BANKING & FINANCE

National, Regional Banking Conditions Detailed in Latest "ViewPoint"

June 29, 2018

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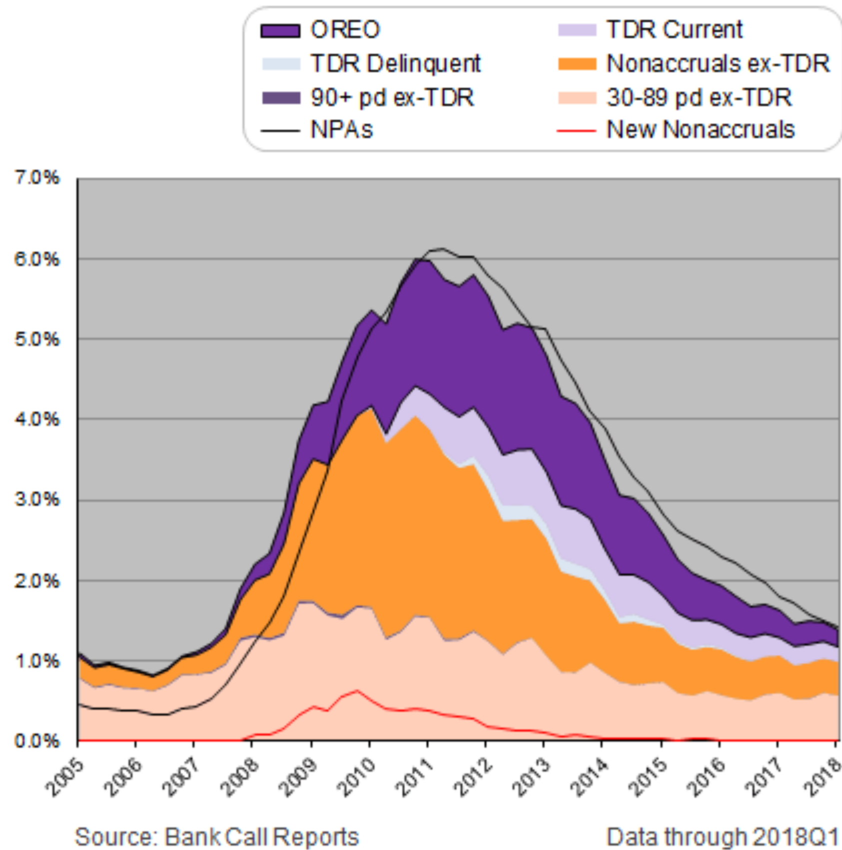
Asset Quality

Despite the length of the recovery and indications of looser underwriting in recent quarters, asset quality remains stable at most community banks in the Sixth District. Chargeoffs as a percentage of loans were at their lowest level in three years. Nonaccrual loans, on a median basis, are below one percent of total loans. Nonaccrual loans that are 90 days or more past due are at a post–financial crisis low. Meanwhile, new nonaccrual loans remain near the historic lows of the last few years. The allowance for loan losses represents 120 percent of nonaccrual loans (see the chart).



The decline in seriously delinquent mortgages appears to have leveled off. A Federal Reserve analysis of the impact of Hurricane Irma shows that aggregate mortgage delinquencies rose sharply following the hurricane. In addition, delinquency data for small business loans in Florida showed an increase in loans 91 days or more past due after the hurricane. The increase in small business delinquencies actually began before the hurricanes hit in September but has declined since the beginning of 2018.

For now, the concern with asset quality may come through indirect exposures. For example, for several years after the financial crisis, auto sales and financing helped drive the growth of consumer loan portfolios. As demand from prime borrowers waned, lenders sought to maintain loan balances by turning to customers with lower credit scores. Unsurprisingly, there are indications that performance on these subprime loans is weakening. According to data reported by Fitch, consumers are defaulting on subprime auto loans at a higher rate than during the financial crisis. Even if banks don't have direct exposure, they may have indirect subprime exposure, through their commercial and industrial portfolio. Many banks are financing the nonbank lenders who provide the majority of subprime financing.

