



Third District Banking Conditions as of June 30, 2016

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

FEDERAL RESERVE BANK OF PHILADELPHIA

Third District Conditions



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Section 1: Executive Summary



- Third District bank financial performance continues to be challenged by the low interest rate environment and competition for loans and deposits. As a result, core earnings challenges remain in the District due to a lower yield on assets and a higher cost of funds when compared with the nation. In response, some banks are offsetting low core earnings with nonrecurring items, such as the sale of securities and/or reporting \$0 or negative provisions.
- Capital ratios are increasing primarily as a result of earnings accretion; however, capital ratios remain below the nation.
- Third District and national asset quality metrics continue to improve as the level of noncurrent loans is at its lowest point since 2008.
- Third District banks' reliance on noncore funding sources continues to outpace the industry as core deposit competition persist.
- Interest rate risk remains somewhat elevated throughout the banking industry and remains an issue; however, most banks have rebalanced their balance sheet to accommodate for an interest rate increase.
- The number of problem banks has fallen by 18 banks to 147 as of 2Q2016. This represents the smallest number of problem banks in more than seven years and is down significantly from the peak of 888 in 1Q2011. Two banks failed during the quarter, one of which was in the Third District.
- Qualitative and/or operational risks that remain on the risk radar include:
 - Commercial real estate (CRE) concentrations and the management of the portfolio (Refer to SR Letters 07-1 and SR 15-17)
 - Cybersecurity
 - Model risk management (Refer to SR 11-7)

Section 2: Conditions of Third District Commercial Banks



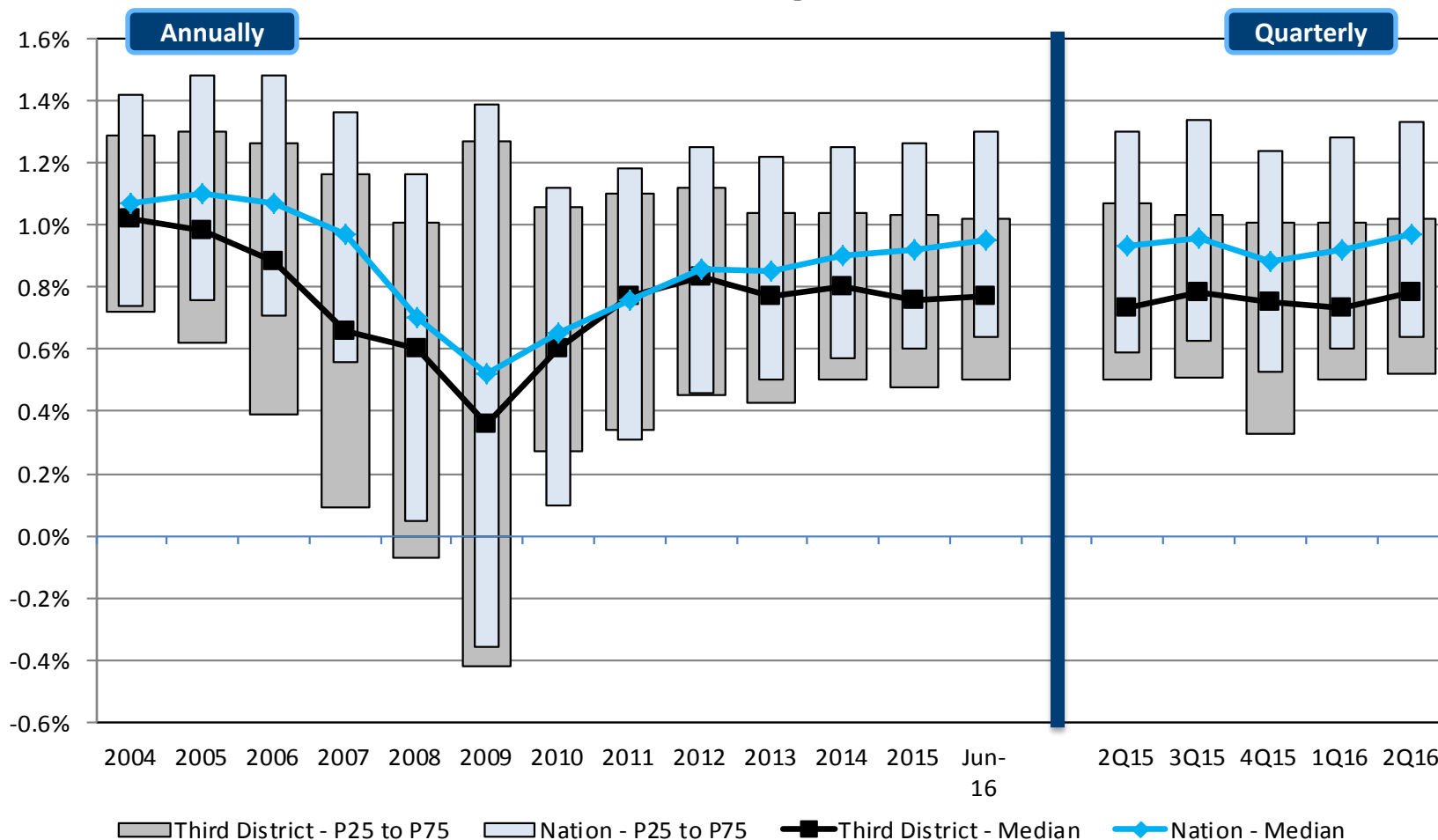
Reporting Methodology

- 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 noted.
- Slides in this section focus on trends among the **109 commercial banks** within the Third District and national or nonmember commercial banks that do not meet at least one of the following criteria as of **June 30, 2016**:
 - 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 uses the **median, the 25th, and the 75th percentiles** to compare 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, as defined by the return on average assets (ROAA) ratio, has lagged the nation since 2004.



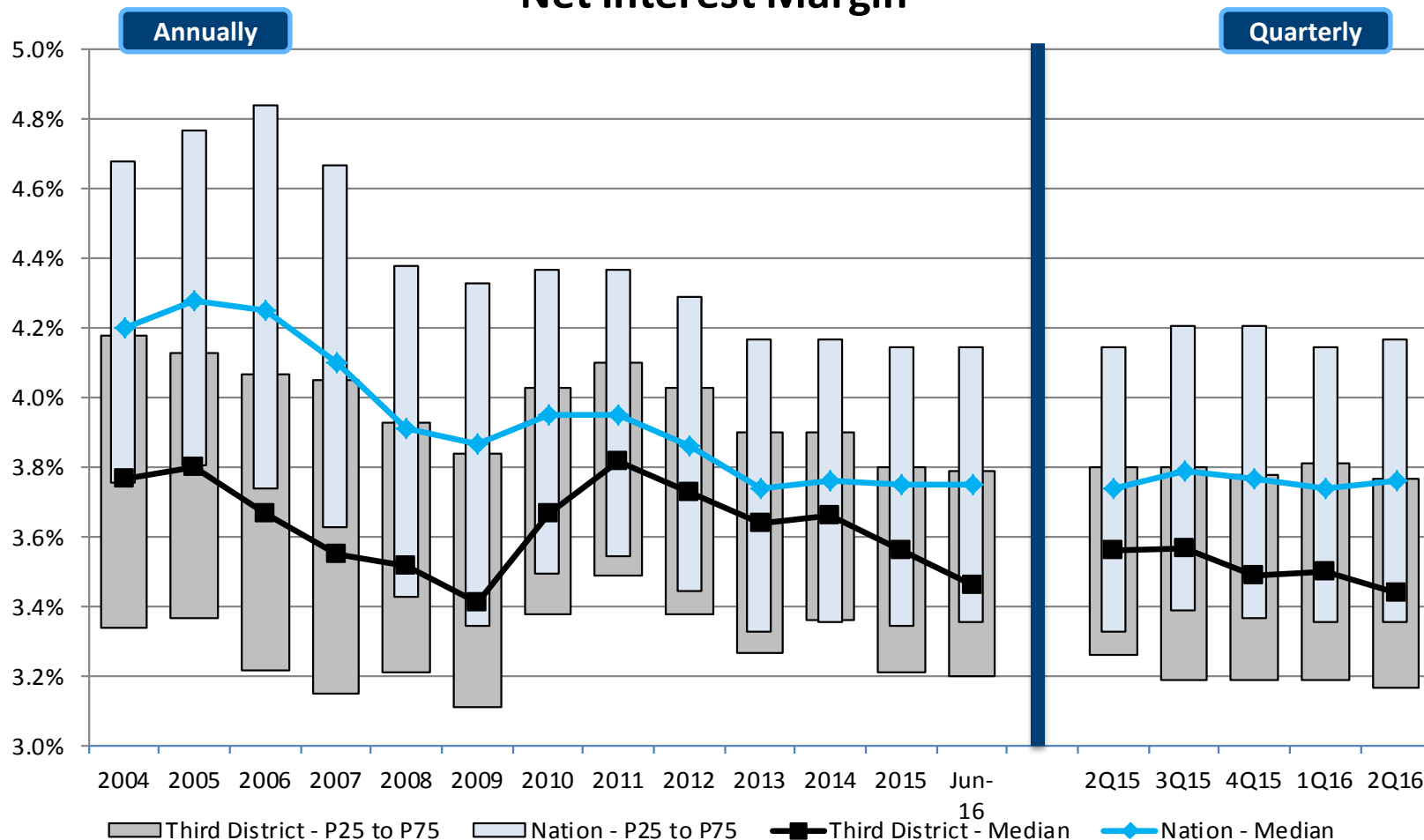
Return on Average Assets



As a result of Third District yield on earning assets being below the nation and the cost of funds being greater than the nation, the Third District NIM continues to compress as of 2Q2016.



