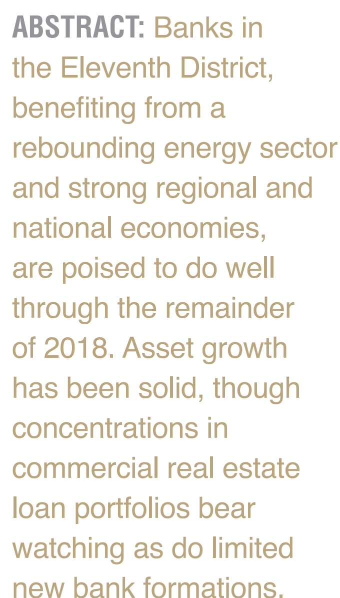
Texas Banking Conditions Improve, but Risks and Uncertainty Remain

By Kelsey Reichow



ABSTRACT: Banks in the Eleventh District, benefiting from a rebounding energy sector and strong regional and national economies, are poised to do well through the remainder of 2018. Asset growth has been solid, though concentrations in commercial real estate loan portfolios bear watching as do limited new bank formations.

Eleventh District banks, benefiting from accelerating economic growth in Texas, appear poised to build on the positive momentum with which they began 2018.[1] The banks experienced improved conditions in 2017, propelled by increased profitability, better asset quality and strong loan growth.

Last year, higher oil prices, rising exports, business optimism following changes to federal tax laws and strength in the U.S. economy bolstered the regional economy. While Hurricane Harvey significantly affected Gulf Coast residents, its impact on economic growth and banking activity was transitory.[2]

Some challenges banks faced abated in 2017. Asset quality and commercial and industrial (C&I) portfolios—hurt by energy-sector weakness in 2015 and 2016—strengthened with the recovering oil market.[3] Banks' overall loan growth picked up after slowing in 2016, with strength in commercial real estate (CRE) portfolios (the largest driver of overall loan growth) at both regional and U.S. financial institutions.

However, some risks remain. While rising CRE concentrations have not negatively impacted banks, risk management practices at institutions with the highest concentrations continue to be closely monitored given CRE's historic volatility.

Banks have also boosted profitability through improved net interest margins.[4] With the Federal Reserve tightening monetary policy, banks have benefited from the resulting higher rates, repricing loans faster than deposits.

As interest rates continue rising from historic lows, the impact on funding costs will bear watching, particularly among the relatively smaller community banks.[5] Also, overall financial industry growth and increased competition from nontraditional institutions could compel banks to pay more to maintain or enlarge their deposit base.

The banking industry continues to confront consolidation. A majority of such consolidation since the end of the Great Recession is attributable to voluntary mergers, as banks have sought economies of scale, expanded business lines or geographic reach, and cost-cutting through operational efficiencies. Bigger, efficient banks can benefit customers and the economy alike as long as access to banking services and credit is not reduced as a result.[6]

Profitability Diverges

Profitability for Eleventh District banks improved in 2017—reversing a two-year slowdown—while profitability nationwide declined, largely due to a one-time hit arising from the Tax Cuts and Jobs Act enacted at year-end 2017 (*Chart 1*).

Eleventh District banks earned a return on assets of 1.15 percent in 2017, similar to profitability prior to the energy bust, and up from 1.02 percent in 2016 and 1.09 percent in 2015. The rise was driven by increased net interest margin and declines in both provision expense—the money banks set aside to cover expected loan losses—and noninterest expense.

Nationwide, bank profitability dropped eight basis points, from 1.05 percent in 2016 to 0.97 percent in 2017. Lower noninterest income (principally fees) and higher tax expense, which more than offset higher net interest income, were responsible.

The new federal tax law prompted banks to take a one-time charge for the revaluation of deferred tax assets. Deferred tax assets are intangible items

created when losses used to claim deductions in a given year are carried forward to offset future profits. For banks, deferred tax assets are usually generated through loan-loss reserves.

