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New England Banking Conditions

Regional & Community Bankers Conference

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Laura Rogers, Senior Examiner

LauraDuhamel.Rogers@bos.frb.org

Presentation available at: www.bos.frb.org/bankinfo/conevent/index.htm

Characteristics of New England Regional and Community Banks

Regional Banks

$1 and $10 billion plus Banknorth

- 30 banks
- $80 billion combined assets

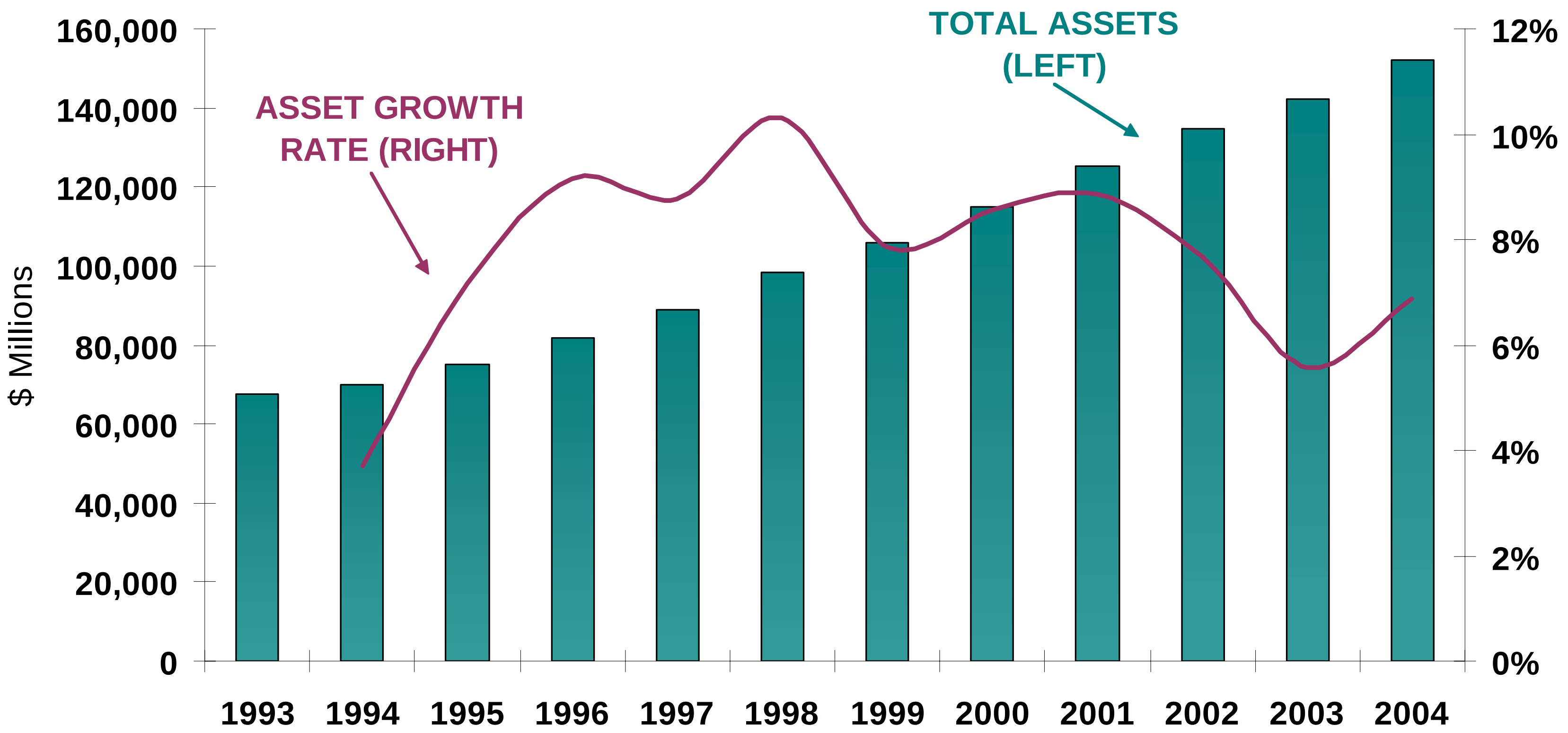
Community Banks

Less than $1 billion

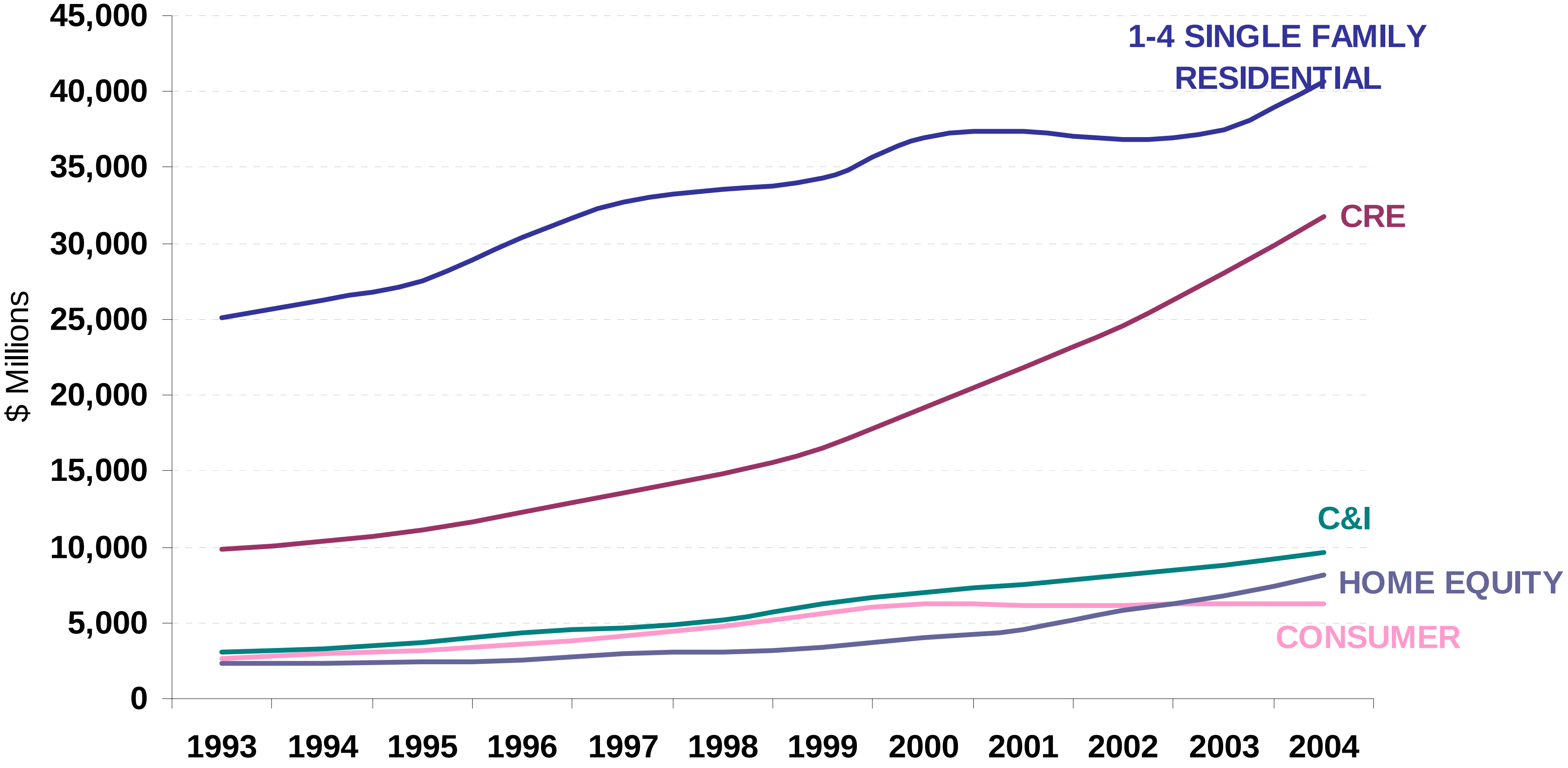
- 240 banks
- $72 billion combined assets

Note: All bank financial data are merger adjusted (historical data for existing institutions and their legacy banks). S&Ls are excluded. Bank financial information is derived from FDIC call reports unless otherwise specified.

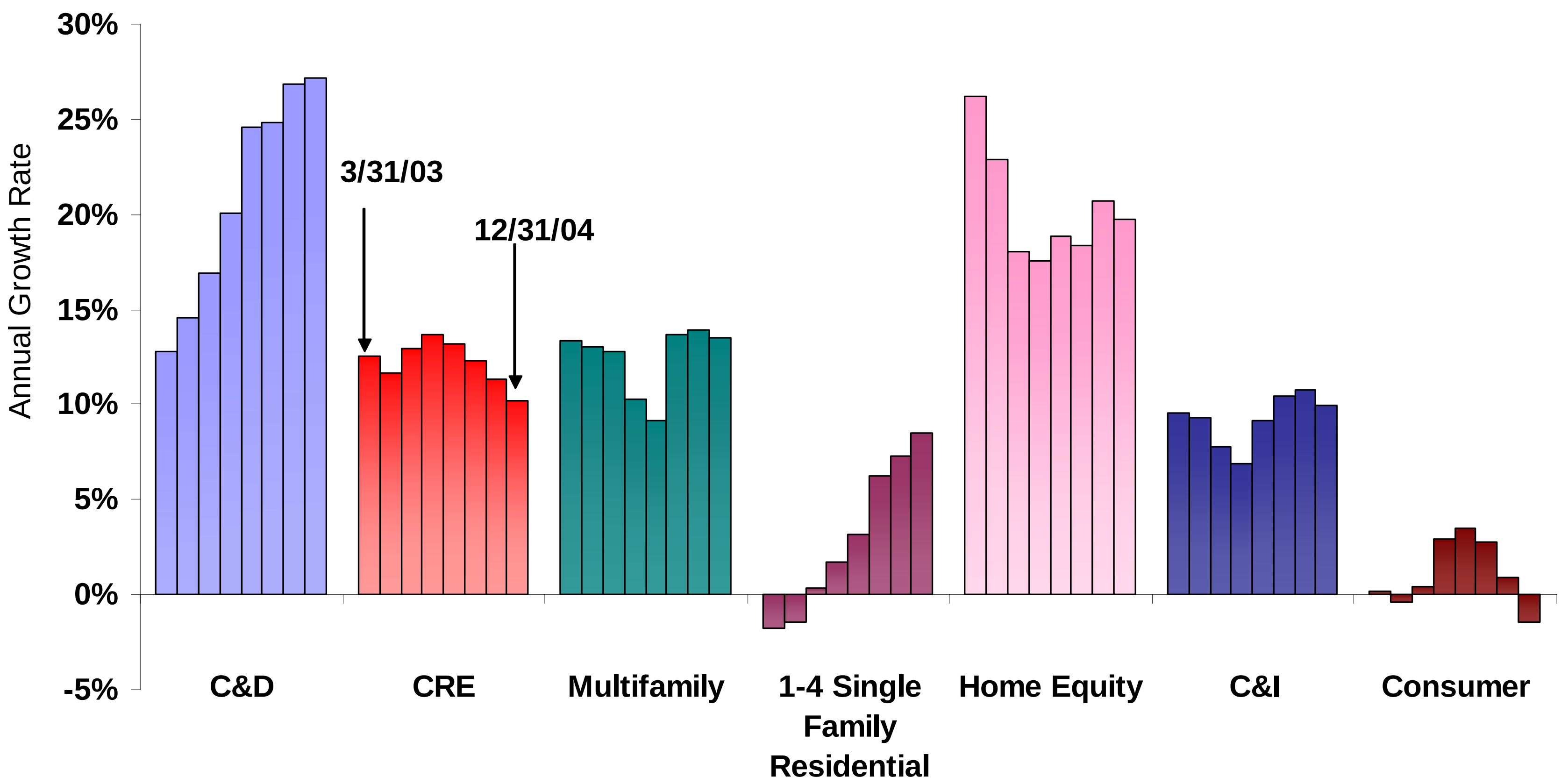
Asset growth more robust this year lead by strong loan growth



$9 billion loan growth with CRE continuing to climb and banks again holding residential



Total loan growth surged more than 3% to 10.6% with return to SFR growth...strong housing market evident in construction and home equity growth