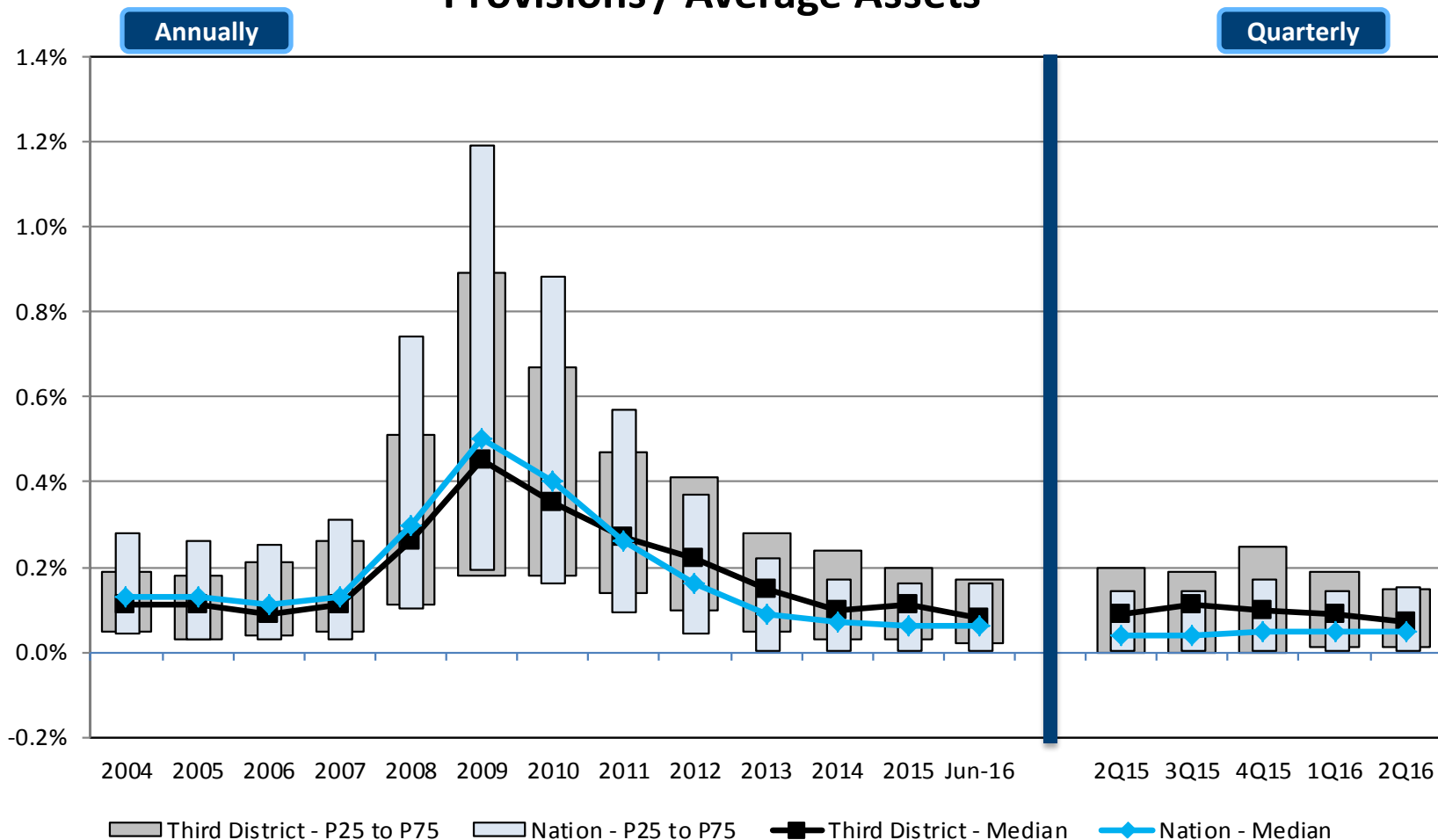
Net Interest Margin



The provision expense continues to trend at or below precrisis levels. The low expense figures help augment earnings and will not be sustainable if a breakdown in the credit cycle occurs.



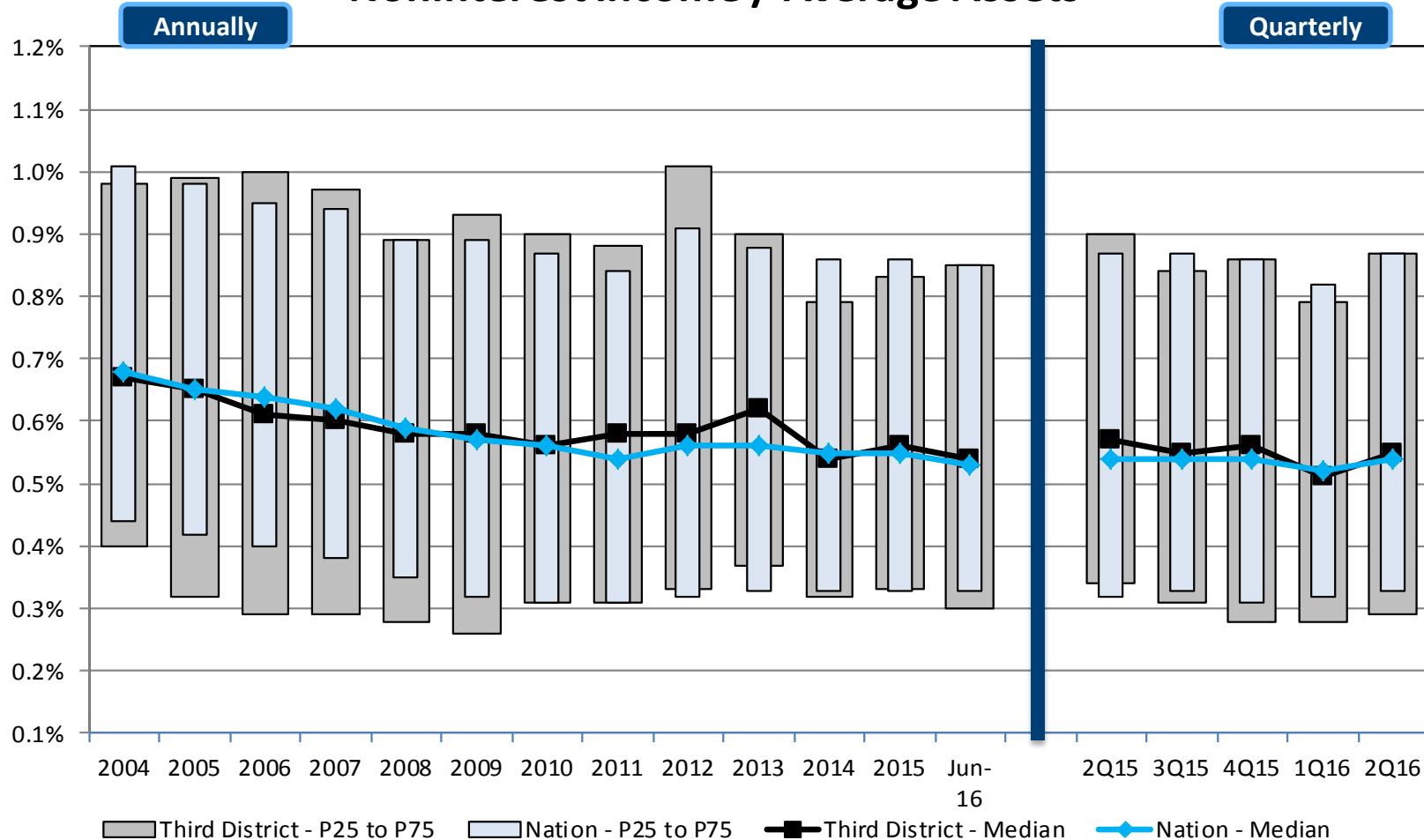
Provisions / Average Assets



Noninterest income improved in 2Q2016; however, it remains below precrisis levels, placing further pressure on earnings.



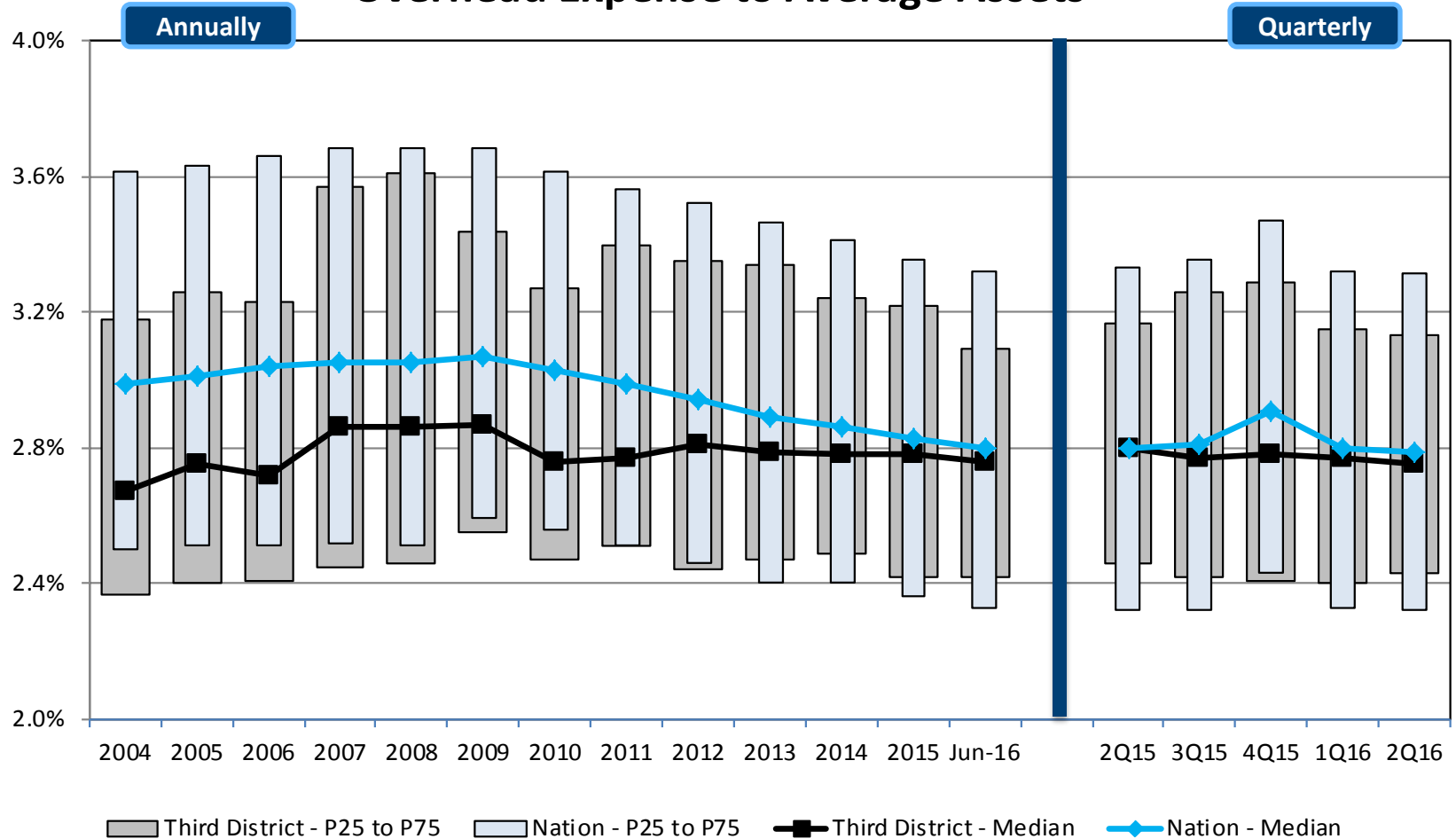
Noninterest Income / Average Assets



Overhead expense has decreased in the nation since 2010 while continuing to moderate within the District. The lower the overhead expense is, the greater the positive impact on ROAA.



