

# The U.S. Economy and 12th District Banking: Conditions & Outlook

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Tuesday, September 24, 2013  
2:00pm Pacific Time



***U.S. Monetary Policy and National  
Economic Outlook***

***CALL THE FED***

***September 24, 2013***

***San Francisco, CA***

**Gary C. Zimmerman, Senior Economist  
Federal Reserve Bank of San Francisco**



# *Overview*

- Current National Economic Situation**
- National Economic Forecast**
- Regional Economic Conditions**
- U.S. Monetary Policy**

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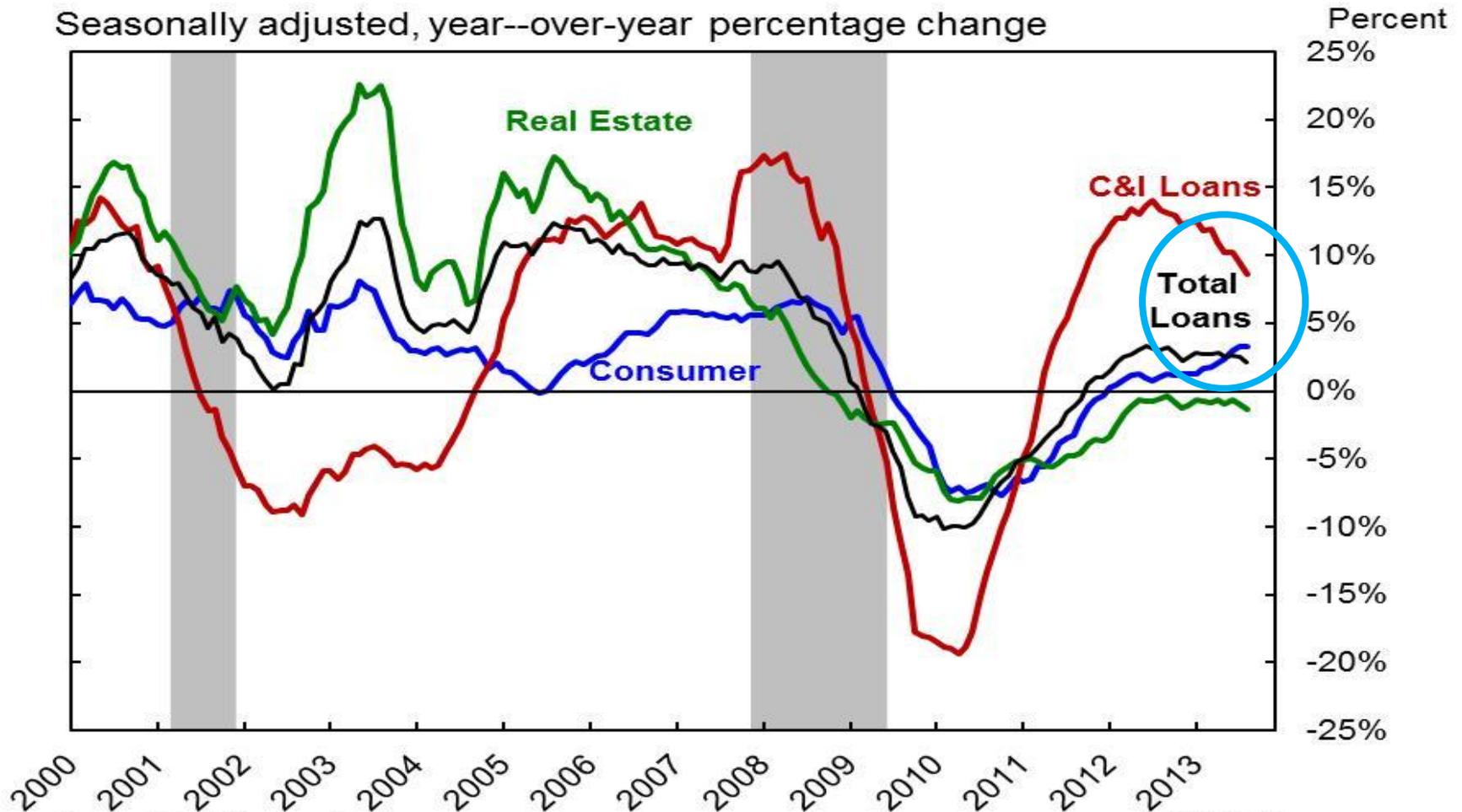
# *Current National Economic Situation*

- **Underlying growth trend remains moderate. Faster growth is expected.**
- **There is improvement in the labor market, but the unemployment rate remains elevated.**
- **Inflation has been subdued and is expected to remain below the Fed's 2% target over the next few years.**

# Improving Financial Conditions: U.S. Commercial Bank Lending Is Expanding, Providing Credit to Businesses and Consumers, although Real Estate Loans Are Still Contracting Slightly

## Commercial Bank Loans

Seasonally adjusted, year--over-year percentage change



Source: Federal Reserve Board

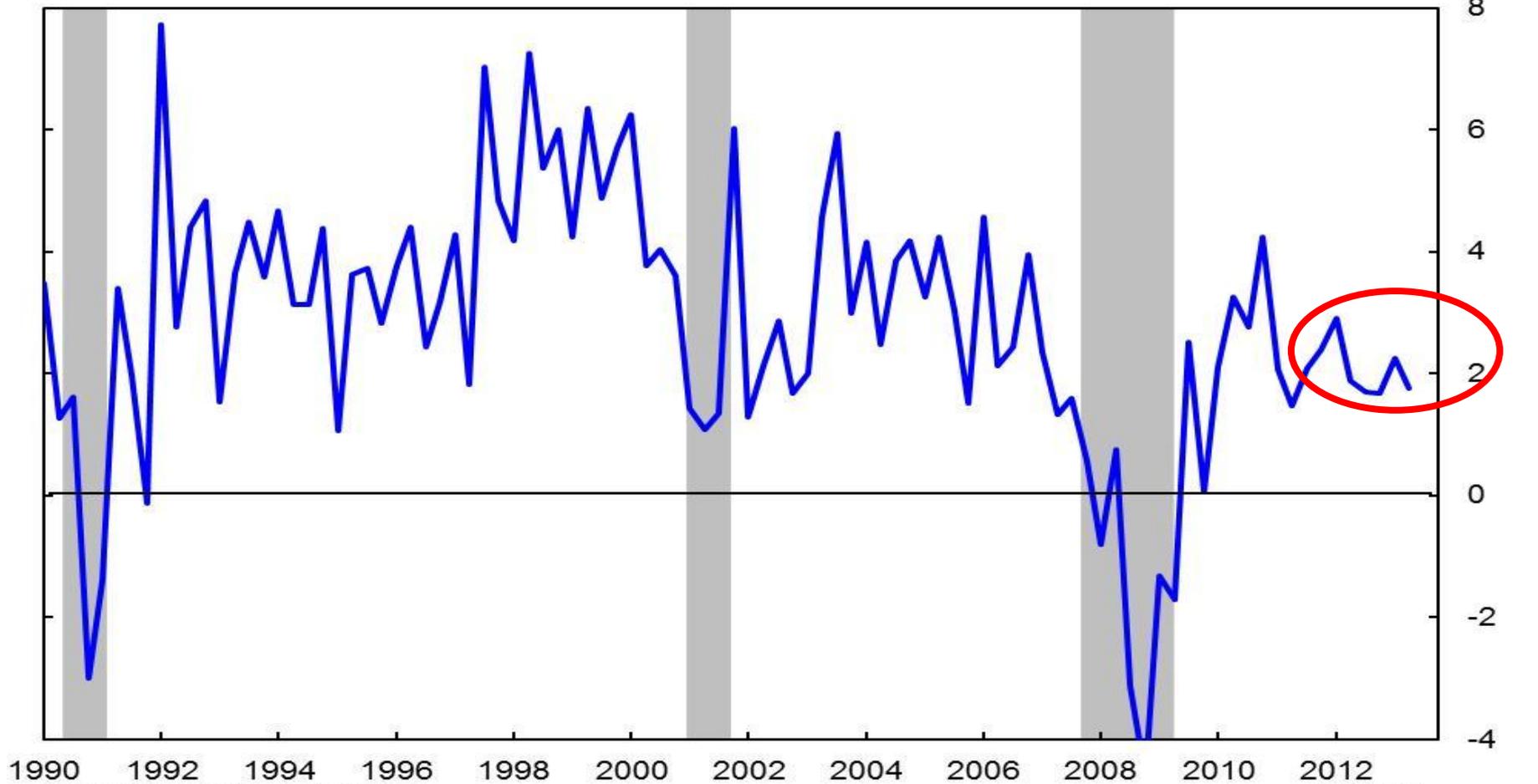
9/20/2013

# *Real Personal Consumption Expenditures Have Been Expanding at a Moderate Pace Despite Recent Tax Increases and Sequester Spending Cuts*

## **Real Personal Consumption Expenditures**

Percent change at an annual rate; quarterly aggregation; SAAR

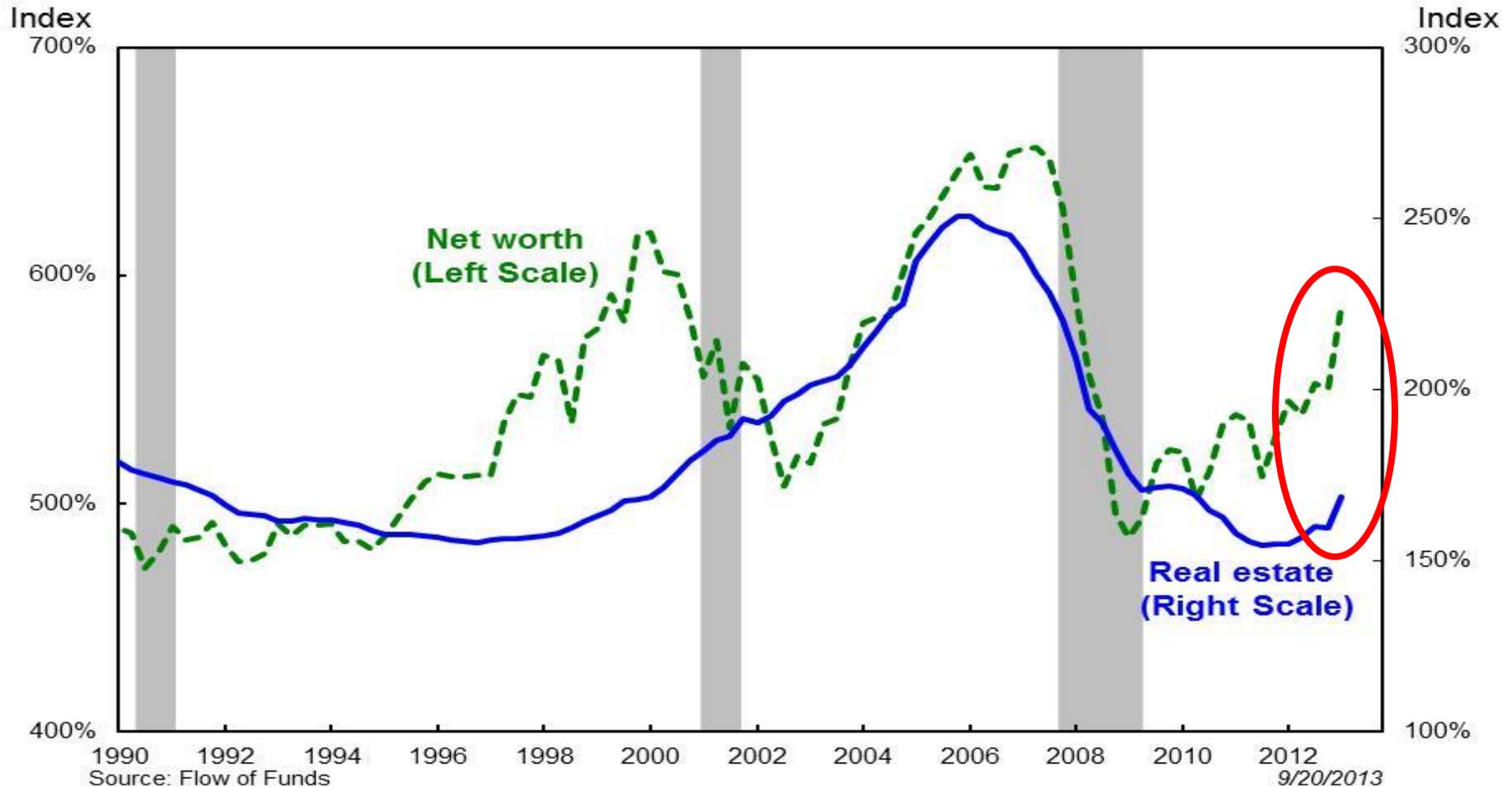
Percent



# Rebound in Stock and Residential Real Estate Markets Has Boosted Households' Net Worth and Supported Consumption Spending (via Wealth Effects)