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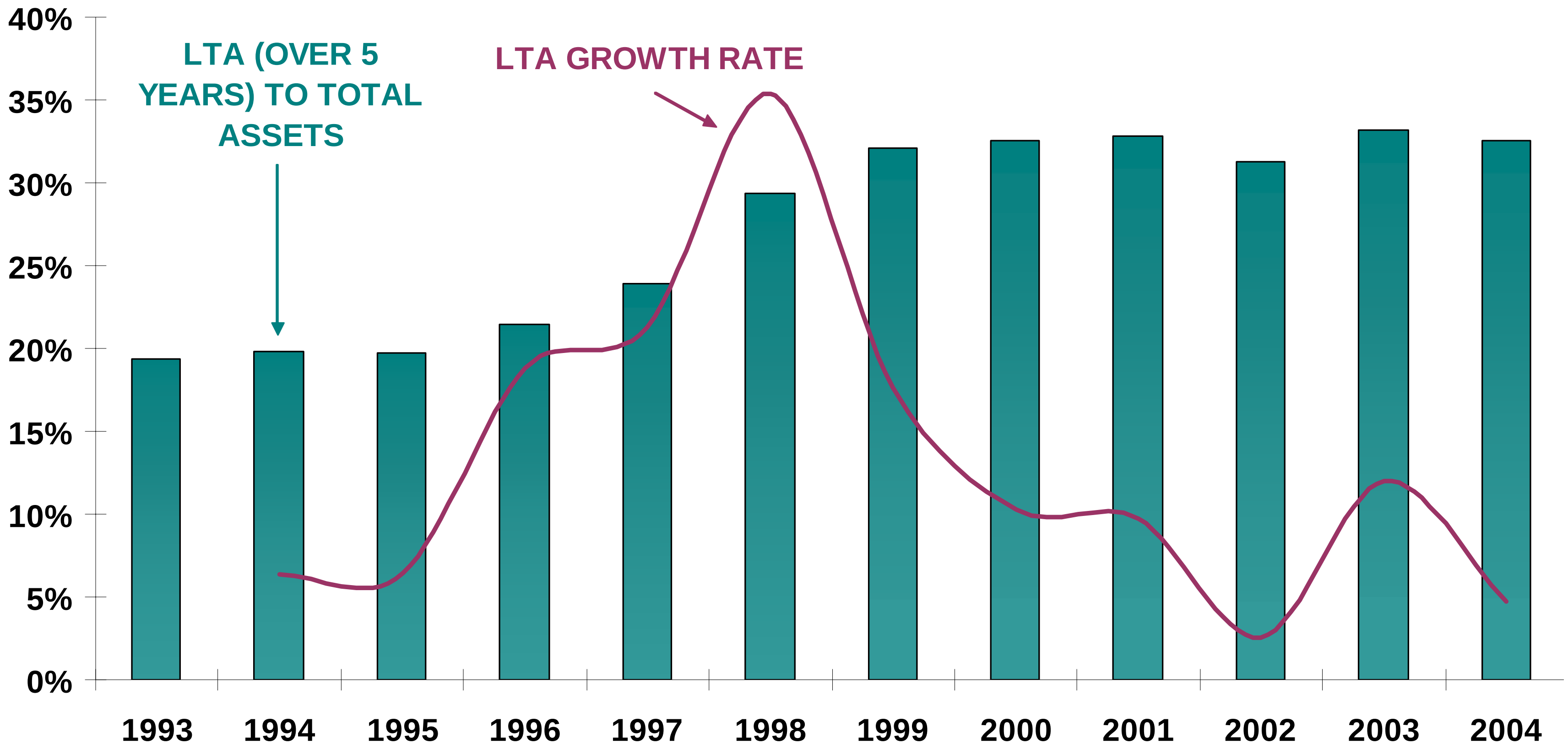
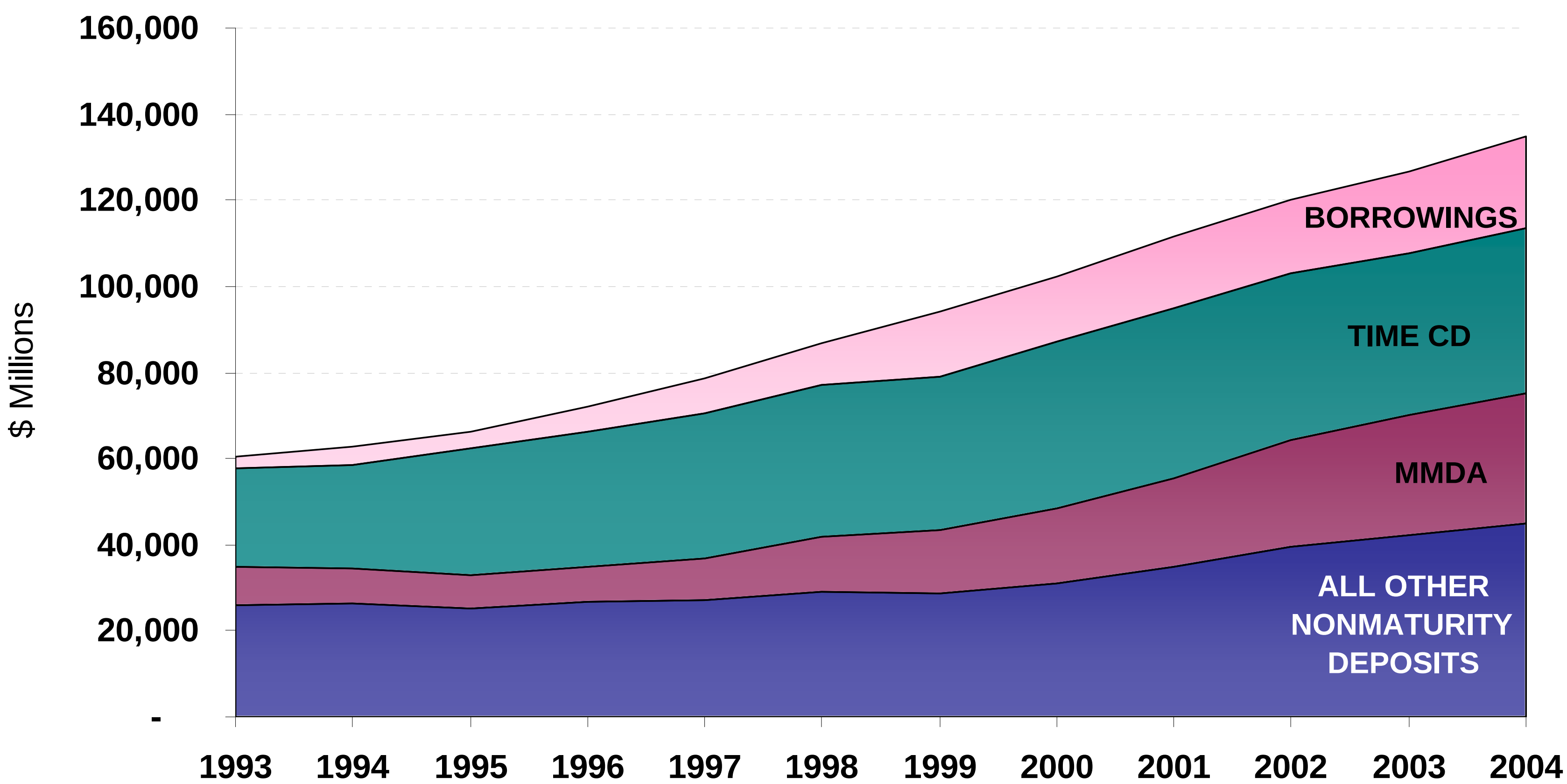
Interest rate risk proxy indicates steady state... level of ARMs in portfolio rising as mortgages grow. Still sizeable number of banks exposed to rising interest rates.



Deposit growth clearly cooling off from peak 2000 – 2002 period



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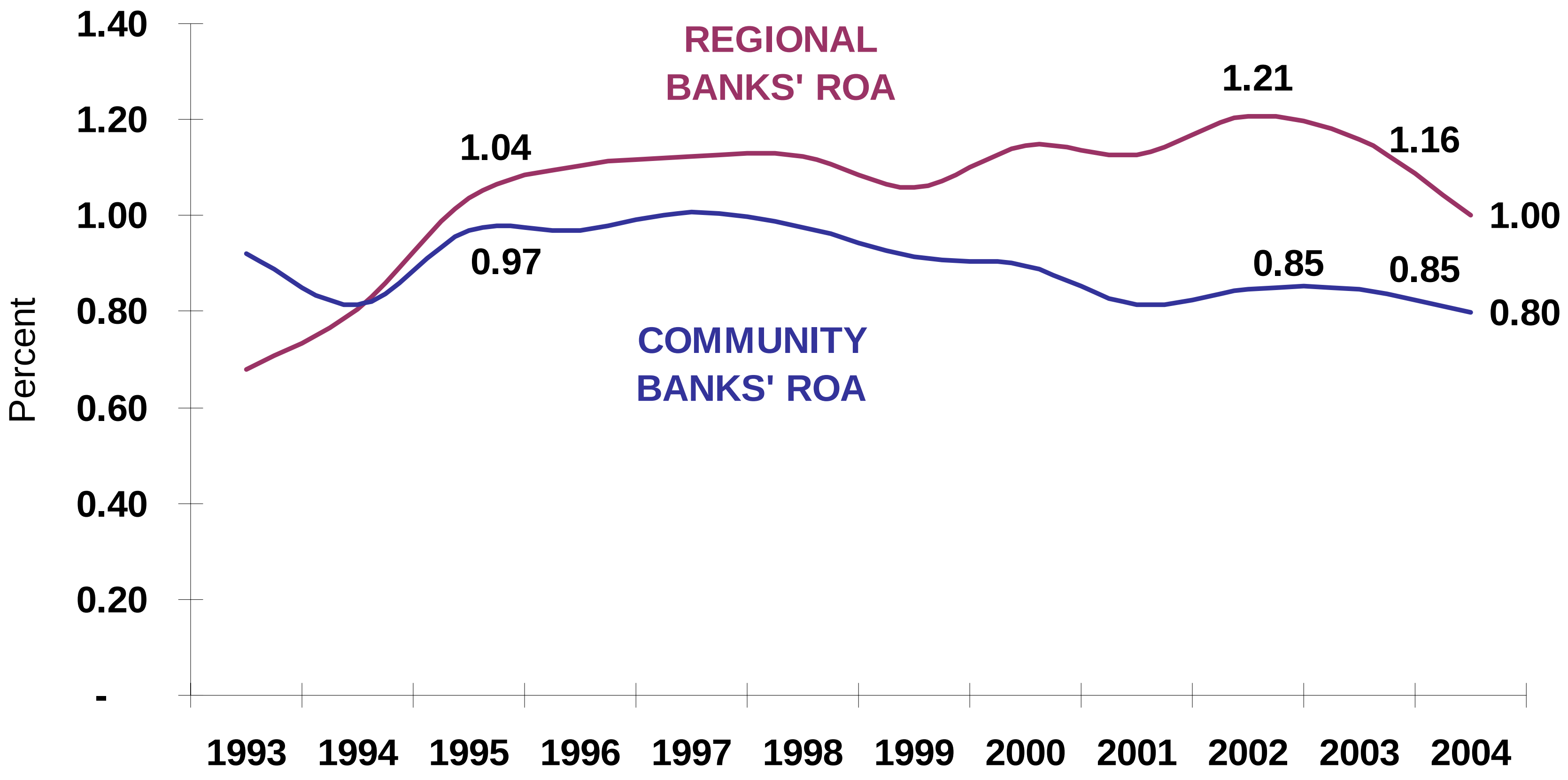
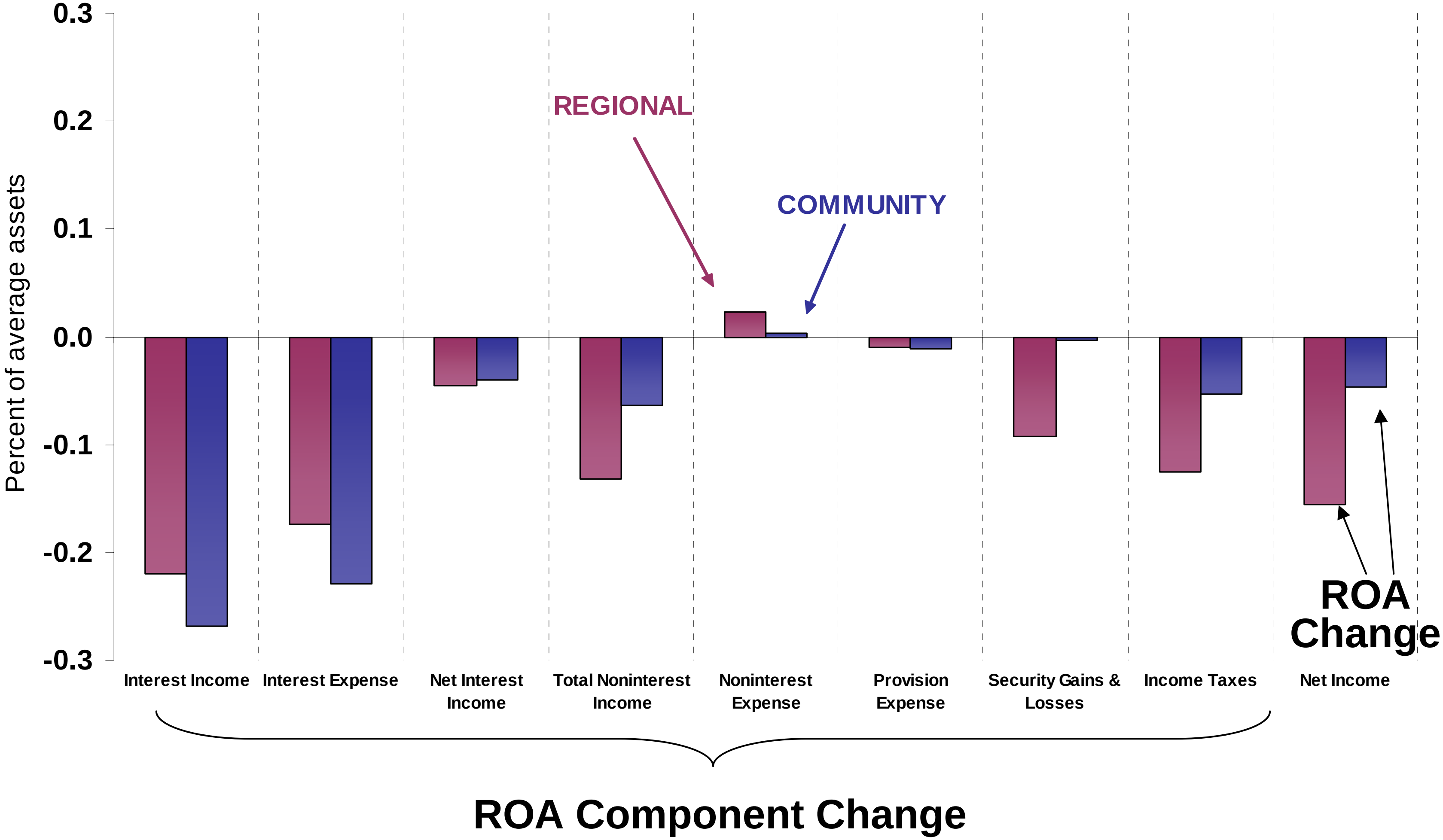
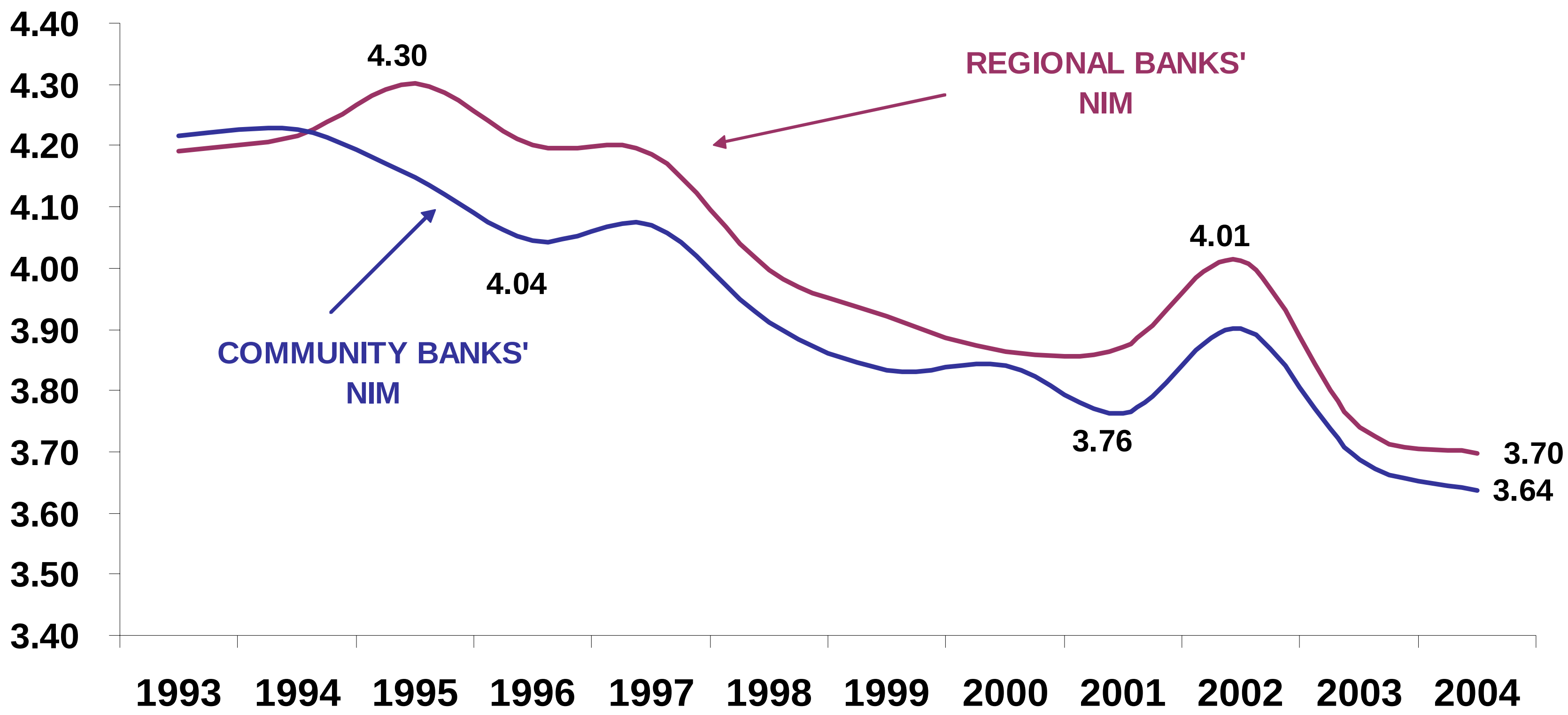
Profitability remains good although returns decline and growth still under pressure



