B | S | Perspectives

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Quarterly Earnings Review | 2015 | Q3

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LOOKING TO FORWARD TRENDS AFTER YEARS OF RECOVERY MEANS BEING ALERT ABOUT NEW CRACKS IN CREDIT QUALITY AND THE SPEED OF DEPOSIT PRICING IN A RISING RATE ENVIRONMENT.

We attended a conference in Boston recently—the 34th annual banking conference of the BancAnalysts Association of Boston—and we found this one to be particularly well-timed. The theme was **"The End of the Beginning—the Beginning of the End?"**—and we must say that we came back from this annual event (of which we have attended about 25 of the last 34) with more questions than we have answers, which was perhaps the intention of the conference planners. And while this annual event has historically involved presentations from the nation's largest banks, it has also tended to predict issues of concern (like the New England commercial real estate meltdown of the late 1980's) that would become more evident throughout the banking industry as a whole in the coming months.

Unfortunately, this year's conference did not present an answer to the question posed by its theme—whether this is the end of the beginning of bank "recovery" or the beginning of the end of the generally positive recent performance of banks and their stocks. The impression that we had coming away from two days of presentations was that the correct answer is "none of the above"—the banking industry's largest banks instead seem to be in some period of suspended animation, during which they are maintaining a stable level of earnings, but they also seem to be awaiting some future event as a catalyst for a more material rate of growth to resume.

We hope that the nation's banks and the investors in their stocks are not waiting solely for the Fed to begin to raise rates, because that longed-for event may simply not be enough to get organically generated bank earnings off the dime. While there seems to be near unanimity of opinion that Janet Yellen will lead the charge for higher rates in December, there also seems to be an overwhelming sentiment that the Fed will make it "one and done" for a matter of months as they weigh the impact of rate increases on economies both foreign and domestic. The resultant pause in raising rates—six months (at least) seems to be the emerging view—will likely lead to further confusion for the markets and will not be of much help to the banking industry in its quest for better spreads and higher margins.

There were two issues that came through in nearly every presentation at the Boston conference, and both of these bear closer examination. The first was a decided note of caution on the subject of credit quality—has the cycle begun to turn down and do loan-loss provisions and reserves thus need to be increased?—and the even larger-looming topic, that of "deposit beta", or the need and speed with which to begin to pass through Fed interest rate increases to depositors who have been starved for yield for many years.

The answer to the credit quality issue seems at this point to be the easier of the two to formulate. Is credit quality deteriorating? Well—yes and no, depending upon the size of the bank and the specific segment of the loan portfolio being considered. We looked at some 3Q15 credit quality data from SNL Financial, and it tells an interesting story. One consistent message from the larger banks that we surveyed for this piece has been that both pricing and structure in commercial lending have been slipping for some time, and the regulators have reinforced this message with some fairly blunt warnings about the dangers of leveraged lending and the deterioration of trends that they saw in the results of the last Shared National Credit (SNC) exam. Indeed, the OCC said that "Leveraged transactions originated within the last year continued to exhibit structures that were cited as weak by examiners."

The SNL numbers seem to bear out these warnings, as well as to reflect the beginnings of the impact of the deterioration in the energy lending portfolios that are mainly a feature of the largest banks and whose woes have been so widely chronicled in the press. Indeed, for the 43 banks with more than $5 billion in commercial loan portfolios, total non-accrual C&I loans climbed slightly from 2Q15 levels—from 43 bps to 44 bps of the $1.2 trillion C&I total in those banks—and continued a climb that began in 4Q14 when C&I non-accruals bottomed out at 31 bps. While this sequential quarterly increase seems pretty subdued, we would note that large bank C&I trends likely do not yet fully reflect the impact of the energy portfolio revaluations that are ongoing in 4Q15 and may result in larger (and lumpier) quarterly increases in non-accruals to come.

The C&I non-accrual trends in the other size segments are a bit harder to discern. The smallest segment—those 900 banks in SNL's data with commercial portfolios of $50 million to $500 million—continue to reflect improving commercial non-accrual trends, with such loans remaining stable sequentially (at 35 bps) and falling from 41 bps in 3Q14. We would posit that the granularity of these loan portfolios and the very local nature of these loans in the smallest banks would somewhat insulate these companies from the "structural" deterioration that the industry seems to be experiencing at the larger end.

In a similar vein, we would note that those 133 banks with C&I loan portfolios between $500 million and $5 billion—the mid-tier community banks—seem to be getting the worst of it; not only did they have the highest level of non-accrual commercial loans (69 bps) at September 30, but they have experienced the worst deterioration in the past year (up 23 bps, or 50%). To us, these numbers vividly point out the pressures of competition at that larger end and likely are one factor (in our opinion) in the very vigorous level of consolidation among these mid-tier banks.