## Household Wealth

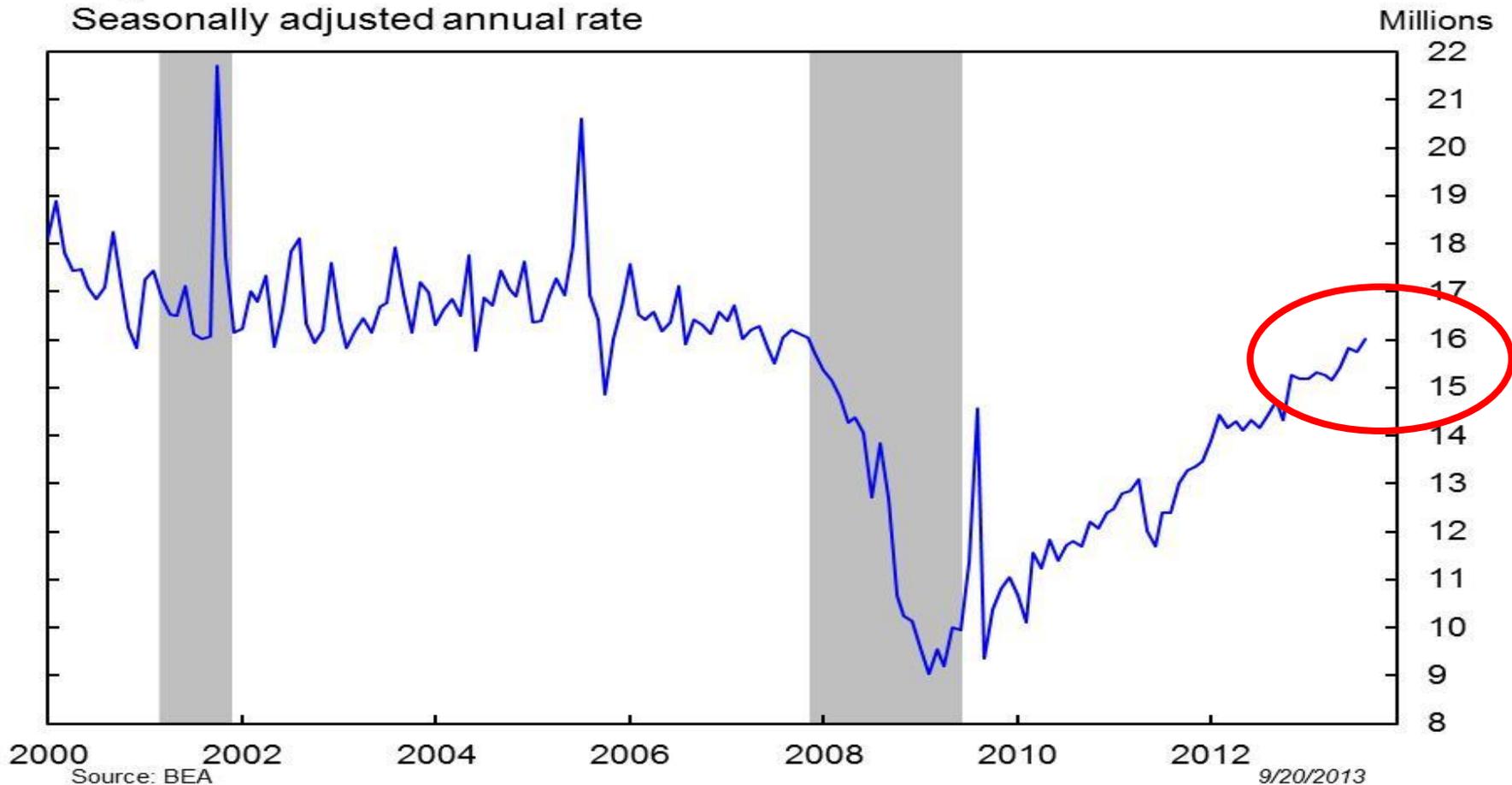
As a multiple of disposable income



# *Low Interests Rates Have Driven Vehicle Sales Back Towards Pre-Recession Levels*

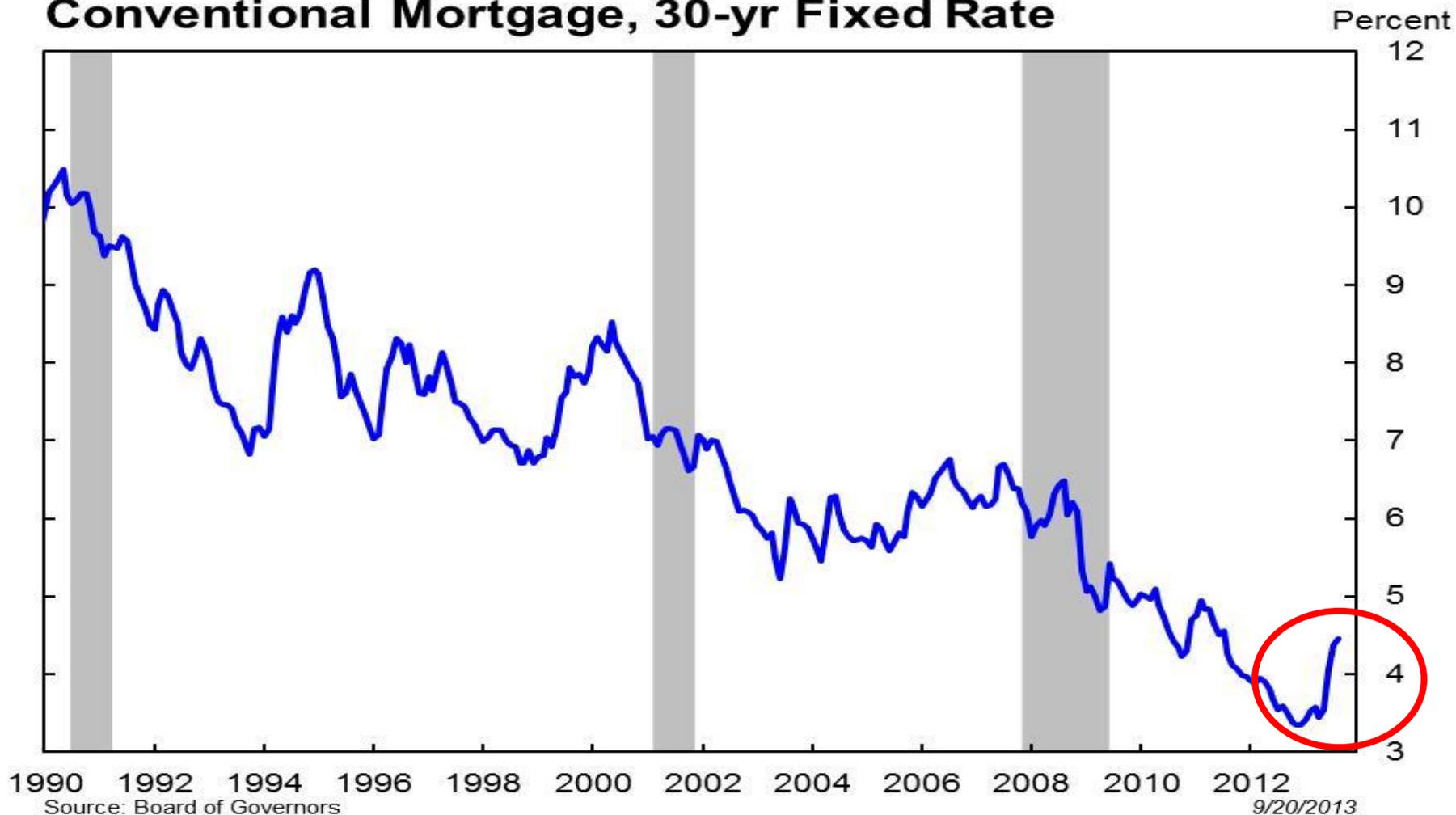
## **Light Vehicle Sales**

Seasonally adjusted annual rate



# *Rising Interest Rates and a Stronger Dollar Both Will Slow Near-term Growth*

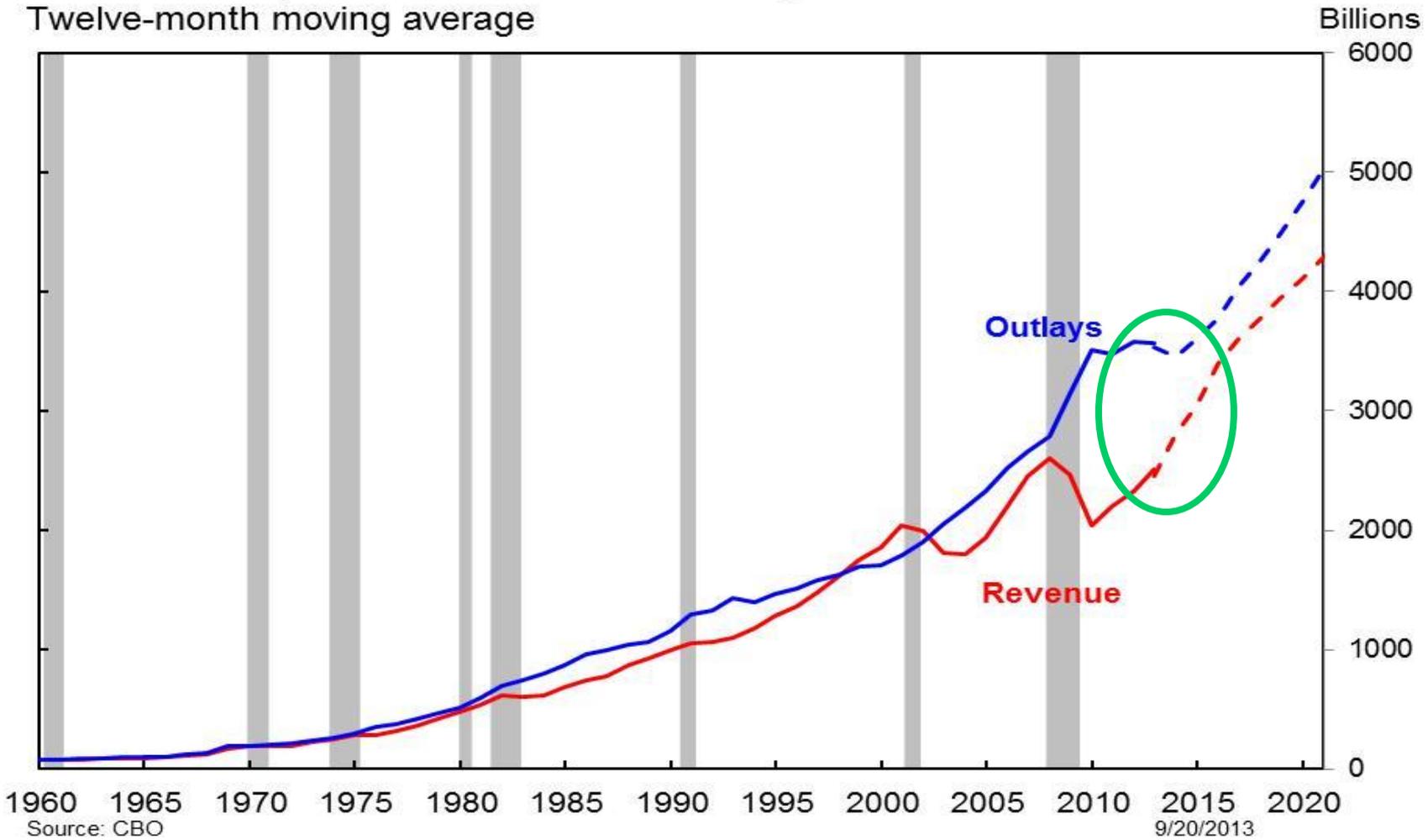
## **Conventional Mortgage, 30-yr Fixed Rate**



# *As the Federal Deficit Shrinks in 2013, Fiscal Policy Has Created an Important Drag on U.S. Growth Rates*

## Federal Expenditures and Receipts

Twelve-month moving average



Source: CBO

9/20/2013

# **A National Economic Forecast**

## **Prepared by the FRBSF Staff**

(available monthly)

Source: *FedViews*, September 20, 2013

<http://www.frbsf.org/publications/economics/fedviews/index.php>

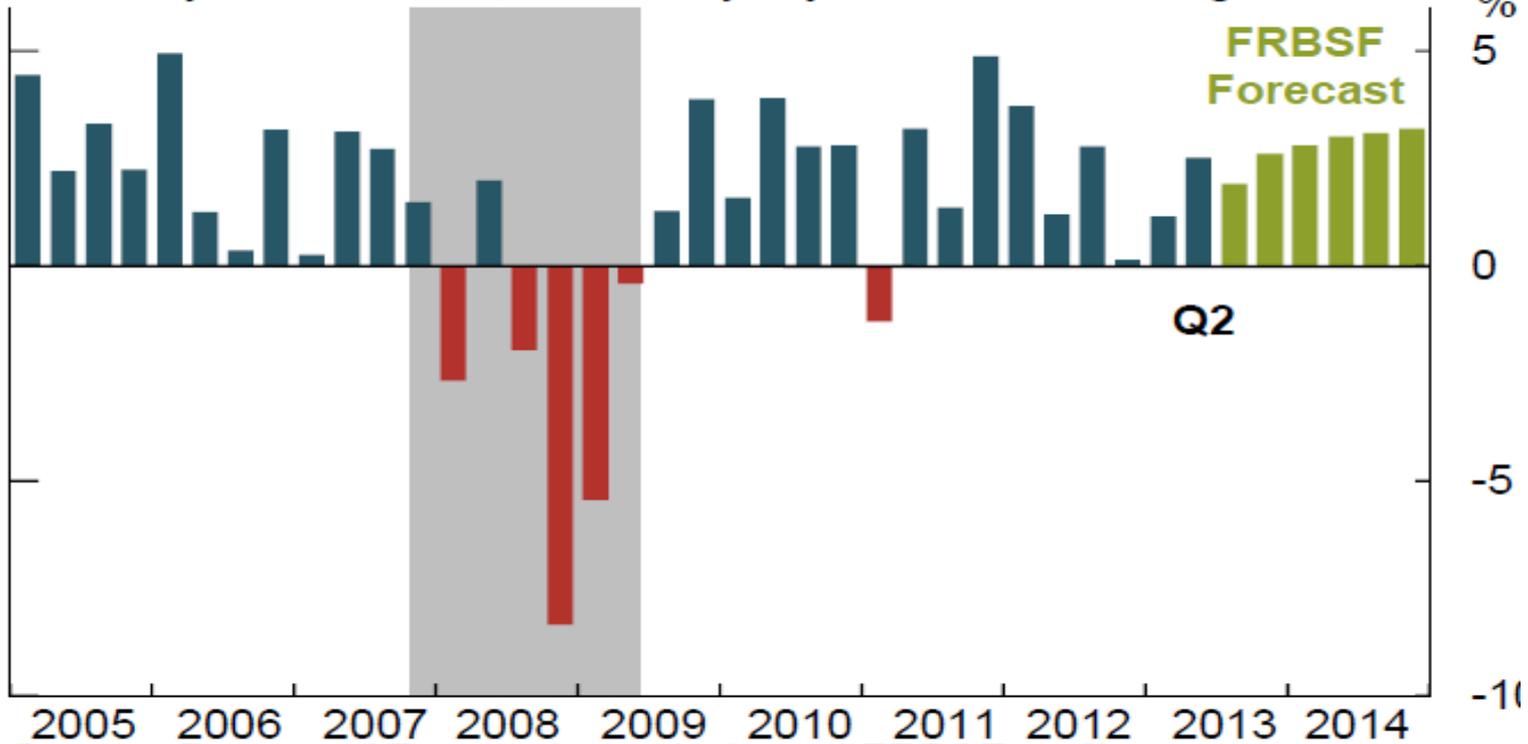
Next release is scheduled on or before October 20th

# National Economic Outlook: FRBSF Projections for Real Gross Domestic Product (GDP) 9-20-2013

## We expect growth to pick up

### Gross Domestic Product

Quarterly observations; seasonally adjusted; annualized growth rate %



Source: Bureau of Economic Analysis and FRBSF staff

Source: *FedViews*, September, 20, 2013

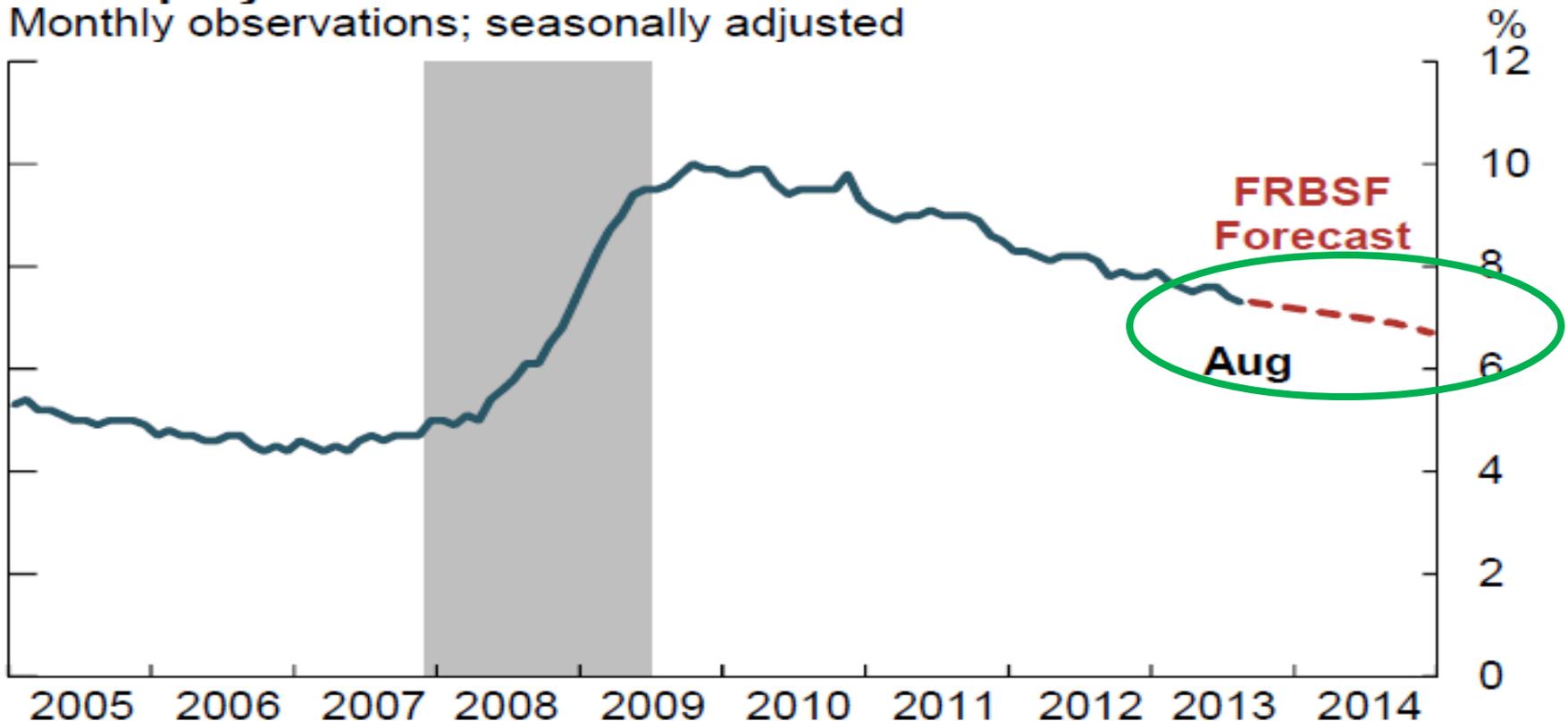
<http://www.frbsf.org/publications/economics/fedviews/index.php>

# National Economic Outlook: FRBSF Projections for Unemployment Rate (9-20-2013)

## We expect unemployment to decline

### Unemployment Rate

Monthly observations; seasonally adjusted



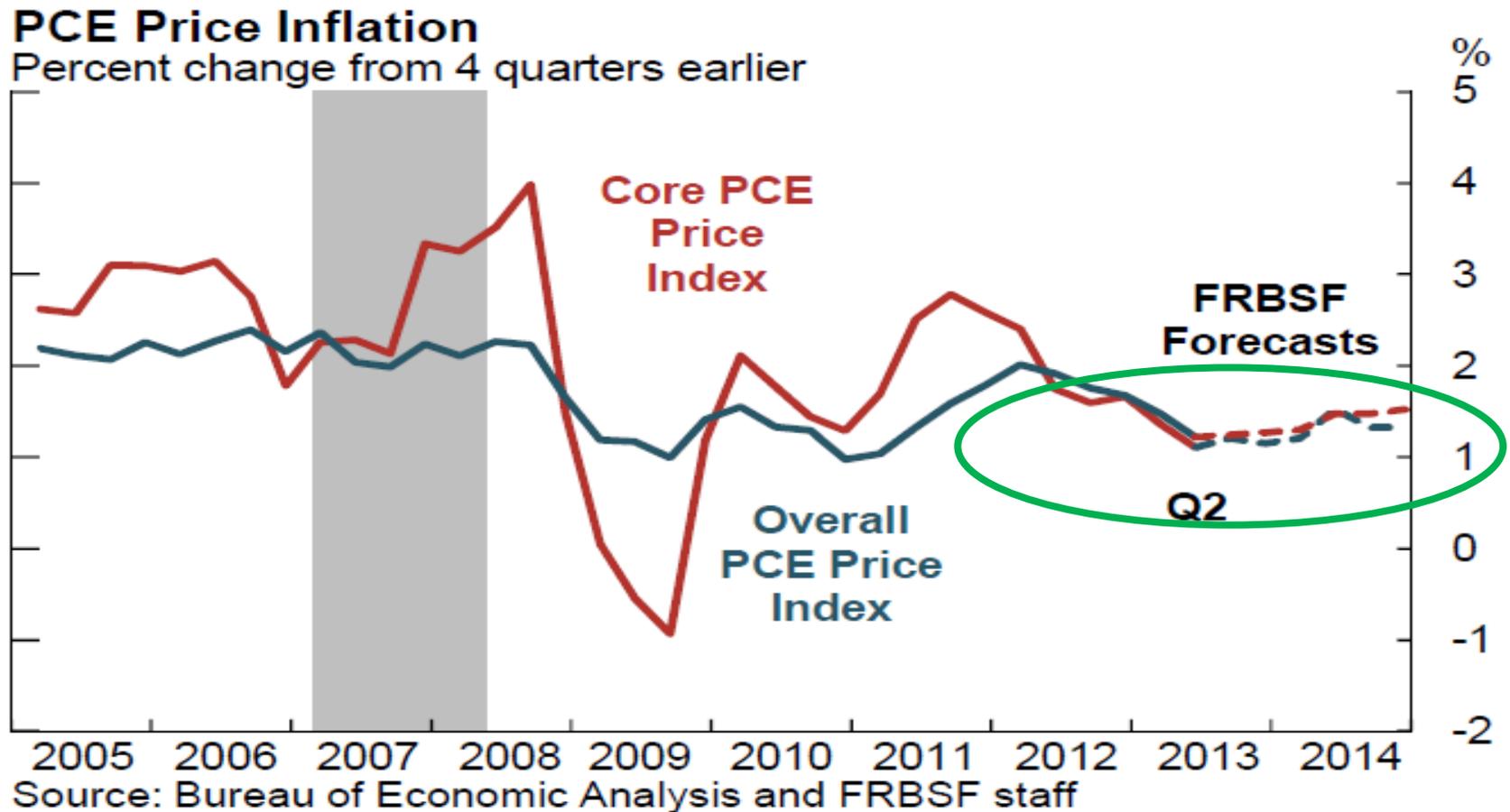
Source: Bureau of Labor Statistics and FRBSF staff