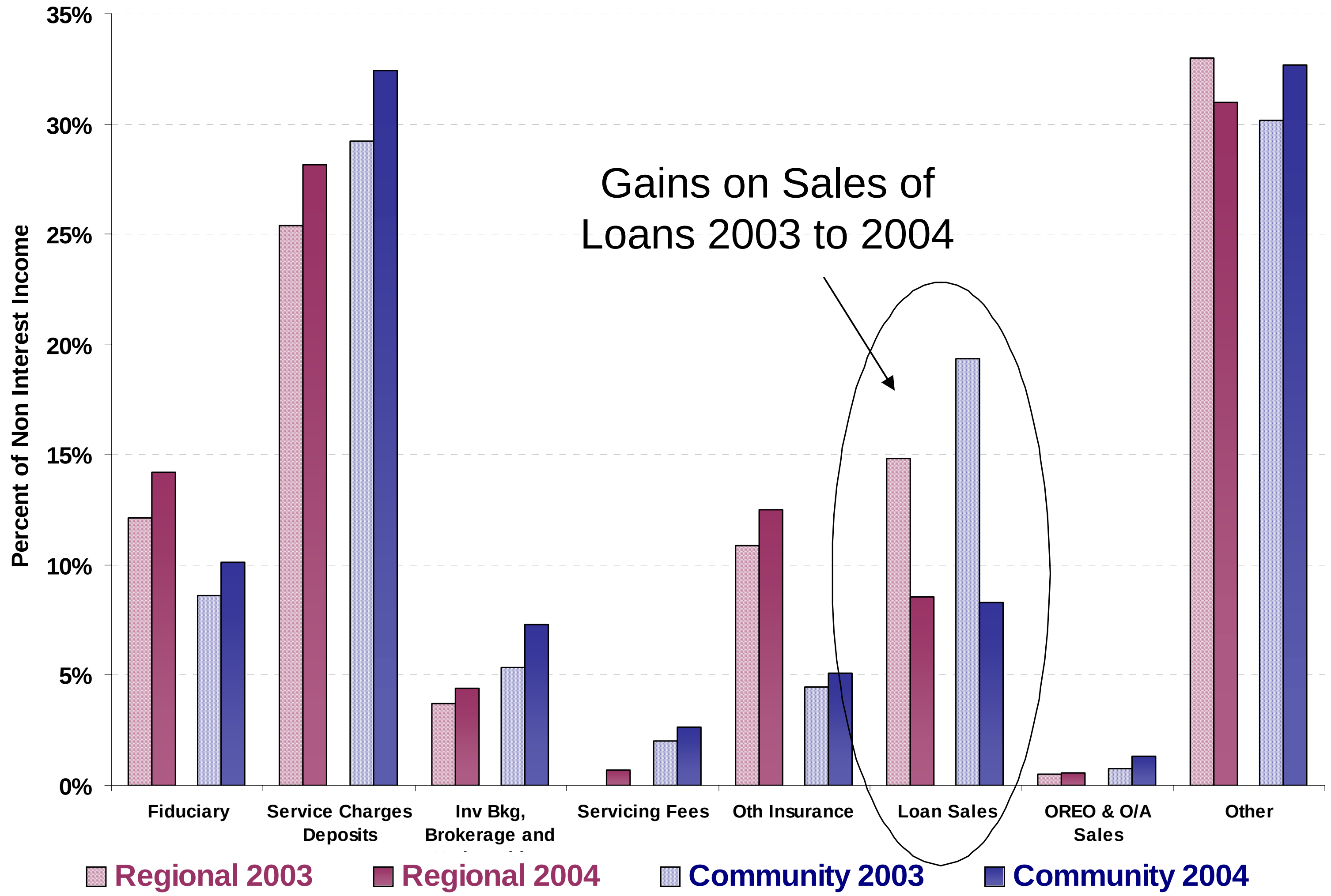
Returns down in part due due to lower noninterest income and net interest income



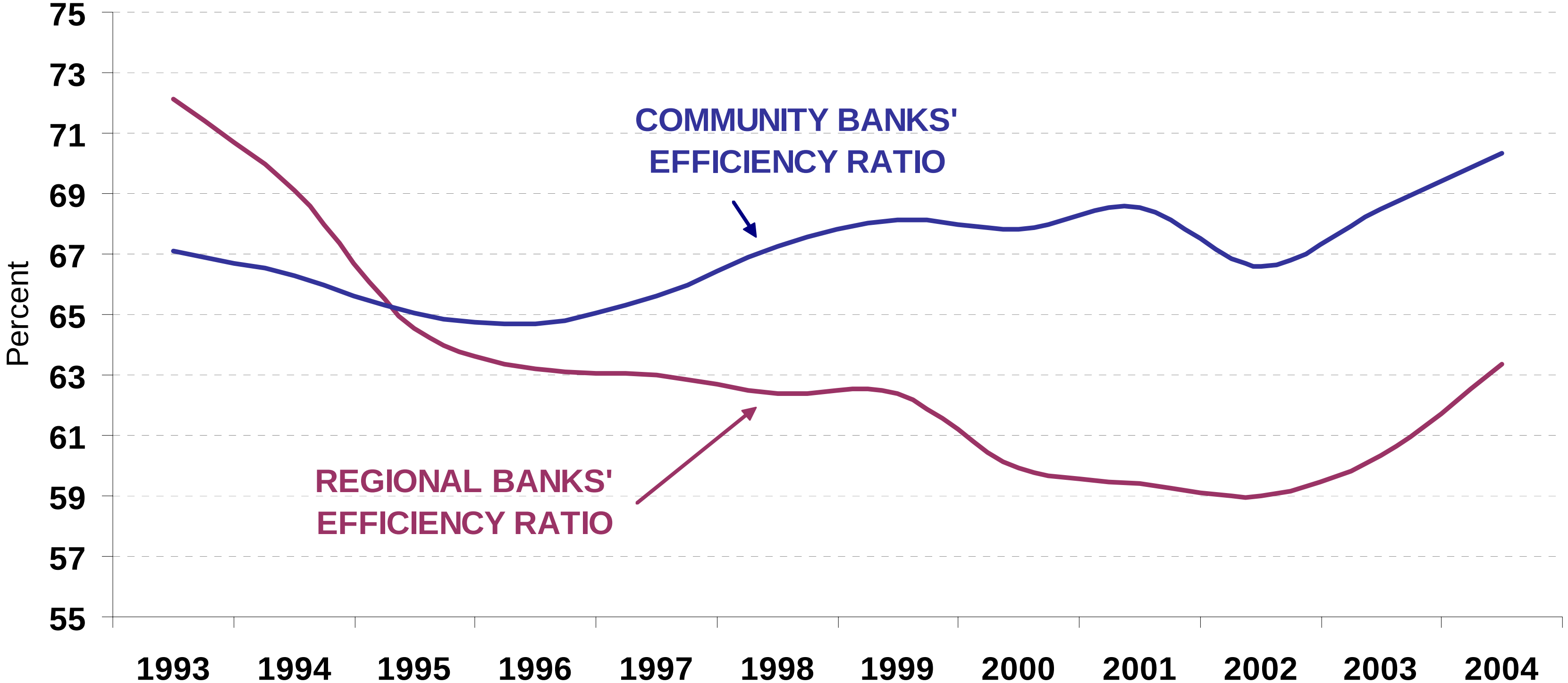
Net interest margins down for the year, quarterly pattern reflects improvement in second half, but pressure mounting



Lower gains on sales of loans the main culprit behind noninterest income trend



Overhead expenses under control but efficiency erodes



Efficiency Ratio =Overhead / (NonII + NII)

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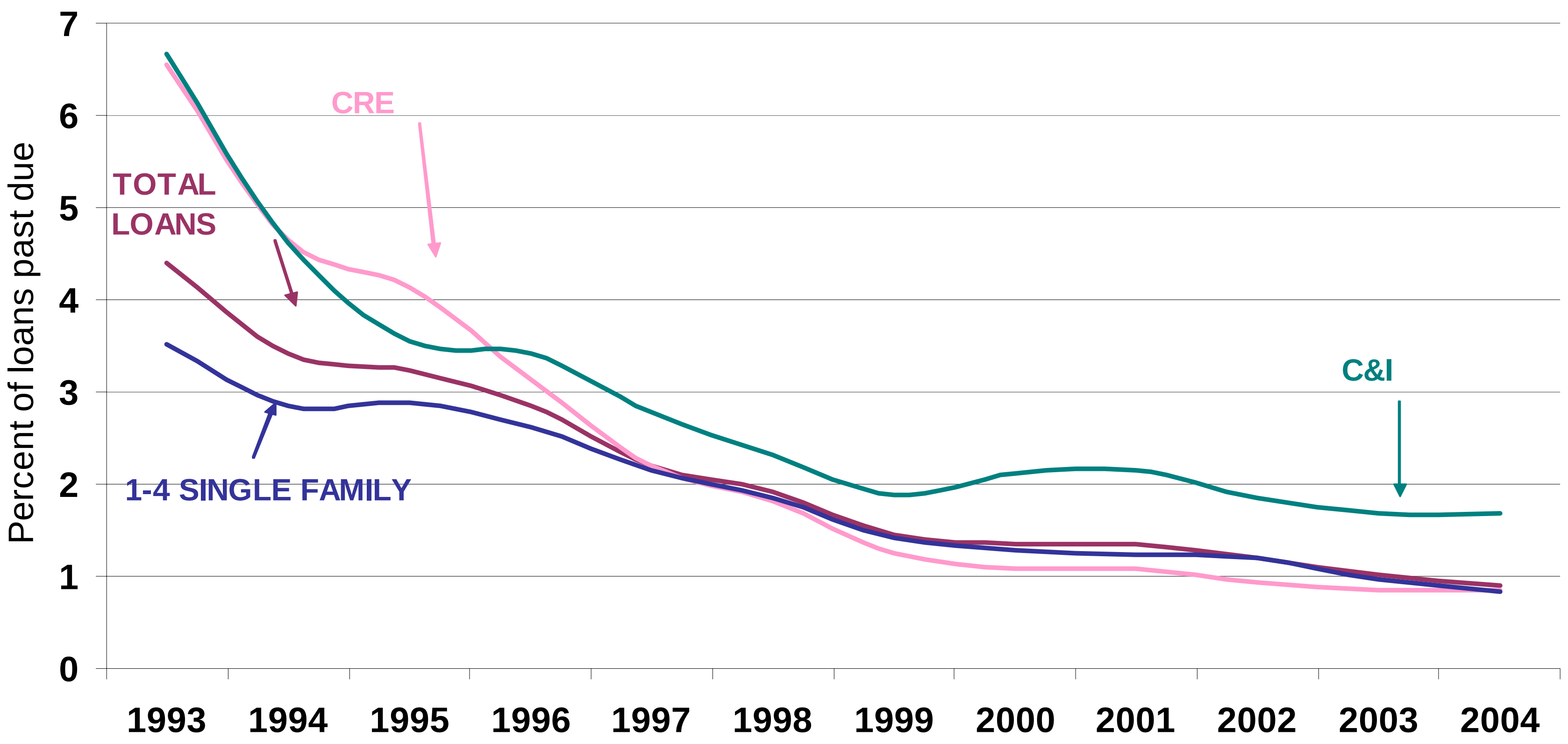
Credit quality as good as it gets and keeping provision expenses low



