Economic Trends

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FEDERAL RESERVE BANK of CLEVELAND

Mixed Signals on Financial Stability

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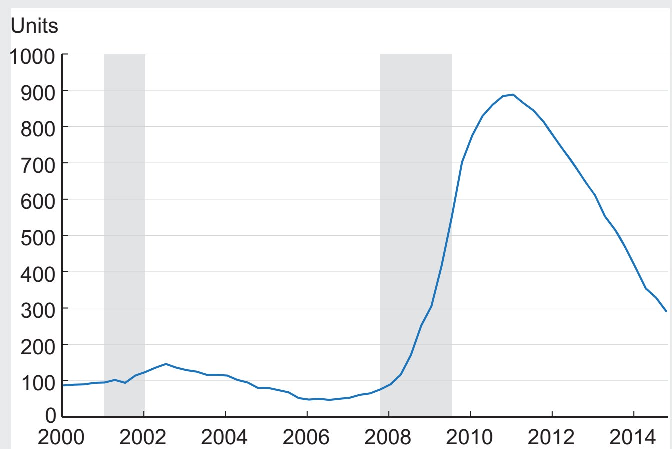
Financial markets are still in what seems to be a tentative recovery period, even six years after the end of the Great Recession. We look at the banking trends observed through 2014 and consider what they may signal about the financial sector in 2015.

One indicator that points to a healthier financial system is that the number of problem institutions continues to fall. Problem institutions are banks determined to have financial and either operational or managerial weaknesses that threaten their continued financial viability. The list of problem institutions is confidential and maintained by the Federal Deposit Insurance Corporation (FDIC), but the aggregate numbers are made public. Following the Great Recession, the number of problem institutions reached 888 in the first quarter of 2011, the highest it had been since 1992. The number has now fallen for 14 consecutive quarters and currently stands at 291, the first time it has been below 300 since 2008.

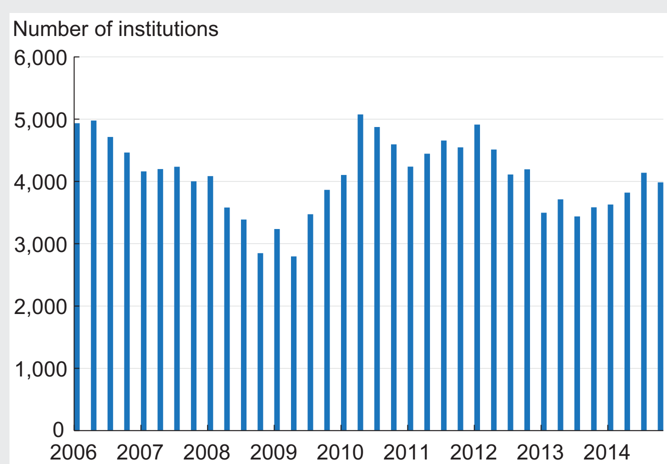
Measures of bank profitability, however, give a picture that is a little more mixed. The number of institutions reporting year-over-year gains in earnings fell in the fourth quarter of 2014 to 3,985 institutions.

Number of Problem Institutions



Notes: Shaded bars indicate recessions. Last observation: 2014:Q3.
Source: Federal Deposit Insurance Corporation.

Institutions with Year-over-Year Earnings Gains



Last observation: 2014:Q4.
Source: Federal Deposit Insurance Corporation.

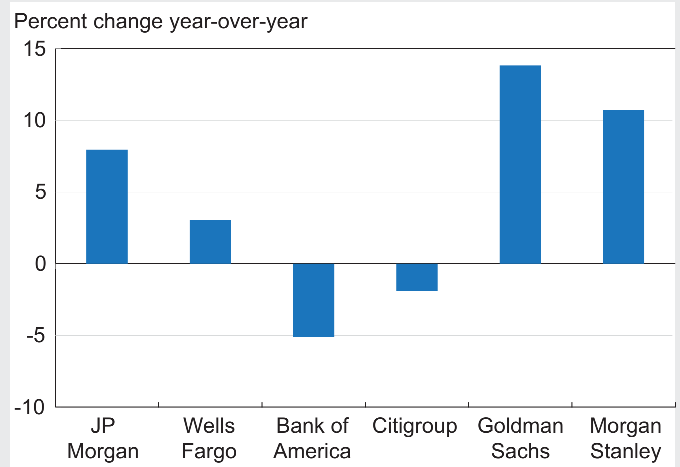
Up to that point, the number of banks reporting yearly earnings gains had increased for five consecutive quarters. The current number is still an improvement over the situation at the end of the recession, when the number of institutions reporting earnings gains year over year reached only 2,797 banks in the second quarter of 2009.

Year-over-year revenue growth for the six largest US banks was not uniformly good or bad. Bank of America and Citigroup posted declines, while Goldman Sachs, Morgan Stanley, and J.P. Morgan posted strong growth. Wells Fargo posted a slight increase.