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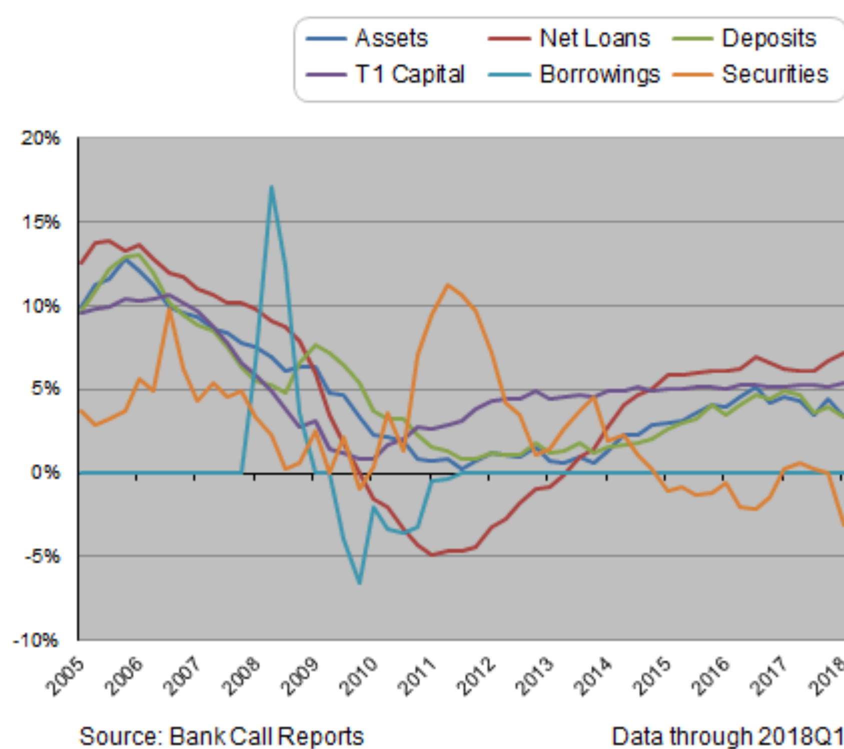
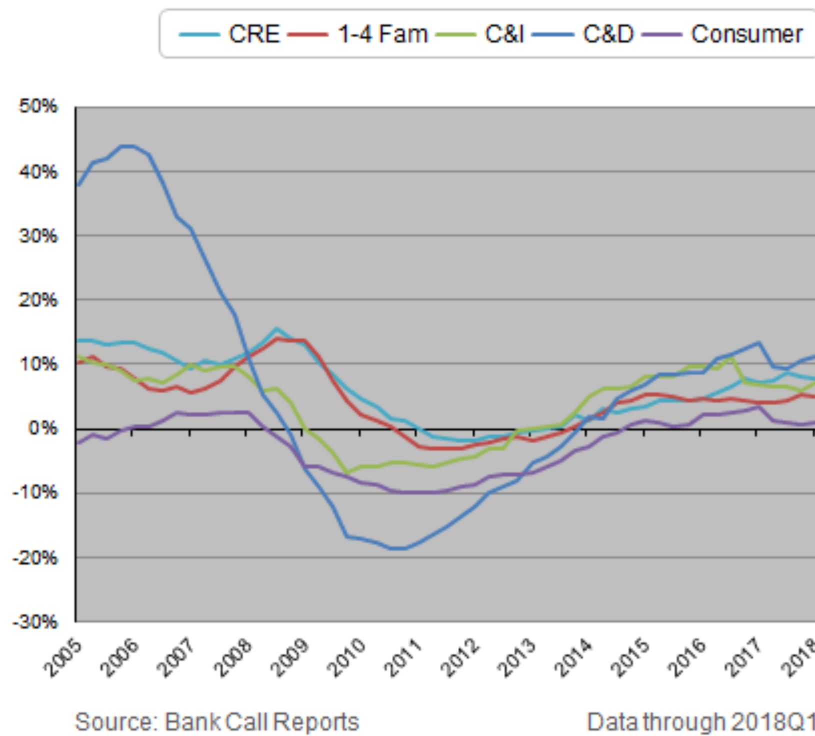
Balance Sheet Growth

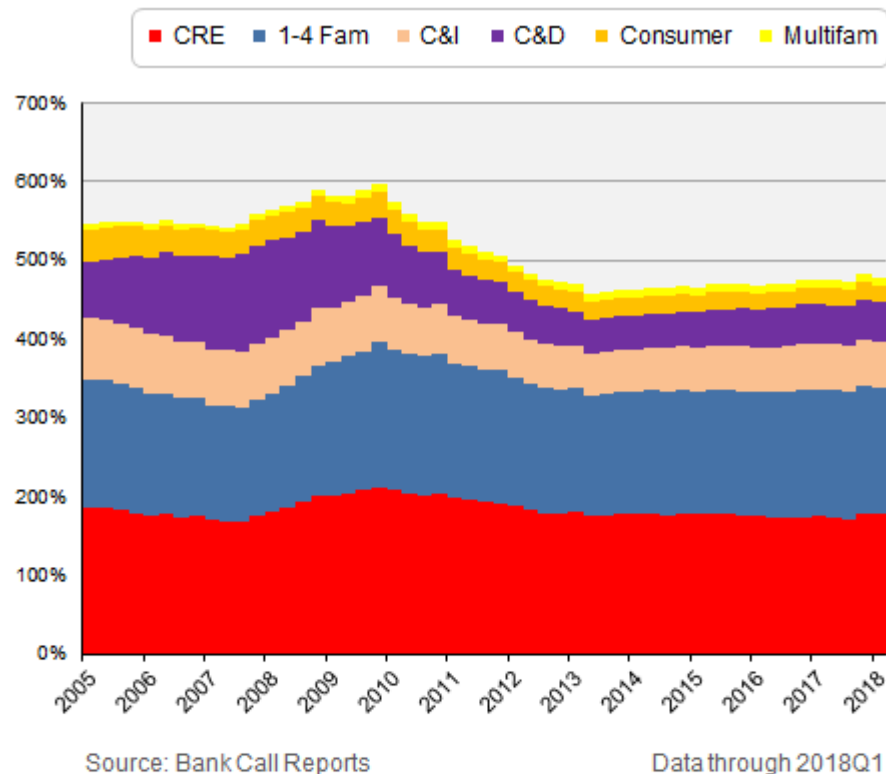
Consistent with national trends, asset growth slowed at community banks in the Sixth District in the first quarter. Median asset growth declined to the lowest level in nearly three years (see the chart).



