



Third District Banking Conditions as of September 30, 2015

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

FEDERAL RESERVE BANK OF PHILADELPHIA

Third District Conditions



Agenda and Table of Contents			
Section 1	Executive Summary	Slide	3
Section 2	Commercial Bank Performance	Slides	4–26
	Earnings	Slides	5–13
	Credit Quality	Slides	14–20
	Loan Growth	Slide	21
	Capital Adequacy	Slides	22–23
	Liquidity	Slides	24–25
	Problem Banks	Slides	26

For any questions about this presentation, please contact Christopher Hahne at 215-574-6406 or christopher.hahne@phil.frb.org.

Section 1: Executive Summary



- Interest rate risk endures and remains the most significant financial risk within the District, especially given the recent rate hike at the October 2015 Federal Open Market Committee (FOMC) meeting. Are banks positioned to withstand the rise in interest rates?
- Third District bank performance continues to recover, although sustainable earnings challenges remain; the net interest margin (NIM) continues to be compressed.
- National asset quality metrics continue to depict improvement; however, the zero or negative provision expense reported over the past few quarters helped contribute to the return on average assets (ROAA).
- Capital ratios are increasing as a result of earnings accretion.
- Third District banks' reliance on noncore funding sources continues to outpace the industry.
- The number of problem banks continues to decline because of improved economic conditions.
- 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
 - Model risk management (SR 11-7 compliance)

Section 2: Commercial Bank Performance



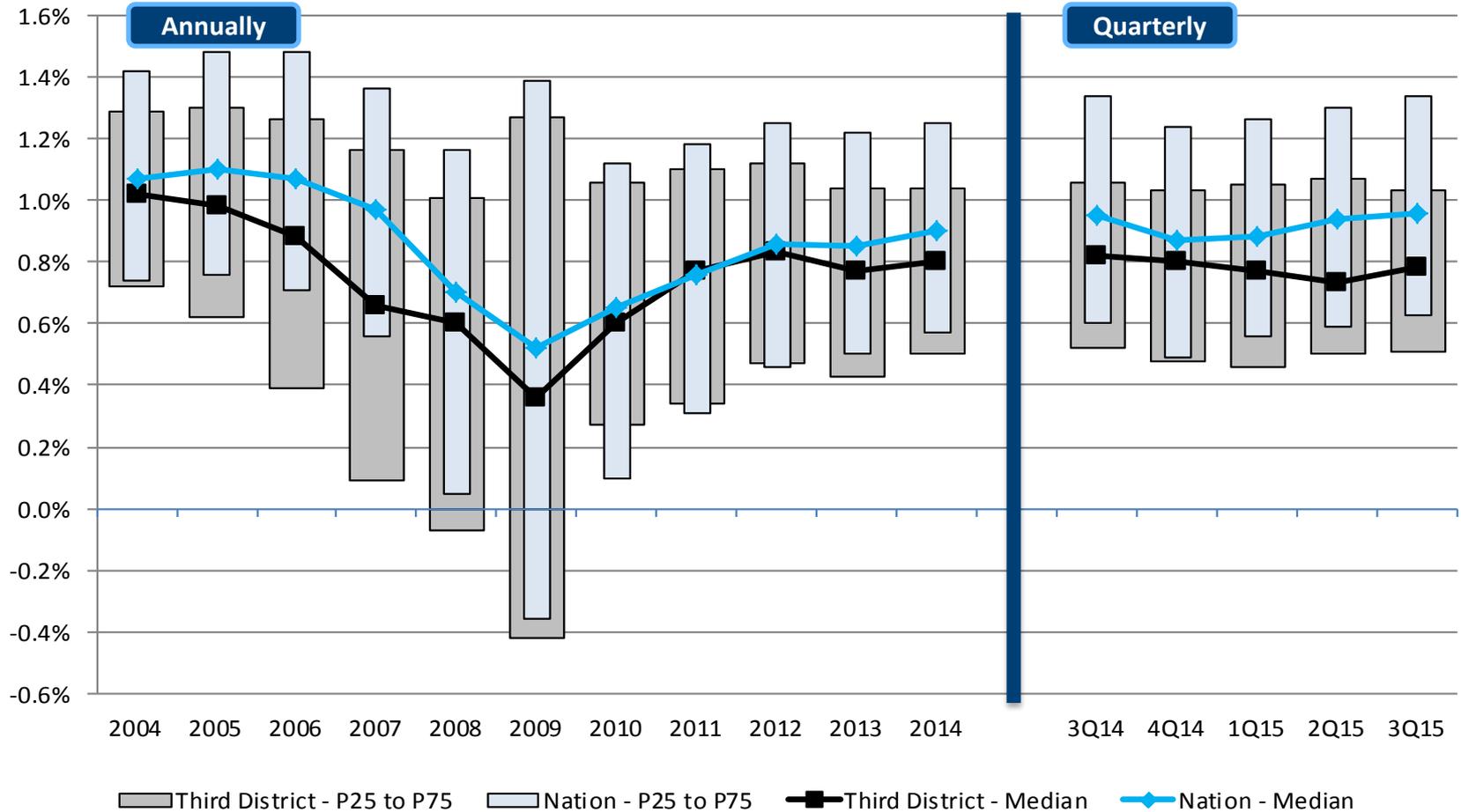
Reporting Methodology

- The quarterly **Reports of Condition and Income (Call Report)** and **Uniform Bank Performance Report (UBPR)** are the primary sources of all information contained here unless otherwise noted.
- The slides in this section focus on trends among the **117 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 **June 30, 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 of 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 consistently lags behind the nation.



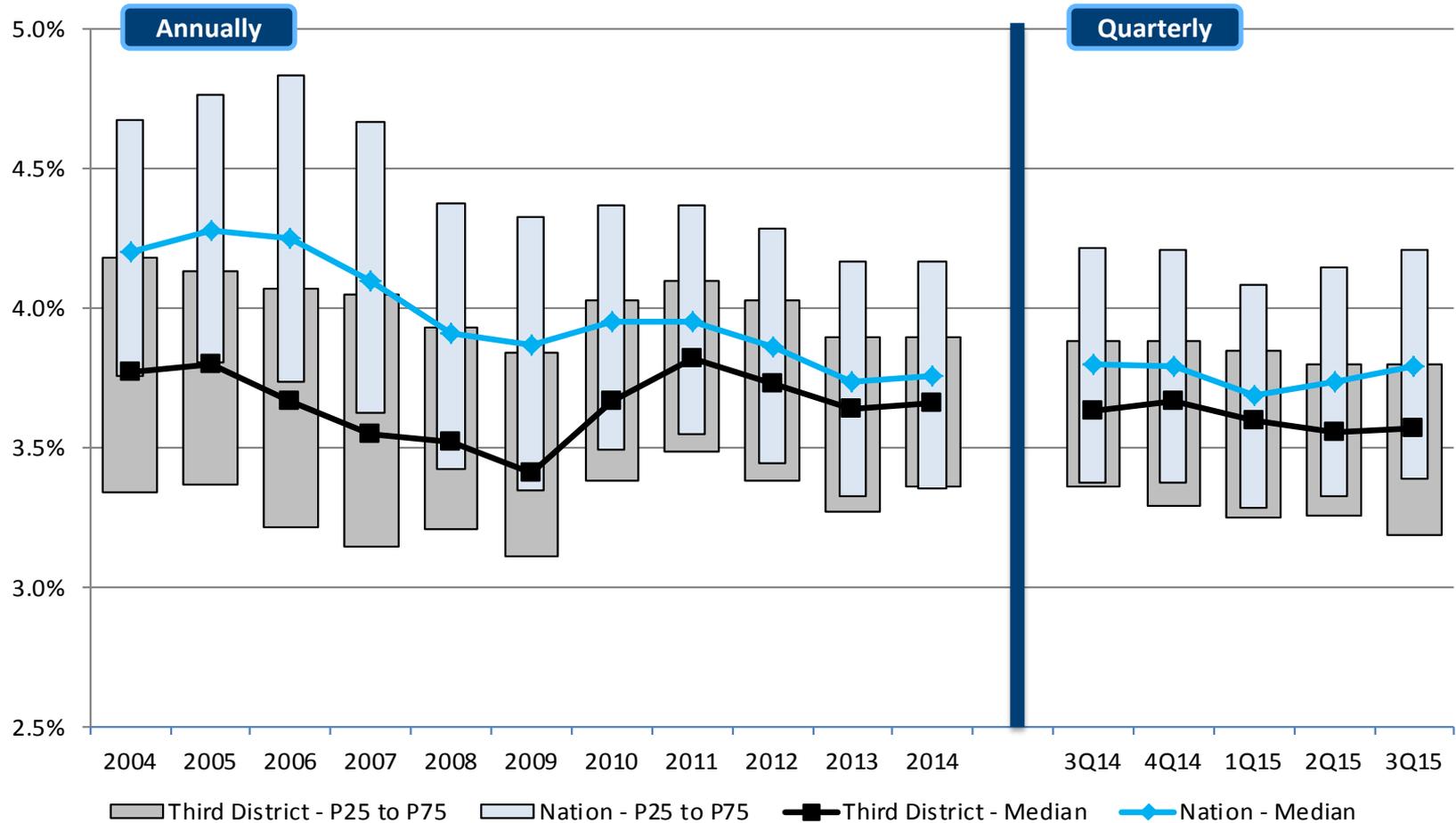
Return on Average Assets



Third District net interest margin (NIM) remains below the rest of the nation as of 3Q2015; asset yield declines continued to outpace the drop in the cost of funds.