Source: *FedViews*, September, 20, 2013

<http://www.frbsf.org/publications/economics/fedviews/index.php>

# National Economic Outlook: FRBSF Projections for Total and Core PCE Inflation Rate (9-20-2013)

## We expect inflation to remain stable



Source: *FedViews*, September, 20, 2013

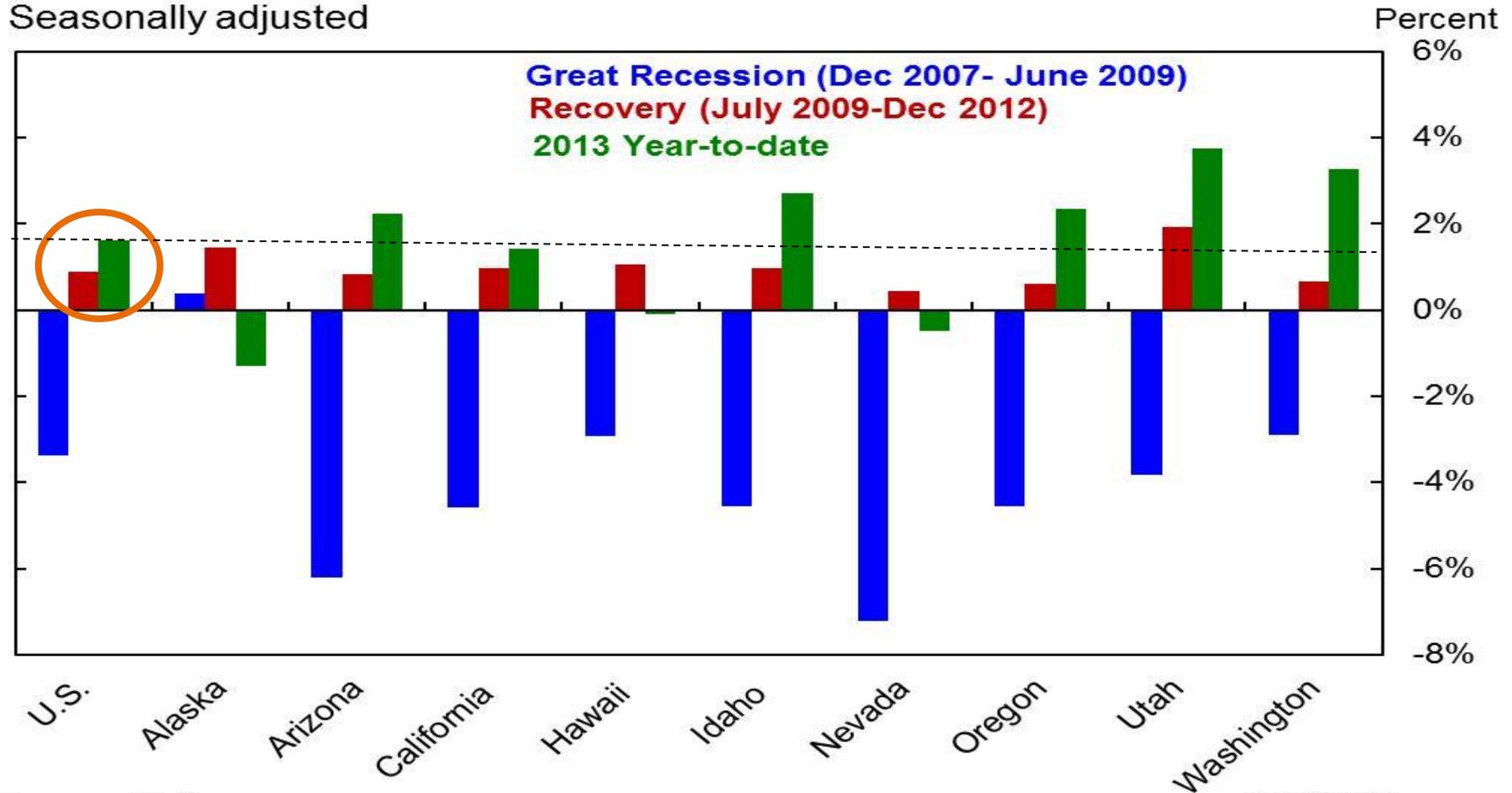
<http://www.frbsf.org/publications/economics/fedviews/index.php>

# **REGIONAL ECONOMIC CONDITIONS**

# 2013 Payroll Job Growth Rates in Most the Western States Have Picked Up – Mountain States and Pacific Northwest Are Recording the Fastest Growth

## Nonfarm Payroll (Average Annualized Growth Rates)

Seasonally adjusted



Source: BLS

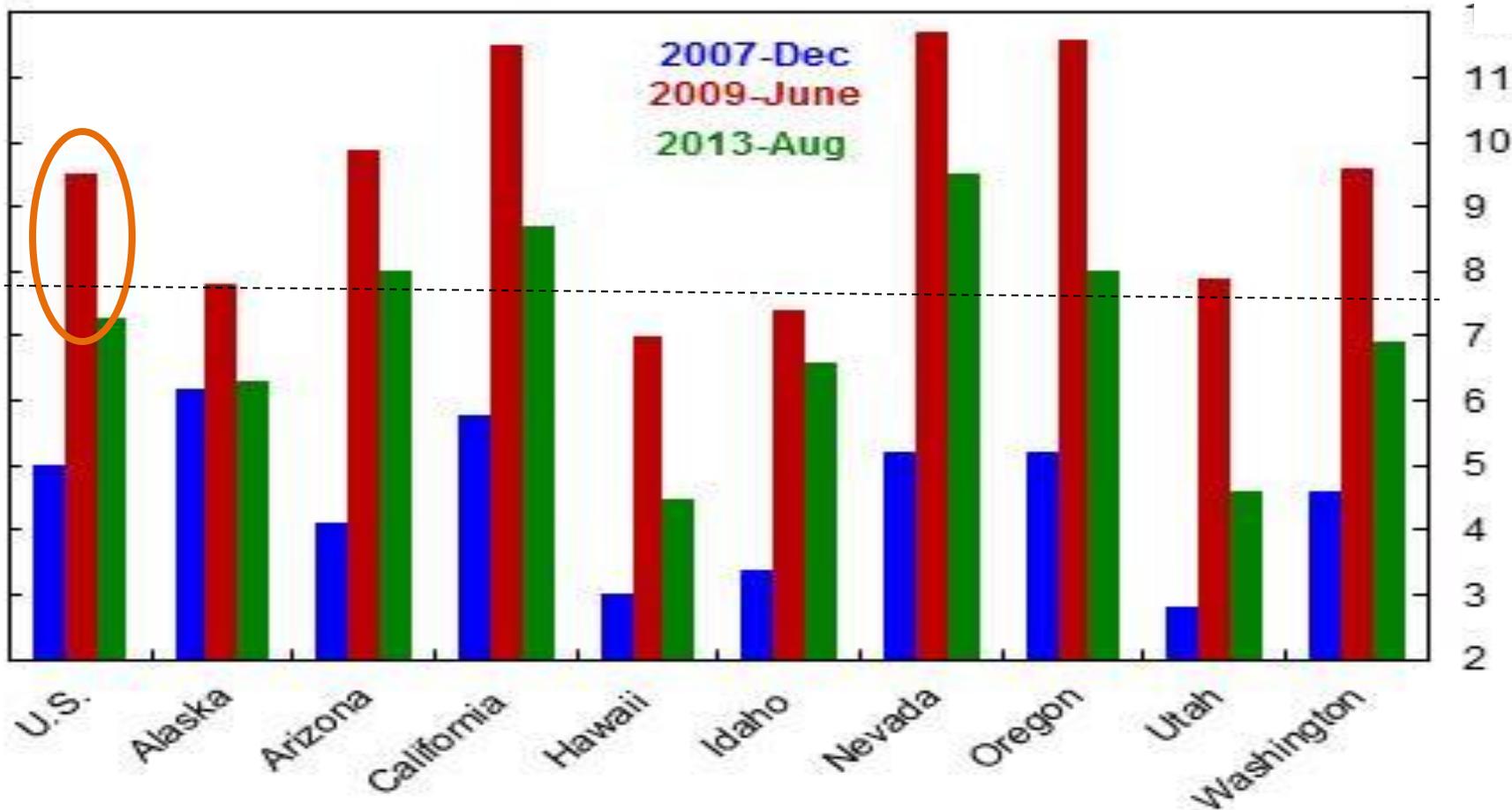
9/20/2013

# The Headline Unemployment Rate Has Fallen Noticeably in each of the Nine Twelfth Federal Reserve District States Since the Beginning of the Recovery

## Unemployment Rate

Seasonally adjusted

Percent

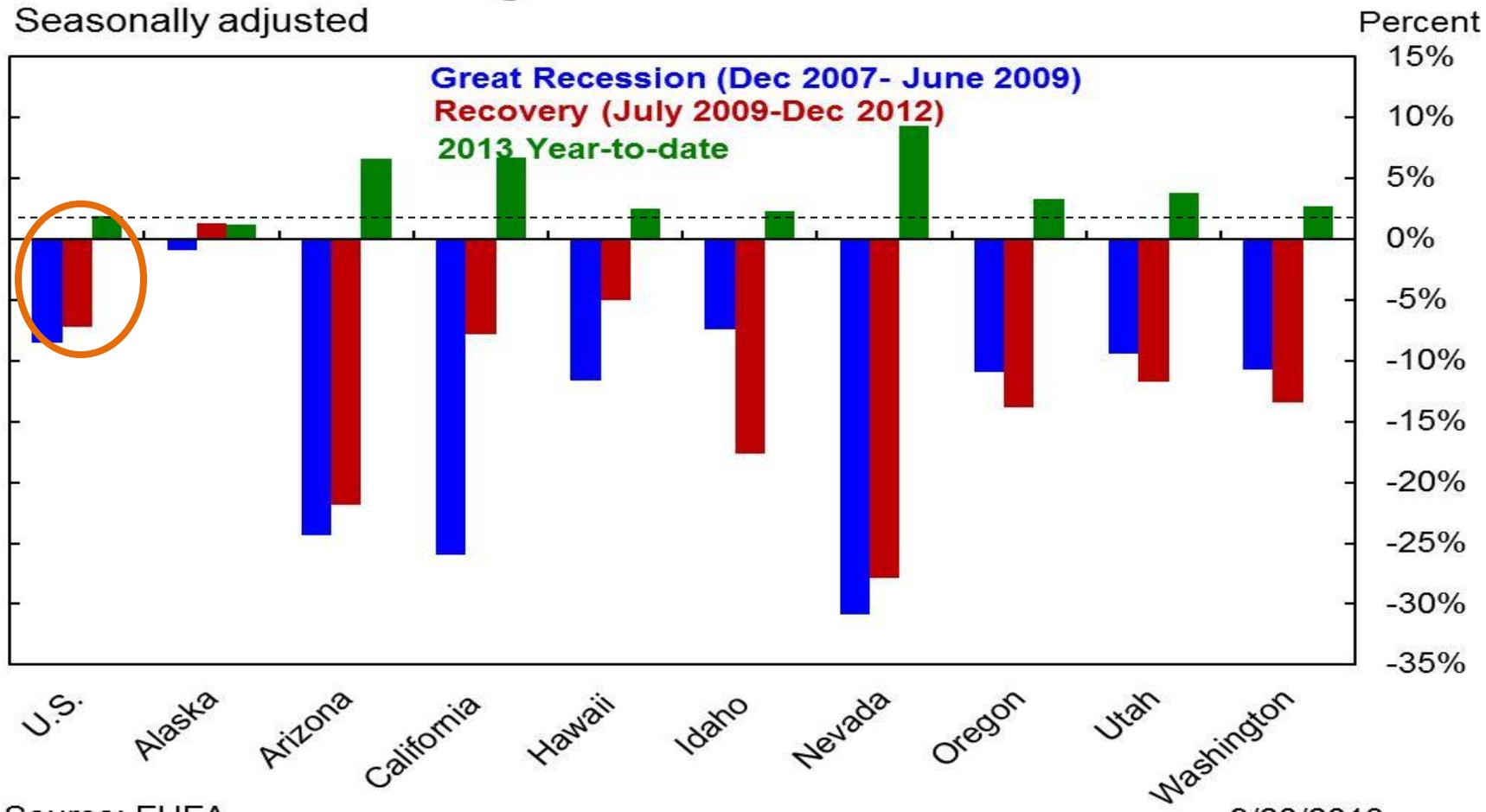


Source: BLS

# Housing Prices (FHFA Index) Are Rising in Each of these Western States – With Arizona, California, and Nevada Reporting the Fastest Appreciation

## House Prices Changes

Seasonally adjusted



Source: FHFA

9/20/2013

# **U.S. MONETARY POLICY**

# *U.S. Monetary Policy Goals*

**Congress has set these two monetary policy goals for the Federal Reserve:**

- 1) Promote maximum sustainable output and employment**
- 2) Promote stable prices**

**Statement of FOMC's longer-run goals and policy strategy (Jan 2012)**

- Inflation target of 2 percent
- Estimates of the longer-run normal rate of unemployment with a central tendency of 5.2 to 6 percent

# *Intermediate Policy Objectives*

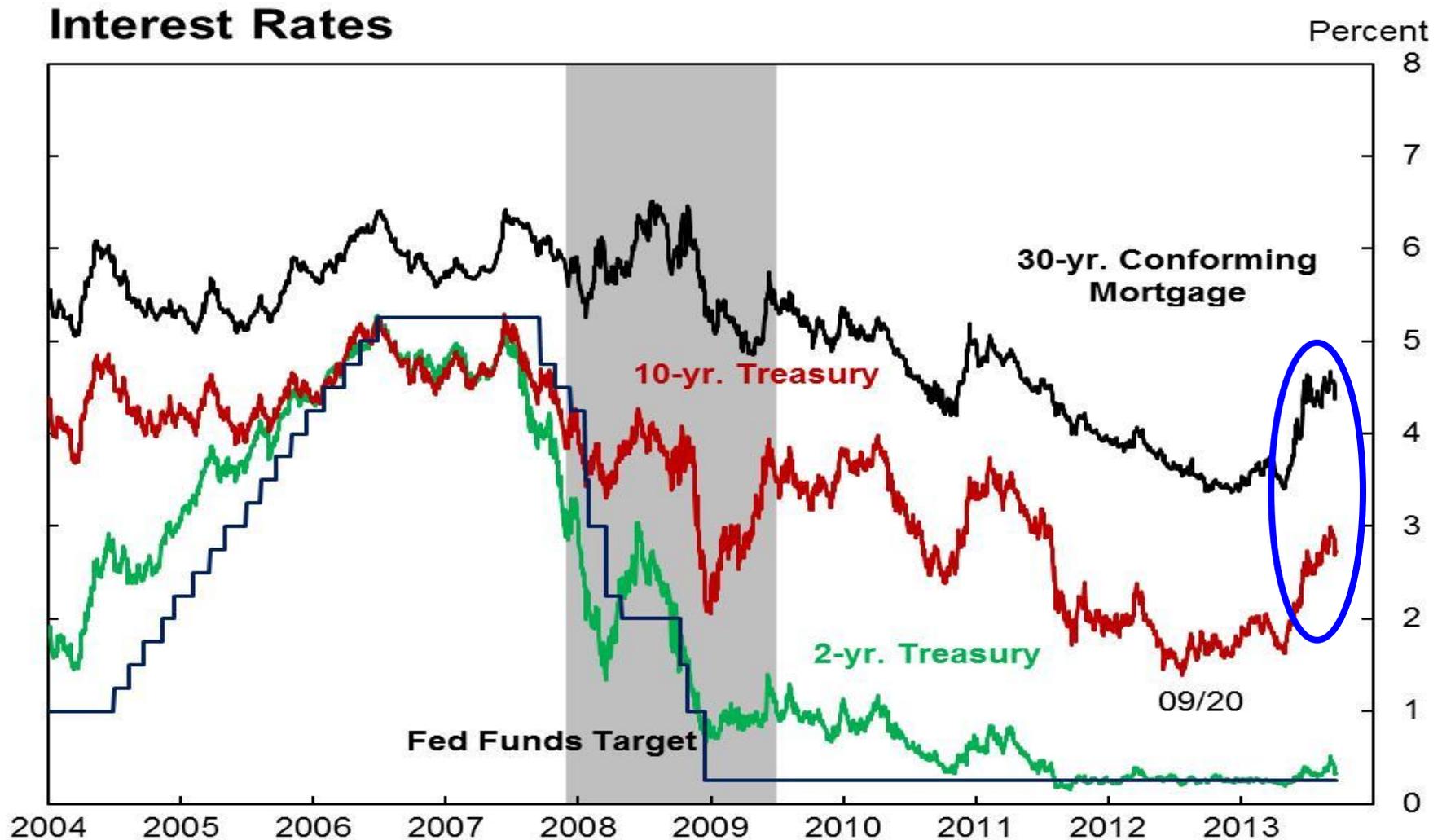
- **Conventional Monetary Policy**

- Target short-term interest rates (open market operations)
- Provide liquidity to banking institutions (discount window)

- **Unconventional Monetary Policy**

- Influence long-term interest rates more directly
  - Large-scale asset purchases (LSAPs or QE)
  - Communications
- Provide liquidity more broadly to the financial system (new credit facilities during the crisis)

# Conventional Tools of Monetary Policy: Target Federal Funds Rate (Feeds Through to Longer-Term Rates). What Impact Will Recent Increases Have on Housing?



