



# Third District Banking Conditions as of March 31, 2015

PREPARED BY THE **RISK ANALYTICS & SURVEILLANCE UNIT**  
SUPERVISION, REGULATION & CREDIT

**FEDERAL RESERVE BANK OF PHILADELPHIA**

# Third District Conditions



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# Executive Summary



- Third District bank earnings performance continues to recover as return on average assets (ROA) stabilizes; however, sustainable earnings challenges remain because of little change in the net interest margin (NIM).
- National asset quality metrics continue to depict improvement; however, the zero or negative provision expense reported over the past few quarters that had helped to contribute to return on average assets (ROA) may not be maintainable. At some point, banks will need to increase provision expense that could negatively impact earnings.
- Although reporting continued improvement, the Third District's noncurrent and nonperforming loans continue to lag the nation.
- Capital ratios are increasing as a result of positive earnings and a decline in risk weighted assets (RWA); however, this may change with the new Basel III RWA policy increases on certain loan categories.
- Third District banks' reliance on noncore funding sources continues to outpace the industry in support of balance sheet growth.
- Interest rate risk is still on the horizon: Have banks composed their balance sheets to withstand the potential rise in interest rates?
- Problem banks continue to decline because of improved economic indicators and stronger balance sheet management
- Qualitative and/or operational risks that remain on the risk radar include
  - Cybersecurity
  - Third-party vendor management (including multiregional data processing servicers (MDPS))
  - Management succession planning and the underlying "war for talent"



## Section 2

# Banking Conditions of Third District Commercial Banks

The quarterly **Reports of Condition and Income (Call Report)** and **Uniform Bank Performance Report (UBPR)** are the primary sources of all information contained in this report unless otherwise footnoted.

Slides in this section focus on trends among the **118 commercial banks** within the Third District and national or nonmember commercial banks (CBs) that do not meet at least one of the following criteria as of **March 31, 2015**:

- Institutions with total assets > \$10 billion
- Credit card banks (credit card loans and receivables > 50% net loans and credit card receivables)
- Trust banks (income from fiduciary activities > 30% of interest + noninterest income)
- Banks with loans to depository institutions > 30% of net loans

**All Third District state member banks (SMBs) are included in Third District calculations.**

The **Nation** consists of all SMBs within the nation, regardless of asset size, and all national and nonmember banks with aggregate assets less than \$10 billion.

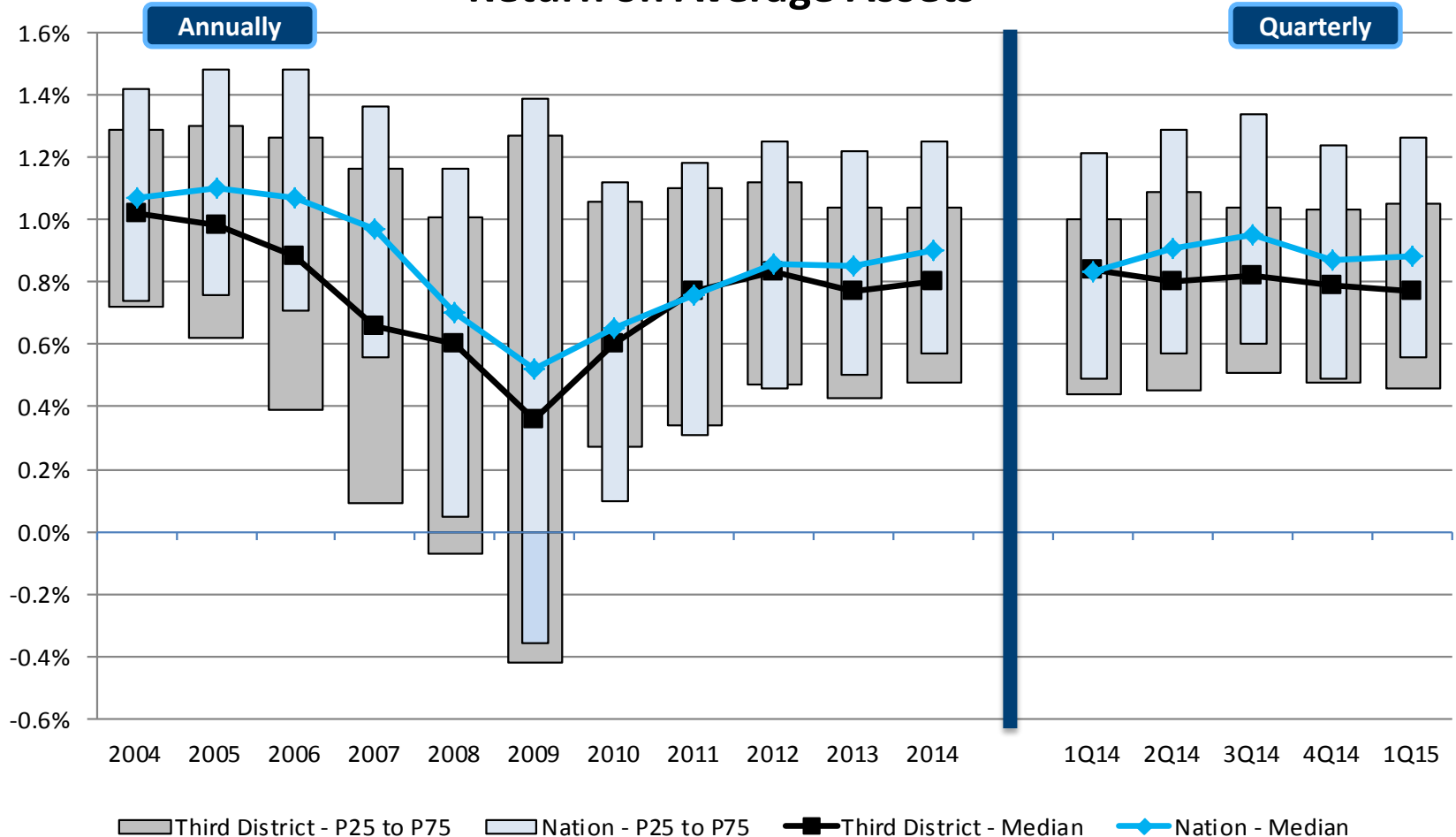
This report utilizes the **median, the 25th, and the 75th percentiles** to compare the Third District and national ratios.

- The line graphs represent the median for the district and the nation, whereas the bar graphs represent the range of results from the 25th through the 75th percentiles for the data included in each of the graphs.

# Third District earnings performance consistently lags the nation; however, the gap has closed in recent quarters.



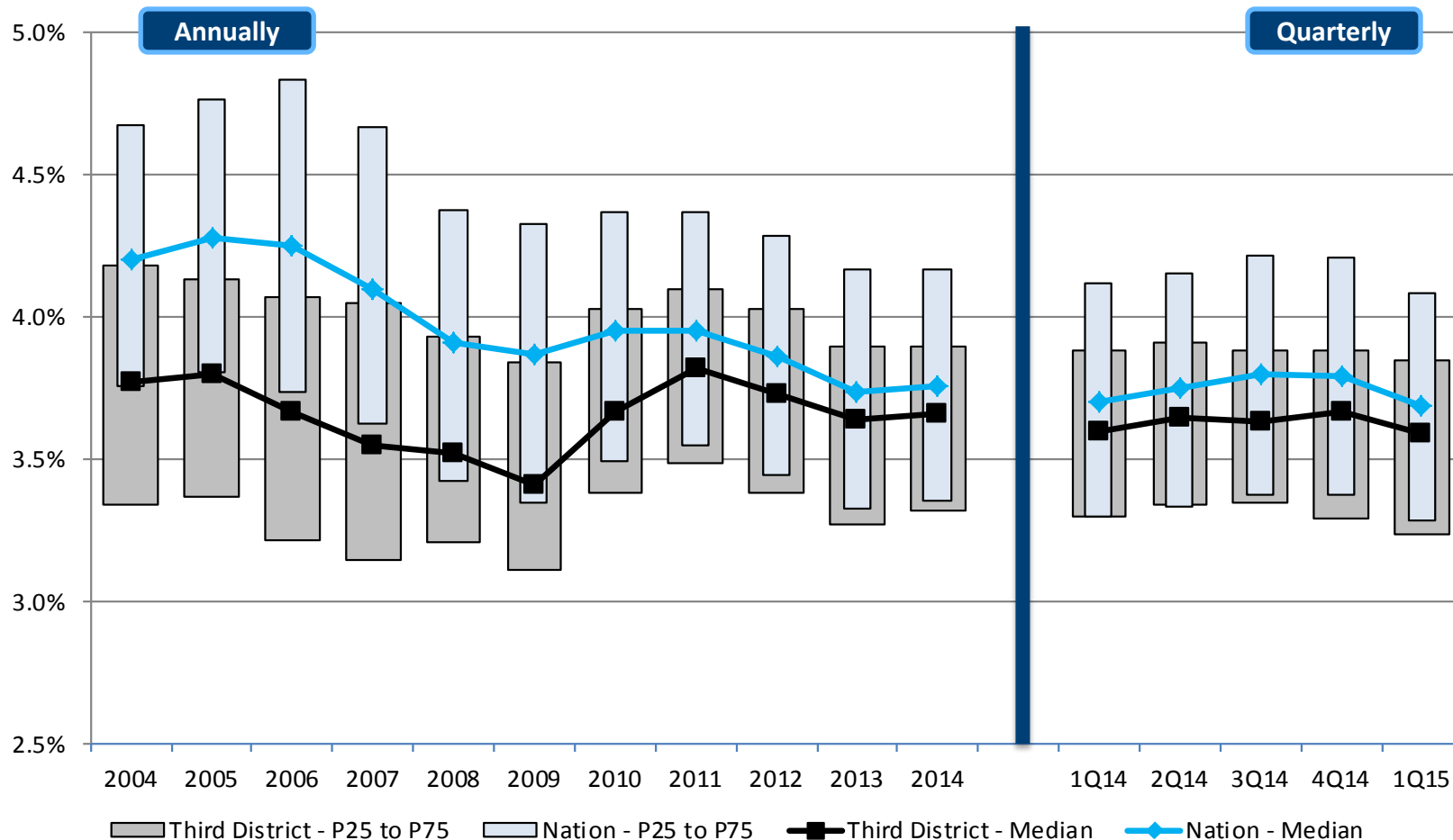
## Return on Average Assets



NIM continues to stabilize and is returning to precrisis levels; however, the Third District remains below the nation.



