BANKING & FINANCE

National, Regional Banking Conditions Detailed in Latest "ViewPoint"

March 30, 2018

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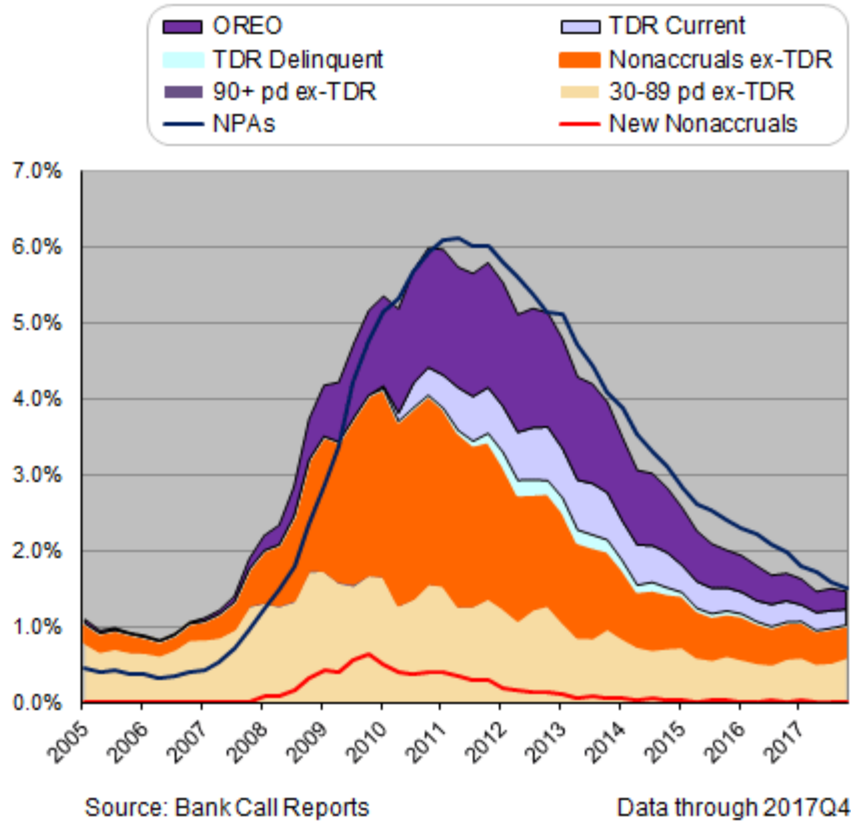
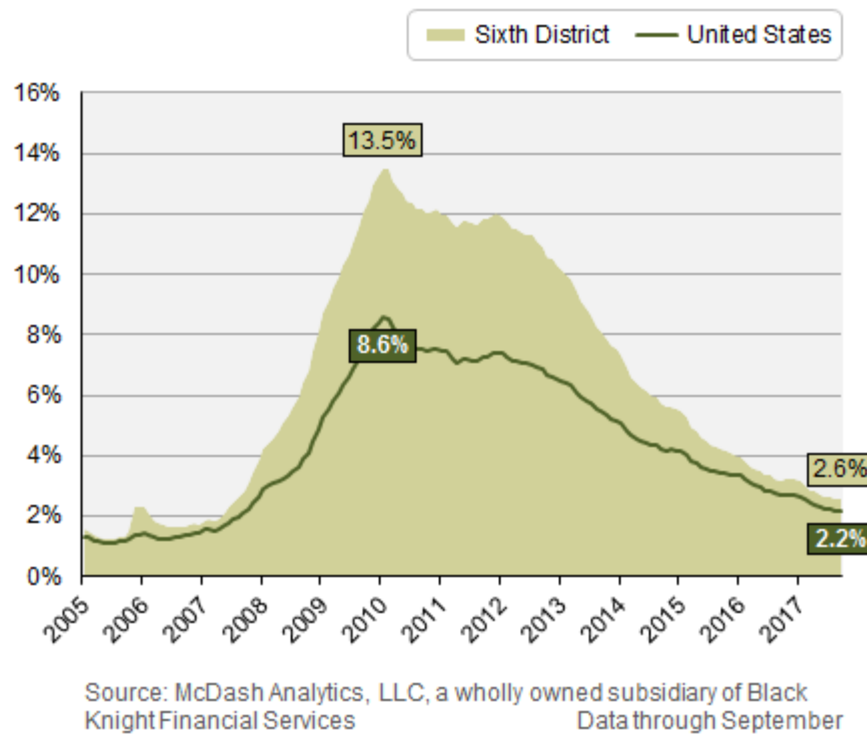
Asset Quality

After several years of economic recovery, asset quality remains stable when viewed at a high level. However, recent Senior Lending Officer Opinion Survey (SLOOS) results indicate that risk may be rising as credit concentrations grow, especially within the commercial real estate (CRE) and consumer portfolios, as out-of-market real estate lending increases. As of the end of the fourth quarter, noncurrent loans remain at low postcrisis levels. Both the 30–89 days and 90 days or more past due ratios are slightly lower than at the end of 2016. New nonaccruals added during the quarter remain less than 1 percent of net loans (see the chart).



