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Regional—"Regional Growth Decelerates in Oil-Dependent Areas"

National—"Job Gains Remain Strong, Inflation Improves"

International—"Uncertainty Still Hangs Over the Global Economy"

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Community Banking Connections

Dallas Beige Book
March 2, 2016, Summary

Economic Letter
"Emerging-Market Debtor Nations Likely to Follow Fed Rate Boosts"

Southwest Economy
"Texas Health Coverage Lags as Medicaid Expands in U.S."

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Bank Performance Stable but Headwinds Mounting

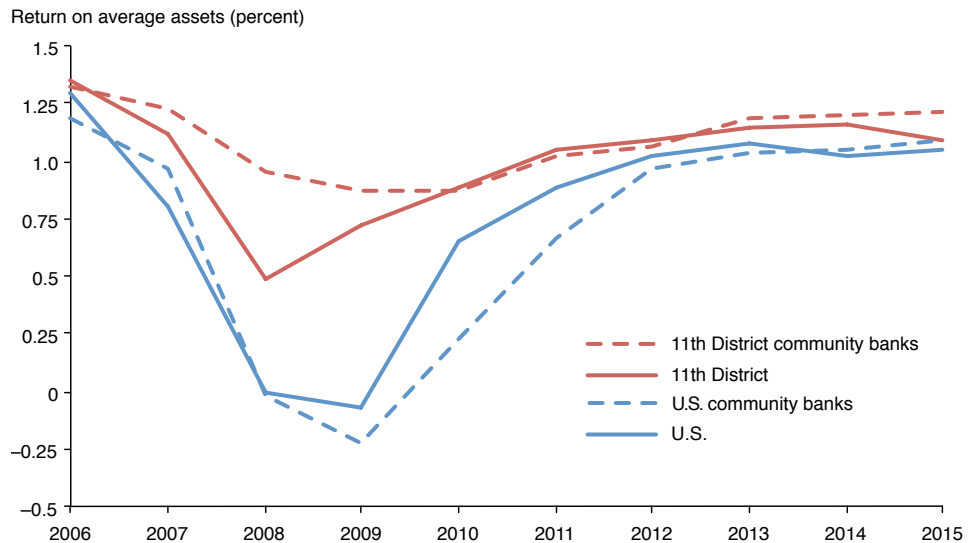
by Kelly Klemme

Bank performance, both nationwide and in the Federal Reserve's Eleventh District, has stabilized.¹ Data for 2015 show steady profits and continued loan growth. While overall asset quality improved nationwide, energy sector troubles are starting to affect commercial and industrial loan quality, particularly among larger Eleventh District institutions. There is also concern over banks' rising exposure to commercial real estate.

Stable Profits but Provision Expense Trending Up

Banks in the Eleventh District continued to outperform their national counterparts in 2015, although the gap has narrowed (*Chart 1*). Eleventh District banks earned a return on average assets (ROAA) of 1.09 percent in 2015, down from 1.16 percent in 2014 but still higher than the 1.05 percent for banks nationwide.² While overall profitability for district banks fell last year, community bank profitability remained strong. Eleventh District banks with assets less than \$10 billion earned an ROAA of 1.21 percent in 2015, roughly even with their return for 2014 and above the 1.09 percent ROAA earned by community banks nationwide.

Chart 1 Banks' Profitability Stable



NOTE: Community banks are banks with assets less than \$10 billion.

SOURCE: Quarterly "Reports of Condition and Income," Federal Financial Institutions Examination Council.

From 2009 to 2014, declines in provision expense boosted profitability as improved asset quality allowed for a reduction in loan loss reserves. This trend reversed in 2015, as four years of strong loan growth, together with concerns over energy-related credits, prompted banks to begin raising loan loss reserves. Provision expense was 0.27 percent of average assets for Eleventh District banks in 2015, eight basis points higher than 2014; similar figures for U.S. banks show an increase of three basis points to 0.23 percent for 2015. Moreover, half of all Eleventh District