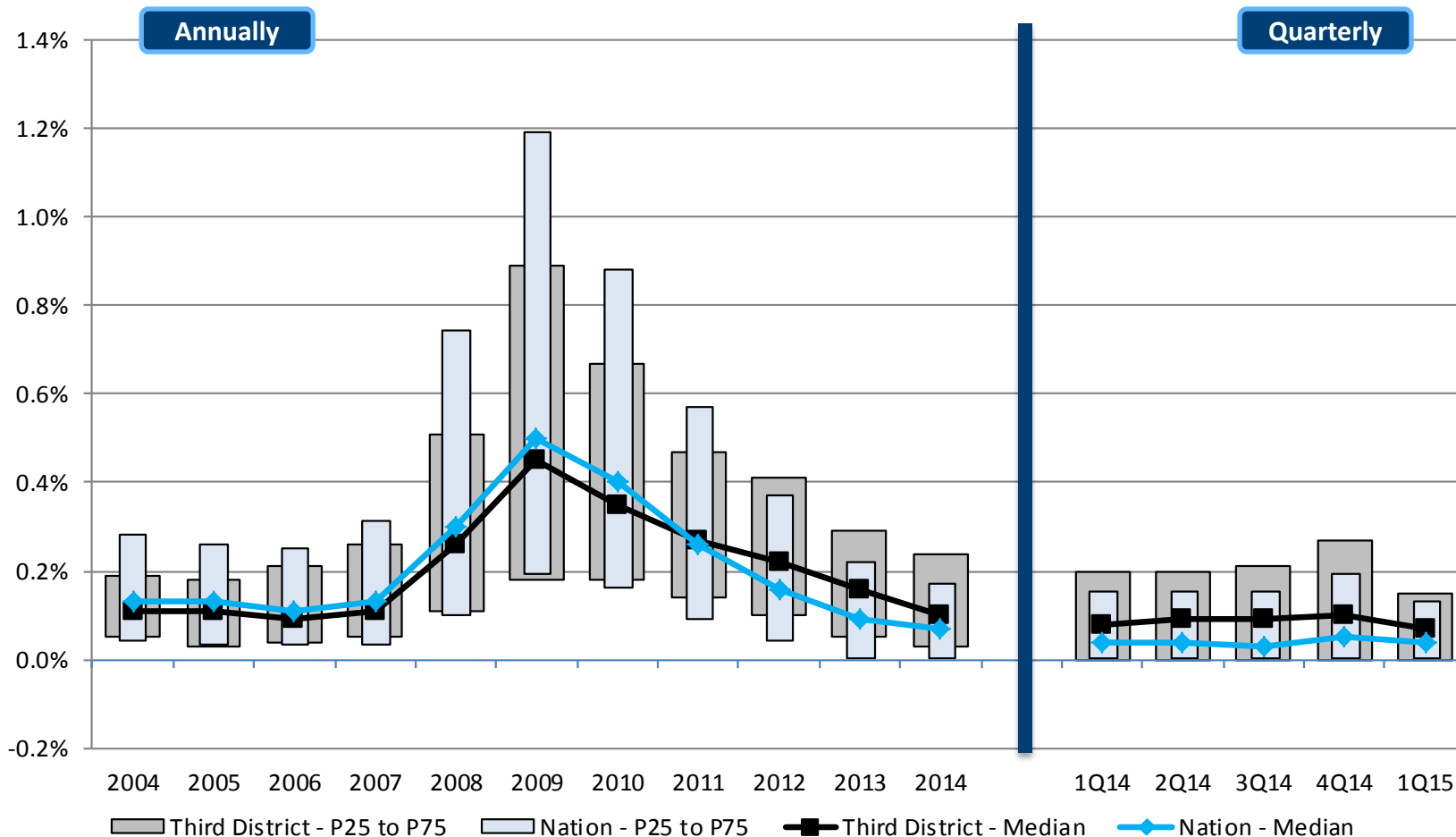
## Net Interest Margin



The decline in provision expense to precrisis levels continues to help bolster earnings, but this may be an unsustainable trend.



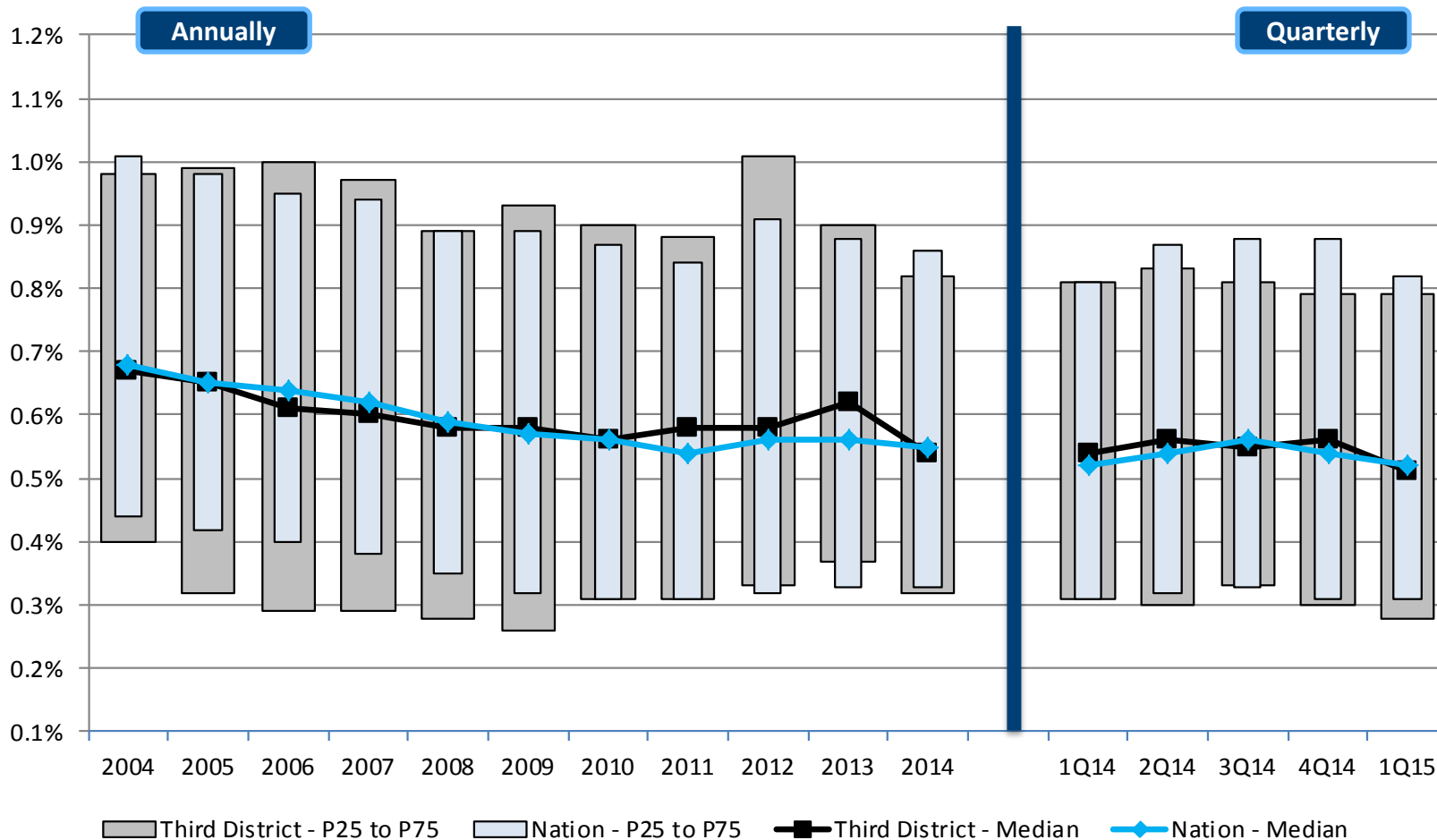
### Provisions / Average Assets



Noninterest income historically contributed more to ROA in the Third District as compared to the nation; however, the spread is tightening.



### Noninterest Income / Average Assets

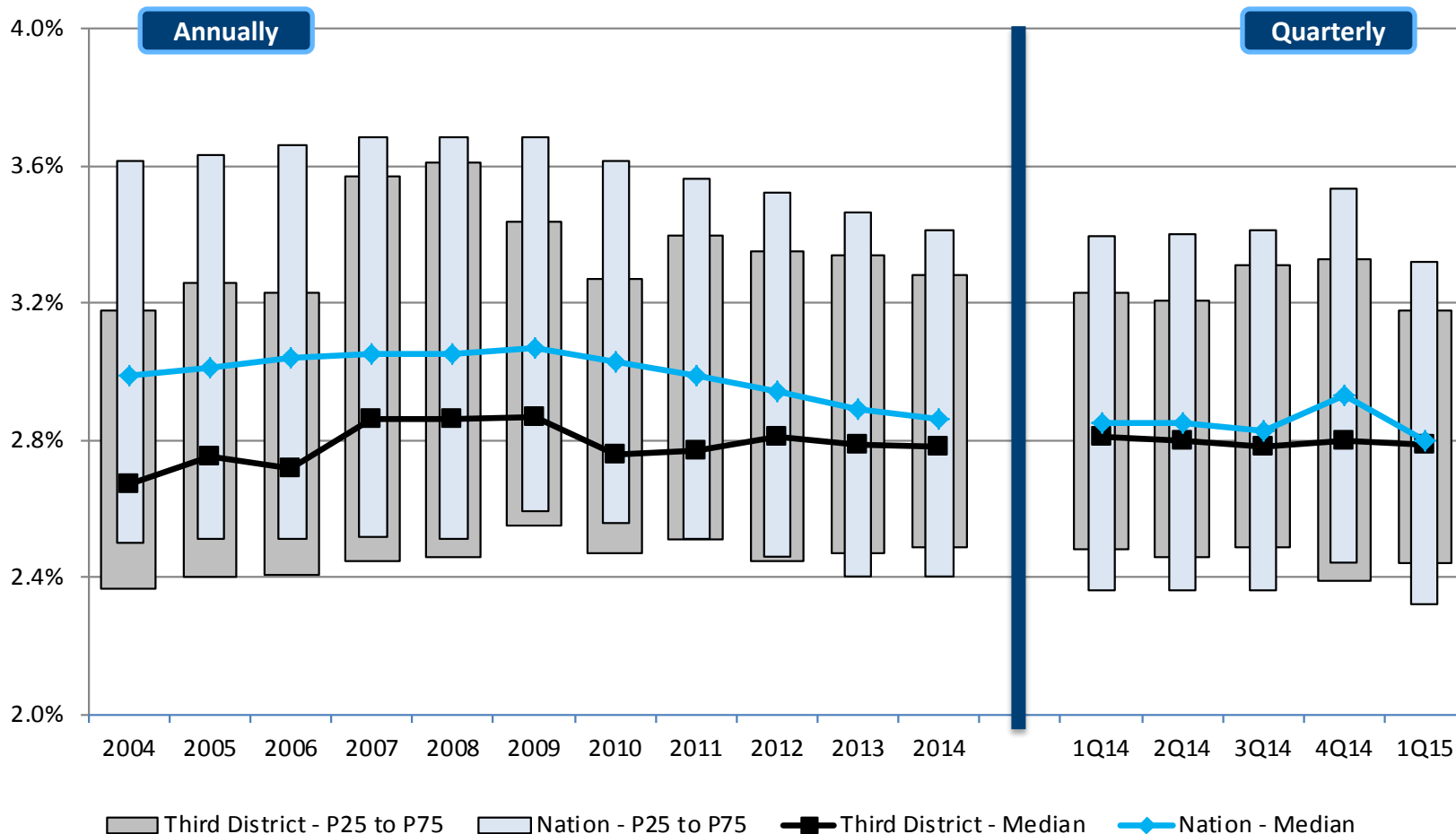




Median Third District overhead expense has remained relatively stable since 2011 and is slightly below that of the nation; this results in a positive contribution to ROA.



