



Third District Banking Conditions as of December 31, 2015

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



- Interest rate risk endures and is the most significant financial risk within the District and throughout the banking industry.
- Third District bank financial performance continues to recover, although sustainable earnings challenges remain. The net interest margin (NIM) fell during 4Q2015 due to lower yields on earning assets and higher costs of funds.
- Third District and national asset quality metrics continue to depict improvement; however, the zero or negative provision expense reported over the past few quarters helped contribute to return on average assets (ROAA), which may be an unsustainable trend.
- Capital ratios are increasing as a result of earnings accretion.
- Third District banks' reliance on noncore funding sources continues to outpace the industry. These sources of funds are primarily used to fund on-balance sheet loan growth
- The number of problem banks continues to decline and are under 200, largely due to 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: Conditions of Third District Commercial Banks



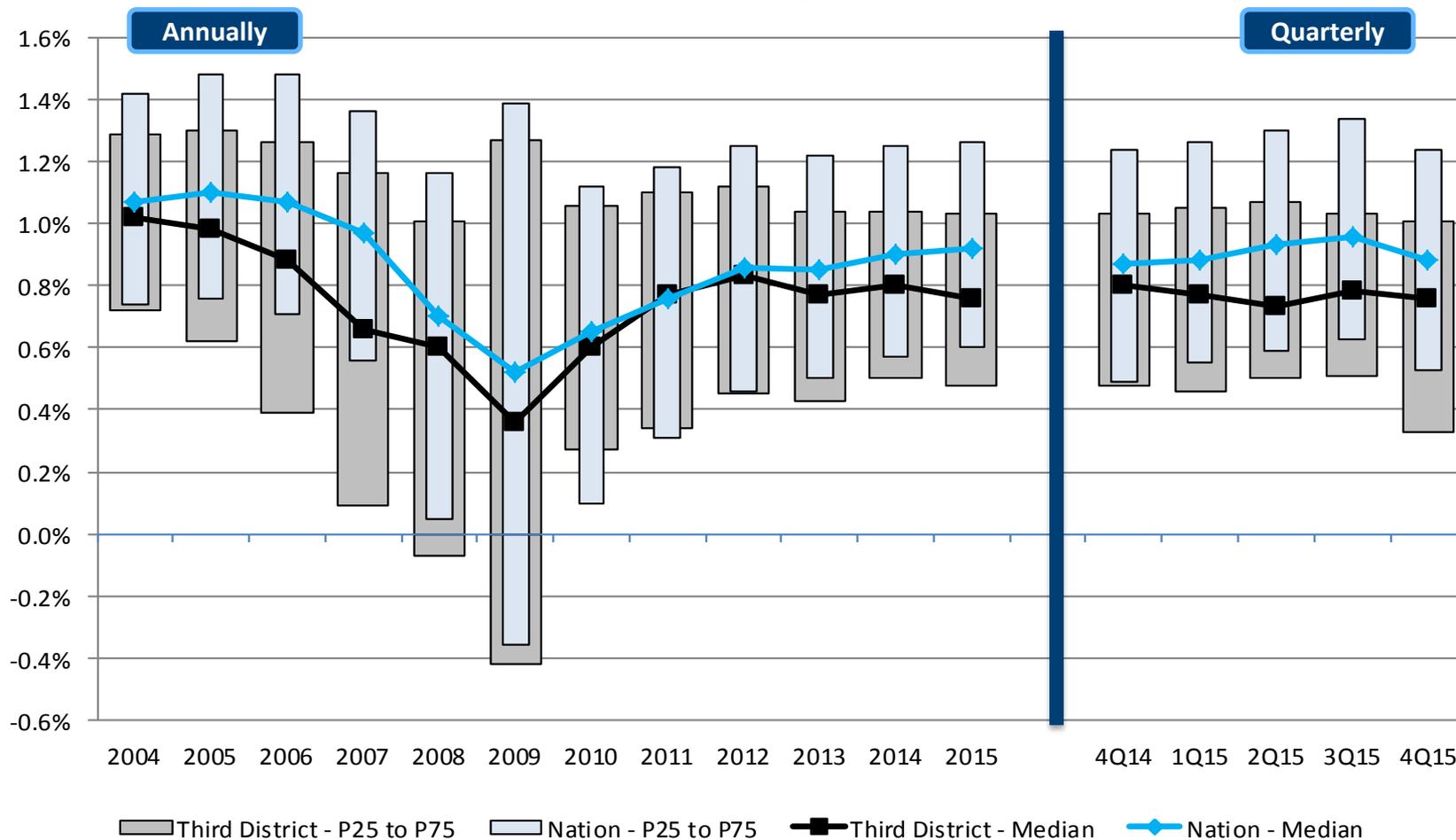
Reporting Methodology

- The quarterly **Reports of Condition and Income (Call Report)** and **Uniform Bank Performance Report (UBPR)** are the primary sources for all information contained in this report unless otherwise noted.
- Slides in this section focus on trends among the **114 commercial banks (CBs)** within the Third District and national or nonmember CBs that do not meet at least one of the following criteria as of **December 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 uses the **median and the 25th and 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 ROAA ratio, has consistently lagged the nation since 2004.



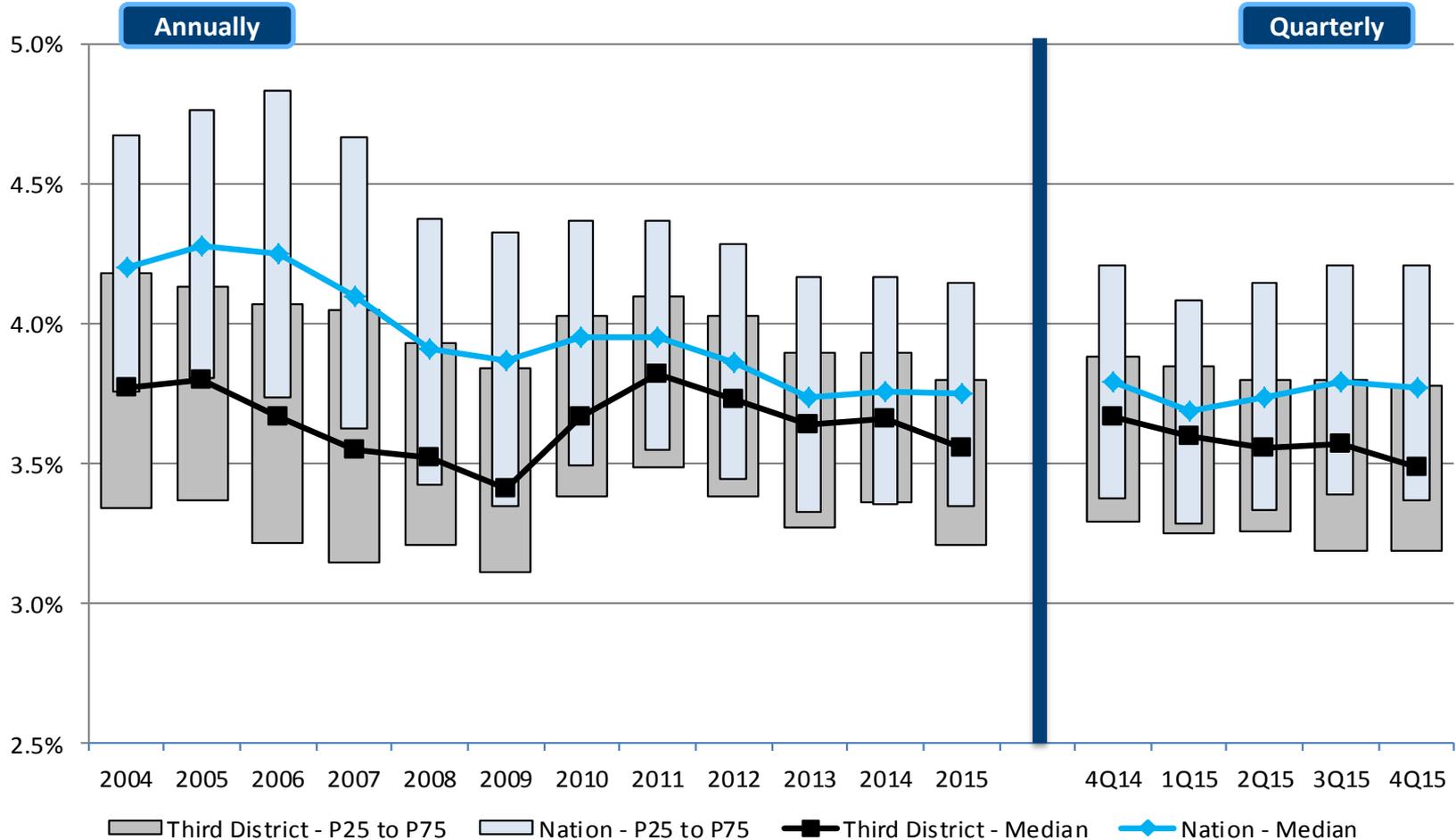
Return on Average Assets



Third District NIM fell in 4Q2015, as earning asset yields continued to decline and the cost of funds slightly increased.