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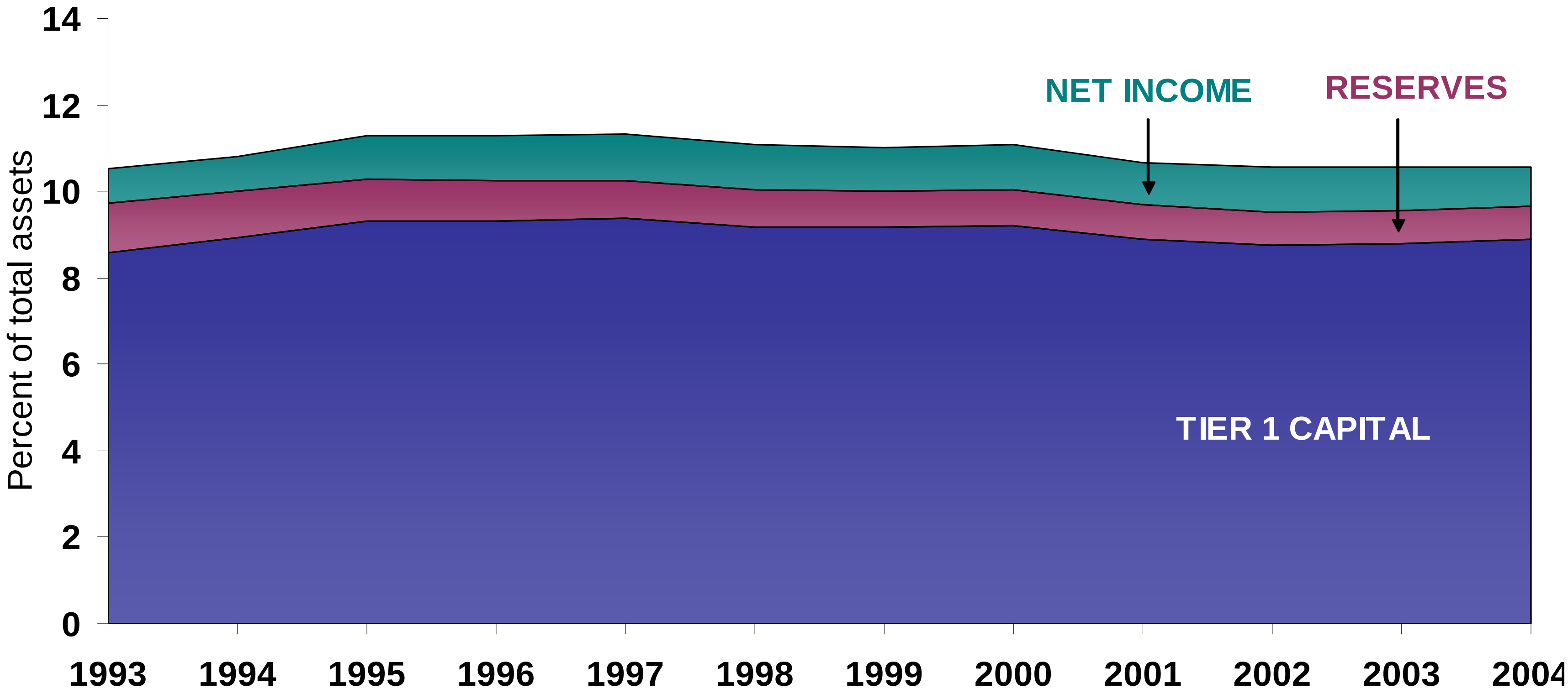
Reserves thining in light of improved credit quality trends but overall protection from capital and reserves solid



2004 Recap....

- Sound credit quality and capital
- Loans continuing to grow at strong pace
  - CRE and C&I rising
  - ARMs and HELOCs growing
  - Community Banks significantly growing CRE portfolios, including construction loans
- Core deposits slowing, noncore rising
- Income growth and returns under pressure
- Competitive banking market

On the horizon...

- Interest rate outlook
- Earnings and balance sheet management implications
- Credit conditions

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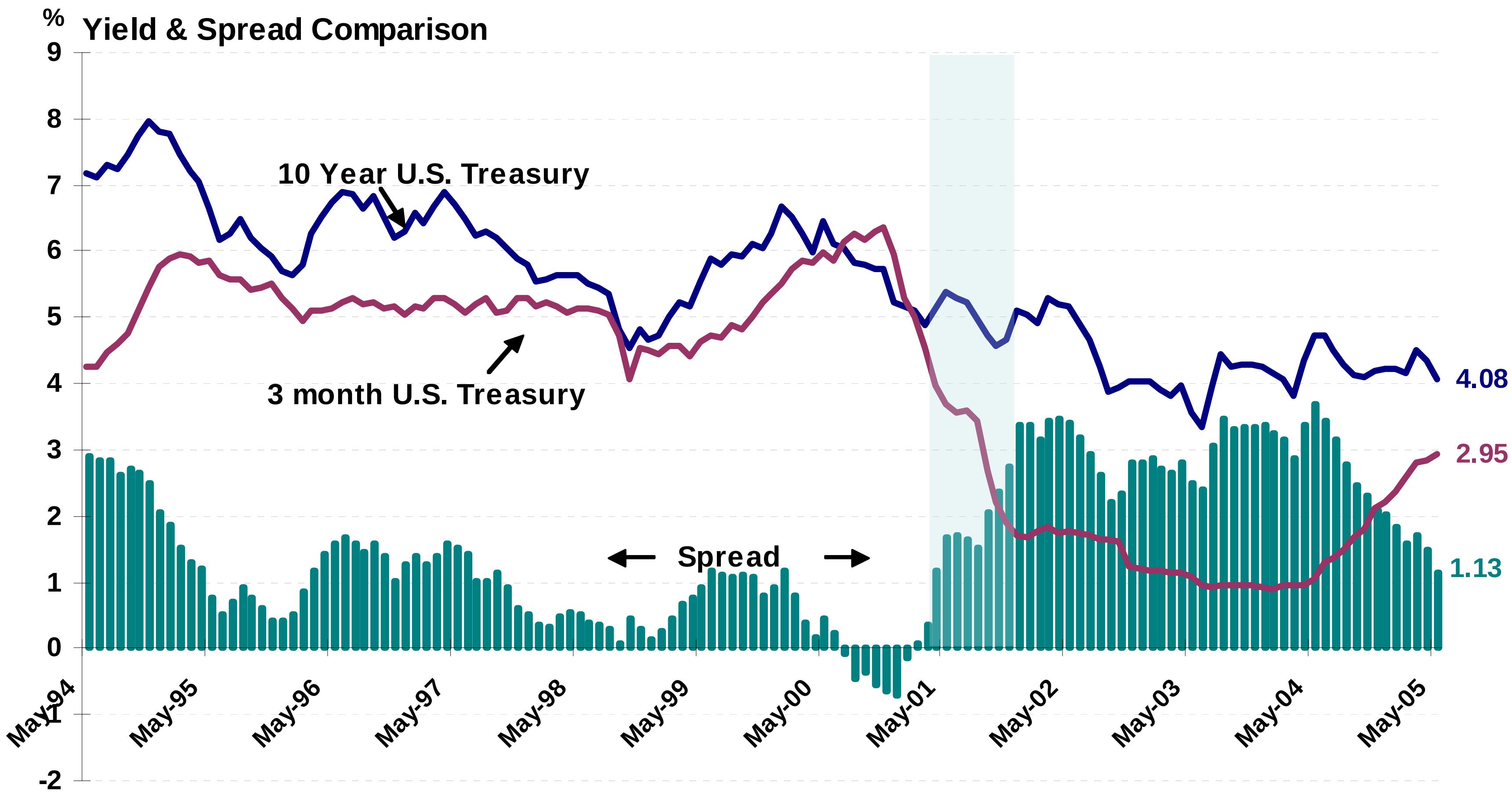
The interest rate “conundrum”....



Source: Federal Reserve Statistical Release H.15, Monthy (May 2005 as of 5/25/05)

Shading represents recessionary period

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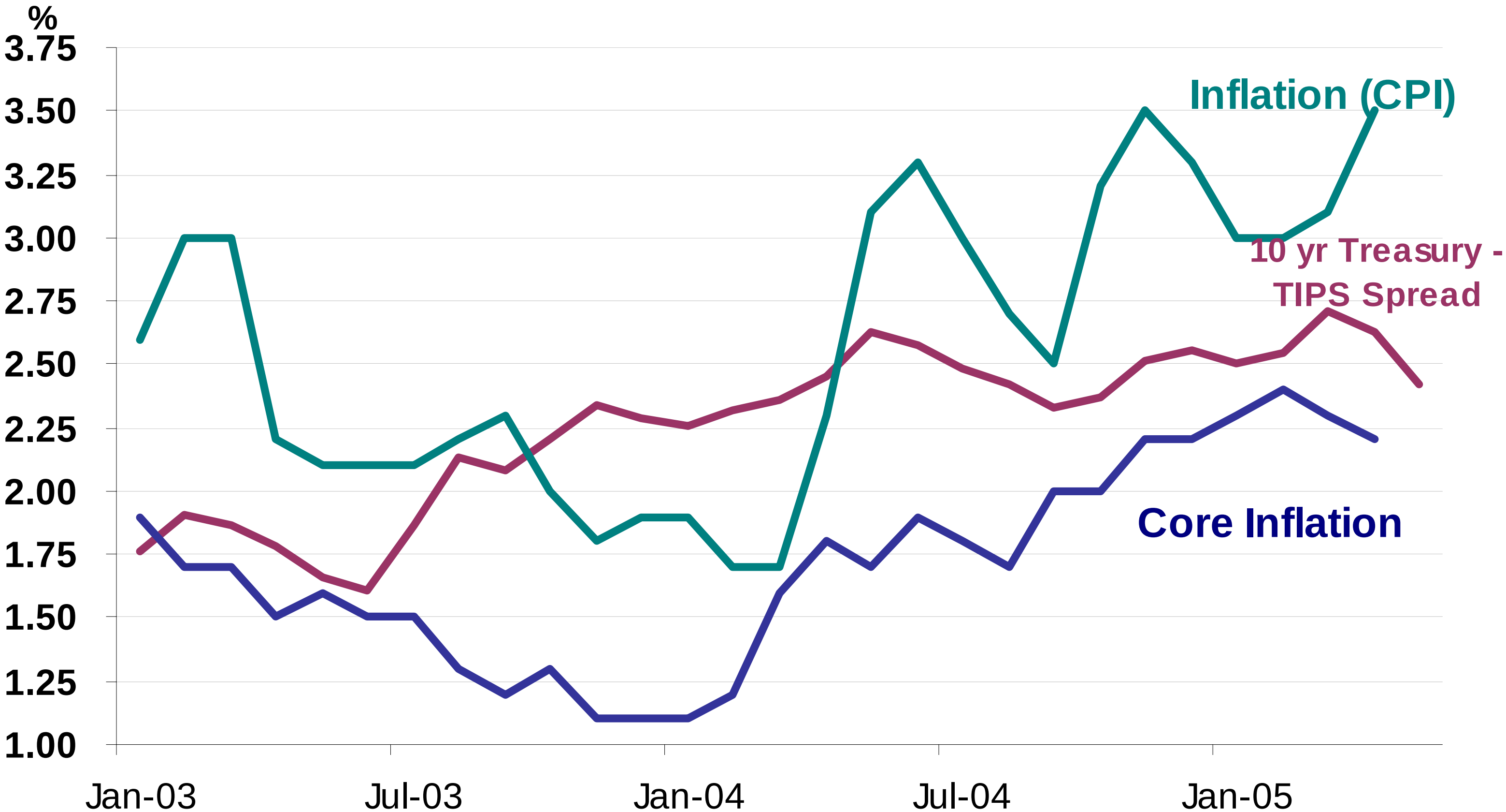
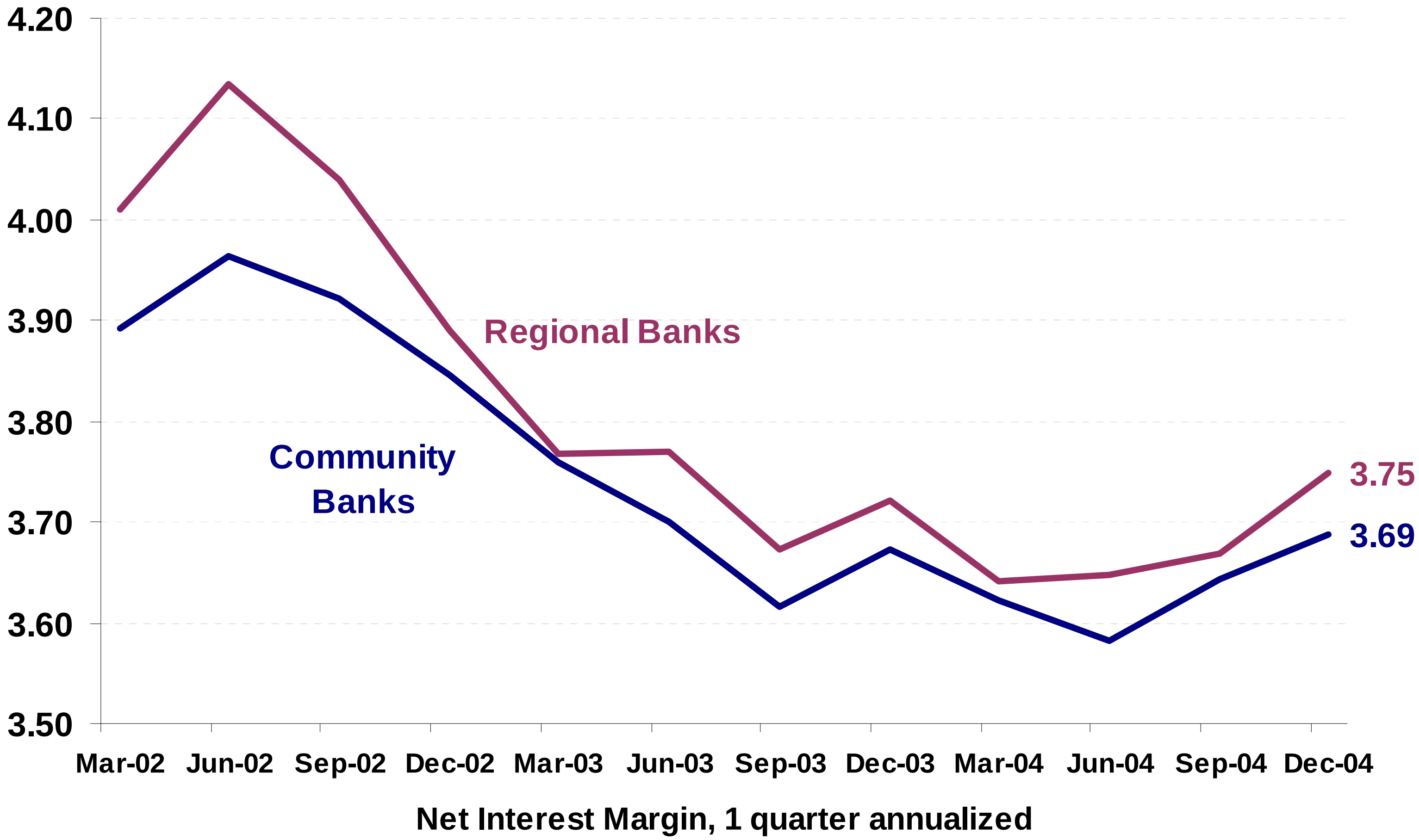
Inflation measures contained but rising which suggests long-term rates should start rising...but when will sentiment shift?

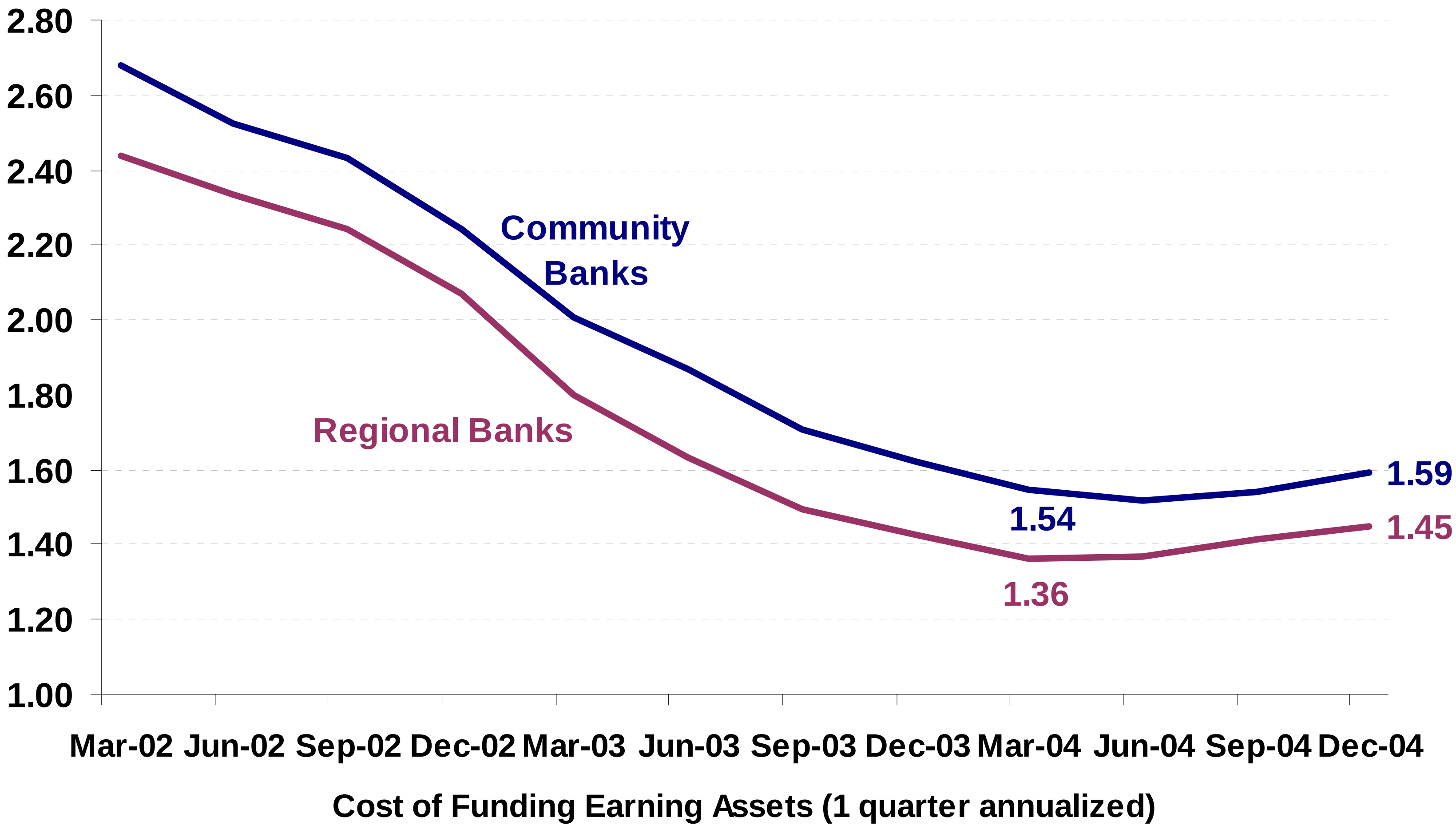


Source: Federal Reserve and BLS

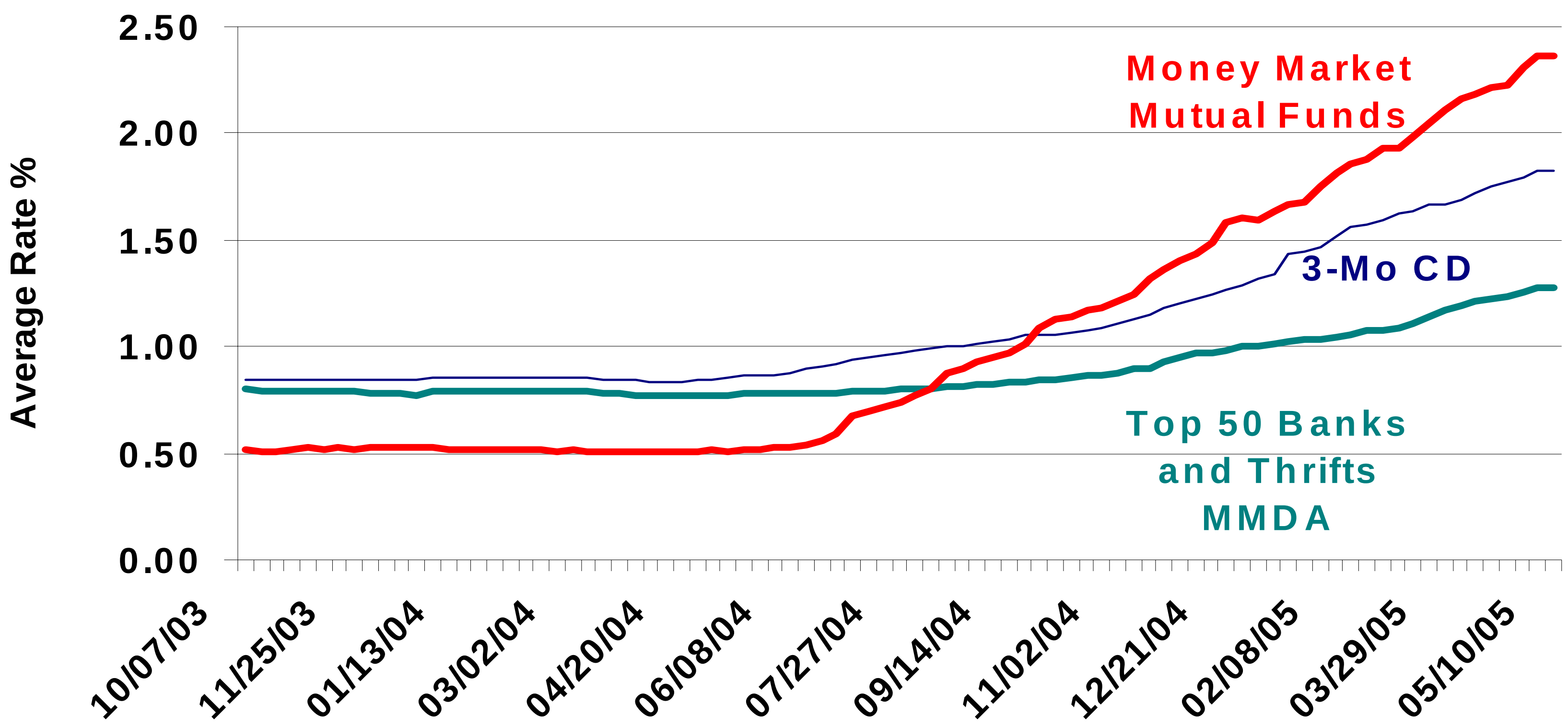
Margins ticked up slightly...