CALENDAR OF EVENTS

April 5
Laredo Banker Roundtable
Laredo, Texas

April 11
Dialogue with the Dallas Fed Community Event
Ruston, Louisiana

April 19
Dallas Credit Union Roundtable
Dallas, Texas

April 21
San Angelo Banker Roundtable
San Angelo, Texas

May 10
Lubbock Banker Roundtable
Lubbock, Texas

May 17
Dialogue with the Dallas Fed Community Event
Midland, Texas

May 24
Corpus Christi Banker Roundtable
Corpus Christi, Texas

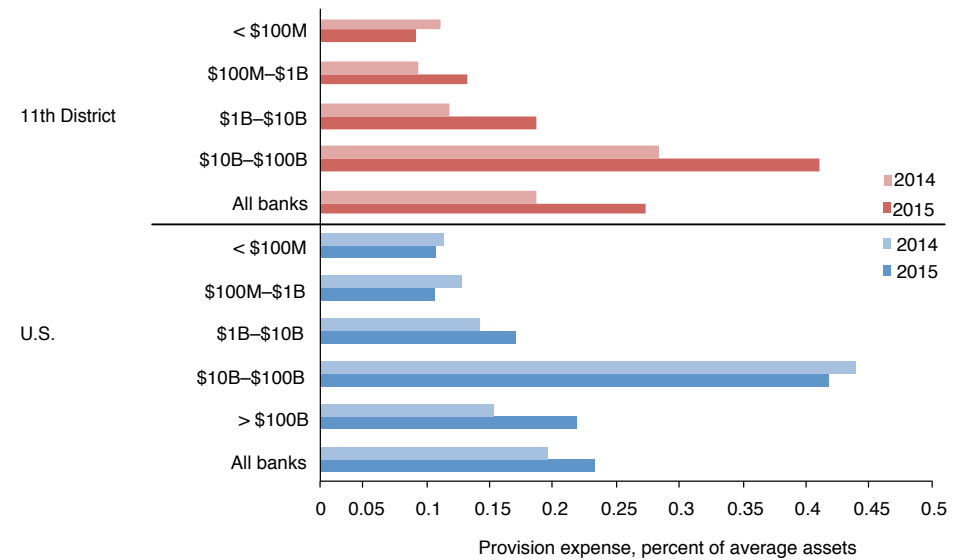
June 2
Frisco Banker Roundtable
Frisco, Texas

June 7
Stephenville Banker Roundtable
Stephenville, Texas

For more information about these events, email FIRM at Dallas_Fed_Firm@dal.frb.org.

institutions and 43 percent of those nationwide increased provision expense in 2015, compared with 42 percent and 37 percent, respectively, in 2014. A more detailed breakdown of the 2015 rise in provision expense by bank asset size shows that the biggest increases have occurred among the largest banks—those with assets greater than \$10 billion in the Eleventh District and those with assets more than \$100 billion nationwide (*Chart 2*).

Chart 2 Provision Expense Growth Driven by Larger Banks



SOURCE: Quarterly "Reports of Condition and Income," Federal Financial Institutions Examination Council.

Overall Asset Quality Solid but Signs of Trouble for Commercial and Industrial Loans

The uptick in provision expense parallels an increase in net losses on commercial and industrial (C&I) loans, particularly among Eleventh District banks. District institutions reported net C&I loan charge-offs of \$250 million in 2015—\$150 million higher than 2014. District banks with assets greater than \$10 billion accounted for two-thirds of this increase. While bank call reports do not provide specific data on energy lending or energy-related reserves, the increases in both provision expense and C&I loan losses are consistent with information from recent regulatory filings and investor conference calls, indicating further increases in energy-related reserves.³

Eleventh District institutions also reported an increase in the percent of loans that are noncurrent—past due 90 days or more or on nonaccrual status. At year-end 2015, 0.93 percent of loans were noncurrent at district banks, up from 0.85 percent at year-end 2014 and above a 2006 precrisis low of 0.54 percent (*Chart 3*). U.S. banks reported a noncurrent loan rate of 1.53 percent at year-end 2015, down from 1.91 percent at year-end 2014 but still high compared with a precrisis low of 0.78 percent.

For Eleventh District banks, the dollar amount of noncurrent real estate loans—both residential and commercial—declined in 2015, while noncurrent consumer loans registered a slight increase, and noncurrent C&I loans, which have been rising since first quarter 2014, continued to grow. As of year-end 2015, 32 percent of Eleventh District banks' noncurrent loans were C&I loans, up from 19 percent in 2014 and 13 percent in 2013. C&I loans now are the largest single component of noncurrent loans at Eleventh District banks, surpassing both residential real estate and commercial real estate for the first time since 2005. Eleventh District banks with assets greater than \$10 billion, many of which have relatively high energy lending exposure, accounted for almost three-fourths of the 2015 increase in noncurrent C&I loans. Noncurrent C&I loans are also up at banks nationwide, increasing from 5 percent of total noncurrent loans in 2014 to 11 percent of noncurrent loans in 2015. Similar to the Eleventh District, the growth has been driven by the largest banks; U.S. banks with assets more than \$100 billion