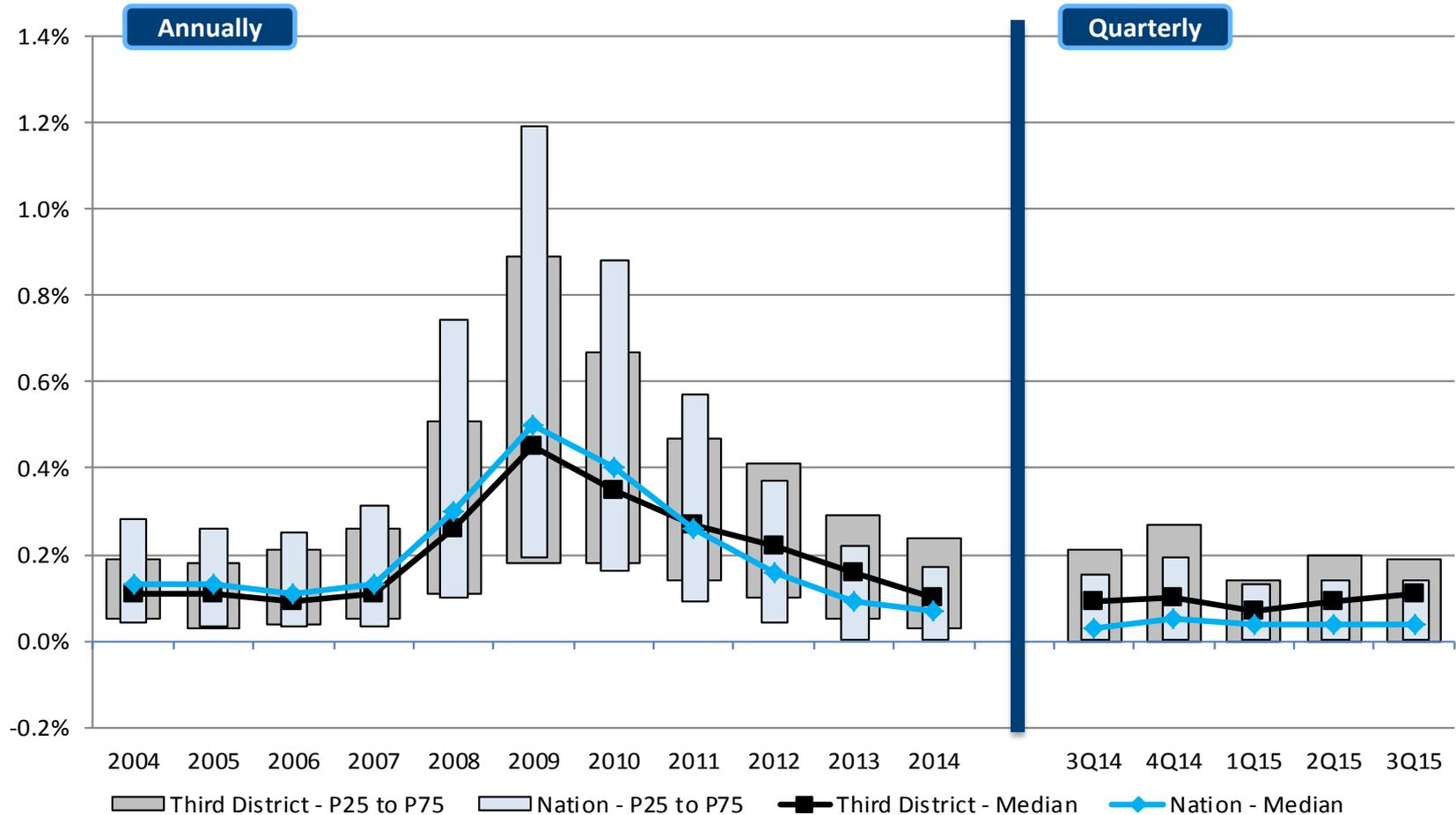
Net Interest Margin



Provision expense remains below precrisis levels, which continues to help augment earnings.



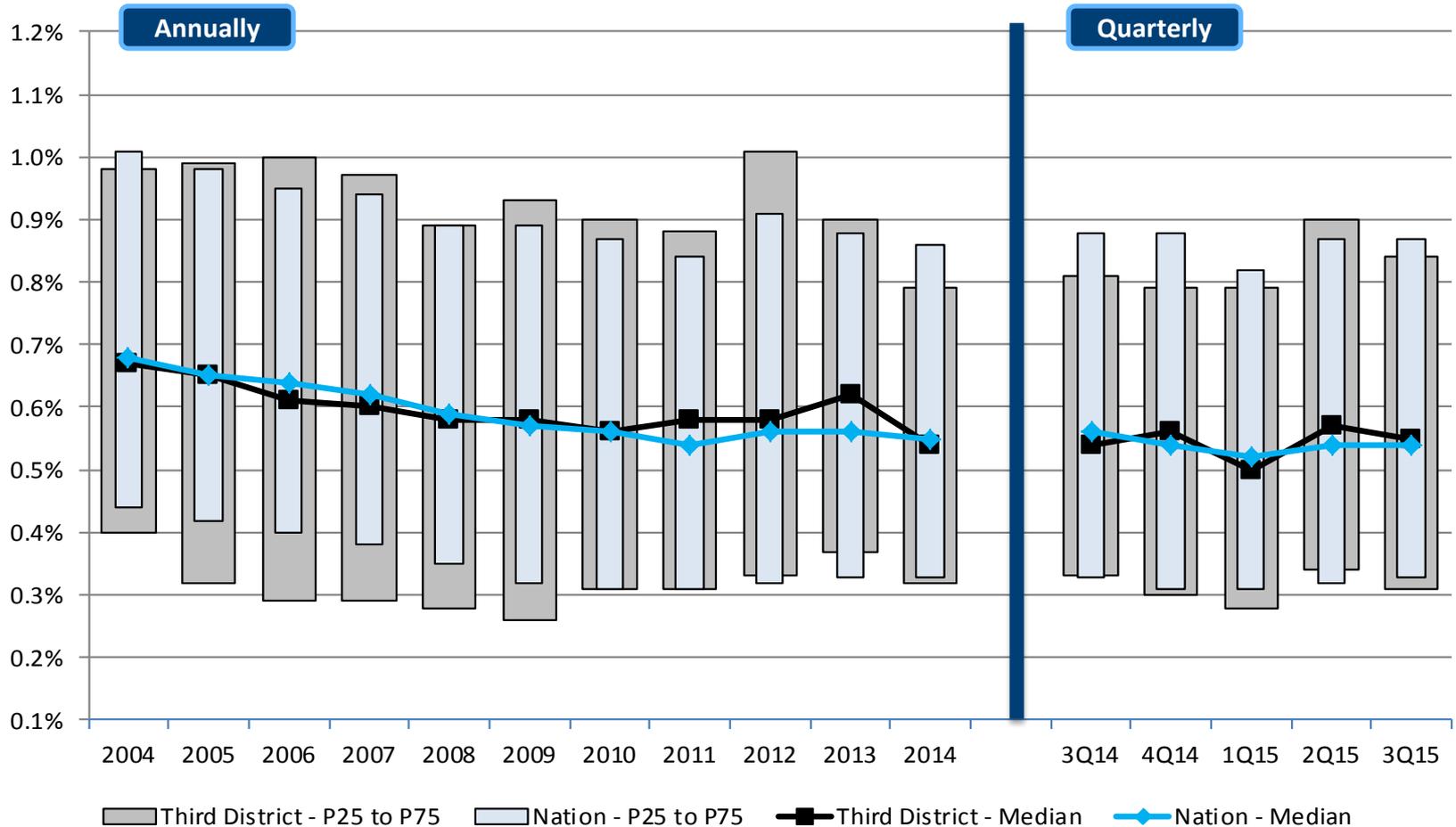
Provisions / Average Assets



Noninterest income fell in 3Q2015, which adversely affected return on average assets (ROAA) in the Third District.



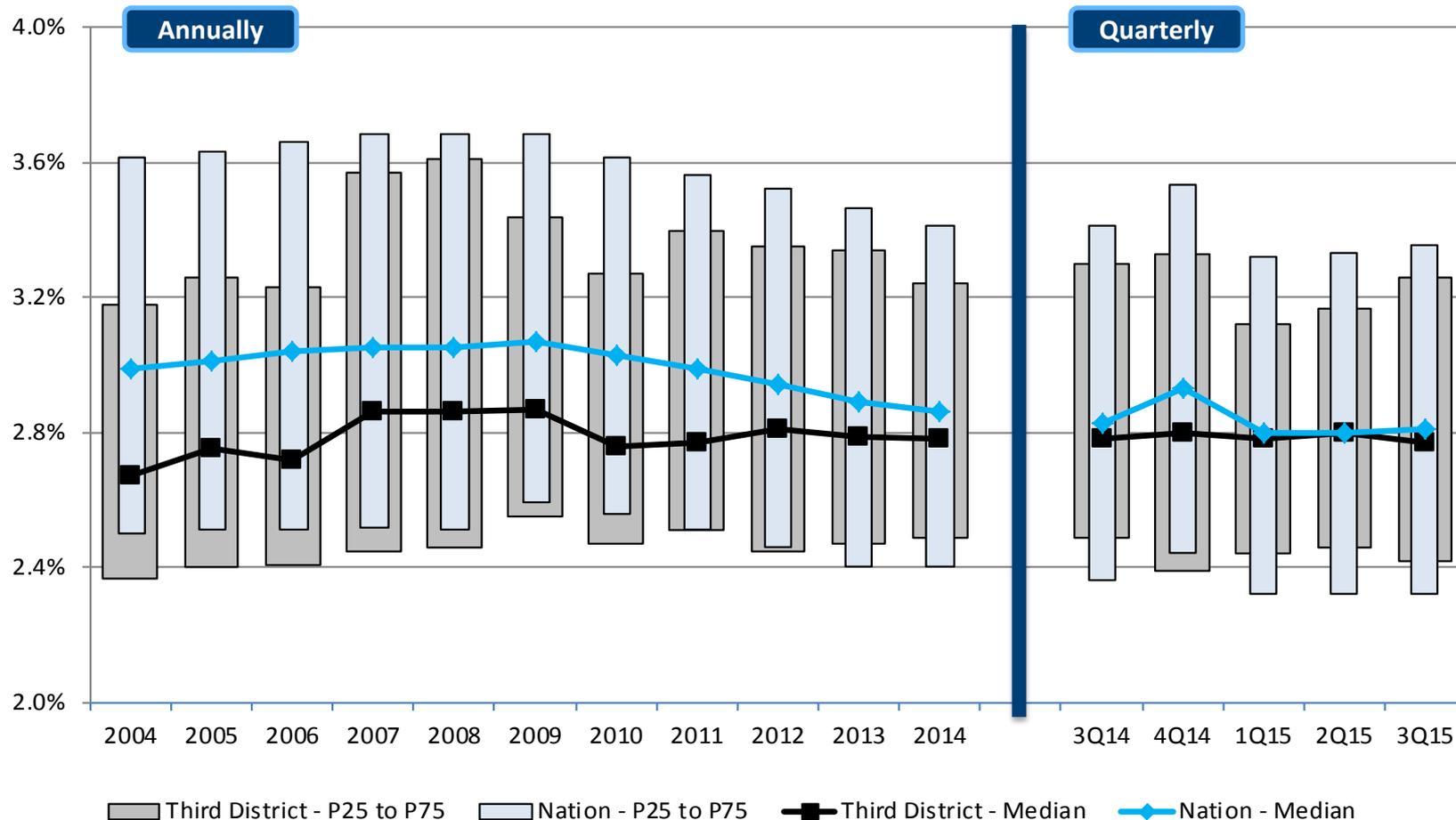
Noninterest Income / Average Assets



Median Third District overhead expense has remained relatively stable since 2010, marginally impacting ROAA.