When the tax law changes were enacted, existing deferred tax assets were revalued at the tax code's new, lower tax rate. In essence, banks were forced to reflect the assets' reduced future value in the fourth quarter, taking the charge, which temporarily increased income tax expense.[7] Another one-off effect of the tax change, encouraging repatriation of profits held abroad, had little impact on banks.

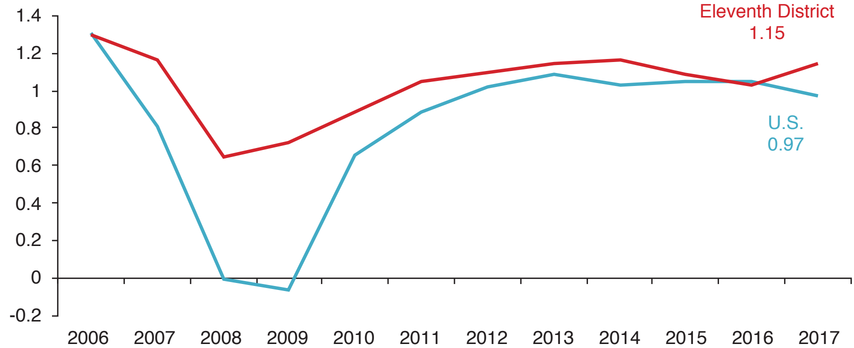
While bank earnings reports and regulatory filings provide insufficient detail to completely delineate federal tax changes' impact on profitability, U.S. banks' deferred tax assets declined $27 billion, or 45 percent, in 2017. Over the same period, tax expense increased $22 billion, or 29 percent. U.S. banks' 2017 tax expense, at 0.58 percent of average assets, was 12 basis points higher than the average for the previous five years, even as total profitability was lower.

The impact was similar among Eleventh District banks, with taxes up 10 basis points to 0.44 percent of average assets in 2017 compared with the average of 0.34 percent for the previous five years (*Chart 2*). Despite district banks' higher profitability, their tax expense remains relatively lower than their national counterparts.[8]

However, the tax law's impact on bank profitability has been transitory. Large banks reported effective tax rates of 16–24 percent in first quarter 2018, down from 23–31 percent in 2017. The median tax rate for regional banks in first quarter 2018 was about 22 percent, down from 41 percent in fourth quarter 2017 and 30 percent in first quarter 2017.[9]

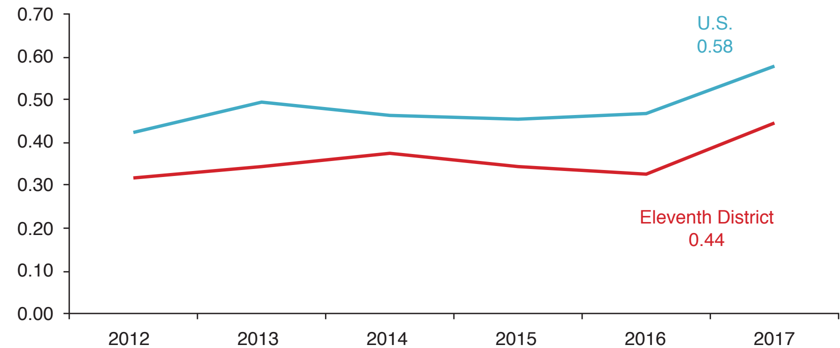
Lower effective tax rates will boost future bank profitability, with strong economic growth providing an additional tailwind this year.

CHART 1 Profitability of Eleventh District Banks Rises, Diverges from Nation



SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

CHART 2 Tax Expense for Banks Increases in 2017



SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

Asset Quality Improving

Eleventh District asset quality improved in 2017 after deteriorating the previous two years; asset quality for all U.S. banks has improved since 2009.