At the end of 2017, net charge-offs, as a percentage of average loans, were on par with the fourth quarter of 2016. In Florida, which was affected by Hurricane Irma, banks still appear to be in good financial condition. According to credit metrics for commercial banks in the state, nonperforming assets have fallen to 1.35 percent of total loans plus other real estate owned (OREO). New nonaccruals added during the quarter remain flat. Banks reported a decrease in the provisions for allowance for loan losses in the fourth quarter after ramping up provisions in the previous quarter as a result of concerns about the impact of the hurricanes on consumers and farmers. Although larger banks are reporting an increase in seriously delinquent mortgages as a result of natural disasters that struck the District late last summer, data from the Call Report shows delinquent mortgages continued to decline for community banks.



Looking to next year, SLOOS respondents expect to ease standards on residential mortgage and commercial and industrial (C&I) loans, while tightening terms on CRE and credit card loans. In addition, senior loan officers anticipate deterioration in consumer portfolios.

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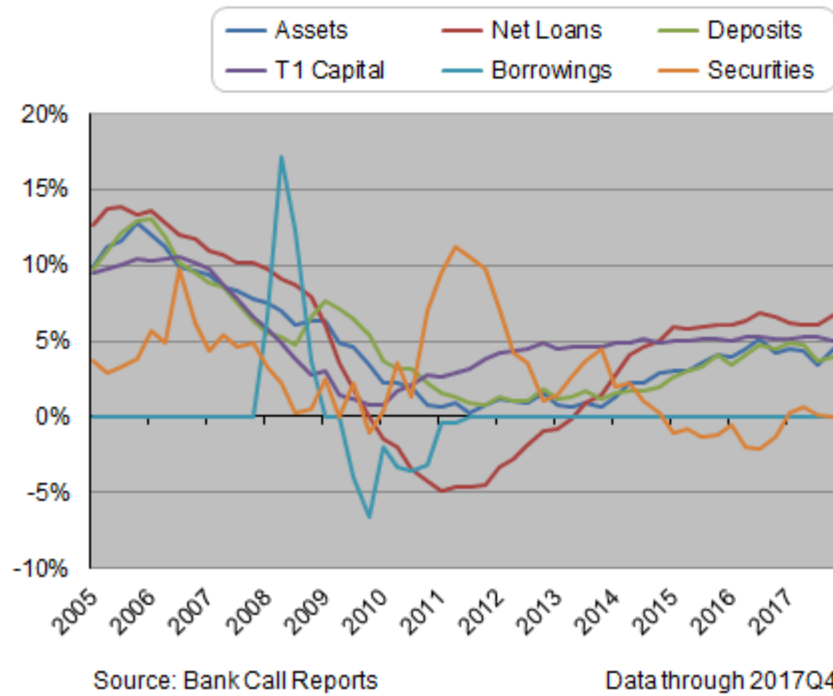
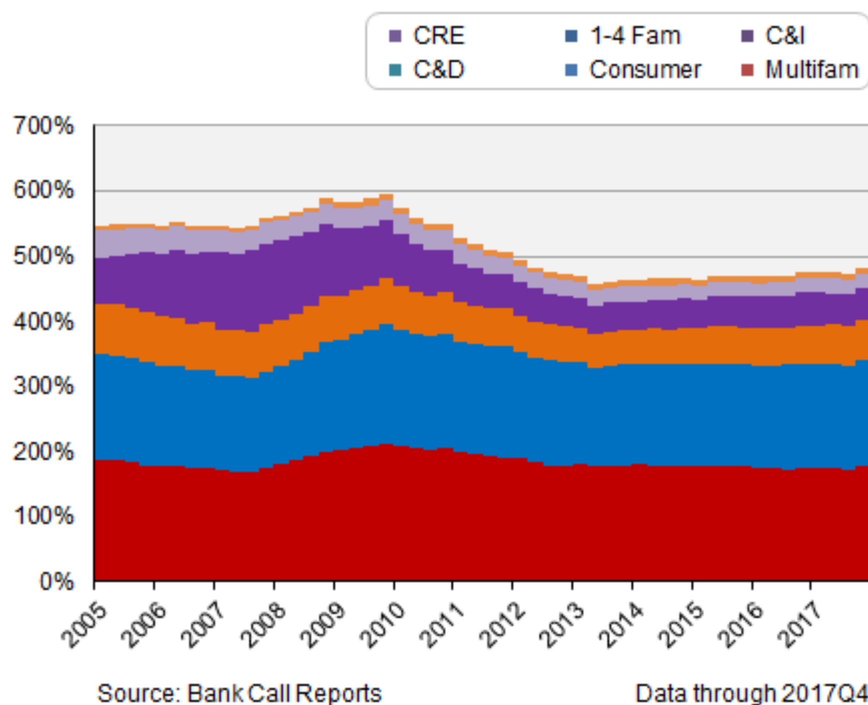
Balance Sheet Growth

During the fourth quarter, banks experienced annualized balance sheet loan growth of nearly 4.5 percent, on a median basis, on par with growth early in 2017 (see the chart).



Loans are the primary driver of balance sheet growth, with activity more concentrated among banks with less than $1 billion in assets. Loan growth remains healthy at most community banks in the Sixth District, with median growth at 6.7 percent. Construction and development (C&D) lending remains the highest growth portfolio, at more than 10 percent, followed by commercial real estate (CRE), while consumer loan growth continued to slow down. Exposures for construction have risen steadily over the past seven quarters as optimism about the economy has increased. With demand for new housing still high, despite the increase in rates, residential construction is leading the growth in C&D. The Case Shiller index shows that home prices continue to increase under the pressure of low inventory in key markets. Many of the housing markets in the District remain healthy as strong job growth and growing in migration fuel demand and create upward pressure on prices. Moving forward, limited levels of housing supply will be a major challenge facing the region. The lack of inventory is pushing home price appreciation. CRE lending is a significant strategic focus for many community banks across the Southeast. In the fourth quarter, for the first time in three years, there was a notable increase in the level of CRE concentrations at community banks. Concentration levels are approaching precrisis levels (see the chart).



