Eleventh District Banks Confront Challenging Energy, Rate Situation

By Kelly Klemme and Edward C. Skelton

ABSTRACT: Regional banks continue to navigate through the reality of depressed, though stable, energy prices. The institutions' performance slipped behind that of their counterparts nationally in 2016. Higher anticipated benchmark interest rates may provide little immediate benefit to bank balance sheets.

Bank profitability remains below its long-term average nationally and in the Federal Reserve's Eleventh District. Overall, district bank activity has declined over the past two years, primarily due to energy-sector woes. Those difficulties contributed to the region ending a 10-year period of outperforming its U.S. counterparts.

Challenges have come into clearer focus since last year, when potential commercial real estate (CRE) and energy lending risks raised concerns about further erosion of performance in the region.[1] CRE concentrations have yet to affect banks, but the same cannot be said of energy prices, which, though relatively stable in recent months, remain below their 10-year averages and continue impacting institutional performance.

At the same time, the financial sector has anticipated a boost from recent Federal Reserve moves to raise interest rates from the zero lower bound, where they had been set since the financial crisis. The central bank raised interest rates a quarter percentage point in December 2015, December 2016, March 2017 and June 14, with further increases expected.

Initial indications suggest that banks are benefiting from recent rate rises, though the future impact is less clear. Institutions face a challenging operating environment, particularly if increased competition among them causes funding costs to rise and leaves them unable to increase loan rates and maintain portfolio growth.

Traditionally, the impact of rate increases is most evident on banks' balance sheets, which are often characterized by a maturity mismatch between assets and liabilities. For example, banks may offer 30-year mortgages or long-term business loans, which they fund with short-term deposits such as savings accounts that have no stated maturity or certificates of deposit that mature in one to five years.

Because of this asset-liability mismatch, banks are exposed to interest-rate risk. An institution with more long-term assets than liabilities is vulnerable to rising interest rates. In this scenario, the earnings on assets—typically loans—may not respond as rapidly as the cost of funds—typically deposits—leading to declining profits.

Conditions Getting Tougher

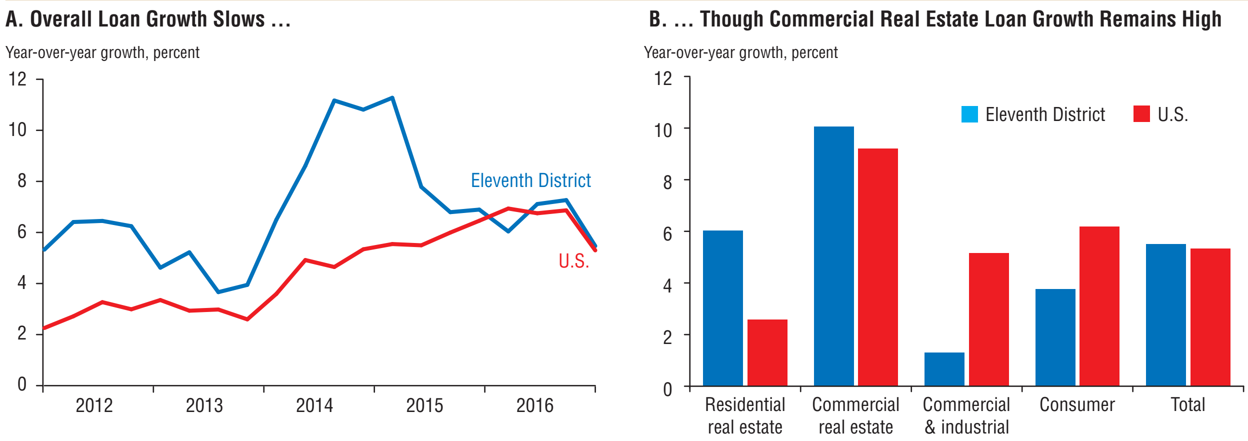
Profitability in 2016 was stable for banks nationwide and down slightly for those in the Eleventh District.[2] Area banks earned a return on assets of 1.03 percent, down from 1.09 percent in 2015 and 1.16 percent in 2014. A 40 percent increase in provision expense—the money banks set aside to cover expected loan losses—hampered profitability. Among banks nationwide, return on assets was 1.05 percent in 2016—the same as 2015.