### Overhead Expense to Average Assets

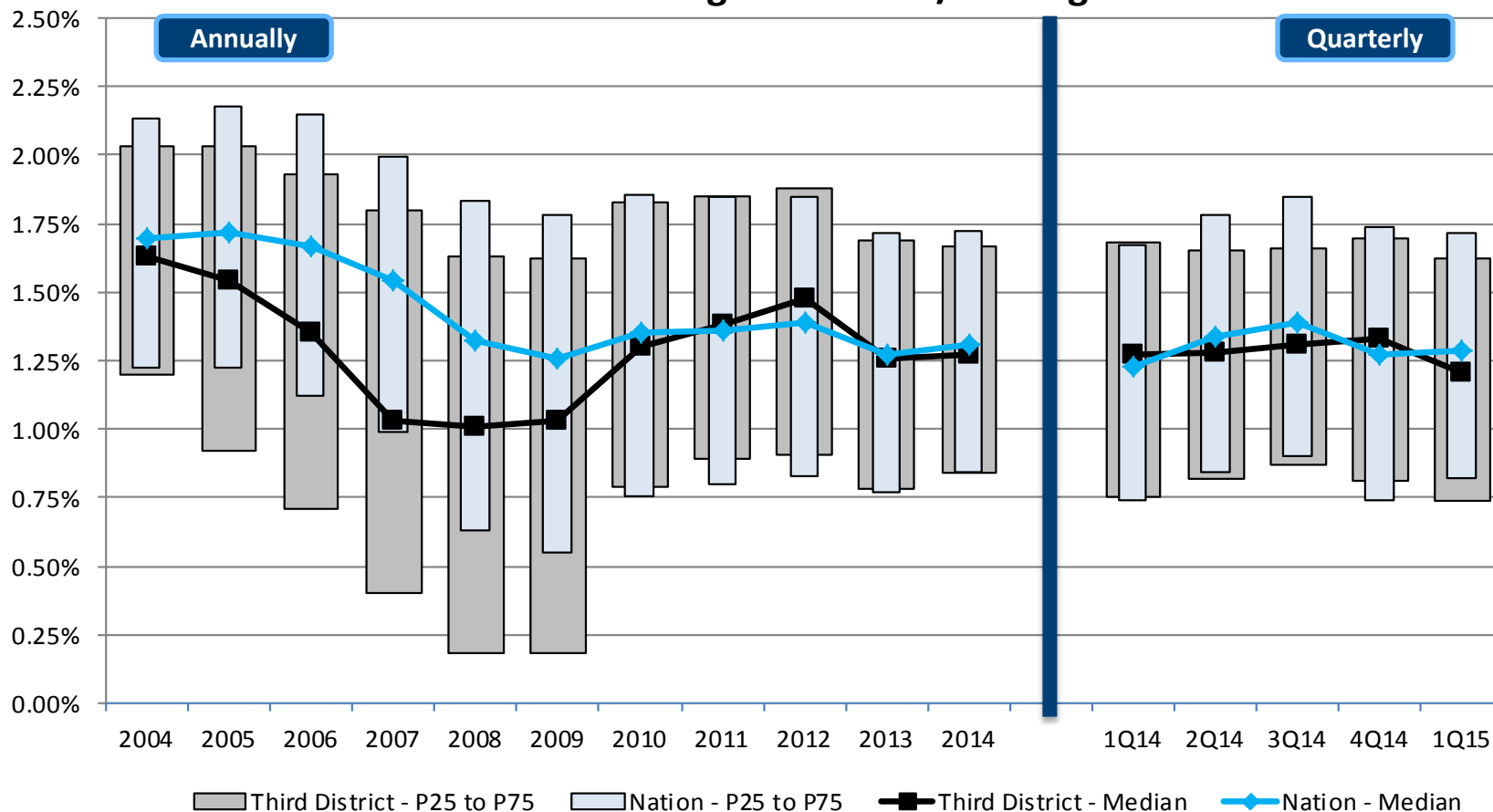


# Core profitability continues to recover; however, it has stabilized over the recent quarters.



## Core Profitability

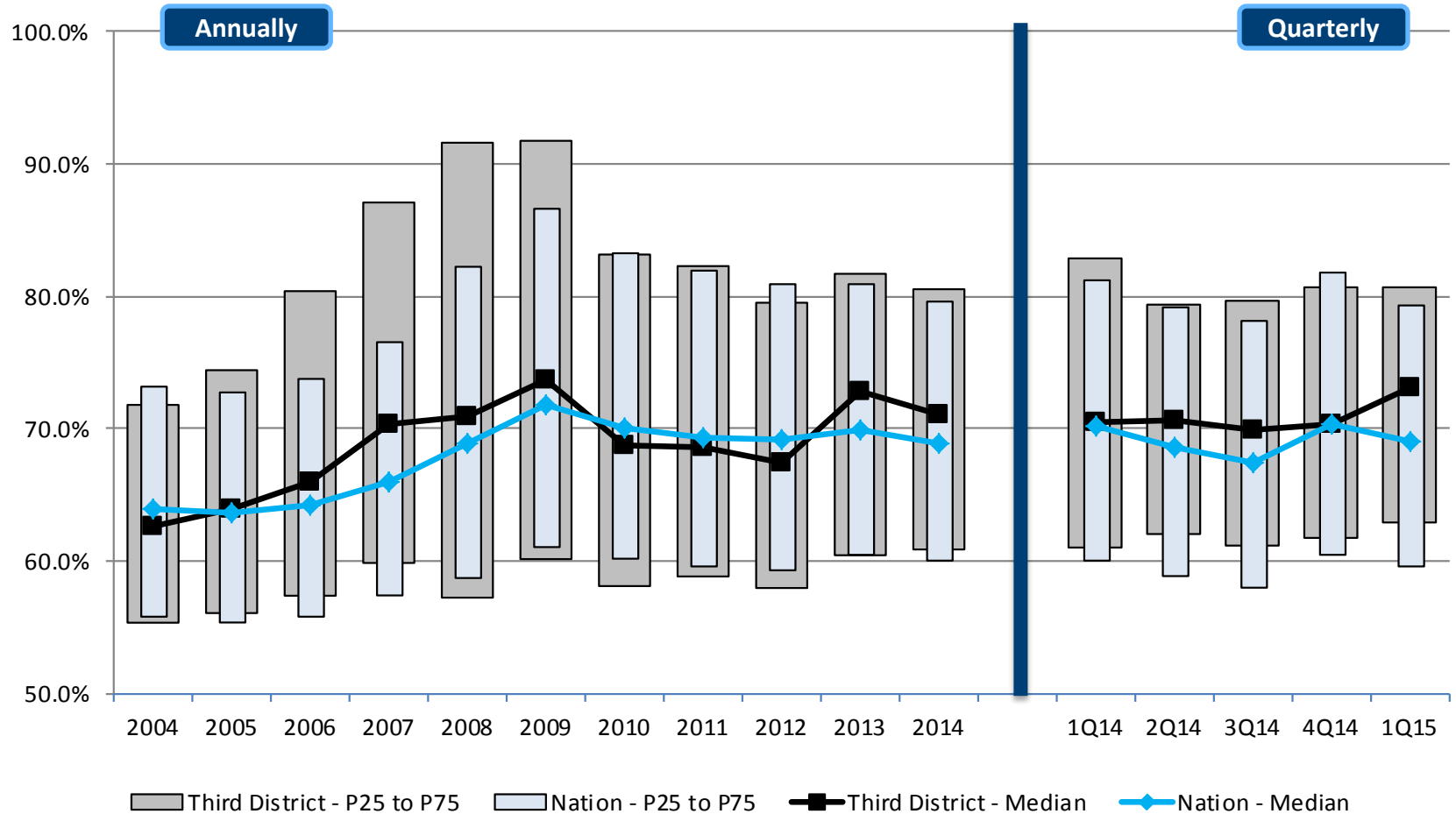
Pre-Tax Income Excluding Provisions / Average Assets



Although efficiency measures continue to remain stable for both the District and the nation, the current ratios remain above precrisis levels.