As interest rates rose, growth in the securities portfolio turned negative during the quarter. Banks are trying to avoid adding lower-yielding securities to their portfolios, knowing that rates are likely to increase through the end of the year. Though growth in the securities portfolio declined, the primary reason for slower asset growth is lower loan growth (see the chart).



Banks in the District still have a heavy concentration in commercial real estate (CRE) loans, though concentration levels remain below the peak of the fourth quarter of 2009 (see the chart).



As interest rates increase, more banks are reporting loosening underwriting standards, particularly in CRE lending. According to the Federal Reserve's April 2018 Senior Loan Officer Opinion Survey, banks indicated their increased risk tolerance for CRE-related lending: was due to more certainty regarding CRE property prices, vacancy rates, other fundamentals, and capitalization rates. The increased risk tolerance could lead to stronger CRE growth in 2018.

According to first quarter call report data, median growth in the 1-4 family portfolio declined slightly from the prior quarter. Higher interest rates and rapidly increasing home prices are affecting mortgage production. Home prices have risen dramatically over the last few years across many markets in the District, especially in Miami. As houses become less affordable, mortgage borrowing becomes difficult, leading lenders to offer alternative financing options, including zero percent down and longer loan terms, which could eventually lead to a correction.

Despite an increase in interest rates and a resulting decline in affordability, decreased mortgage production appears largely due to a lack of inventory at the beginning of the spring selling season. Home building has never returned to precrisis levels, and underwriting for new mortgages remains much tighter than it was before the financial crisis. Builders might be planning to increase production as construction and development (C&D) is one of the few portfolios that experienced an increase in growth in the first quarter. C&D has been a consistent growth portfolio over the last two years, although most of the growth has been for commercial projects rather than residential developments.

Commercial and industrial (C&I) lending growth has remained fairly consistent over the past year. Small business lending appears to be migrating to fintech lenders, although banks remain a primary source. Banks in the western half of the District have more exposure to the oil and gas industry. With the recent increases in oil prices, energy lending is projected to grow. Buying more land, drilling wells, renting equipment, and securing distribution all require additional capital. Banks will begin evaluating borrowing bases in the fall, and it's likely that the value of producers' collateral—the oil—will be worth more, allowing for a larger credit line.

Consumer loan growth remains barely positive. Since many community banks in the District do not have credit card portfolios, personal loans for debt consolidation and auto loans have been the primary drivers of growth. In recent quarters, banks appear to be focusing on customers with better credit quality and are willing to cede overall market share to other lenders, which could be contributing to slower growth. In addition, for auto loans in particular, banks have suggested that concern over declining collateral values is an important reason for tightening standards.

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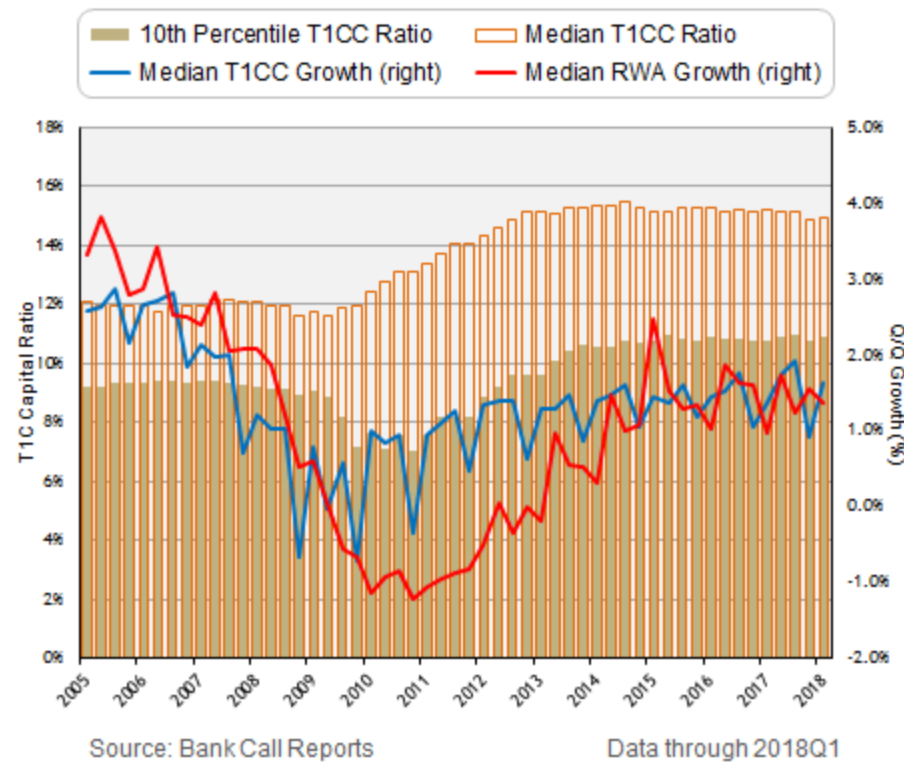
Capital

Increased earnings and slower loan growth are contributing to stable capital levels among community banks in the Sixth District. The median tier 1 common equity ratio remains just below 15 percent, recovering from the decline in the prior quarter which was caused by the one-time recognition of the impact of changes in tax laws (see the chart).