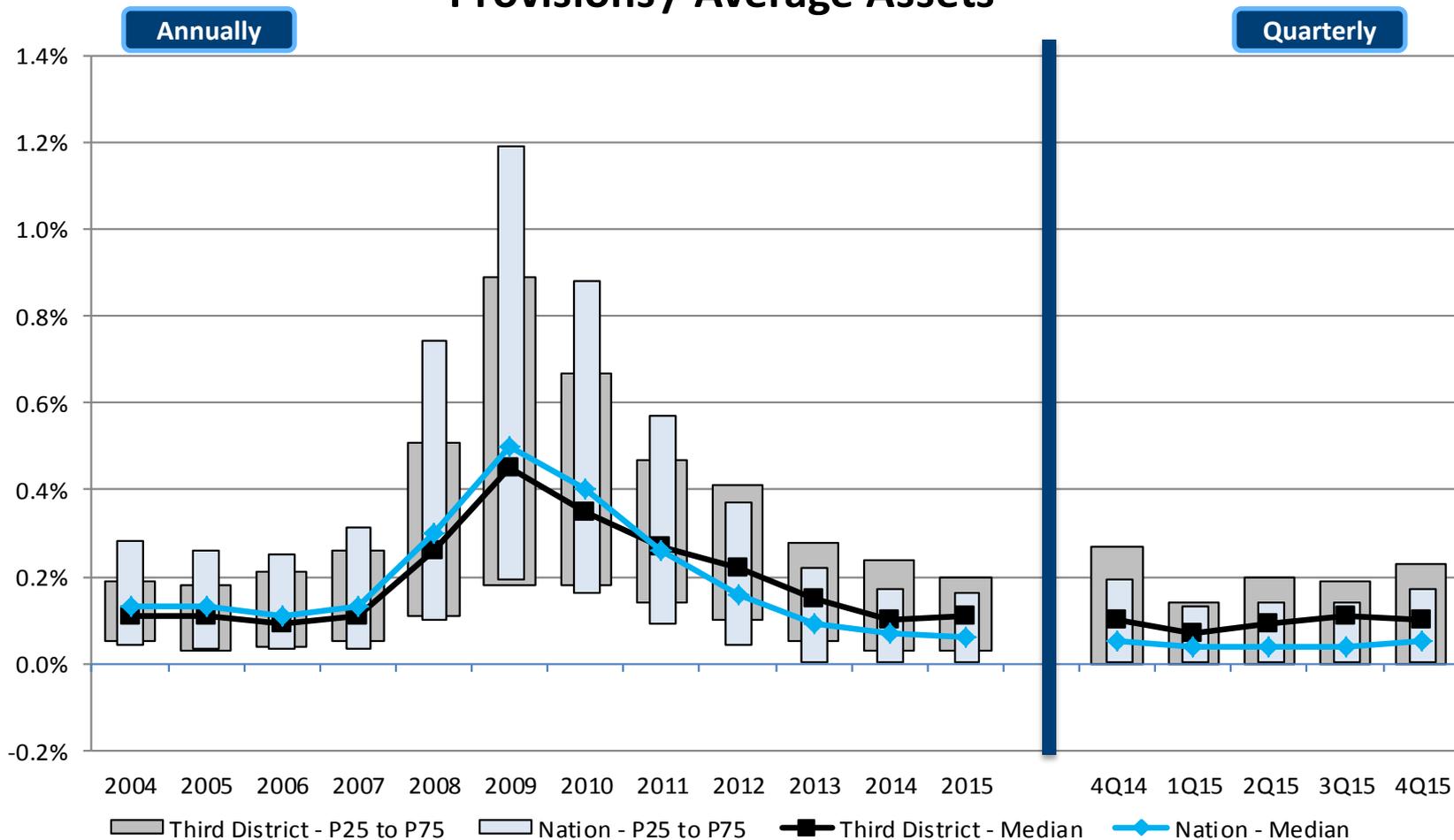
Net Interest Margin



The provision expense continues to trend around or below precrisis levels, which continues to help augment earnings. This trend will not be sustainable if a downfall in the credit cycle occurs.



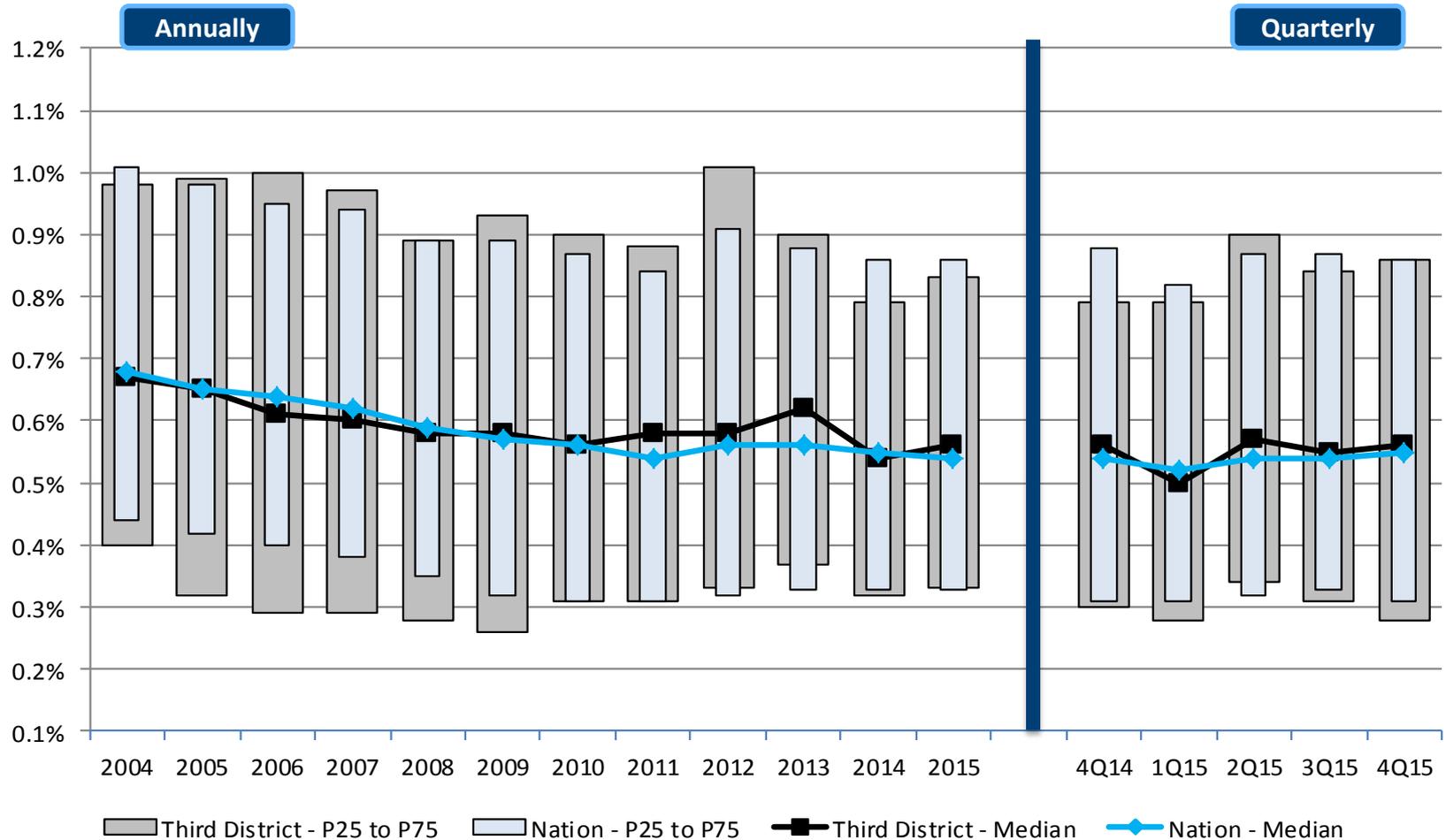
Provisions / Average Assets



Noninterest income rose in 4Q2015, which contributed to a higher return on average assets within the Third District.



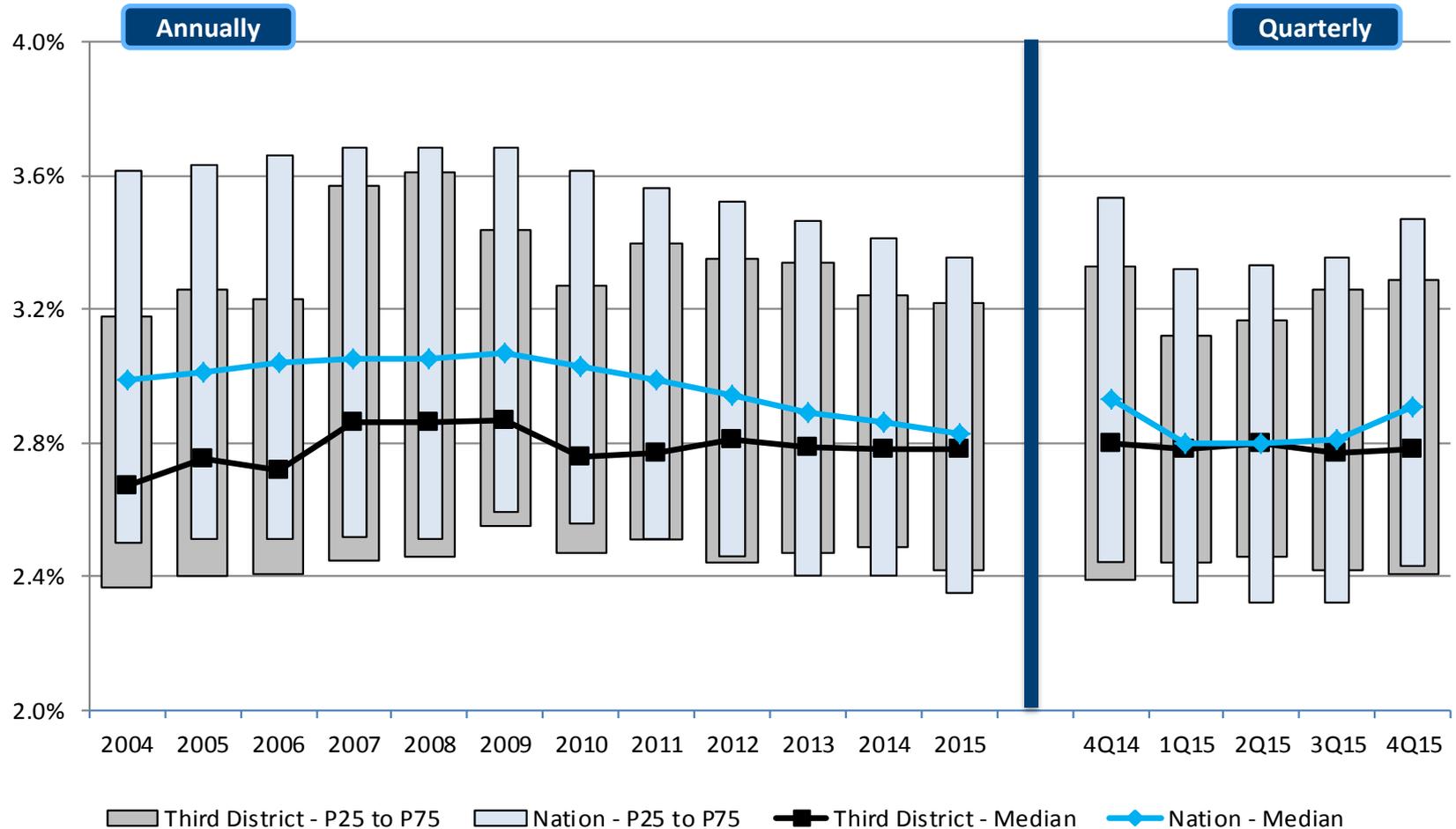
Noninterest Income / Average Assets



Median Third District overhead expense has remained relatively flat since 2010, contributing positively to ROAA.