Banks have become more selective in financing nonresidential properties. Concerns about overbuilding in the multifamily sector appear to be weighing on developers and lenders as multifamily construction is starting to slow. In markets like Atlanta, the level of multifamily projects in the planning phase is declining. Although C&I lending was a growth engine coming out of the crisis, banks have scaled back in recent quarters. Growth in the C&I loan portfolio started slowing at the end of 2016 and continued dropping through 2017. Some of the decline may be demand driven. For example, banks may not see a benefit from increased business borrowing due to the tax cut, at least in the short-term. Many companies already have sufficient liquidity to carry out their business plans and, as a result, will use the additional savings from the tax cut to pay down debt. Consumer loan growth remains stagnant as concerns about credit card balances and the level of vehicle lending have increased for banks. Larger banks are increasingly looking at point-of-sale (POS) loans to drive growth in their consumer lending portfolio, in part, through partnerships with fintech companies. POS loans are similar to the way some retail stores used to provide credit through store branded credit cards. However, POS loans are for fixed amounts and, in some cases, a fixed interest rate.

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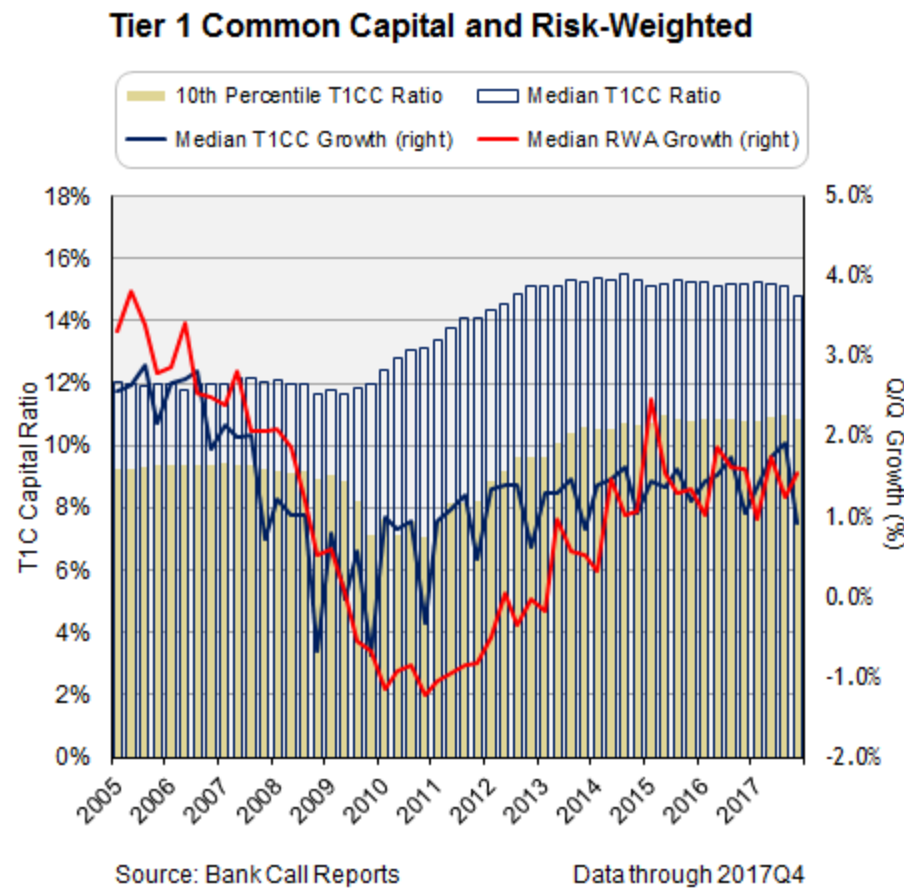
Capital

Capital levels remain strong, with around 97 percent of banks in the District deemed well capitalized. Risk-weighted assets' growth remains manageable at 1.5 percent for the quarter (see the chart).



However, the median tier 1 common equity ratio fell below 15 percent for the first time since 2012. Earnings have generally outpaced the growth in risk-weighted assets since the recovery from the financial crisis began. In the fourth quarter, earnings dipped as a result of effects of the tax law changes, though the decline is expected to be temporary. At the same time, growth in risk-weighted assets was slightly higher than in the prior quarter. Since many Sixth District banks focus on commercial real estate (CRE), which carries a higher risk weighting compared to other assets, an increase in CRE lending has a greater effect on capital than growth in other assets.

Dividend payouts were higher than the prior quarter but remained below 100 percent. Next to retained earnings, business combinations have had most impact on total capital as assets are revalued in merger transactions. The Financial Accounting Standards Board's new allowance guidance, which will replace the current methodology with the Current Expected Credit Loss (CECL) model, is expected to affect capital levels. Consultants continue to sound the alarm over the new model, with one suggesting that some community banks are in danger of losing their "well-capitalized" rating. However, most published analyses need further refinements, tailored to each bank's loan mix, which would likely change the impact on capital. Based on informal surveys, many small banks have yet to make estimates of the impact of CECL, so it's still too early to tell how much the change will affect capital.