Loan growth slowed for district banks to 5.5 percent in 2016 from 7.3 percent in 2015, although it continued outpacing the nation at 5.3 percent (*Chart 1A*). 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 (*Chart 1B*). CRE loans grew 10 percent on a year-over-year basis and accounted for 59 percent of overall loan growth among Eleventh District banks compared with a 9 percent growth rate and a 36 percent share of loan growth nationwide.

Asset Quality Weakening

The weakening asset quality accounts for recent increases in loan-loss provision expense that negatively affected district bank profitability. Among district banks, 1.04 percent of loans were noncurrent at year-end 2016, up from

Chart 1 Eleventh District Bank Loan Growth Softens in 2016



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

0.93 percent at year-end 2015 and 0.85 percent in 2014.[3] While still below the national rate of 1.39 percent, the ratio's rise is notable, with the gap between district and national rates continuing to narrow (*Chart 2*).

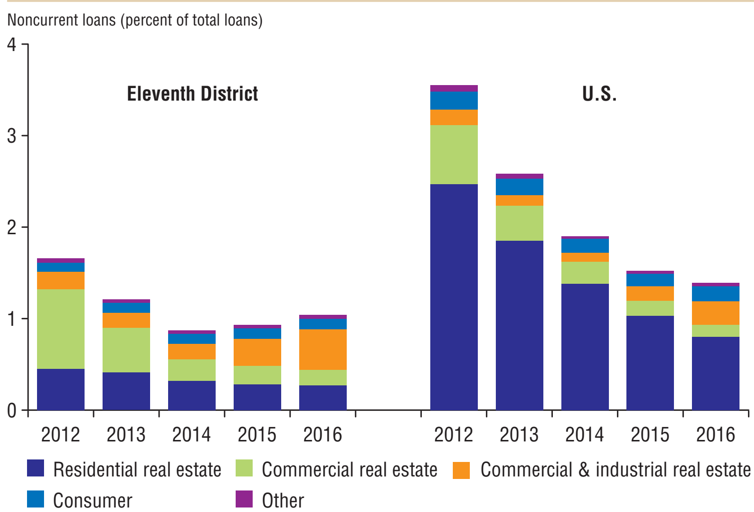
Troubled commercial and industrial (C&I) loans are driving noncurrent loan growth in the district. They account for 43 percent—the largest portion—of total noncurrent loans, up from 32 percent in 2015 and 19 percent in 2014. Nationwide, total noncurrent loans have declined, although noncurrent C&I loans rose 72 percent in 2016, albeit from a low base, and constituted 19 percent of all noncurrent loans. Residential real estate was the biggest trouble spot, at 58 percent.

The C&I noncurrent increase can be traced to the troubled energy sector. Energy prices hit a trough in late 2015 and early 2016. While prices rebounded in the second half of 2016, boosting energy industry activity, they remained below historical levels, and their recent improvement has yet to benefit district banks' asset quality.[4]

Bank call reports do not separate energy loans from the broader C&I loan category, but recent increases in noncurrent loans come disproportionally from banks with higher levels of energy-related loans, particularly the three largest energy lenders.[5]

In dollar terms, district banks' total noncurrent loans increased $854 million, or 37 percent, from year-end 2014 to year-end 2016; the top three energy lenders together accounted for $495 million of the increase, while noncurrent loans at other, like-sized banks declined. A similar story plays out if the focus is narrowed to only the district C&I portfolios. Noncurrent C&I loans increased $894 million, or more than 200 percent, from 2014 to 2016, with the top three energy lenders accounting for $535 million of the increase, compared with only a slight increase for similarly sized banks.

Chart 2 Commercial and Industrial Real Estate Driving Rise in District Noncurrent Loans



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

Higher Interest Rates

While Eleventh District institutions navigate commercial real estate exposure and relatively low energy prices, arguably the biggest question facing the overall industry is how banks will adapt to the Federal Reserve normalizing monetary policy by increasing interest rates. Broadly speaking, the rates earned on loans and the rates paid to attract deposits have been very responsive to changes in monetary policy (*Chart 3*).