Overhead Expense to Average Assets

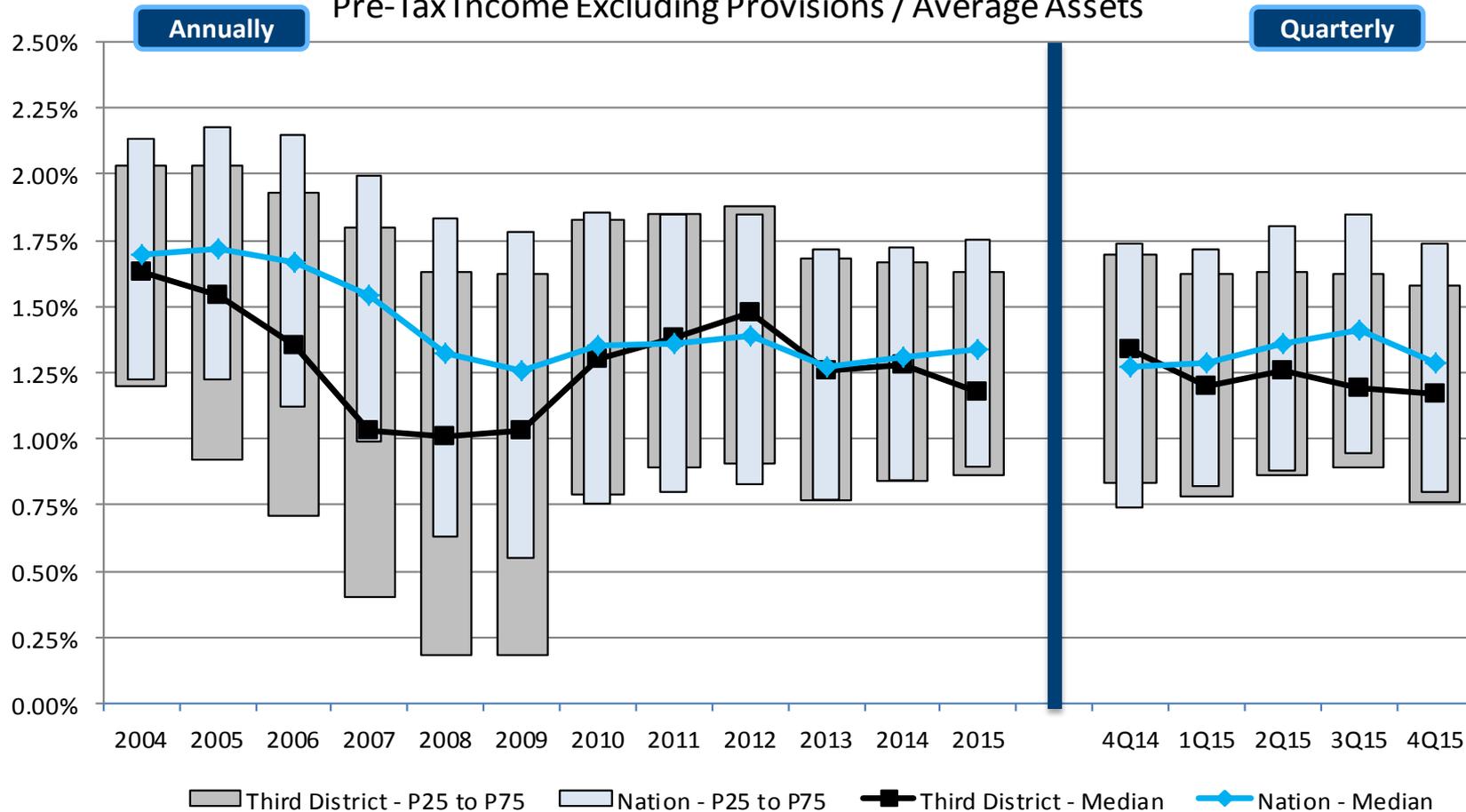


Core profitability is more sound nationally, while the Third District remains well below precrisis levels.



Core Profitability

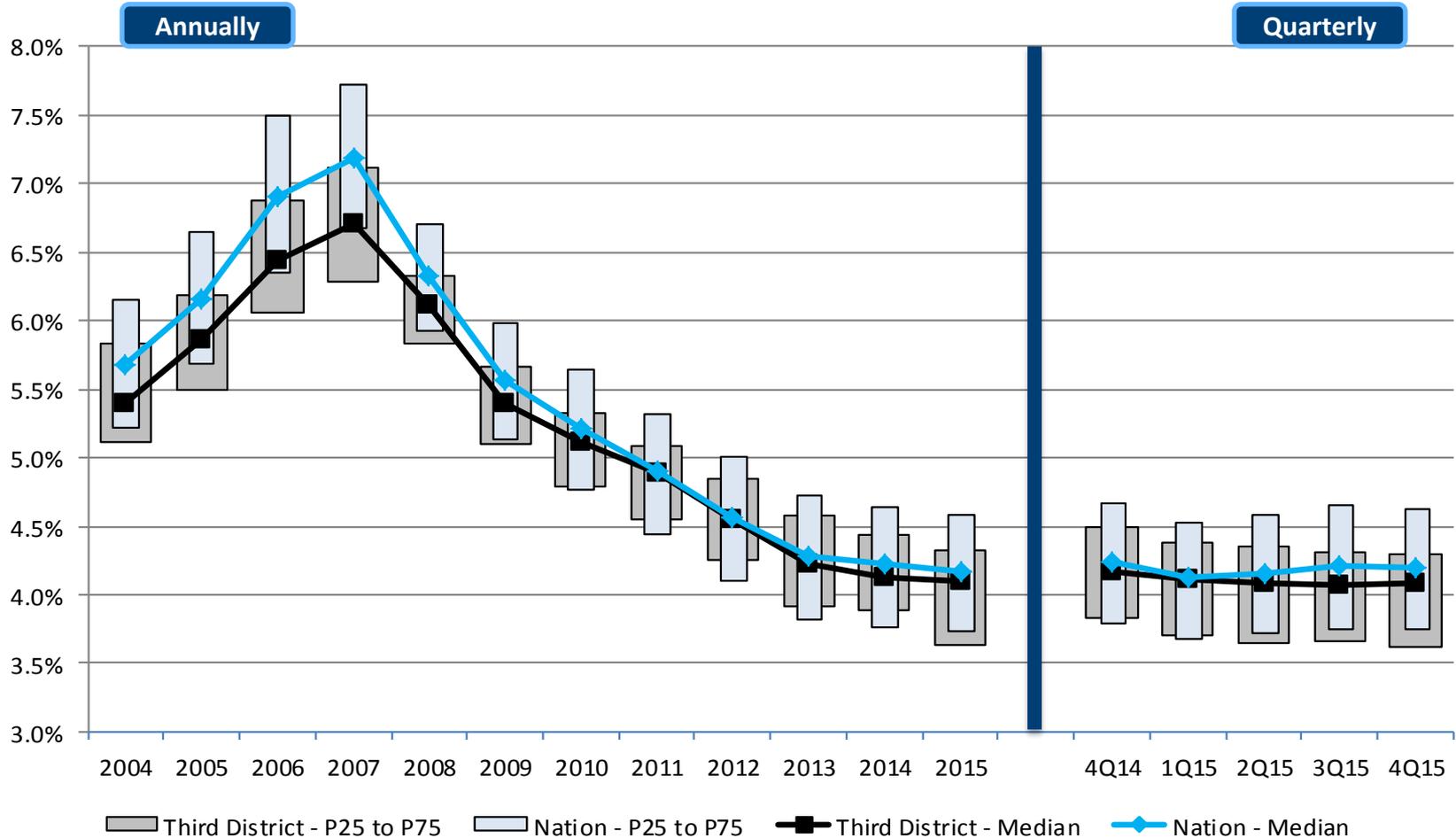
Pre-Tax Income Excluding Provisions / Average Assets



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



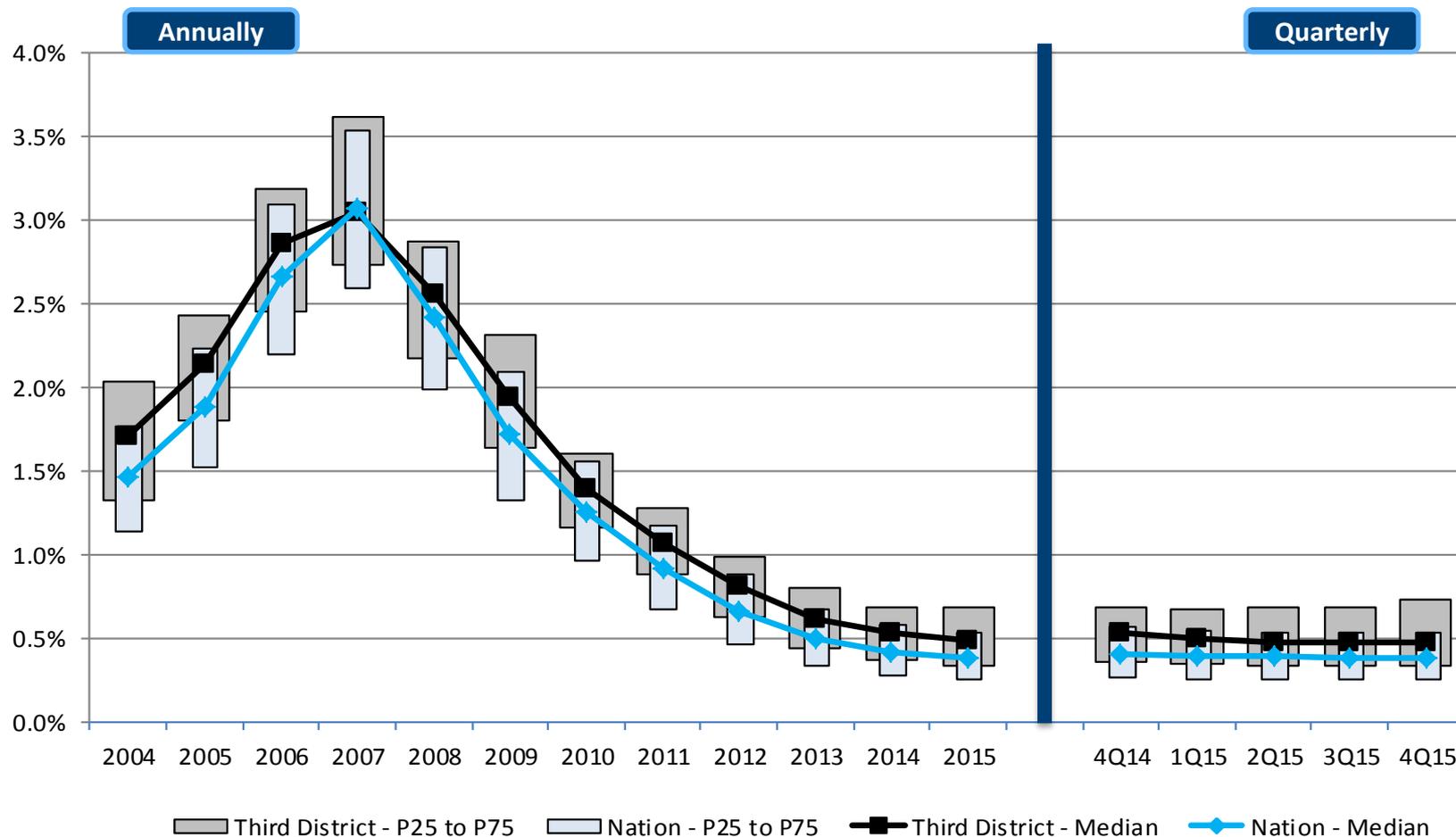
Yield on Assets



On the other hand, the low interest rate environment enables lower cost of funds; however, the District's funding costs remain higher than those of the nation.