C&I Loan Book, as of 09/30/15	# of Banks	Total C&I Loans, 3Q15	% of C&I Loans on Nonaccrual, 3Q15	% of C&I Loans on Nonaccrual, 2Q15	% of C&I Loans on Nonaccrual, 1Q15	% of C&I Loans on Nonaccrual, 4Q14	% of C&I Loans on Nonaccrual, 3Q14
$50mm - $500mm	900	$126.7B	0.35%	0.35%	0.37%	0.37%	0.41%
$500mm - $5B	133	$209.2B	0.69%	0.53%	0.51%	0.44%	0.46%
> $5B	43	$1.2T	0.44%	0.43%	0.36%	0.31%	0.32%

Sources: 3Q15 call reports, SNL Financial (percentage figures shown are medians)

As to those other areas of credit quality concern—commercial real estate (CRE) and acquisition and development (ADC) loans—these areas that led to so much grief in the financial crisis seem to be very well-behaved in the present environment. Non-accruals in both segments continue to improve across all bank sizes, with the exception of a small 3Q15 sequential blip upward (up 10 bps, to 1.01%) for the ADC portfolios in the largest banks. Our only conclusion here can be that a watched pot never boils, and the regulatory focus on this segment has resulted in a thus-far cautious lending posture among banks both large and small.

That air of caution may be changing somewhat, however. We would note the commentary from many banks during our survey that referenced very intense competition in lending for multi-family housing, particularly in cities in the Southeast where a boom in college attendance has overwhelmed available dormitory space and sent students in search of apartments. One banking executive with whom we spoke said that good credits in these areas are getting priced "very thin" and that there seems to be developing a psychology of "no fear" in ADC and CRE lending. It will be interesting to see if a regulatory caution is issued as a result, but thus far CRE deterioration seems to be an issue for earnings periods yet to come.

Non-Owner-Occupied CRE ("NOO") Loan Book, as of 09/30/15	# of Banks	Total NOO Loans, 3Q15	% of NOO Loans on Nonaccrual, 3Q15	% of NOO Loans on Nonaccrual, 2Q15	% of NOO Loans on Nonaccrual, 1Q15	% of NOO Loans on Nonaccrual, 4Q14	% of NOO Loans on Nonaccrual, 3Q14
$50mm - $500mm	1,117	$153.2B	0.12%	0.16%	0.23%	0.25%	0.28%
$500mm - $5B	176	$229.5B	0.32%	0.39%	0.44%	0.41%	0.52%
> $5B	30	$253.9B	0.23%	0.39%	0.42%	0.66%	0.73%

ADC Loan Book, as of 09/30/15	# of Banks	Total ADC Loans, 3Q15	% of ADC Loans on Nonaccrual, 3Q15	% of ADC Loans on Nonaccrual, 2Q15	% of ADC Loans on Nonaccrual, 1Q15	% of ADC Loans on Nonaccrual, 4Q14	% of ADC Loans on Nonaccrual, 3Q14
$50mm - $500mm	547	$72.3B	0.27%	0.38%	0.46%	0.49%	0.65%
$500mm - $5B	65	$75.7B	0.40%	0.45%	0.55%	0.65%	1.08%
> $5B	7	$67.2B	1.01%	0.91%	1.11%	1.34%	1.79%

Sources: 3Q15 call reports, SNL Financial (percentage figures shown are medians)