Earnings and business combinations were the primary capital drivers in the first quarter of 2018. Dividend payouts declined slightly from the fourth quarter but were higher than in the first quarter of 2017, reflecting stronger earnings. Risk weighted assets grew moderately in the quarter at 1.3 percent compared with the prior five quarters. Capital amounts could shift over the next few quarters as a result of several rule changes that have either been proposed or finalized. In April, the agencies proposed an option to phase in the regulatory capital effects of the new accounting standard for credit losses, known as the Current Expected Credit Losses (CECL) methodology. The proposal addresses the regulatory capital treatment of credit loss allowances under the CECL methodology and would allow banking organizations to phase in the day-one regulatory capital effects of CECL adoption over three years. Capital may be further impacted given changes required under the Economic Growth, Regulatory Relief, and Consumer Protection Act, which passed in May.

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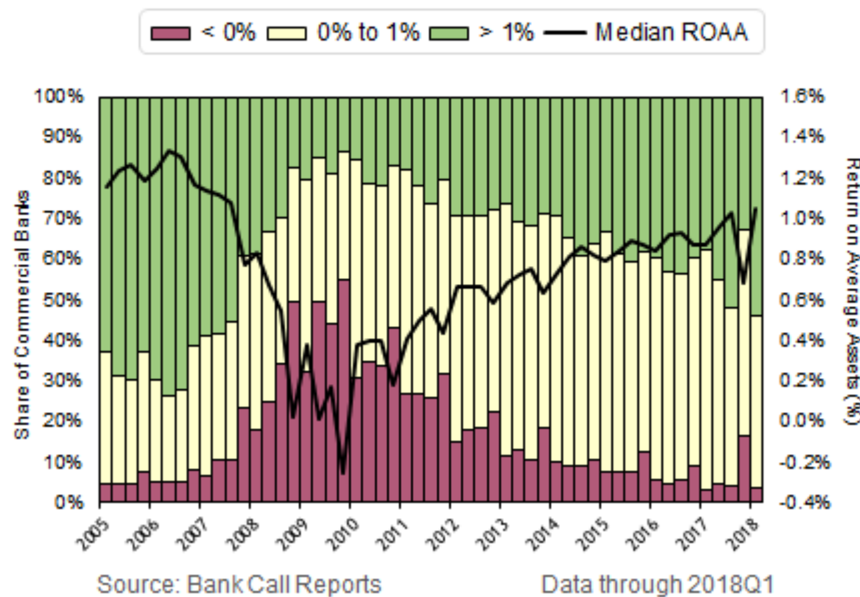
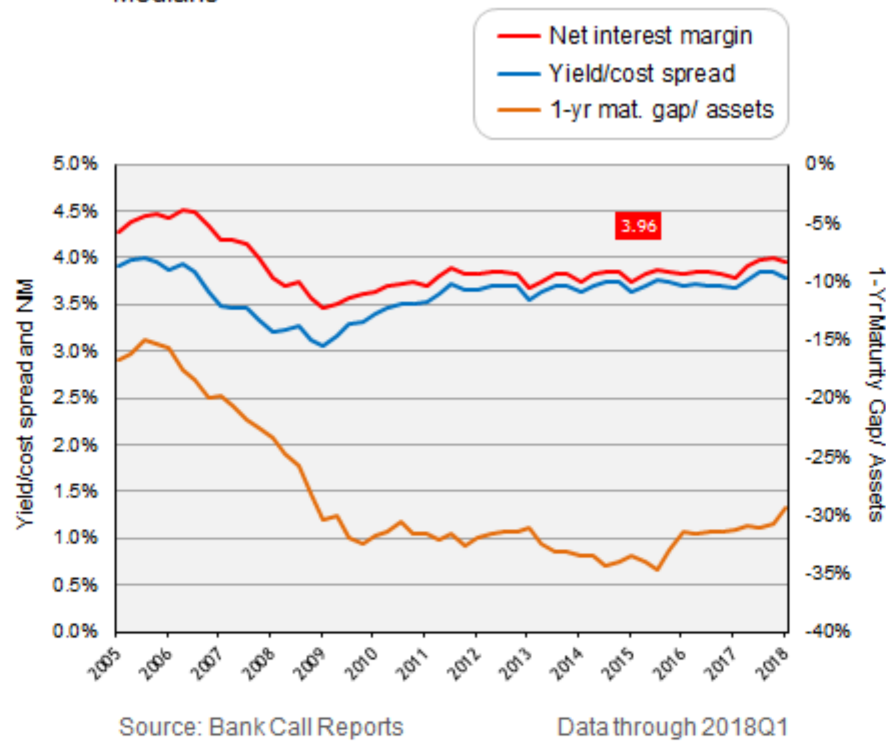
Earnings Performance