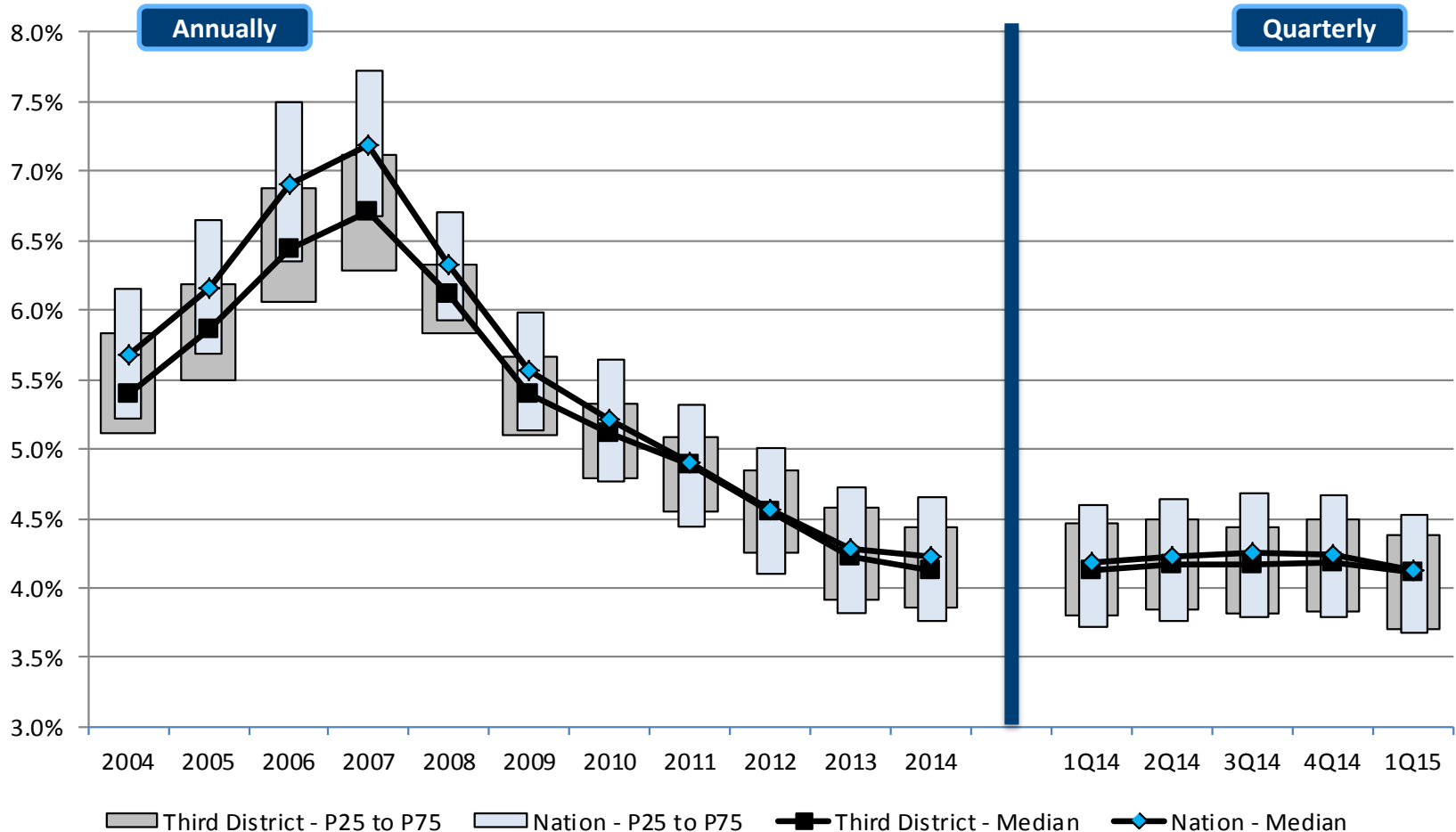
## Efficiency Ratio



# A low-interest rate environment is suppressing the yield on assets within the District and the nation.



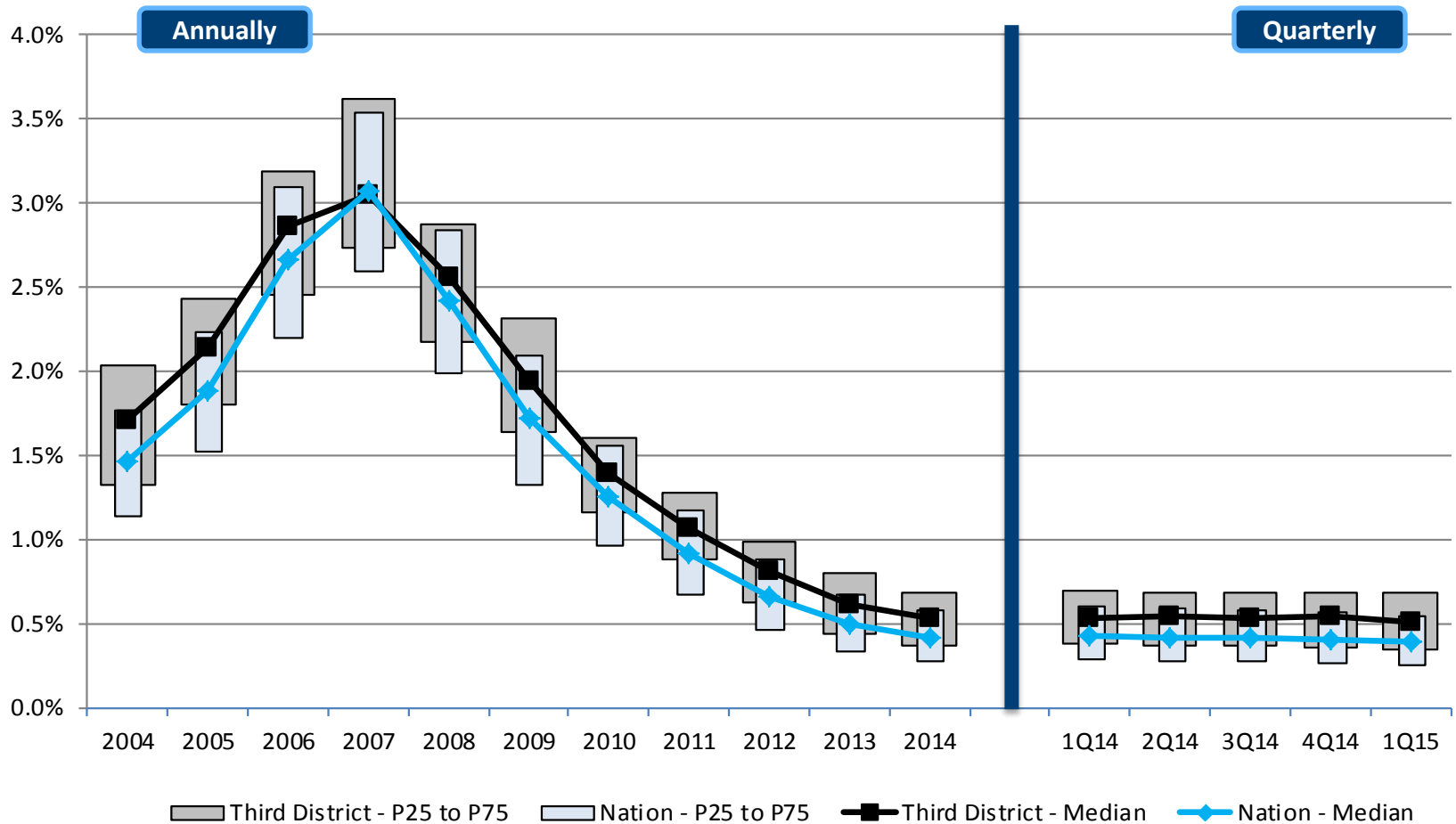
## Yield on Assets



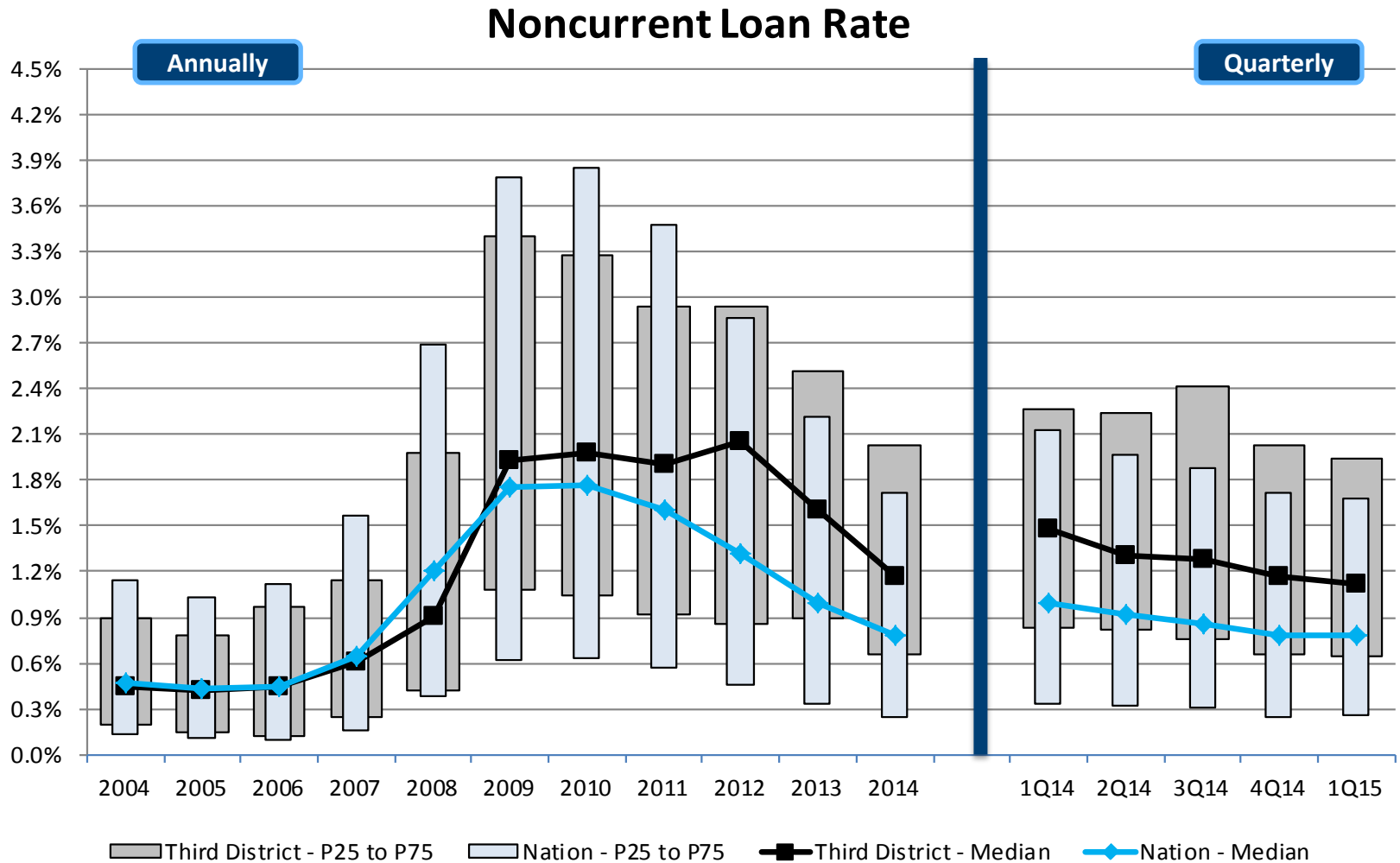
The identical low-interest rate environment is also decreasing the cost of funds within the District and the nation.



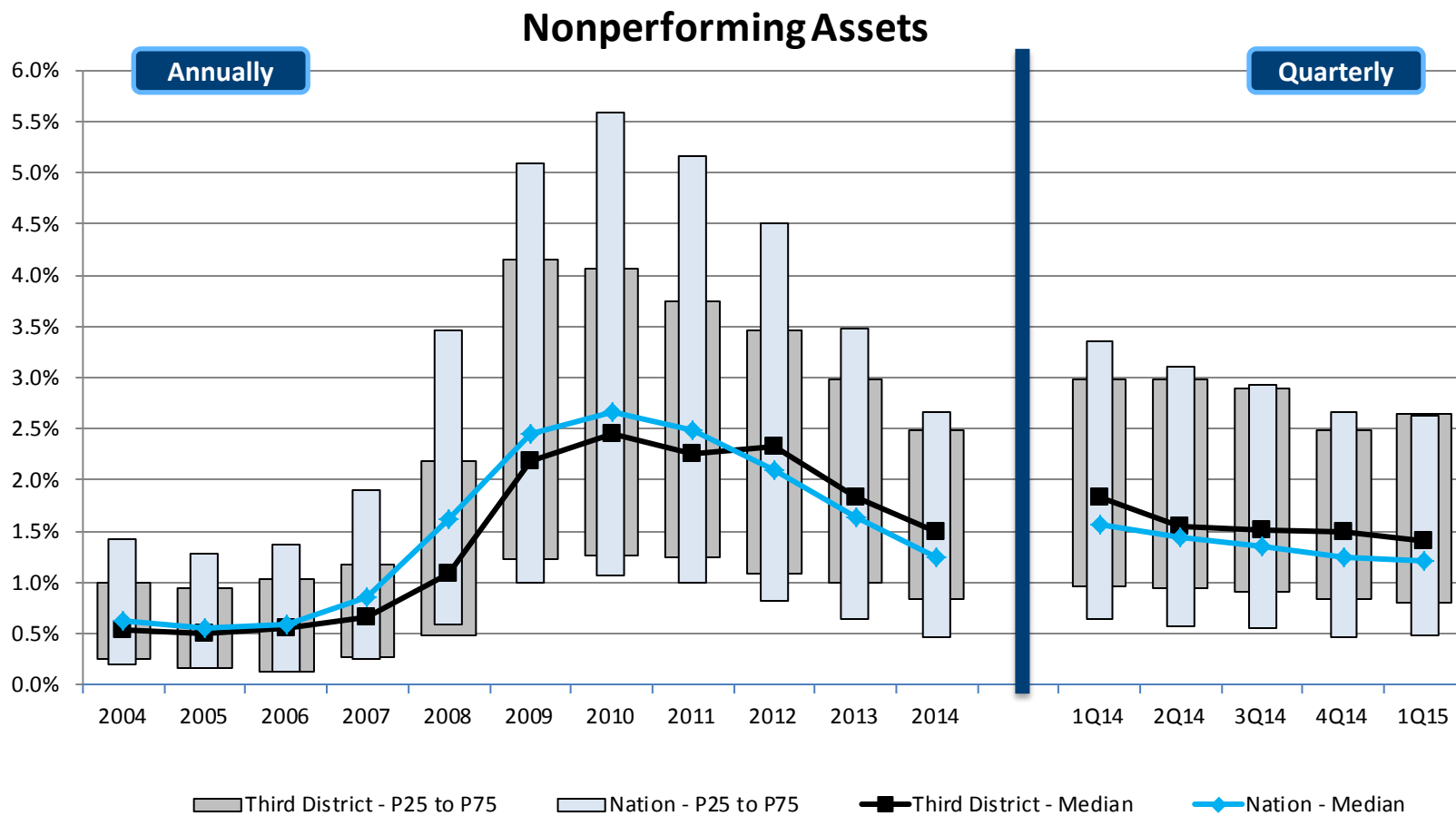
### Cost of Funds



# Although the noncurrent loan rate continues to decline, Third District metrics remain more elevated than those of the nation.



