

BANK

State of Banking, 2015

Commercial lending is growing, bad debts are down. But banks face their share of challenges, still.



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Though the bad debts that have wounded bank balance sheets in recent years continued to abate in 2014, the operating environment for US banks remains challenging.

Low interest rates have squeezed banks' net interest margins. The aggregate net interest margin of US banks stood at 3.04 percent as of year-end 2014, the lowest it's been since at least 1992.

Loan demand remains constrained, and competition for what loan demand exists is high.

Complying with new regulations comes at a price, as does defending against ongoing threats to cybersecurity.

These are the conditions Federal Reserve Bank of Cleveland bank examiners have gleaned from bankers in the course of their supervisory work, and aggregate data available via recent bank financial filings corroborate what they've heard.

These data also reveal that for the first time since 2010, the aggregate profit of US banks fell (2.3 percent between December 31, 2013, and December 31, 2014). The same is true for the profits of those banks supervised by the Cleveland Fed in Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky. Their aggregate net income fell 4.7 percent over the same period.

Why, if margins have been compressed for some time, did banks' net income grow for years and then drop over the course of 2014?

For one, securities gains, or money that institutions make by selling investment securities, boosted profits in other recent years. Plus, bank profits were bolstered as institutions released money from their loan-loss reserves as the volume of bad debts declined. That kind of profit is not sustainable, Cleveland Fed supervisors explain.

Low loan growth (compared to what was seen pre-recession) is motivating banks in the region to pursue growth in other ways, including mergers and acquisitions (M&A). It's a trend that's reflected in changing bank signage across the country—and a story aggregate data also tell.

M&A involving US banks rose to 328 last year from 209 in 2010, an increase of 57 percent. Meanwhile, deals involving banks supervised by the Cleveland Fed increased to 25 from 3 in 2010, a staggering 733 percent increase.

“The number [of bank mergers and acquisitions industry-wide] that we saw in 2014 was higher than we've seen in several years,” said Stephen H. Jenkins, the Cleveland Fed's senior vice president of banking supervision.

But why might the increase have been so much sharper in this region?

Fred Cummings has a theory.

“There's just more supply” compared to other parts of the country, says Cummings, president of Elizabeth Park Capital Management, an Ohio-based hedge fund that invests in banks from coast to coast. “I think it's due to the relatively high number of independent banks, particularly in Pennsylvania. Even Ohio still has a lot of small banks.”

‘Everyone's trying to get growth’

Though it's under pressure, the banking industry is financially stable and gradually improving, Cleveland Fed supervisors say. Historically speaking, though, its return on equity is lower, and revenue growth is down.

Loan growth may not be as robust as bankers would like (for one, because many businesses have the liquidity they require to self-fund their needs), but one category of lending is up.

“Commercial and industrial (C&I) lending was where we saw relatively strong growth,” says Jenni Frazer, an assistant vice president with the Cleveland Fed.

During recent earnings calls, bankers reported they feel “reasonably optimistic” about loan growth in 2015, too, Cummings says.

“C&I lending is really the key driver of the loan growth,” he continues. “Mortgage is still tough, given down payment requirements. Home equity isn't growing.”

Cleveland Fed banking supervisors agree: Where there is consumer lending growth, it tends to be auto loans. Most of the loan demand that exists appears to be commercial, and traditional banks and nonbank organizations are competing for it. Hedge funds and insurance companies are among banks' nonbank competitors, Frazer says.

There's integration risk as firms combine: Are the appropriate processes and controls in place? Has due diligence been done?

“All banks are talking about the pricing environment,” Cummings adds. “Pricing is more competitive now than it was last year because everyone's trying to get growth.”

The reach for yield by financial institutions, through the assumption of risks as a means to generate earnings, is a concern for banking regulators, notes Nadine M. Wallman, a Cleveland Fed vice president.

“The banks themselves are telling us they are beginning to loosen underwriting standards,” she says, citing the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices.

When asked whether he sees emerging risks, Elizabeth Park Capital's Cummings cautions that C&I lending is riskier because in many cases it's unsecured, or without pledged collateral.

“Some banks are going to make mistakes in commercial and industrial lending because they don't have much experience” in that area, Cummings says. “They don't have the option of doing more consumer-based lending. The demand side for that is just weaker right now.”

Indeed, in their annual reports, a number of Fourth Federal Reserve District banks noted that their mortgage banking incomes dropped in 2014. They cite the slower housing market, a slowdown which some attributed to the recently introduced Qualified Mortgage and Ability to Repay standards. However, anecdotal information suggests that mortgage activity picked up in the first quarter of 2015.

Margins and Mergers

US banks¹ may not be as burdened by delinquent loans as they have been in recent years, but the industry faces other challenges.

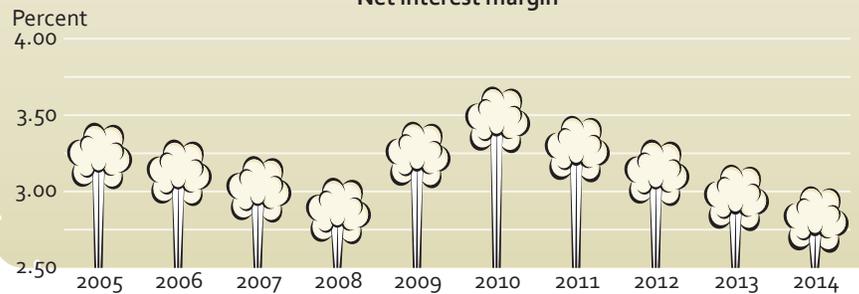
First, some good news. When a bank writes off a loan that a borrower is not paying, it's called a charge-off. Net charge-offs, as a percentage of US banks' total loans and leases, ballooned to 2.69 percent at year-end 2009, but since then have declined. As of year-end 2014, net charge-offs had returned to pre-recession levels.