Among Eleventh District banks, 0.91 percent of total loans were noncurrent, down from 1.04 percent at year-end 2016 and below the national rate of 1.17 percent.[10] The share of noncurrent loans has been lower at Eleventh District banks than U.S. banks over the past decade, although the difference between local and national institutions has narrowed (*Chart 3*).

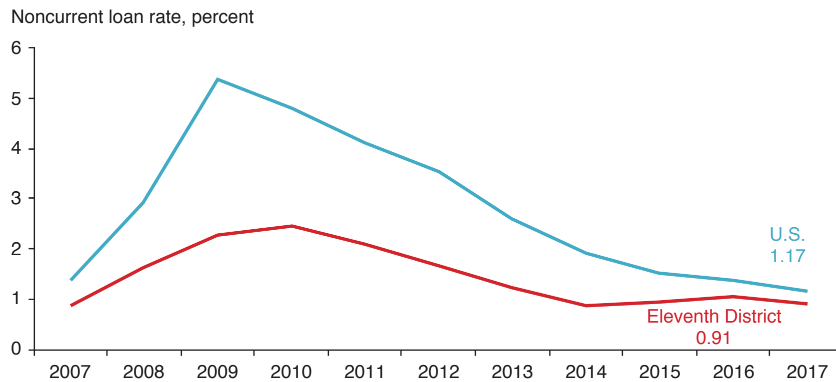
Commercial and industrial loans remain the largest portion of noncurrent loans in the Eleventh District, at 41 percent. They are followed by residential real estate (26 percent) and commercial real estate (16 percent). Recovery in the energy industry in 2017—with increases in oil prices, rig counts and production—improved the quality of the C&I portfolio. However, economic changes affect asset quality with a lag; thus, higher energy prices are not yet fully reflected in C&I portfolios.

Nationwide, the noncurrent loan rate declined from 1.39 percent in 2016 to 1.17 percent in 2017, with declines in all categories except consumer loans—those increased 11.5 percent, largely attributable to the credit card portfolio. Nationally, noncurrent residential real estate loans remain the biggest component of noncurrent loans at 57 percent, dropping slightly from 58 percent in 2016, followed by C&I (16 percent) and consumer (14 percent).

Another measure of asset quality is loan charge-off rates—the share of total loans deemed unlikely to be collected.

CHART 3

Noncurrent Loan Rate Drops for U.S. and Eleventh District Banks

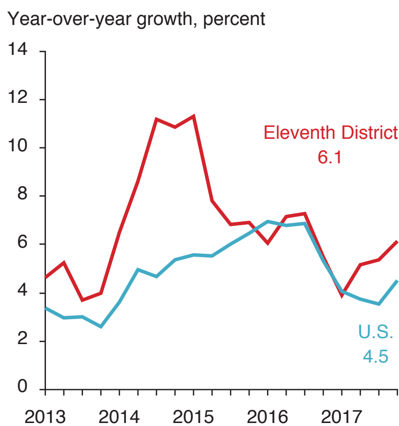


SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

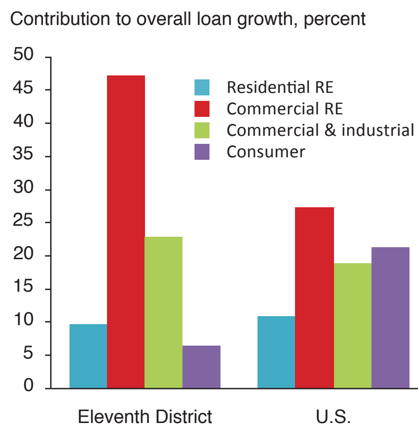
CHART 4

U.S. and Eleventh District Loan Growth Picks Up in 2017

A. Eleventh District Loan Growth Rebounds, Outpaces National Loan Growth



B. Commercial Real Estate Drives Overall Loan Growth in 2017



SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

District banks charged off 0.38 percent of loans in 2017, down from 0.45 percent in 2016, another sign of improving asset quality. The net charge-off rate for U.S. banks increased slightly to 0.50 percent in 2017 from 0.47 percent in 2016.