Although monetary policy affects the economy as a whole and most businesses, banks' financial condition and performance are more directly tied to interest-rate change. The net effect of Federal Reserve policy for any given bank broadly depends on that institution's maturity profile, or the level of long-term assets (mostly loans) relative to long-term liabilities (deposits), and the impact of changes in interest rates on the cost of funding relative to the rate charged on loans.

Generally, banks positioned to benefit from rising interest rates have a relatively low level of long-term assets, a relatively high level of long-term funding and the ability to reprice loans faster than deposits.

One way to assess banks' maturity structure is to look at what is referred to as the "net-over-three-year position," 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 (*Chart 4*). A positive value indicates a greater proportion of long-term assets than long-term liabilities. From 2007 through 2014, banks responded to the low interest-rate environment by increasing the gap in a search for longer-term, higher-yield assets. However, this left banks more vulnerable to rising rates.[6] Over the last two years, banks in the aggregate have not materially reduced their gap despite more signs of rates returning to normal.

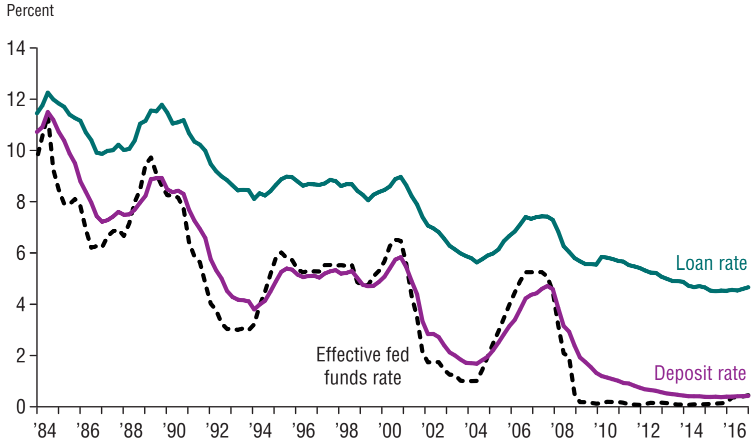
Still, recent history suggests higher interest rates have been a net positive for banks. Researchers from the Federal Reserve Board analyzed 3,418 banks from 47 countries between 2005 and 2013 to test the correlation between higher interest rates and higher bank profits. The study found that profitability, as measured by return on assets, is higher in high-rate environments.[7]

Specifically, higher profitability was propelled by a higher net interest margin. The net interest margin—defined as the difference between interest income and interest expense, weighted by average earning assets—is considered the bedrock of bank performance. Moreover, at lower interest rates, the decline in profitability caused by a drop in rates was more pronounced, and profitability was also more volatile.

Additionally, smaller banks tended to better manage their net interest margin during the most recent low-rate environment, which began in 2008. A second Federal Reserve Board study using data from 2010 to 2015 found that, while the net interest margin compressed across the banking industry, larger banks experienced a sharper decline than community banks.[8] The study found that large banks' net interest margins declined 70 basis points compared with a decline of 20 basis points for small banks.

Coming out of a low-interest-rate environment would seem to be especially beneficial for banks whose interest-related income is a large source of revenue (relative to fee income, for example), as is the case for community banks. This sug-

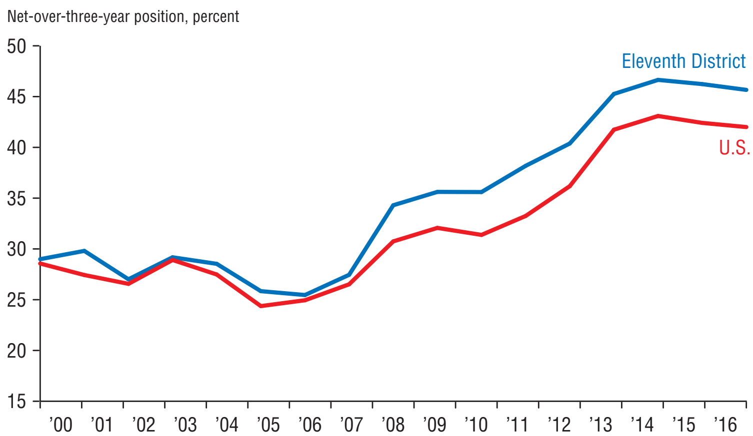
Chart 3 Loan and Deposit Rates Respond to Monetary Policy



NOTE: Loan rate is equal to interest income on loans as a percent of loans; deposit rate is equal to interest expense on deposits as a percent of interest-earning deposits.