...but funding pressures on the rise

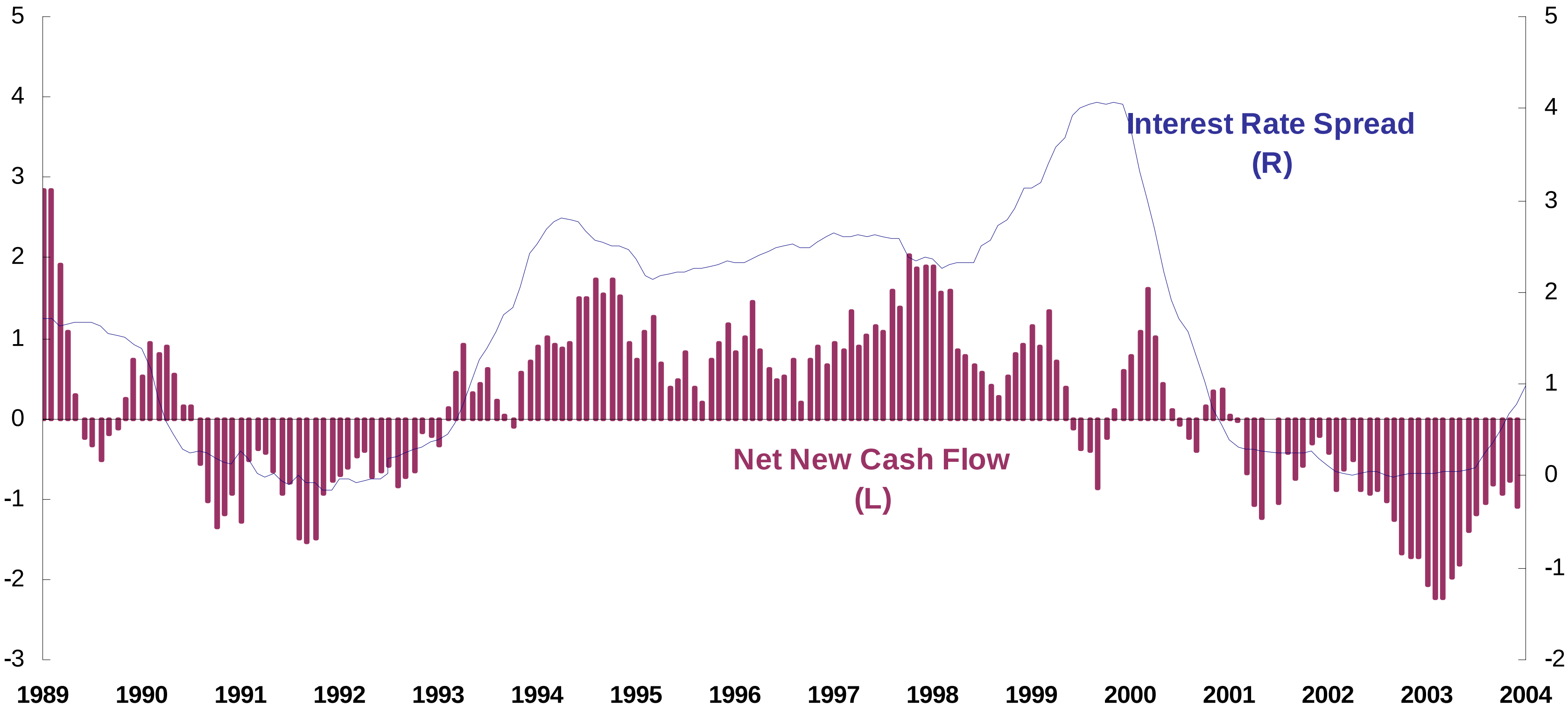


Spreads between money market funds and bank deposits widening



Source: Informa Research Services, iMoneyNet

Funding pressure will likely rise as rate spread widens

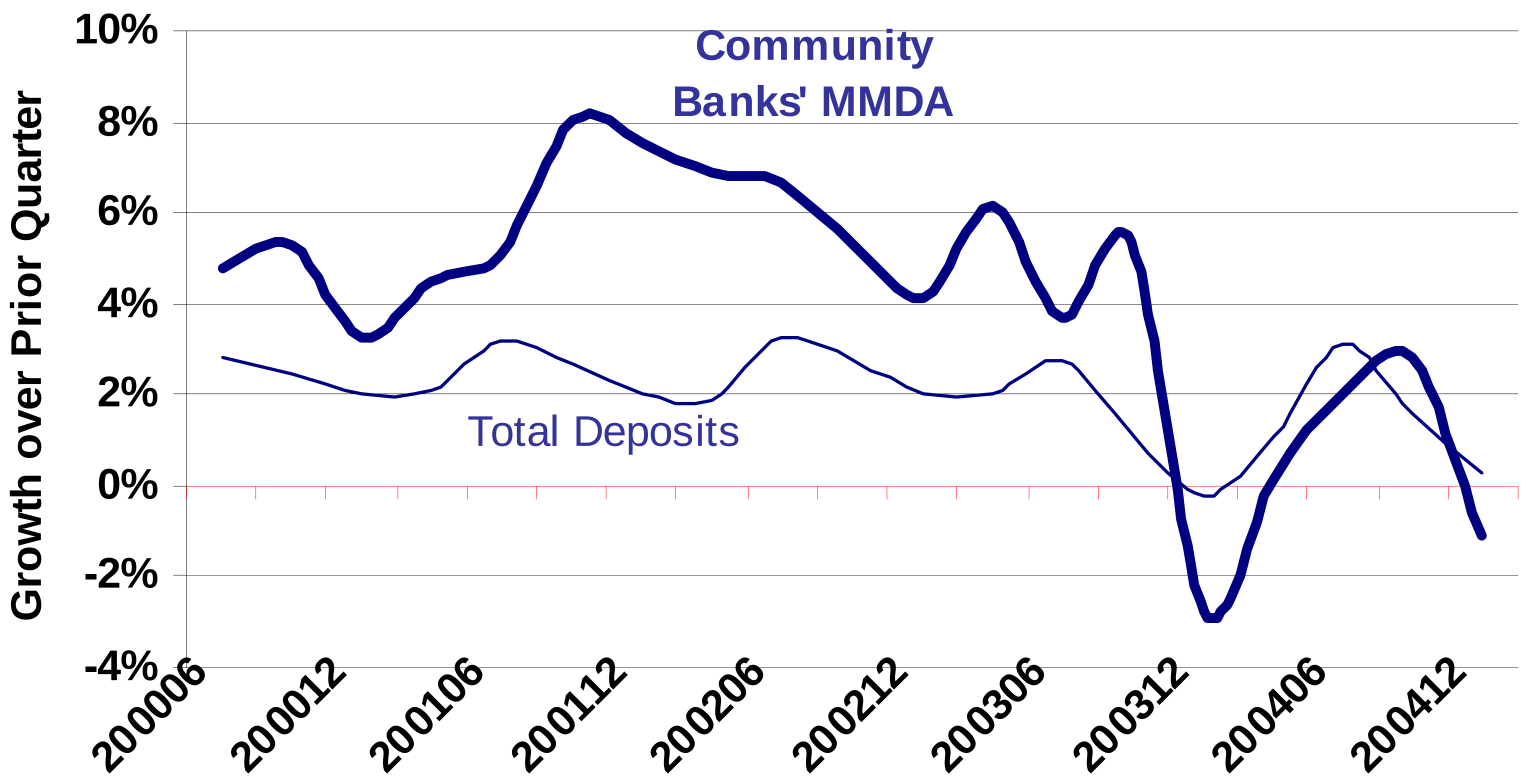


[1] Net new cash flow is measured as a percentage of previous month-end taxable retail money market fund assets and is shown as a six-month moving average.

[2] The interest rate spread is the difference between the taxable money market fund yield and the average interest rate on money market deposit accounts.

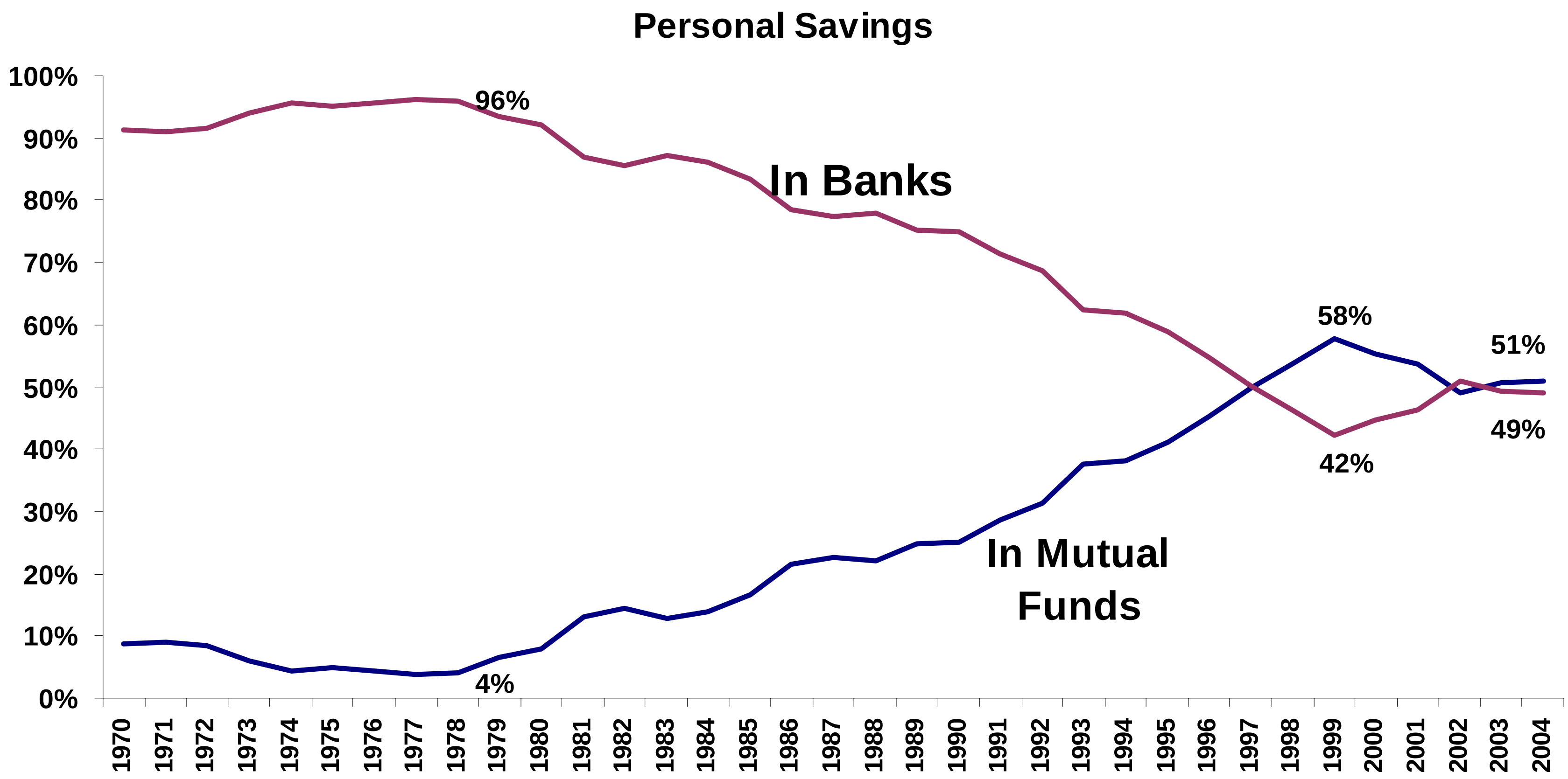
Sources: Investment Company Institute, iMoneyNet, and Bank Rate Monitor

Deposit growth slowing and being influenced by MMDAs



Source: FDIC call reports

Good news...consumer balance sheets have not exhibited big shifts in deposit shares thus far in the economic recovery but historical patterns loom large



Source: Federal Reserve Flow of Funds

Includes funds in Time and Savings Deposits versus Money Market and all other Mutual Funds

Where does that leave us?

- Economy expected to improve with tenable inflation
- Growing loan demand
- Slowing deposit growth
- Overhead cost pressure
- A flat yield curve that may persist

Playing defense in the upcoming year...effective asset/liability committees

- Develop proactive strategies based on data analysis versus anecdotal thinking
- Income simulations based on realistic assumptions; watch for shifts between assumptions and actuals
- Focus on better projecting cash flow and liquidity needs; rationalize your deposit specials
- Be opportunistic about growth; monitor margins
- Consider your marginal cost of funds if your specials cause existing money to flow from lower to higher cost deposits
- Be aware of extension risk
- Know your cap risk and ensure correct modelling

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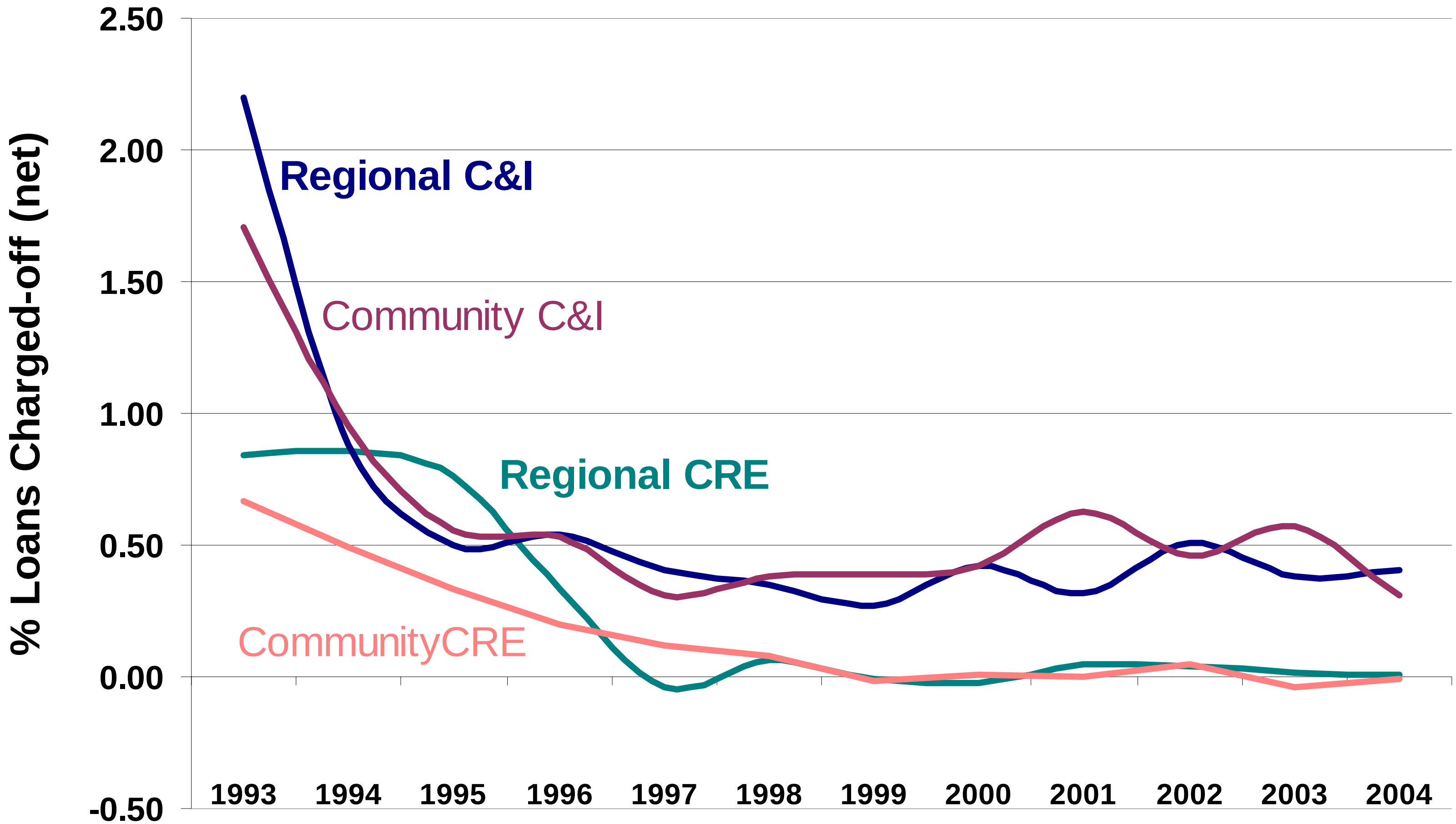
Outlook is favorable but time to be watchful in light of competition and earnings pressures

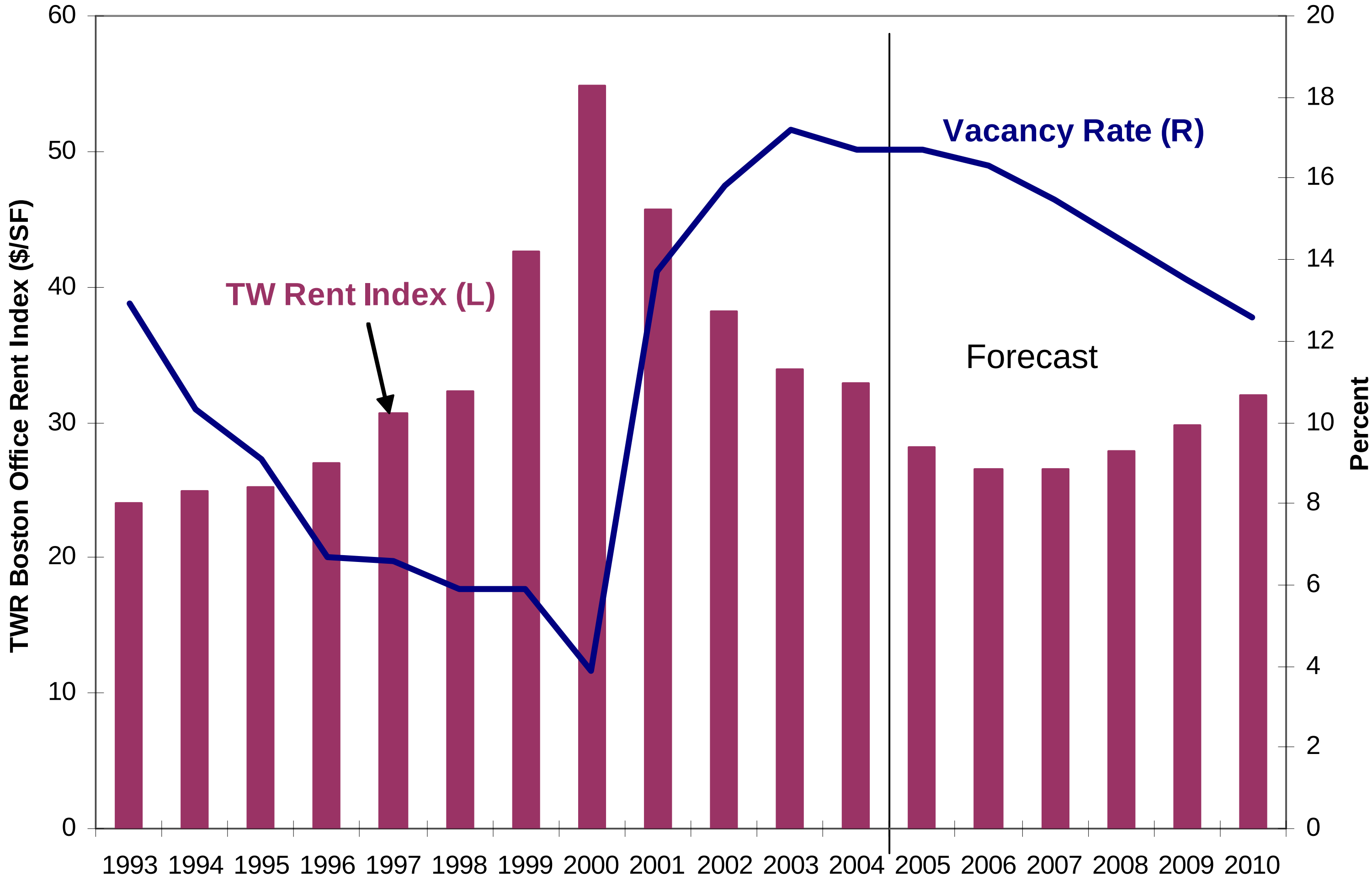


New England R&C banks provide anecdotal reports of heightened competition

- Supply greater than demand (more money to lend than demand for funds)
  - Larger companies coming down market for loan customers
  - New lenders entering CRE market
- Easing of lending standards
  - “razor thin” pricing
  - loosening covenants
  - longer maturities

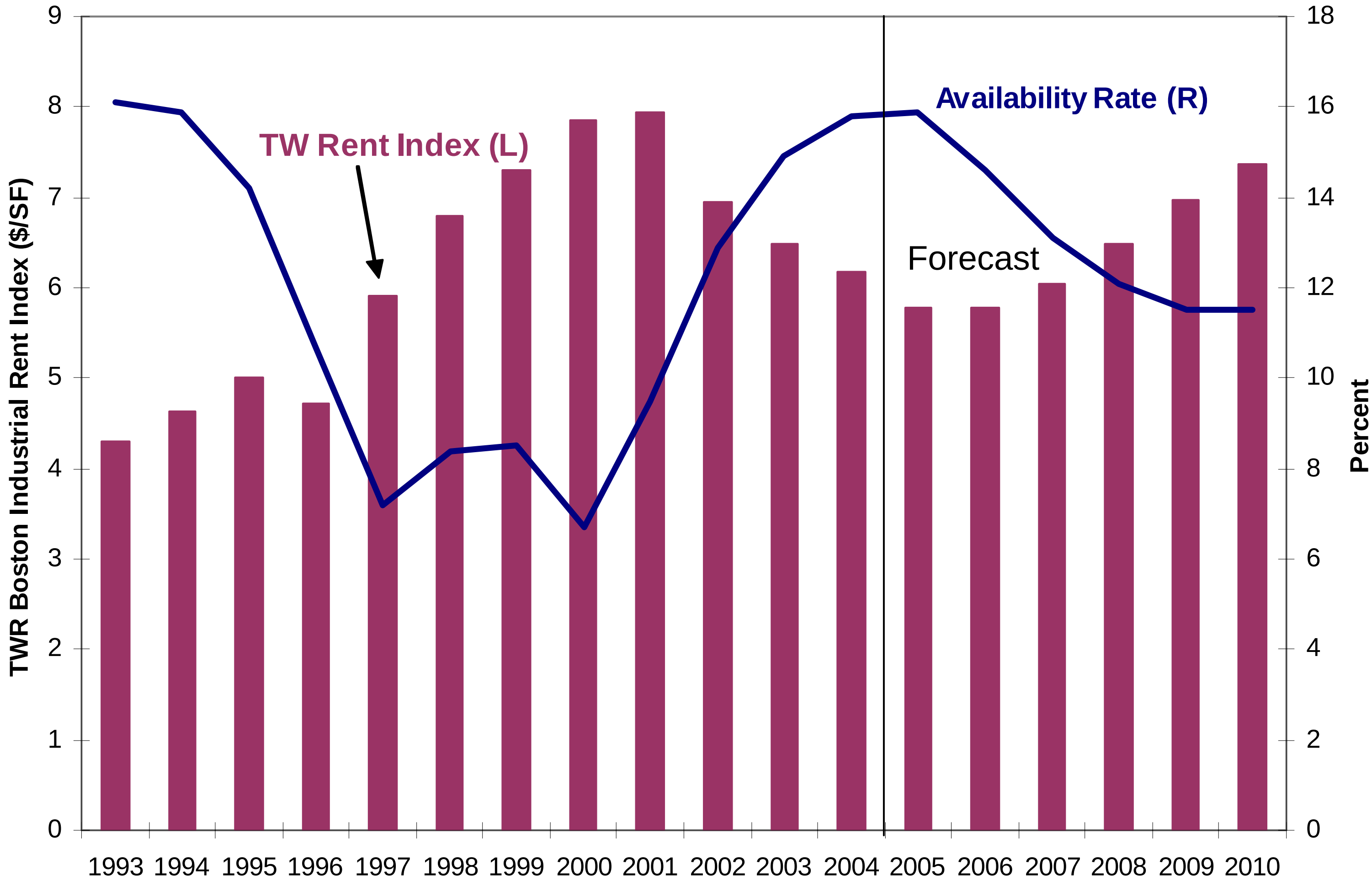
Examples are not like the 1980’s, but enough to question whether 2004 originations will prove to have higher losses in the next downturn.

Potential for weakening NOI and property values in Boston office markets



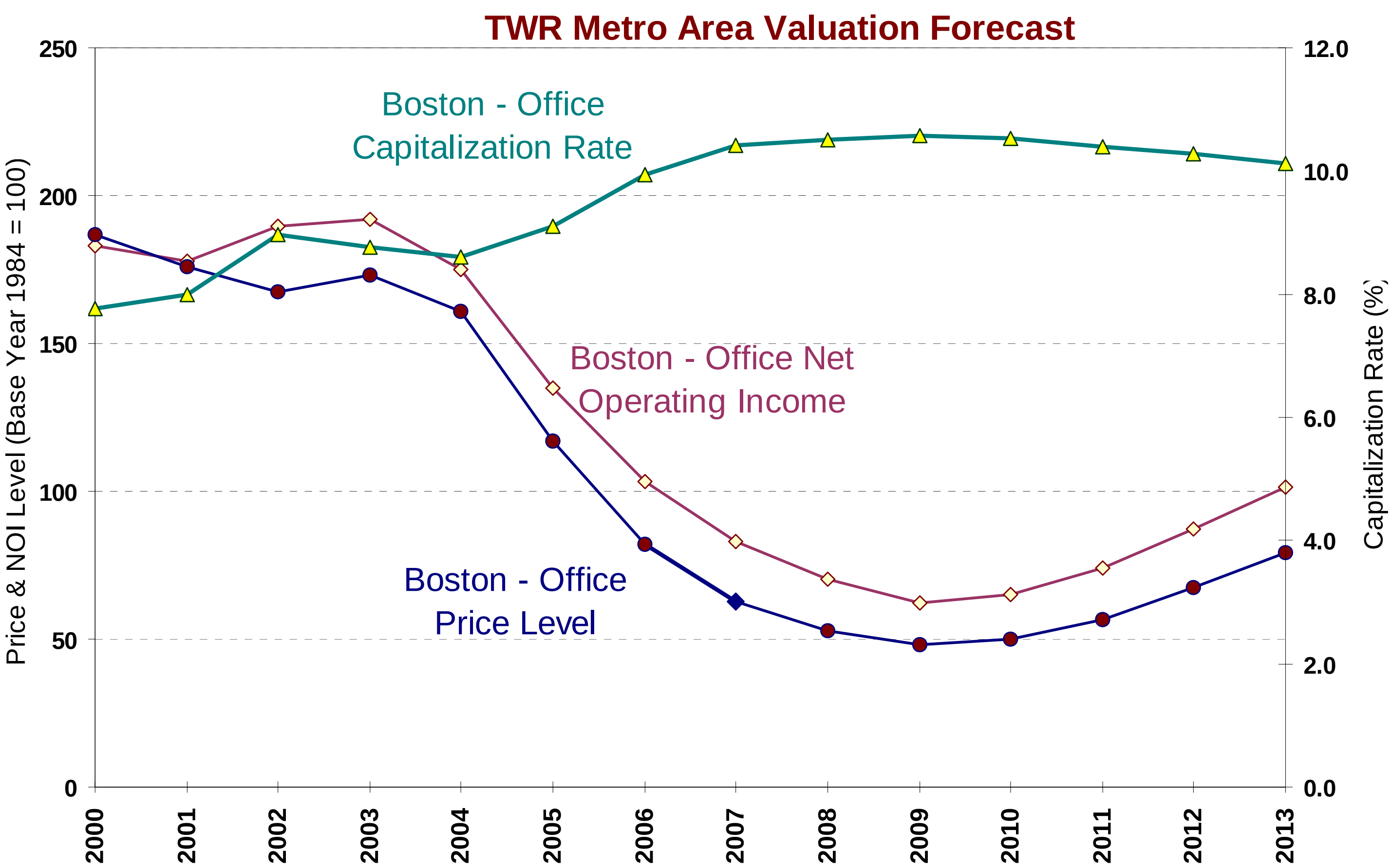
Source: Torto Wheaton Research Spring 2005 Forecast

Similar pressure on Boston industrial property valuations, although lower levels



Source: Torto Wheaton Research Spring 2005 Forecast

Improved vacancy rate does not offset declining rents and expected rise in cap rates for typical investment property



Source: Torto Wheaton Research, NCREIF Spring 2005 Forecast

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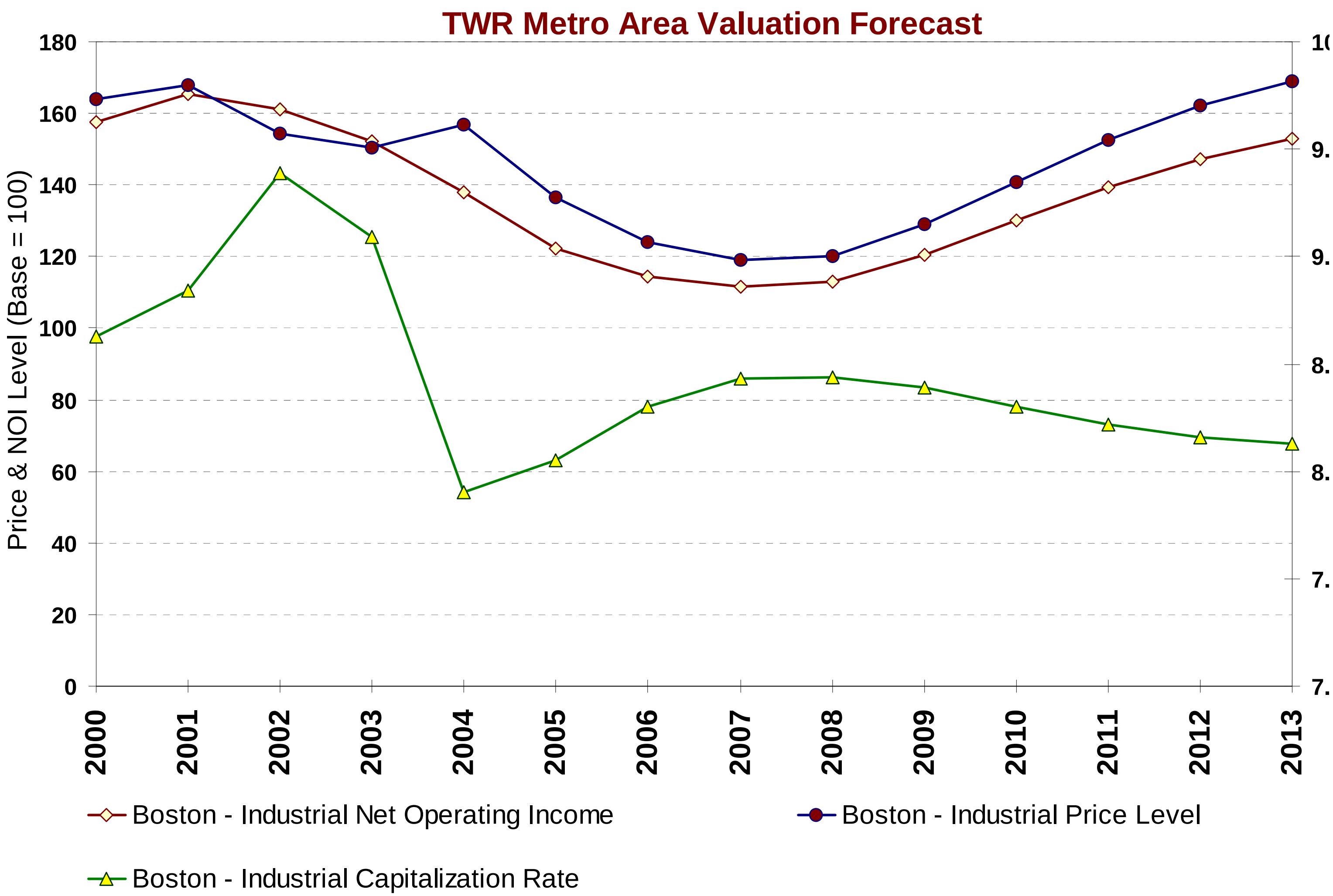
Industrial valuations subject to similar pressures