Source: FRBSF

# *Forward Guidance on Two Policy Decisions*

- **Qualitative guidance regarding QE3 Policy Decision**  
(Currently \$85b/month in long-term asset purchases):
  - Labor market conditions
    - “Substantial improvement”
  - Cost/benefit analysis
- **Quantitative guidance regarding FOMC expectations for the federal funds rate target Policy Decision**  
(Liftoff from the zero overnight federal funds rate):
  - Initially a Calendar Date
  - Numerical Thresholds for labor markets and future inflation

# *Forward Guidance: Introduction of Numerical Thresholds for the Federal Funds Target Rate (“6-1/2 2-1/2 Policy”) on 12/12/12*

Exceptionally low range for the federal funds rate will be appropriate for at least as long as:

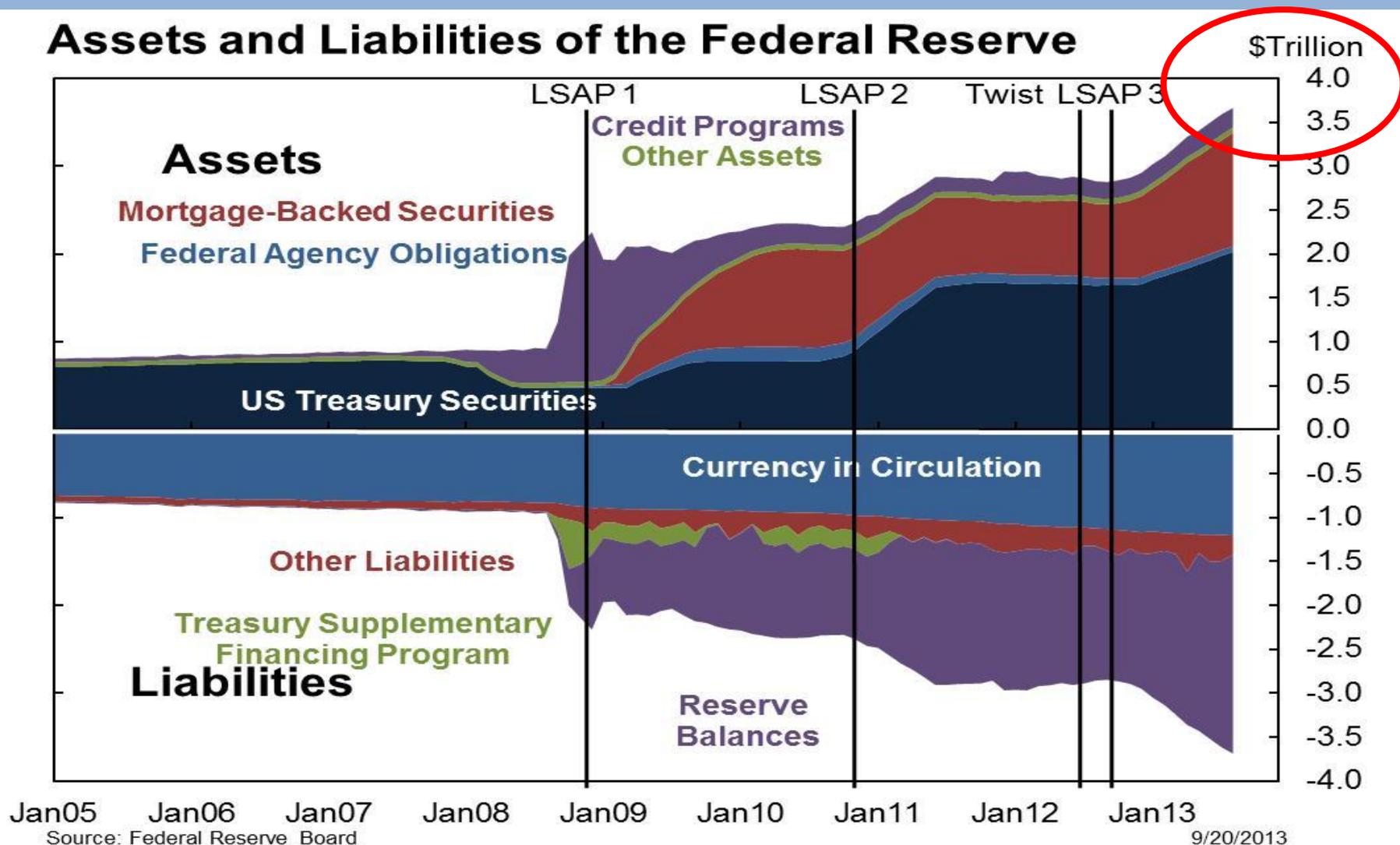
1. The unemployment rate remains above 6-1/2 percent
2. Inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee’s 2 percent longer-run goal, and
3. Longer-term inflation expectations continue to be well anchored

***NOTE: Thresholds are not triggers!***

***Decisions are conditional on economic developments!***

# Unconventional Monetary Policy Actions Increased the Size and Changed the Composition of the Federal Reserve Balance Sheet and Pushed Down Long-Term Interest Rates

## Assets and Liabilities of the Federal Reserve

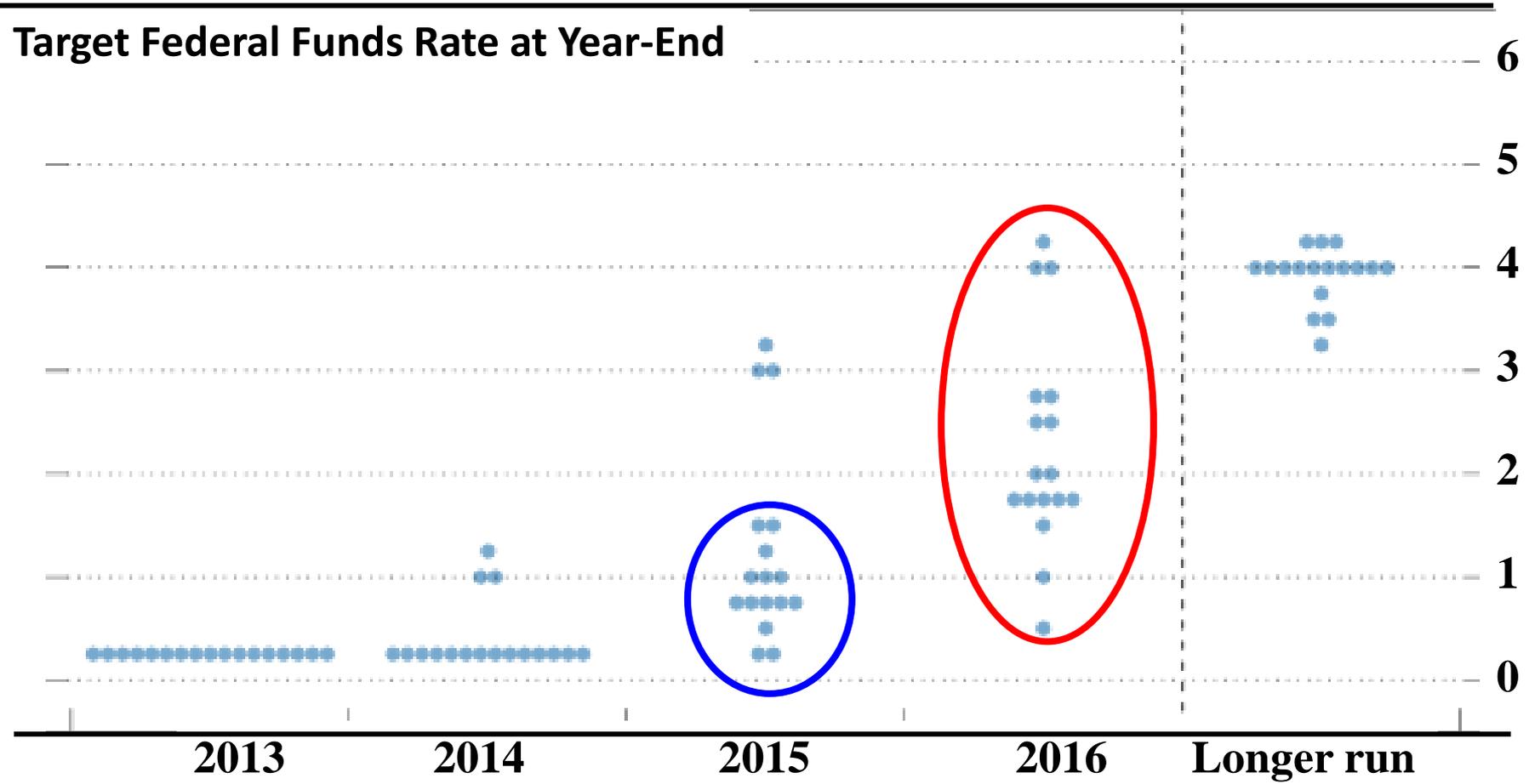


# Quantitative Guidance for Individual FOMC Members Regarding Their Federal Funds Rate Expectations

Appropriate Pace of Policy Firming

Percent

Target Federal Funds Rate at Year-End



September 20, 2013 Projections. Next Projections: December 18, 2013.

# *Summary*

- **National Economy:**
  - Moderate growth in 2013 (about 2%), improving in 2014 and 2015 to about 3%.
  - Gradual decline in the unemployment rate to about 6 3/4 percent by the end of 2014.
  - Inflation to rise towards the Federal Reserve's target of 2% over the next few years.

**QUESTIONS?  
THANK YOU!**

**Gary C. Zimmerman, Senior Economist  
Federal Reserve Bank of San Francisco**



# Banking Conditions & Outlook

## 12<sup>th</sup> Federal Reserve District Focus

Based on “First Glance 12L” / “Banks at a Glance”

<http://www.frbsf.org/banking-supervision/publications/>



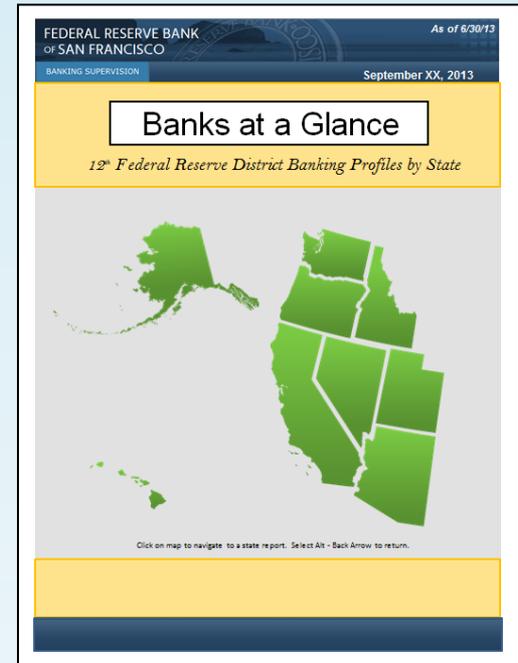
### First Glance 12L (2Q13)

*Banking Recovery – Liquidity Buildup and  
Deleveraging May be Over*

A First Look at the Financial Performance of  
Banks\* Headquartered within “12L”  
(the 12th Federal Reserve District)

Based on Preliminary 2Q2013 Call & Income Report Data

August 21, 2013



Gary Palmer, FRBSF, Banking Supervision & Regulation

with Colin Perez

# 12<sup>th</sup> District Banking Conditions & Outlook

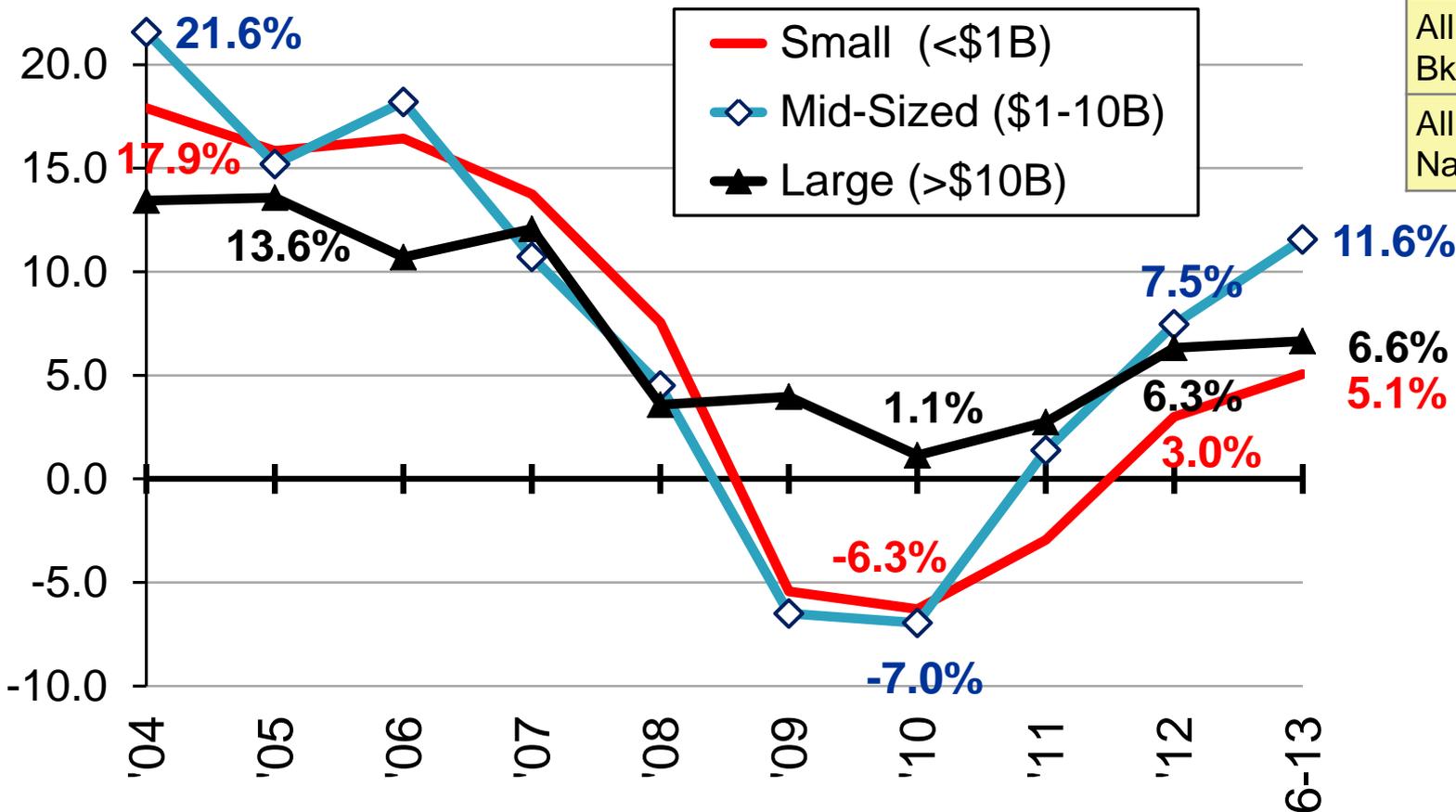
*Focus: commercial banks headquartered  
within the 12<sup>th</sup> Federal Reserve District*

- I. Loan Growth is Back
- II. Profitability & Credit Quality Recovering
- III. Capital / Liquidity – Post Recession Build-up May be Over
- IV. Regulatory Ratings (CAMELS) Reflects Recovery
- V. Selected Bank Supervisors' Hot Topics
- VI. Outlook

# I. Loan Growth is Back: Turnaround Continued

Avg. District bank loan growth 6.1% with fastest growth at mid-sized banks

Avg. District Year-Over-Year Loan Growth Rates (%)



Avg. Annual Loan Growth 6/13	
All 12 <sup>th</sup> Dist. Bks	6.1%
All Banks Nationwide	2.7%

Based on commercial banks, excluding De Novos; large bank statistics prior to 2006 reflect nationwide data as there were too few District banks; trimmed means