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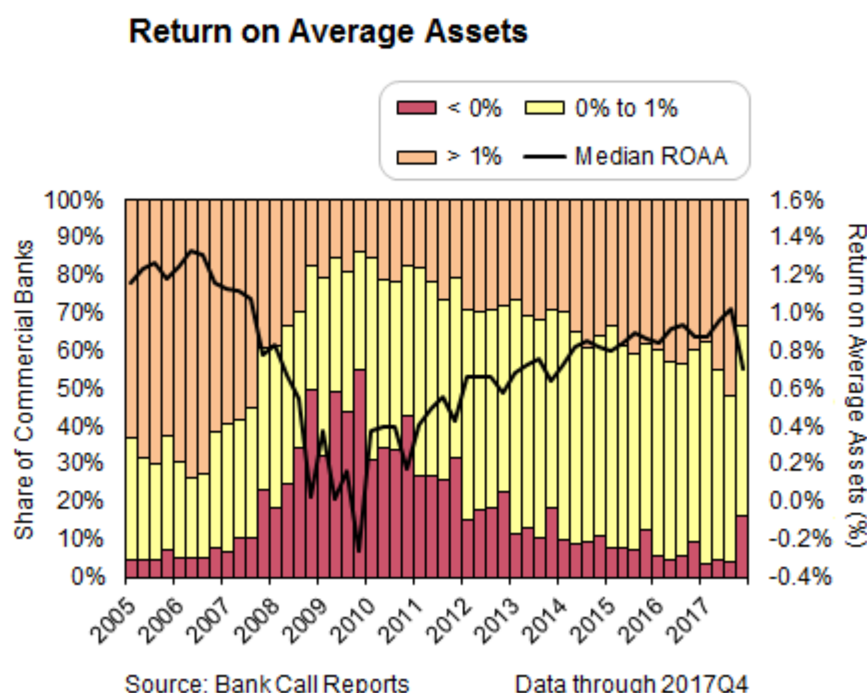
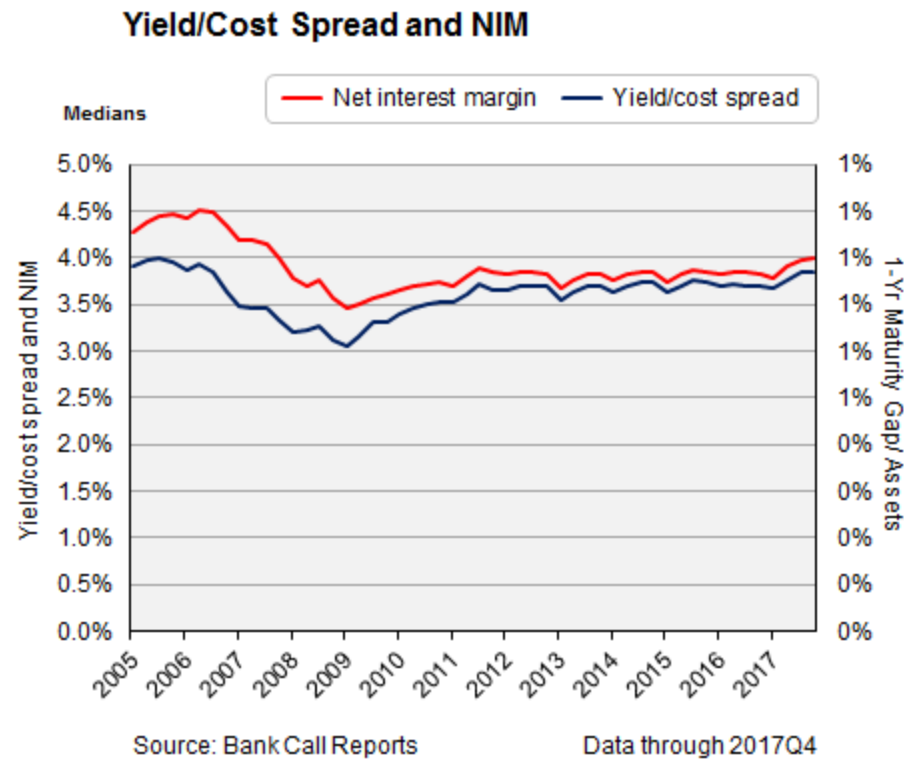
Earnings Performance

Similar to community banks on a national level, the median return on average assets (ROAA) of banks in the Sixth District declined to 0.70 percent, primarily the result of write-downs of deferred tax assets associated with the change in tax laws (see the chart).