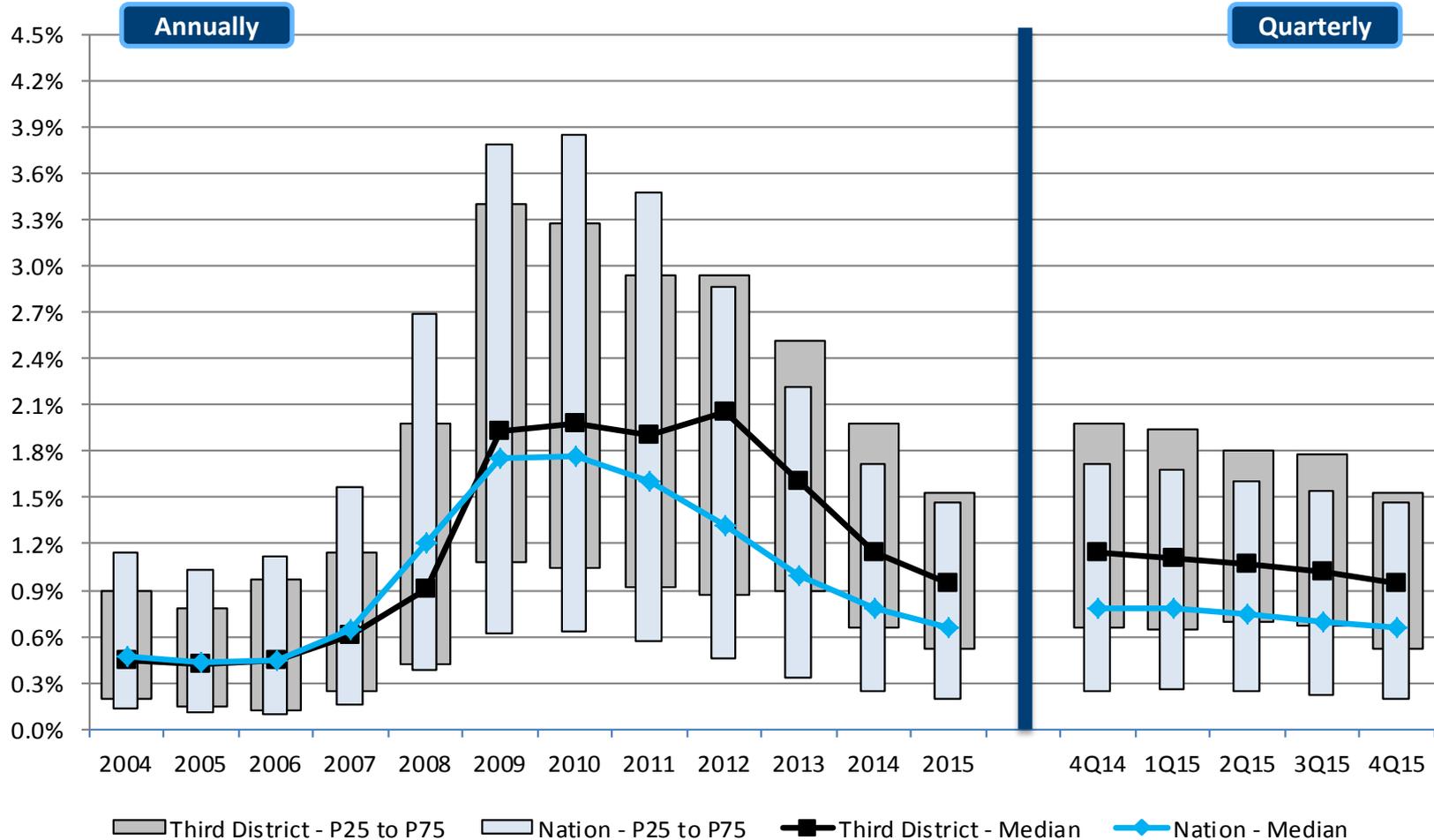
Cost of Funds



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



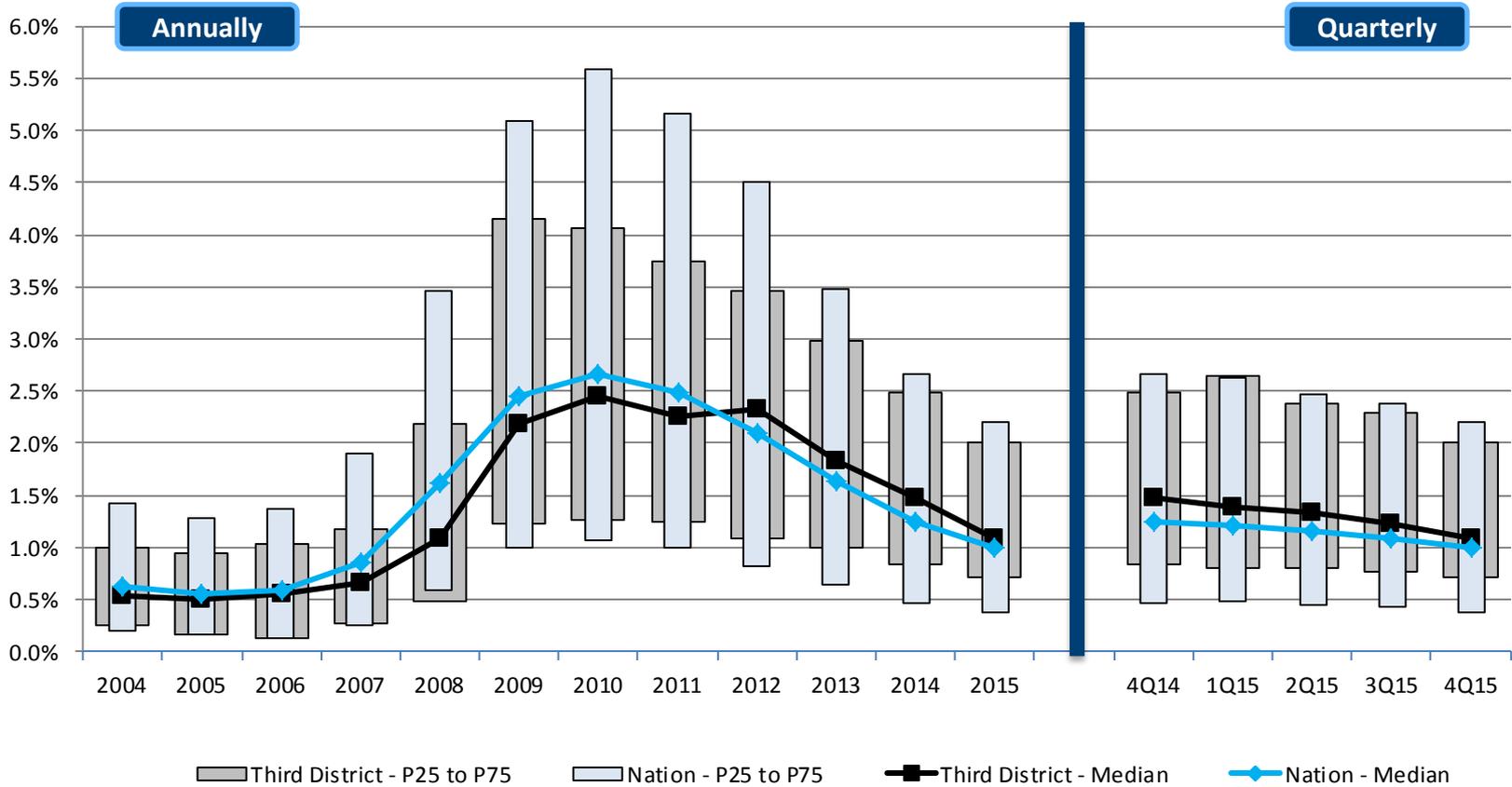
Noncurrent Loan Rate



Third District nonperforming assets* are falling, but the District's levels remain slightly above the nation.



Nonperforming Assets

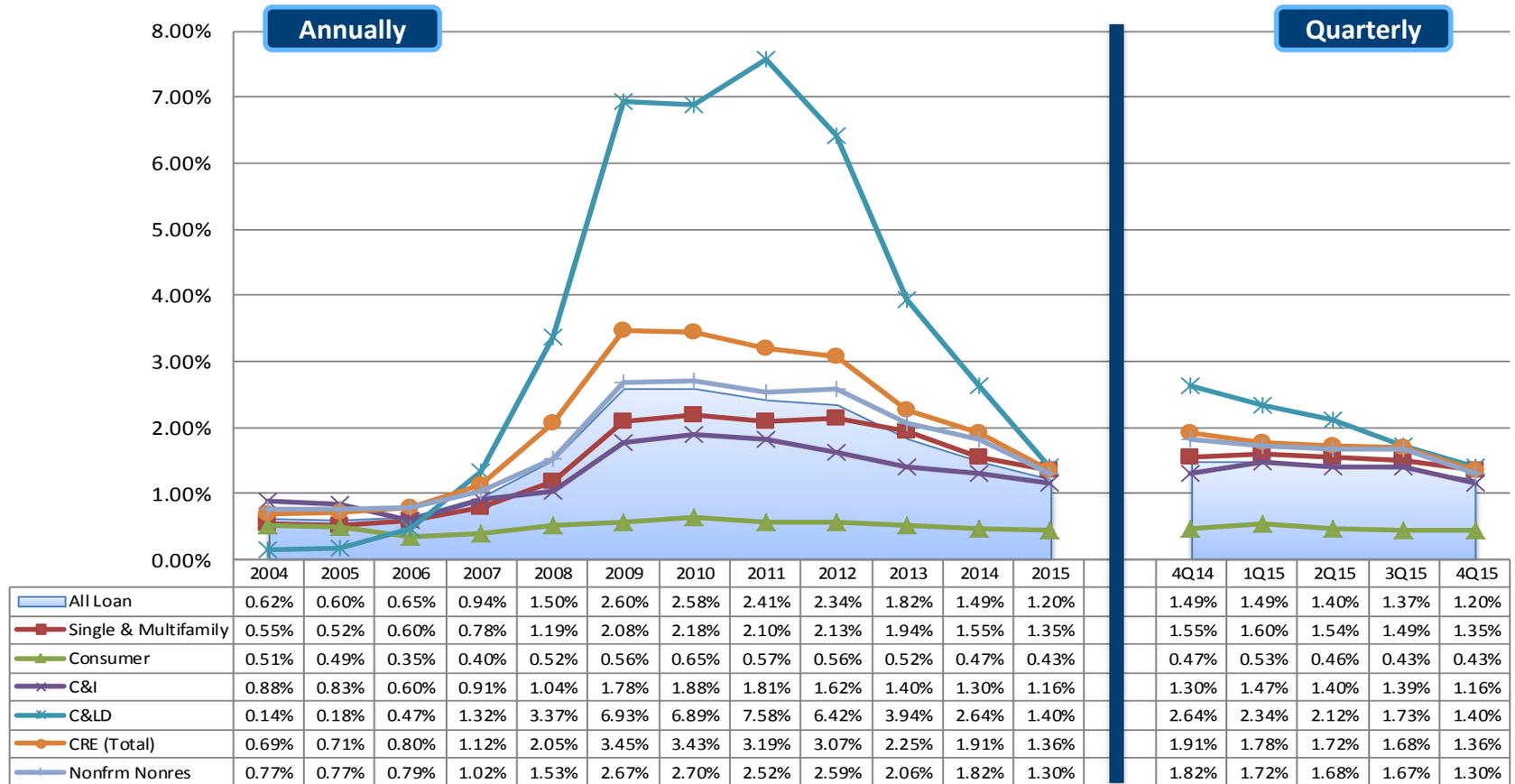


*Nonperforming assets, or NPAs, are the total of other real estate owned (OREO) + noncurrent loans (loans 90+ days past due + nonaccrual loans).