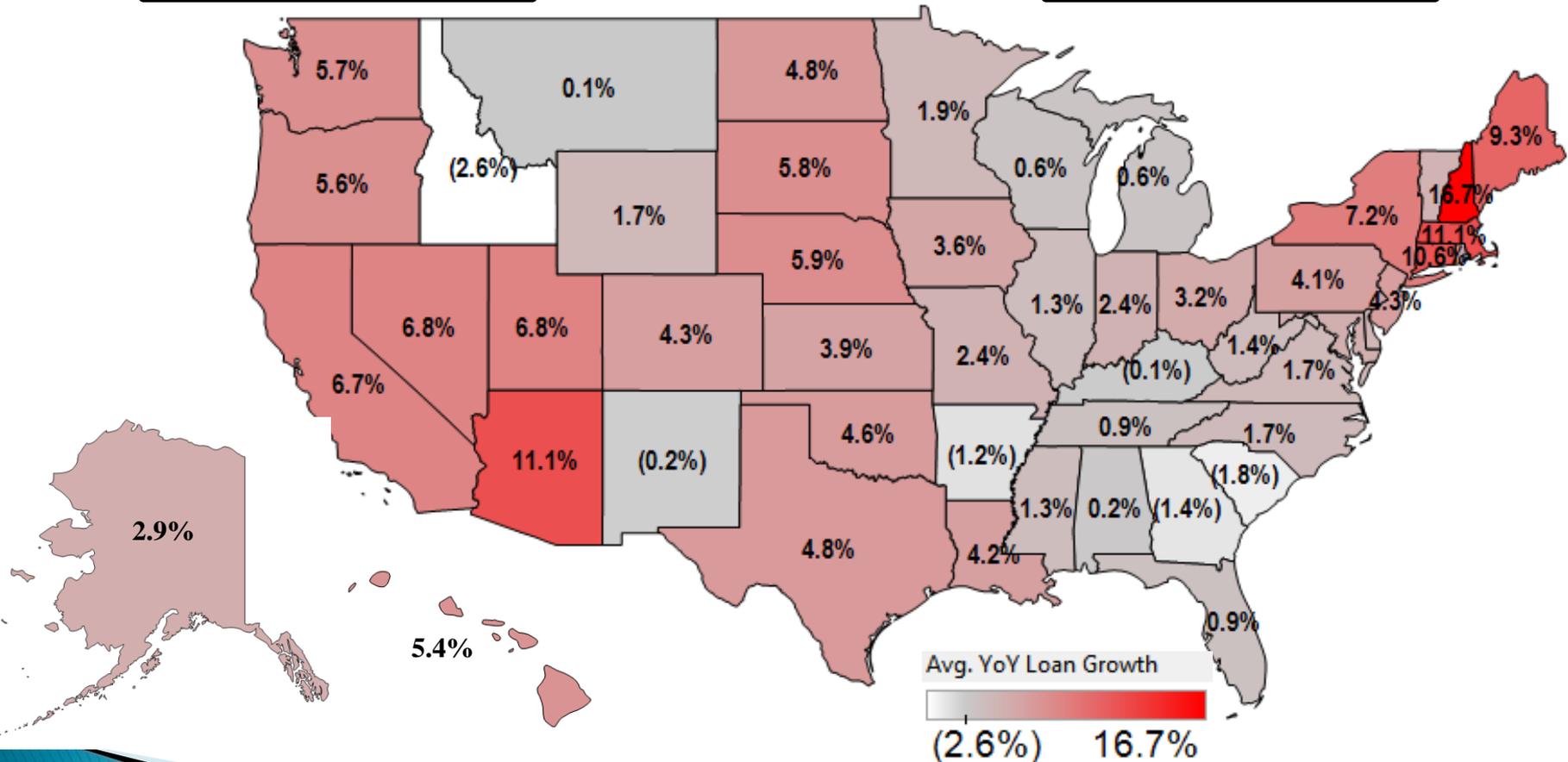
# Loan Growth up Broadly

AZ, CA, NV, & UT in the top 10 for average YoY loan growth

## 12<sup>th</sup> District Average Year-Over-Year Loan Growth through June 2013

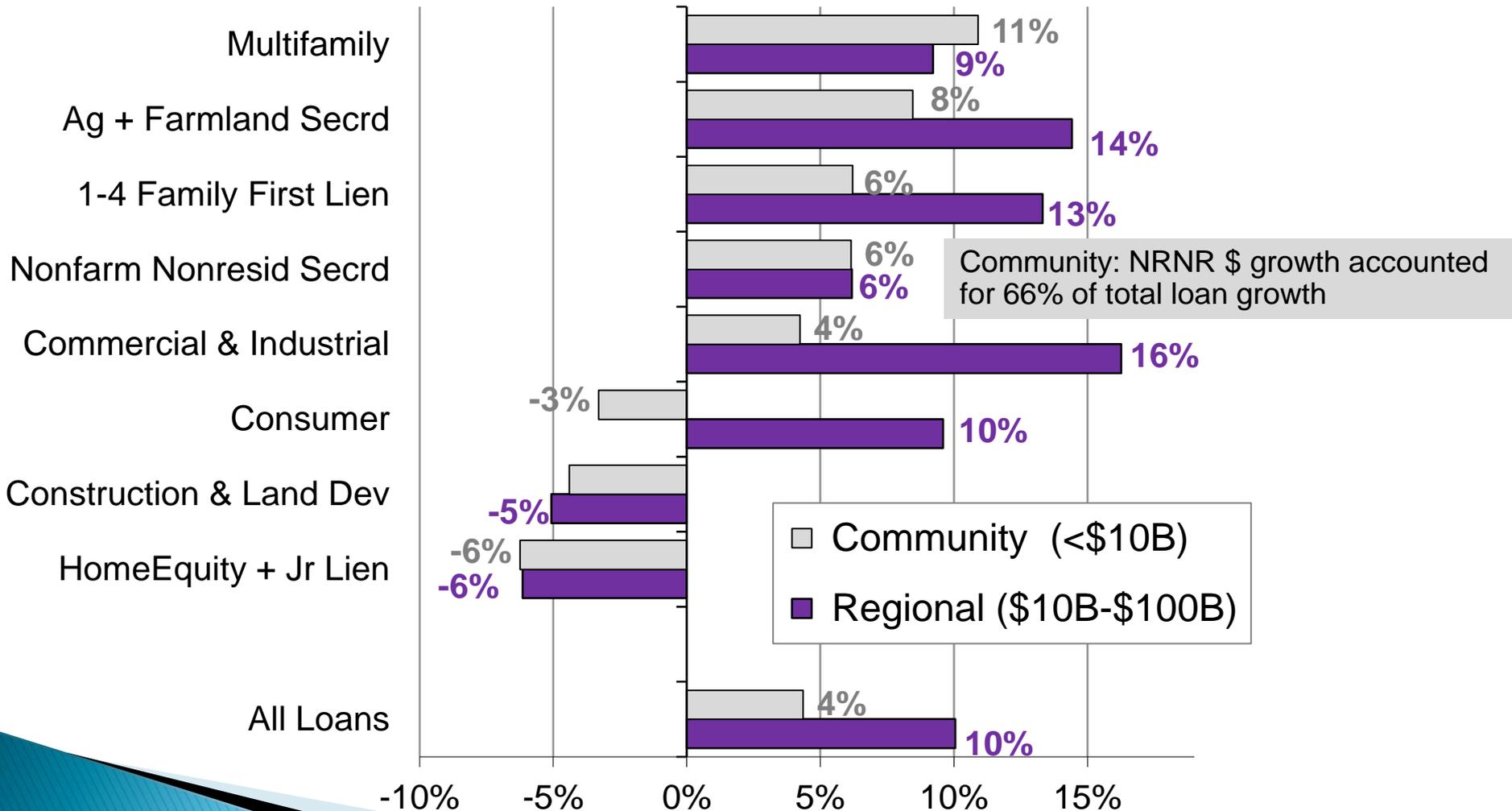
**12<sup>th</sup> District: 6.1%**

**Nation: 2.7%**



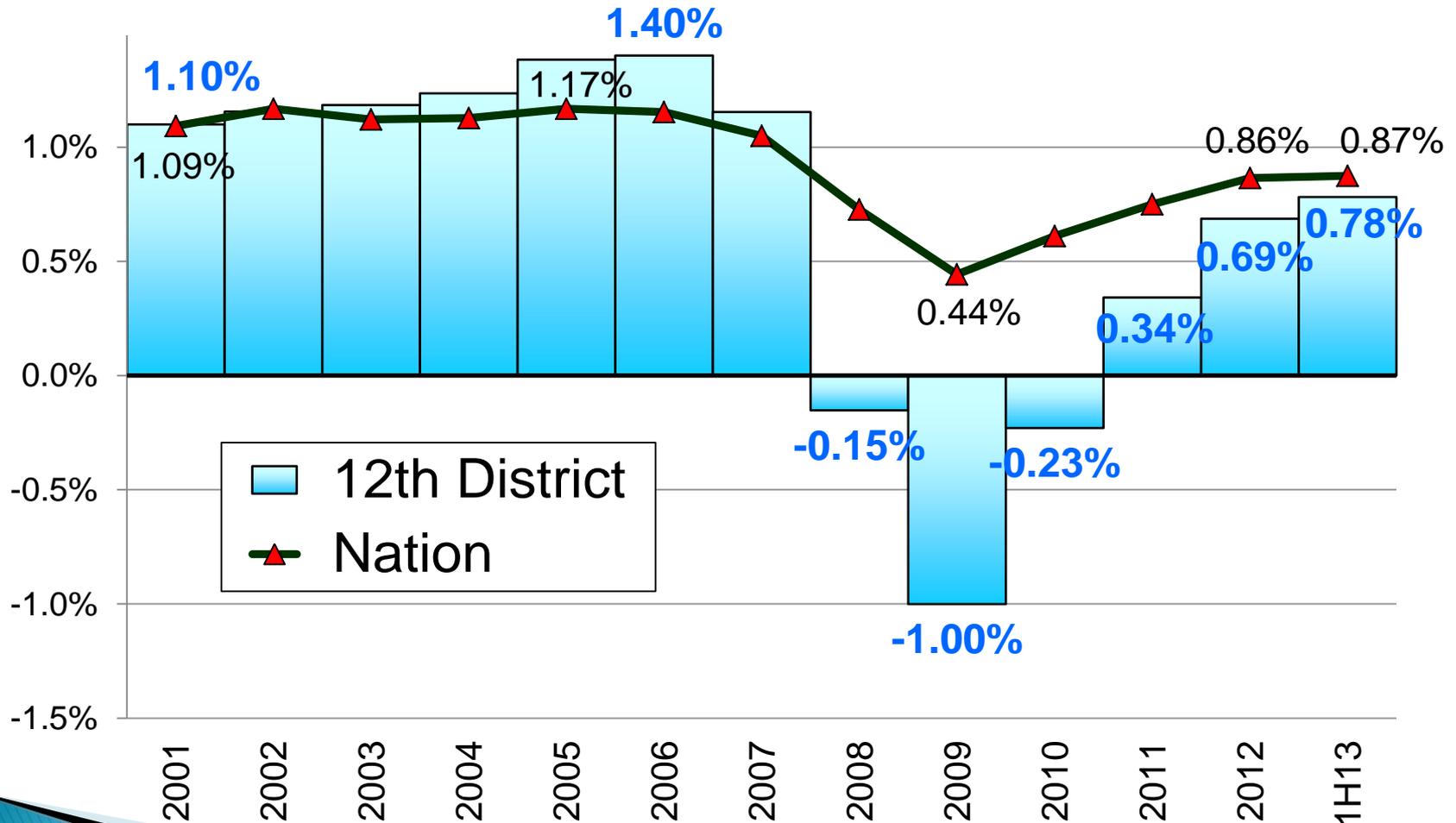
# Loan Types and Growth

## 12<sup>th</sup> District Bank Aggregate Annual Loan Growth Rates – 6/13



## II. Profitability & Credit Quality Recovering: ROAAs Continued to Improved

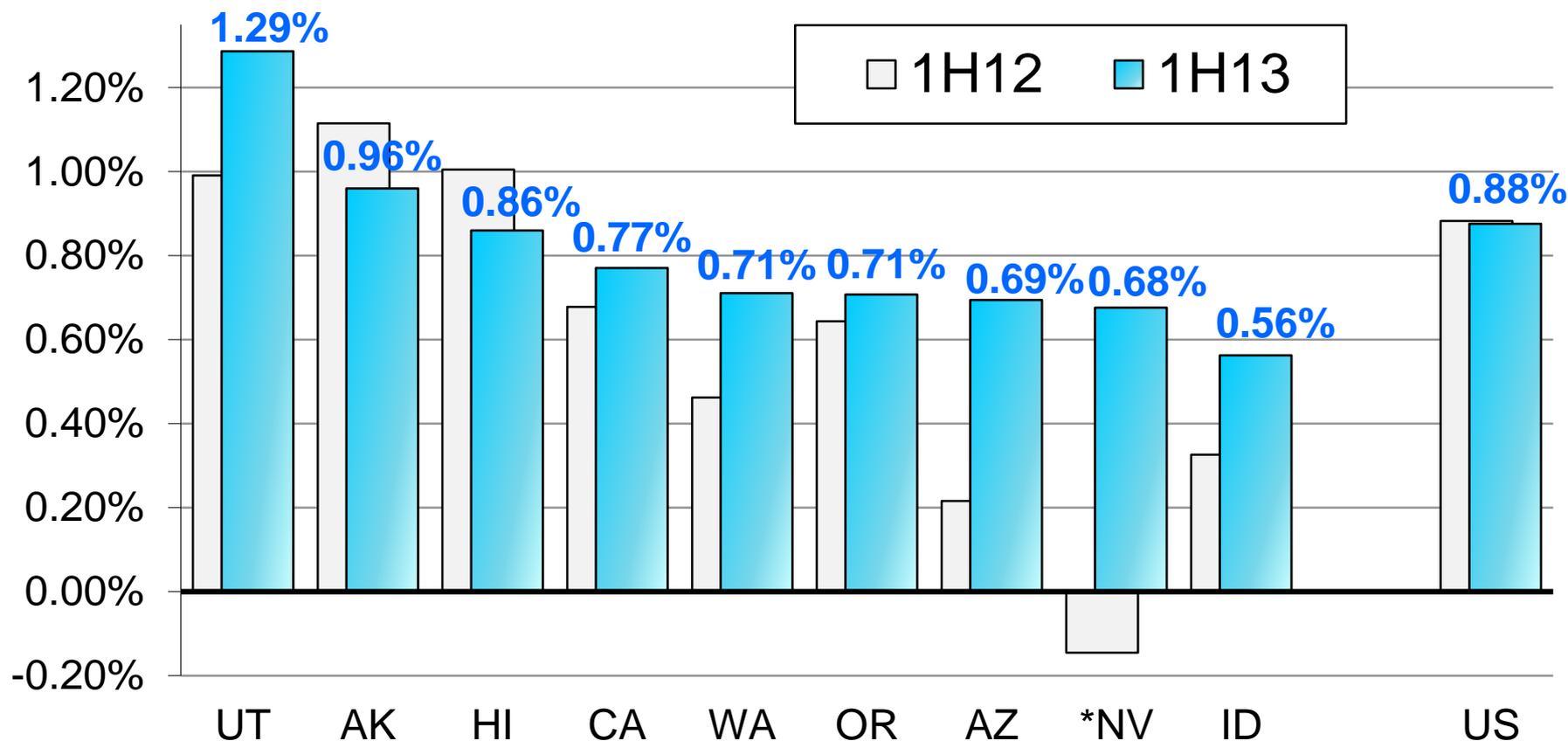
Average Return on Average Assets – YTD annual (%)



# Avg. ROAAs Improved in 7 of 9 Western States

*NV and AZ banks had the strongest rebound*

Average Return on Average Assets YTD Annualized (%)

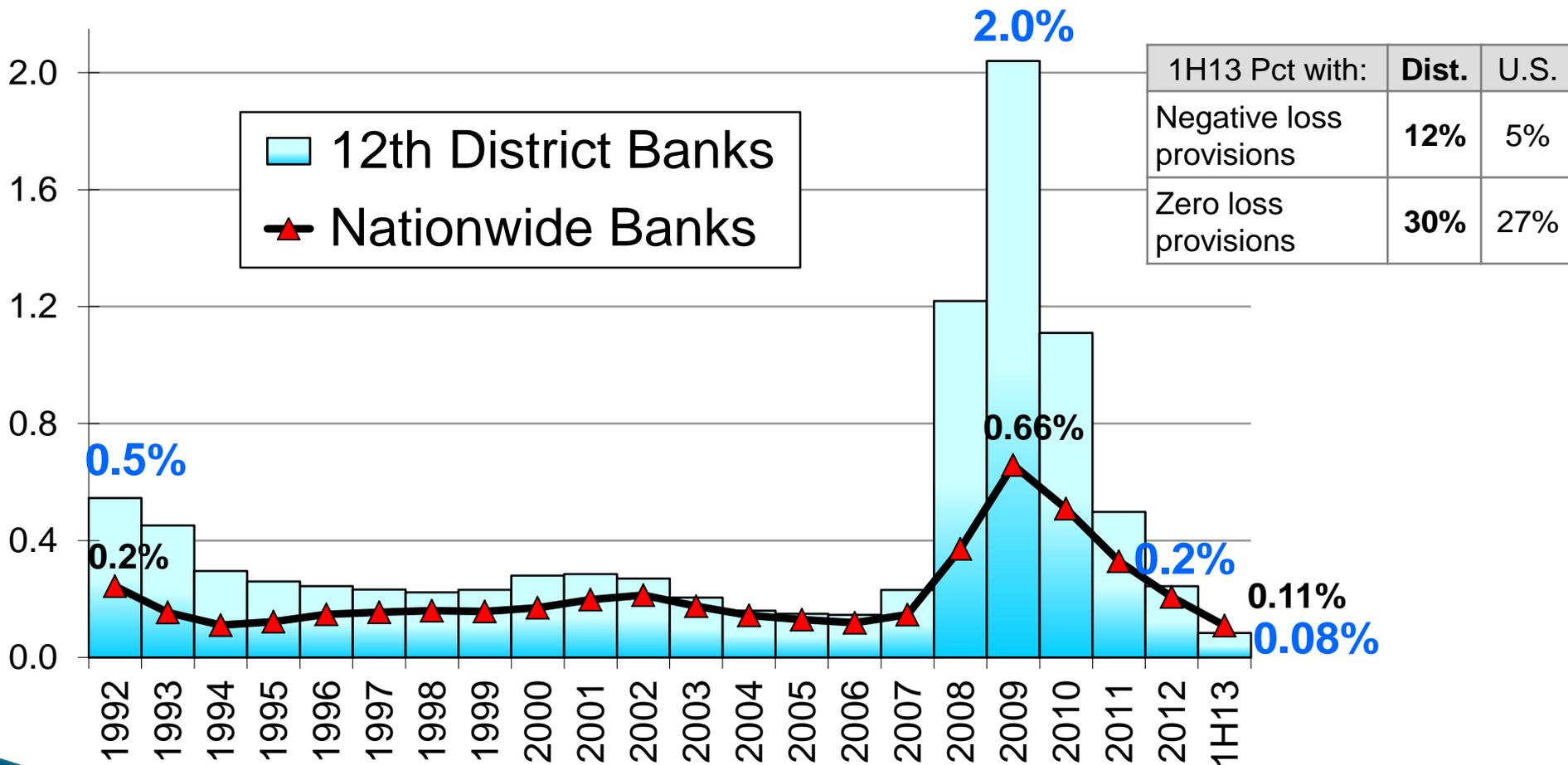


Based on commercial banks, excluding De Novos;  
trimmed mean ratios

\*NV: excludes credit card and zero-loan banks

# Boosting Bottom Lines, Loan Loss Provisions Dropped to 20+ Year Lows, on Average

Loan Loss Provisions/Average Assets (% - Adjusted Averages)



FRB-SF

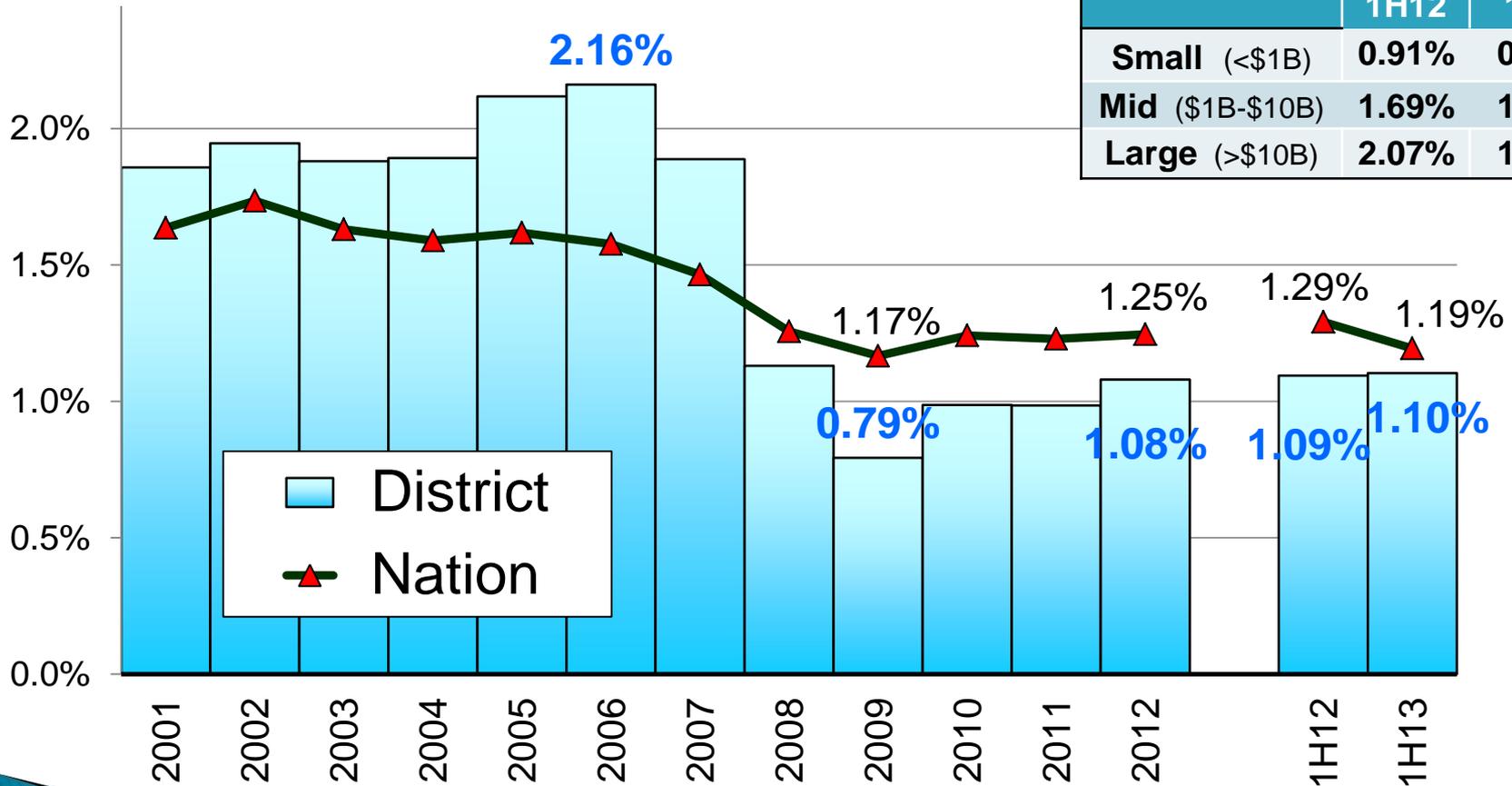
Based on:  
First Glance 12L - Aug. 2013