Loan Growth Picks Up

Loan growth accelerated among Eleventh District banks in 2017 after slowing in 2016. It reached 6.1 percent in 2017, from 5.5 percent in 2016, and continued outpacing national loan growth at 4.5 percent (*Chart 4A*).

CRE loans—loans for construction and land development, loans secured by multifamily property and loans secured by nonfarm nonresidential real estate—remain the biggest driver of overall lending. CRE loans grew 9 percent on a year-over-year basis, accounting for 47 percent of overall loan growth among Eleventh District banks (*Chart 4B*). Nationally, loan growth is more balanced, though CRE is the biggest driver of lending, up 6 percent year over year and accounting for 27 percent of total loan growth.

Banks' CRE loan concentrations have increased, particularly within the Eleventh District.[11] While CRE loan performance remains strong, contributing to bank profitability and asset quality, a disruption in the sector would be especially felt within the Eleventh District.[12]

Increased Consolidation

The banking industry continued to consolidate as profitability improved. Nationwide, the total number of banks declined from a peak of 14,483 in 1984 to 4,909 at year-end 2017 (*Chart 5*). In Texas, commercial banks reached a high of 1,972 in 1986, falling to 423 at year-end 2017.[13] Mergers predominated, though failures contributed to the trend.

The number of bank mergers has exceeded failures every year, even in crisis periods.[14] Voluntary mergers have been the primary force behind the decreased number of community banks since 2011.

Most mergers occur as smaller banks aim to become more efficient by realizing economies of scale or diversifying to expand business lines or geographic reach. Improved economic and banking conditions also play a role, making targets more attractive, acquirers stronger and the overall banking market healthier.

On the surface, a decline in the number of firms suggests a less competitive market. However, technological advances allow banks to extend their geographic reach electronically, and banks also face increased competition from nontraditional financial institutions, such as alternative lenders and financial technology (fintech) that promote financial transactions through mobile phones.

Aside from the business and economic motivations for mergers, banking industry contacts frequently report regulatory burden as another factor fueling consolidation, particularly among smaller entities.

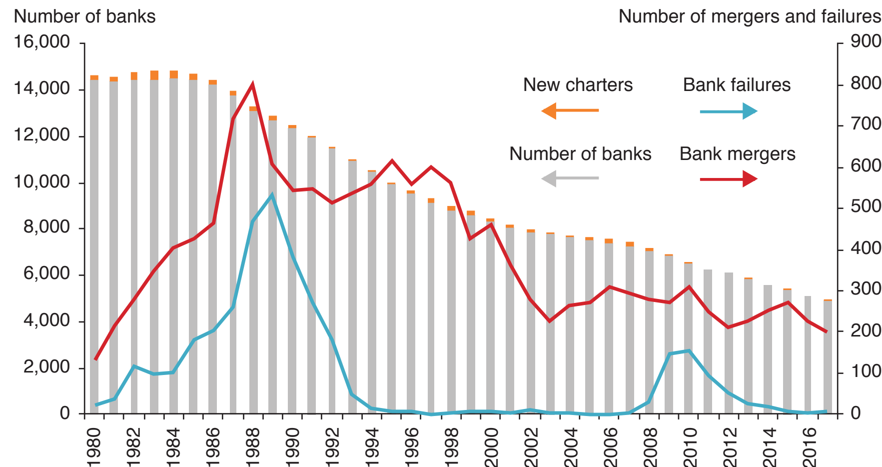
While the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 was designed to end institutions deemed "too big to fail"—those whose demise would pose existential risks to the financial system—an unintended consequence was increased regulatory and compliance burden on

the smaller banks that were tangential to the financial crisis.[15]

In response, the Federal Reserve, Office of the Comptroller of the Currency, Treasury and Federal Deposit Insurance Corp. have looked at requirements for smaller banks and reduced by 40 percent the number of items on small banks' call reports that outline the institutions' financial health. Additionally, the time between bank examinations has been extended and a more risk-focused supervisory approach implemented. Yet, even with these measures and overall industry conditions improving, few new banks have formed since the most recent financial crisis.