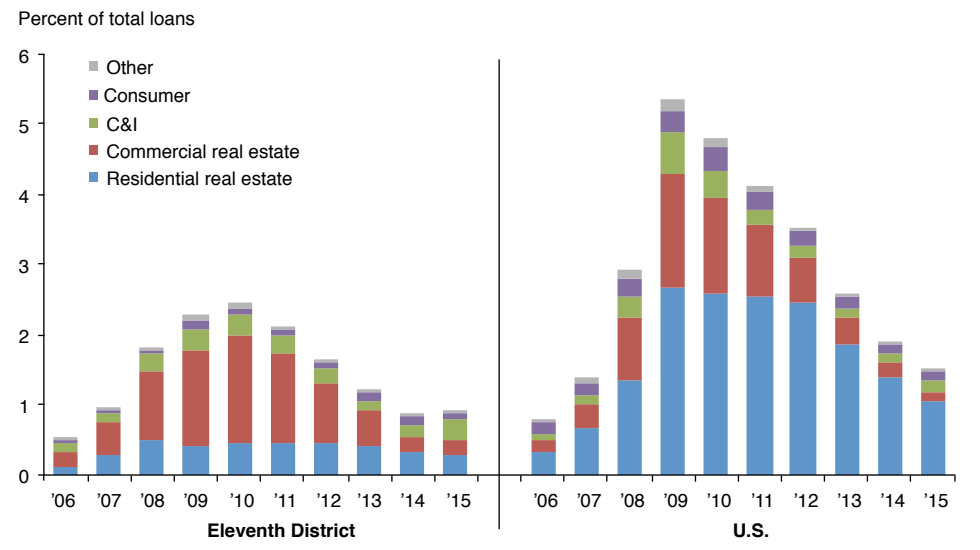
ABOUT FINANCIAL INSIGHTS AND FIRM

Financial Insights is published periodically by FIRM—Financial Institution Relationship Management—to share timely economic topics of interest to financial institutions. The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

FIRM was organized in 2007 by the Federal Reserve Bank of Dallas as an outreach function to maintain mutually beneficial relationships with all financial institutions throughout the Eleventh Federal Reserve District. FIRM's primary purpose is to improve information sharing with district financial institutions so that the Dallas Fed is better able to accomplish its mission. FIRM also maintains the Dallas Fed's institutional knowledge of payments, engaging with the industry to understand market dynamics and advances in payment processing.

FIRM outreach includes hosting economic roundtable briefings, moderating CEO forums hosted by Dallas Fed senior management, leading the Dallas Fed's Community Depository Institutions Advisory Council and Corporate Payments Council, as well as creating relevant webcast presentations and this publication. In addition, the group supports its constituents by remaining active with financial trade associations and through individual meetings with financial institutions.

Chart 3 Noncurrent Loans Up at Eleventh District Banks



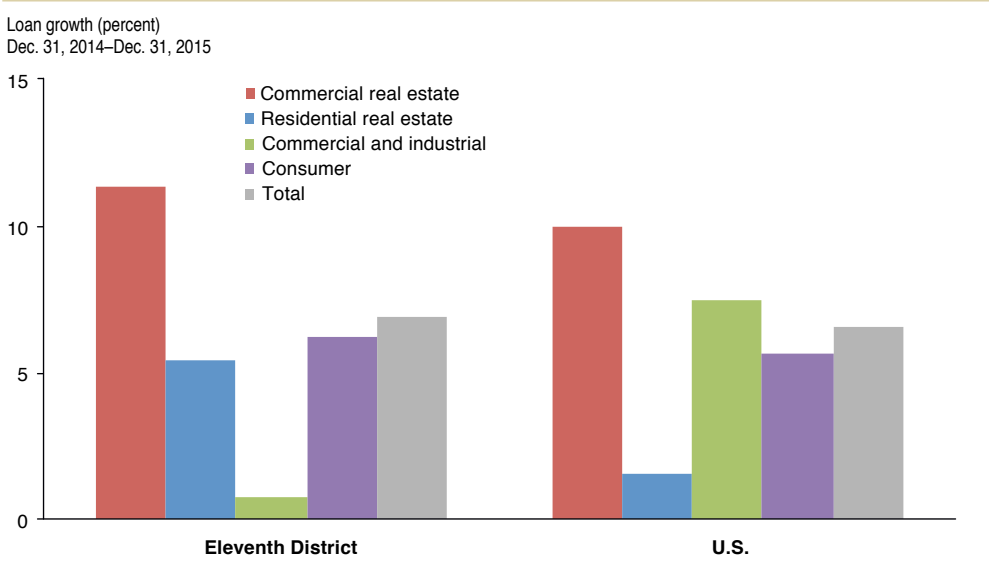
NOTES: Residential real estate loans are loans secured by 1- to 4-family residential property. Commercial real estate loans are loans for construction and land development, loans secured by multifamily property and loans secured by nonfarm nonresidential property.
 SOURCE: Quarterly "Reports of Condition and Income," Federal Financial Institutions Examination Council.

accounted for more than 70 percent of the 2015 increase in noncurrent C&I loans. Information from the most recent Shared National Credit Review specifically noted an increase in classified commitments among oil and gas borrowers.⁴

Loan Growth Continues but Commercial Real Estate Gains Spark Concern

Loan growth rebounded in 2011 and continued through 2015, with growth among Eleventh District institutions just outpacing nationwide figures. Total loans outstanding at Eleventh District banks expanded 6.9 percent in 2015, compared with 6.5 percent for all banks nationwide (Chart 4). Commercial real estate (CRE) loans—loans for construction and land development, loans secured by multifamily property and loans secured by nonfarm

Chart 4 Commercial Real Estate Lending Strong in 2015



NOTES: Commercial real estate loans are loans for construction and land development, loans secured by multifamily property and loans secured by non-farm nonresidential property. Residential real estate loans are loans secured by 1- to 4-family residential property.
 SOURCE: Quarterly "Reports of Condition and Income," Federal Financial Institutions Examination Council.