The profitability of community banks shows a much clearer positive trend than that of commercial banks overall. Community banks reported strong income growth in the fourth quarter of 2014, with quarterly earnings rising 28 percent. They reported net income of $4.8 billion, up $1.0 billion from the previous year. The FDIC quarterly banking report noted that this increase in net income resulted from a combination of higher net operating revenue and lower loan-loss provisions. Yet, even with this increase in revenue for community banks, the banking industry as a whole still experienced an earnings decline of 7 percent.

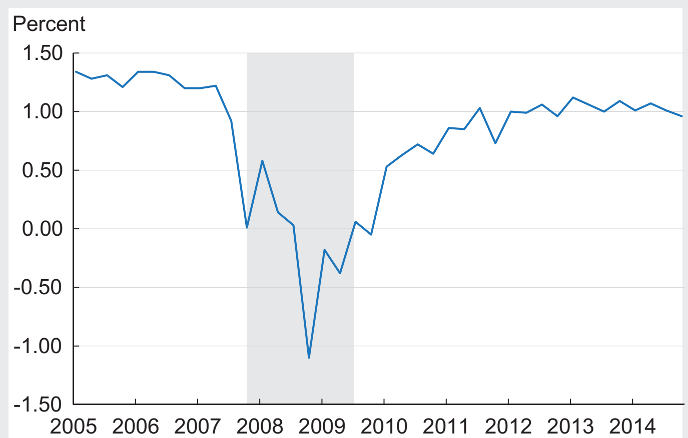
Return on assets—net income as a percentage of average total consolidated assets—is another measure of bank profitability. For the first time in two years, the average quarterly return on assets for the banking industry as a whole has fallen below 1 percent, coming in at 0.96 percent in the fourth quarter of 2014.

Change in Bank Revenue



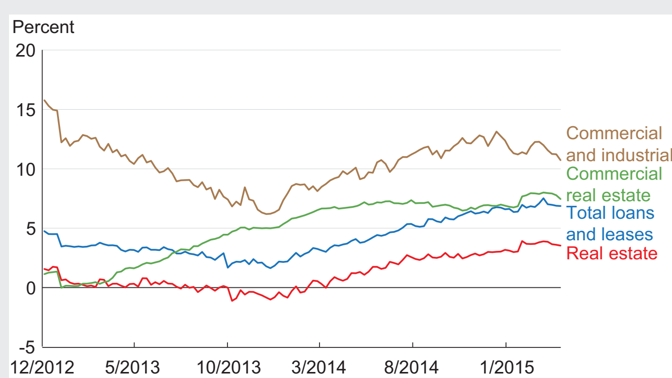
Last observation: 2014:Q4.
Source: Thomson Reuters.

Quarterly Return on Assets, Annualized



Notes: Shaded bar indicates recession. Last observation: 2014:Q4.
Source: Federal Deposit Insurance Corporation.

Year-over-Year Change in Loans at All Domestically Chartered Commercial Banks



Last observation: 4/29/2015.
Source: Board of Governors of the Federal Reserve System/Haver.

Taking a look at the lending behavior of commercial banks, we see that there has been strong growth in total loans during 2015. At domestically chartered commercial banks, year-over-year increases in total loans have been above 2 percent since February 2014. As of May, there has been a leveling off in the year-over-year growth rate, which is currently at 6.9 percent as of the week of May 6, down from 7.5 percent at the beginning of April 2015. While year-over-year changes are down slightly, the level of total loans and leases for domestically chartered commercial banks was at an all-time high of $7.35 trillion at the beginning of April. As of May 1, total levels of loans and leases are only down 0.14 percent from the high in April.

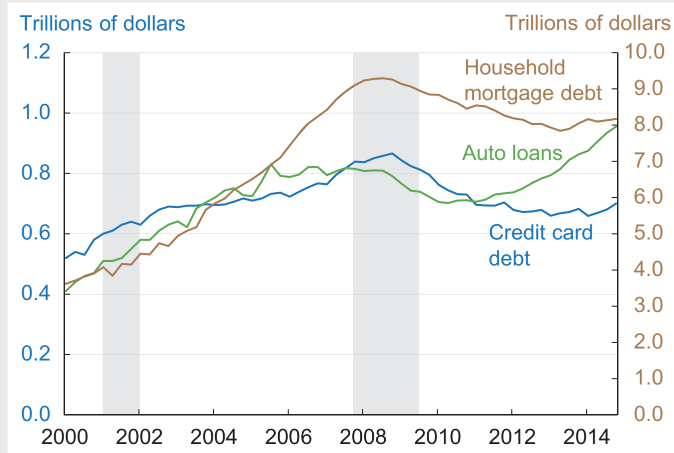
Looking at total debt balances across all accounts excluding those in bankruptcy, we are able to see current trends of the most common consumer-debt categories. While credit-card, mortgage, and auto-loan debt all decreased during the Great Recession, auto-loan debt increased soon after the Great Recession ended. Credit-card and mortgage debt have been a little slower at reversing the declines experienced during the recession. In 2014, auto-loan and credit-card debt both experienced four consecutive quarters of increases. As of fourth quarter 2014, auto-loan debt is up 10.7 percent year over year, credit-card debt is up 1.5 percent, and household-mortgage debt is up 2.5 percent.