Based on commercial banks, excluding De Novos;  
trimmed means; 1H ratios are annualized

# District Bank Core Profitability: Up from '09, but Flat in the Past Year; Levels for Small Banks Remain Lackluster

## Core Profitability

(Pre-tax pre-provision income/avg. assets)

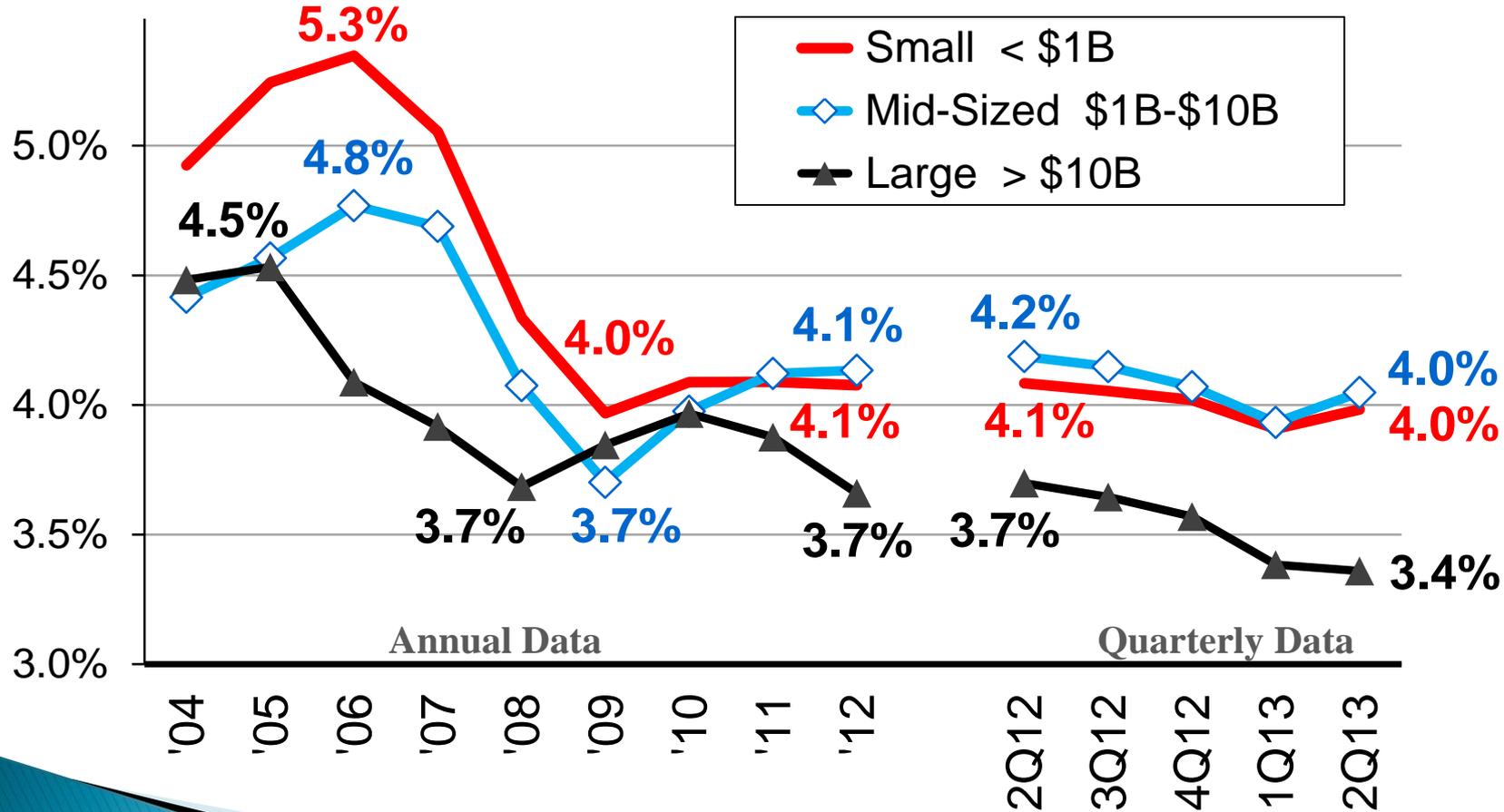


	1H12	1H13
<b>Small (&lt;\$1B)</b>	<b>0.91%</b>	<b>0.97%</b>
<b>Mid (\$1B-\$10B)</b>	<b>1.69%</b>	<b>1.61%</b>
<b>Large (&gt;\$10B)</b>	<b>2.07%</b>	<b>1.78%</b>

# Main Issue: Net Interest Margins Remained Narrow

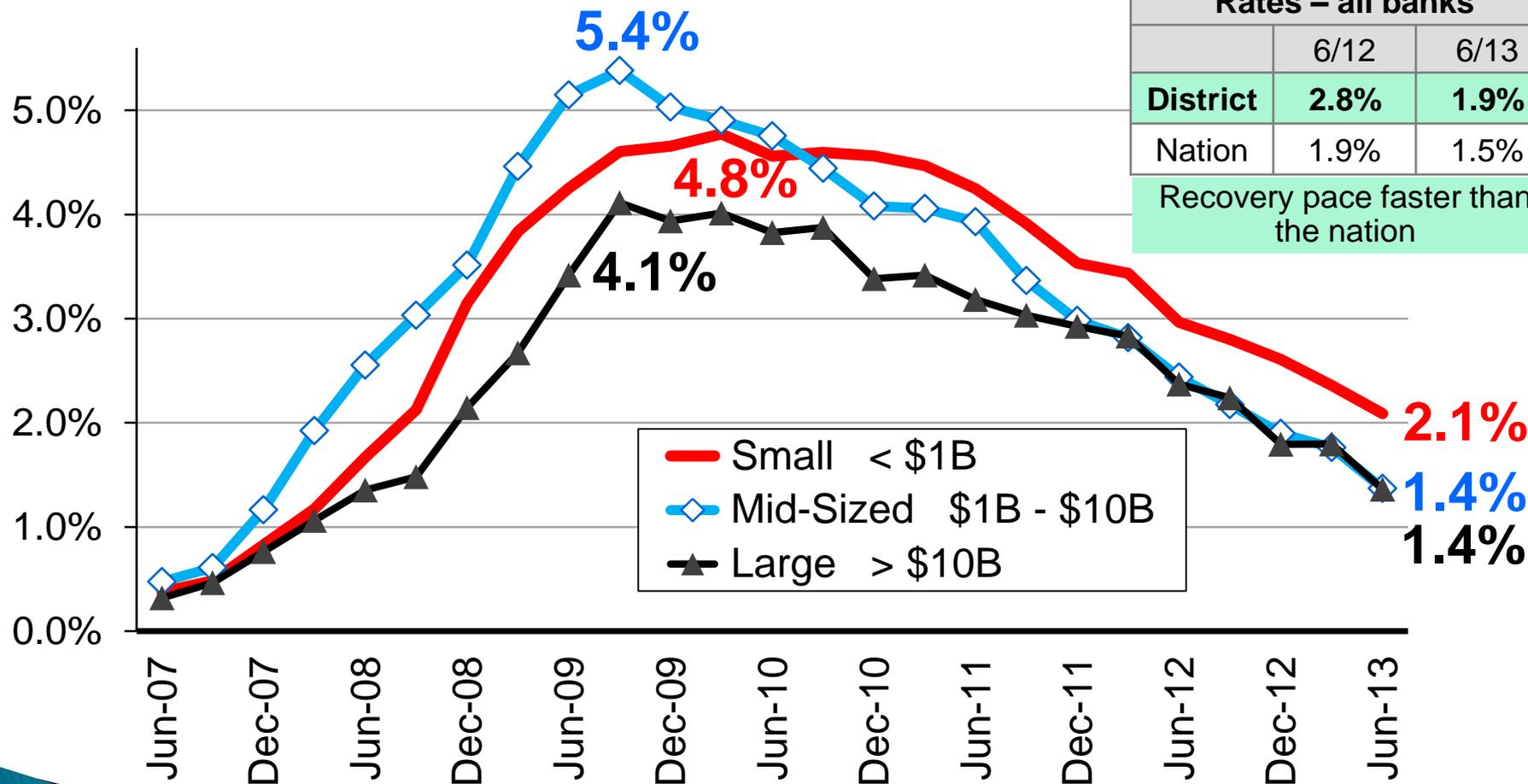
*Large bank NIMs fell further in 2Q13*

Net interest income (tax equiv) / average earning assets (NIM)  
12<sup>th</sup> District Commercial Banks



# Credit Quality: Noncurrent Rates Trending Down in All Size Groups; Small Banks Lag

## Average 12th District Bank Noncurrent Loan Rates



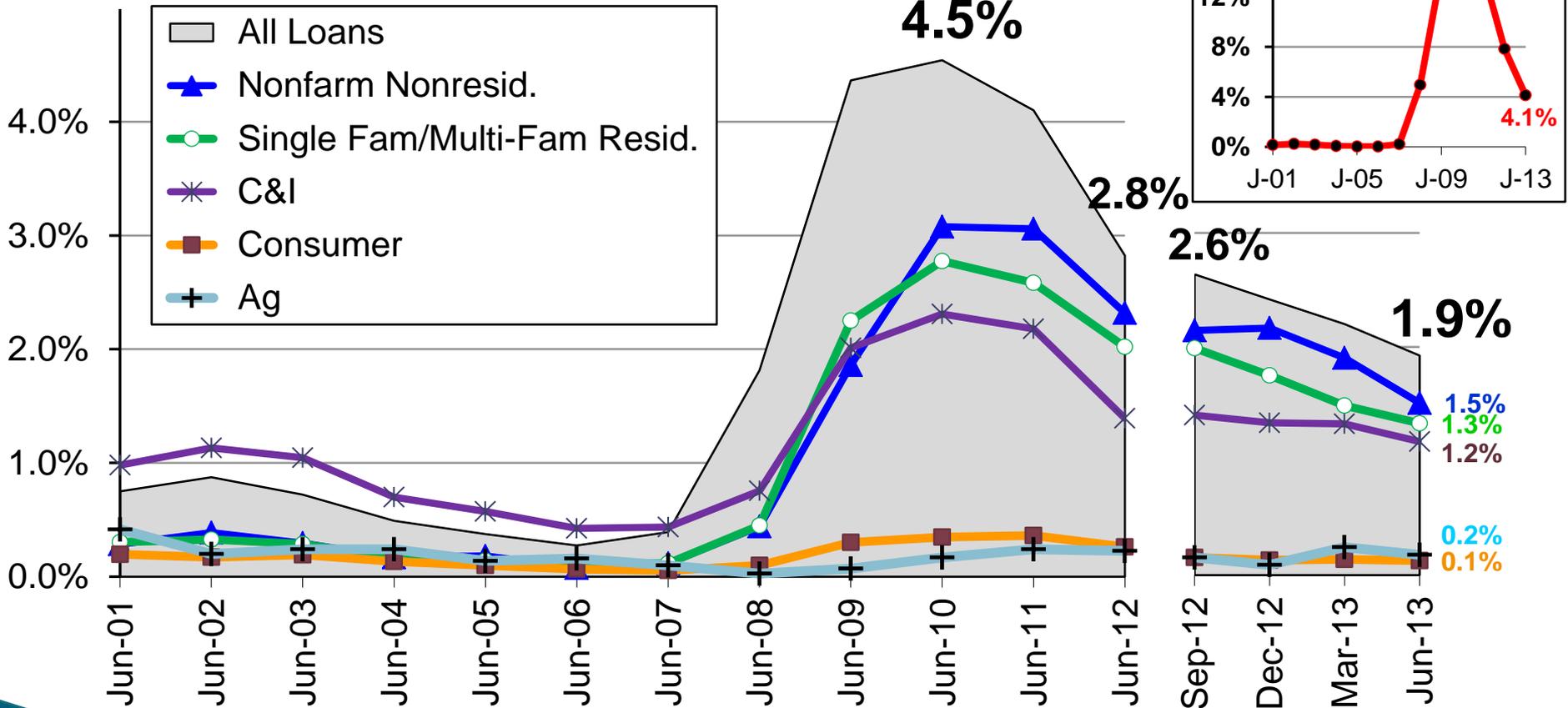
FRB-SF

Based on commercial banks, excluding De Novos; trimmed means; Noncurrent = 90 Days past due or on nonaccrual

# Avg. Noncurrent Rates by Loan Type

All improving; note: C&LD noncurrent rates are shown in inset chart

## Average 12<sup>th</sup> District Bank Noncurrent Loan Rates



Data as of 6/30 each year

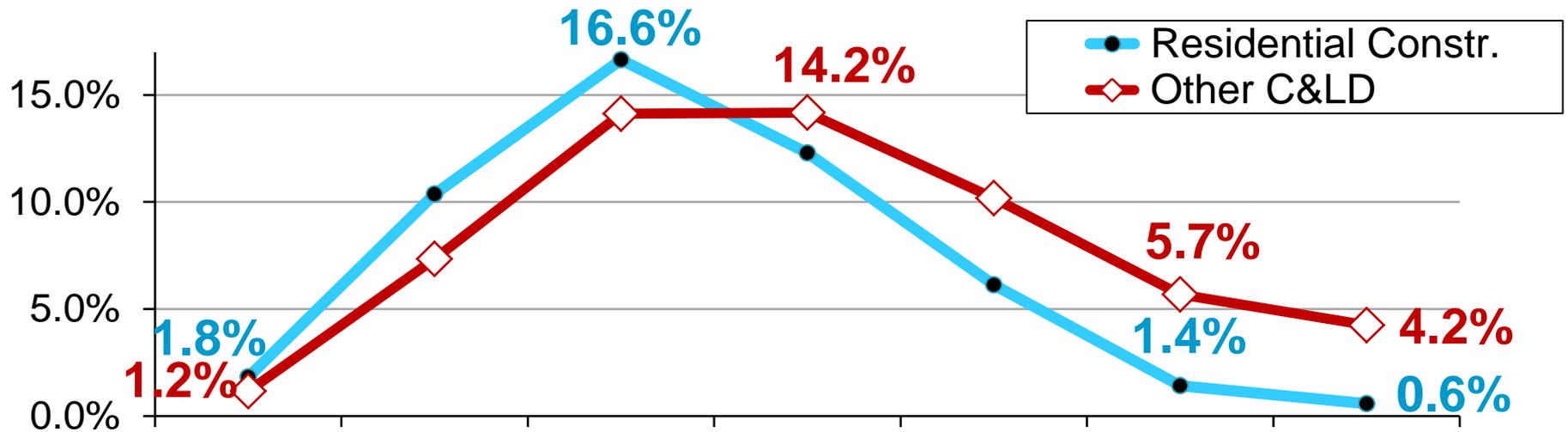
Quarterly Data

FRB-SF

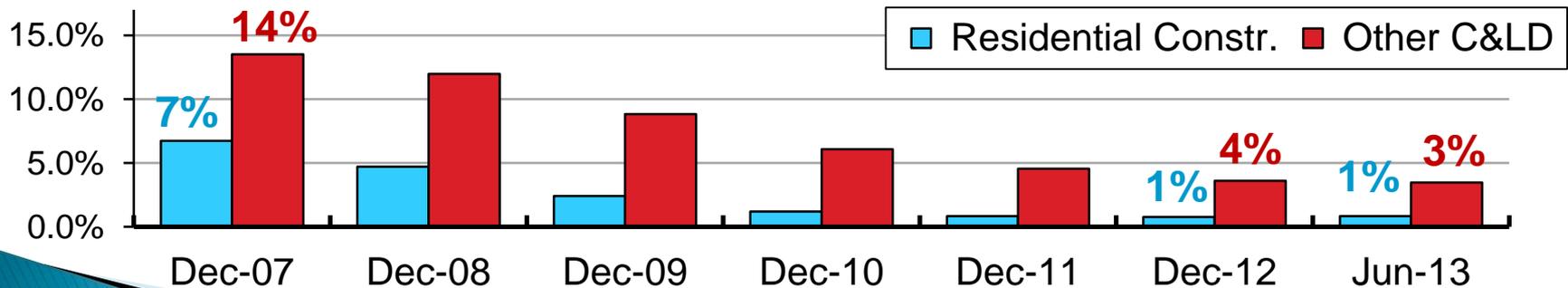
Based on commercial banks excluding De Novos; trimmed means; Noncurrent = Pct. of loans 90+ days past due or on nonaccrual

# C&LD: Residential Construction Loan Noncurrent Rate Fell Below 1%

Avg. Construction & Land Development Loan Noncurrent Rates – 12<sup>th</sup> Dist. Bks



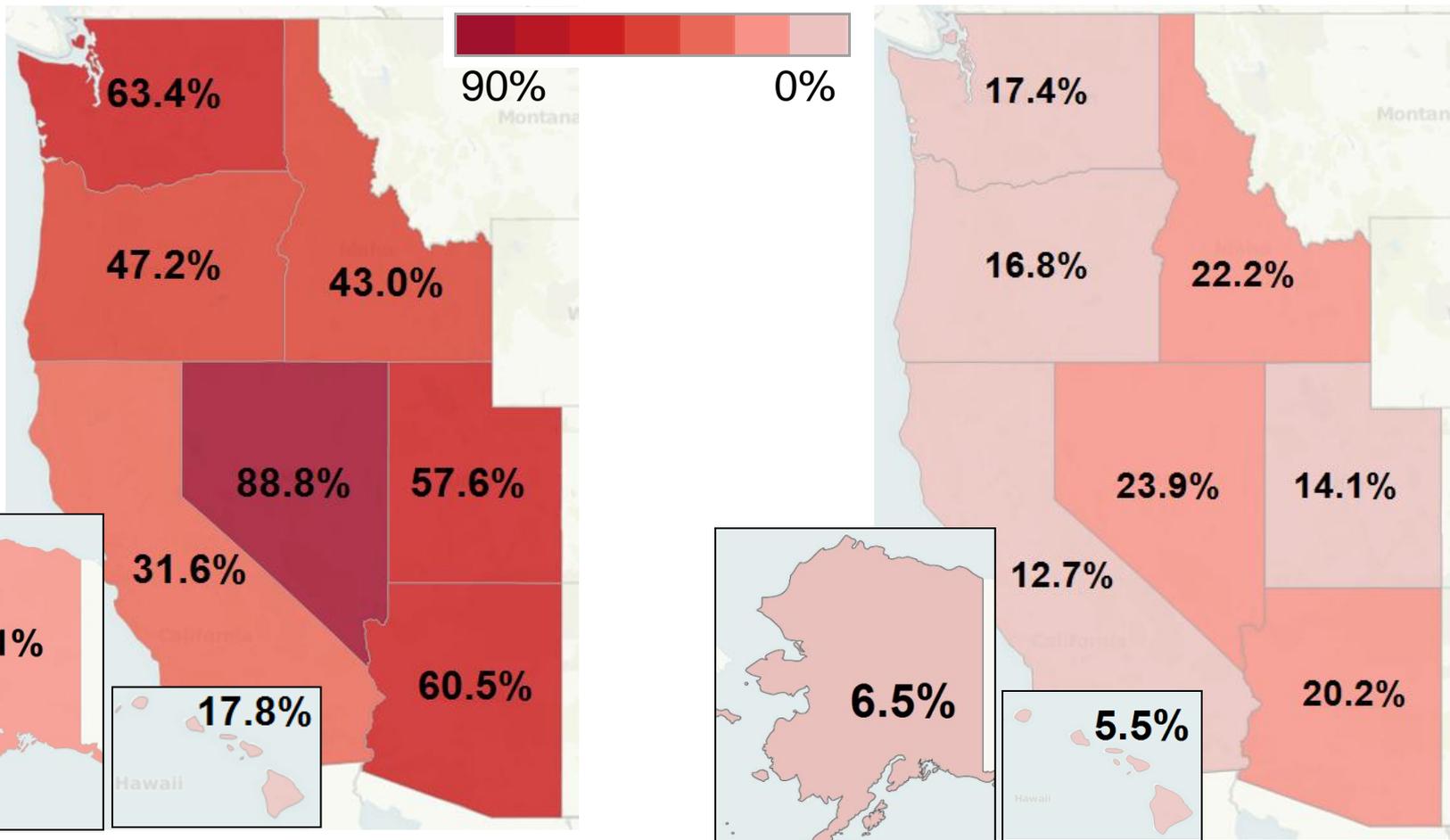
Avg. Loan Portfolio Mix: 12<sup>th</sup> District Banks – As % of Total Loans