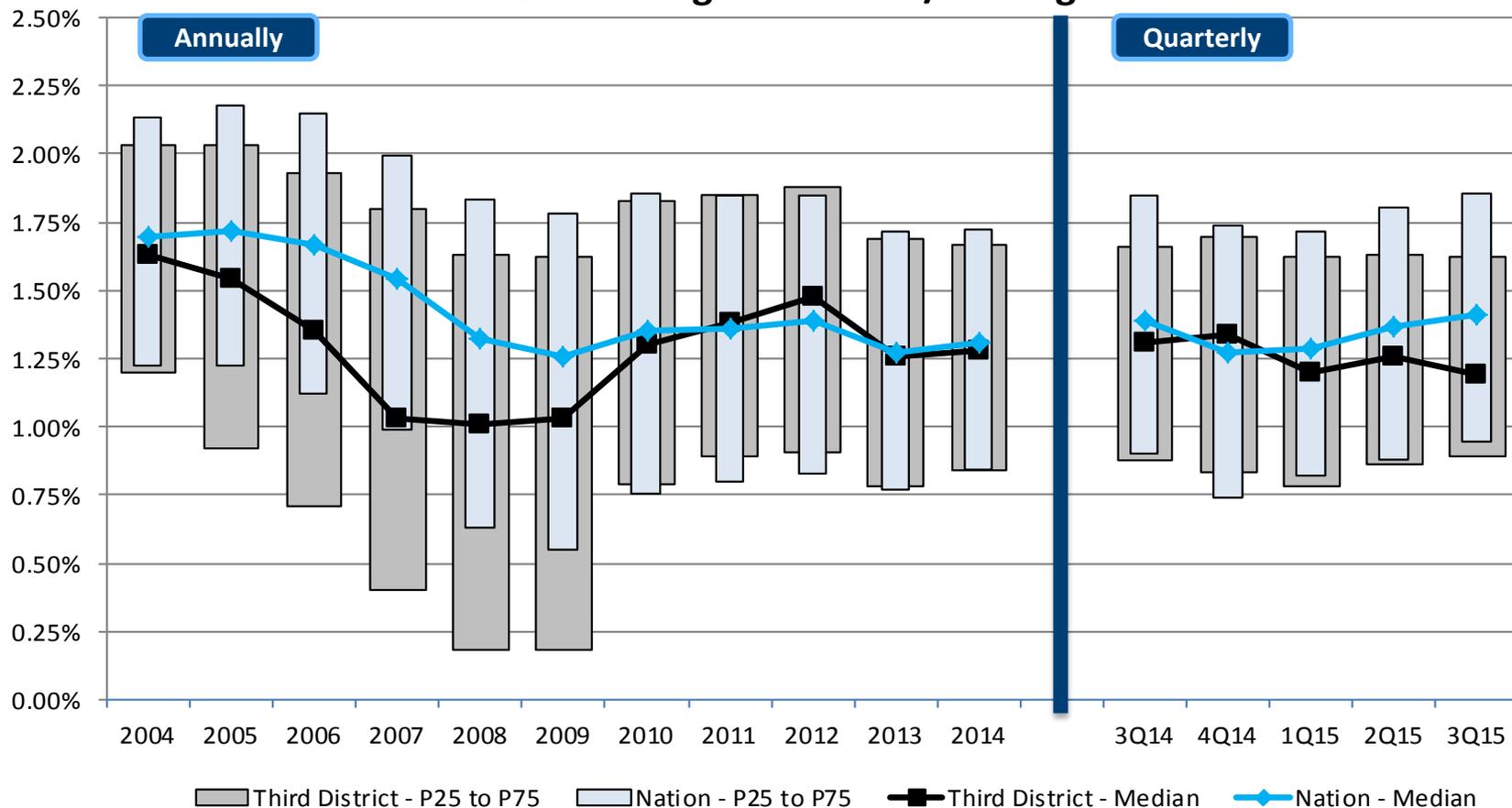
Overhead Expense to Average Assets



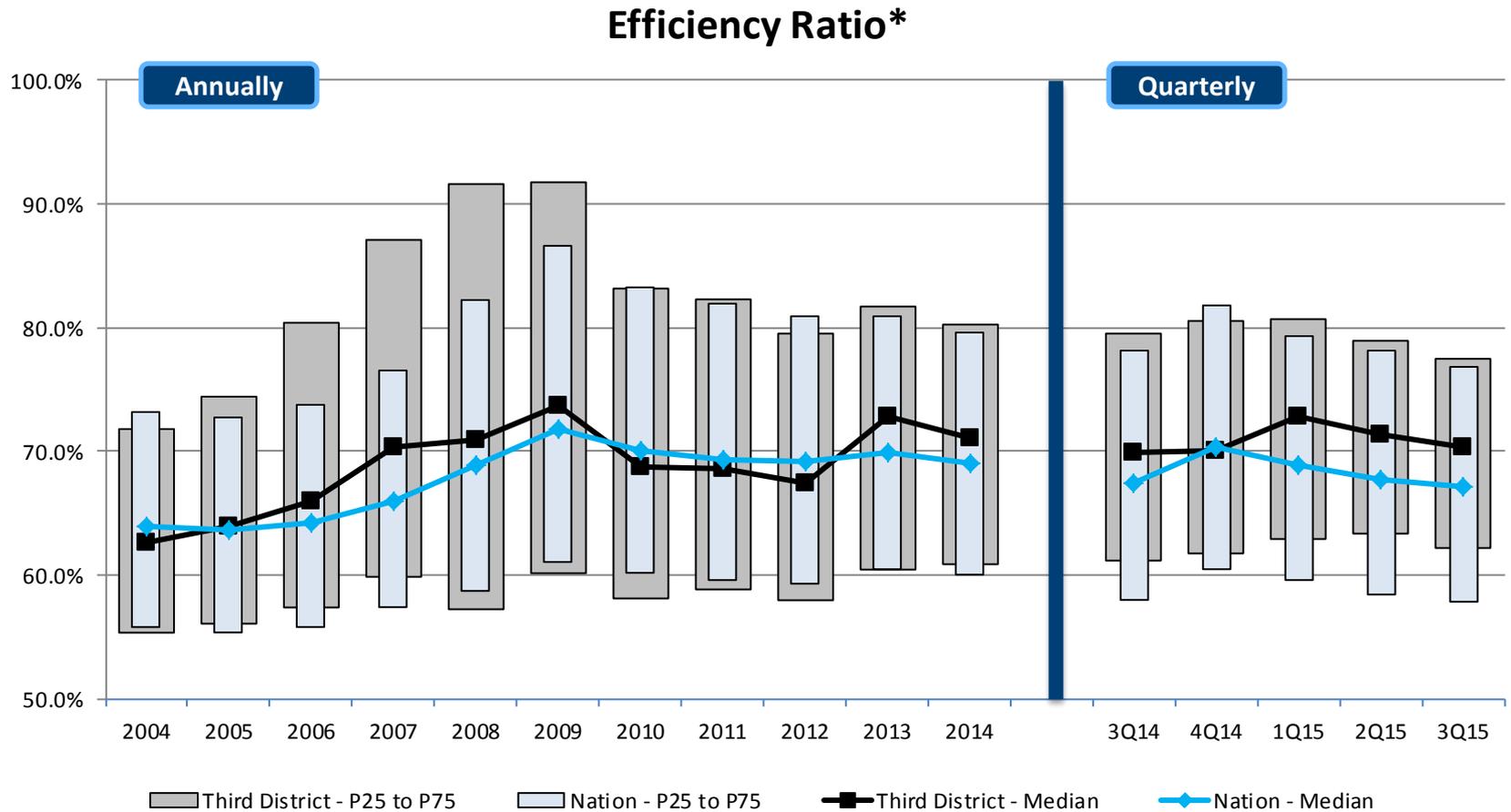
Core profitability in the Third District continues to remain below precrisis levels.



Core Profitability Pretax Income Excluding Provisions / Average Assets



Efficiency ratios remain elevated but are stabilizing; the current ratios remain above precrisis levels.

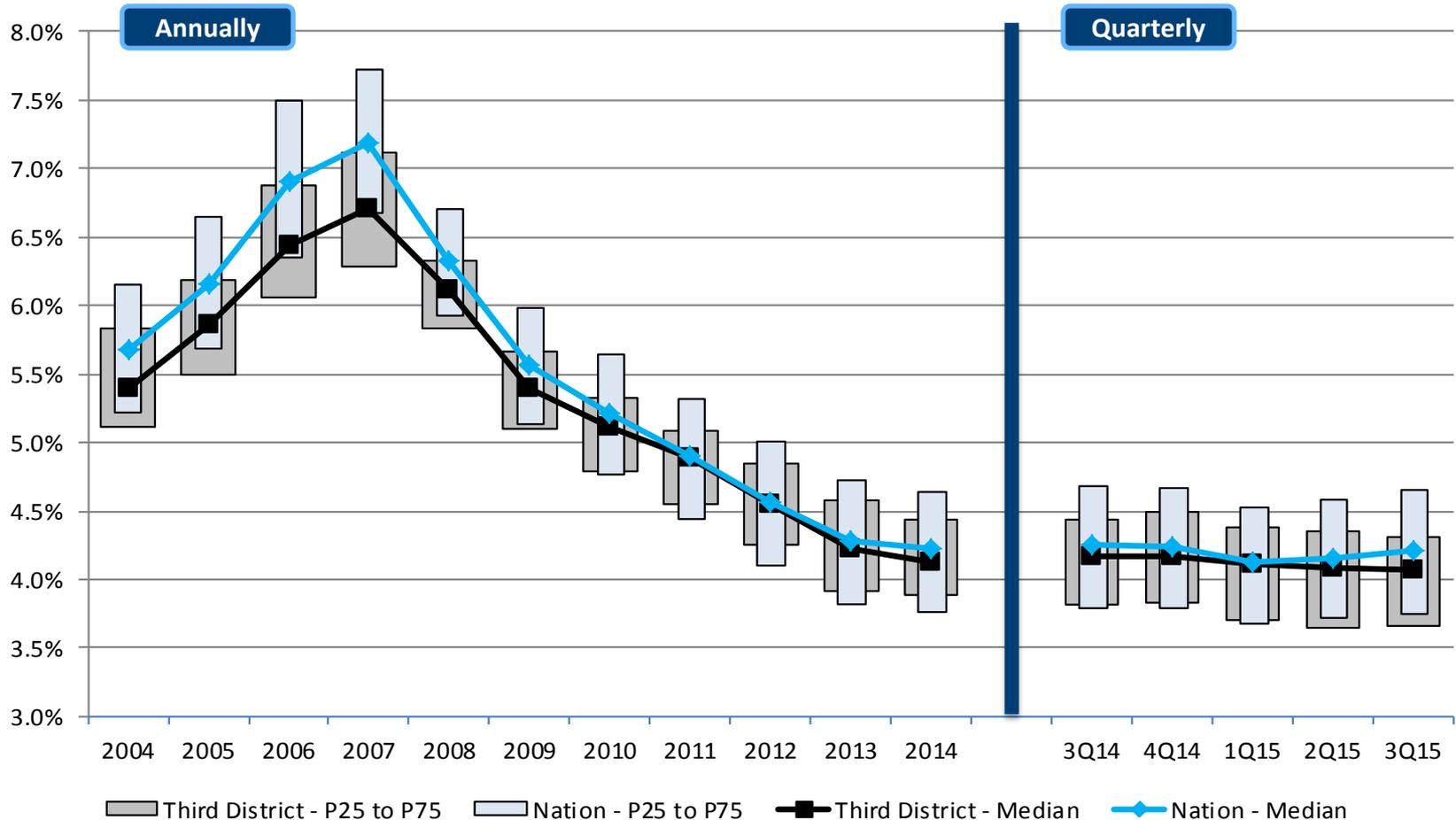


*The **efficiency ratio** is a measure of total overhead expense expressed as a percentage of net interest income plus noninterest income.

The continued low interest rate environment suppresses the yield on assets within the District and within the nation.



