Banking Conditions Survey

Federal Reserve Bank of Dallas

July 2017

Data for this report were collected June 13–21, and 68 financial institutions—12 credit unions and 56 banks—responded.

Over the past six weeks, the Eleventh District financial sector has strengthened but at a slower pace compared with last period. Banking leaders indicated that loan volume and loan demand continued to expand but at a slower pace. The loan volume index was 29.5, down from 43.5. Similarly, the loan demand index moved to 16.4 from 26.9.

The survey suggests that nonperforming loans declined overall and at the same pace as last period, with an index value of −20.3. Nonperforming consumer loans went down the most over the period, dropping from an index of –3.3 to –9.5. Loan pricing continued to increase but at a slightly slower pace, with an index of 24.2, down from 27.7. Overall, credit standards and terms have not changed, though financial leaders reported minor tightening in commercial real estate and residential real estate. General business activity continued to expand but at a slower pace, with a reading of 39.7, down from 42.6.

The gains in loan volume were mainly driven by residential real estate loans, expanding quickly from 15.2 to 39.2. Commercial and industrial (C&I) loans and commercial real estate (CRE) loans also experienced increases in loan volume but at a much slower pace compared with last period; the C&I index dropped from 22.0 to 10.3 and the CRE index fell from 40.3 to 27.1. Consumer loan volume largely remained the same.

Core deposit volumes continued to grow but at a slower pace over the period, with an index of 11.8, down from 33.3. The cost of funds index increased and at nearly the same pace with a reading of 39.7. The net interest margin index increased over the period at 16.2. Over the past six weeks, noninterest income has continued to expand but at a slower pace, with a reading of 13.4, down from 19.1.

The outlook for the Eleventh District financial sector remains optimistic. Banking leaders expected continued expansion in total loan demand and general business activity, though they were slightly less optimistic than they were last period. The respondents also expected nonperforming loans to decline over the next six months.

Next Release: September 6, 2017

The Federal Reserve Bank of Dallas conducts the Banking Conditions Survey twice each quarter to obtain a timely assessment of activity at banks and credit unions headquartered in the Eleventh Federal Reserve District. CEOs or senior loan officers of financial institutions report on how conditions have changed for indicators such as various loan types, deposits and loan pricings. Respondents are also asked to report on their banking outlook and how they perceive broader economic conditions to have changed (general business activity).

The answers serve a dual function: They provide supplemental anecdotal information for the Eleventh District Beige Book and supply timely information on banking conditions in preparation for monetary policy deliberations before the eight Federal Open Market Committee meetings each year.

Participants are asked whether they are seeing changes in a series of indicators. In addition, participants are given the opportunity to submit comments on current issues that may be affecting their business.

Survey responses are used to calculate an index for each indicator. Each index is calculated by subtracting the percentage of respondents reporting a decrease (or tightening or worsening) from the percentage reporting an increase (or easing or improvement). When the share of firms reporting an increase exceeds the share of firms reporting a decrease, the index will be greater than zero, suggesting the indicator has increased over the prior reporting period. If the share of firms reporting a decrease exceeds the share reporting an increase, the index will be below zero, suggesting the indicator has decreased over the prior reporting period. An index will be zero when the number of firms reporting an increase is equal to the number reporting a decrease. Note: Percentages may not add to 100 due to rounding.

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1. Total loans: Over the past six weeks, how have the following changed?

Indicator	Current index	Previous index	Percent reporting increased	Percent reporting no change	Percent reporting decreased
Loan volume	29.5	43.5	47.1	35.3	17.6
Loan demand	16.4	26.9	34.3	47.8	17.9
Nonperforming loans	–20.3	–20.3	6.3	67.2	26.6
Loan pricing	24.2	27.7	30.3	63.6	6.1

Indicator	Current index	Previous index	Percent reporting eased	Percent reporting no change	Percent reporting tightened
Credit standards and terms	0.0	–4.7	9.5	81.0	9.5

2. Commercial and industrial loans: Over the past six weeks, how have the following changed?

Indicator	Current index	Previous index	Percent reporting increased	Percent reporting no change	Percent reporting decreased
Loan volume	10.3	22.0	24.1	62.1	13.8
Nonperforming loans	–11.1	–19.6	3.7	81.5	14.8

Indicator	Current index	Previous index	Percent reporting eased	Percent reporting no change	Percent reporting tightened
Credit standards and terms	0.0	–6.6	5.2	89.7	5.2