SOURCE: Federal Deposit Insurance Corp., Quarterly Banking Profile.

Chart 4 Asset–Liability Gap Shrinking Only Slightly



NOTE: The net-over-three-year position is equal to loans and securities repricing in more than three years minus liabilities that reprice in more than three years as a percent of assets.

SOURCE: Uniform Bank Performance Report, Federal Financial Institutions Examination Council.

gests that small banks may not only be better at navigating a low-interest-rate environment but also may benefit more from the expected normalization in interest rates. The Eleventh District has a higher concentration of community bank assets, 55 percent, compared with 18 percent nationwide. Thus, increasing interest rates could be especially beneficial for district banks.

The Fed's rate increases in 2015 and 2016 appear to have benefited the banking industry. During 2016, the increase in interest income outpaced the increase in interest expense, leading to a higher net interest margin. District banks boosted their net interest margin almost 4 basis points (a basis point equals 0.01 percentage points) in 2016; nationally, banks achieved a 4.6 basis-point rise.

The increase in net interest margin is notable because net interest margin has generally been on a downward trend for the last 16 years. And, the initial pickup fueled analyst, banker and media consensus that a rising rate environment will help banks profit from a fatter margin between what they earn on loans and what they pay for deposits. One of the main reasons for banks enjoying a wider net interest margin is that their cost of funds has not increased and matched the Fed's recent policy moves (*Chart 5*).

However, there has been a mixed record regarding the impact of rising interest rates on bank results. Overall, net interest margins have generally fallen since 2000, regardless of whether the Fed was raising or lowering interest rates (*Chart 6*). In fact, the one instance of a pickup in net interest margin followed the 2008 policy easing.

In short, there is no assurance that rate hikes will unequivocally boost net interest margin and profitability, particularly if a lengthier history is considered. A Federal Reserve Bank of Richmond publication studied the link between net interest margin and interest rates and found that the relationship is not as clear as most observers expected.[9]

In the 30 years before the current monetary tightening cycle, there were four cases of the Fed raising interest rates: first quarter 1988 through second quarter 1989, fourth quarter 1993 through second quarter 1995, second quarter 1999 through third quarter 2000 and second quarter 2004 through third quarter 2006. Only the first incidence of policy tightening coincided with a rise in the net interest margin; the net interest margin fell in each of the other three periods.

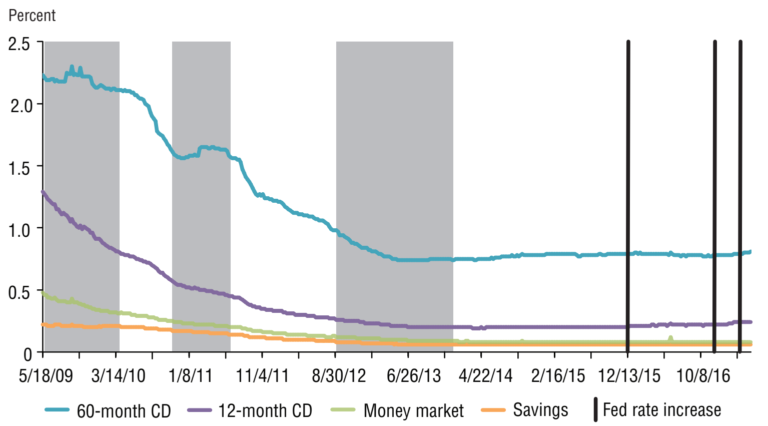
In sum, the historical record tells us that rate increases are not unambiguously positive for the banking sector, and that the industry and analysts may be overly optimistic.

Looking Ahead

The banking industry, especially in the Eleventh District, seems to be at a crossroads. Banks' performance and financial conditions are generally stable, yet risks seem to be rising.