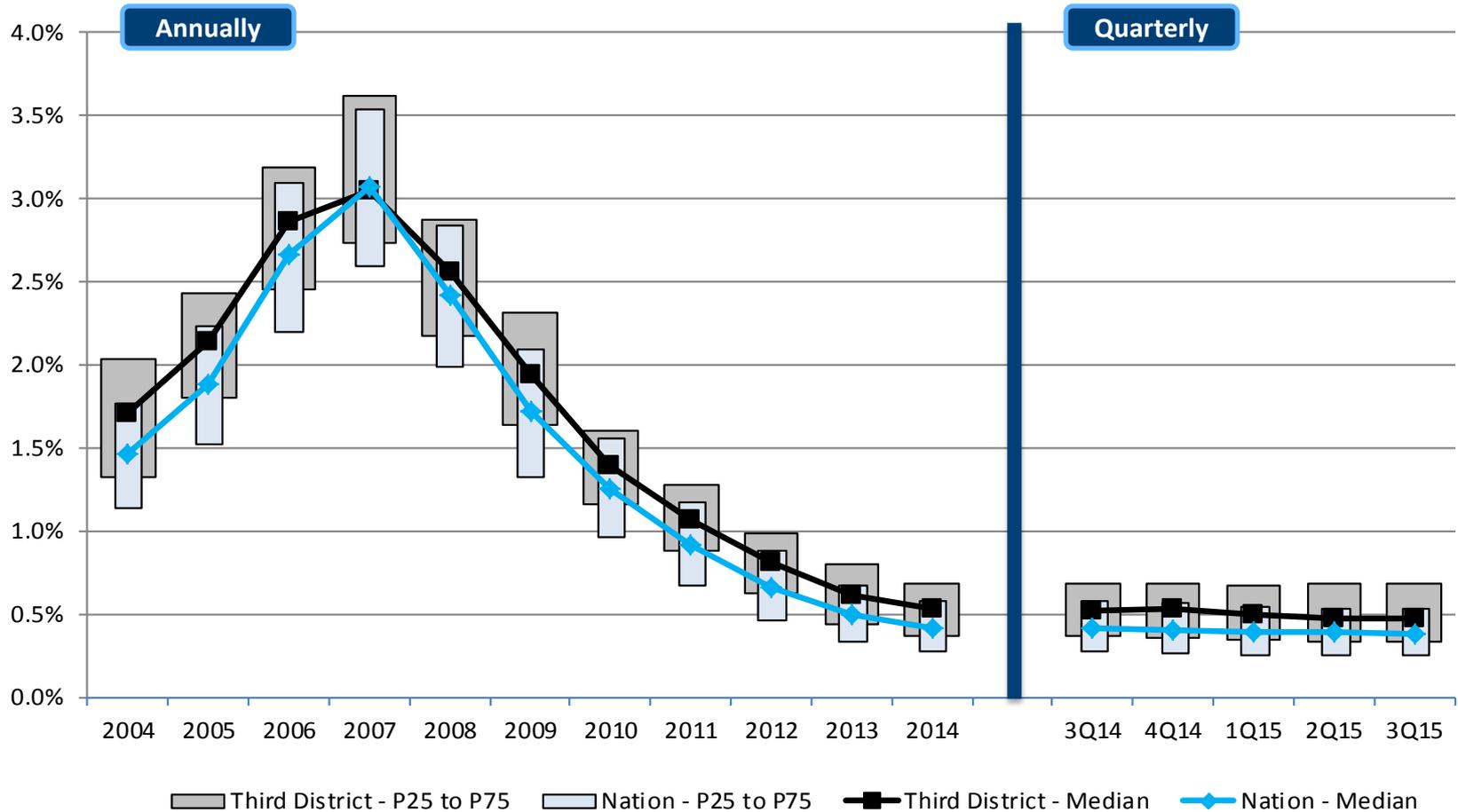
Yield on Assets



The current interest rate environment enables lower cost of funds; however, the District's costs remain slightly elevated when compared with the nation.



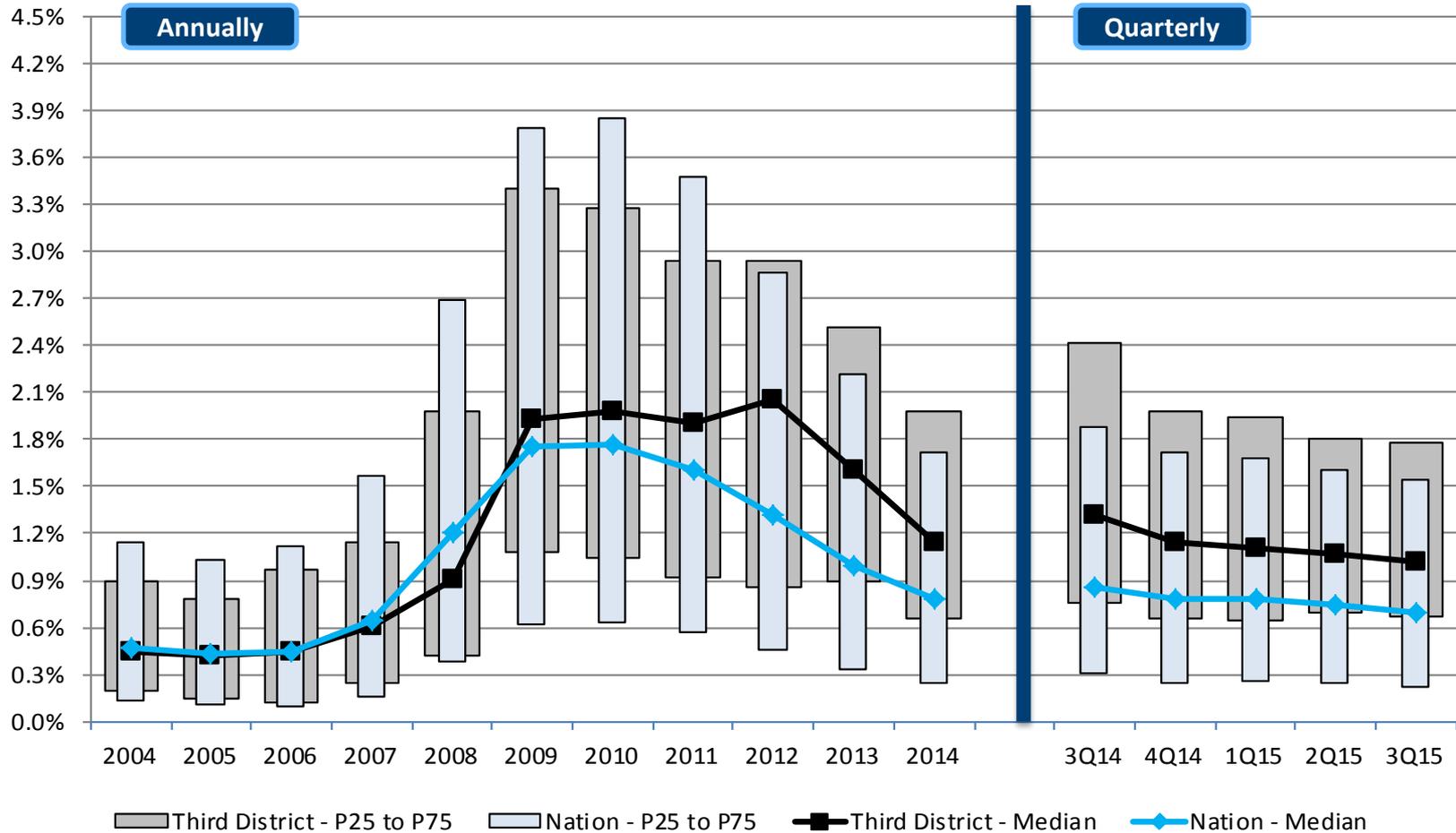
Cost of Funds



Although the noncurrent loan rate continues to decline, the District is not recovering as quickly as the nation.



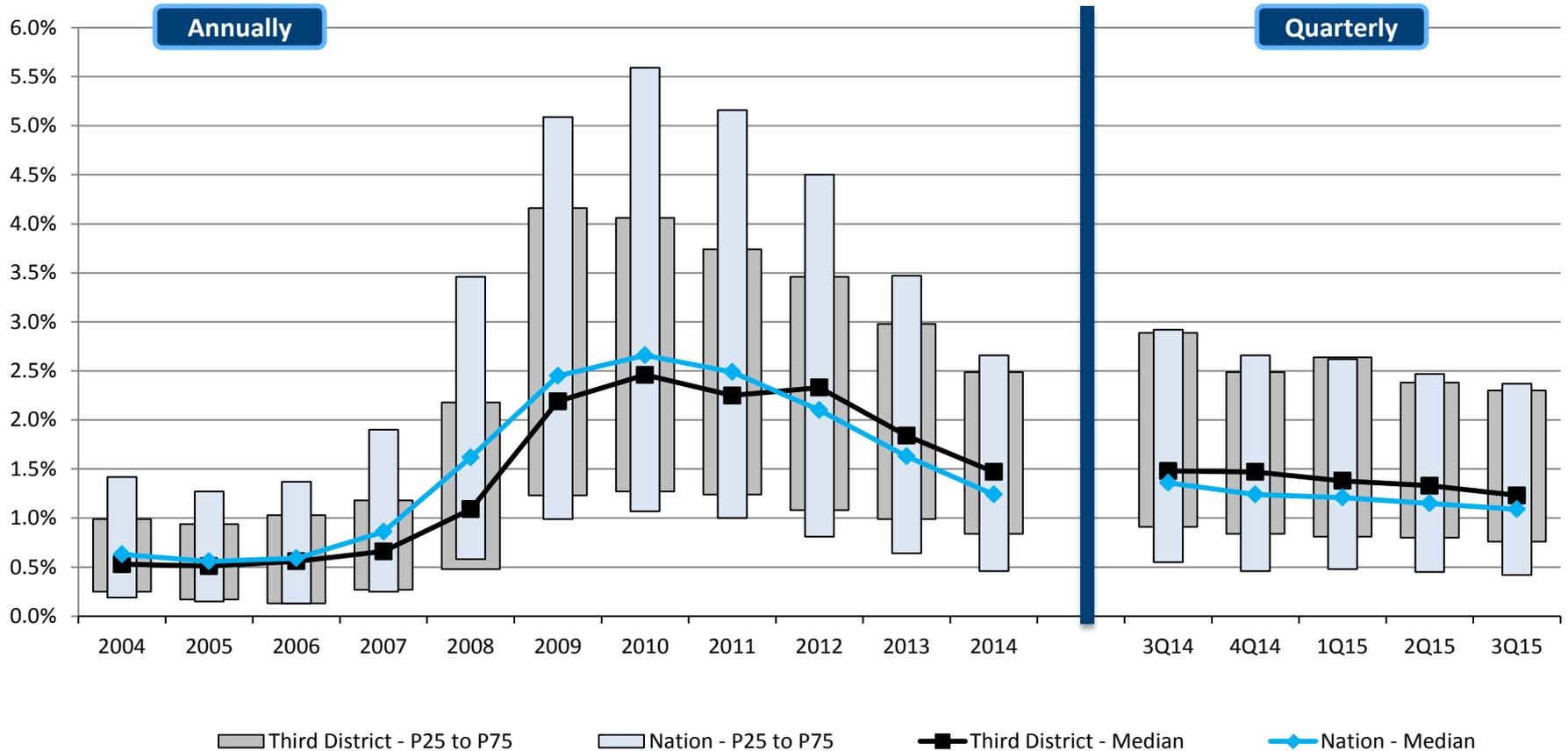
Noncurrent Loan Rate



Third District nonperforming assets (NPAs) are decreasing, but the District's levels remain slightly above that of the nation postcrisis.