While merger activity continues a long-run trend, there is no historical precedent for the recent downturn in the number of de novo (newly formed) banks.[16] Seven years after Dodd–Frank, only seven new banks have been chartered nationally compared with an average of 123 annually in the seven prior years, 2003–09.[17] In Texas, only one new bank has been chartered since 2010.

CHART 5 Mergers Drive Decline in Number of U.S. Banks



SOURCE: Federal Deposit Insurance Corp.

Net Interest Margin

Amid economic improvement and Fed efforts to normalize monetary policy, rising interest rates create uncertainty for the banking industry. The impact on an institution's net interest margin (NIM)—the difference between a bank's interest income and interest expense—and earnings depends on the maturity profile. Simply, that's the level of long-term assets (mostly loans) relative to long-term liabilities (mostly deposits).

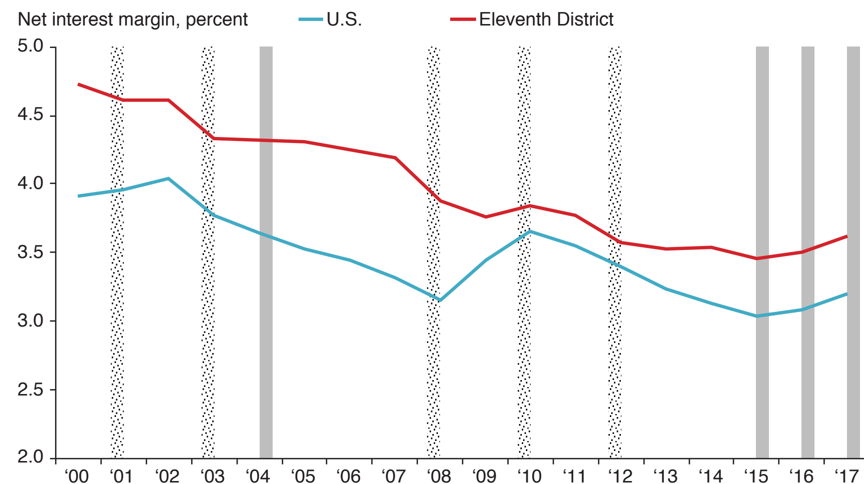
Broadly speaking, banks with the ability to reprice loans faster than deposits benefit from rising interest rates.[18] The "net-over-three-year position" of a bank is defined as loans and securities that reprice in more than three years minus liabilities that reprice in more than three years as a percent of assets. It offers guidance regarding profitability as interest rates change. The higher the net position, the greater the vulnerability to rising interest rates.

Banks began narrowing their net position in third quarter 2015 as the Fed began normalizing the federal funds rate, though the net position remains high by historic standards. The net position has narrowed more rapidly for Eleventh District institutions compared with the industry as a whole due to area banks' balance sheet composition.

Still, rising rates do not have an unambiguous effect on bank profitability. Theoretically, a bank's NIM should increase after rate hikes and decline after periods of easing, as assets tend to reprice faster than liabilities. However, policy rate decisions impact the NIM and profitability inconsistently.

For example, NIMs decreased after rates rose in 2004, yet increased among U.S. banks after interest rates fell in 2008 (*Chart 6*). In the 30 years before the current tightening cycle, the only case in which a higher NIM accompanied a rate hike was from first quarter

CHART 6 Banks' Net Interest Margin Increased Following Recent Rate Hikes



NOTE: Solid gray bars denote periods of tightening by the Federal Reserve, and patterned bars denote periods of easing.
SOURCE: Uniform Bank Performance Report, Federal Financial Institutions Examination Council.