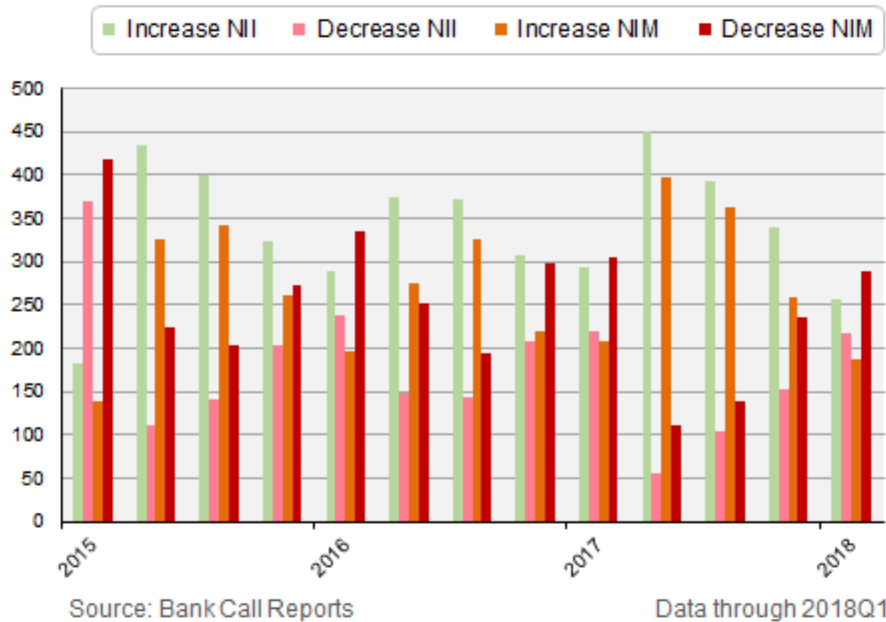
Banks have waited for years for interest rates to normalize. The wait is starting to pay off as recent increases in rates have boosted earnings for many banks in the Southeast. On a median basis, ROAA is 1.05 percent at community banks in the Sixth District as of the first quarter of 2018 (see the chart).



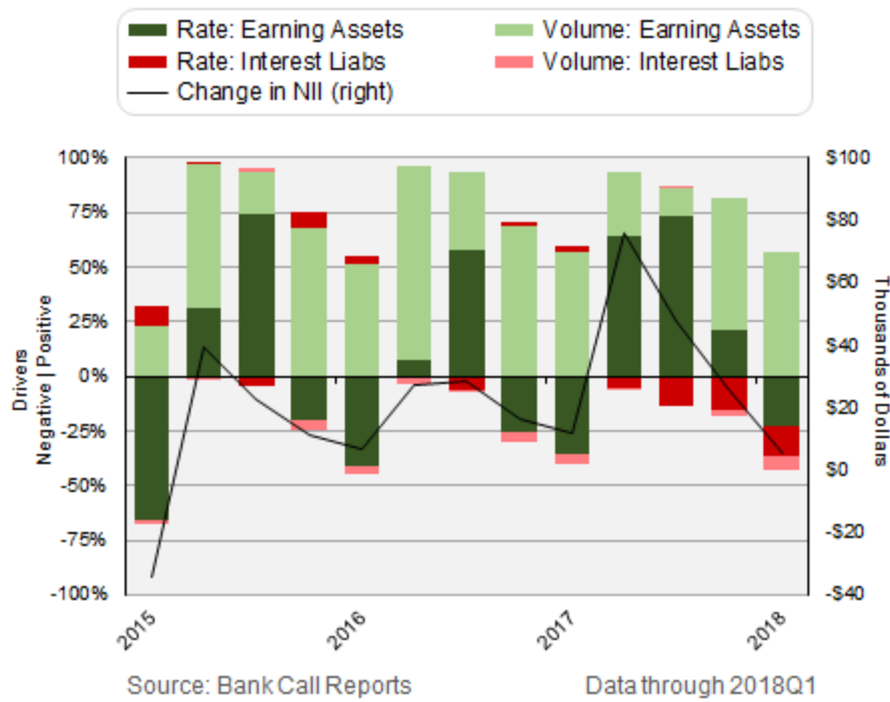
ROAA has been above 1 percent, on an aggregate basis, in four out of the last five quarters. Just under 4 percent of banks in the District are still losing money. The increase in the net interest margin is the primary driver of the improved earnings. The median net interest margin (NIM) is 3.96 percent, roughly 22 bp higher year over year (see the chart).



The aggregate net interest margin has not been above 4 percent since the third quarter of 2007, and, in the depths of the financial crisis, dropped to just above 3 percent. Loan growth and higher interest rates have fueled the margin improvement. Interest expense remains near historic lows but community banks are under pressure to increase deposit rates to remain competitive with large banks who are raising their rates to attract more deposits as a result of liquidity coverage ratio (LCR) requirements (see the chart).



Community banks are also increasing their reliance on borrowed funds to meet continued loan growth. Additional rate increases in 2018 should further improve the NIM. However, recent surveys indicate that loan growth may slow with the higher rates, at least in the short-term, which could stall the increase in NIM over the next few quarters. Despite overall improvement, more banks experienced a decrease in their NIM than an increase according to first quarter call report data, consistent with performance in the first quarter of 2017 (see the chart).