Nonperforming Assets*

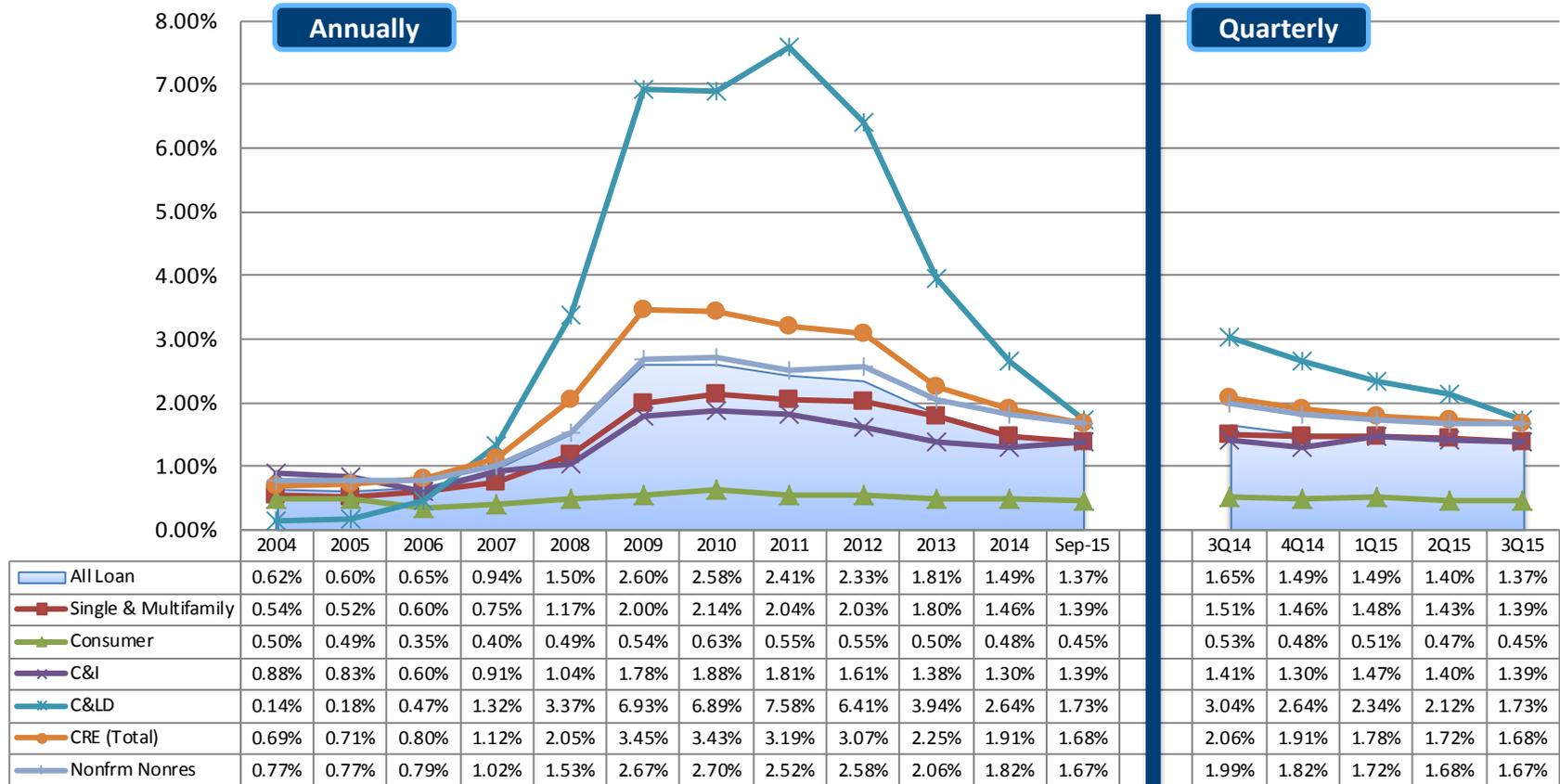


*NPAs (nonperforming assets) are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans).

Third District loan performance shows improvement within most main loan categories; however, commercial and industrial (C&I) loan performance declined slightly in 2015.



Noncurrent Loan Ratios by Loan Category

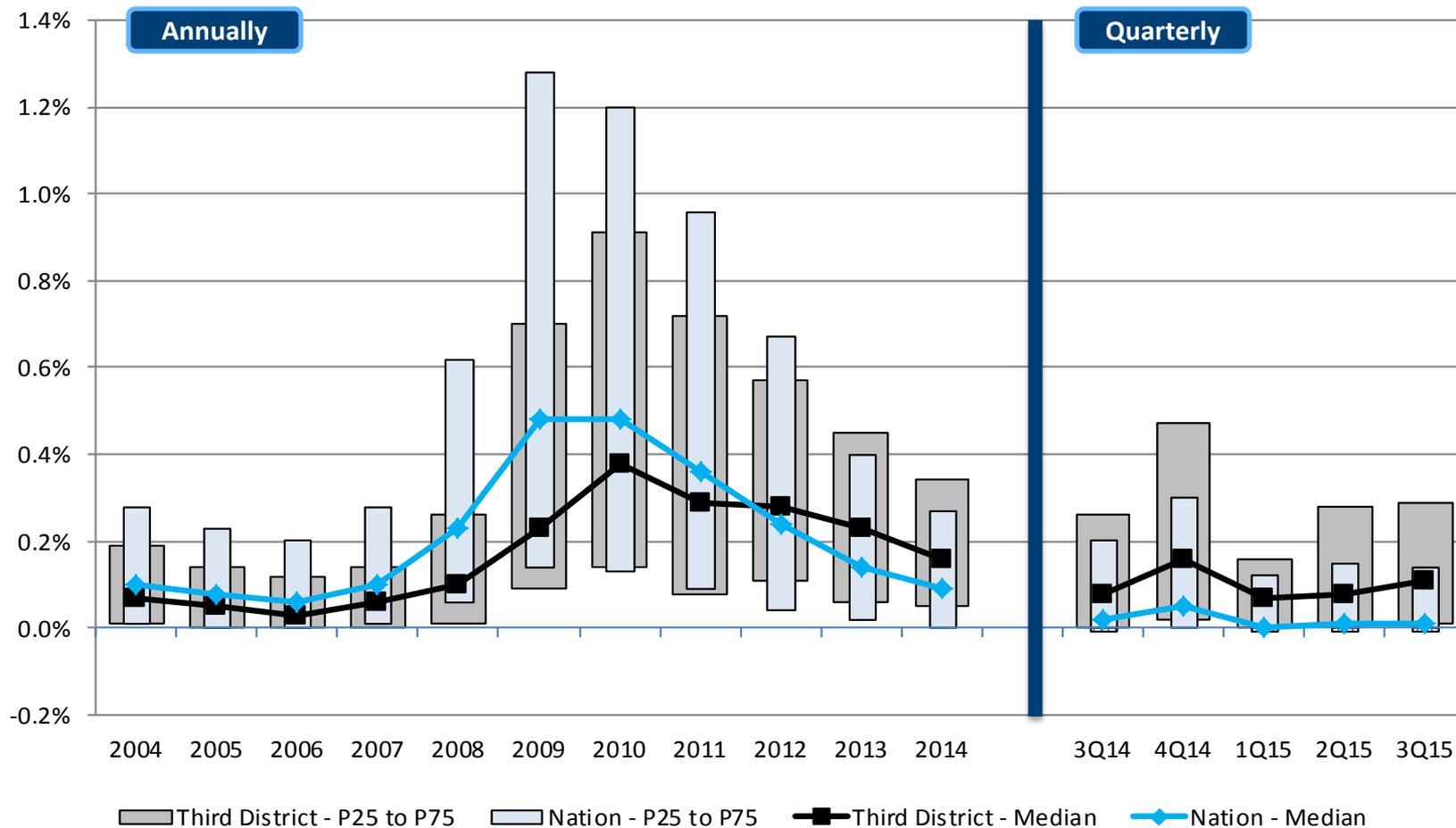


This chart uses a **10% capped mean**, or **winsorized mean**, to compute the average District and national ratios. The capped mean is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers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

Net charge-off rates have declined annually since 2009; the nation is at precrisis levels, while the District is lagging.



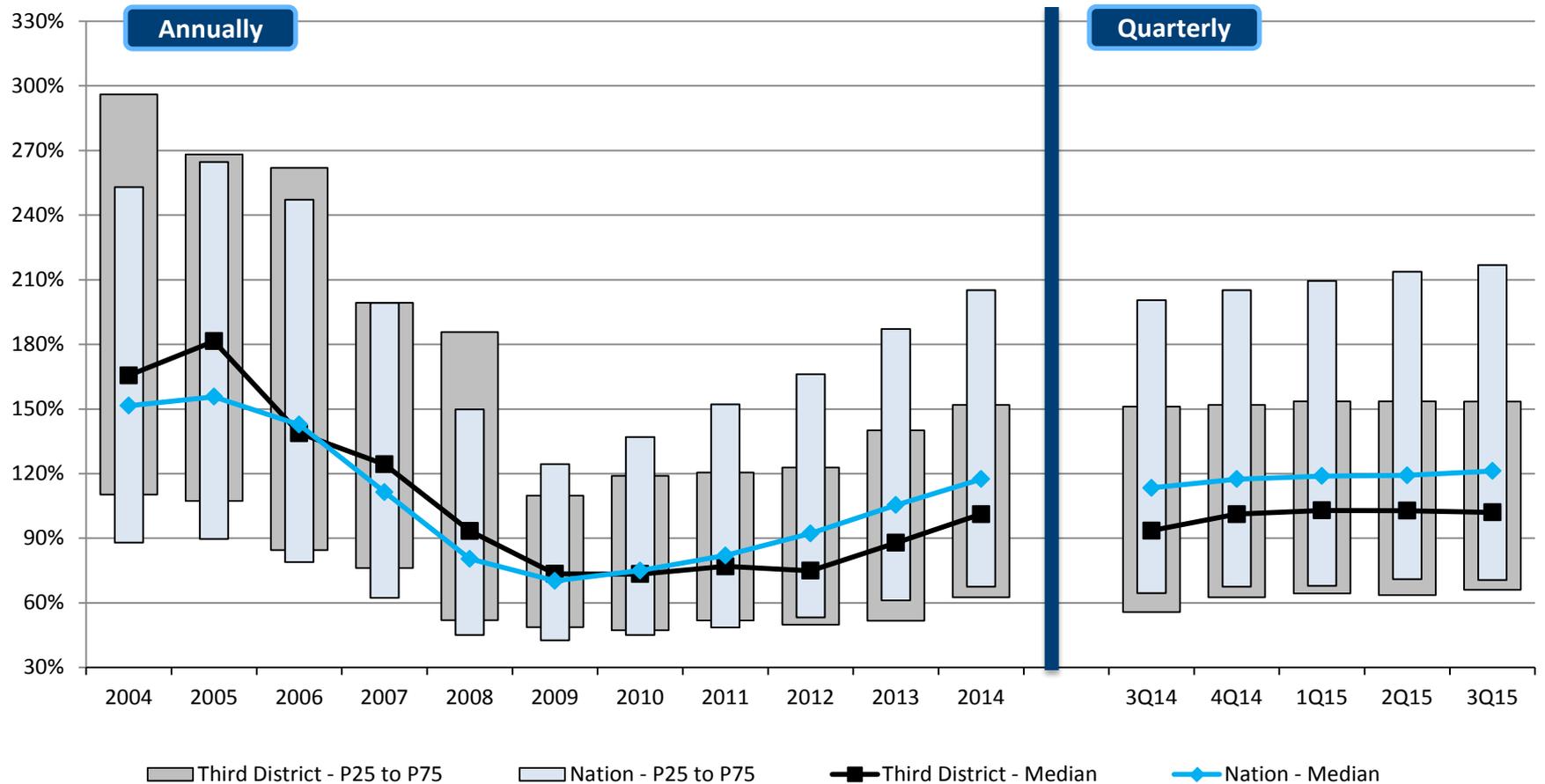
Net Charge-Offs / Loans



The Third District allowance for loan and lease losses (ALLL) reserve coverage ratio continues to trail that of the nation.