> While the industry stands to benefit from more efficient banks, consolidation becomes a concern if the reduction in smaller banks reduces access to credit and banking services, especially in rural areas.

1988 through second quarter 1989.[19] So far, bank NIMs have increased during the ongoing tightening period.

Looking Ahead

The performance of Eleventh District banks is strong and looks to further improve in 2018. The energy industry turnaround and a robust state economy reduced risks to the industry, leading to increased profitability, strengthened C&I portfolios and improved loan growth.

The number of institutions continues to decline, largely because of voluntary mergers. While the industry stands to benefit from more efficient banks, consolidation becomes a concern if the reduction in smaller banks reduces access to credit and banking services, especially in rural areas.

Rising interest rates are the greatest uncertainty this year. Banks' NIMs and earnings have increased after each rate hike as the Fed has tightened monetary policy, though this is an area for continued monitoring.

While the future impact of consolidation and expected rate increases remains unclear, economic conditions will likely remain the primary performance driver for the banking industry. The Federal Reserve Bank of Dallas forecasts Texas job growth of 3.3 percent in 2018, significantly higher than in 2017. Lower effective tax rates coupled with a strong economic outlook should help boost the profitability of Eleventh District institutions through this year.

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Notes

[1] The Eleventh Federal Reserve District consists of Texas, northern Louisiana and southern New Mexico.

[2] See "Texas Economy Starts 2018 Firing on All Cylinders," by Keith R. Phillips and Christopher Slijk, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter, 2018.

[3] See "Risks Mount for Eleventh District Banks amid Energy Weakness," by Kelly Klemme and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter, 2016.

[4] Net interest margin is the difference between interest income and interest expense, weighted by average earning assets.

[5] See "Smaller Banks Less Able to Withstand Flattening Yield Curve," by Pavel Kapinos and Alex Musatov, Federal Reserve Bank of Dallas *Economic Letter*, forthcoming.

[6] See "Bank Consolidation and Merger Activity Following the Crisis," by Michael Kowalik, Troy Davig, Charles S. Morris and Kristen Regehr, Federal Reserve Bank of Kansas City *Economic Review*, First Quarter, 2015.

[7] Some banks have net-deferred tax liabilities, so their earnings were helped by the tax reform. However, for the industry as a whole, deferred tax assets far exceed deferred tax liabilities.

[8] One reason tax expense is historically lower among district banks is that 53 percent of the banks in the Eleventh District elect Subchapter S reporting status, which allows a flow-through of tax expenses to shareholders, compared with only 35 percent nationwide.

[9] According to S&P Global Market Intelligence. Large banks include institutions with more than $50 billion in total assets; regional banks in this discussion include U.S. banks and savings and loans with total assets between $20 billion and $50 billion.

[10] Noncurrent loans are loans that are past due 90 days or more or on nonaccrual status.

[11] Typically, commercial real estate concentrations are measured relative to risk-based capital, which weighs assets by their riskiness, adjusting bank capital levels to reflect the risk in the balance sheet.

[12] See "Eleventh District Banks Confront Challenging Energy, Rate Situation," by Kelly Klemme and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter, 2017.

[13] According to Federal Deposit Insurance Corp. (FDIC) Number of Institutions, Branches and Total Offices, FDIC-Insured Consolidated Banks, U.S. Balances at Year-End, 1934–2017.

[14] See note 6.

[15] See "Small-Business Lending Languishes as Community Banking Weakens," by Kelsey Reichow, Federal Reserve Bank of Dallas *Economic Letter*, vol. 12, no. 3, February 2017.

[16] See "Explaining the Decline in the Number of Banks Since the Great Recession," by Roisin McCord, Edward Simpson Prescott and Tim Sablik, Federal Reserve Bank of Richmond *Economic Brief*, March 2015.

[17] Data from FDIC Statistics at a Glance, Changes in Number of Institutions, FDIC-Insured Commercial Banks, 1934–2017 year to date.

[18] See note 12.

[19] See note 12.