Overhead Expense to Average Assets

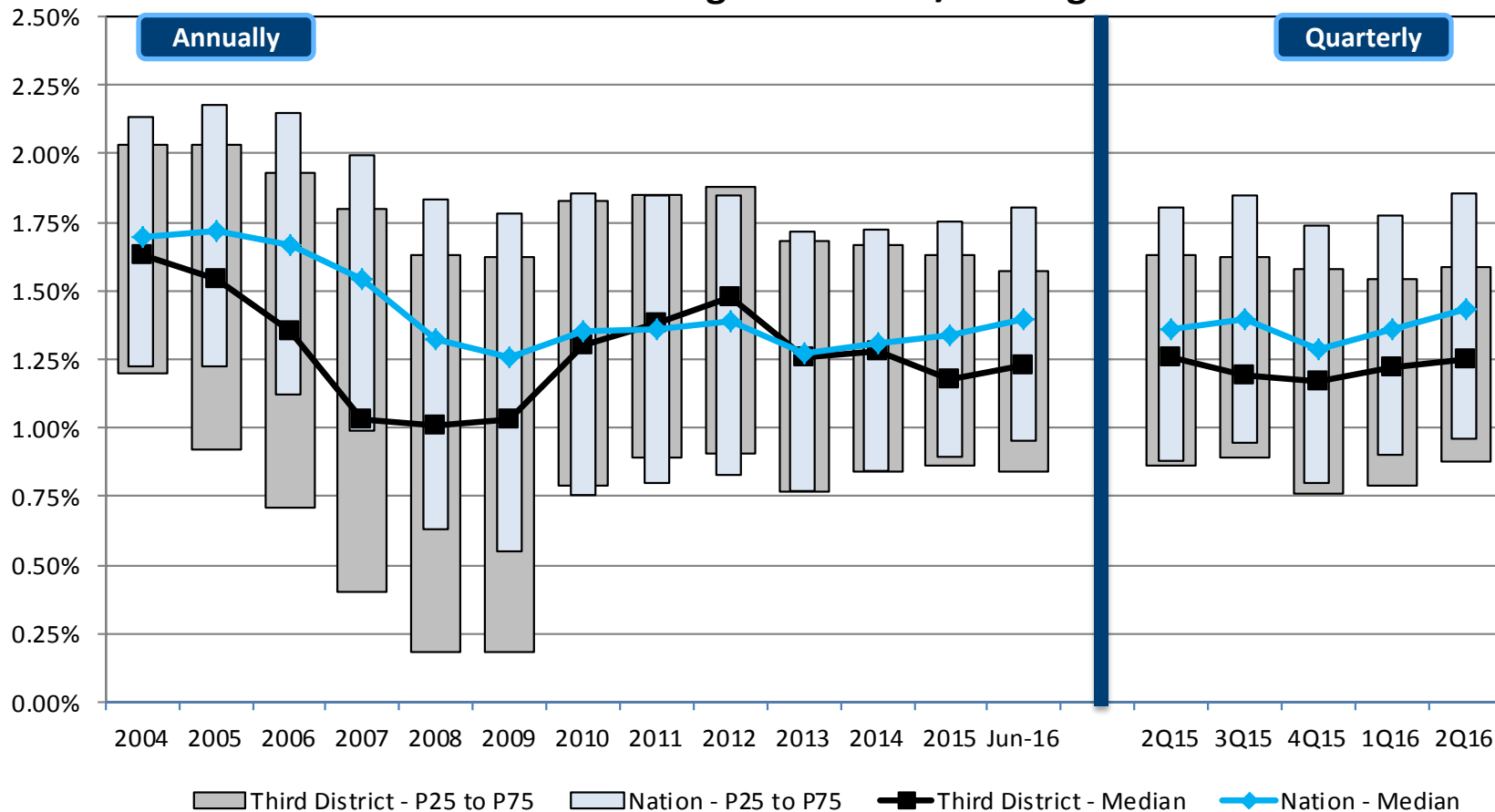


Core profitability has been rising slightly nationally, while the Third District remains below precrisis levels.



Core Profitability

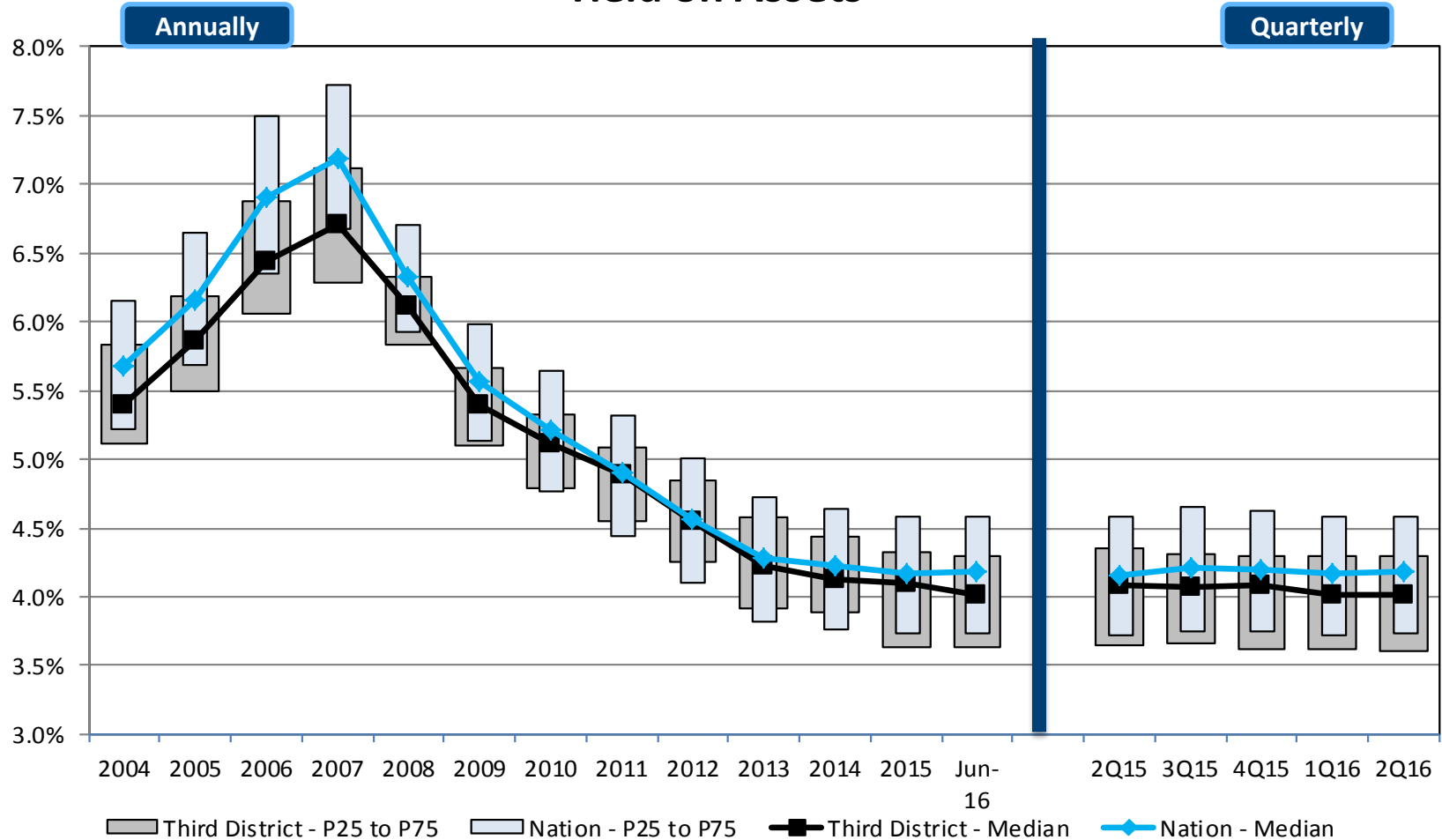
Pre-Tax Income Excluding Provisions / Average Assets



The continued low interest rate environment and overall loan composition suppresses the yield on assets within the District.