Allowance for Loan and Lease Losses Coverage Ratio*

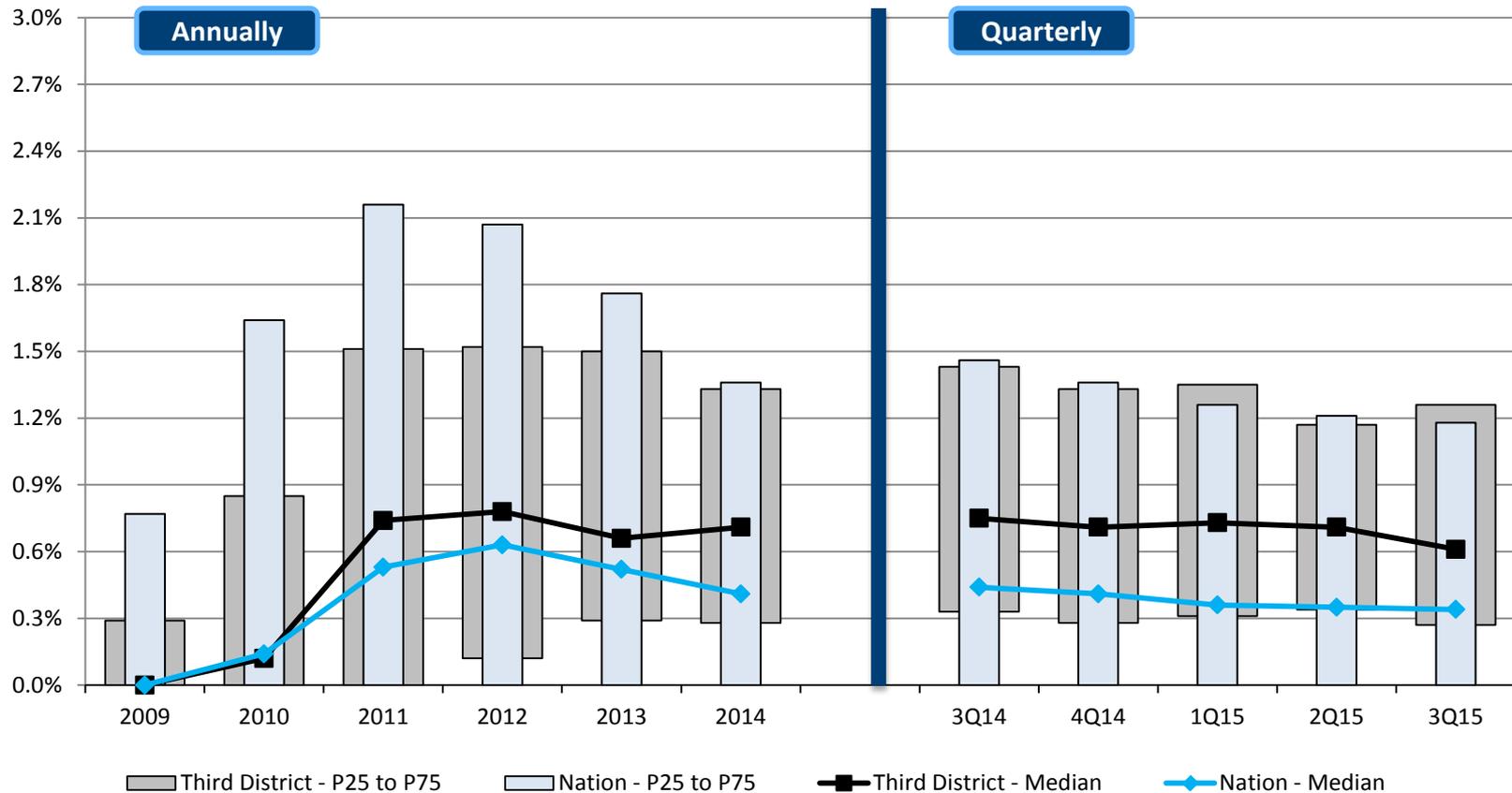


*The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.

Third District troubled debt restructurings (TDRs) remained stable but were elevated when compared with the nation.



Troubled Debt Restructurings*

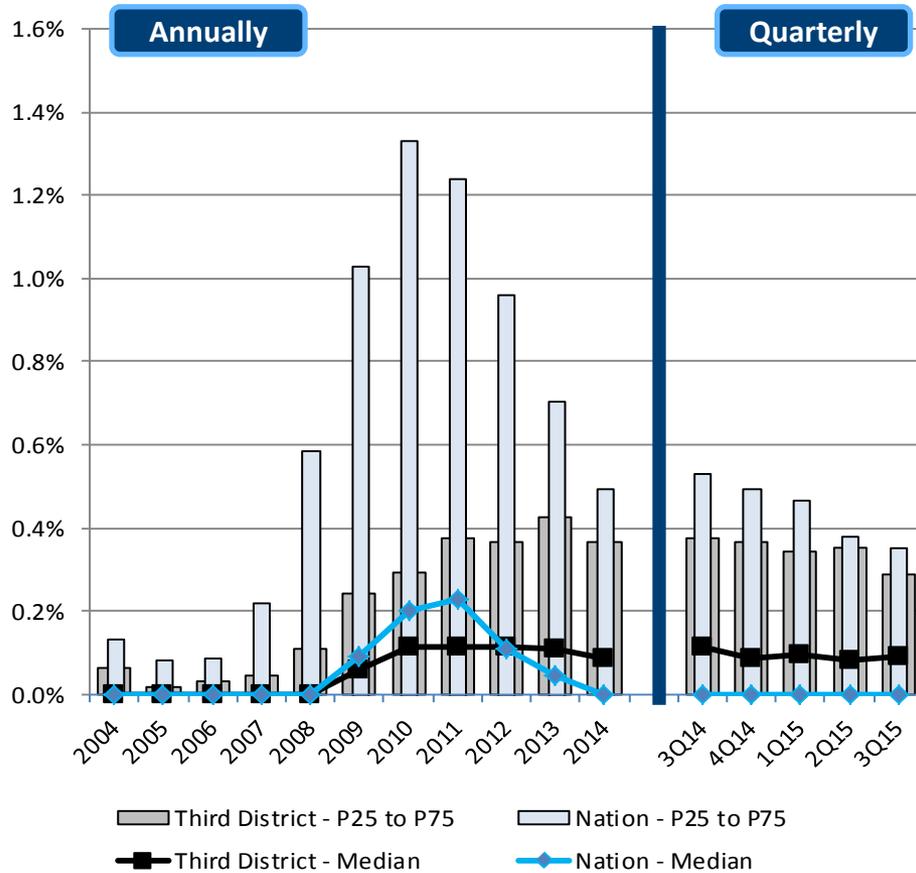


*Troubled debt restructurings (TDRs) were not included on the Call Report until the March 2009 reporting period.

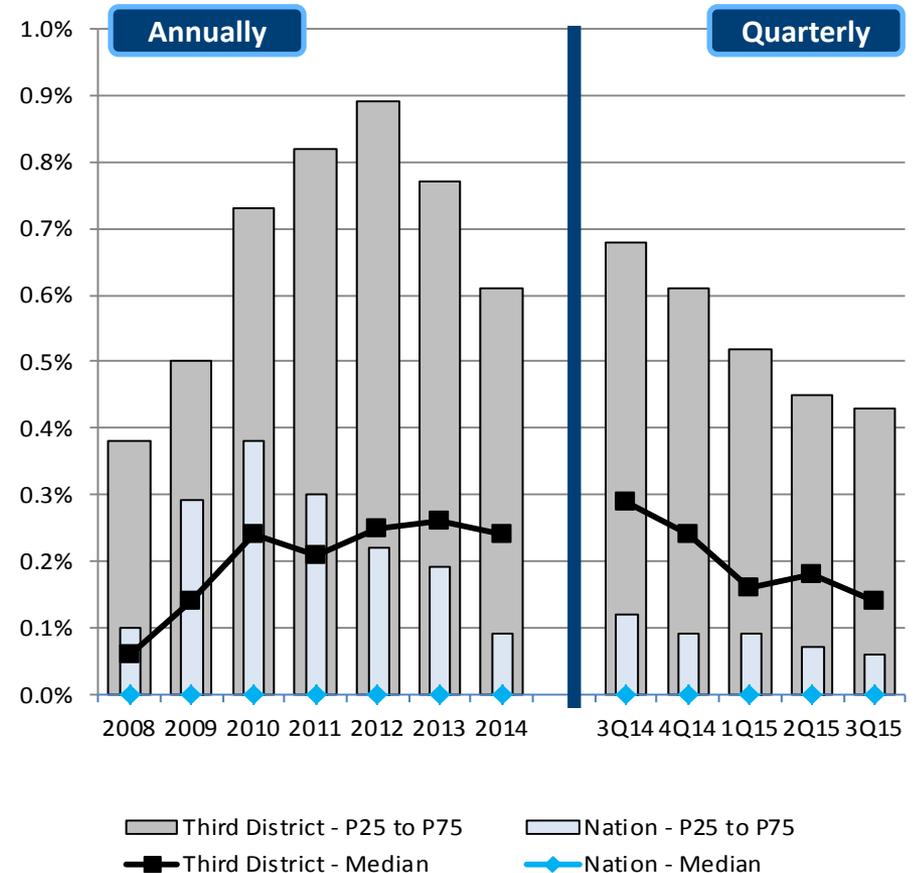
One- to four-family OREO is decreasing faster nationwide; the Third District also trails in the foreclosure process, mostly due to judicial bankruptcy rules in DE, NJ, and PA.



1- to 4-Family OREO *



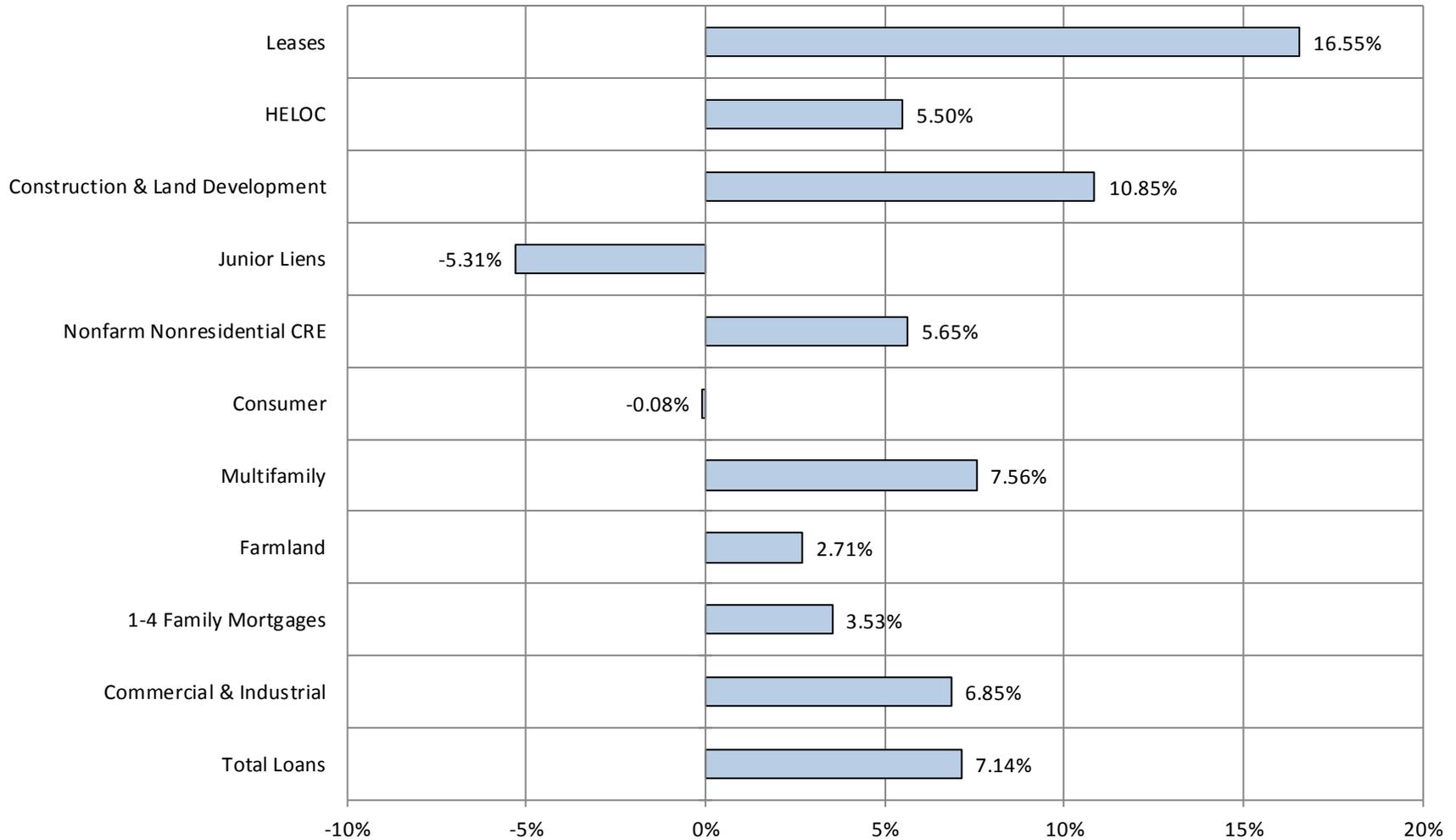
Loans in Process of Foreclosure **



*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 select categories year-over-year was positive; loan contraction continues in the junior lien and consumer loan categories.