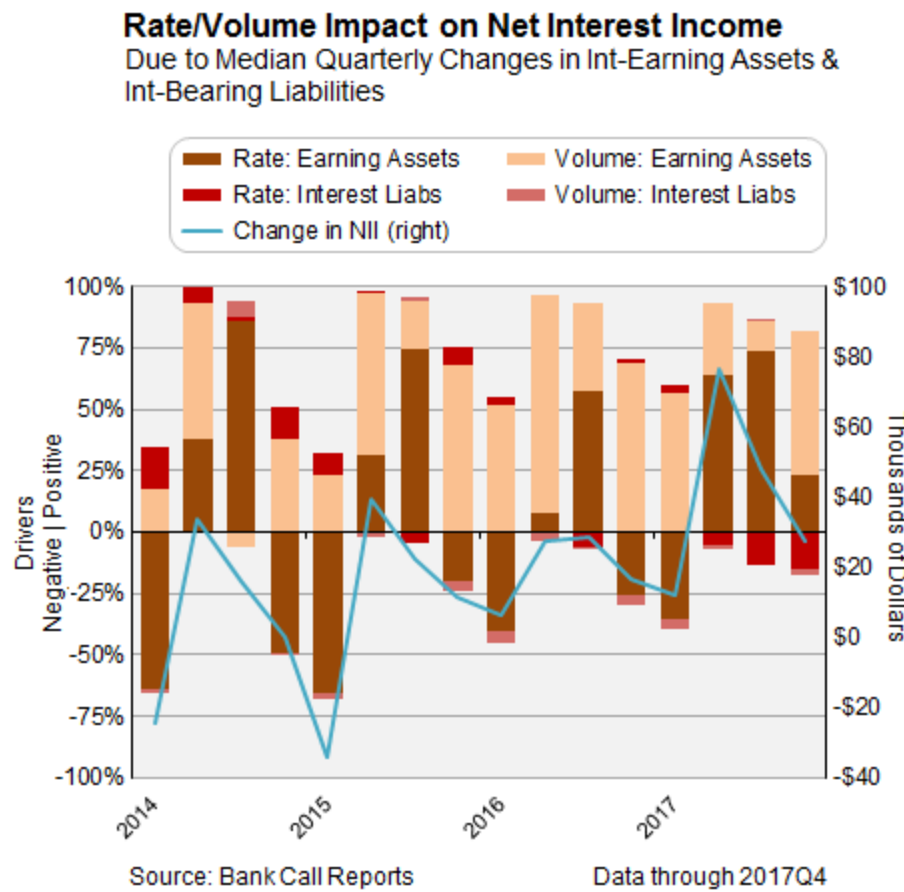


The number of banks with ROAAs above 1 percent declined to the lowest level since early 2014, though the drop is expected to be temporary. ROAA at regional banks, with assets between $1 billion and $10 billion, declined more than ROAA at smaller

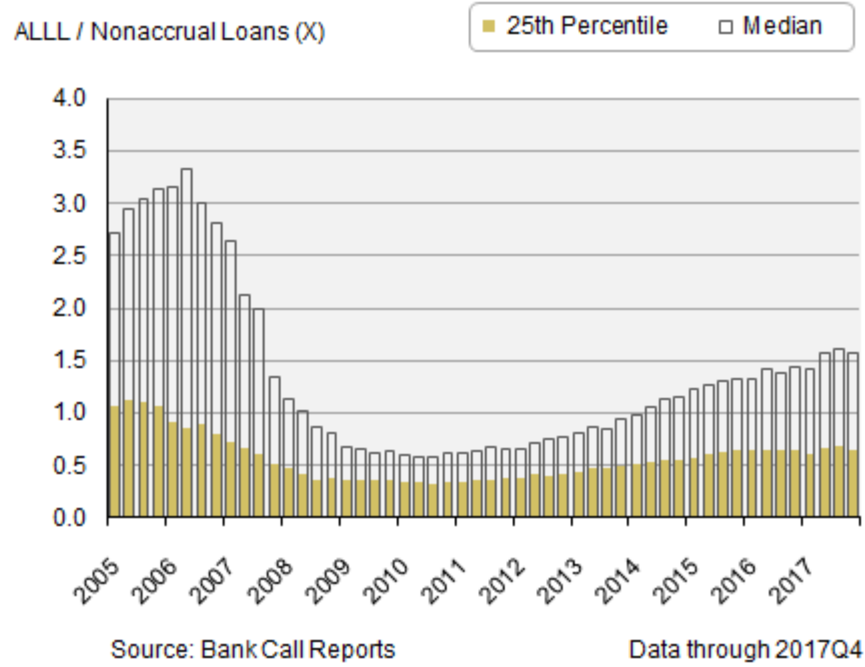
community banks, which carried lower balances of deferred tax assets after the financial crisis. While a short-term increase in earnings is expected going into 2018, some of the tax savings may encourage banks to pay higher rates on their deposits, as competition for deposits increases, or invest in different technologies. However, another potential impact could be a lower demand for debt from commercial customers since interest expense may no longer be deductible. Generally, banks in the District benefitted from the recent changes in interest rates. Currently, the median net interest margin (NIM) is 3.99 percent, a slight increase over the prior quarter and a 16 basis point increase year over year (see the chart).



It's the highest NIM reported since the beginning of the financial crisis nearly a decade ago. An increase in the volume of interest bearing assets was the primary driver of the higher NIM (see the chart).



Banks are slowly pushing rates upward on loans and are replacing some lower yielding securities with higher rate securities. Banks have also been able to manage interest expense, at least in terms of deposits. Continued asset growth may pressure interest expense as banks have started using brokered deposits and Federal Home Loan Banks borrowings to help fund loan growth. Provision expense ticked up slightly at yearend, which is common as many banks address problem loans prior to the start of the new year (see the chart).



The overall coverage ratio remained stable. Growth in noninterest income has also been relatively flat in recent quarters and a change in accounting for revenue could further slow noninterest income recognition, especially in banks with trust operations. The efficiency ratio for community banks remains low as banks continue to manage operating expenses. Though many of the expense reductions have been in response to environmental adjustments (branch closings and consolidation), options for further reductions in personnel may be limited as asset growth continues, particularly in risk and control functions.