In the midst of the financial crisis and early in the recovery, bank managements discussed the need to improve their noninterest income. However, the increase in the margin has reduced the reliance on noninterest revenue to drive earnings growth. Although community banks would like to diversify revenue streams not tied to the earning asset portfolio, few banks have found ways to increase fees in the current operating environment. Provision expense remains low compared to historical levels due to stable asset quality. Banks continue to prepare for the implementation of the Current Expected Credit Loss (CECL) standard, which will occur in 2020 or 2021. However, using the current methodology, banks have not identified any factors that would dramatically increase provisions. Overhead expenses have crept up slightly as revenue has improved. The efficiency ratio for community banks has remained basically unchanged over the last five quarters and has not changed significantly since mid-2016.

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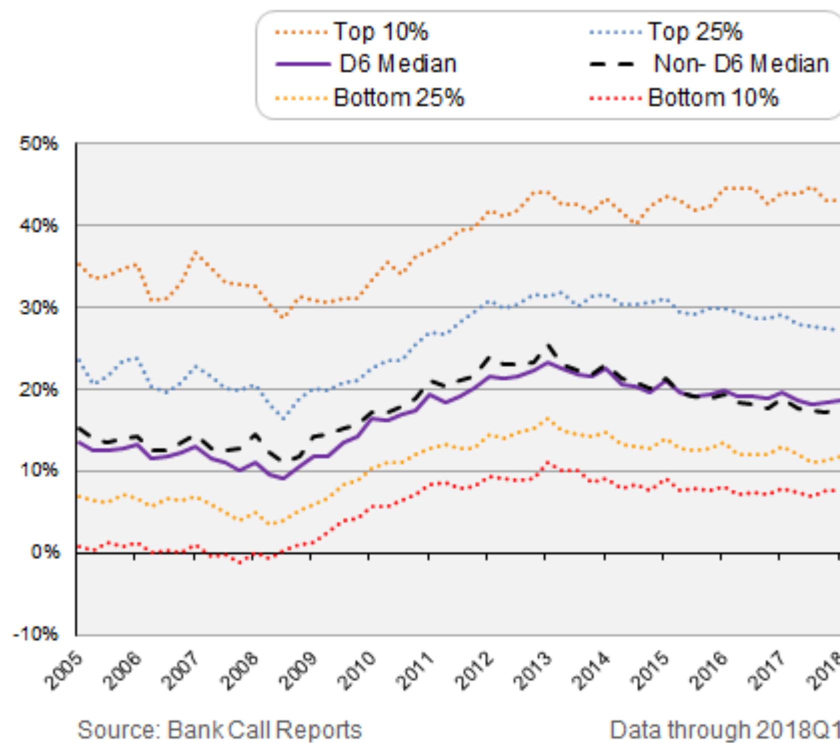
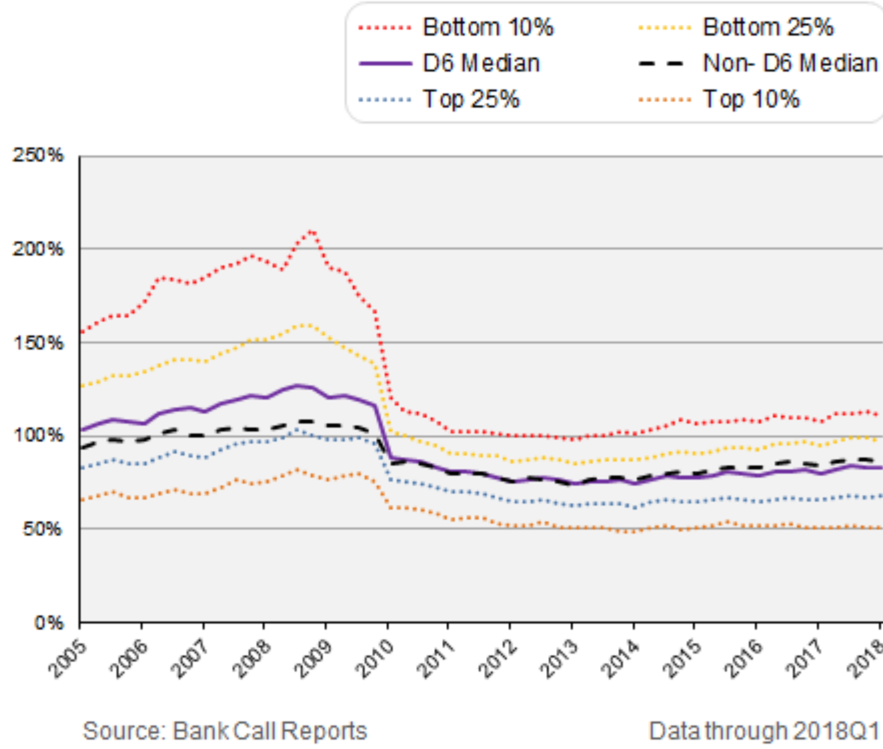
Liquidity

Leading up to the financial crisis, banks relied heavily on borrowings and noncore funding to fuel loan growth. Following the crisis, deposits exceeded loans, which reduced the need for borrowing. The recent sustained increase in interest rates has made maintaining a low-cost funding base a priority once again (see the chart).