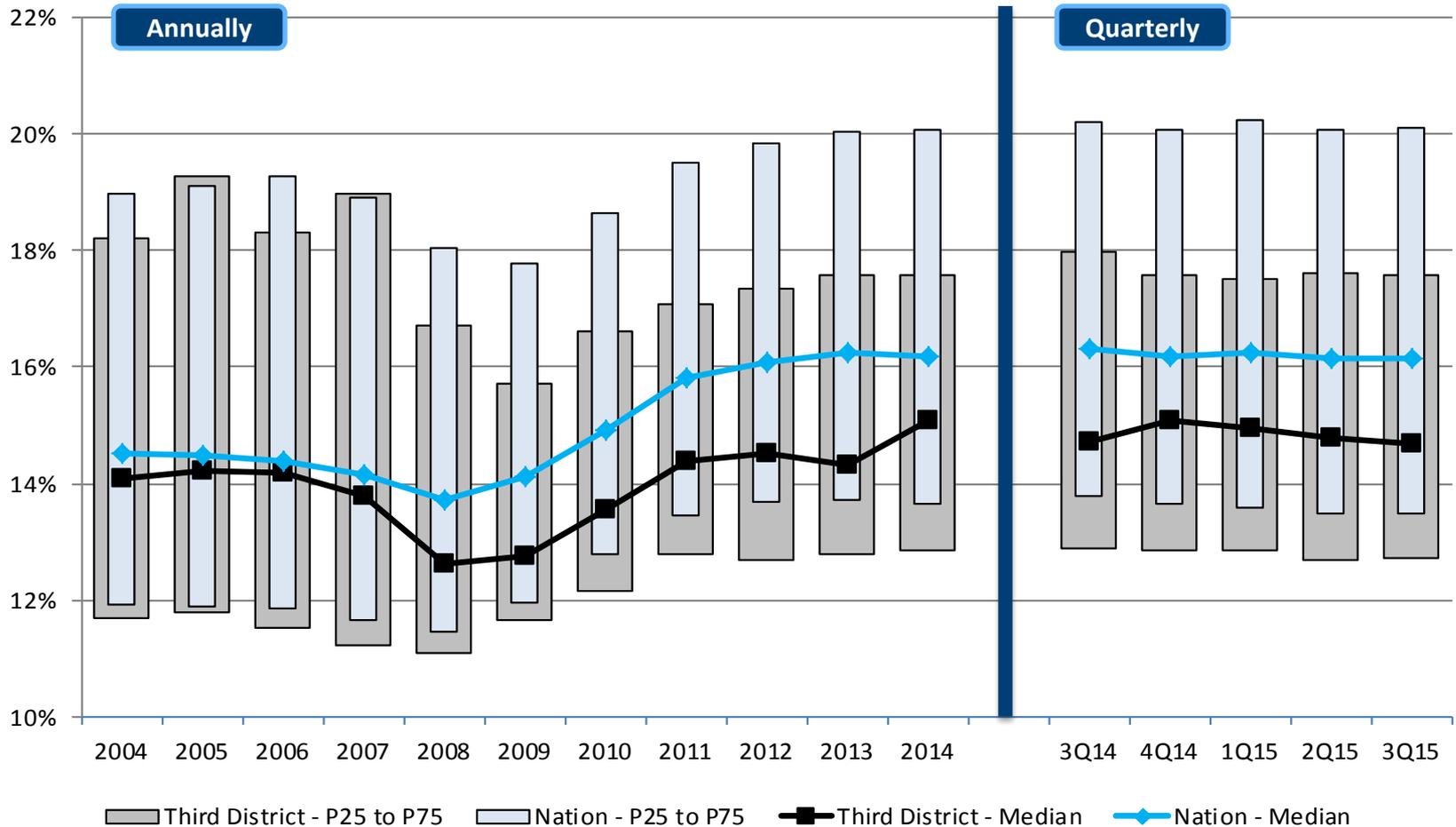


*This report shows the median year-over-year percentage loan growth for Third District commercial banks that meet the commercial bank criteria on Slide 4.

Capital ratios have increased considerably postcrisis; however, District levels remain below those of the nation.



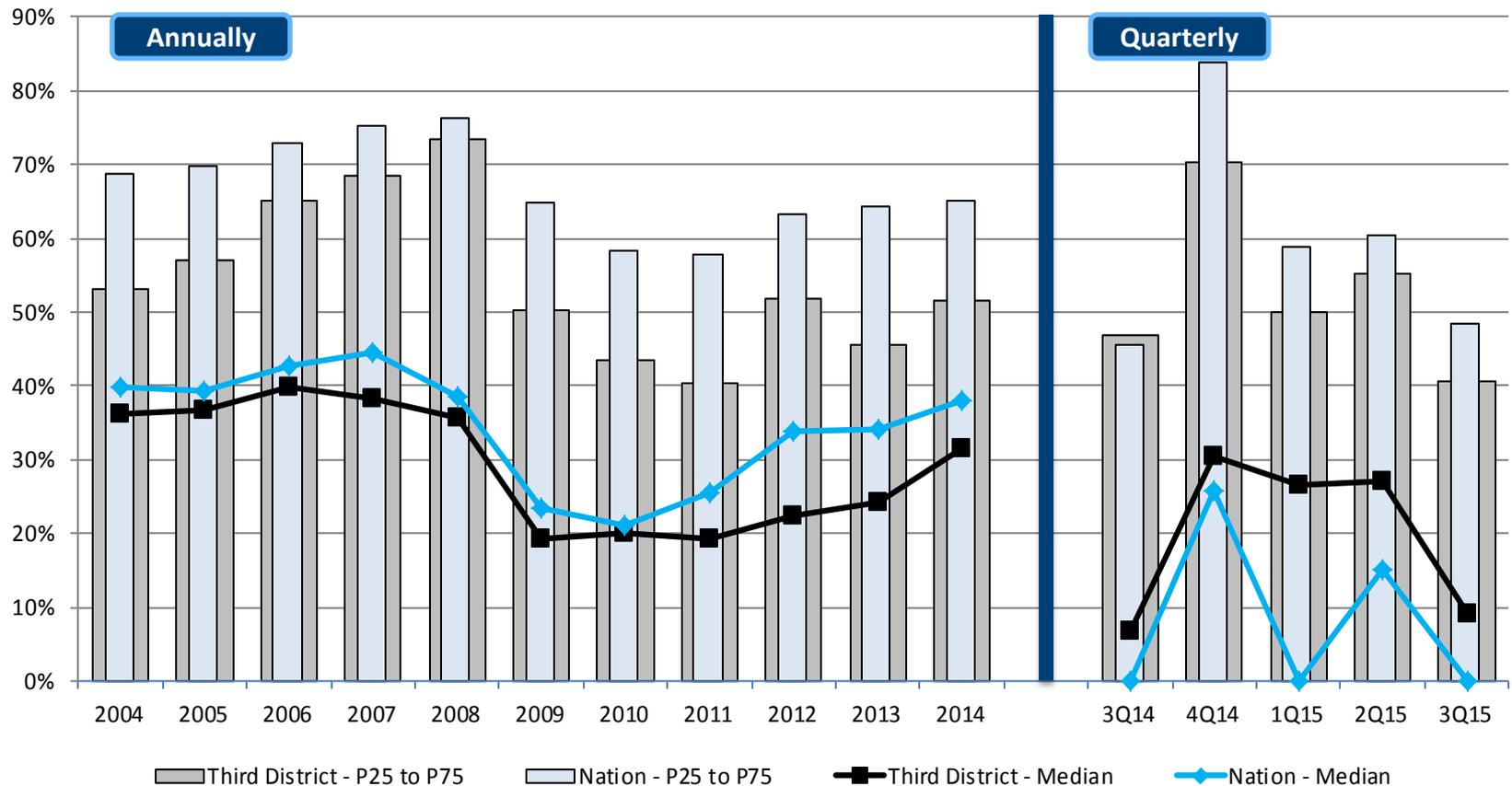
Total Risk-Based Capital



Dividend payments have continued to rise after the recessionary period.



Dividends

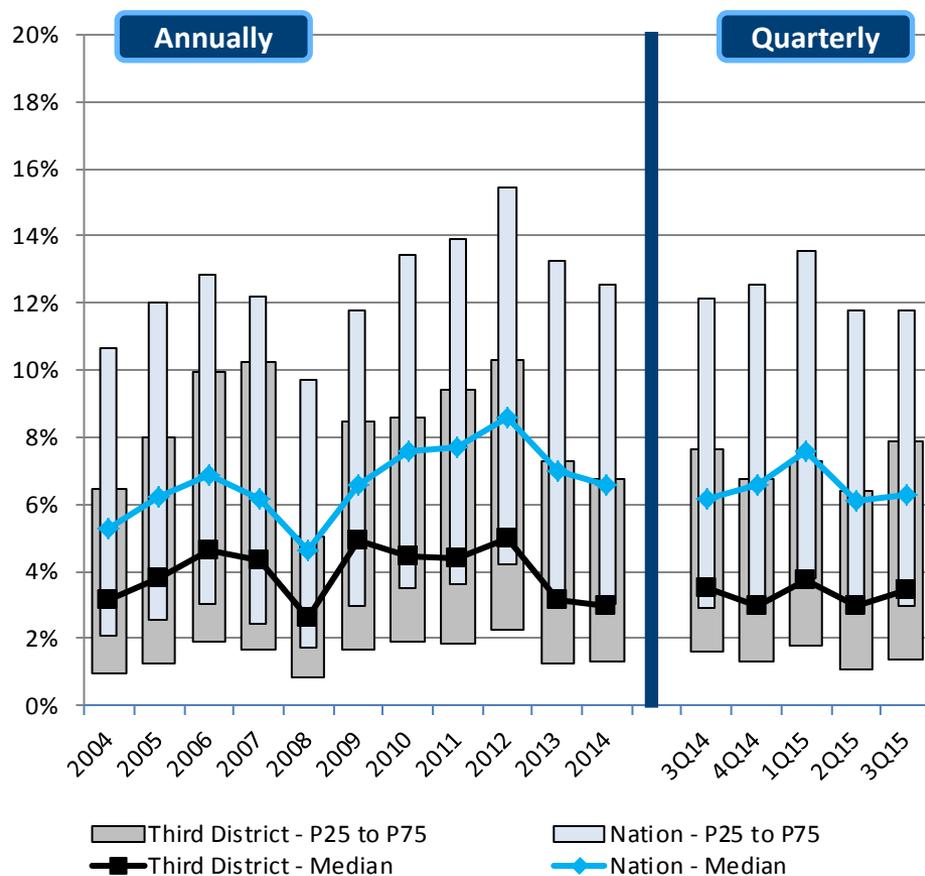


Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the dividend payout (DPO) ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income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