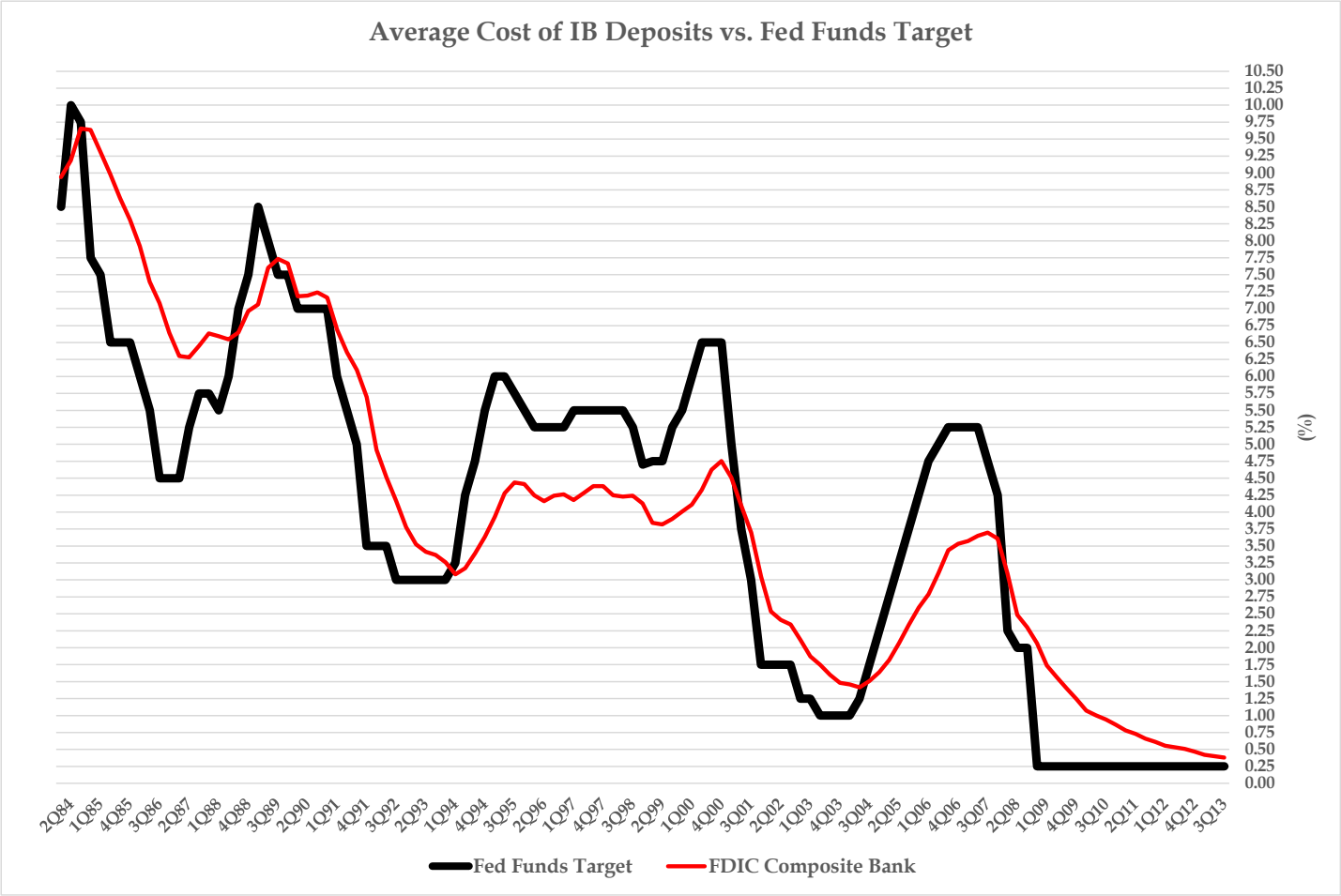
There is one good thing about the issue of credit quality—we have reams of historical data around credit trends and there is usually plenty of time for investors and others to spot deterioration and to prepare accordingly, and we think that many banks are simply trying to get their shareholders ready at this point for that change. But not so with the other hot issue of the third quarter—that of deposit beta, or how much of projected future interest rate increases banks should share with their depositors and how quickly that sharing should take place in order to cement customer loyalty and to prevent core deposit base attrition.

Why so much attention to the issue now, when we have the results of many past periods of rising rates and much evidence of how core deposit pricing has responded? Jamie Dimon of **J.P. Morgan Chase** set off the debate earlier this year, when he said that he foresaw a need for his bank to begin to pass along Fed rate increases to a greater degree and with more rapidity than in the past. The reason given by Mr. Dimon was the requirement for banks to maintain a 30-day reserve of liquid funds in case of a period of "liquidity stress" in order to comply with Basel III requirements—the so-called LCR, or liquidity coverage ratio—and the premium put upon retail deposits by the LCR requirements.

Mr. Dimon has backed off from that definitive pronouncement a bit in the intervening months, but the discussion has gone on. For our part, we would note that the issues surrounding the whole subject of deposit pricing in a rising rate environment have changed dramatically since the mid-1990s, which was the last period of rapidly rising rates. For one thing, it is very unlikely that interest rates will rise with any speed in the next few years, and that both banks and their customers will have ample time to weigh the consequences of moving deposits between non-interest bearing and interest-bearing accounts, or to know whether depositors will move them out of the banks altogether. The first 25 bps move will likely barely register upon depositor consciousness, and it will not be until the second rate increase—if and when it comes—and the resultant changes in the long-term rate structure that we will need to be more vigilant on the subject of deposit pricing.

There are also a couple of prevailing trends in the Southeast that need to be considered. The biggest is that some of the new entrants to the Southeast—we're thinking of **Wells Fargo** and **PNC** particularly—have come in as a consequence of the financial crisis and have displaced banks that had felt the need to be rate-aggressive in past cycles. Wells Fargo is well known as the nation's stingiest bank in paying its depositors, and we think that their discipline is likely to weigh upon major markets (like Atlanta) that had been hotbeds of rate competition in the past. We would also note the newfound deposit identity of **Bank of America**, with its massive daily deposit inflows and its emphasis on mobile technology, as a factor that will make the Southeastern deposit market likely one of the nation's most liquid and best-behaved from the vantage point of bankers.