Net charge-offs
(as a percent of total loans and leases)

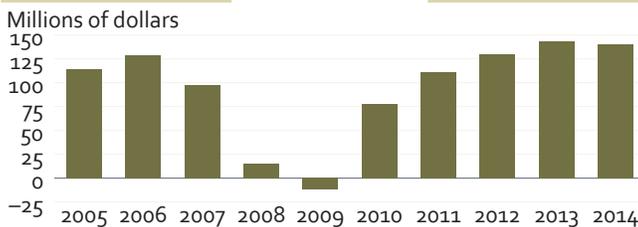


Banks remain under pressure, however. Competition for loans (from both banks and nonbanks such as hedge funds and insurance companies) is tight, and banks' net interest margin—the spread between how much interest banks pay for money they take in and how much interest they make lending it—is squeezed. In fact, banks' net interest margin hasn't been lower than it was at the end of 2014 since at least 1992.

Net interest margin



Bank profits



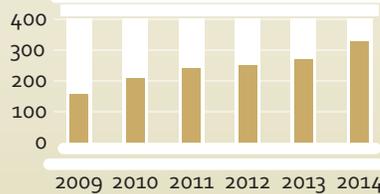
Although net interest margins are squeezed, the banking industry's profits have been on the upswing, growing every year since 2010—until 2014. Many institutions' profitability was due, in no small part, to money they were able to release from loan-loss reserves as the need to cushion against bad debts abated. Between the end of 2013 and the end of 2014, though, US banks' net income dropped 2.3 percent.

Bank mergers and acquisitions

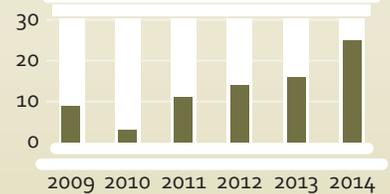
Bank mergers and acquisitions have picked up since 2010, increasing 57 percent nationally and a whopping 733 percent in the region the Cleveland Fed serves.² Often, bankers doing these deals cite squeezed margins and increased costs of compliance as reasons for the transactions.



Nation



Fourth District



1. The term "US banks" refers to US institutions that have commercial bank charters.
2. The Federal Reserve Bank of Cleveland serves the Fourth Federal Reserve District, which comprises Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky.

Increased regulation and continued margin compression are 2 things bankers cite as reasons for doing M&A, Wallman says.

Federal Reserve supervisors aren't for or against increased bank consolidation.

"We are indifferent on the number of mergers and acquisitions," Jenkins says. "It is individual banks' boards of directors and ultimately the market that determine the amount of consolidation."

But the Fed does monitor the risks created by increased deals. There's integration risk as firms combine: Are the appropriate processes and controls in place? Has due diligence been done?

The execution risk is especially high for some of the smaller banks engaging in deals, Cummings says.

"Some of these small banks have not been that active in deals, and they're starting to do deals," he says. "They may not execute that effectively, in terms of capturing cost savings in a timely manner."

Burdens, yet optimism

While bankers tell Nick DiFrancesco, president and chief executive officer of the Pennsylvania Association of Community Bankers, that net interest margins are a concern, they identify a bigger threat.

"It's a very burdensome regulatory environment," DiFrancesco says. "You talk to most banks, [and] if they're hiring people, they're hiring people for compliance, not customer-facing positions."

Many banks are also struggling with the cost of introducing technology — from web-based to mobile — to the way they do banking, but it's imperative they do, DiFrancesco asserts.

"Those banks that have not been able to get where they need to be to compete with technology and products will continue to see a rather challenging economic position," he says. "There are still banks that have not reached into that area at all. As the older population starts to leave the banking market, the millennials are expecting something completely different in terms of services. We can't continue to do what we've always done. The manner in which financial services are transacted is changing dramatically."

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Though there are pressures, there's reason for optimism: When it comes to their troubled debts, banks as a whole reported that their nonperforming assets, or delinquent, nonaccruing loans and repossessed assets, and their charge-offs, or written-off debts, have declined.

The volume of nonperforming assets has been dropping for nearly a half decade, and the improvement reveals something about banks' customers, the Cleveland Fed's Frazer says.

"Improving trends in asset quality are continuing," she says. "It means that the banks will be stronger; they will be able to retain capital as opposed to losing capital from taking losses on loans. It signals that our businesses in the community are faring better financially because they're able to pay their debts, and, along the same lines, consumers are faring better because they're able to pay their mortgages, their credit cards, their car loans."

One asset class that worries some, Cummings says, is multi-family lending, which has grown very fast and, in some markets, perhaps to an extent where supply may exceed demand, Cummings says.

Still, he expects the banking industry's credit quality to remain strong and the industry to enjoy stable to improving profitability this year. Cummings also foresees more banks returning capital to shareholders in the form of dividend increases and stock buybacks. Additionally, he expects increasing mergers and acquisitions to be a key trend in 2015 and 2016.

DiFrancesco uses stronger wording: He expects 2015 to be "rampant" with M&A, but he's not seen so far this year the level of activity he would have expected.

Bankers, for their part, seem optimistic that credit quality will continue to move in a positive direction. They're also building, Frazer says, into their second-half forecasts something they'd very much welcome: higher interest rates. ■