# Third District median NPAs are barely above the nation's because of lower OREO levels when compared with the nation.

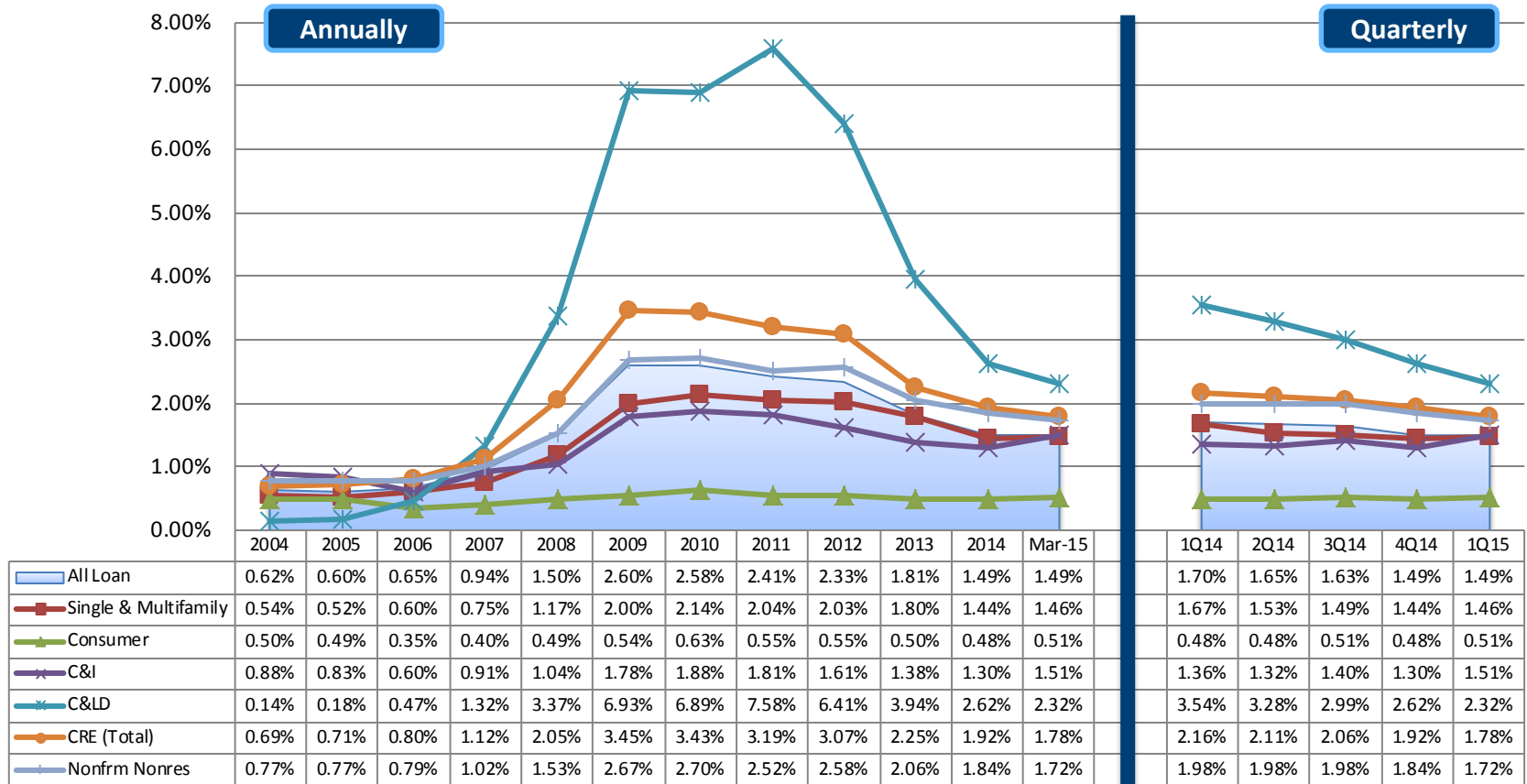


**NPAs** (Nonperforming Assets) are the total of Other Real Estate Owned (OREO) + Noncurrent Loans (Loans 90+ days past due + Nonaccrual Loans)

# Third District loan performance by category illustrates improving conditions, driven by declines in all major loan categories.



## Noncurrent Loan Ratios by Loan Category



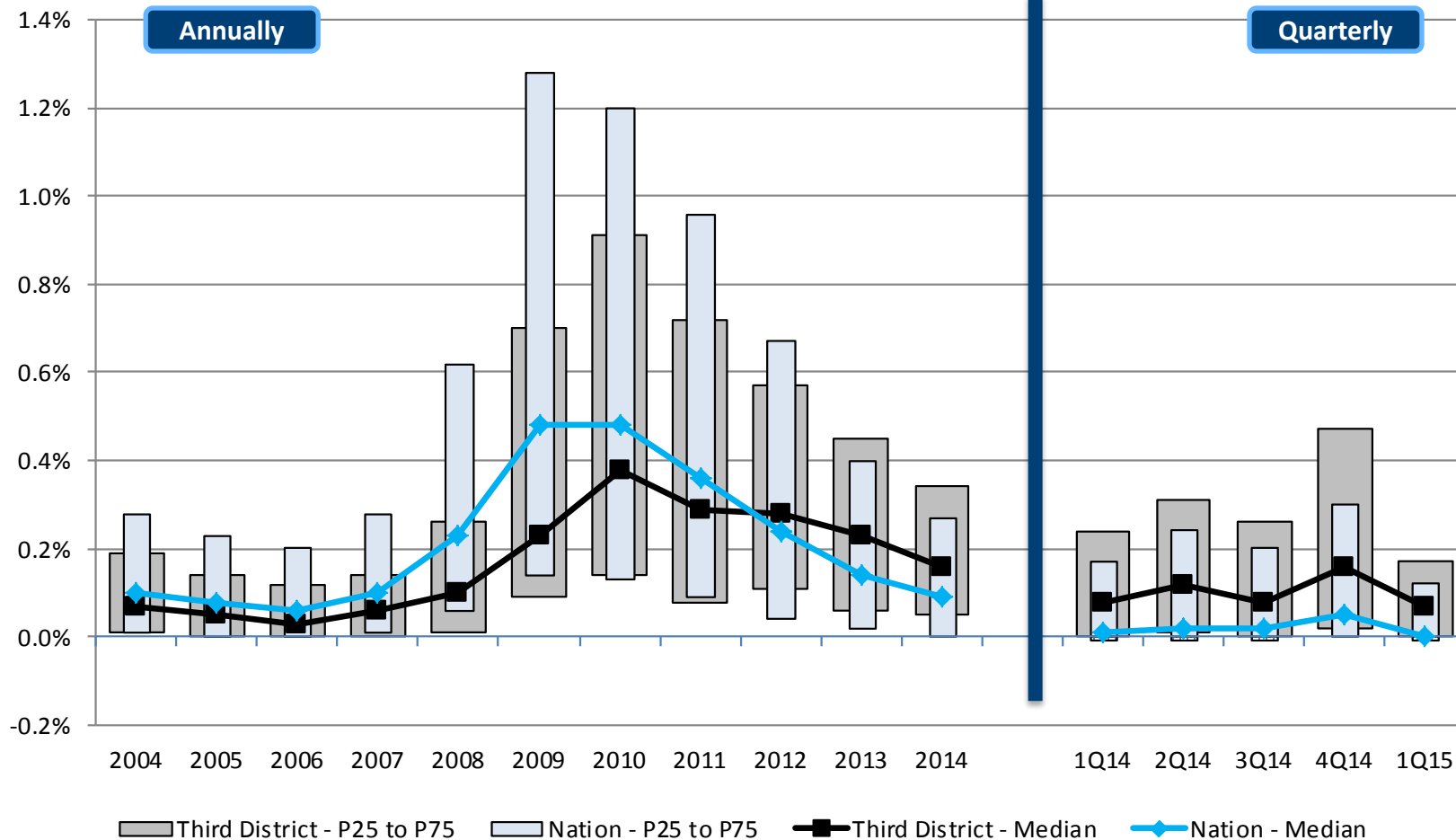
This chart utilizes a **10% capped mean, or winsorized mean**, to compute the average district and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for small sample. The capped mean is used to reduce the effects of outliers on the calculated average by “capping” values of the upper and lower 5% bounds of institutional data reported.



Net charge-off (NCO) rates have continued to decline annually since 2009; the nation is now at precrisis levels, while the Third District is lagging.