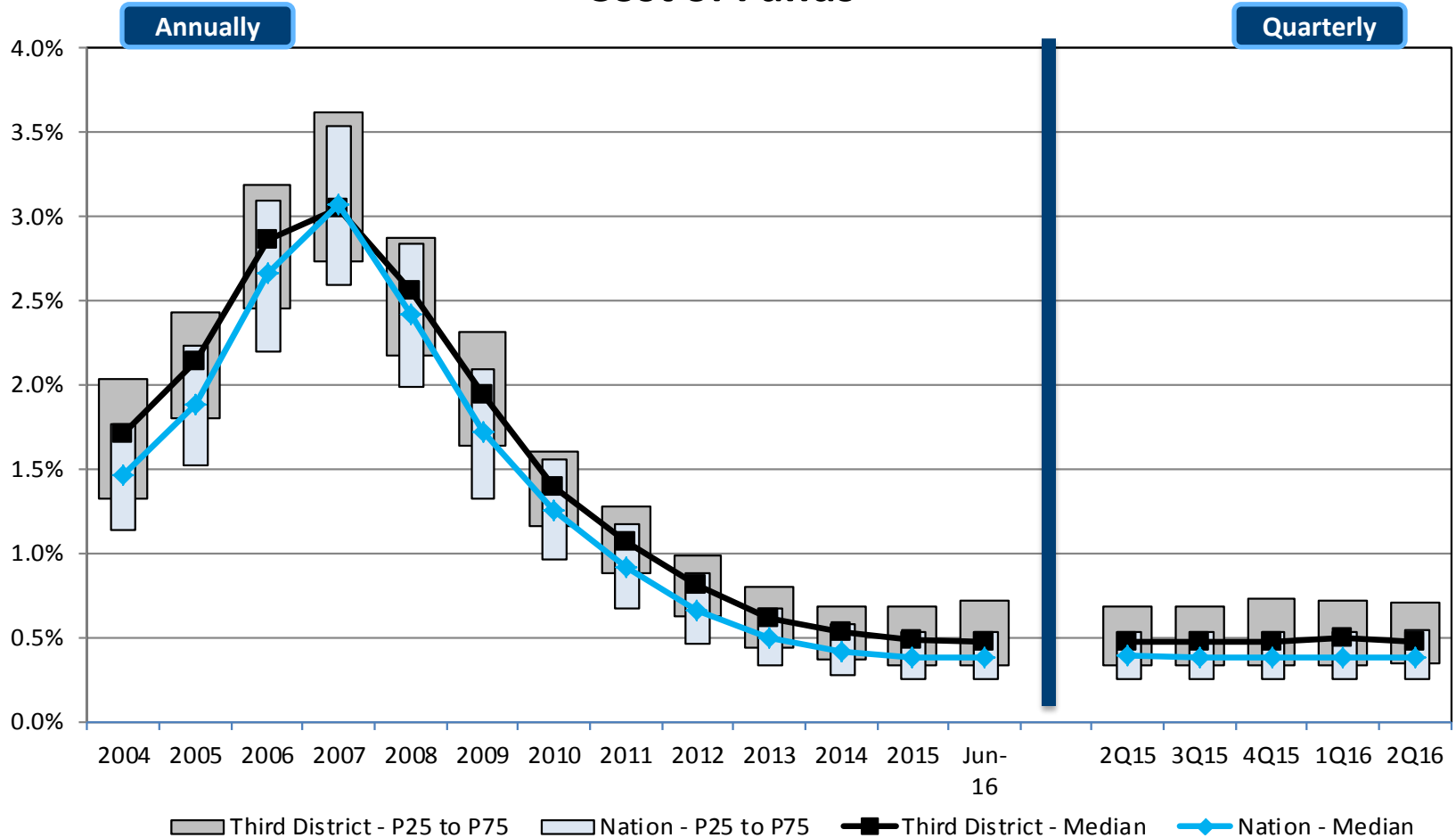
Yield on Assets



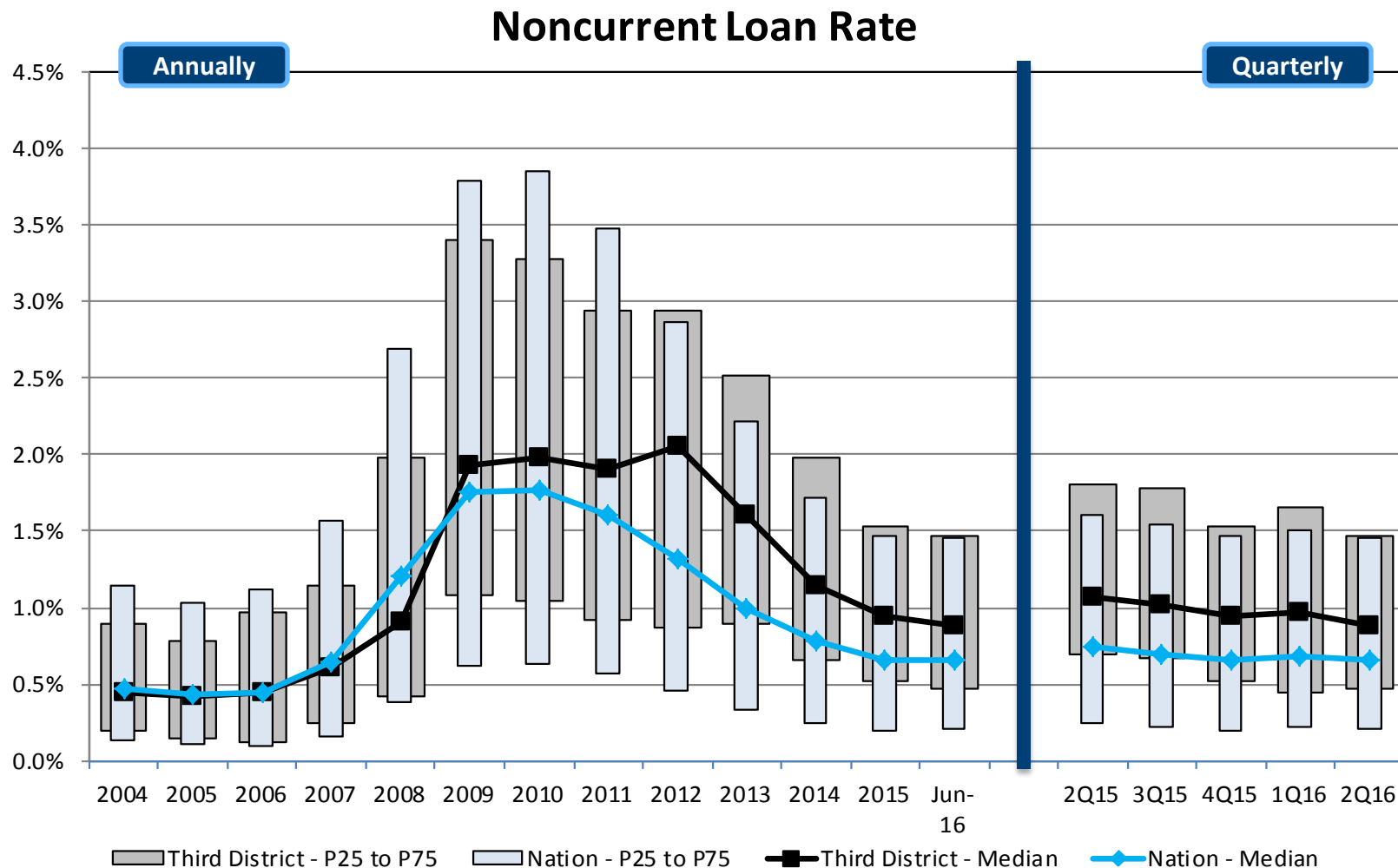
The continued low interest rate environment enables banks to reduce their cost of funds. Many District banks rely on higher-cost noncore funding sources as a source of liquidity and balance sheet growth.



Cost of Funds



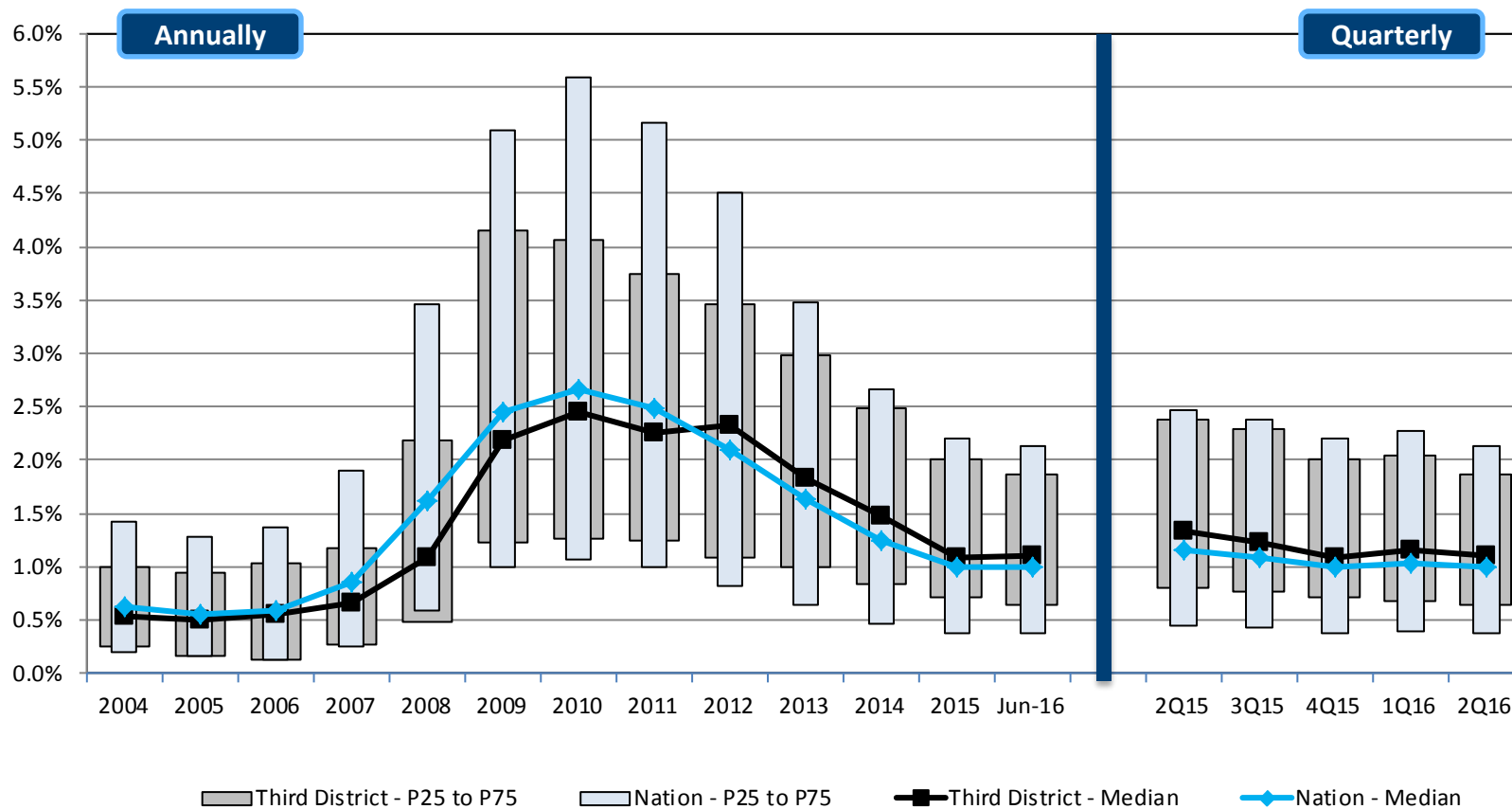
Although the noncurrent loan rate continues to decline, the District continues to lag the nation's recovery.



Third District nonperforming assets are falling, but the District's median remains slightly above the nation as OREO has not declined since 2014.



Nonperforming Assets*

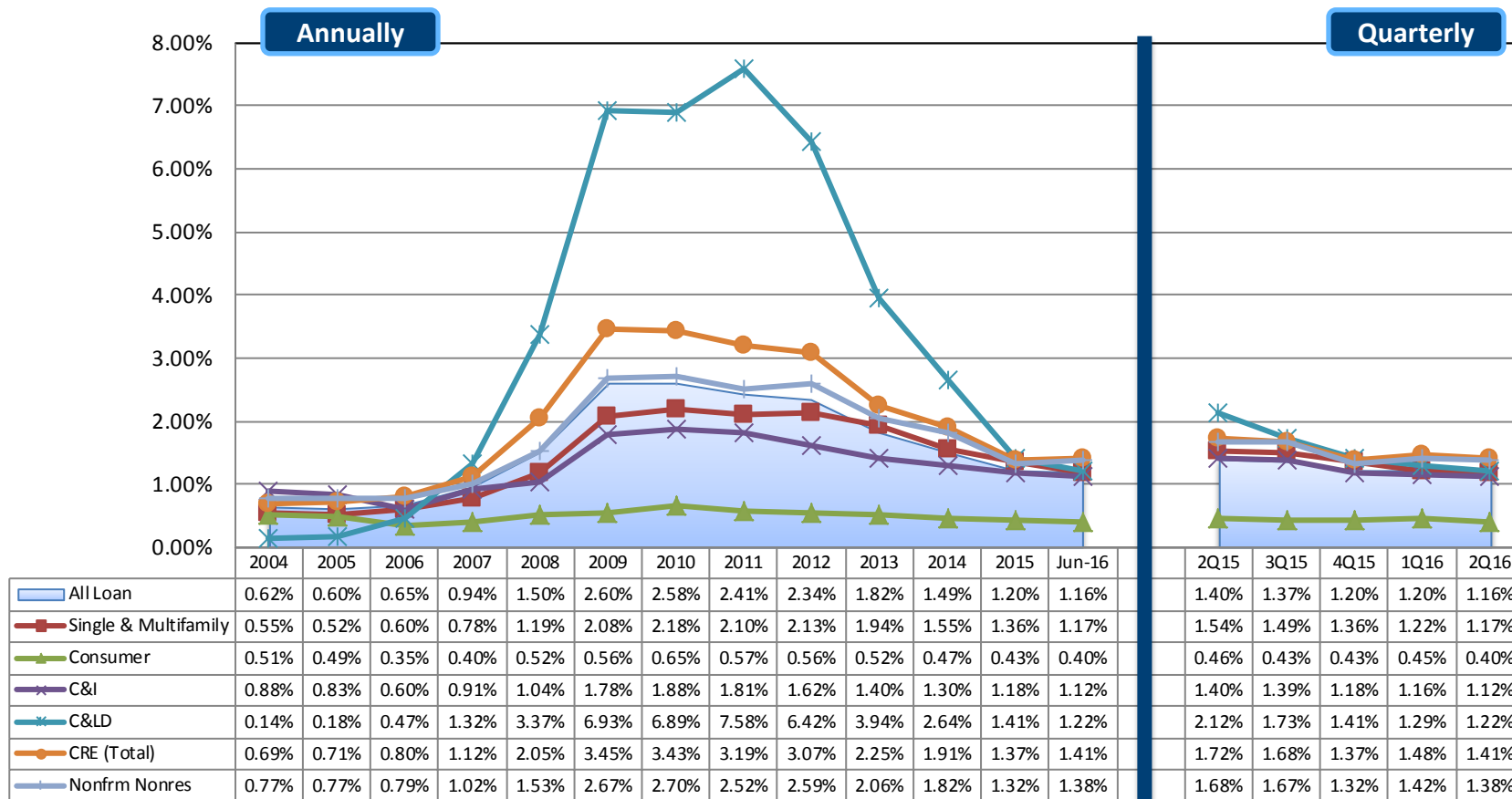


*Nonperforming assets are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans).