As interest rates continue to rise, customers will likely begin to shift their deposits to higher-yielding financial products. Going into the first quarter of 2018, data for Sixth District banks shows growth in borrowings now exceeding growth in deposits on median basis However, the loan-to-deposit ratio remains below 100 percent and has been stable over the last four quarters at 86 percent (see the chart).



Nonmaturity deposits are the primary funding source for loan growth for roughly half of the banks in the district. Since the fed funds rate has risen, the deposit mix has shifted very little, and nonmaturity deposits are actually still growing. Median liquidity on hand, as a percentage of total liabilities, was 18.6 percent for the quarter, a slight increase from the prior quarter. In the future, if lending picks up, banks may start to consider merging with other institutions to increase their deposit base.

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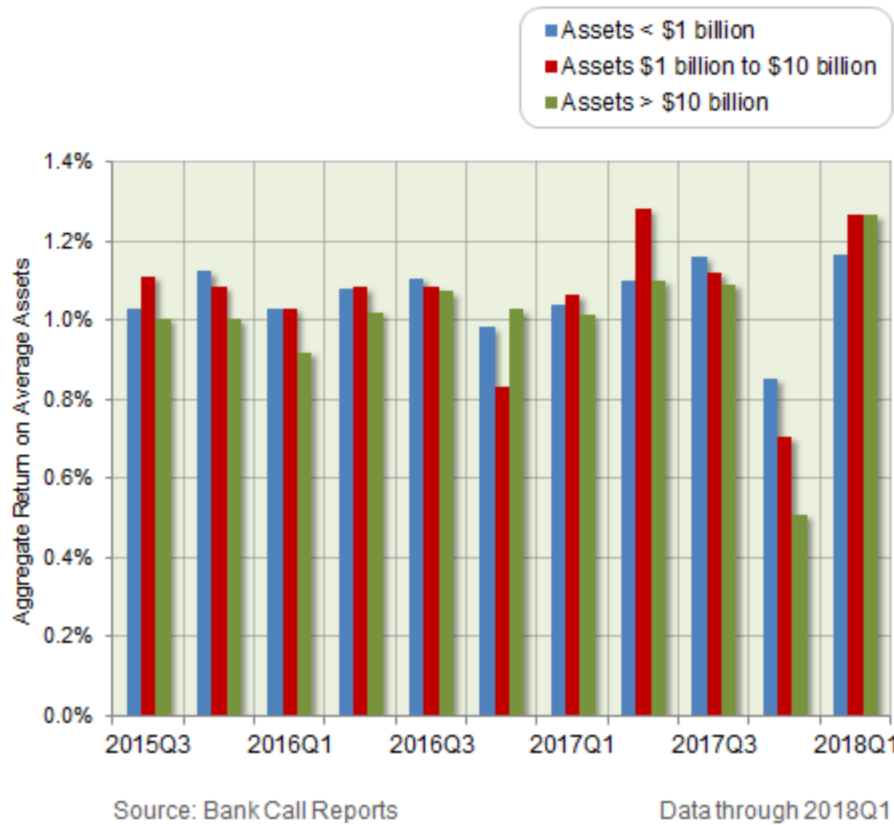
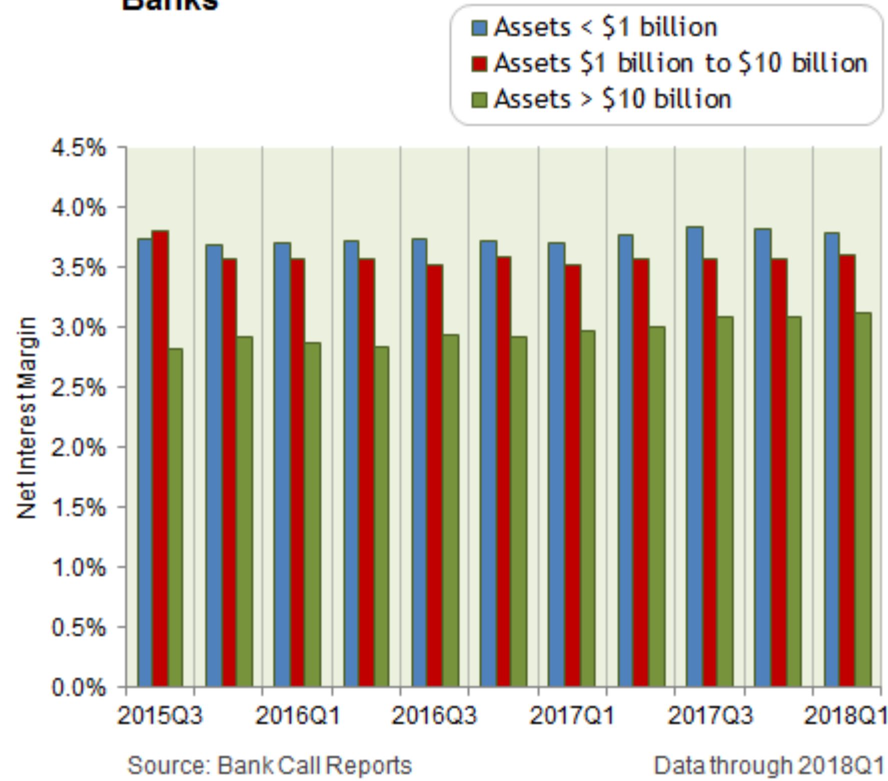
National Banking Trends

Following the dip in in the fourth quarter due to the changes in tax law, earnings normalized in first quarter of 2018. Aggregate return on average assets (ROAA) across all banks is 1.26 percent, the highest in 11 years (see the chart).