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



Noncurrent Loan Ratios by Loan Category

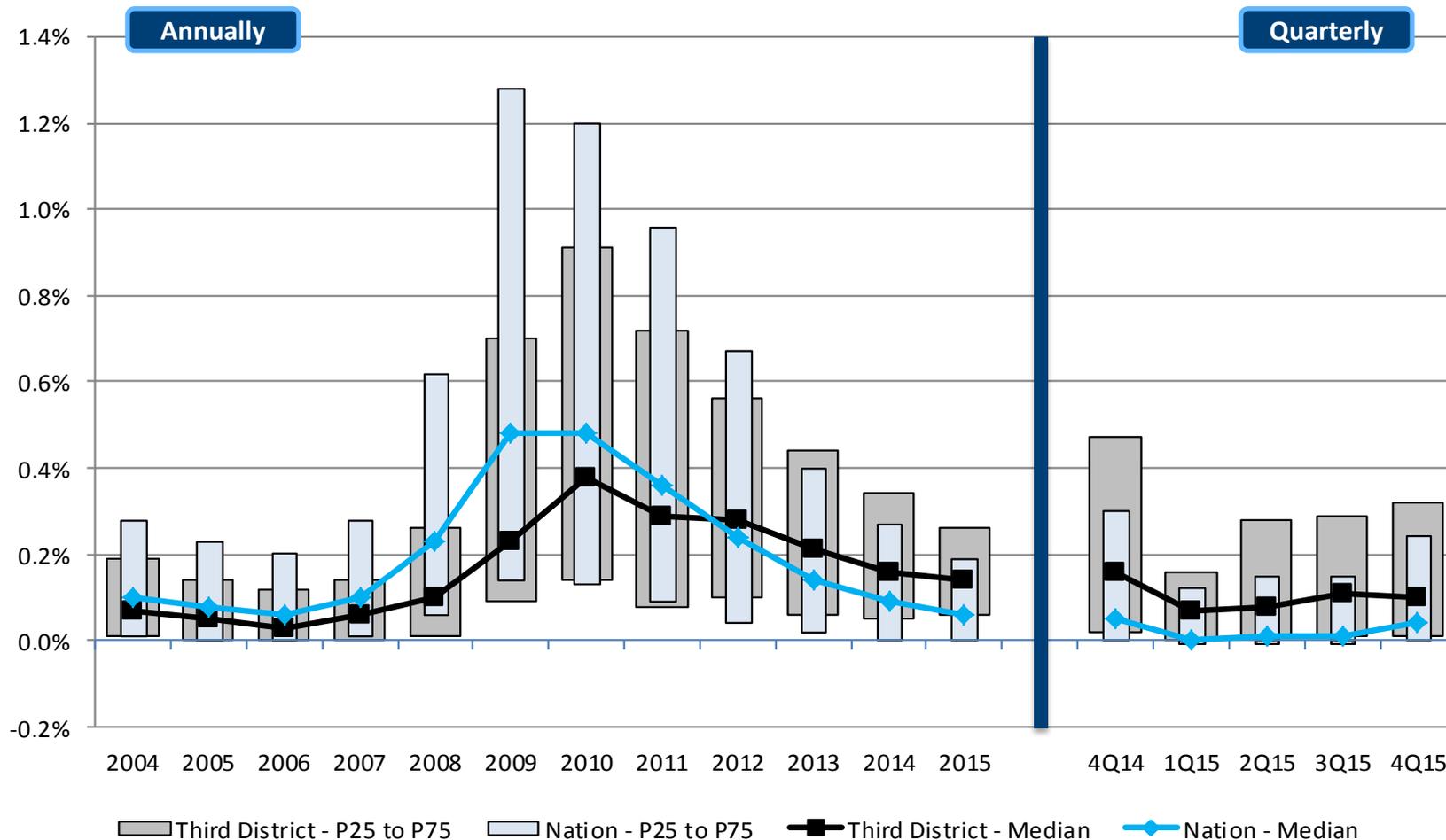


This chart uses a **10% capped mean, or winsorized mean**, to compute the average District and national ratios. The *capped mean* is a statistical measure of central tendency without losing observations, especially robust for a small sample. The capped mean is used to reduce the effects of outliers on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

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



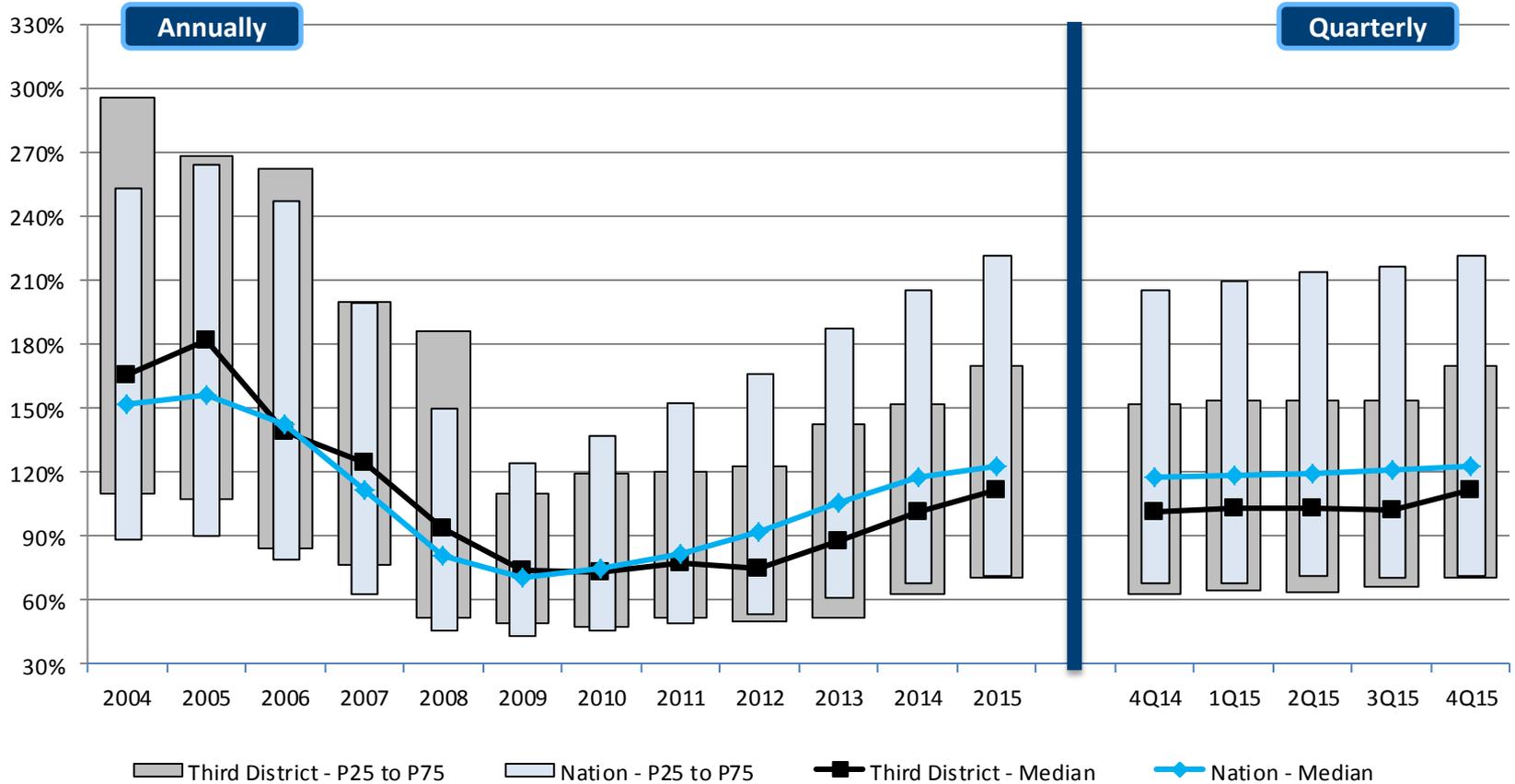
Net Charge-Offs / Loans



The allowance for loan and lease losses (ALLL) reserve coverage ratio* is improving due to recovering asset quality metrics (declines in noncurrent loans) and not by increases in the ALLL.