Third District loan performance shows significant improvement among the principal loan categories.



Noncurrent Loan Ratios by Loan Category

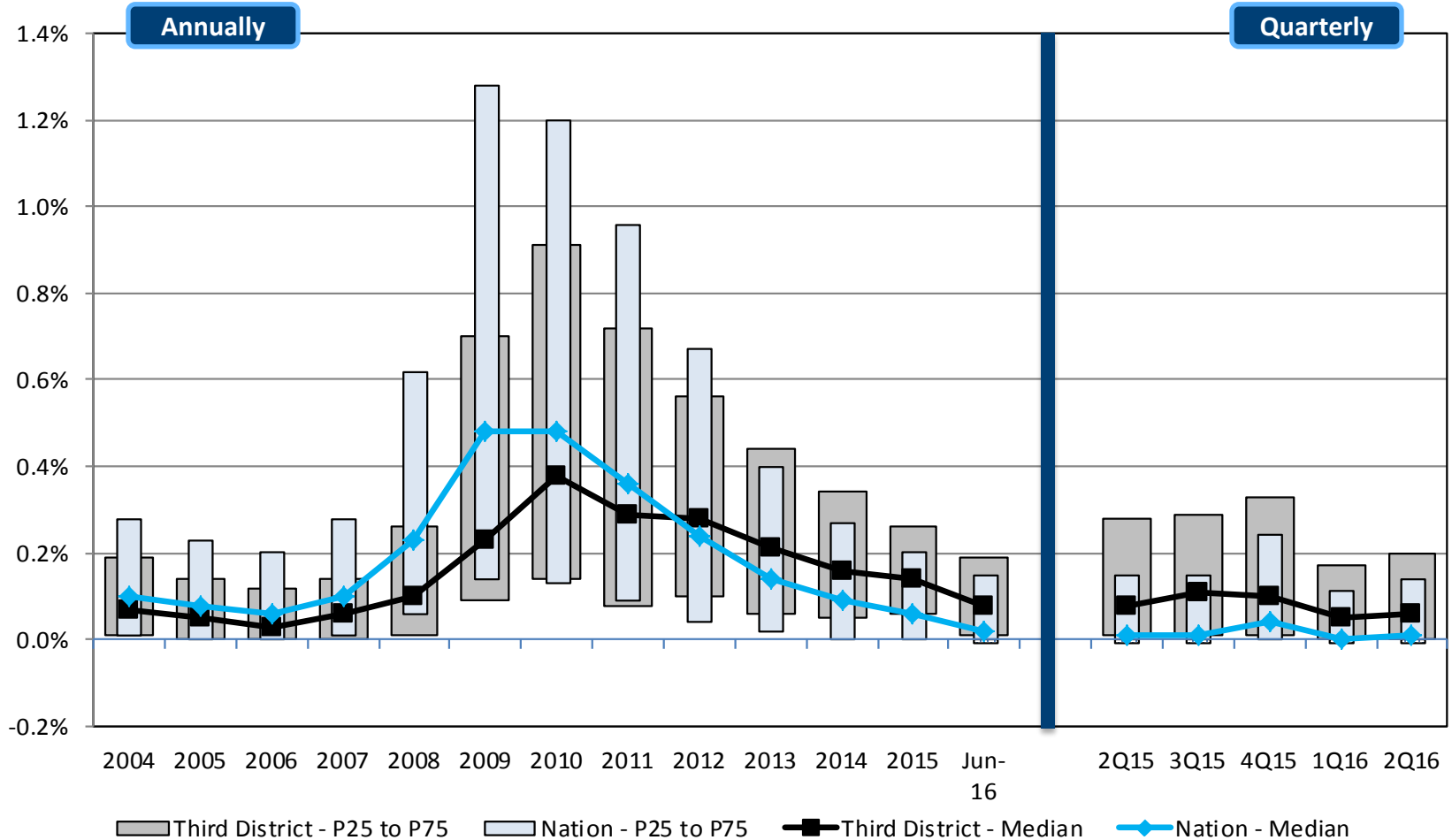


This chart uses a **10% capped mean, or winsorized mean**, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on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

Net charge-off rates have steadily declined since 2009 and are almost in line with precrisis levels.



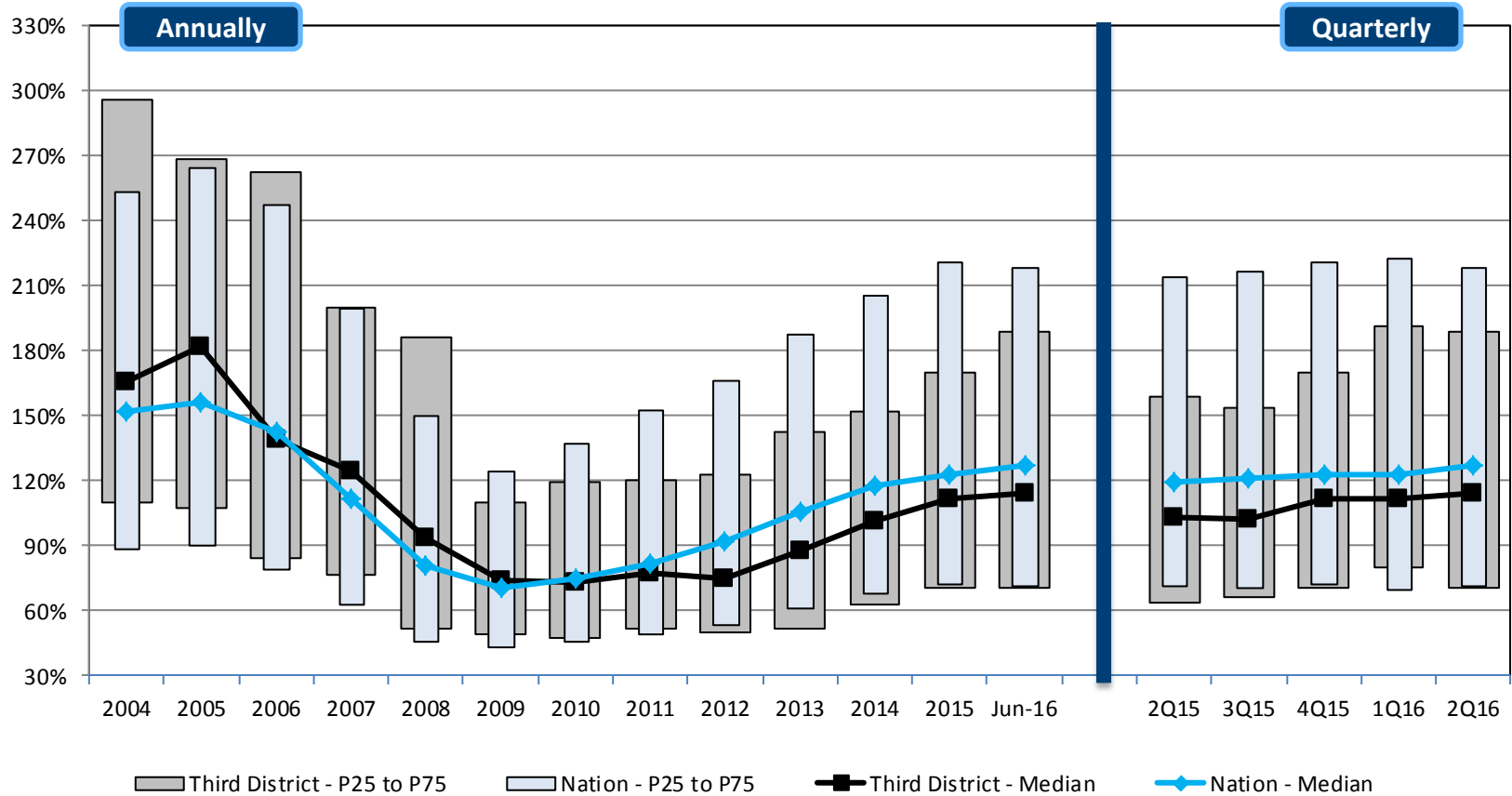
Net Charge-offs / Loans



The allowance for loan and lease losses (ALLL) reserve coverage ratio continues to improve as asset quality metrics improve, not because of increasing provision expense.