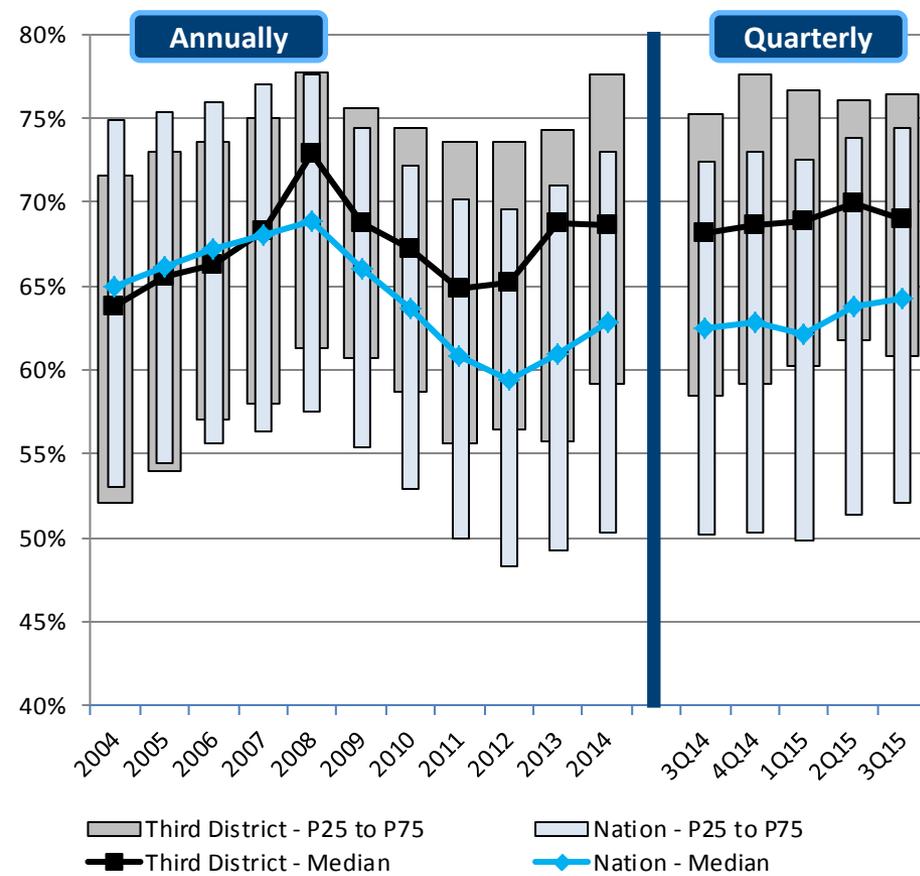
Interest rate risk remains a concern as Third District banks are not as flush with short-term investments compared with the nation while also maintaining higher loan levels.



Short-Term Investments / Assets *



Loans / Assets

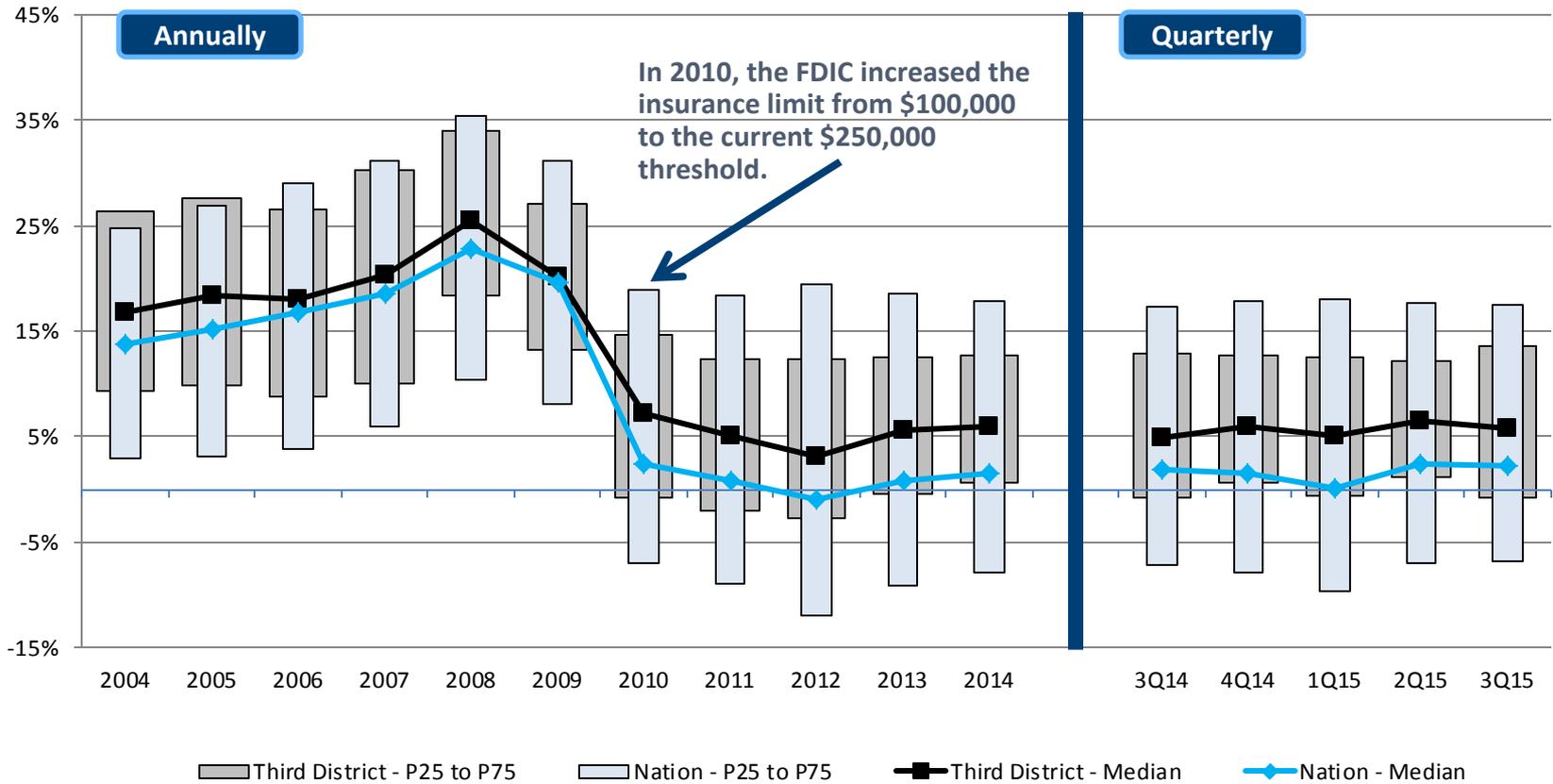


*Short-term investments equal the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

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

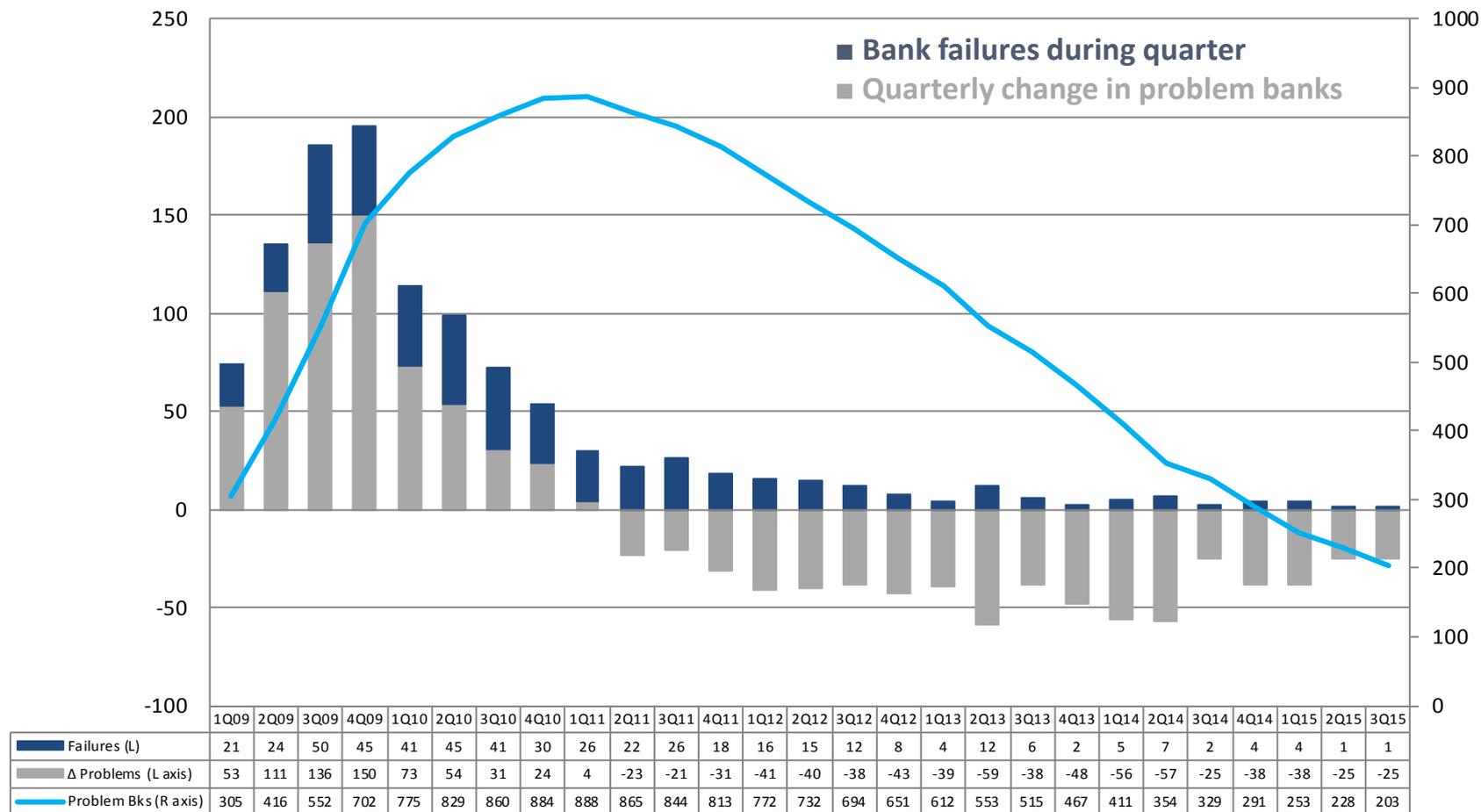


Net Noncore Funding Dependence*



*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. **CAMELS** is an acronym for the components assessed at a safety and soundness examination. The components are **C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk.