Eleventh District Banks Have Performed Well Despite Rising Funding Costs, Nonbank Competition

By Kelsey Reichow and Amy Chapel

ABSTRACT: Profitability picked up for Eleventh District banks in 2018 despite rising funding costs and slowing loan growth. Overall asset quality strengthened, though room for further improvement may be limited. Changes in capital regulation could affect bank risk taking.

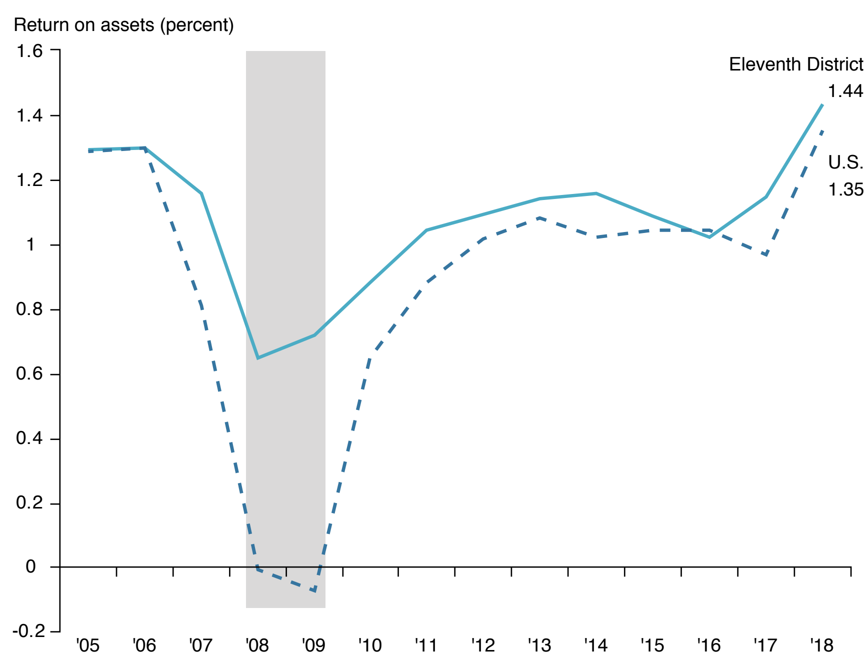
Bank performance in the Eleventh Federal Reserve District was strong in 2018, outpacing the rest of the country.[1] Profitability increased, returning to prefinancial-crisis levels of more than a decade ago, and asset quality strengthened modestly with improvement in most loan categories.

Given that comparatively smaller community banks have a larger presence in the district than in the rest of the U.S., their relatively better performance is a reflection of strong regional economic growth, according to recently compiled data for 2018.[2]

Despite the strong performance, banks face a challenging landscape in 2019, with rising funding costs and continued competition from nonbank lenders. Cybersecurity remains a top bank risk, largely due to the dynamic and highly sophisticated nature of cyber risks and evolving external threats. Still, the majority of cyber breaches are caused by preventable factors including poor internal controls, a failure to keep systems properly updated or patched and a failure to follow internal policies.

Asset concentration levels rose at some banks. Concentration detracts from one of the most important strengths in the banking industry—diversification. While capital levels meet or exceed regulatory requirements, share buybacks and dividend pay-

CHART 1 Bank Profitability Up in District and Nation



NOTE: Shaded area indicates U.S. recession.
SOURCE: Reports of Condition and Income, Federal Financial Institutions Examination Council.

ments are increasing, which could strain some banks' lending during the next downturn.

Profitability Picks Up

Bank profitability improved in 2018—propelled by higher net interest income and lower tax expense. Eleventh District banks earned an annualized return on assets of 1.44 percent in 2018, up from 1.15 percent in 2017 (*Chart 1*). Nationwide, bank profitability picked up 38 basis points to 1.35 percent in 2018 from 0.97 percent in 2017.

Maintaining current levels of profitability in upcoming quarters may become more challenging in light of increasing funding pressures and limited potential for asset quality to improve further. Higher short-term interest rates have prompted depositors to seek greater returns on their deposit balances.