Allowance for Loan & Lease Loss Coverage Ratio*

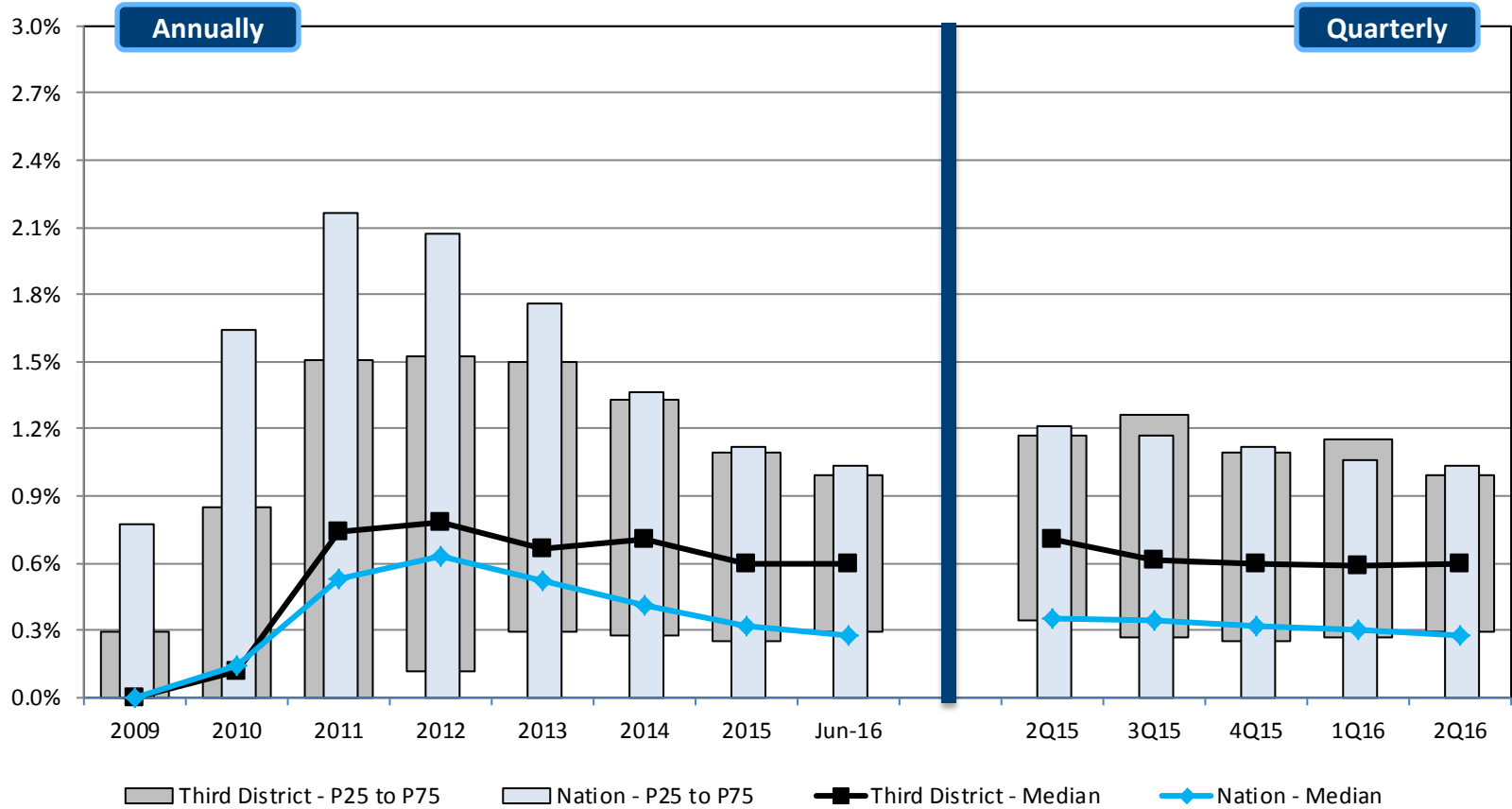


*The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.

Third District troubled debt restructurings remained stable but are elevated compared with the nation.



Troubled Debt Restructurings*

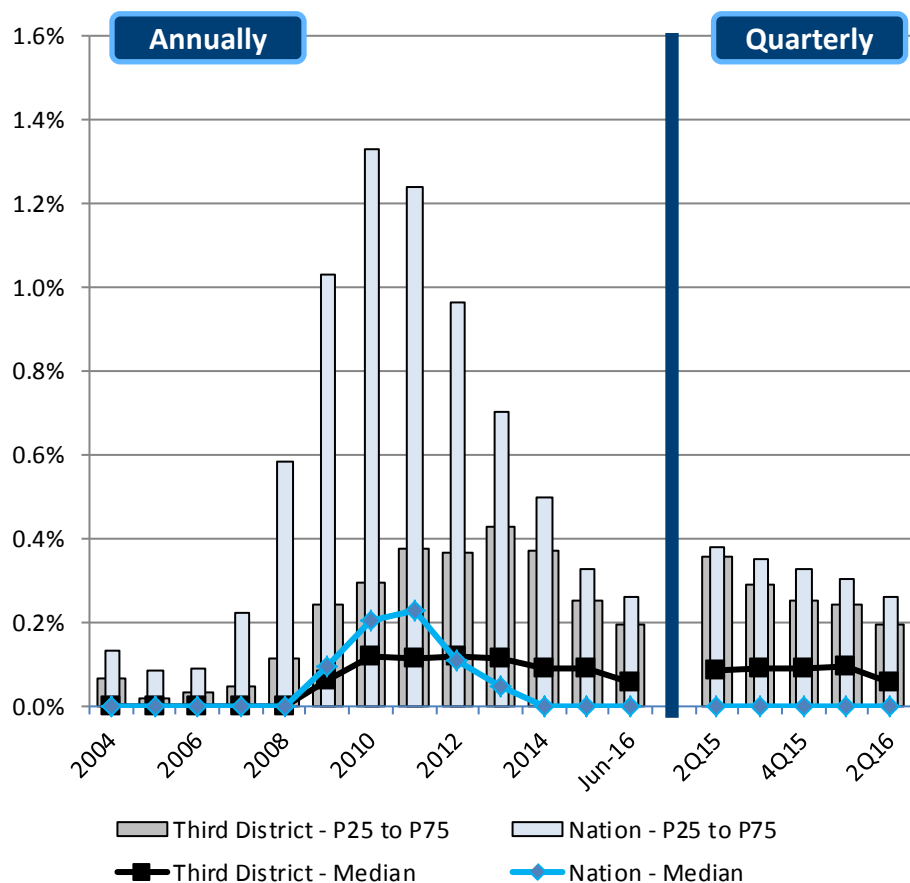


*Troubled debt restructurings were not included on the Call Report until the March 2009 reporting period.

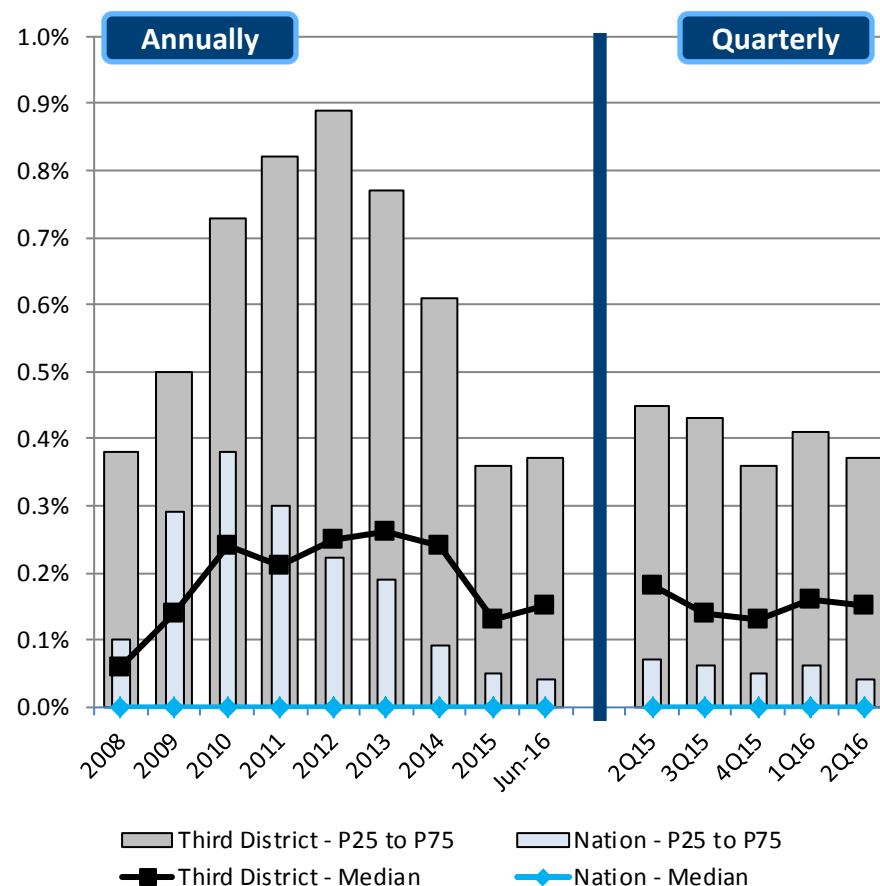
One- to four-family OREO continues to decrease, but the Third District trails in the foreclosure process primarily due to the judicial foreclosure process in PA, DE, and NJ.



1-4 Family OREO*



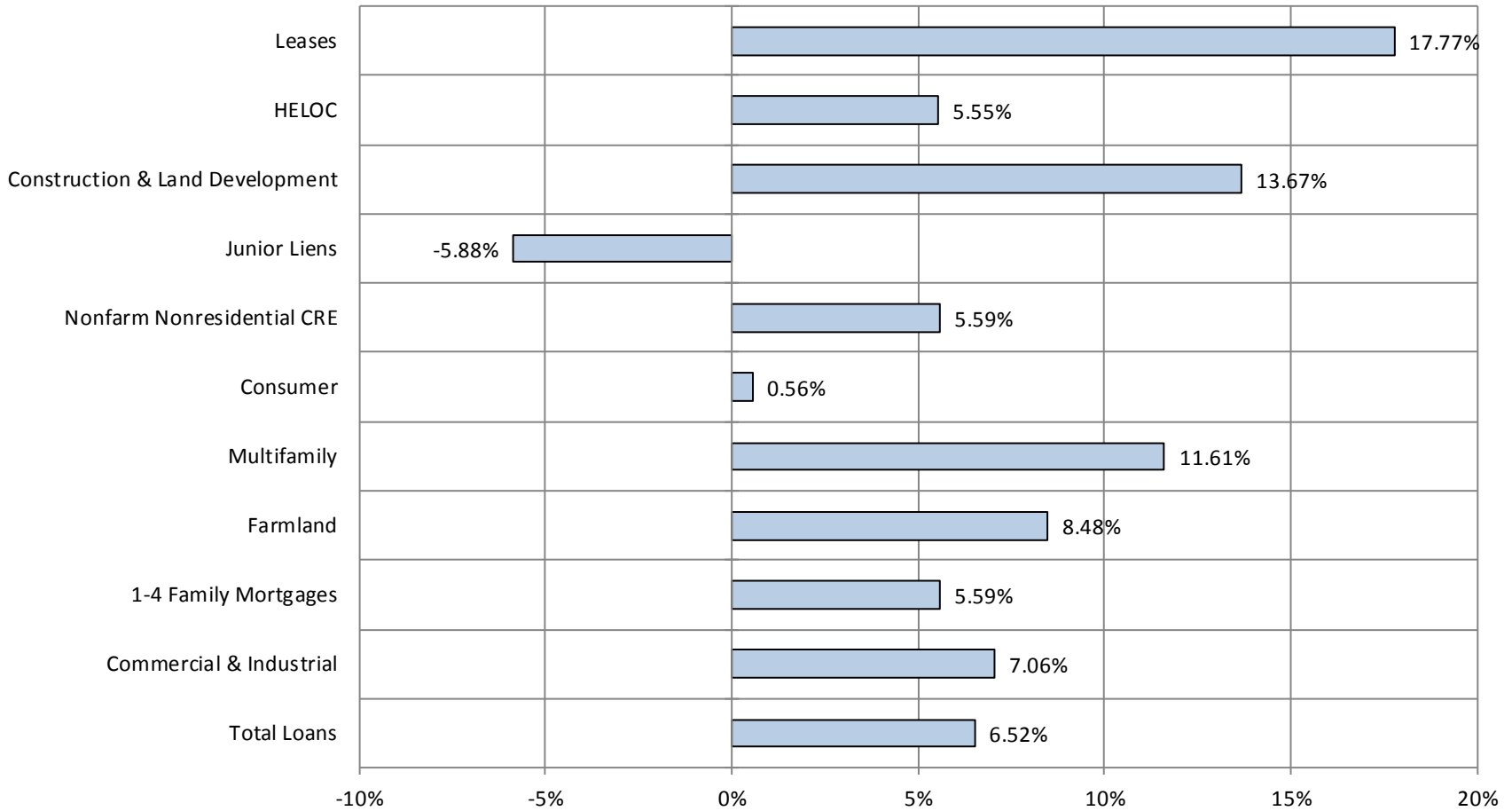
Loans in Process of Foreclosure**



*As a percentage of one- to four-family loans.