# Average "Texas Ratios" Each State's Recession Peak vs. Now

Peak\*

June 2013

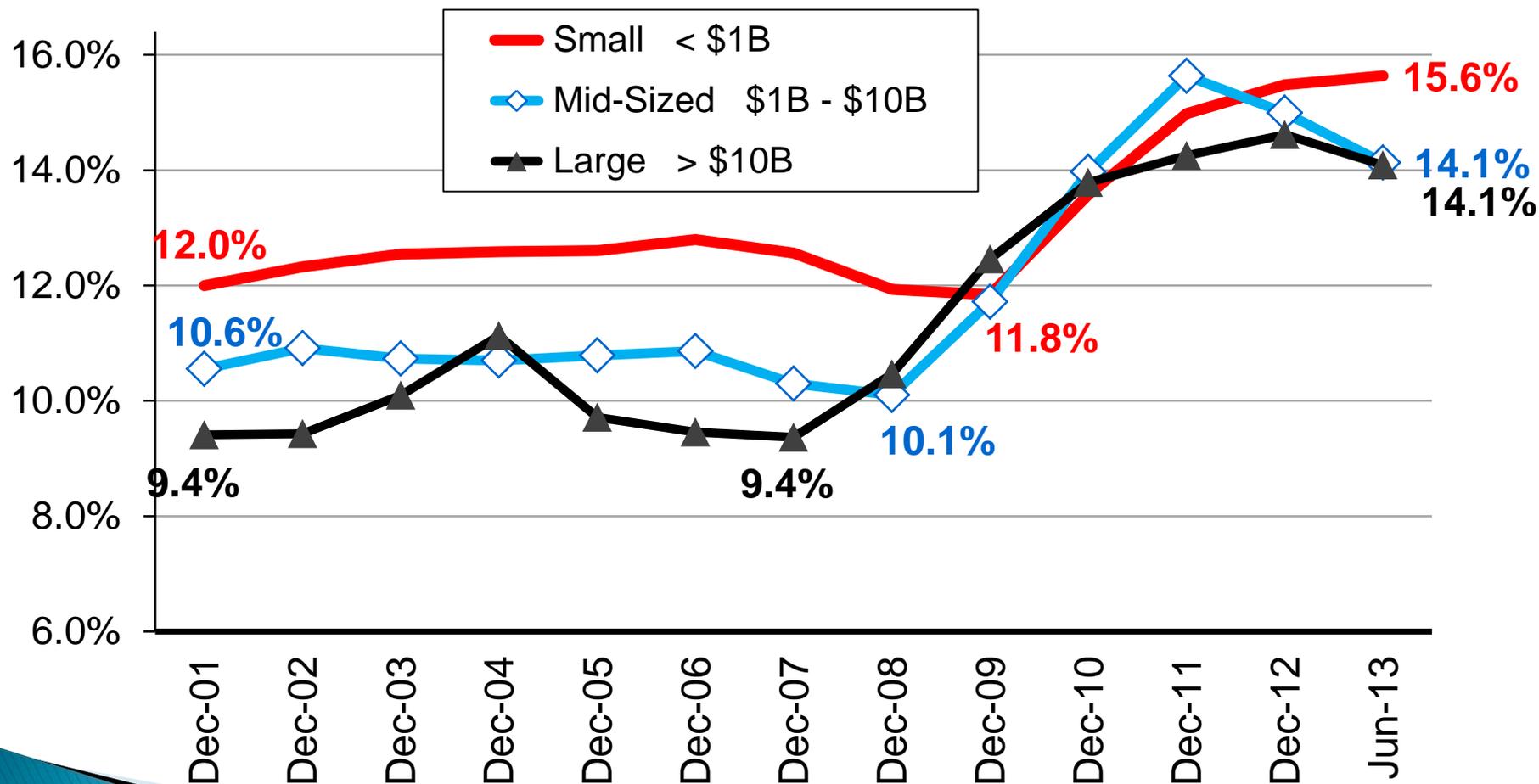


Texas Ratio: noncurrent loans + foreclosed real estate / equity + allowance for loan and lease losses; \*Peak ratios occurred from 9/09 to 3/11; commercial bank trimmed means, excluding De Novos

# Capital/Liquidity: Post Recession Build-up May be Over

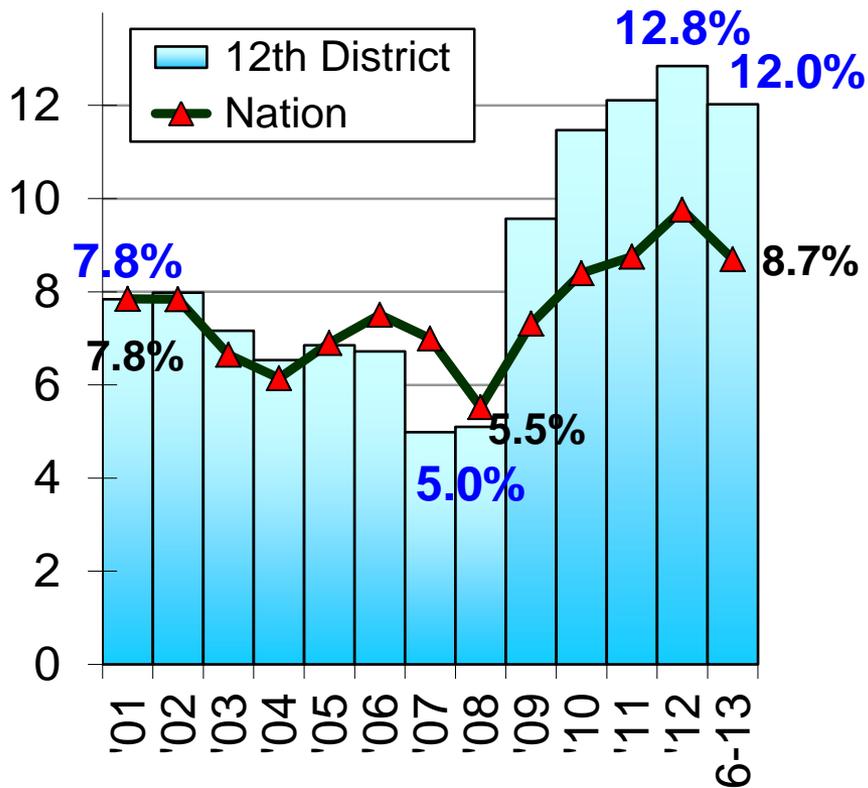
## Capital Ratios at a Turning Point as Loan Growth Accelerates?

Average District Bank Tier 1 Common Equity / Risk-Weighted Assets Ratios

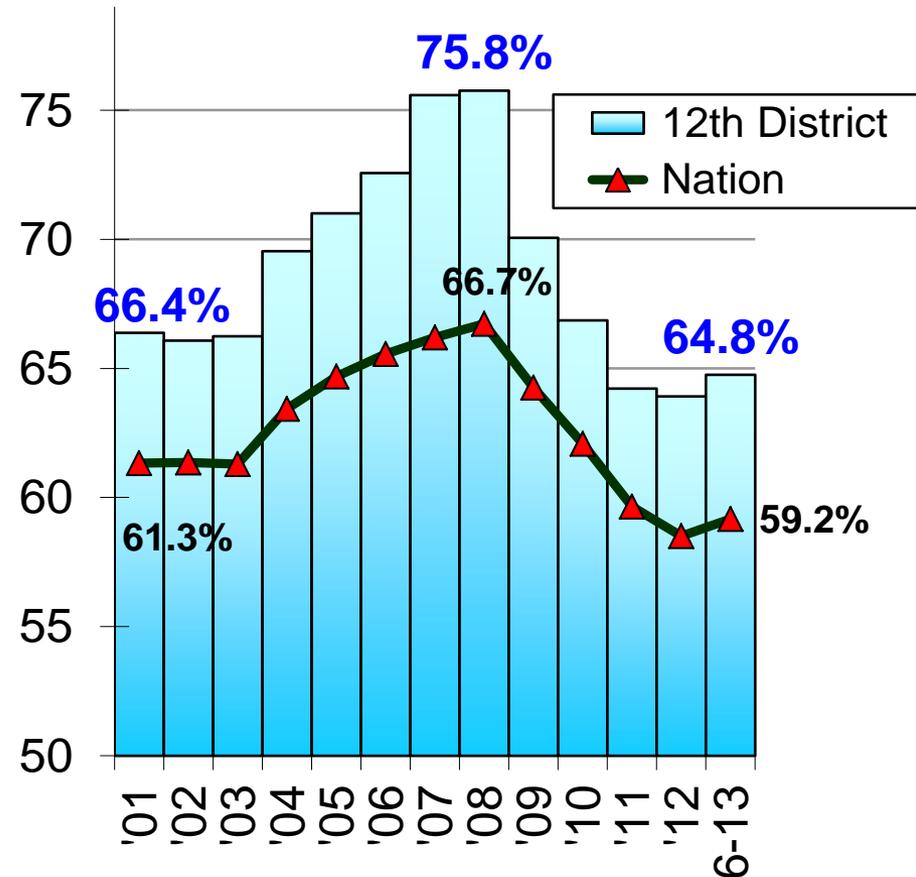


# Liquidity: Bank Liquidity Build-Up Also Appears Over with Stronger Loan Growth Through 2Q13

## Short-Term Investments/Assets (average %)



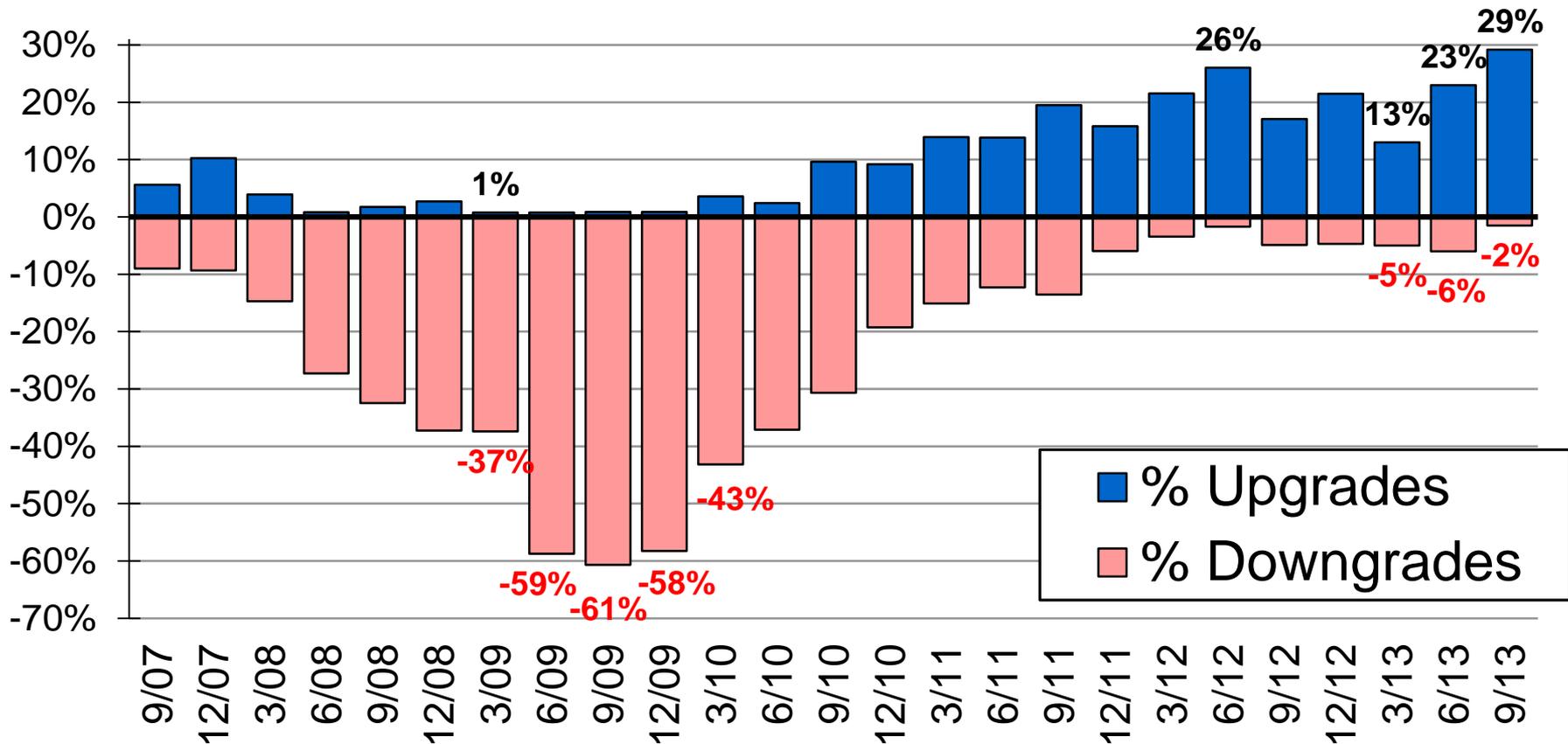
## Loans/Assets (adj. average %)



# IV. Regulatory Ratings Reflect Recovery

## CAMELS Upgrades Outpaced Downgrades for the Past 10 Quarters

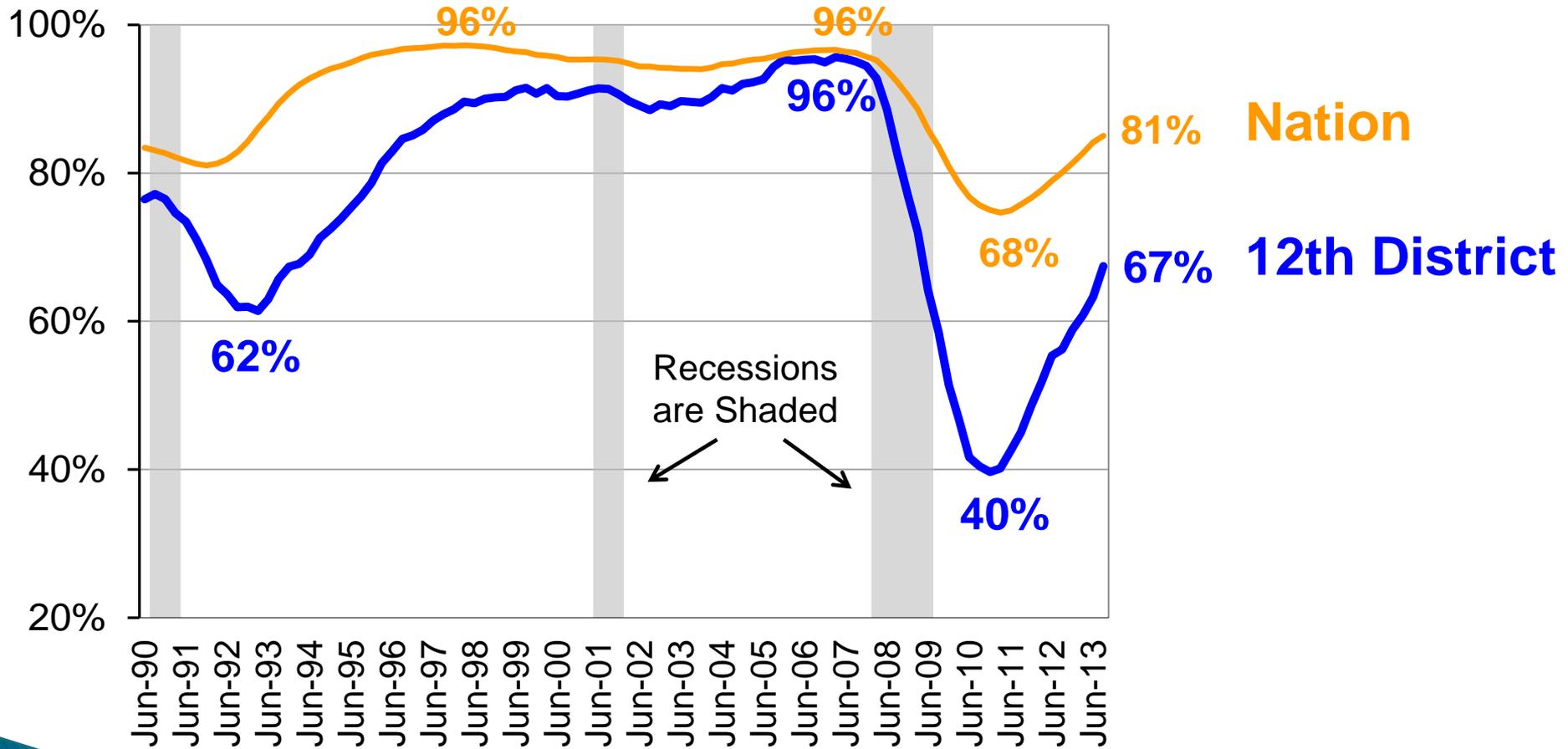
Pct. of 12<sup>th</sup> District Exams Each Quarter that Resulted in CAMELS Composite Rating Upgrade or Downgrade (downgrades are shown as negative percentages)