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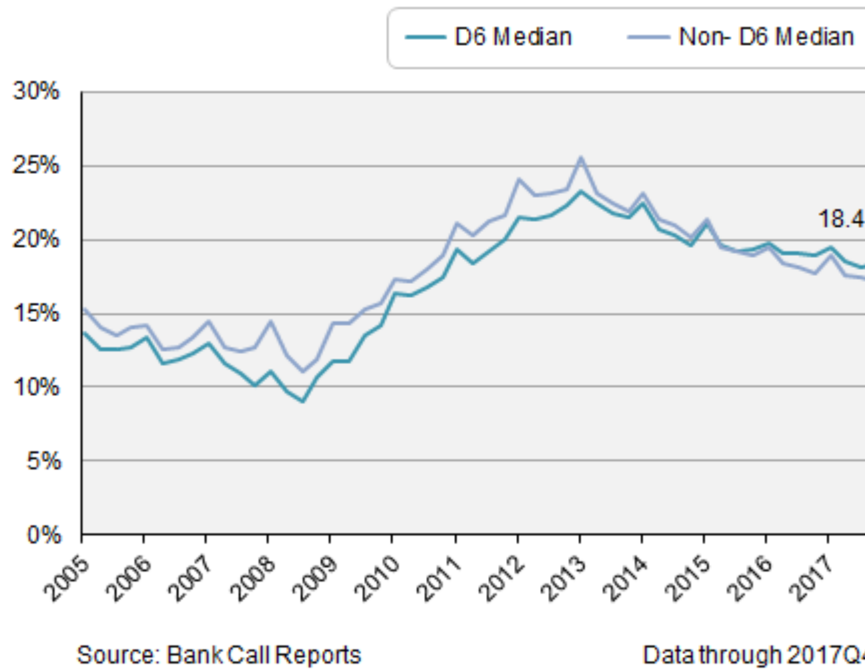
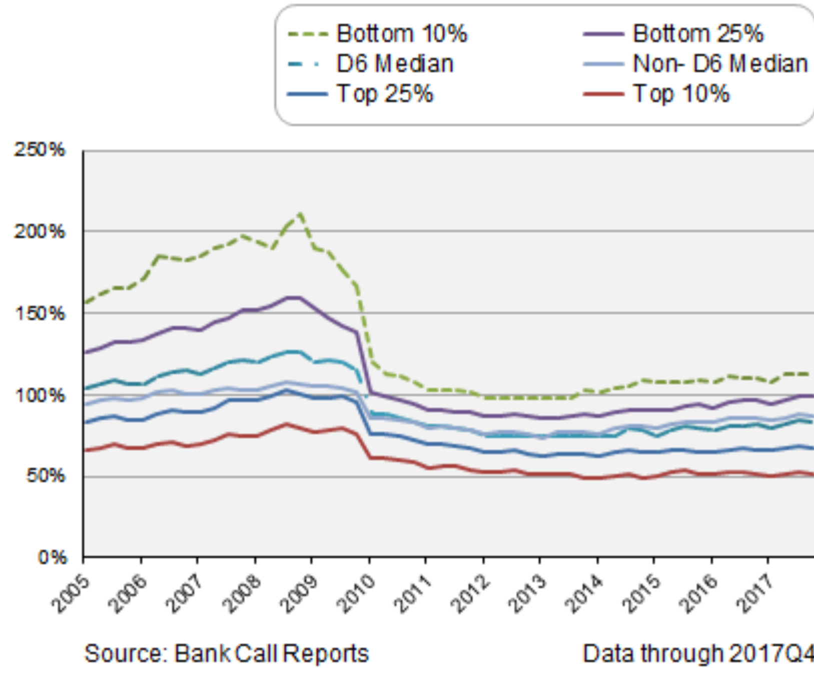
Liquidity

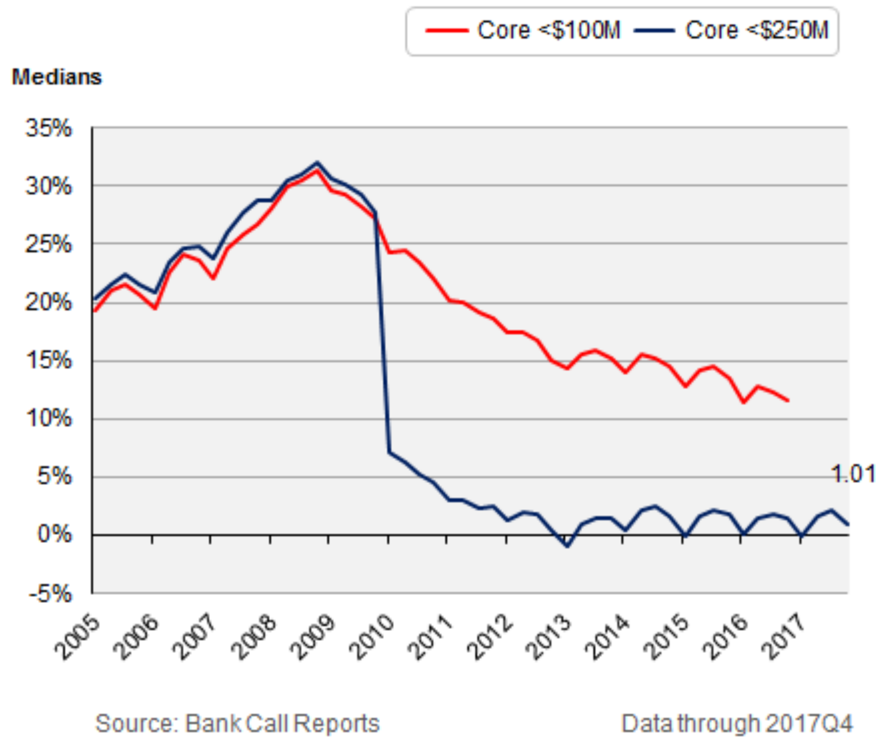
As interest rates continue to rise, it is expected that customers will shift from lower yielding deposits to higher-yielding financial products. Research suggests that when fed funds rates increase by more than 150 basis points, bank liquidity levels tend to decline by 30 to 50 percent. However, banks appear to be willing to risk that customers won't follow rates available at other institutions. However, customers have options for researching rates and ways to easily move their money, so banks may be risking long-term relationships in turn for short-term margin gains. Changes in deposits, as interest rates rise, are slowly affecting liquidity at Sixth District community banks, although the level of deposits remains higher than before the crisis. Median on-hand liquidity trended downward for most of 2017 despite a slight uptick in the fourth quarter 2017, according to Call Report data (see the chart).