**Loans in the process of foreclosure were not included in the Call Report until the March 2008 reporting period. New Jersey, Pennsylvania, and Delaware are all judicial foreclosure states that can extend the foreclosure process.

Third District commercial bank median loan growth* in most categories year over year was positive; loan contraction continues in the junior lien loan category.

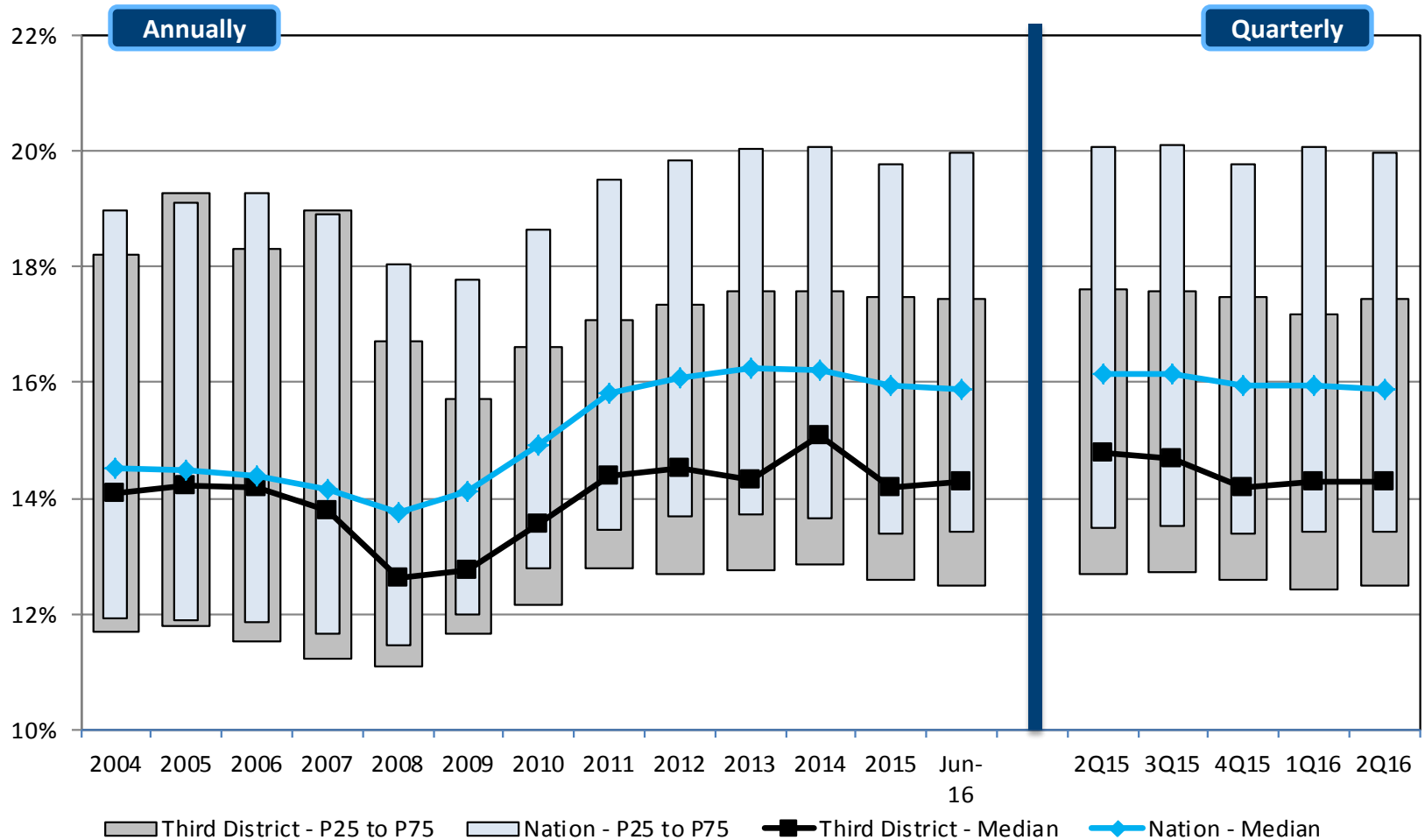


*This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank definition on Slide 4.

Capital ratios have increased postcrisis; however, capital levels have flattened since 2016 and remain below the nation.



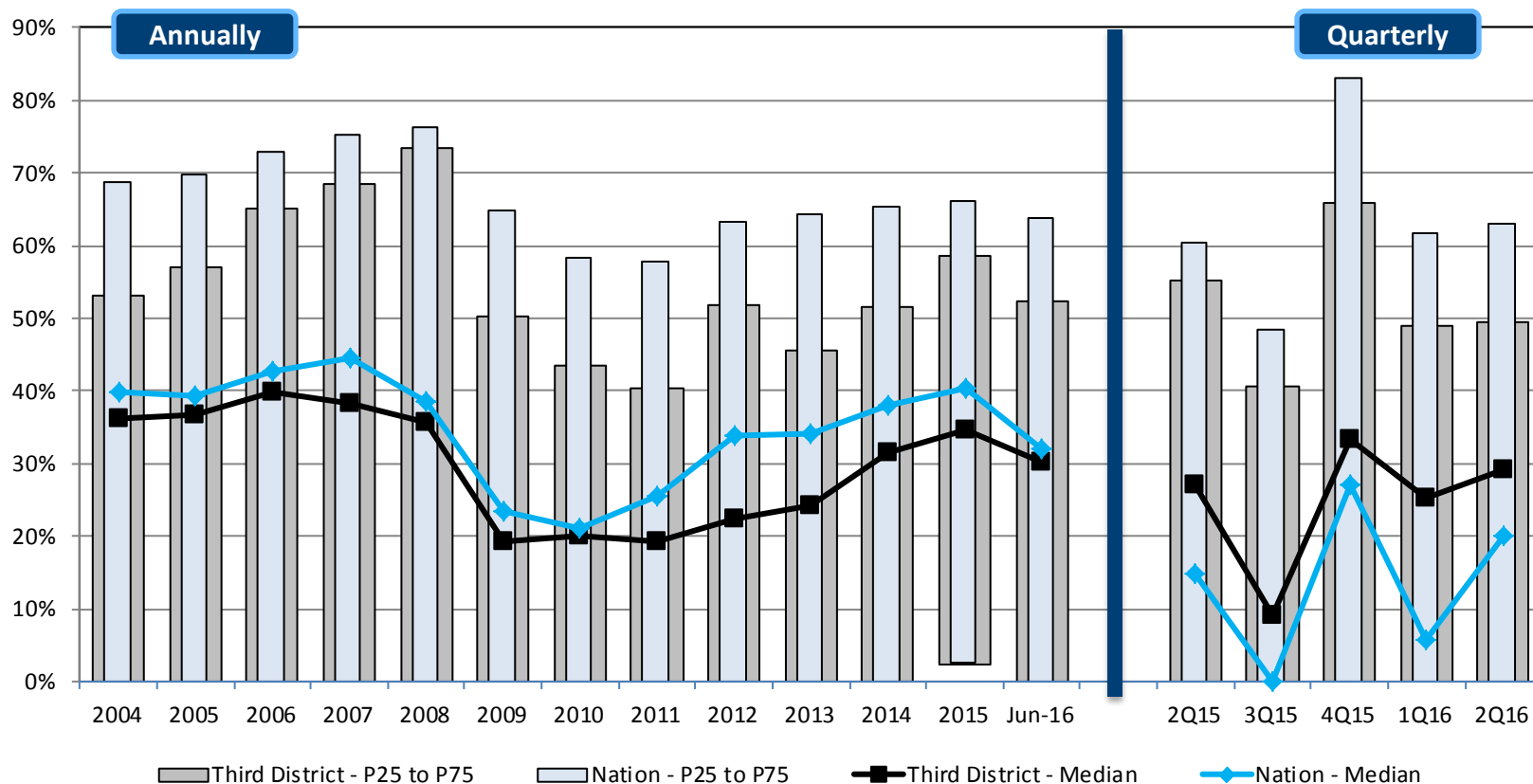
Total Risk-Based Capital



Dividend payments increased in 2Q2016 as many banks pay dividends semiannually. Based on the year-over-year increase, the District may outpace the 2015 dividend payouts.



Dividends*

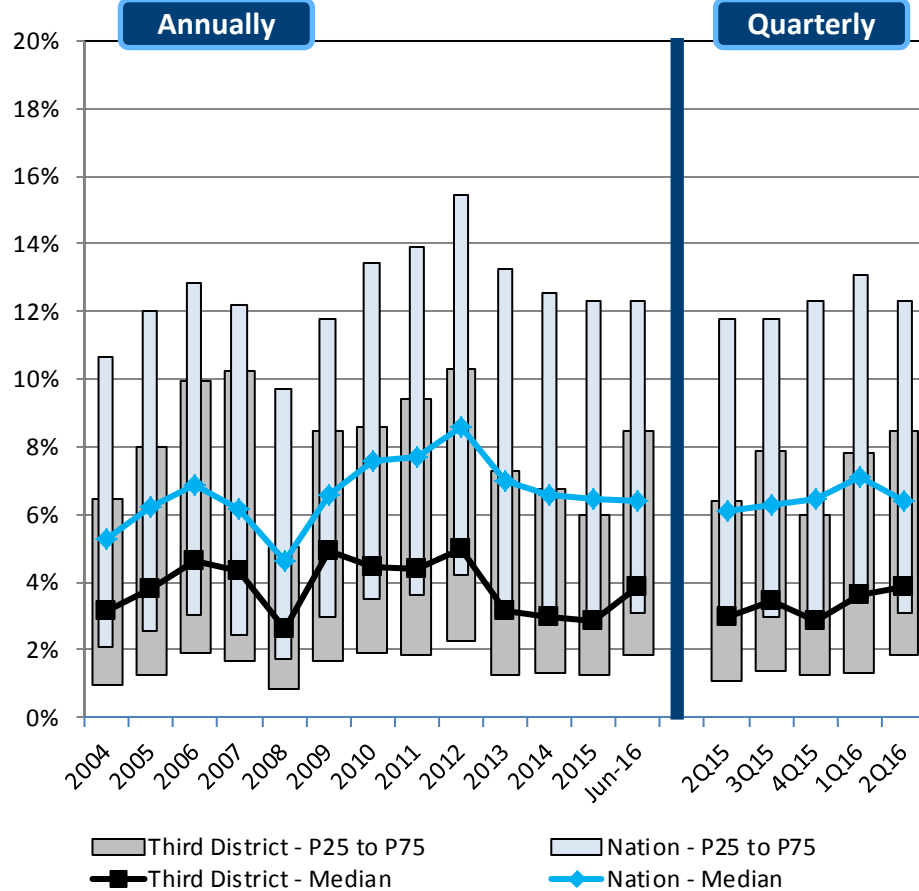


*Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income as dividends in 2014.