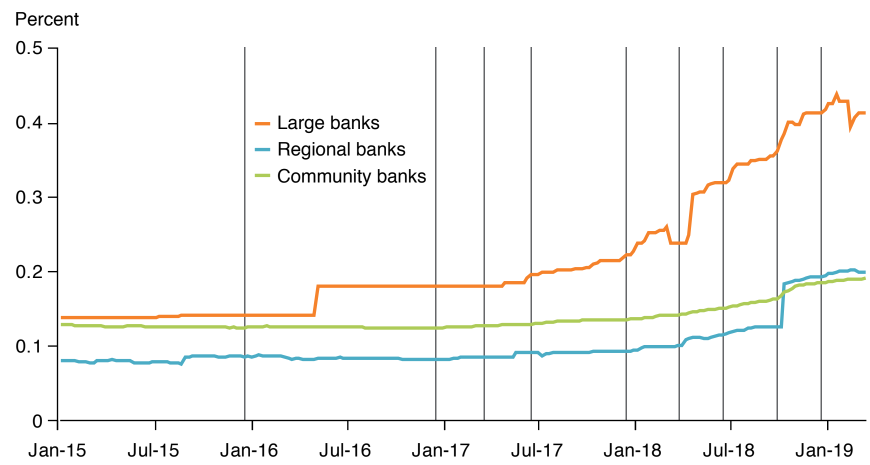
Community banks, which traditionally faced competition only in their local markets, now encounter it from larger banks, online-only banks, money market funds and nonbank institutions that are all expanding their geographic reach online. Faced with the possibility of losing market share to digital competitors, banks with a traditional brick-and-mortar branch presence have increased rates on deposit accounts.

Since the monetary policy tightening cycle began in December 2015, rates paid on savings accounts by large banking organizations (assets exceeding $100 billion) are up 27 basis points nationally. Rates on savings accounts among regional banking organizations (assets between $10 billion and $100 billion) rose 11 basis points, while rates at community banking organizations (assets less than $10 billion) edged up seven basis points (*Chart 2*).

Some institutions, particularly community banks, have been able to minimize deposit rate increases, largely due to strong customer relationships and multiple product offerings.

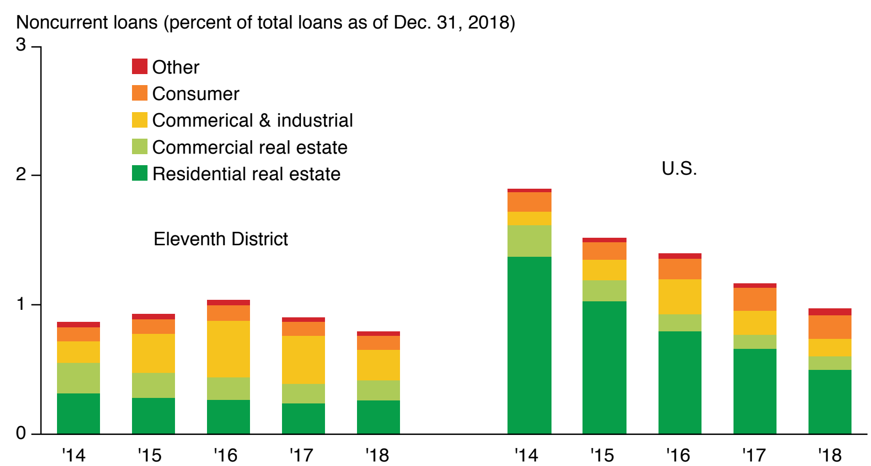
The extent of funding pressure and competition for deposits is not fully captured in deposit rate increases.

CHART 2 Savings Account Deposit Rates Trend Higher for Banks of All Sizes



NOTES: Gray lines indicate federal funds rate hikes. Banks are distinguished by asset size. Community banks have total assets less than $10 billion; regional banks have total assets of $10 to $100 billion; large banks have total assets exceeding $100 billion.
SOURCE: S&P Global Market Intelligence.

CHART 3 Asset Quality Improves in the District and Nationally



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

Some banks are offering consumers one-time cash incentives to open savings accounts and hold certain levels of deposits for a set period.

Asset Quality Strengthens

Bank asset quality improved again in 2018, although more so nationally than in the Eleventh District. Among Eleventh District banks, 0.79 percent of total loans were noncurrent (past due 90 days or more or on nonaccrual status), down from 0.92 percent at year-end 2017 and below the national rate of 0.96 percent (*Chart 3*).

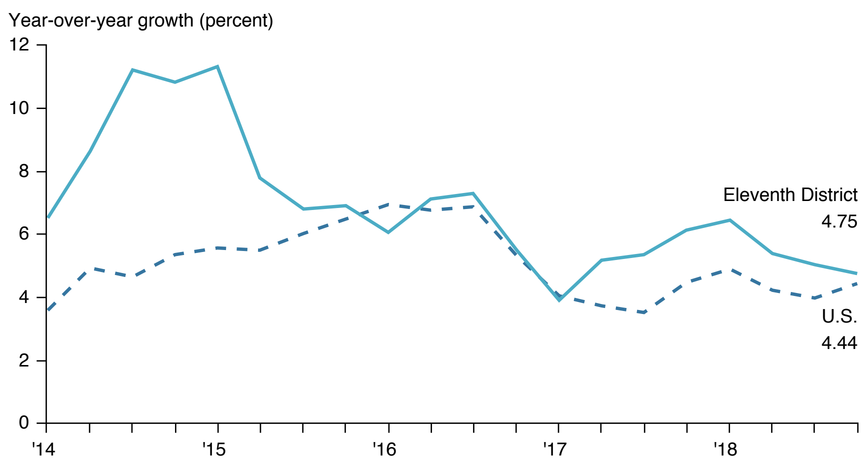
Nationwide, the noncurrent loan rate declined 21 basis points (an eight-basis-point greater improvement than the district), from 1.17 percent to 0.96 percent in 2018, with noncurrent loan rates falling for most loan categories but ticking up one basis point for consumer loans.

The credit quality of Eleventh District banks' non-business portfolios generally is higher than that of their national peers—largely due to fewer problem mortgages and comparatively limited credit card lending—while the credit quality of their commercial portfolios is lower.

During the energy downturn in 2015–16 and its aftermath, commercial and industrial (C&I) loans were the largest component of noncurrent loans in the Eleventh District. The trend reversed in 2018—reflecting the pass-through impact of improved energy prices in 2017—with the value of noncurrent C&I loans declining. The reduction in the noncurrent C&I portfolio in 2018 was not widespread—80 percent of the decline in the fourth quarter can be attributed to three banks, perhaps suggesting that there is limited room for further improvement in asset quality.

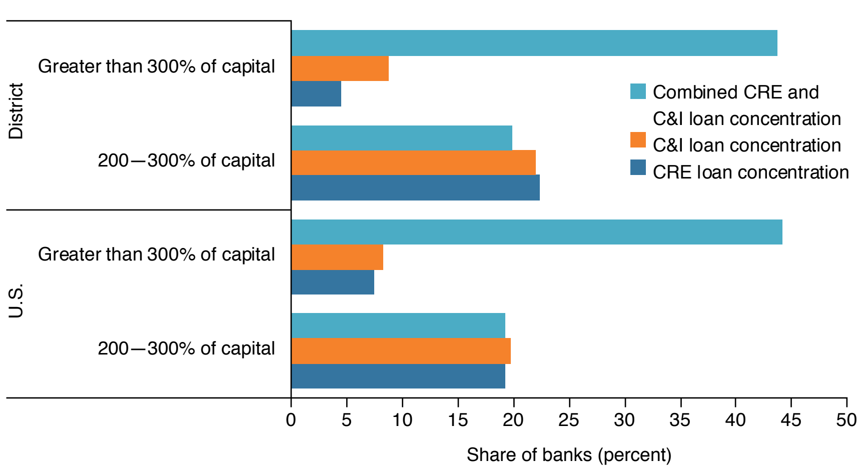
Noncurrent residential real estate loans (0.27 percent of total loans) were the largest portion of noncurrent loans in the Eleventh District in 2018, followed by C&I (0.23 percent) and commercial real estate (CRE) (0.15 percent). Residential real estate remains the largest portion of noncurrent loans nationally at 0.50 percent of the total portfolio, down from 0.66 percent, followed by consumer lending (0.18 percent) and C&I (0.14 percent).