Relatively low oil prices continue to take a toll on district C&I portfolios and on asset quality in general, though

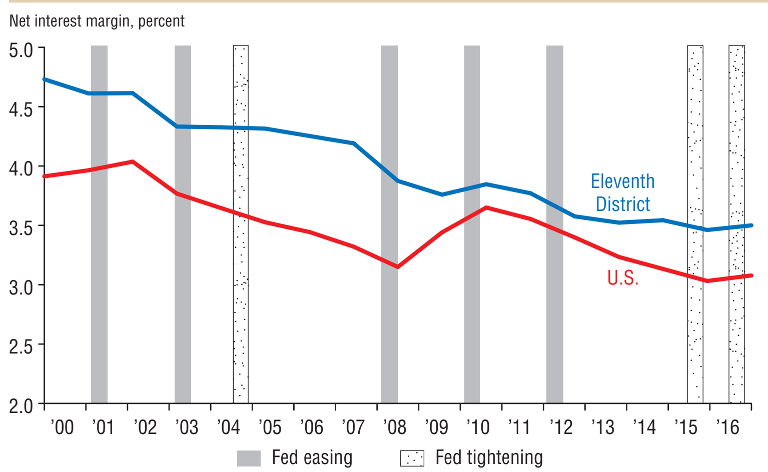
Chart 5 Banks' Cost of Funds Unresponsive to Recent Rate Increases



NOTES: Shaded bars indicate quantitative-easing (QE) periods. QE 1 was announced Nov. 25, 2008, and began in December 2008.

SOURCE: Federal Deposit Insurance Corp., Weekly National Rates and Rate Caps.

Chart 6 Lower Policy Rates Erode Bank Net Interest Margin



SOURCE: Uniform Bank Performance Report, Federal Financial Institutions Examination Council.

conditions within the energy industry have begun to boost economic activity. More broadly, in spite of the broad improvement in the energy sector as shown in job growth and rig counts, the firming will not likely benefit bank performance this year due to the long lag between such sector strengthening and the performance of institutions lending to the industry.

Banks' commercial real estate growth remains high. While fundamentals within the CRE segment remain strong, support current levels of activity and contribute to bank profitability and loan growth, a reversal of fortune within CRE would disproportionately affect district banks, a reflection of the institutions' relatively high exposure.

CRE tends to follow a boom-and-bust cycle, making it even more important to keep a close eye on the risk management practices of the banks with the highest CRE concentrations.

The impact of the Federal Reserve's current policy path poses the biggest unknown for district banks. While the initial impact appears positive, the responsiveness of loan and deposit rates should be monitored closely to determine the effects of future rate moves.

Nevertheless, the top driver of bank performance is likely to remain overall economic growth. The Dallas Fed is forecasting Texas job growth of 2.6 percent in 2017, up from 1.2 percent in 2016. If economic growth fails to meet expectations, loan growth will continue to fall, and district institutions will find it difficult to increase, or even maintain, their profitability.

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Notes

[1] 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.

[2] Eleventh District banking industry data have been adjusted for structure changes such as mergers, acquisitions and relocations. The district comprises Texas, northern Louisiana and southern New Mexico.

[3] Noncurrent loans are loans that are either at least 90 days past due or on nonaccrual status.

[4] See "Texas Economy Shifting into Second Gear in 2017," by Keith R. Phillips and Christopher Slijk, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter, 2017.

[5] Call reports, formally referred to as Reports of Condition and Income, are quarterly regulatory reports containing detailed balance sheet and income statement information.

[6] See "Banking Recovery Could Be Vulnerable to Interest Rate Increases," by Kenneth J. Robinson, Federal Reserve Bank of Dallas *Southwest Economy,* Second Quarter, 2014.

[7] See "'Low-for-Long' Interest Rates and Banks' Interest Margins and Profitability: Cross-Country Evidence," by Stijn Claessens, Nicholas Coleman and Michael Donnelly, Federal Reserve Board of Governors *International Finance Discussion Series*, no. 1197, February 2017.

[8] See "Why Are Net Interest Margins of Large Banks So Compressed?" by Francisco B. Covas, Marcelo Rezende and Cindy M. Vojtech, *FEDS Notes*, Oct. 5, 2015.

[9] See "Do Net Interest Margins and Interest Rates Move Together?" by Humberto M. Ennis, Helen Fessenden and John R. Walter, Federal Reserve Bank of Richmond *Economic Brief*, May 2016, no. 16-05.

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