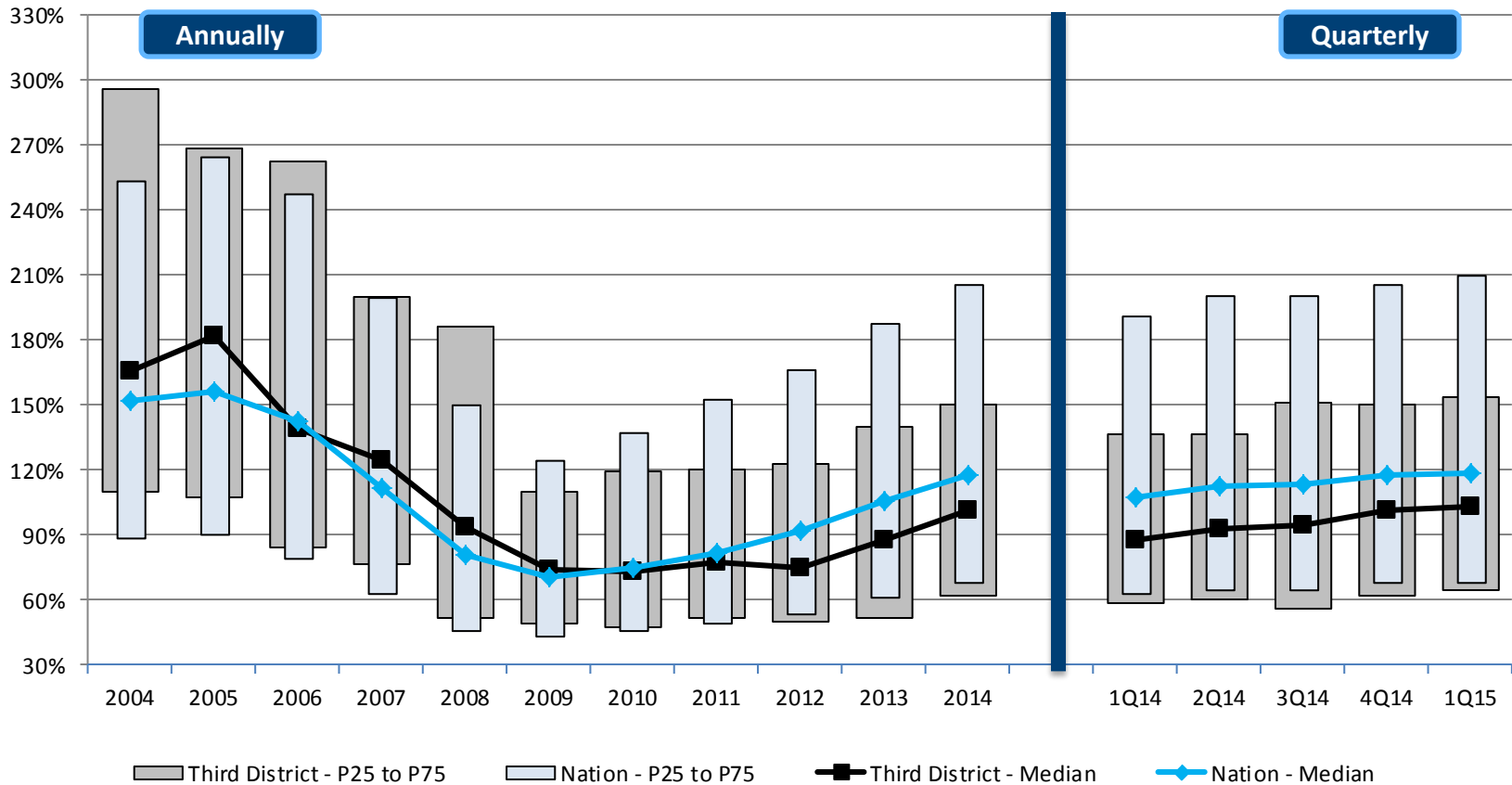
### Net Charge-offs / Loans



# The Third District allowance for loan and lease losses (ALLL) reserve coverage ratio\* is trailing that of the nation.



## Allowance for Loan & Lease Loss Coverage Ratio

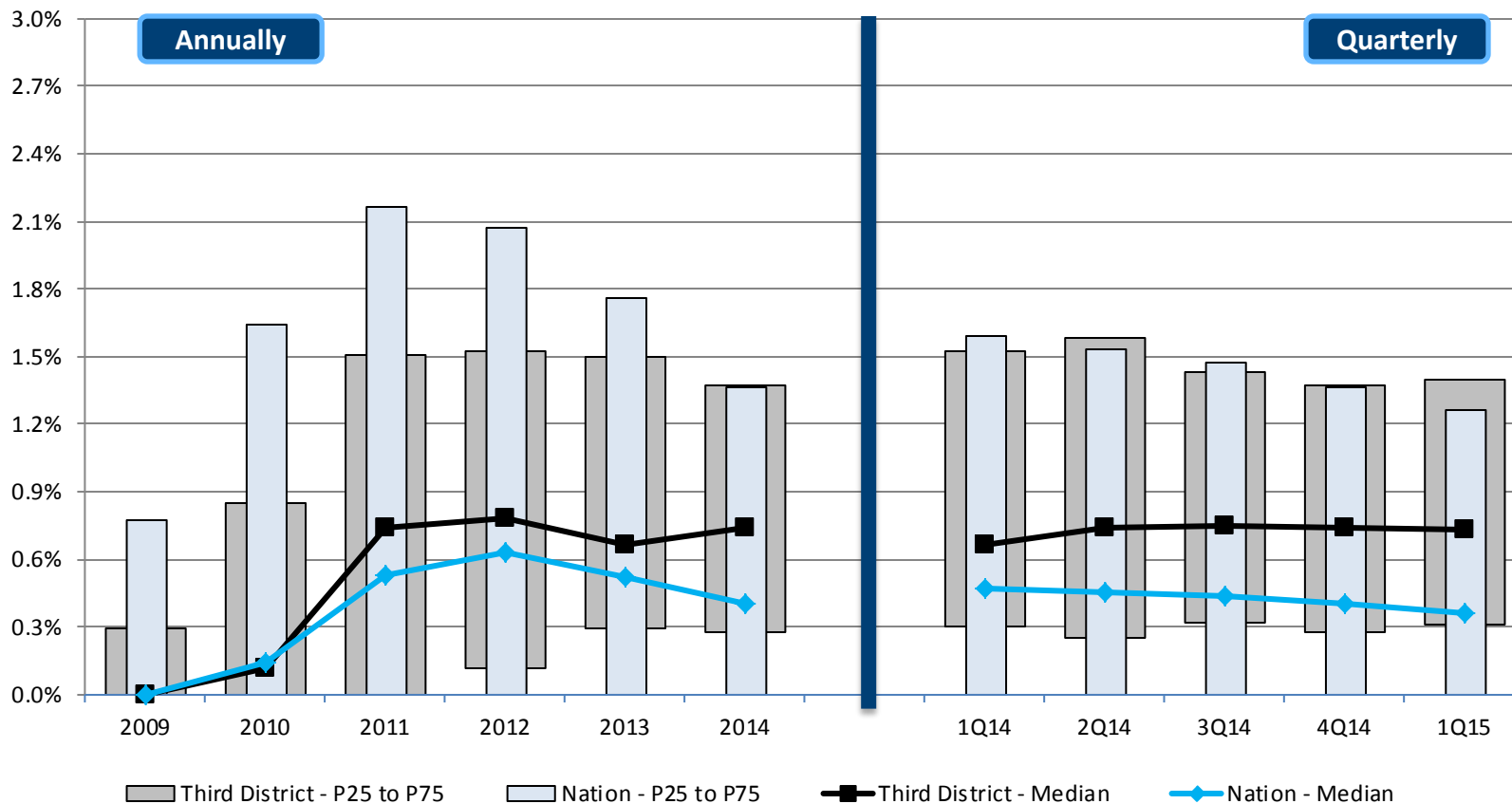


\*The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.

# The rise in Third District troubled debt restructurings (TDRs) were stable over prior periods but elevated when compared with the nation.



## Troubled Debt Restructurings

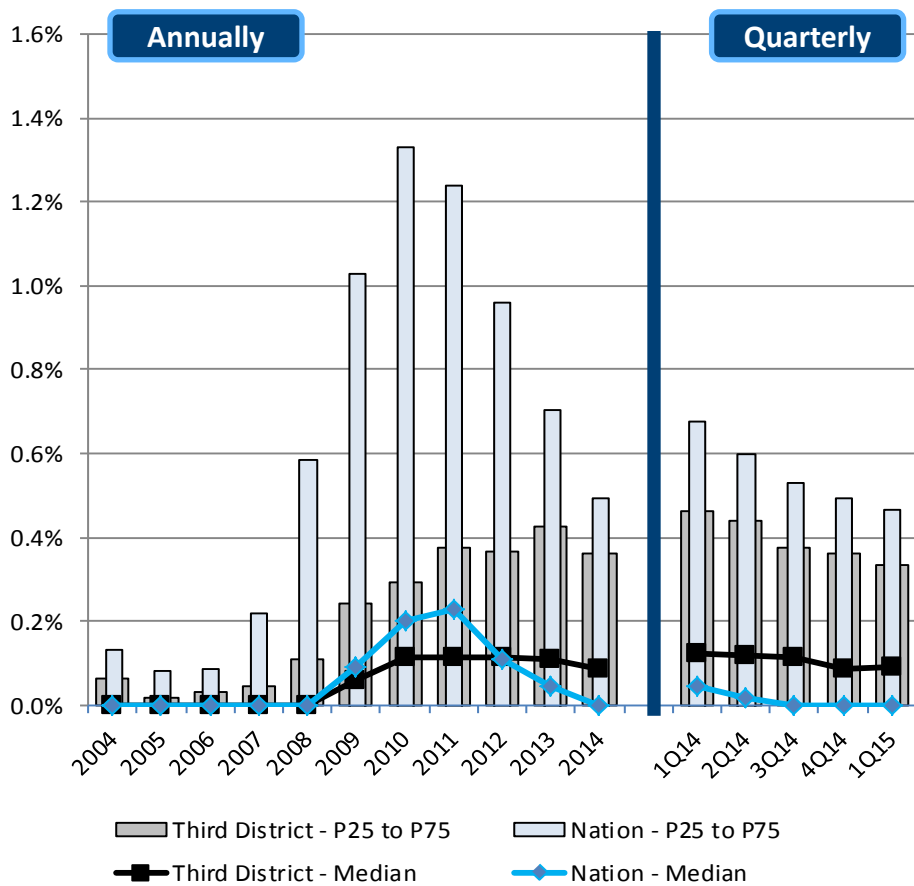


\*Troubled Debt Restructurings (TDRs) were not reported on the Call Report until the March 2009 reporting period.

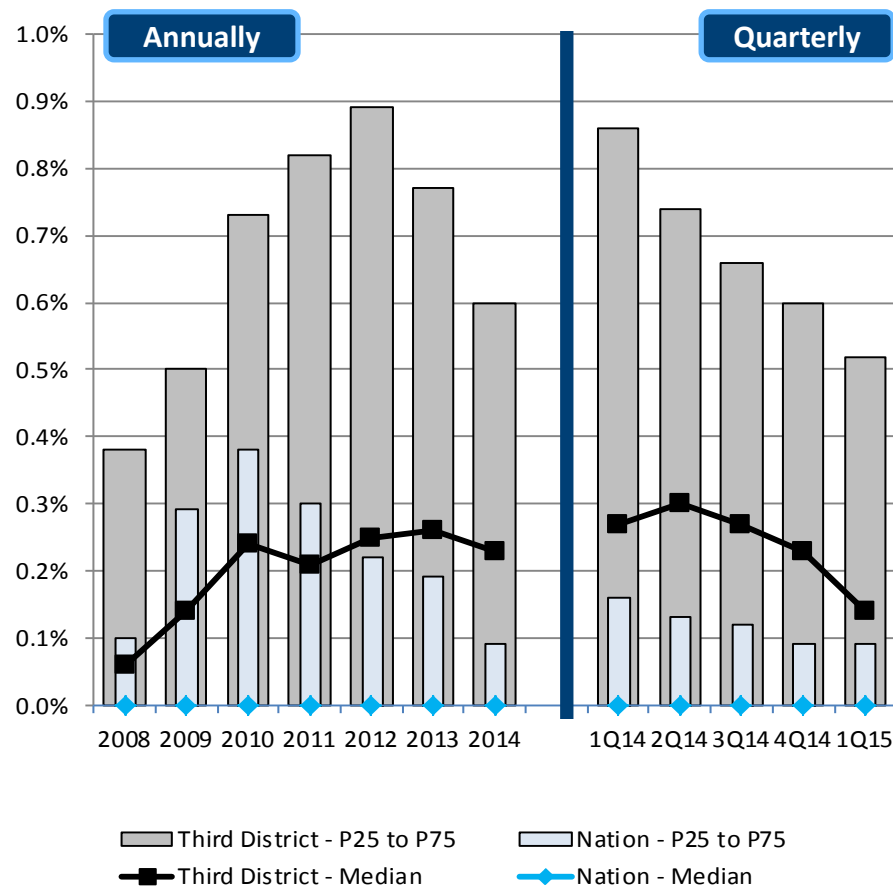
One- to four-family OREO\* is much higher in the nation, but the Third District trails in the foreclosure process\*\*; New Jersey, Pennsylvania, and Delaware are all judicial foreclosure states that can extend the foreclosure process.



### 1-4 Family OREO



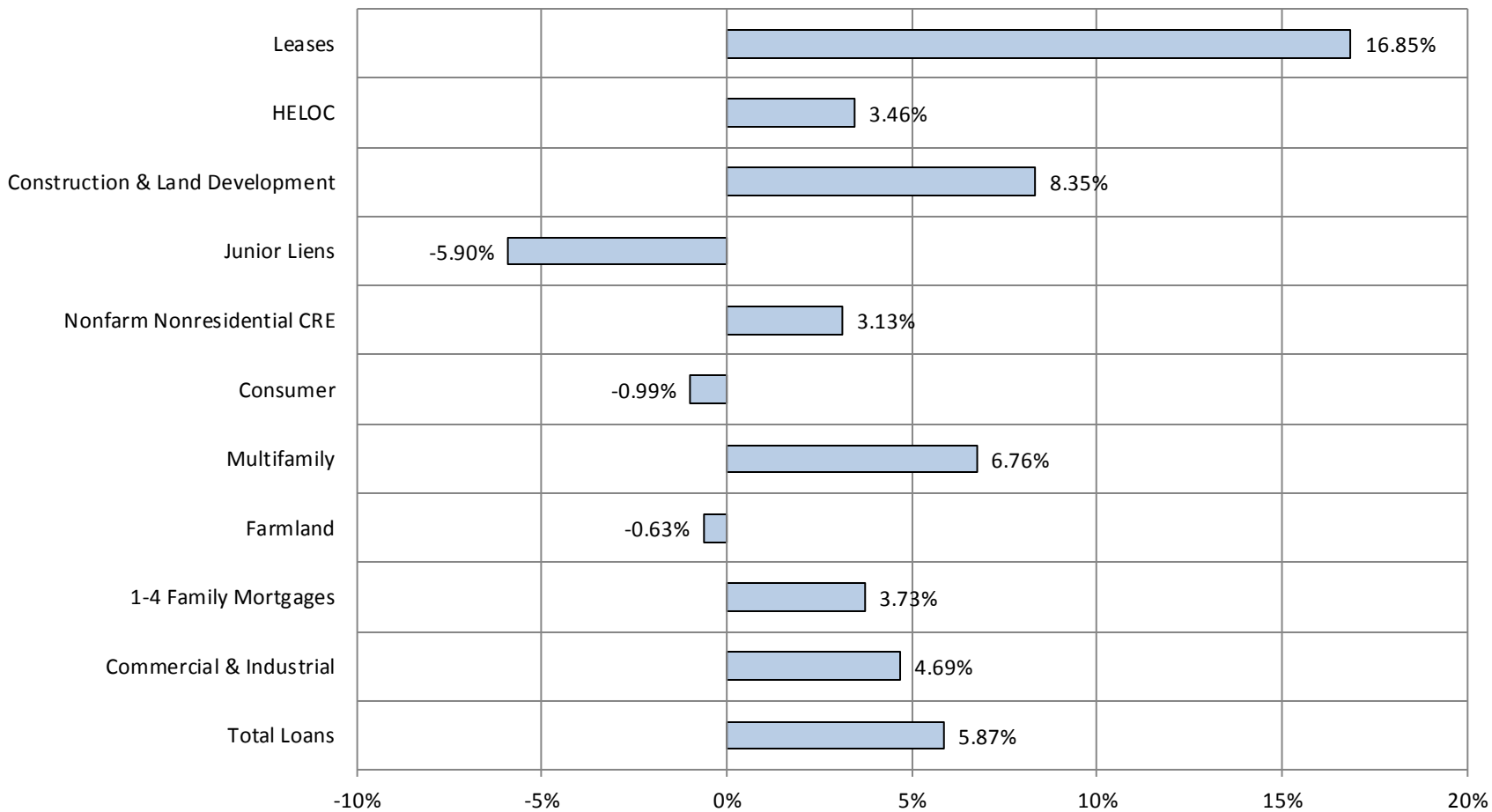
### Loans in Process of Foreclosure



\*As a percent of one-to-four family loans

\*\*Loans in the process of foreclosure were not included on the Call Report until the March 2008 reporting period.