CHART 4 District Loan Growth Slows, Converges Toward Nation



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

CHART 5 Majority of District, U.S. Banks Have Combined CRE and C&I Loan Concentrations Exceeding 200 Percent of Capital



NOTE: Commercial real estate (CRE) loans include commercial land development loans, multifamily loans and nonowner-occupied nonfarm nonresidential real estate loans. Commercial and industrial (C&I) loans are defined as C&I loans plus owner-occupied nonfarm nonresidential real estate loans, plus other leases. Loan concentrations are calculated as a share of total risk-based capital; data are as of 2018.

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

District Loan Growth Slows

Loan growth was little changed at U.S. banks at 4.44 percent year over year in fourth quarter 2018. Eleventh District bank loan growth, while still outpacing national loan growth, slowed to 4.75 percent year over year, converging toward the national growth rate (*Chart 4*). The district's decrease in year-over-year CRE loan growth from year-end 2017 (8.44 percent) to year-end 2018 (6.77 percent) contributed to the slowdown.

Meanwhile, C&I loan growth remained strong, 7.76 percent year over year in the nation and 6.57 percent in the district.

A more competitive lending environment has contributed to slower loan growth for banks even as the economy continues expanding. Competition from nonbanks, which are increasing their lending footprint, is growing. For example, nonbank retail and broker mortgage originations nationally accounted for 54.8 percent of the value of all mortgage originations in 2018, up from 43.8 percent in 2013.[3]

Credit Concentration Concerns

Over the past three years, CRE and C&I concentrations at some banks have remained high or increased. Relative to some other assets, CRE and C&I assets can be more volatile and have greater potential to lose value during an economic downturn. Bank loan diversification is important, given a significant correlation between loan portfolio concentrations—particularly CRE—and bank failures.4

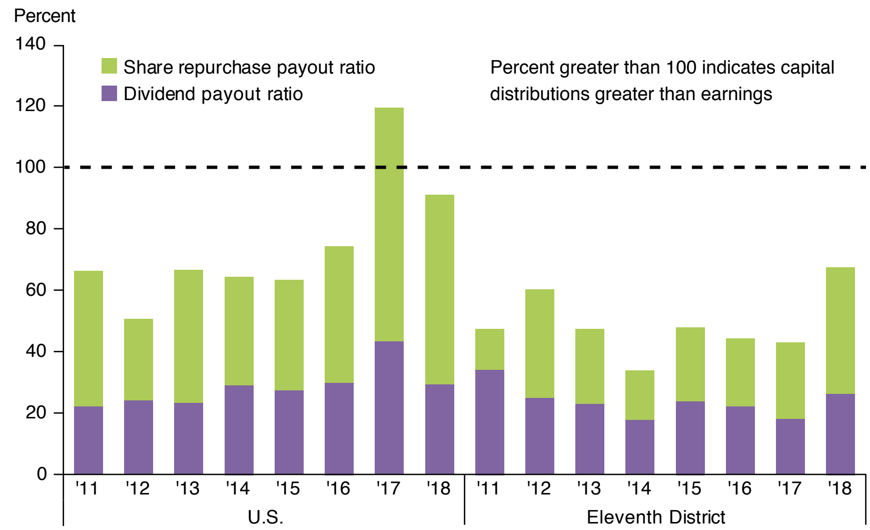
Nationally, as well as in the district, 27 percent of banks have a CRE concentration above 200 percent of risk-based capital, the financial cushion available to absorb losses for a given level of risk (*Chart 5*).5 However, a larger share of banks nationally have a concentration exceeding 300 percent of risk-based capital—7 percent compared with 4 percent in the district.