Allowance for Loan & Lease Loss Coverage Ratio

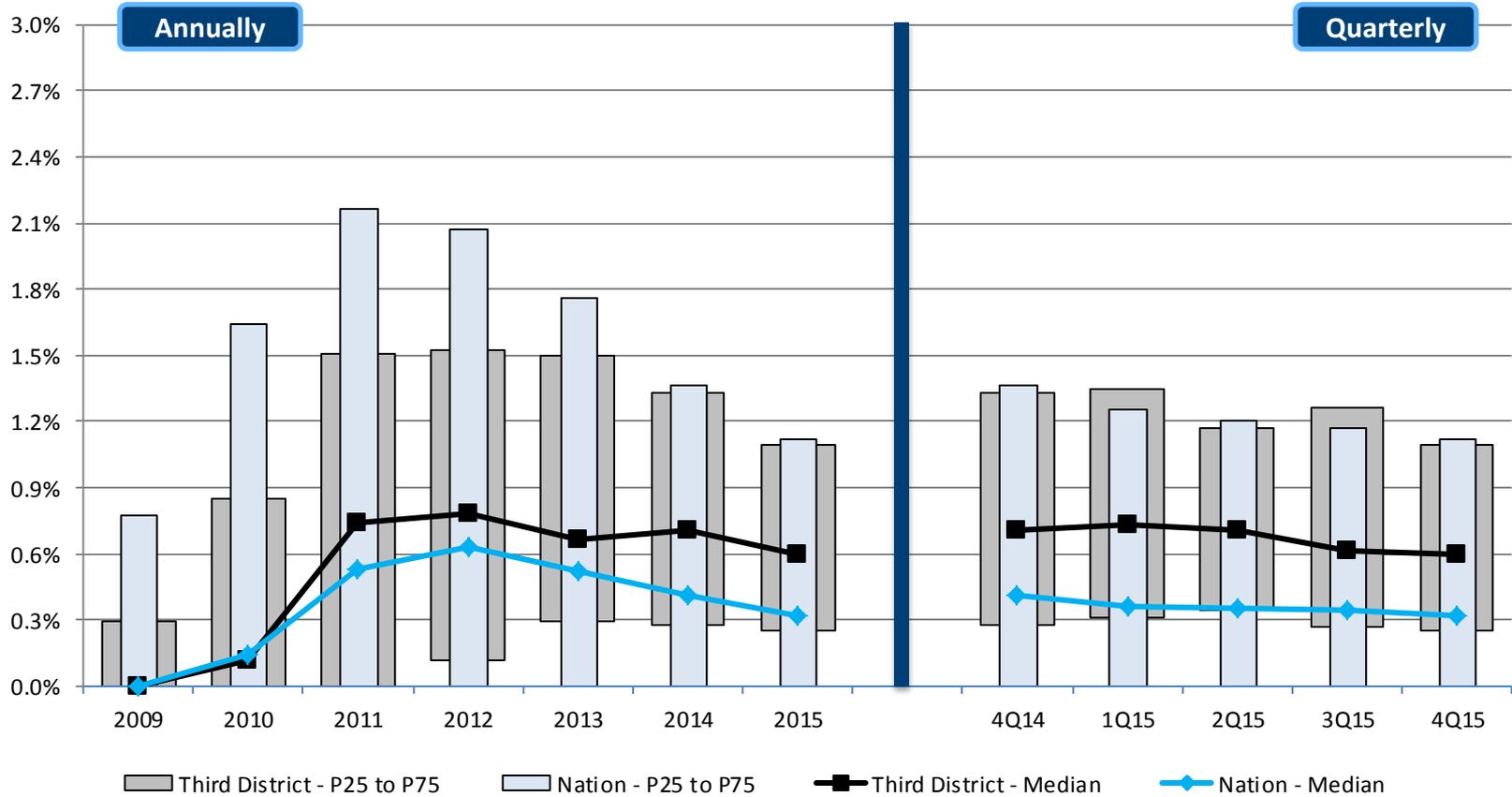


*The reserve coverage ratio, or ALLL coverage, is calculated by dividing noncurrent loans by the allowance for loan and lease losses.

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



Troubled Debt Restructurings

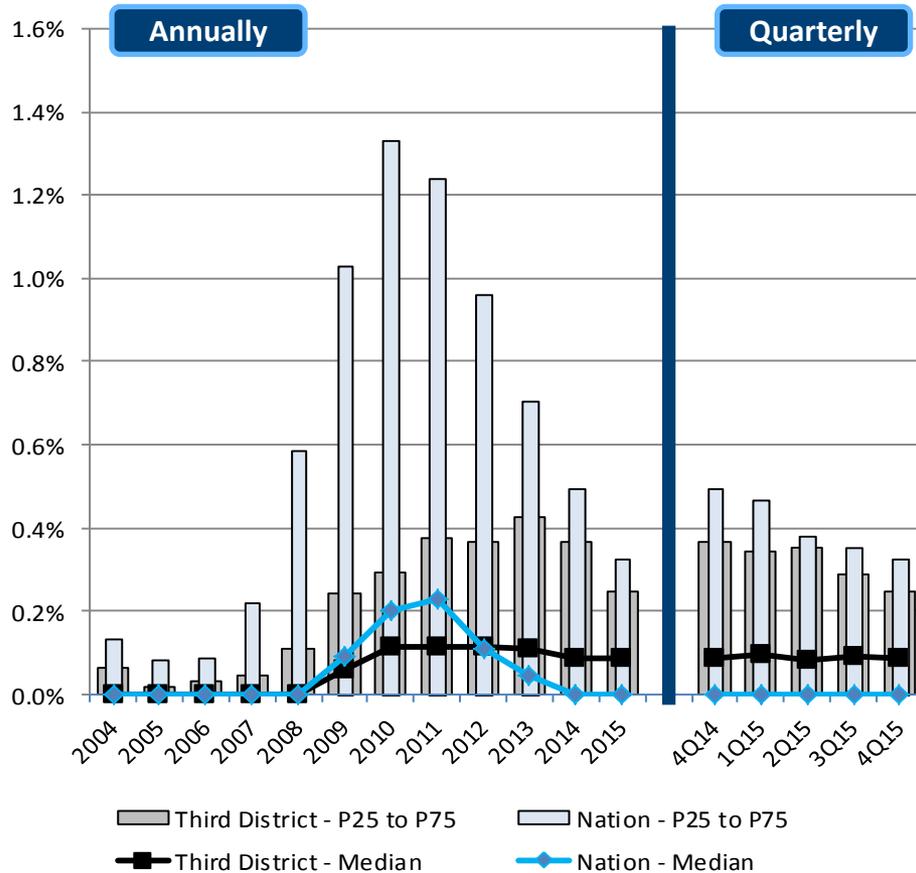


*Troubled debt restructurings were not included on the Call Report until the March 2009 reporting period.

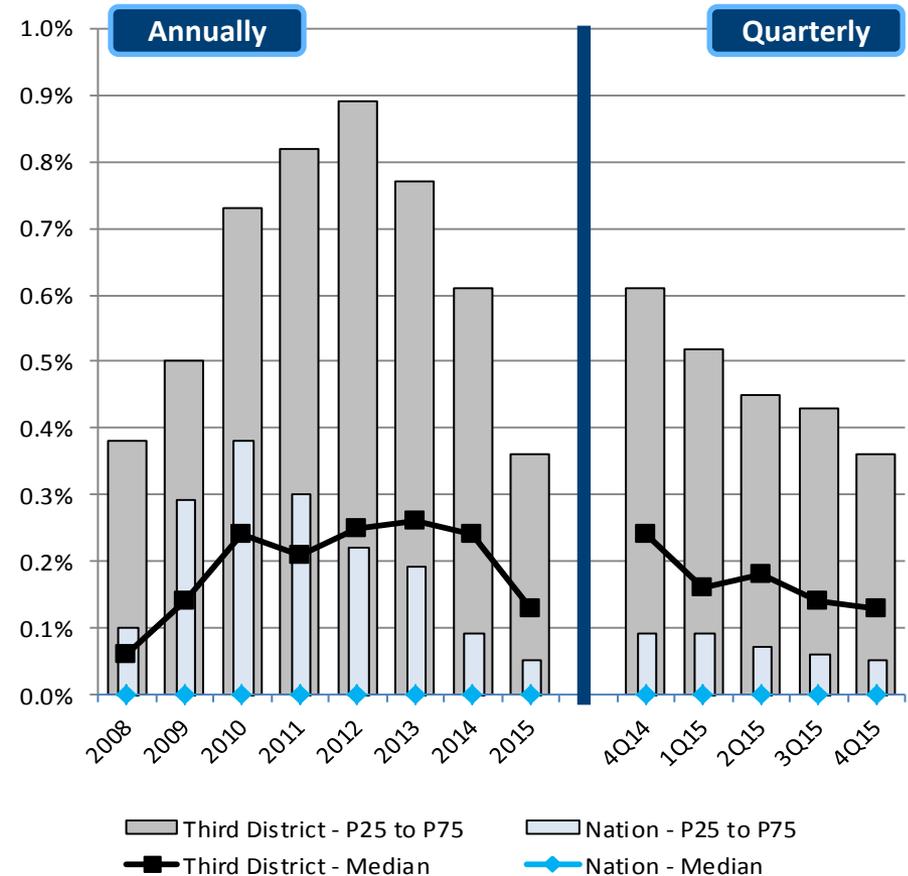
One- to four-family OREO is decreasing faster within the nation, but the Third District trails in the foreclosure process.



1-4 Family OREO*



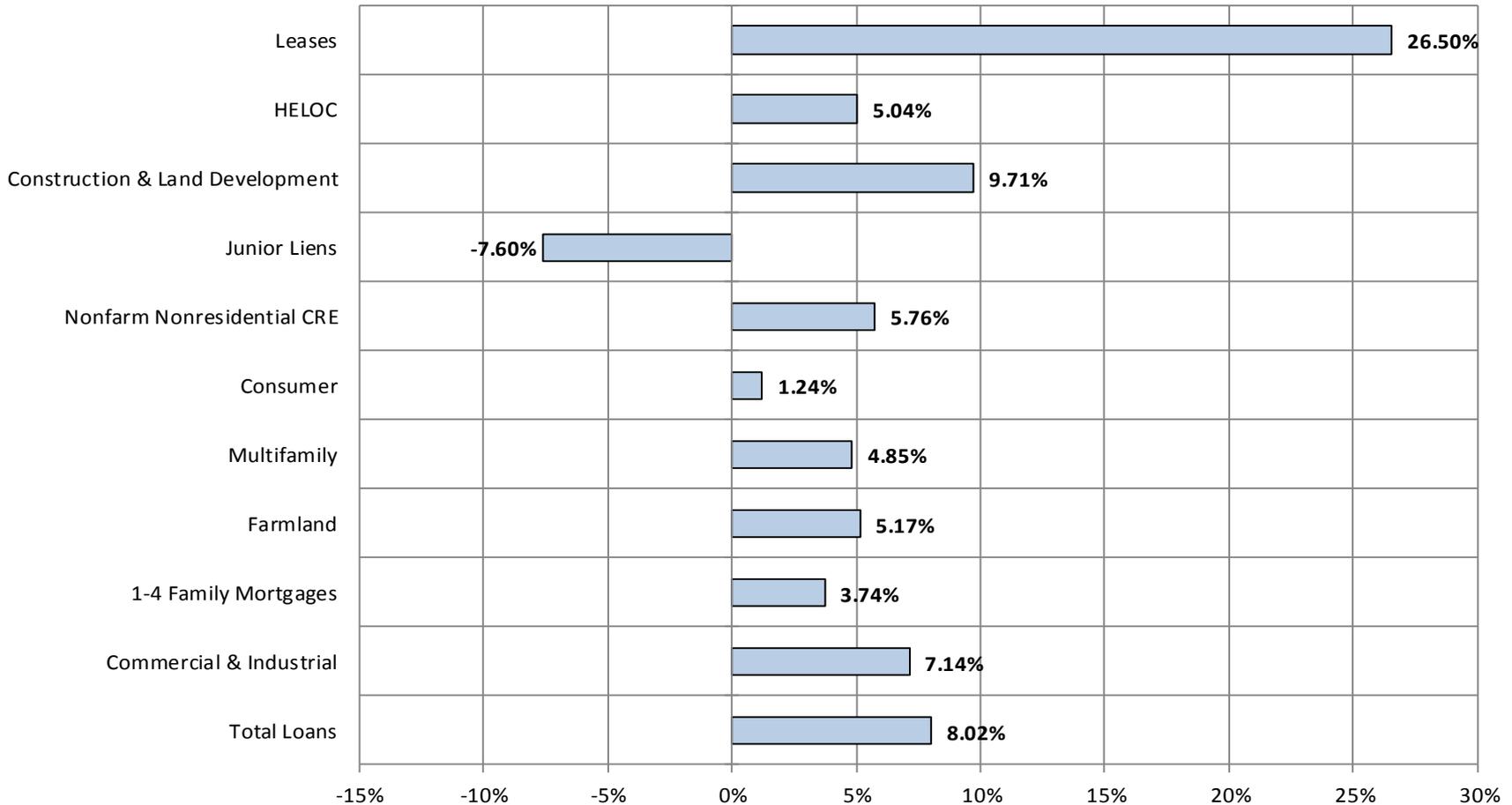
Loans in Process of Foreclosure**



*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.