Liquidity on hand, as a percentage of total liabilities, was 18.4 percent for the quarter on a median basis. The ratio peaked in the first quarter of 2013 at 25.6 percent. Loan growth has outstripped deposit growth for the last three years. Still, the median loans-to-core deposits ratio remains favorable at 84 percent. As the ratio between loans and deposits has stabilized, the use of more volatile funding sources has fluctuated (see the chart).



For example, net noncore dependence decreased slightly in fourth quarter, after reaching its highest level in two years at the end of the third quarter (see the chart).



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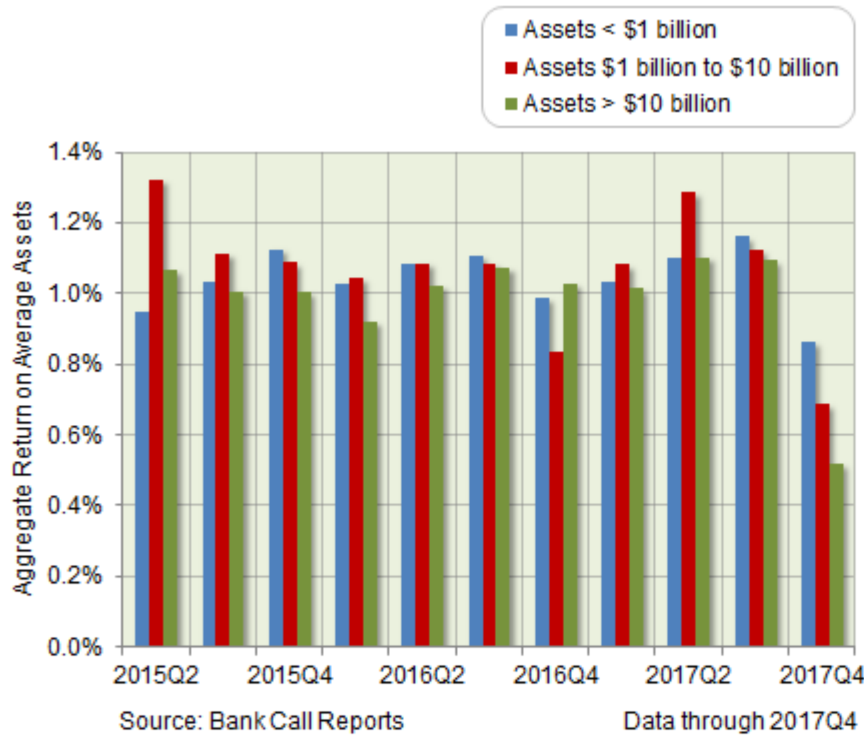
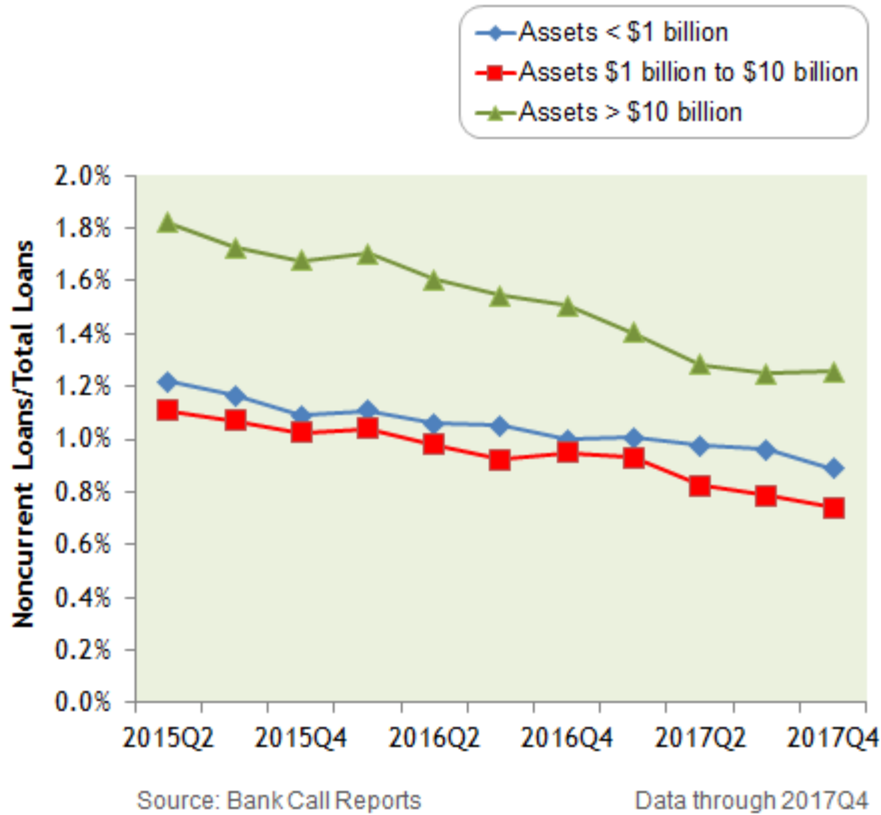
National Banking Trends