C&I concentrations are more significant. Twenty-eight percent of banks nationally have a C&I concentration above 200 percent of risk-based capital compared with 31 percent in the district. A total of 9 percent of district banks and 8 percent of national banks have concentrations exceeding 300 percent.

Sixty-four percent of U.S. and district banks have a concentration above 200 percent of risk-based capital in these two commercial lending sectors combined. Among national and district banks, 44 percent have combined commercial credit concentrations exceeding 300 percent of risk-based capital.

Rising capital levels may mitigate credit concerns. Risk-based capital as a share of risk-weighted assets is a good measure of an institution's capital adequacy.6 This share for the district was relatively unchanged, rising two basis points in 2018 from 2017. Nationally, risk-based capital as a share of risk-weighted assets rose nine basis points in 2018.

CHART 6 District Payouts Rise as Banks Retain Fewer Earnings, Return More Capital to Shareholders



NOTE: Share repurchase and dividend ratios calculated as a percentage of net income.
SOURCE: Reports of Condition and Income, Federal Financial Institutions Examination Council.

Capital Distributions Grow

Dividend payments and share repurchases also impact capital levels. When banks make dividend payments and repurchase shares (for those that are publicly traded), capital that otherwise could have been used for loans to businesses and consumers is returned to shareholders.

Growing capital distributions faster than earnings—which banks nationally did in 2017—could strain an institution's ability to lend in the next downturn. Additionally, banks' return of capital may indicate they believe there are comparatively few attractive lending prospects in the economy.

Nationally, banks' dividend and share buybacks moderated in 2018 (to 91.4 percent of net income, down from 119.6 percent in 2017), with banks paying out slightly less than their earnings. District banks paid out more earnings in 2018 than in 2017—payouts totaled 67.4 percent of net income in 2018, up from 43 percent in 2017 (*Chart 6*).

Capital Regulations Ease

The purpose of bank capital is to buffer unexpected loss. Inadequate capitalization of banks can reduce overall credit availability and negatively affect the economy. Recent legislation directs a reduction in capital requirements for U.S. banks.

Specifically, the 2018 Economic Growth, Regulatory Relief and Consumer Protection Act provides relief for some large banks on leverage standards and for community banks on risk-based capital standards. These changes have the notable feature of reducing for each type of bank its most binding regulatory capital constraint.

Risk-based capital ratios assign different weights to assets to account for the difference in their level of risk. Riskier assets receive a higher weight, which requires banks to hold more capital to meet the regulatory requirement. Leverage ratios treat all assets as having the same risk, requiring banks to hold the same amount of capital for any asset.

A new community bank leverage ratio, a regulatory capital relief provision for community banks, affects a number of banks in the district.[7] A bank with total assets under $10 billion may opt to report only the community bank leverage ratio—proposed as a capital-to-asset ratio of 9 percent—rather than the four regulatory measures of capital adequacy they currently report.

Backers of the community bank leverage ratio standard say the risk-weighted system is unnecessarily complex for smaller institutions. Community bank leaders have spoken about the difficulties of dealing with regulations designed for larger institutions that were more central to the financial crisis.[8]

Nonetheless, the new leverage ratio alone may be insufficient to account for a bank's riskiness, and without risk weighting, banks may have an incentive to take on more risk.

The Congressional Budget Office estimates that 70 percent of community banks will opt in to the new leverage regime, assuming adoption of the 9 percent threshold.[9] A majority of community banks already exceed a 9 percent leverage ratio, and within the district, 88 percent of community banks have a leverage ratio higher than 9 percent.

Industry Consolidation Continues

Nationwide, the total number of banks has declined 35 percent over the past decade, from 8,279 institutions in 2008 to 5,393 in 2018. Given that technological advances can extend a bank's geographic reach, the downward trend is not necessarily a source of concern in terms of the provision of financial services as long as sufficient competition remains.