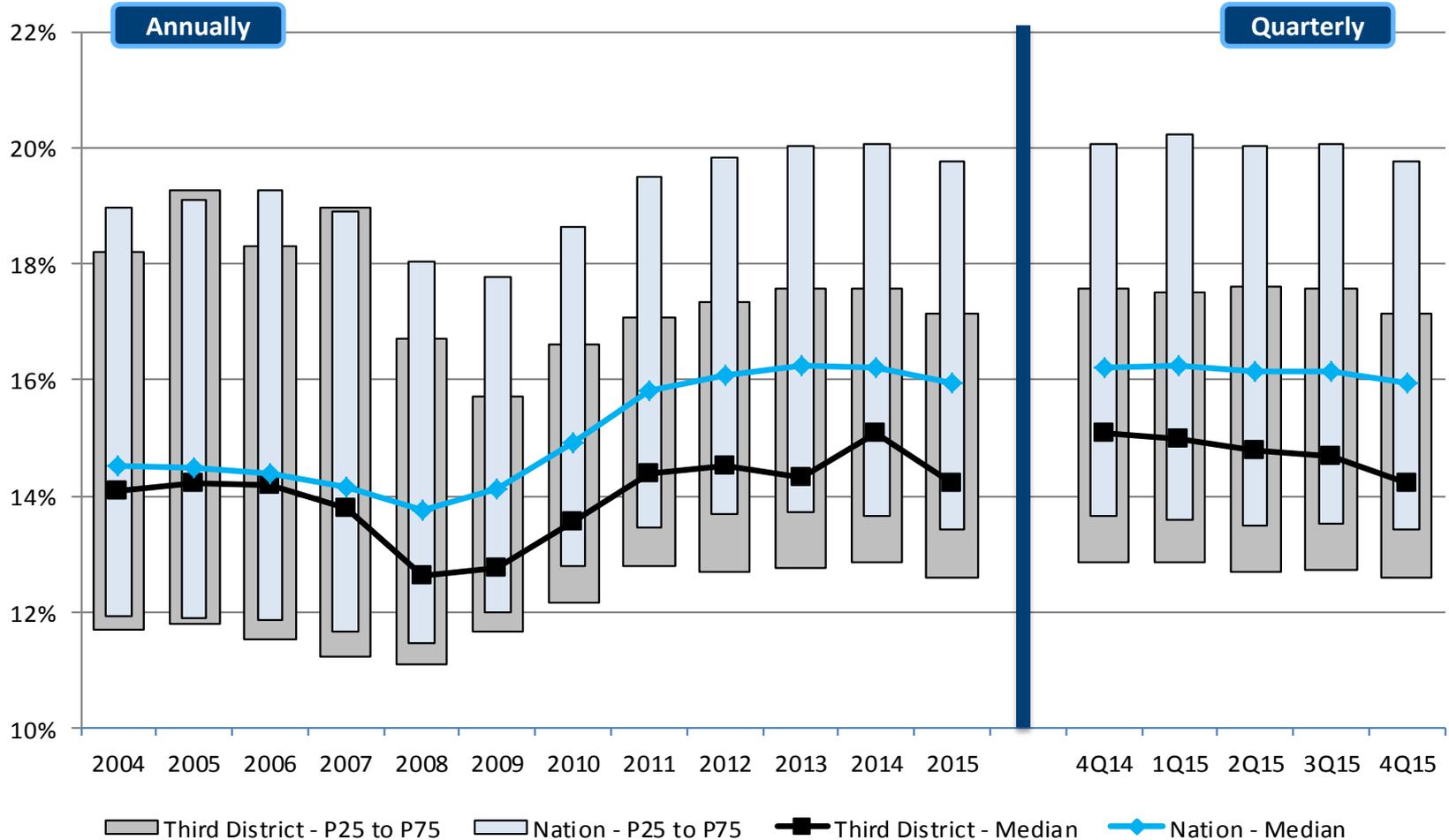


*This report shows the median year-over-year percentage loan growth for Third District CBs that meet the CB definition on Slide 4.

Capital ratios have increased postcrisis; however, District levels have fallen in recent quarters.



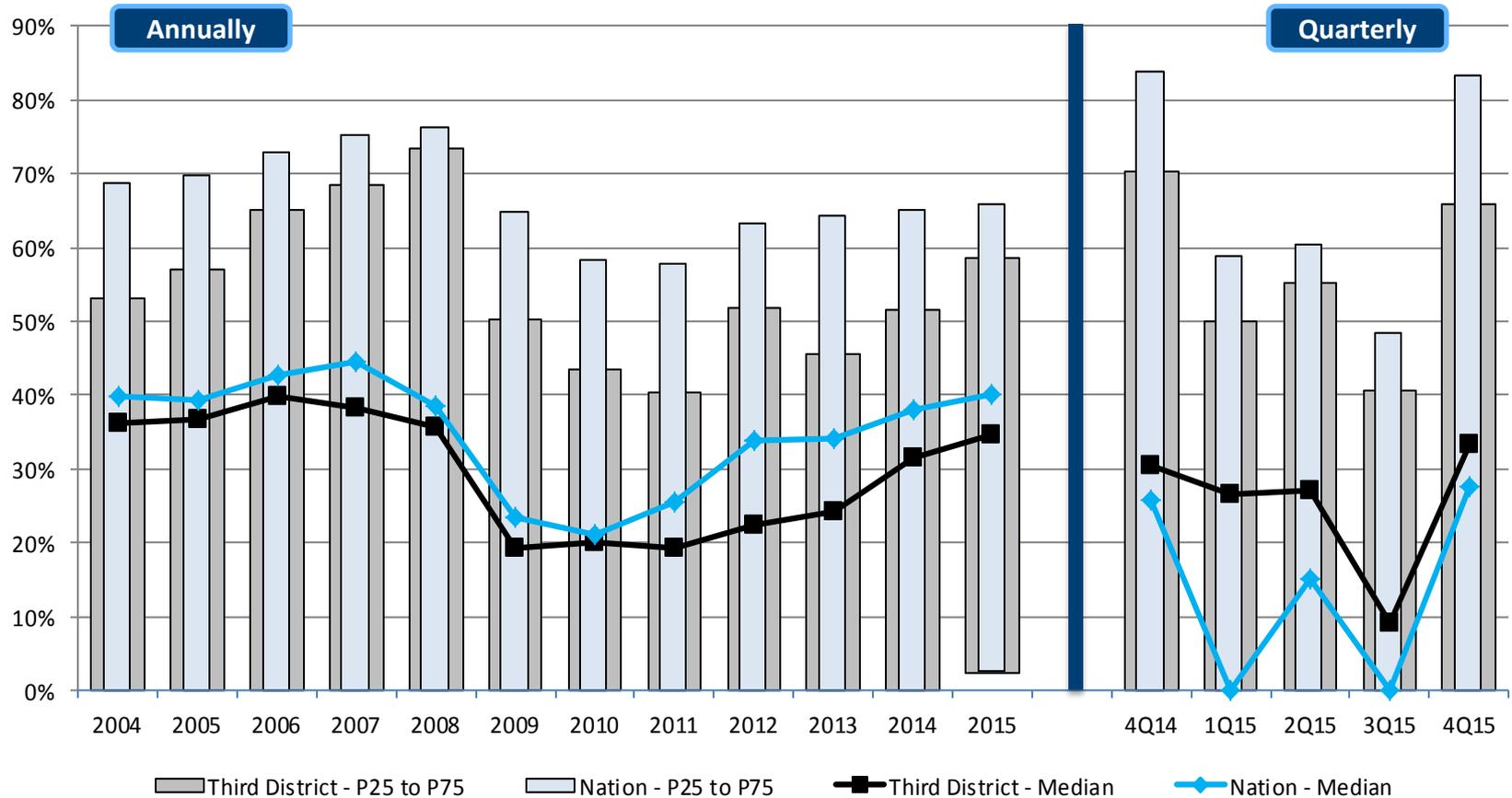
Total Risk-Based Capital



Dividend payments* have continued to increase since the end of the recession.



Dividends

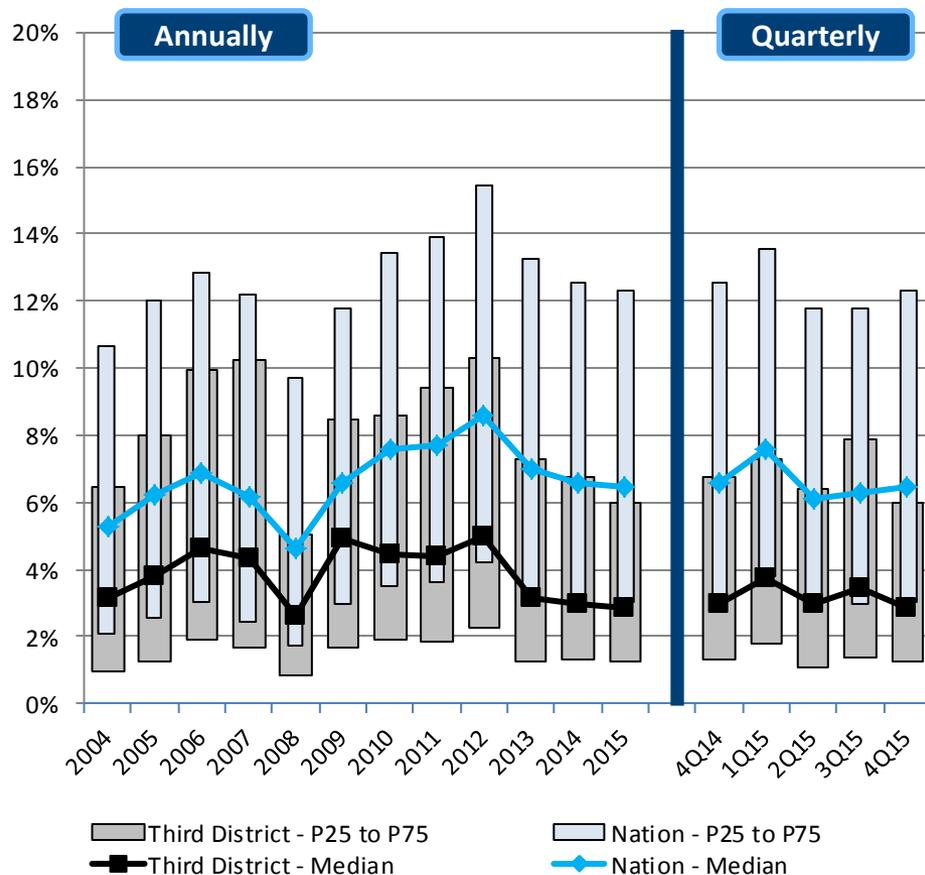


*Some banks pay dividends semiannually; therefore, 1Q and 3Q dividends are normally lower than those for 2Q or 4Q. However, the *dividend payout* ratio for the Third District is above the value when compared with a year ago, which may indicate that banks may have paid out more of their net income as dividends in 2015.