3. Commercial real estate loans: Over the past six weeks, how have the following changed?

Indicator	Current index	Previous index	Percent reporting increased	Percent reporting no change	Percent reporting decreased
Loan volume	27.1	40.3	40.7	45.8	13.6
Nonperforming loans	–17.9	–16.9	0.0	82.1	17.9

Indicator	Current index	Previous index	Percent reporting eased	Percent reporting no change	Percent reporting tightened
Credit standards and terms	–1.8	–13.2	3.4	91.4	5.2

4. Residential real estate loans: Over the past six weeks, how have the following changed?

Indicator	Current index	Previous index	Percent reporting increased	Percent reporting no change	Percent reporting decreased
Loan volume	39.2	15.2	44.6	50.0	5.4
Nonperforming loans	–9.4	–7.1	0.0	90.6	9.4

Indicator	Current index	Previous index	Percent reporting eased	Percent reporting no change	Percent reporting tightened
Credit standards and terms	–3.5	–1.7	3.6	89.3	7.1

5. Consumer loans: Over the past six weeks, how have the following changed?

Indicator	Current index	Previous index	Percent reporting increased	Percent reporting no change	Percent reporting decreased
Loan volume	0.0	–1.5	16.7	66.7	16.7
Nonperforming loans	–9.5	–3.3	4.8	81.0	14.3

Indicator	Current index	Previous index	Percent reporting eased	Percent reporting no change	Percent reporting tightened
Credit standards and terms	0.0	–1.5	3.1	93.8	3.1

6. Other banking developments: Over the past six weeks, how have the following changed?

Indicator	Current index	Previous index	Percent reporting increased	Percent reporting no change	Percent reporting decreased
Volume of core deposits	11.8	33.3	32.4	47.1	20.6
Cost of funds	39.7	39.1	41.2	57.4	1.5
Net interest margin	16.2	17.4	30.9	54.4	14.7
Noninterest income	13.4	19.1	22.4	68.7	9.0

7. Banking outlook: What is your expectation for the following items six months from now?

Indicator	Current index	Previous index	Percent reporting better	Percent reporting no change	Percent reporting worse
Total loan demand	47.0	55.9	54.4	38.2	7.4

Indicator	Current index	Previous index	Percent reporting more	Percent reporting no change	Percent reporting fewer
Nonperforming loans	–26.5	–25.0	8.8	55.9	35.3

8. General business activity: What is your evaluation of the level of activity?

Indicator	Current index	Previous index	Percent reporting improved	Percent reporting no change	Percent reporting worsened
Over the past six weeks	39.7	42.6	48.5	42.6	8.8
Six months from now	39.7	47.7	50.0	39.7	10.3

9. Issues of concern: Please feel free to comment on any issue that may be affecting your business.

These comments are from respondents' completed surveys and have been edited for publication.

- Our bank is divesting itself from all foreign national deposits and loans. Bank Secrecy Act validation and verification has made it too expensive to continue in this line of business.

- Compliance, fair lending, the Bank Secrecy Act and the Community Reinvestment Act still are the areas of focus.

- Cybersecurity and IT-related costs are continuing to eat into our bottom line. It is difficult to find skilled IT workers to serve community banks due to salary demands and other outside forces. Also, the continued confusion in Washington with the new administration makes the next few months difficult to judge due to the uncertain political climate. Compliance topics have eased recently; however, the focus seems to have shifted to vendor management and IT infrastructure.

- We have a dampening outlook.

- Federal regulations continue to be the biggest drag on the economy and have been the last 8 1/2 years and counting.

- We are concerned with the flattening of the yield curve. We have a sizable percentage of the bank's balance sheet in the bond portfolio due to a lack of quality loans. With the flattening of the curve, we are looking at margin compression as the Fed raises short-term rates and we have to increase deposit rates. We will have reduced earnings since the cost to carry the bond portfolio will not be offset by increased bond yields. The Office of the Comptroller of the Currency has been putting pressure to reduce our commercial real estate concentration, so increasing loans is not really an option. Our margin is already low.