# Third District commercial bank median loan growth in select categories (Y/Y) as of 1Q15; loan contraction occurred in junior liens, consumer loans (predominantly auto loans), and farmland loan categories.

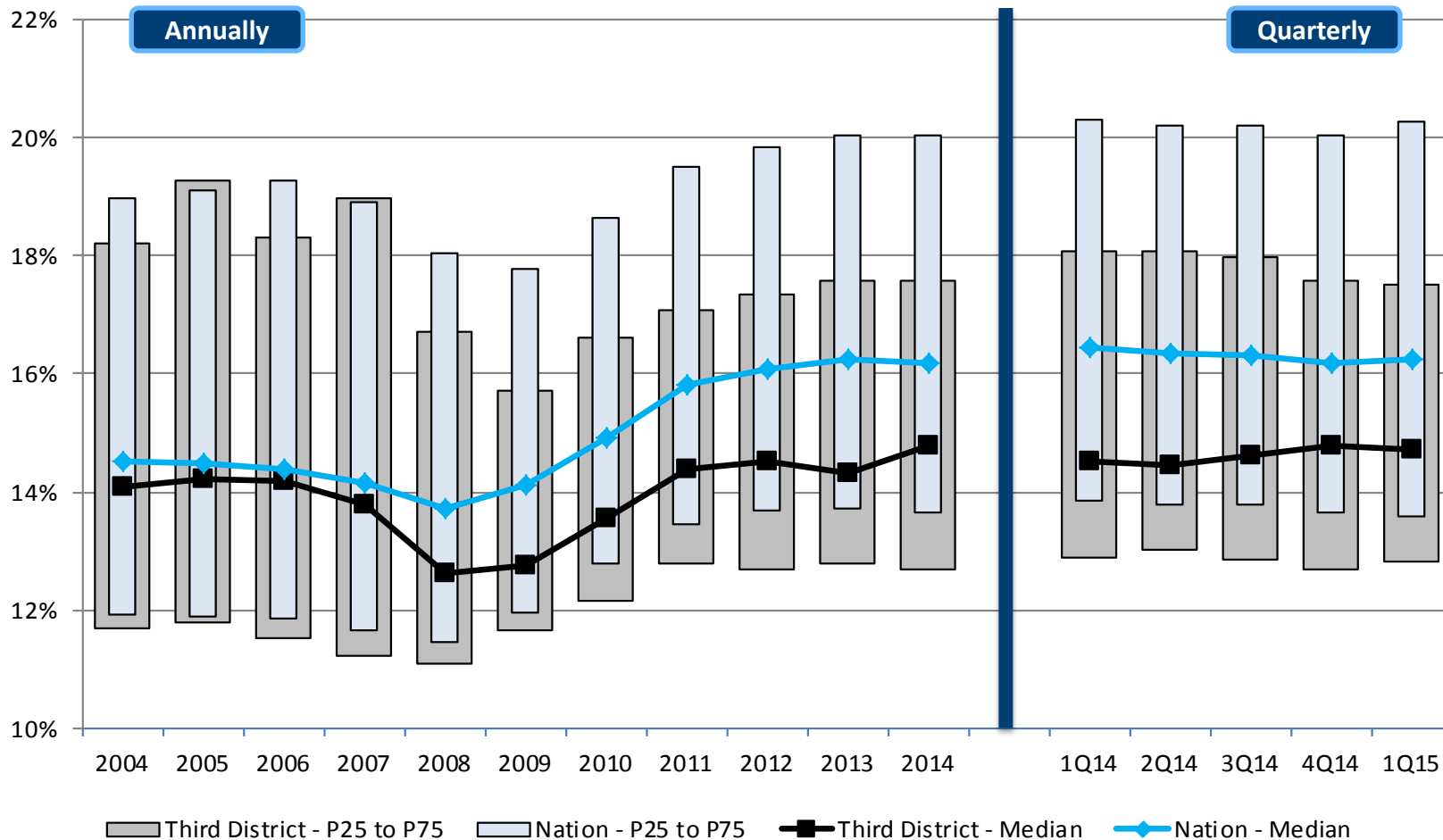


\*This report illustrates the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 4.

After several years of capital rising for the District and industry, ratios are moderating; however, District levels remain below national levels.



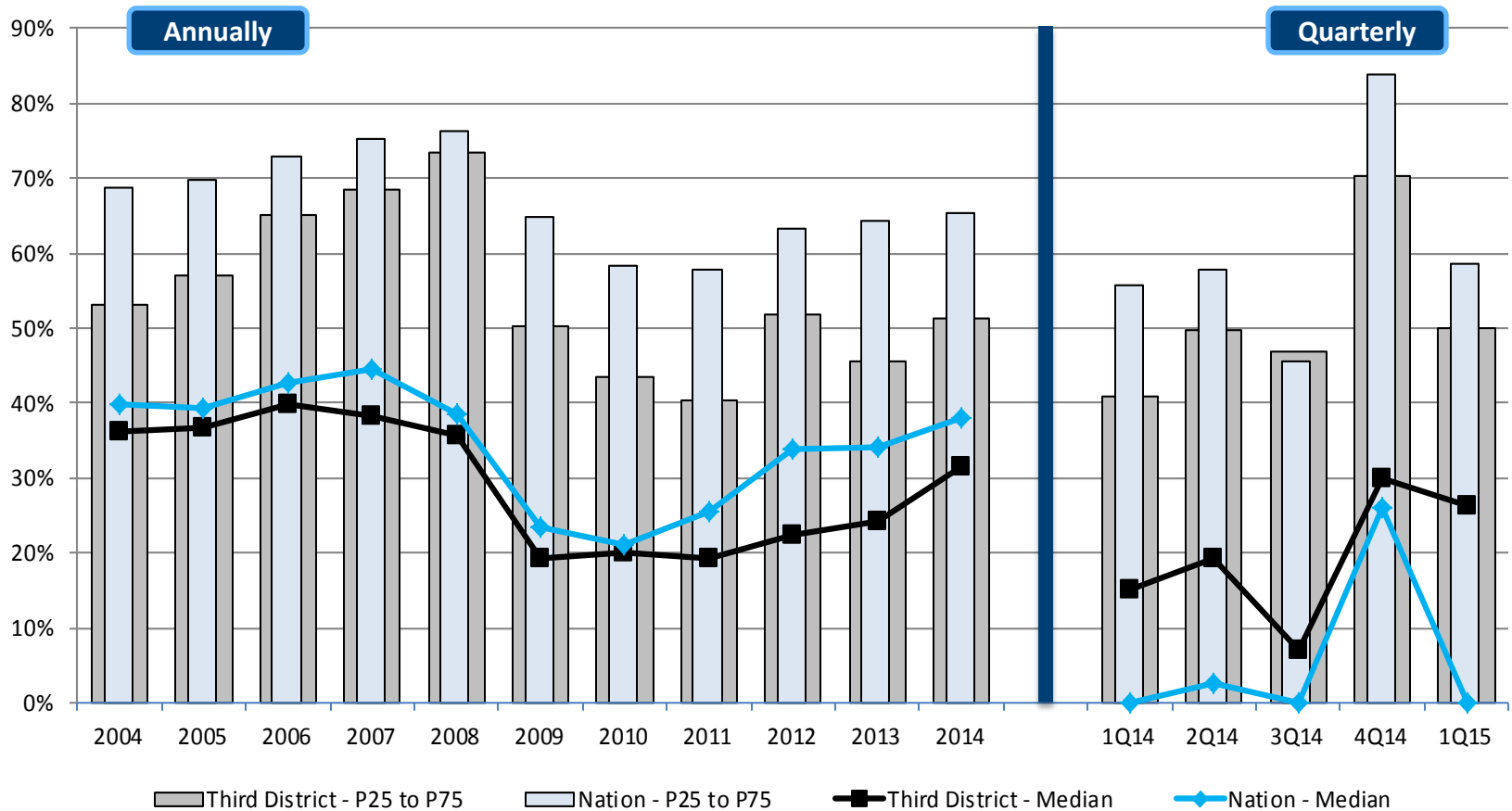
## Total Risk-Based Capital



# Annual dividend payments are beginning to rise after the recessionary period at both the national and District level.



## Dividends

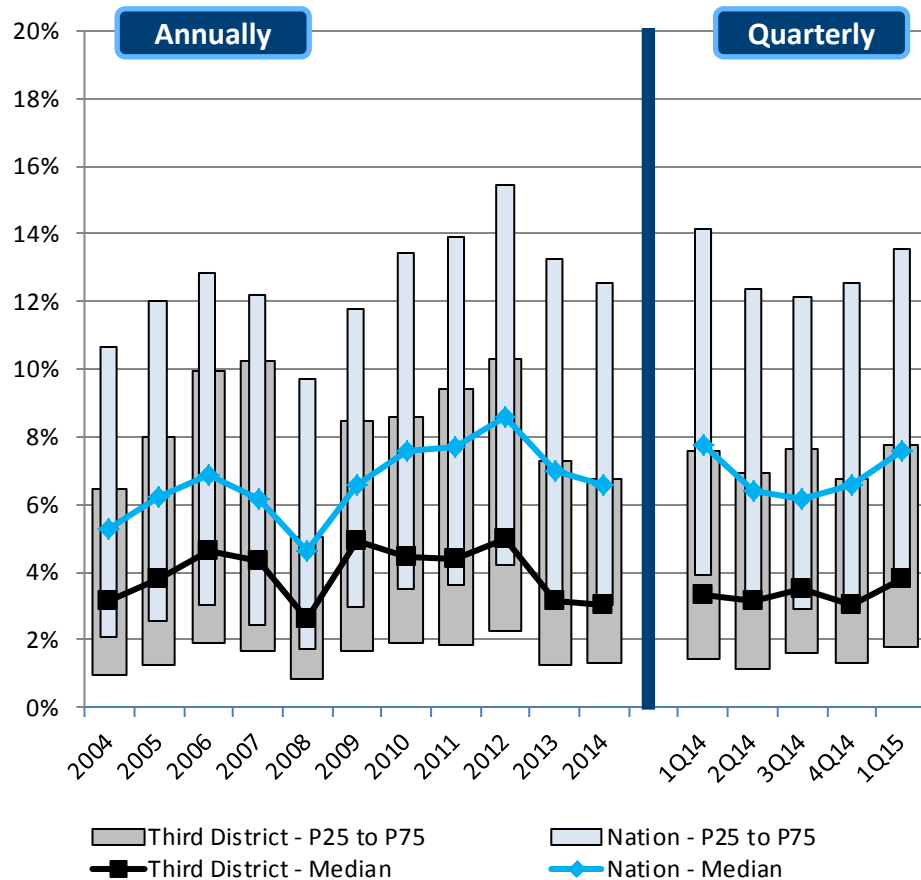


Some banks pay dividends semiannually; therefore, Q1 and Q3 dividends are normally lower. However, when compared to a year ago, the 2015Q1 dividend payout (DPO) ratio for the Third District is above the value when compared to a year ago, which may indicate that banks may pay out more dividends in 2015.