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nonresidential real estate—were the biggest driver of overall lending. Year-over-year growth in CRE loans was 11.3 percent among Eleventh District banks and 10.0 percent for banks nationwide. Strong CRE growth has heightened concerns over CRE loan concentration, prompting regulators to issue a December 2015 statement reinforcing prudent risk management practices for CRE lending.⁵

Outlook

Data for 2015 show stable profits and solid loan growth. Banks in the Eleventh District continued to outperform their national counterparts, although the gap narrowed. Troubles in the energy sector are beginning to affect provision expense and C&I loan quality measures, especially at larger banks in the Eleventh District—a trend that is expected to continue through the first half of 2016. Moreover, strong growth in CRE lending has heightened concerns over loan concentration in that sector.

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NOTES

- ¹ The Eleventh Federal Reserve District consists of Texas, northern Louisiana and southern New Mexico.
- ² Data used in this article were obtained from the Federal Financial Institutions Examination Council "Reports of Condition and Income." Data for the Eleventh District banking industry have been adjusted for structural changes involving recent relocations of banks into or out of the district.
- ³ "Comerica Warns of Possible Energy Reserve Build in Q1," by Nathan Stovall, SNL Financial, Feb. 29, 2016; "Regions' Energy Disclosure Amplifies Market Worry," by Kevin Dobbs, SNL Financial, Feb. 24, 2016.
- ⁴ "Shared National Credits Review Notes High Credit Risk and Weaknesses Related to Leveraged Lending and Oil and Gas," joint press release, Board of Governors of the Federal Reserve System, www.federalreserve.gov/newsevents/press/bcreg/20151105a.htm, Federal Deposit Insurance Corp. and Office of the Comptroller of the Currency, Nov 5, 2015. The Shared National Credit (SNC) program covers any loan or loan commitment of at least \$20 million that is shared by three or more supervised institutions. For more information on the SNC program, see www.federalreserve.gov/bankinfo/snc.htm.
- ⁵ "Statement on Prudent Risk Management Practices for Commercial Real Estate Lending," joint press release, Board of Governors of the Federal Reserve System, www.federalreserve.gov/newsevents/press/bcreg/bcreg20151218a1.pdf, Federal Deposit Insurance Corp. and Office of the Comptroller of the Currency, Dec. 18, 2015.

Noteworthy Items

Federal Reserve Vice Chairman Stanley Fischer speaks at the "Energy Transition: Strategies for a New World," 35th Annual IHS CERA Week in Houston, Texas, about recent monetary policy developments (Feb. 23, 2016)

Vice Chairman Fischer indicates that it is still too early to clearly assess how financial market volatility is impacting the U.S. economy. He suggests that if the volatility leads to the tightening of financial conditions, then there could be a slowdown in the global economy, which could have serious implications on growth and inflation in the United States. He also mentions that growth is forecasted to uptick in first quarter 2016 and that wage growth has been looking strong nationally.

Federal Reserve Bank of Dallas President and CEO Rob Kaplan speaks at the University of Texas Investment Management Company 20th Anniversary Event in Austin, Texas, discussing economic conditions and implications for monetary policy (March 3, 2016)

President Kaplan says that even though excessive accommodation carries a cost in terms of distortions and imbalances in hiring, asset allocation and investment decisions, he believes the Fed needs to show patience in decisions to remove accommodation. He claims this is particularly important in light of recent developments relating to slowing global economic growth and tightening financial conditions.

Federal Reserve Governor Lael Brainard speaks at the Institute of International Bankers Annual Washington Conference in Washington, D.C., discussing taking stock of economic and financial developments (March 7, 2016)

Governor Brainard indicates some signs of improvements in the performance of the economy and inflation. Overall, she gave a cautious view of the outlook, saying that the Fed needs to make sure that a tightening labor market will move inflation back to the inflation target. She also voiced concern over the increase in high-yield corporate bond spreads, saying it could be a sign of liquidity problems in financial markets.

Federal Reserve releases Federal Open Market Committee Statement (March 16, 2016)

Did You Know?

The Federal Reserve is self-supporting and receives no government funding.