- Compliance costs related to laws, regulations, "guidance" and "best practices" have increased to the level that community banks are not economically viable. Community bank personnel are constantly dealing with regulators on-site for the following: safety and soundness examinations, compliance examinations, IT examinations and CRA (Community Reinvestment Act) examinations. In addition to the regulatory examinations, laws, regulations, "guidance" and/or "best practices" require community banks to engage with outside, independent third parties to conduct the following: annual audits of the community banks' financial statements, annual loan reviews to determine the adequacy of the allowance for loan and lease losses, reviews of internal controls, compliance with bank secrecy, information technology, review of the

assumptions used in the asset/liability modeling, and review of the algorithms used in the asset/liability model. My institution is a small community bank with only a few offices and a low number of total employees, of whom only a handful are full-time equivalent personnel trying to comply with these laws, regulations, “guidance” and "best practices.” Additionally, due to the four periodic regulatory examinations and the eight periodic engagements conducted by outside independent third parties, the other full-time equivalent personnel spend a great deal of time and effort constantly dealing with bank examiners conducting examinations and third parties conducting various engagements. There is little time left for customers. Lastly, there are a number of situations where the number and requirements of laws, regulations, “guidance” and “best practices” resulted in many community banks withdrawing from various types of activities/lending. The best example is loans secured by dwellings where the use of proceeds is the purchase of the dwelling and/or “personal and household use.” In the county where we are located, there are a few branches of out-of-county depository institutions and very small credit unions. None of the branches of out-of-county depository institutions or credit unions offer loans secured by dwellings where the use of proceeds is the purchase of the dwelling and/or “personal and household use.” Three of the depository institution branches are branches of very large depository institutions that have mortgage subsidiaries that process mortgage loans, while the other three depository branches refer mortgage applications to nonaffiliated mortgage companies. Our bank has historically made a number of residential mortgage loans (primarily owner-occupied, single-family detached homes) and many have smaller balances (under $100,000). Due to the laws, regulations, “guidance” and “best practices,” we have decided to greatly curtail the lending for loans secured by dwellings where the use of proceeds is the purchase of the dwelling and/or “personal and household use” (including home equity loans). The Dallas Fed published an article in late 2015, titled “Too Small to Succeed?—Community Banks in a New Regulatory Environment,” describing that community banks are not economically viable due to: (1) the cost of complying with the existing number and requirements of laws, regulations, "guidance" and "best practices” and (2) the competitive advantage enjoyed by their competitors. Examples of competitive advantage enjoyed by their competitors include but are not limited to the following: credit unions are federal-income exempt, and Farm Credit Banks do not have to maintain deposit-gathering operations (funding is borrowed from the Farm Credit System, which borrows at U.S. agency rates), so operating costs are less than depository institutions that have deposit-gathering operations.

- Home-equity lending is down and does not indicate any short-term growth prospects.

- Looking for some regulatory clarity. Getting ready for Current Expected Credit Loss (CECL) is beginning to take resources and we are not sure our allowance for loan and lease losses estimate and timing of provision are any better under CECL than the current methodology. Still wish we had a safe harbor on nonqualified mortgage loans we hold in our portfolio. We need to

get Washington to cancel or delay the new Home Mortgage Disclosure Act reporting. I see no benefit to the community, regulators, consumers or banks for the increased cost associated with the new reporting.

- Looking forward to regulatory relief from Dodd–Frank and the Consumer Financial Protection Bureau being put under some oversight.
- I am concerned about the macroeconomic effect of energy on the Houston economy.
- We need regulatory relief.
- Our bank is cautious about fixing rates for longer than three years due to the anticipated interest rate increases by the Fed. However, the market appears to be in denial that the Fed is planning additional increases. The market continues to request five-year fixed-rate commercial and commercial real estate loans. The market is adverse to variable-rate loans for commercial and commercial real estate loans.
- I am concerned with overly burdensome and inconsistent regulatory oversight.
- There is a bit of joy in the air, given the House has approved Rep. Hensarling's bill, which would relieve some of the burden placed on community banks by Dodd–Frank.
- I am uncertain about the impact of the Federal Reserve balance-sheet reduction. Oil prices are showing lower-for-longer tendencies. This may put addition strain on the energy sector. Fiscal policy uncertainty is high.
- There is uncertainty concerning: Washington, D.C., related to tax reform (reduction), deregulation and infrastructure spending (in that order), and these continue to be primary concerns for our bank and our clients.
- We continue to see no regulatory relief, which is very much needed. We are seeing more and more compliance and regulatory issues continue coming down the track.
- We remain cautious on larger or development-based real estate financing requests as real estate values in Central Texas continue to appreciate rapidly.
- We're finding increased traffic in the branches both for lending as well as for credit advice. Deposits have slowed down a bit after good flows the first four months of the year. Loan demand still exceeds deposit flow. The difference is made up by borrowing or nonmember deposits.