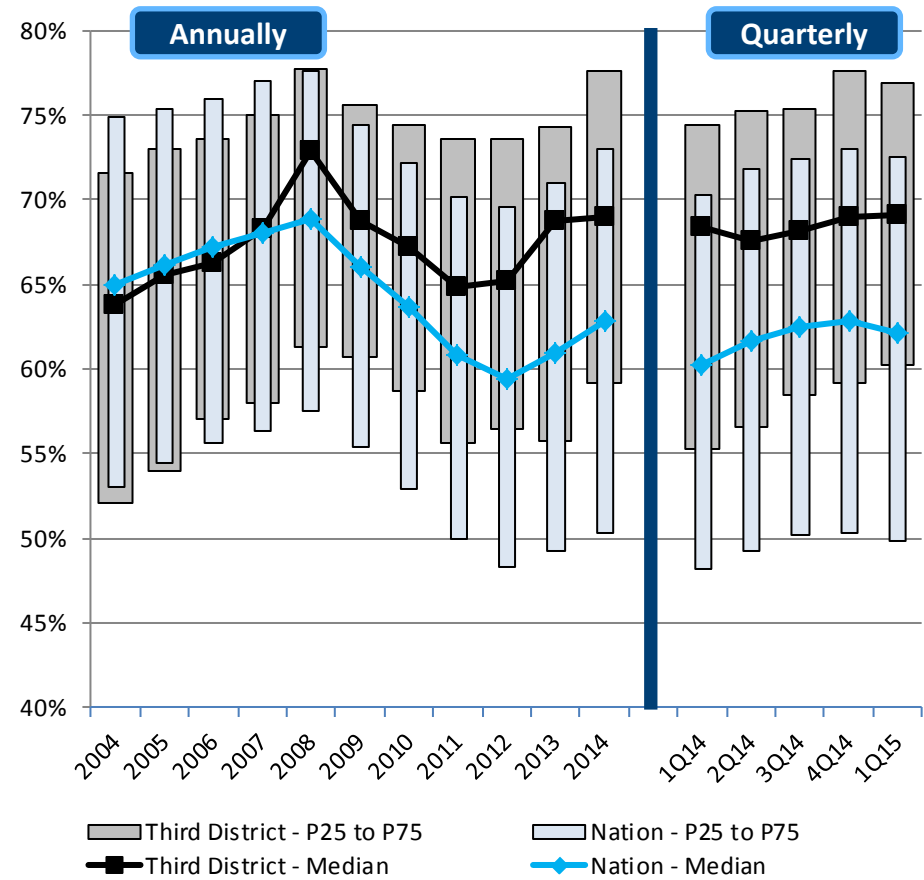
# Potential IRR concern as the Third District holds fewer short-term investments\* compared with the nation while also maintaining higher loan levels.



## Short-Term Investments / Assets



## Loans / Assets



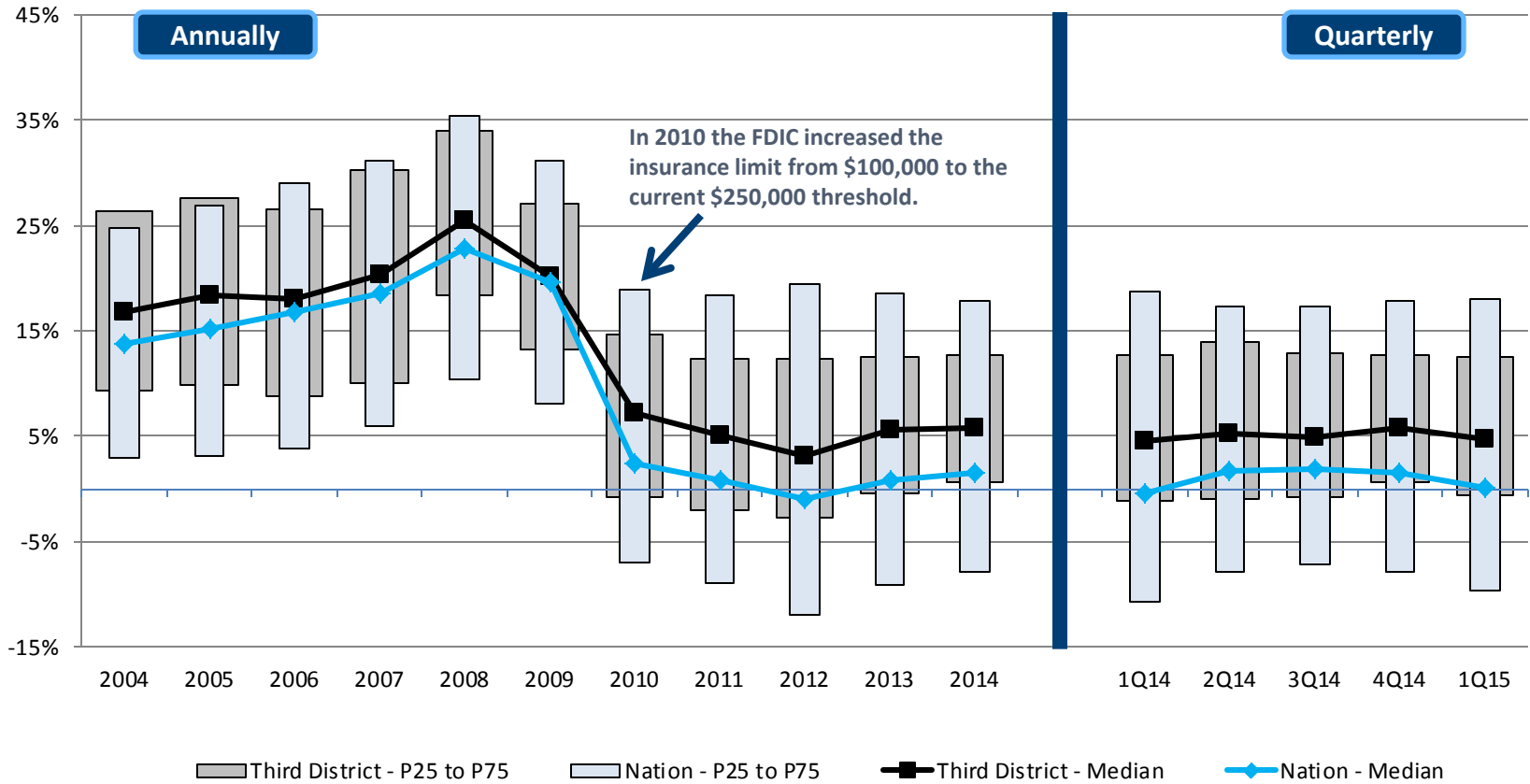
\*Short-term investments equals the sum of: interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.



# Third District banks' reliance on noncore funding sources continues to outpace that of the nation.

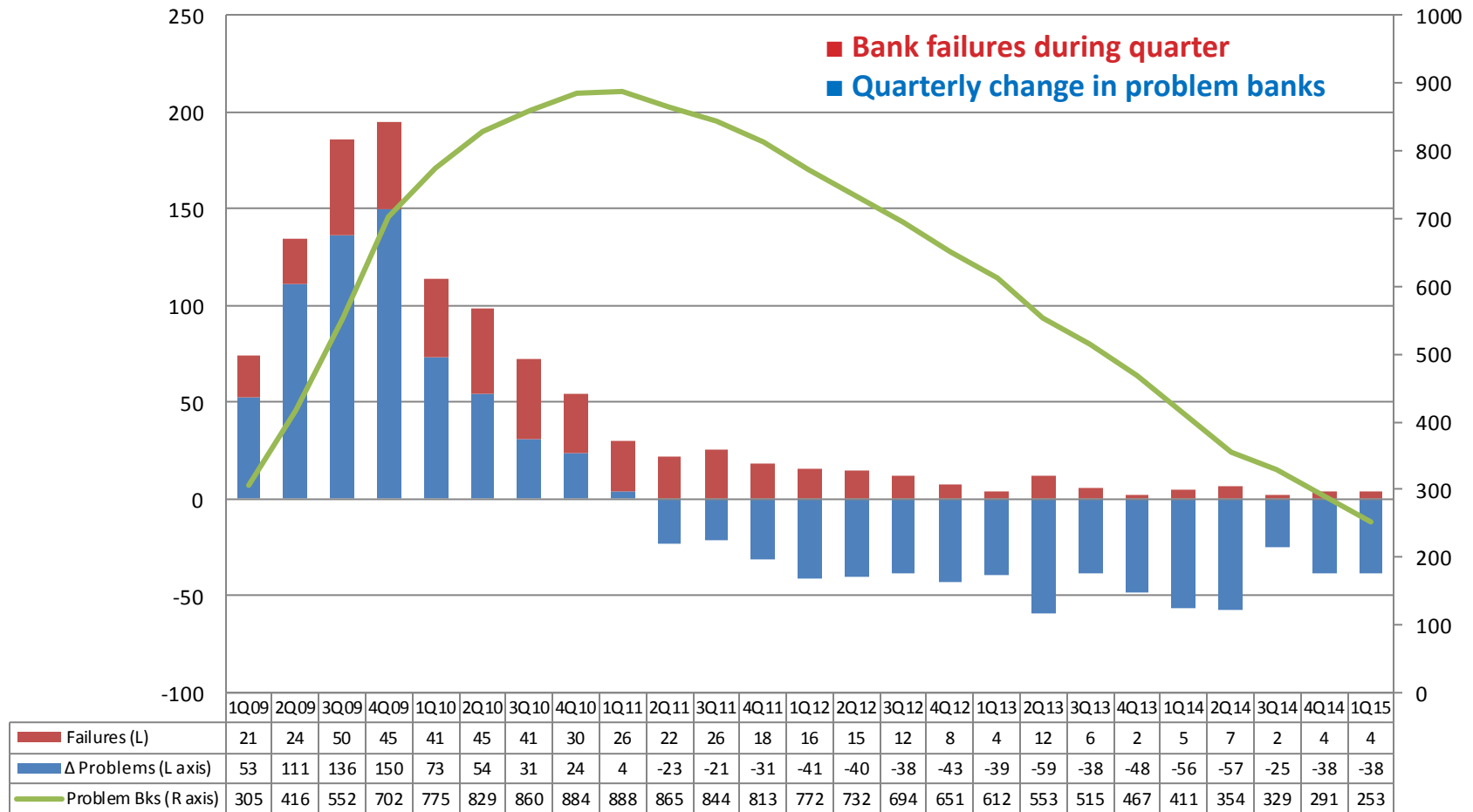


## Net Noncore Funding Dependence



\* Net noncore funding dependence measures the degree to which banks fund longer-term assets with noncore funding sources.

# Industry problem banks and failures continue to decline.



Source: FDIC; “problem banks” are defined as having a CAMELS composite rating of 4 or 5.