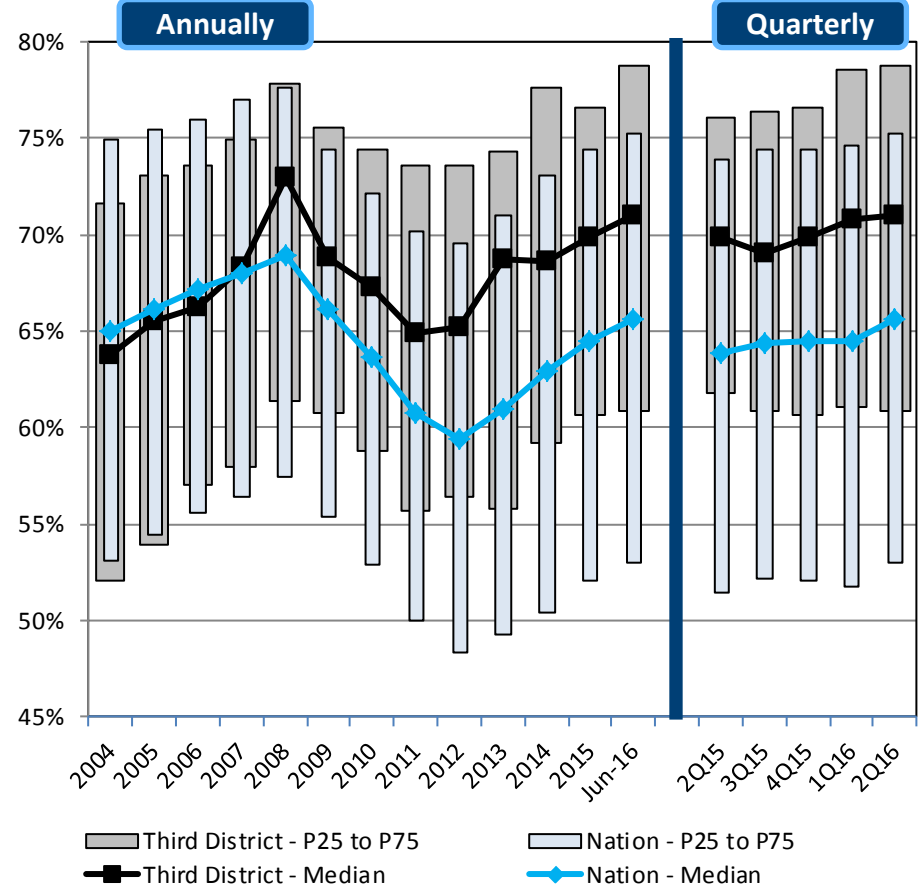
Third District banks hold fewer short-term investments compared with the nation. Additionally, the District is growing its loan portfolio, which may increase duration and interest rate risk.



Short-Term Investments / Assets*



Loans / Assets

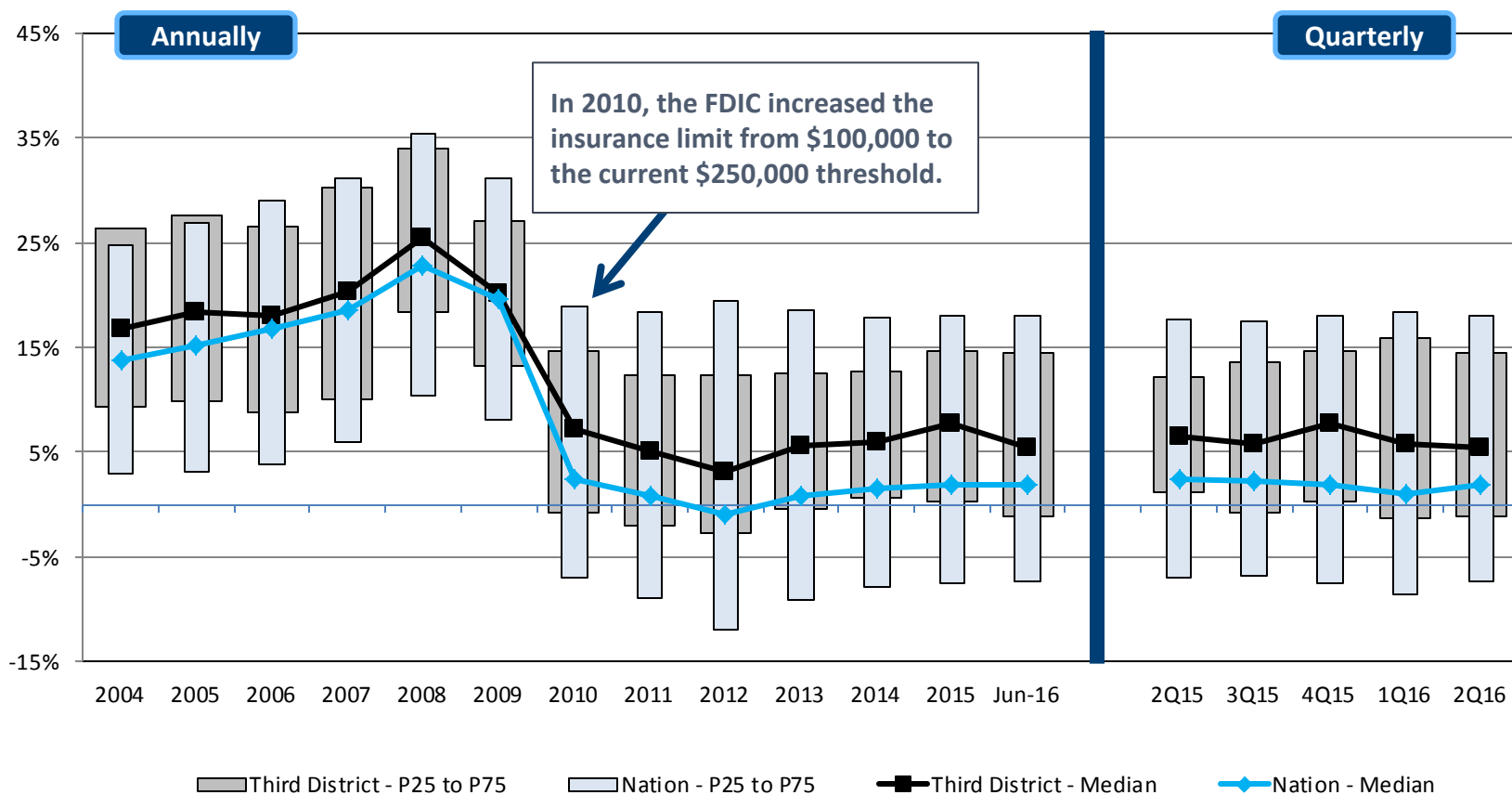


*Short-term investments equal the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

Third District banks' reliance on noncore funding sources to fund its balance sheet growth continues to outpace that of the nation.

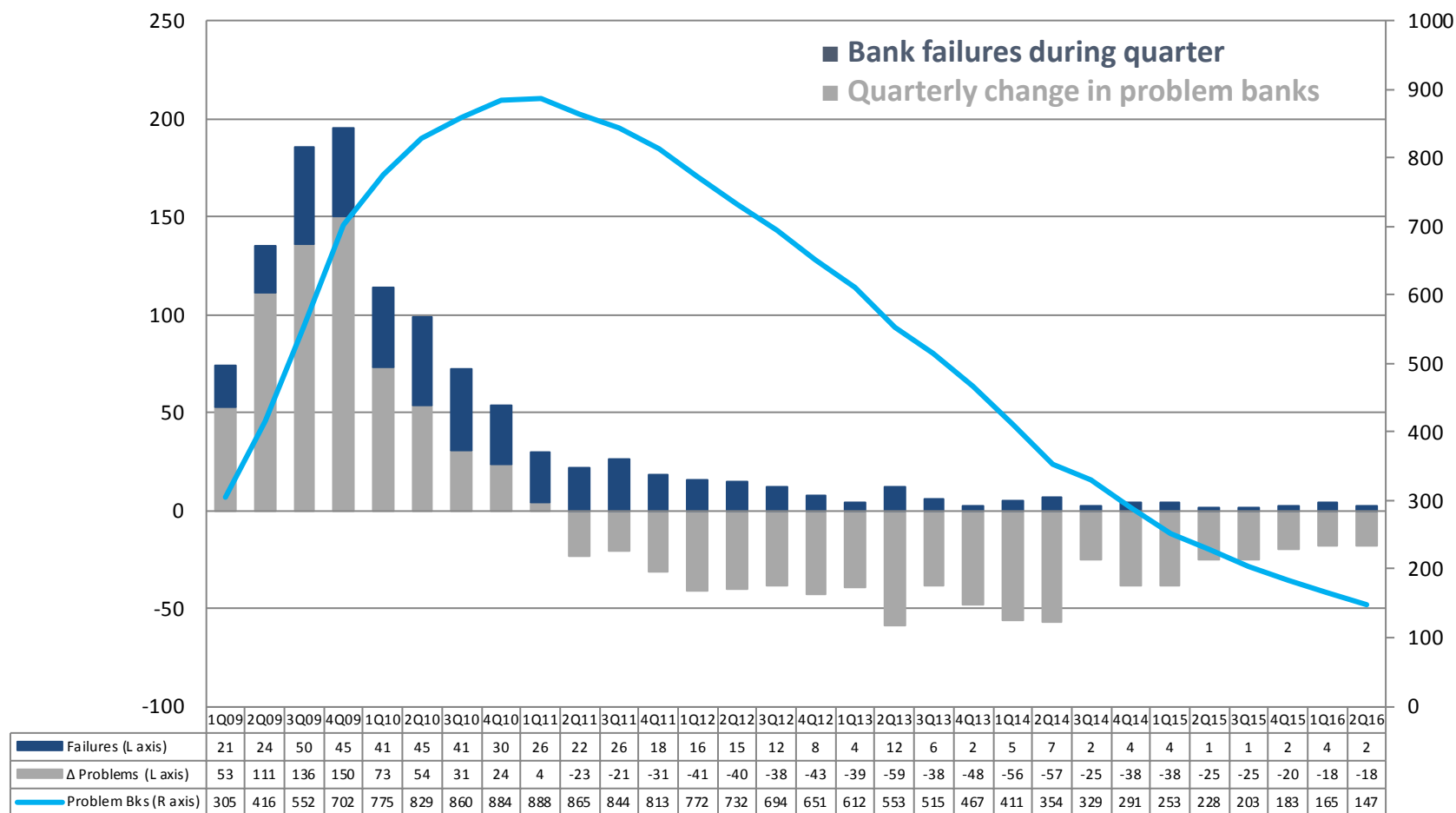


Net Noncore Funding Dependence*



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

Problem banks within the nation fell by 18 institutions to 147 as of 2Q2016.



Source: FDIC; problem banks are defined as having a CAMELS composite rating of 4 or 5. CAMELS is an acronym for the components assessed at a safety and soundness examination: **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk.