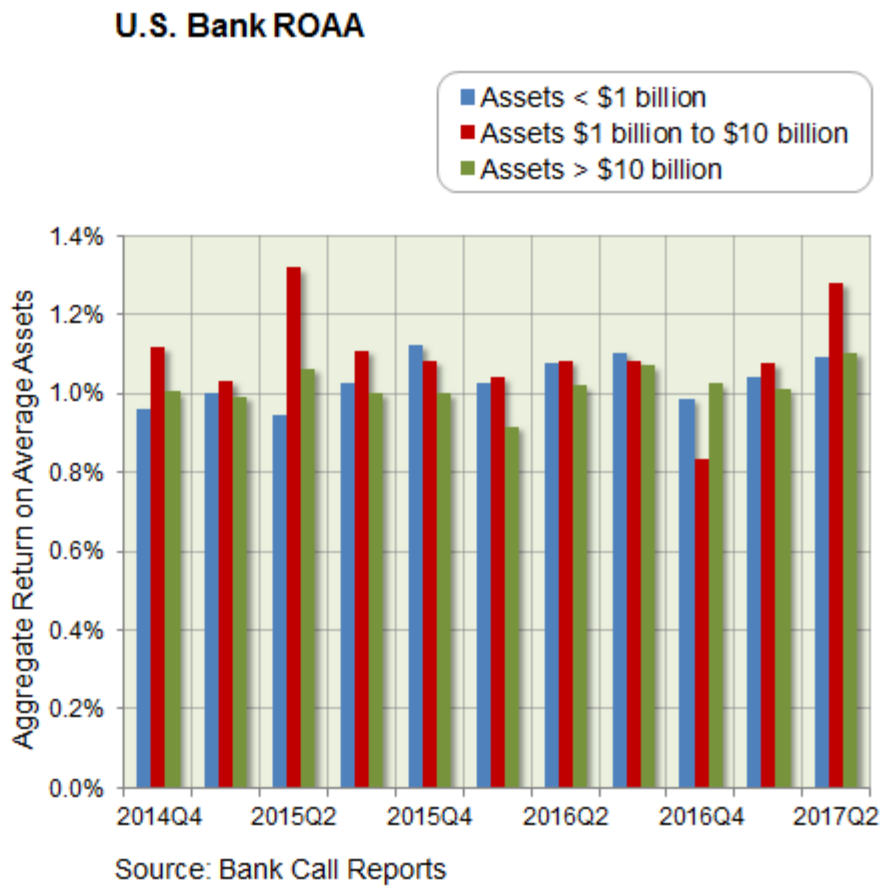
After two interest rate increases, deposit rates are starting to tick up but only for certain groups, such as businesses and affluent customers. So far, the deposit rate increases have not migrated to community banks in general. Traditional retail customers have not seen any movement on deposits rates as banks remain flush with deposits and loan growth appears to have slowed midway through 2017. Any shifts in retail deposit rates at large banks could put pressure on community banks to quickly change their rates to retain customers.

For larger banks, which are subject to the liquidity coverage ratio (LCR), maintaining key deposit relationships is central to their compliance strategy. As a result, they are more willing to pay higher rates on certain deposit products to specific customers. Funding pressure may come later in the year if rates continue to increase and depositors seek better returns. Already, the Federal Deposit Insurance Corporation has expressed concern over the amount of noncore funding that some community banks are relying on to fuel loan growth. In the Sixth District, the net noncore funding ratio remained relatively low, 1.71 percent, at the end of June. The ratio has remained fairly stable since the end of the financial crisis (see the chart).

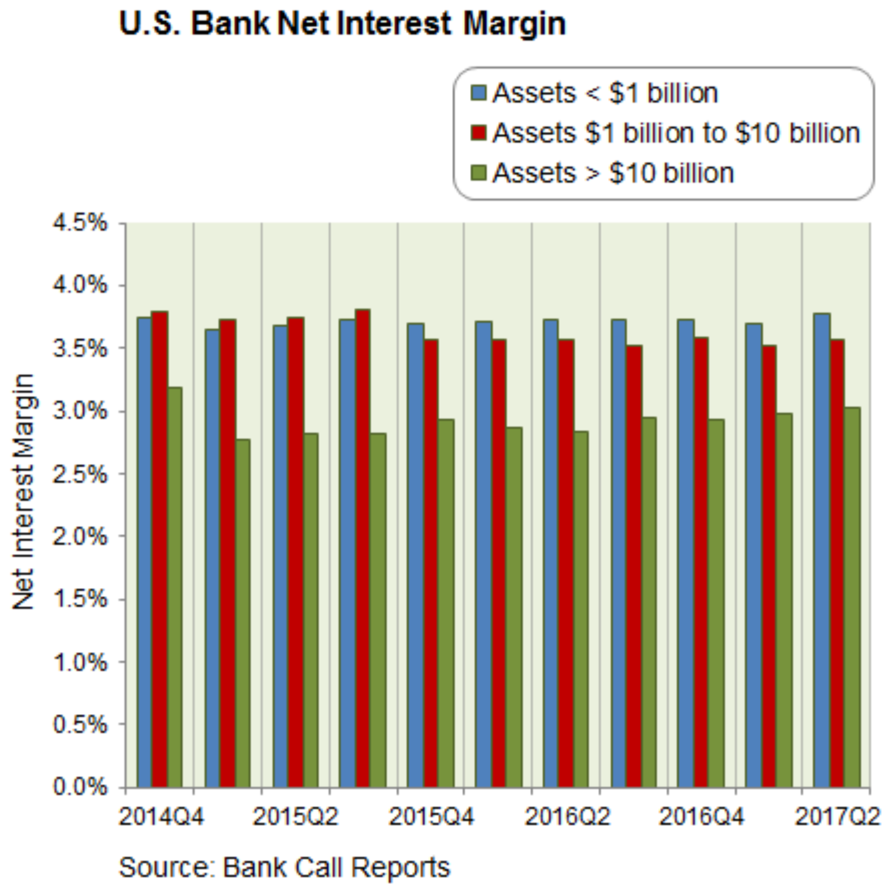


National Banking Trends

Return on average assets continued to improve in the second quarter, especially for banks with assets between $1 billion and $10 billion (see the chart).

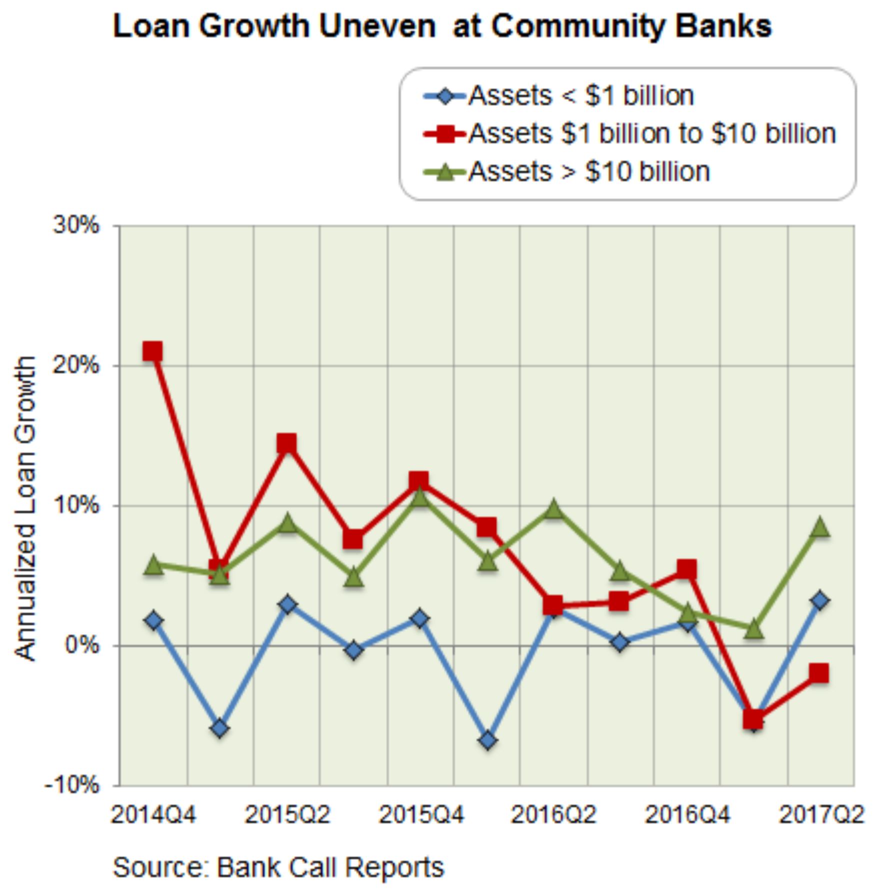


With two increases in interest rates over the prior two quarters, the median net interest margin (NIM) for banks rose to 3.12 percent, its highest level in more than two years (see the chart).



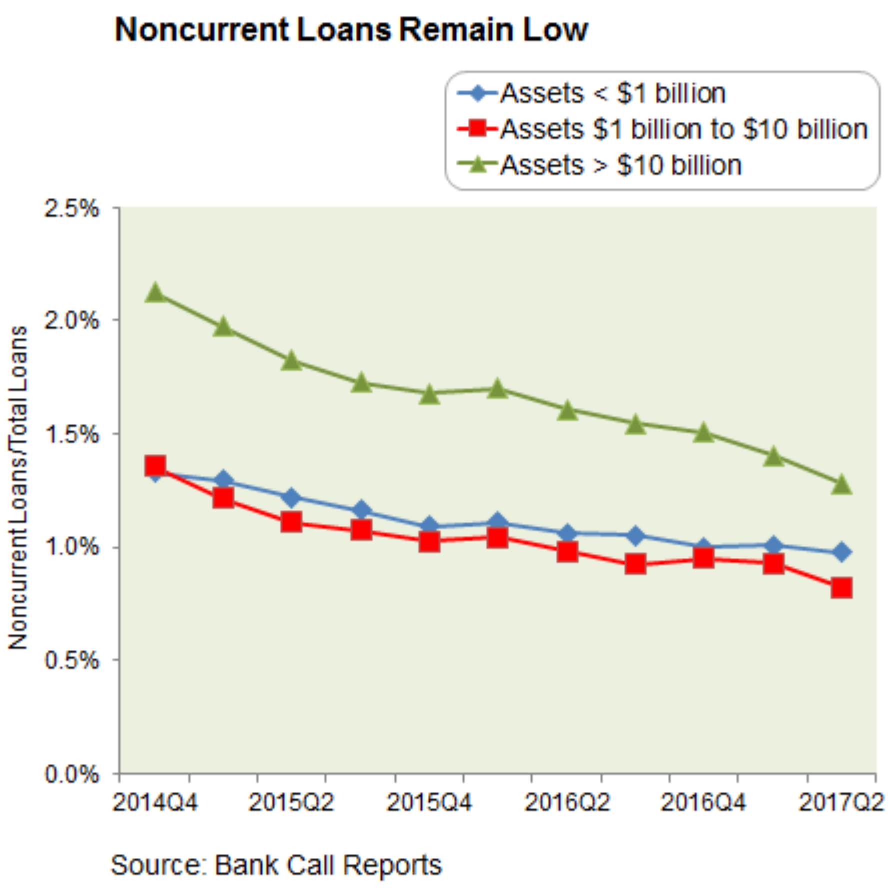
Banks have been able to maintain growth in NIM in part because of deposit rate increases that have not migrated to community banks in general. However, if the large banks start extending higher rates to retail customers, that could quickly change. Indications are that the Fed could increase rates one more time in 2017, which should continue to improve community banks' margins. Banks are also managing noninterest expenses more effectively as the efficiency ratio fell to 56 percent on an aggregate basis. The higher operating costs related to problem assets have declined as banks have disposed of or worked out many of their credit-related issues with customers.

Nationally, overall annualized loan growth was positive but remained negative in the second quarter for the larger community banks with assets between $1 billion and $10 billion (see the chart).



Banks are reporting weaker demand for commercial and industrial (C&I) and commercial real estate (CRE) loans while banks are also reporting tightening their underwriting standards. In the consumer portfolio, banks reported tightening standards on some consumer portfolios, like vehicle lending, which has driven much of the consumer portfolio growth. Banks are also seeing weaker demand for auto loans. For autos, many creditworthy borrowers have shifted toward leasing in recent years because of the quickening pace of price increases on new vehicles and the desire to stay updated with new models that have improved safety features, fuel economy, and navigation systems.

Some signs indicate that the credit cycle is turning with a few portfolios are starting to see increases in nonperforming loans, though the amounts remain well below the levels seen during the crisis (see the chart).



Concerns about a possible turn in the credit cycle were also pointed out in the American Bankers Association's Consumer Credit Delinquency Bulletin, released on July 5, 2017. The bulletin pointed to delinquencies for both open- and closed-end loans increasing from the historic lows that banks experienced during the last five years. The agencies have issued a statement about the shared national credit review, which voices some concerns over underwriting and risky bank lending. The agencies found that risk overall remains high, but underwriting and risk management continue to improve. The agencies continue to express concern that any downturn in the economy would result in a significant increase in risk-rated leveraged lending exposure.