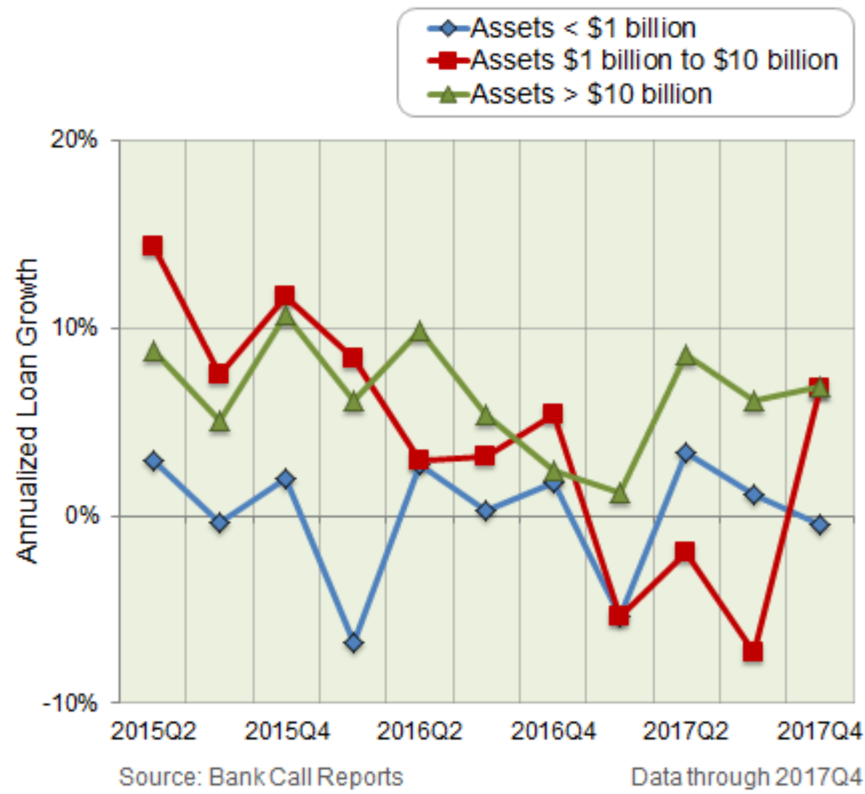
Despite a continuing trend of positive economic news, community banks reported a lower return on average assets (ROAA) in the fourth quarter of 2017 as a result of the transitory impact of write-downs of deferred tax assets resulting from corporate tax reform. The largest community banks, those with assets between $1 billion and $10 billion, reported a median ROAA of 0.69, down 44 basis points from the prior quarter. Eventually, the change in tax rates should provide a boost to earnings. Even though the Federal Reserve's benchmark interest rate increased three times in 2017, banks margins have been stable during the last two years. As of the fourth quarter, the median net interest margin (NIM) for banks was 3.68 percent, unchanged from the prior quarter, although up 4 basis points year over year. Margins may continue to improve in 2018 as rate increases filter through the economy (see the chart).



Asset quality metrics in the fourth quarter showed overall conditions remain benign. Call Report data show that noncurrent loans remain at their low postcrisis levels, with the amount loans 90 days or more past due declining from the prior year. Despite the positive news, risk may be increasing across the community bank industry based on reports of credit concentrations, more reliance on volatile funding sources, and more "out-of-area lending." Given the long period of benign credit quality conditions, regulators are reminding banks of the need to continue to focus on maintaining sound underwriting standards with reasonable risk tolerances, knowing that at some point the credit cycle will turn. Already, delinquency rates for credit cards are pushing upwards. Delinquency rates on consumer credit cards issued by community banks, those outside the top 100 banks, have increased dramatically over the last 18 months, approaching levels seen during the financial crisis (see the chart).



Overall loan growth on a quarterly basis was uneven throughout 2017. However, it strengthened in the fourth quarter. Annualized loan growth for community banks was 3.7 percent, on par with the prior year. Banks have started targeting specific portfolios for growth. Construction loan growth has accelerated and concentration levels have drifted upward, and the median level for all banks is now approaching precrisis levels. Regional banks have been very active in commercial real estate, particularly in multifamily developments. Commercial and industrial loan growth continues to slow despite multiple surveys that show small business owners remain extremely optimistic about the economy and are looking for additional funding (see the chart).



Banks are focusing on liquidity as they plan for additional growth. As interest rates continue to increase, it is expected that more customers will shift from lower-yielding deposits to higher-yielding financial products, especially if banks fail to competitively price their products. According to Call Report data, deposit growth slowed significantly throughout 2017, declining just over 2 percent in the fourth quarter year over year.

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