Will the community banking segment in the Southeast observe this same degree of deposit pricing discipline? We think so, given the searing experience of the "hot money" community banks here in Georgia and the utter debacle that followed. We would also point out that the rapid pace of consolidation of the smaller banking franchises—occurring now on an almost-daily basis—places more and more deposit pricing power in the hands of larger community banks that will have every incentive to be conservative and moderate in their competitive deposit pricing decisions.



Sources: Federal Reserve, FDIC (Composite Bank represents sectorwide statistics reported quarterly by FDIC)

However, we did get an interesting countervailing view from one of our industry contacts, and it needs to be considered (Contrarian opinions are always the most interesting, anyway). He pointed out that the sheer speed with which the consolidation in the Southeast is taking place is likely to mean that some of the acquiring banks are buying deposit bases with which they are likely unfamiliar, and that these acquired customers may have little loyalty to their new banks. Will

these displaced customers have an incentive to move for a few basis points extra? We think that the general stickiness of core deposits argues against this thesis, but in an ultra-low rate environment that has not changed for many years—who knows what new behaviors and surprises may yet be in store?

As we were writing this piece, it suddenly occurred to us that the theme of the BAAB conference which we mentioned at the beginning of this discourse may have been more prescient than we knew. While 3Q15 results for banks both large and small did not mark some milestone in bank achievement or the end of present banking trends, it did mark (for us, anyway) the beginning of the end of the time during which we have been focused excessively on what went wrong during the financial crisis and the aftermath of those days. In looking at credit quality trends and the likely course of deposit pricing, we are beginning to look more intensively at the issues of the future and the new banking world that has unfolded since the dark days of 2008. On the advent of the holidays, that fact is indeed something to be thankful for.

To read NAB Research's disclosures for the preceding commentary, please follow this link: http://www.bushonbanks.com/disclosure.shtml

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QUARTERLY BANKING DATA, BY REGION

Region	# of Banks	Nonaccrual Loans/ Loans			ALLL/ Gross Loans			Common Texas Ratio		
		3Q15	2Q15	3Q14	3Q15	2Q15	3Q14	3Q15	2Q15	3Q14
All Banks	**5,452**	**0.57%**	**0.59%**	**0.71%**	**1.34%**	**1.35%**	**1.42%**	**8.84%**	**9.26%**	**10.66%**
Mid-Atlantic	355	0.80%	0.79%	0.99%	1.23%	1.23%	1.29%	10.35%	10.43%	11.52%
Midwest	2,627	0.50%	0.52%	0.61%	1.32%	1.33%	1.39%	8.28%	8.85%	9.93%
New England	75	0.75%	0.80%	0.77%	0.98%	1.00%	1.06%	8.86%	9.00%	11.08%
Southeast	1,040	0.92%	0.97%	1.13%	1.39%	1.42%	1.51%	14.61%	14.93%	17.90%
Southwest	959	0.37%	0.37%	0.42%	1.30%	1.31%	1.34%	5.38%	5.40%	5.91%
West	396	0.47%	0.52%	0.79%	1.52%	1.57%	1.68%	7.61%	8.64%	11.32%

Region	# of Banks	Taxable ROAA (LTM)			Net Interest Margin			Cost of Funds		
		3Q15	2Q15	3Q14	3Q15	2Q15	3Q14	3Q15	2Q15	3Q14
All Banks	**5,452**	**0.84%**	**0.84%**	**0.83%**	**3.68%**	**3.63%**	**3.69%**	**0.41%**	**0.41%**	**0.45%**
Mid-Atlantic	355	0.74%	0.74%	0.72%	3.45%	3.44%	3.49%	0.50%	0.50%	0.52%
Midwest	2,627	0.85%	0.86%	0.85%	3.61%	3.57%	3.61%	0.42%	0.42%	0.46%
New England	75	0.63%	0.69%	0.67%	3.25%	3.24%	3.28%	0.55%	0.55%	0.54%
Southeast	1,040	0.78%	0.77%	0.74%	3.81%	3.77%	3.84%	0.46%	0.46%	0.50%
Southwest	959	0.91%	0.91%	0.91%	3.87%	3.76%	3.86%	0.33%	0.33%	0.35%
West	396	0.90%	0.90%	0.85%	3.83%	3.86%	3.85%	0.27%	0.29%	0.31%

Sources: 3Q15 call reports, SNL Financial (percentage figures shown are medians)