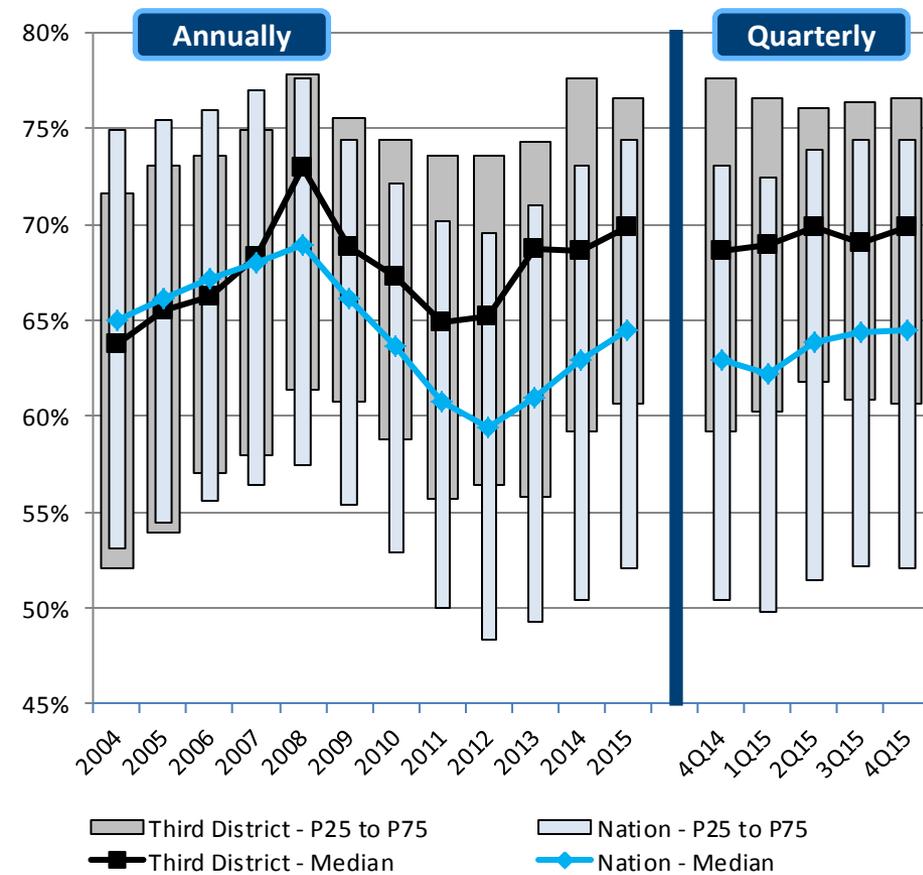
Third District banks do not hold as many short-term investments* when compared with the nation. The District's institutions maintain a higher percentage of loans, which may increase duration risk.



Short-Term Investments / Assets



Loans / Assets

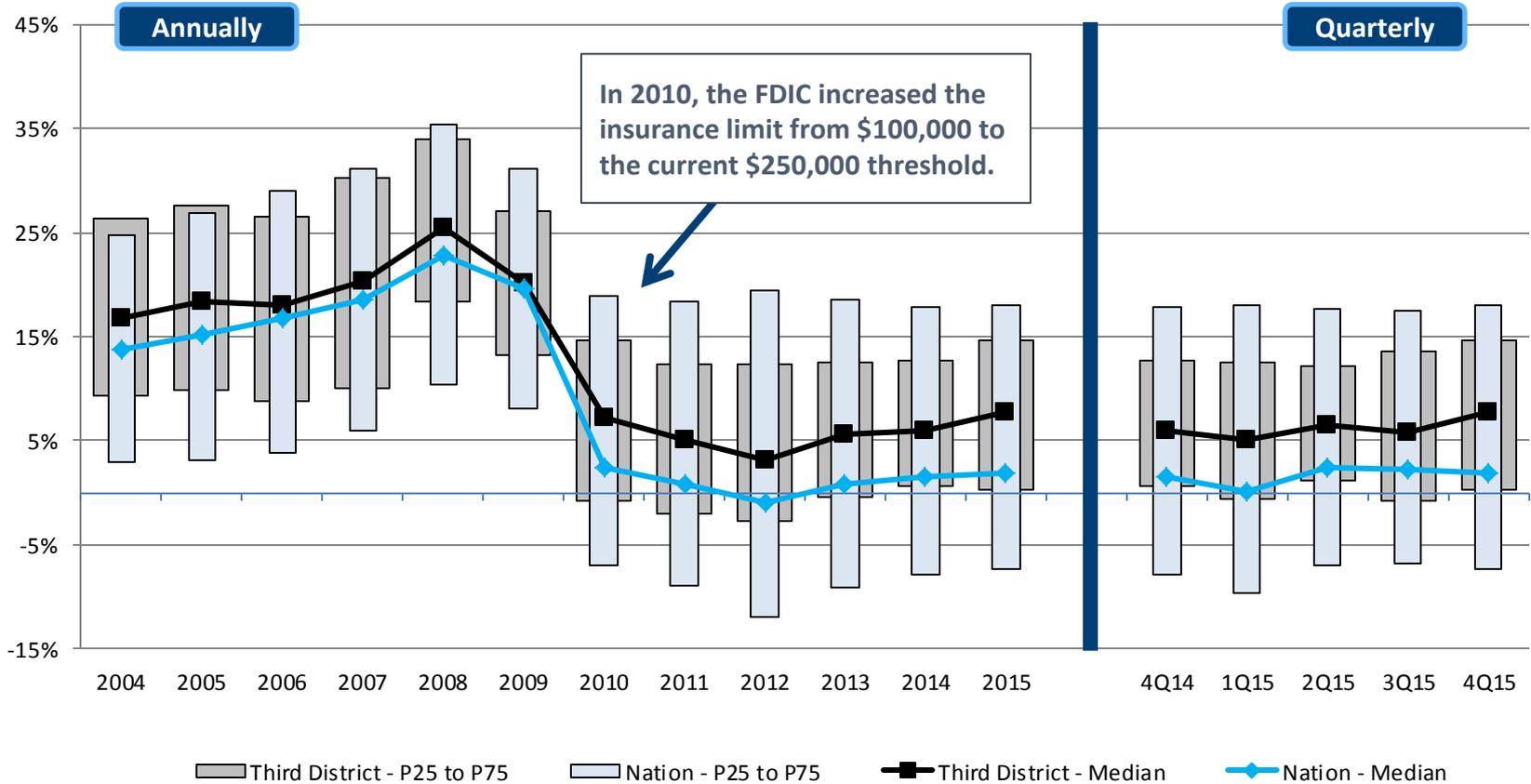


*Short-term investments equals the sum of interest-bearing bank balances + federal funds sold + securities purchased under agreements to resell + debt securities with a remaining maturity of one year or less.

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

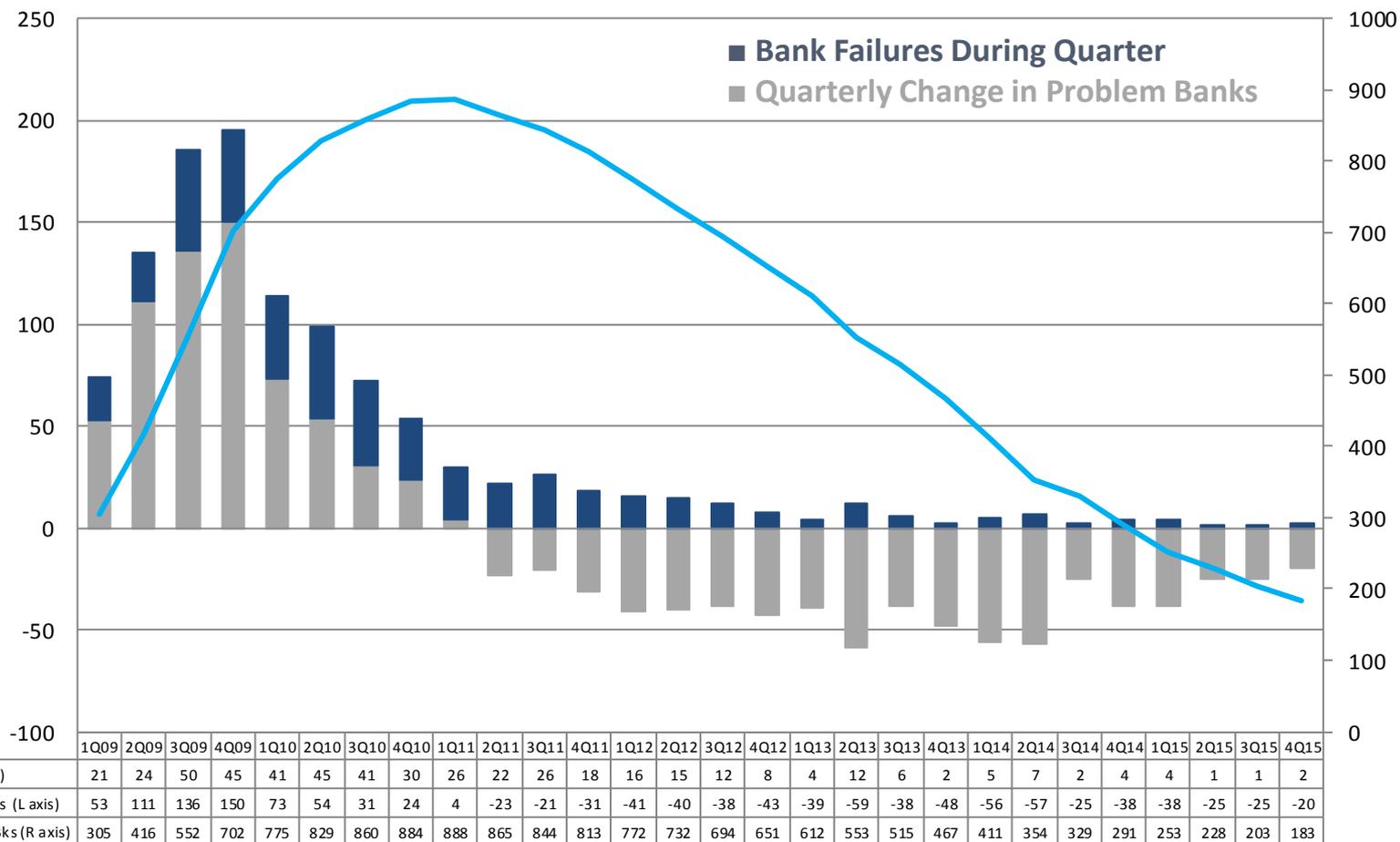


Net Noncore Funding Dependence



*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 and are below 200 in 4Q2015.



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: capital, asset quality, management, earnings, liquidity, and sensitivity to market risk.