The growth of consumer lending is a positive signal about the health of the market, but one area of concern is an increase in new delinquent auto loans. This increase seems to mirror the increases seen in the total amount of auto-loan debt taken out.

While auto-loan debt has increased for 16 consecutive quarters, reaching $1 trillion in the fourth quarter of 2014, the average length of an auto loan has also increased. The average length is up to 66 months this quarter, while last year at this time it was 65 months. Every type of borrower is experiencing an increase.

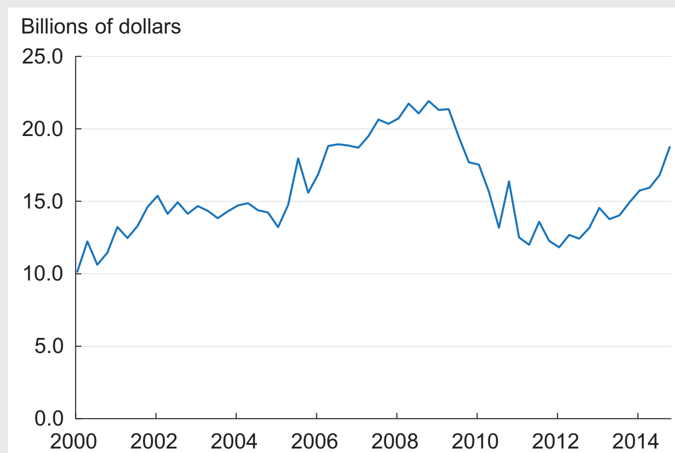
The second quarter of 2014 marked the second consecutive quarter of year-over-year increases in banks' provisions for loan losses. Loan-loss provisions

Total Consumer-Debt Balances



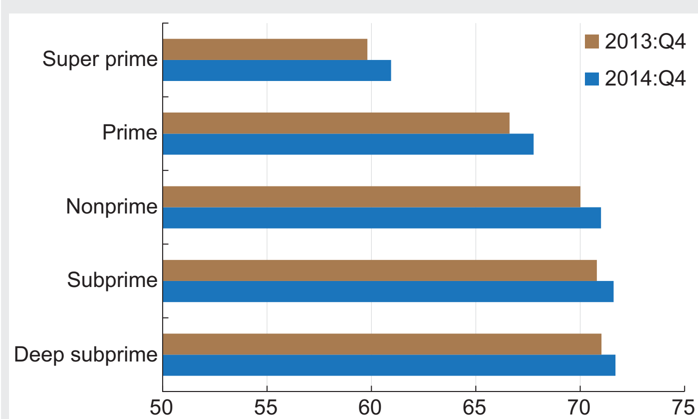
Notes: Shaded bars indicate recessions. Last observation: 2014:Q4.
Source: Federal Reserve Bank of New York's Consumer Credit Panel/Equifax.

New Delinquent Auto Loans



Last observation: 2014:Q4.
Source: Federal Reserve Bank of New York's Consumer Credit Panel/Equifax.

Average Term of New Car Loan

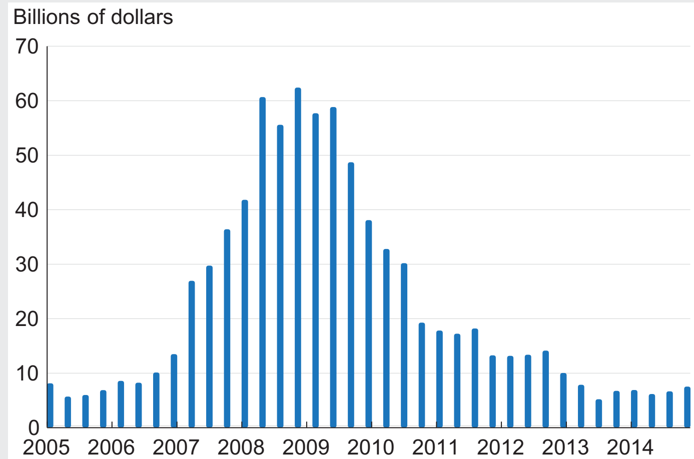


Last observation: 2014:Q4.
Source: Experian.

increased 29.8 percent year over year in the third quarter of 2014, and in the fourth quarter, provisions are up 12.4 percent year-over-year.

Increases in loans and profits both point to healthier banks, but the increase in loan-loss provisions could mean that banks fear the prospect of increased loan defaults or that they are responding to losses they are already experiencing. The mixed signals from financial institutions may indicate that banks are continuing to recover slowly while trying to provide support for future growth in the economy.

Quarterly Loan-Loss Provisions



Last observation: 2014:Q4.
Source: Federal Deposit Insurance Corporation.

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