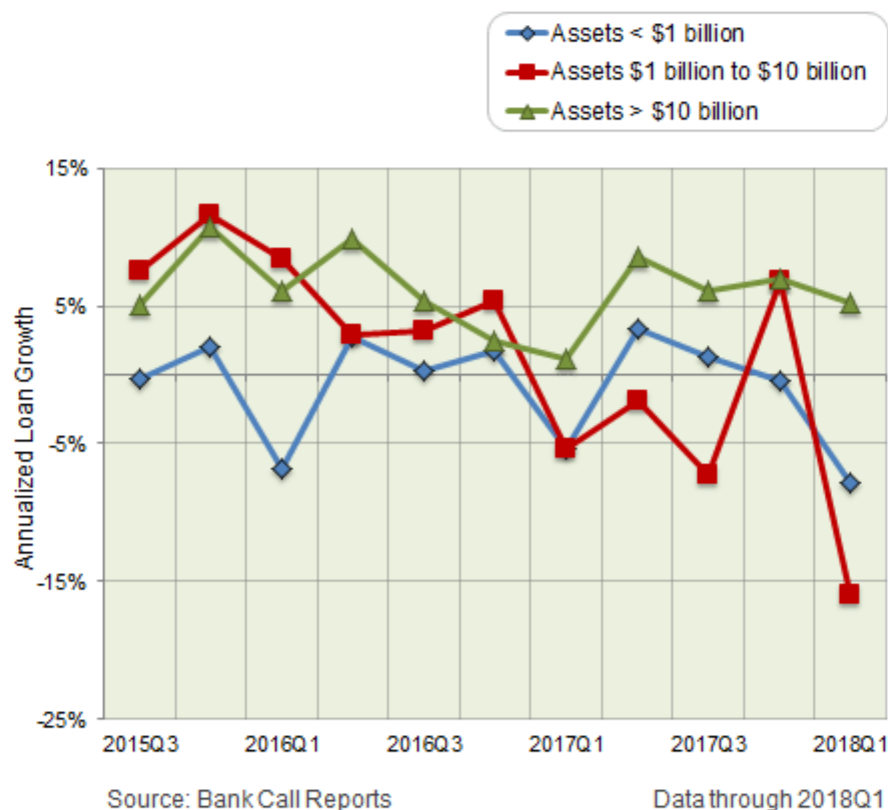


The percentage of banks losing money dropped below 4 percent again, matching the same level as third quarter 2017. The net interest margin continues to improve, increasing 13 basis points (bp) year over year to reach 3.20 percent (see the chart).



Provision expense remains near historic lows and currently represents 43 bp of total average loans, 2 bp lower than the prior year. The overall improvement in revenues pushed the efficiency ratio slightly lower across all banks, although the ratio remains well above 60 percent for banks with assets below $10 billion.

Annualized asset growth slowed significantly in the first quarter for small and large sized banks. Growth was 0.32 percent year over year. Large bank growth remains positive but declined from the prior period. The dip in growth is consistent with the first quarter of 2016 and 2017 (see the chart).



Community banks report that customers are more reluctant to request new loans as interest rates rise. However, regional banks with assets between $10 billion and $50 billion have experienced consistent loan growth of over 5% over the past 4 quarters, exceeding other sectors. Across banks of all sizes, the ratio of total loans to total deposit remains around 80 percent, as it has over the last 10 quarters.

Overall asset quality metrics continued to improve in the first quarter as nonaccrual loans and other real estate owned (OREO) dropped to 0.75 percent of total average loans plus OREO. Call report data show that nonaccrual loans have negative growth over the last 10 quarters. Asset quality conditions are benign. Despite the positive news, consumer debt delinquencies remain a concern as interest rates rise, increasing overall payments. At the same time, the Federal Reserve's last report on consumer debt suggests that although aggregate household cash flow has improved significantly since the great recession, it has recently started to decline slightly. The April 2018 Senior Loan Officer Opinion Survey also showed that a large fraction of banks have eased commercial real estate (CRE) credit policies as a result of the aggressive competition from other lenders. A significant percentage of the banks responding also mentioned their increased tolerance for risk on CRE-related lending. Regulators continue to remind banks of the need to conscientiously focus on maintaining sound underwriting and limiting concentrations.

The Federal Reserve raised rates in late March, and media pundits speculate that there will be two more increases in 2018. There is an increasing concern about the impact on deposits and liquidity at banks as rates rise. Banks, especially community banks, may start to rely too much on borrowing to fund additional loan growth because they can't retain or grow their deposit

base. A recent analysis by S&P Global Market Intelligence showed that deposit costs increased for the largest banks in the prior quarter as depositors started to shift into higher-yielding accounts. Large banks have started raising rates on deposits, these actions will likely filter down to community banks in the next few quarters.

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