Lower taxes, higher interest rates and regulatory changes encouraged increased merger activity. Lower taxes can generate additional liquidity that may be used to acquire other companies. Higher interest rates increase competition for most banks and make mergers more attractive for those requiring access to stable deposits or needing other efficiencies.

Furthermore, the recently enacted increase in regulatory thresholds may encourage merger activity as some banks have more room to grow before surpassing the new limits.

Most of the decline in the number of institutions can be attributed to a lack of new bank formation and voluntary mergers rather than bank failures.

Mergers increased from 196 in 2017 to 226 in 2018.[10] Smaller banks seeking to take advantage of economies of scale drove the majority of the mergers. At the same time, the number of newly chartered banks across the nation increased from only five in 2017 to seven in 2018. There were no bank failures in 2018, compared with an average of eight during each of the past five years.

Data suggest banks are becoming more efficient—better leveraging technology for products, distribution and analytics and enjoying economies of scale that come with consolidation. A measure used to quantify how much it costs an institution to generate revenue—the efficiency ratio—has declined since 2014 for all U.S. banks and since 2016 for district banks, indicating increased efficiency.[11] The ratio declined from 65 percent in 2008 to 57 percent in 2018 for U.S. banks and from 66 percent to 62 percent for district banks.

In spite of the efficiency gains from mergers, the falling number of smaller banks can have an unintended consequence. Community banks are key providers of credit in rural communities and for small businesses, which are important contributors to the economy.

Texas' 2019 Economic Gains

Eleventh District banks' performance continued to improve in 2018, but increased funding pressures and competition in 2019 will likely pressure profitability. Asset quality is high and improved again in 2018, but further gains may be limited.

Community banks should benefit from regulatory relief this year. However, due to the new regulations, institutions' regulatory capital may not fully capture the riskiness of loan portfolios at a time when the number of institutions with concentrations in riskier assets is high.

By various measures, banks are becoming fewer but more efficient as a result of consolidation, though concerns remain about credit and banking service availability for small businesses and rural areas.

Banking industry performance remains highly dependent on economic conditions. The Dallas Fed forecasts Texas job growth at slightly over 2 percent in 2019, about the same as in 2018 and close to trend.[12] District banks face challenges this year but should continue to reflect healthy regional economic fundamentals.

Reichow was a financial industry analyst at the Federal Reserve Bank of Dallas, and Chapel is a macrosurveillance manager in the Banking Supervision Department.

Notes

1 The Eleventh District includes all of Texas, northern Louisiana and southern New Mexico.

2 Community banks have total assets of less than $10 billion.

3 Inside Mortgage Finance Publications Inc., 2019, www.insidemortgagefinance.com.

4 See "Estimating Today's Commercial Real Estate Risk," by Pablo D'Erasmo, Federal Reserve Bank of Philadelphia *Banking Trends*, First Quarter, 2019, www.philadelphiafed.org/-/media/research-and-data/publications/banking-trends/2019/bt-estimating-todays-commercial-real-estate-risk.pdf.

5 Specifically, risk-based capital is a method of measuring the minimum amount of capital (assets less liabilities) based on riskiness of the lending portfolio required by regulation to support an institution's operations given its size.

6 Risk-weighted assets are calculated by assigning a weight to an institution's assets based on the asset's riskiness.

7 Other small-bank regulatory relief provided for by the Economic Growth, Regulatory Relief and Consumer Protection Act includes a Volcker Rule exemption, a shorter required regulatory report, an extended exam cycle and other mortgage-related exemptions.

8 See "Small Banks Squeezed," by Jeffery W. Gunther and Kelly Klemme, Federal Reserve Bank of Dallas *2012 Annual Report*.

9 Congressional Budget Office cost estimate, March 5, 2018, www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/s2155.pdf.

10 2018 merger data for the district were unavailable as of May 2019.

11 The efficiency ratio is calculated by dividing a bank's noninterest expense by its net income.

12 See the Dallas Fed's Texas Employment Forecast at www.dallasfed.org/research/forecast.