Includes any change in composite CAMELS rating for commercial banks; quarterly trends based on examination completion dates (mail dates); preliminary 3Q13 data; updated 09/11/13

# Percent of Banks Rated Satisfactory or Better

Percentage of District Banks with CAMELS ratings of "1" or "2"



Trends for all commercial banks based on examination completion dates (mail dates); preliminary recent figures including some 3Q13 exams; updated 9/11/13

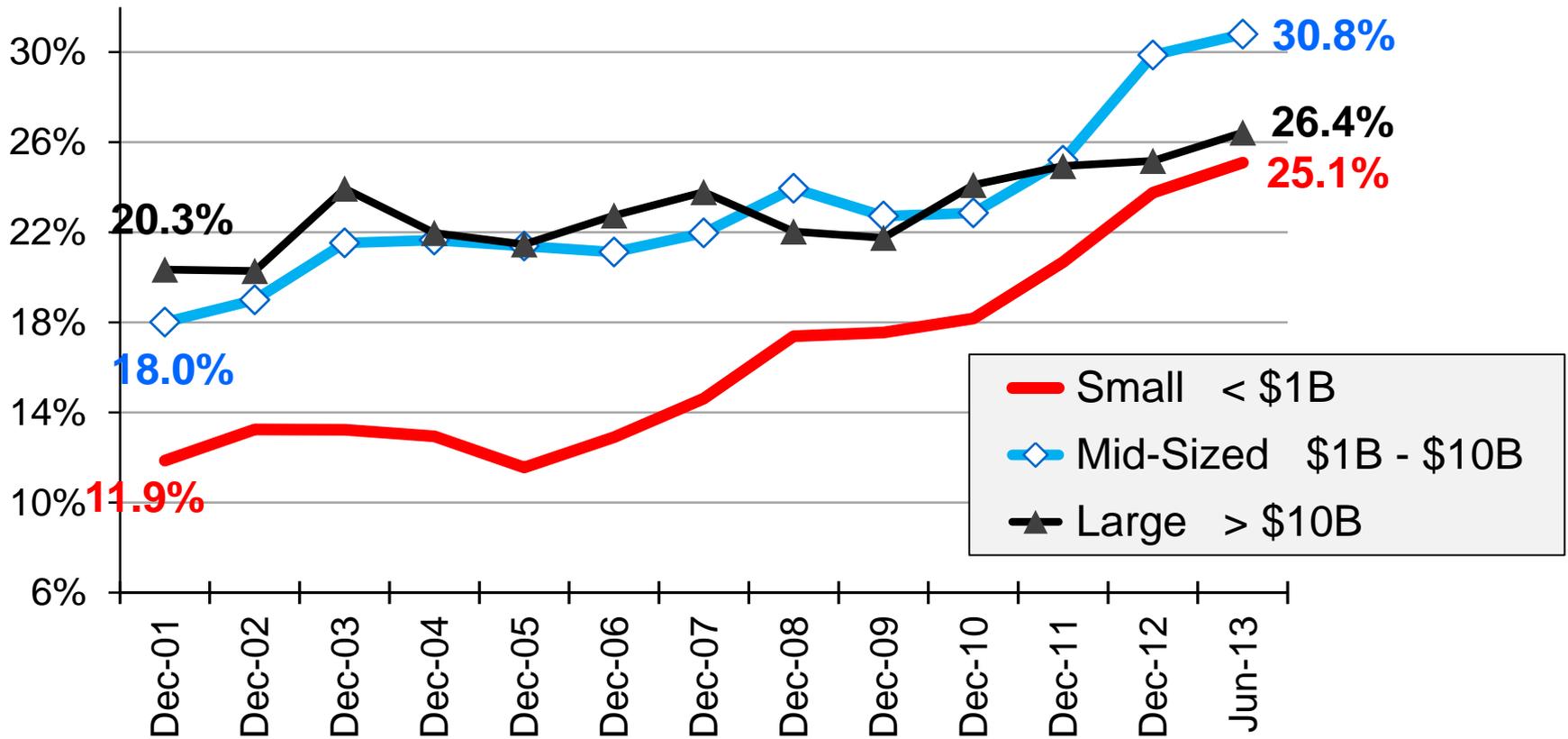
# V. Selected Bank Supervisors’ “Hot Topics”



# Interest Rate Risk: District Banks Extended Asset Maturities in Recent Years, Seeking Yield

*A concern mainly when a bank's overall balance sheet is vulnerable to rising rates*

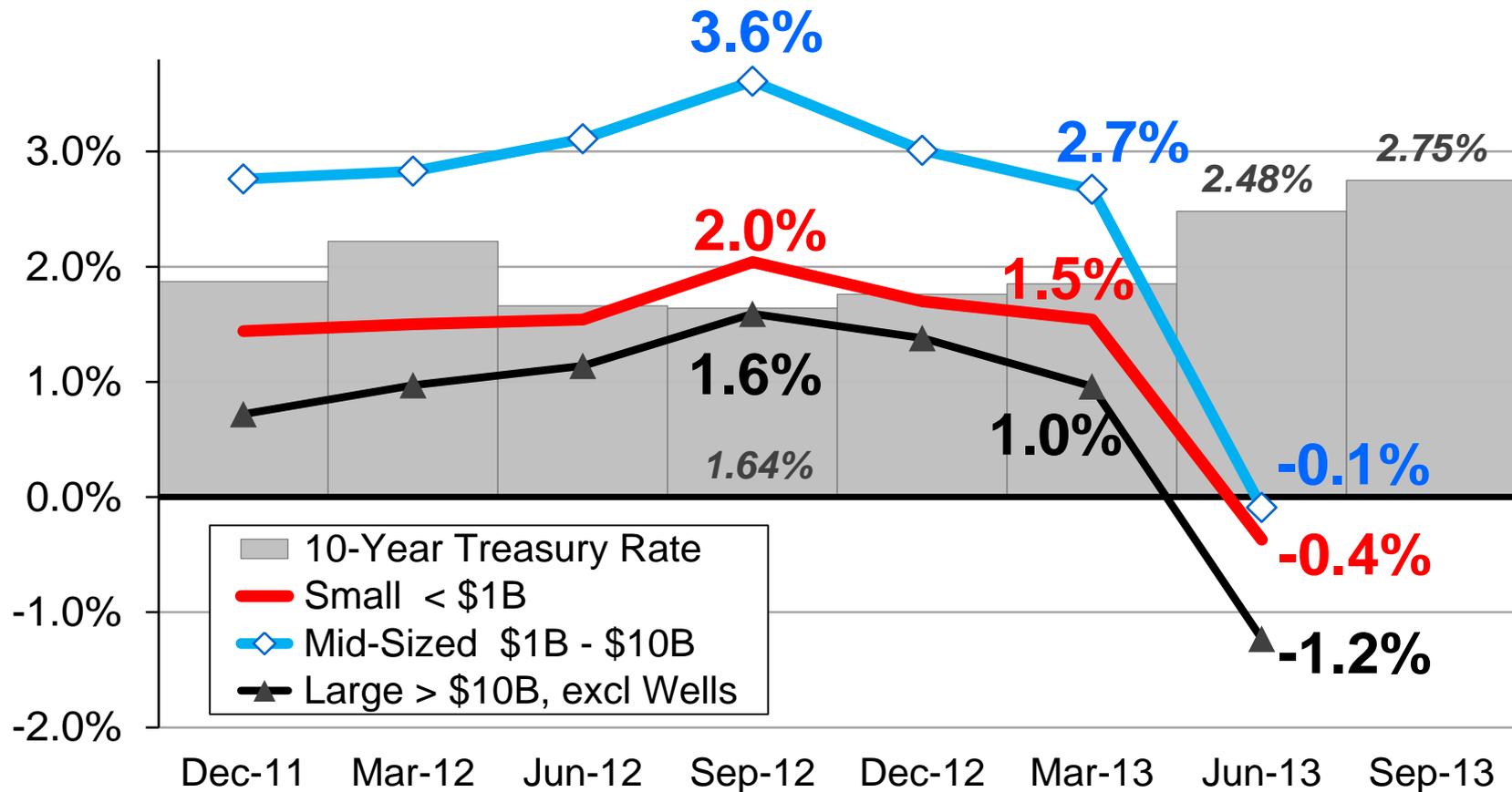
12<sup>th</sup> District Banks: Loans & Securities Maturing or Repricing > 5 Years / Assets



Based on aggregate data for all 12<sup>th</sup> District commercial banks active as of, and grouped into peer groups as of 6/30/13, with their information back in time

# Rising Rates Already Caused Net Unrealized Losses on Securities Across Banks of All Sizes

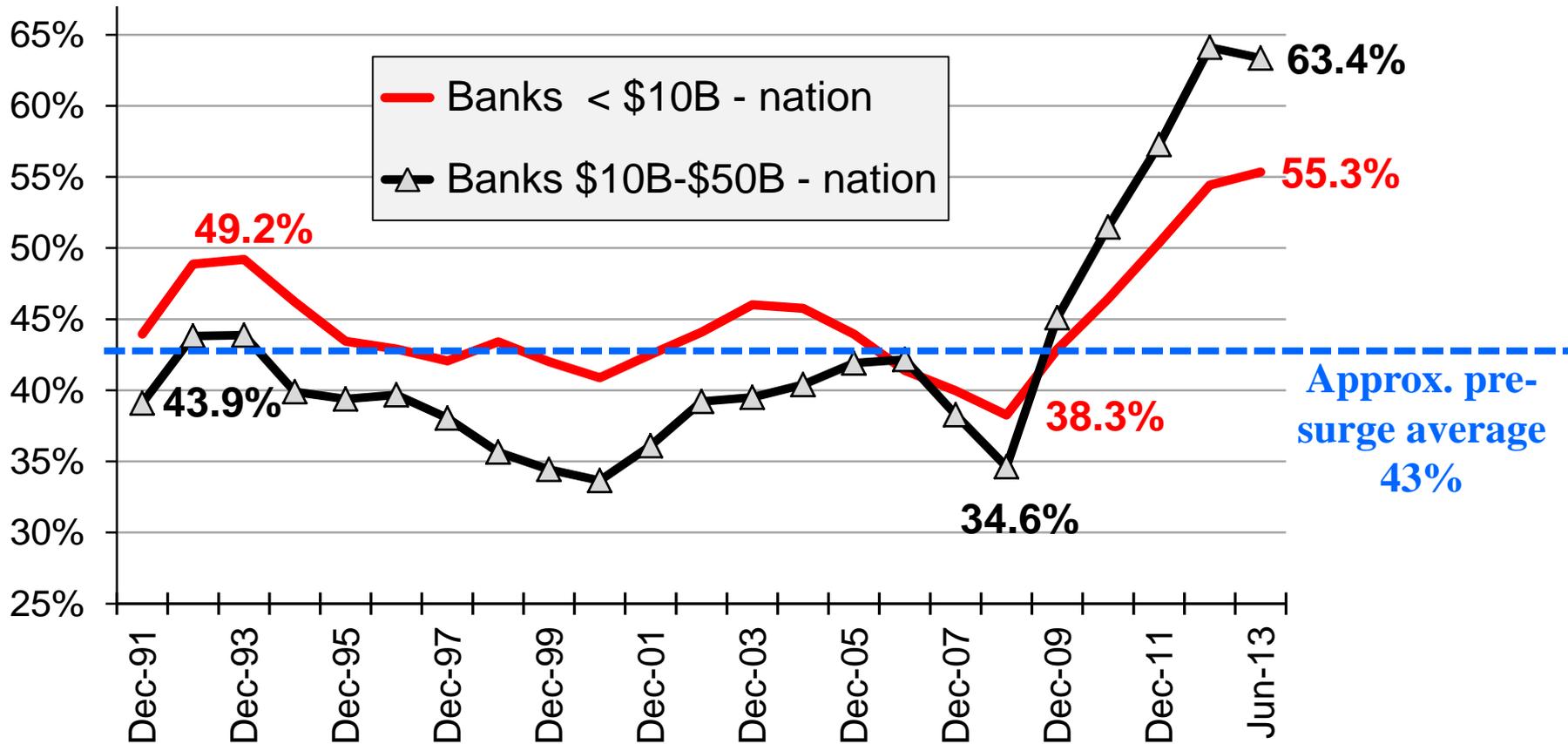
Unrealized Gains (Losses) on all Securities / Equity – District Banks in Aggregate



Based on a panel of commercial banks active over this period, excluding De Novos  
 10-yr treasury constant on last day of each qtr. Yahoo Finance ticker ^TNX - latest data as of 9/19/13

# Interest Rate Risk Analysis Needs to Consider Likely Outflows of Non-Maturity Deposits as Rates Rise

Non-Maturity Deposits / Total Assets - Nationwide Bank Aggregates

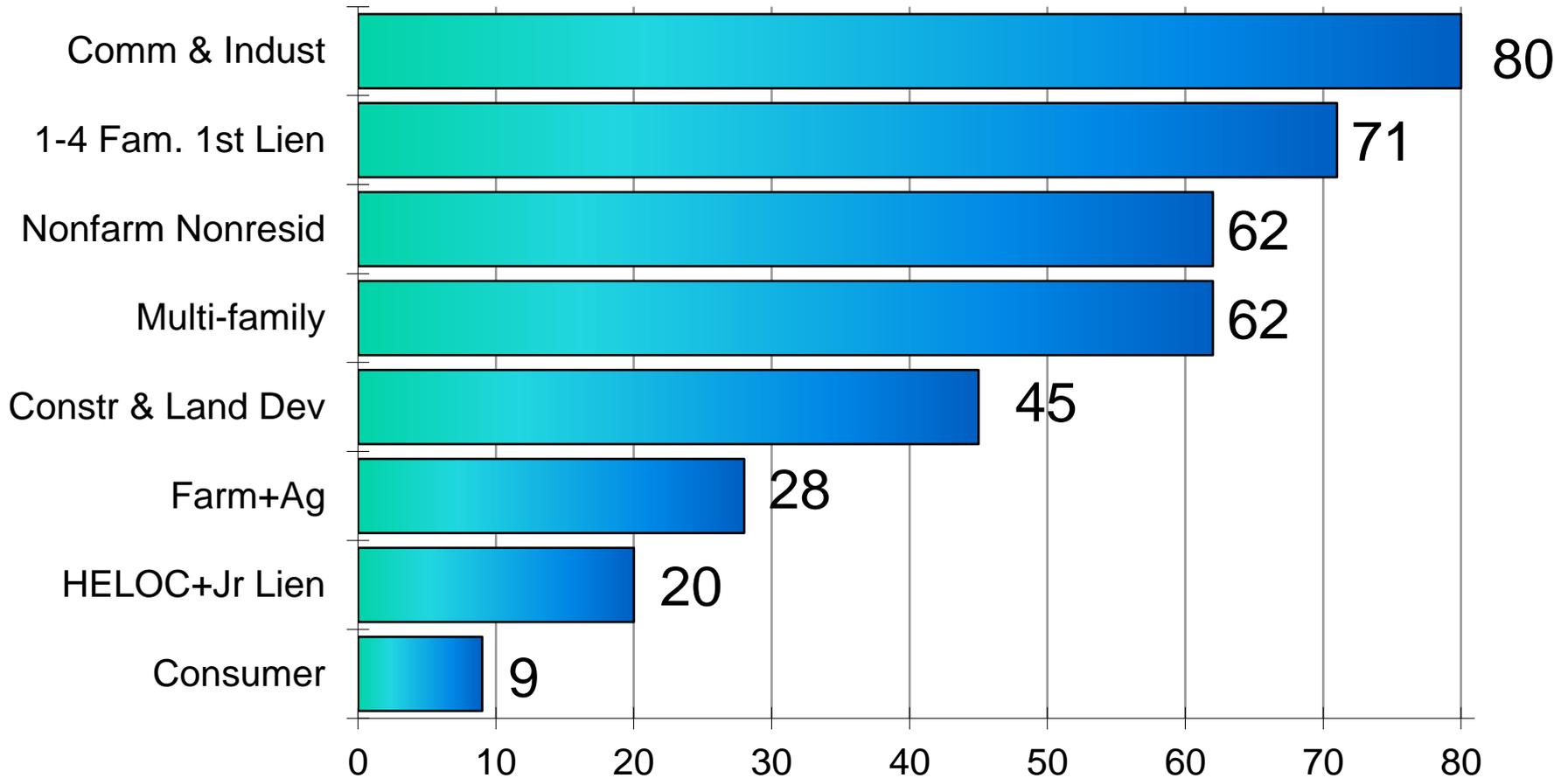


## Rapid Loan Growth: at Some Banks

- Loan growth is a welcome sign of recovery
- Relaxation of underwriting standards is generally appropriate
- Concern: underwriting standards and loan pricing may be compromised by competitive pressures or growth objectives
- High loan growth rates are statistically correlated with future credit problems
- Examiners will generally look more closely at underwriting at banks with high loan origination rates and those entering new lending areas

# Number of District Banks with High Loan Growth Rates

# of District Banks\* With >20% YoY Growth by Loan Type - 6/30/13



\* Based on a panel of 341 District commercial banks without significant mergers, loan sales or loan purchases over the period. Each bar above is based on banks with at least 4% of loans in the particular loan type

# Other Bank Supervisors' Hot Topics Include

## ■ Information Security – Cyber Attacks

- Distributed denial of service attacks
- Account takeovers/fraudulent funds transfers
- Vendor security
- Targeted attacks against bank employees to steal or destroy data, or disable systems

## ■ Model Risk Management

- Supervisory Guidance on Model Risk Management - OCC 2011-12 and FRS SR 11-7
- Many banks found not aligned with guidance – e.g.
  - Governance structure weaknesses
  - Incomplete / erroneous model inventories, model documentation
  - Model validation weaknesses
- Applies to all institutions, although current supervisory focus is banking institutions >\$10B in assets

“Banking organizations should be attentive to the possible adverse consequences (including financial loss) of decisions based on models that are incorrect or misused, and should address those consequences through active model risk management” SR 11-7

# Banking Outlook

- With moderately growing economy & better housing market, credit quality should continue to strengthen
- Profitability should continue to climb as loans replace lower earning assets, & problem credits further decline
- Low interest rate environment may keep NIMs compressed for some time; but steeper yield curve is generally a positive
  - *Some banks may be negatively impacted by rising rates*
- Hit harder by recession, 12<sup>th</sup> District banks have momentum to soon have stronger profits and loan quality than national averages
- Extrapolating trends, by YE2015 <10% of District banks should have less than satisfactory CAMELS ratings

# Questions / Comments?

# Appendix: Recent Growth in the M2 Money Supply Remains Close to the Long Run Average Growth Rate

## Money Supply and Inflation

Year-over-year growth