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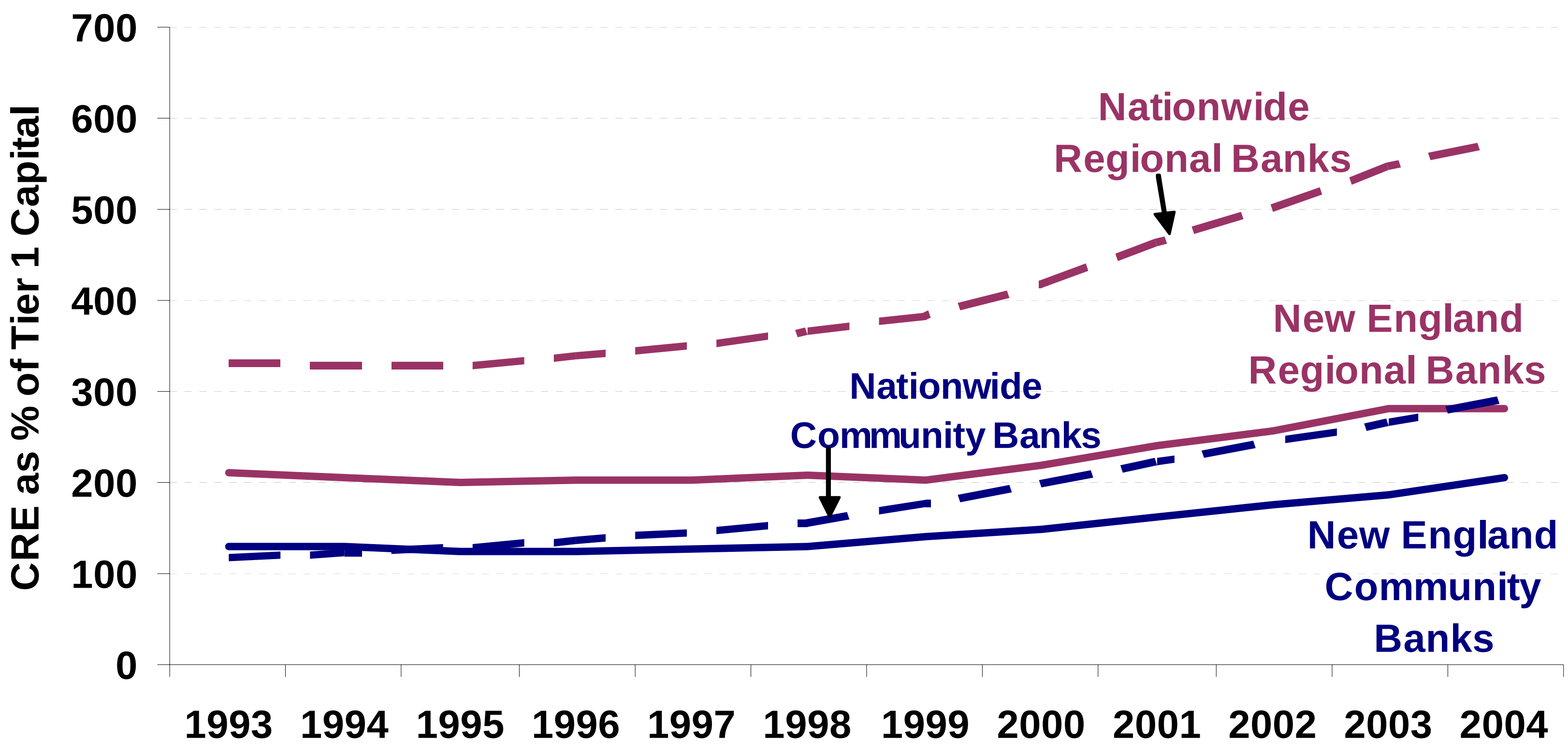
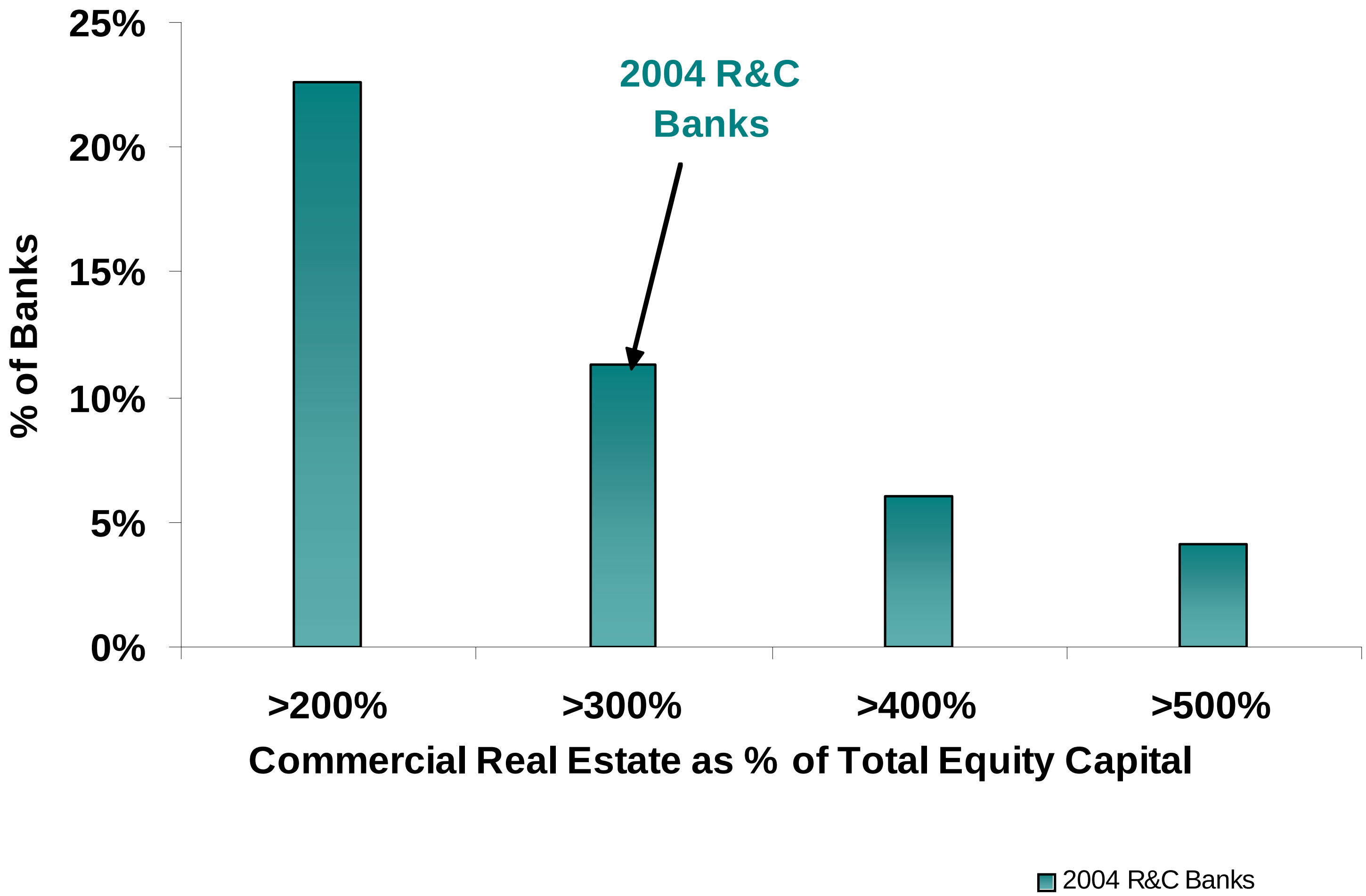
Concentrations rising on average



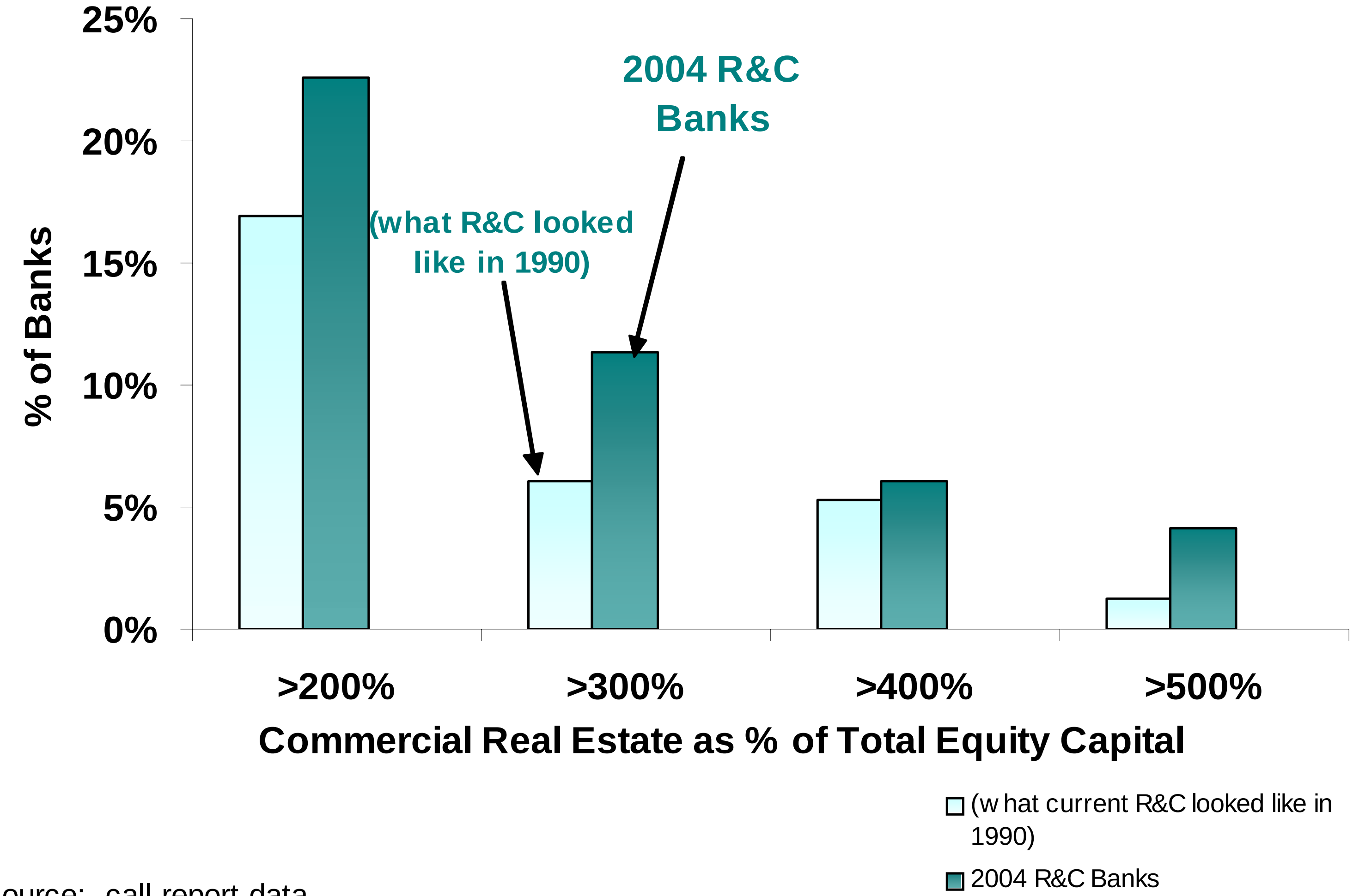
Note: Merger Adjusted- prior period data does not include banks that failed

Still a relatively low number of New England banks that are in the extremes...



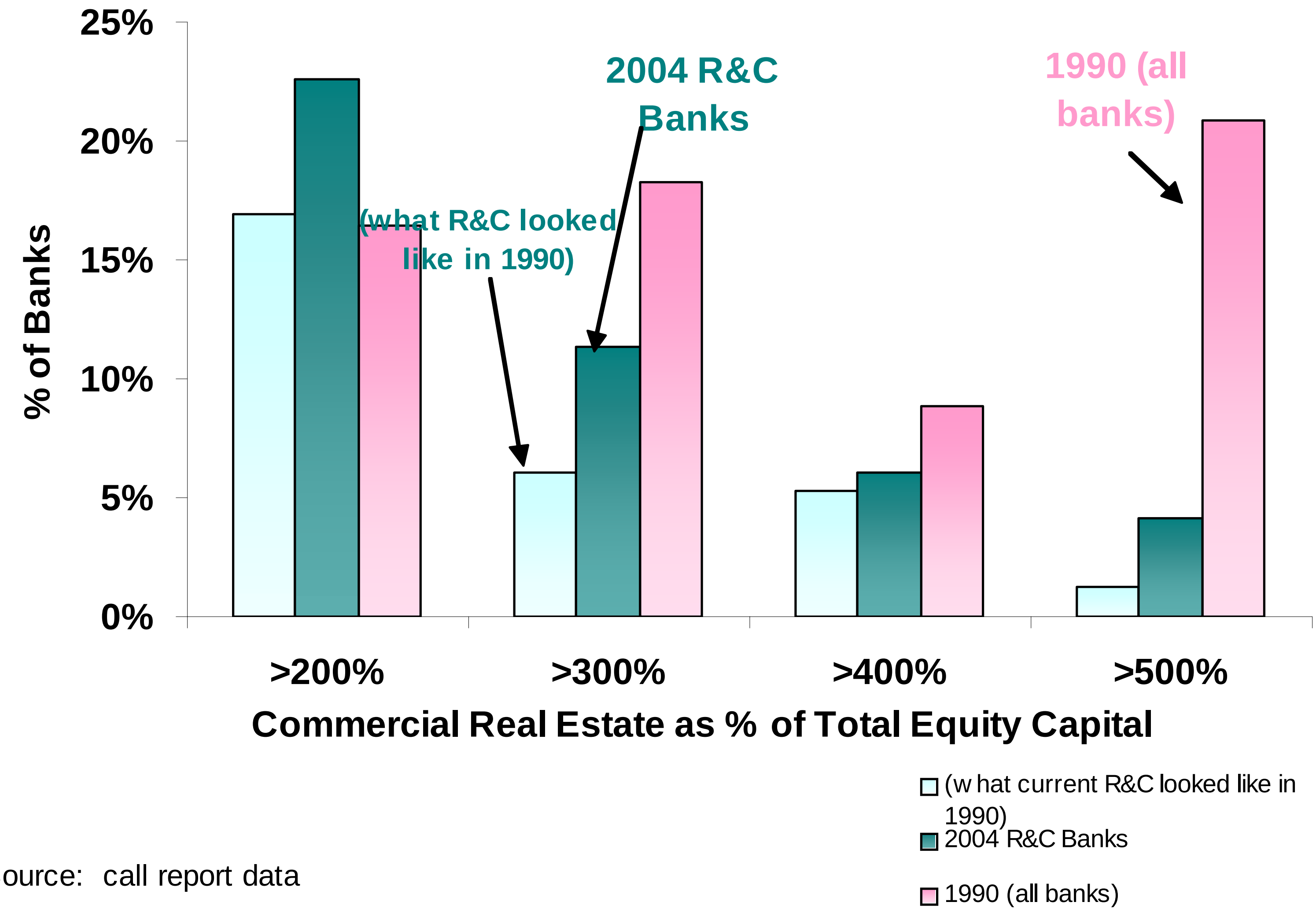
Source: call report data

Although current banks are crossing into unfamiliar territory



Source: call report data

New England is still below the extremes of the 1990s...so why be concerned?



Source: call report data

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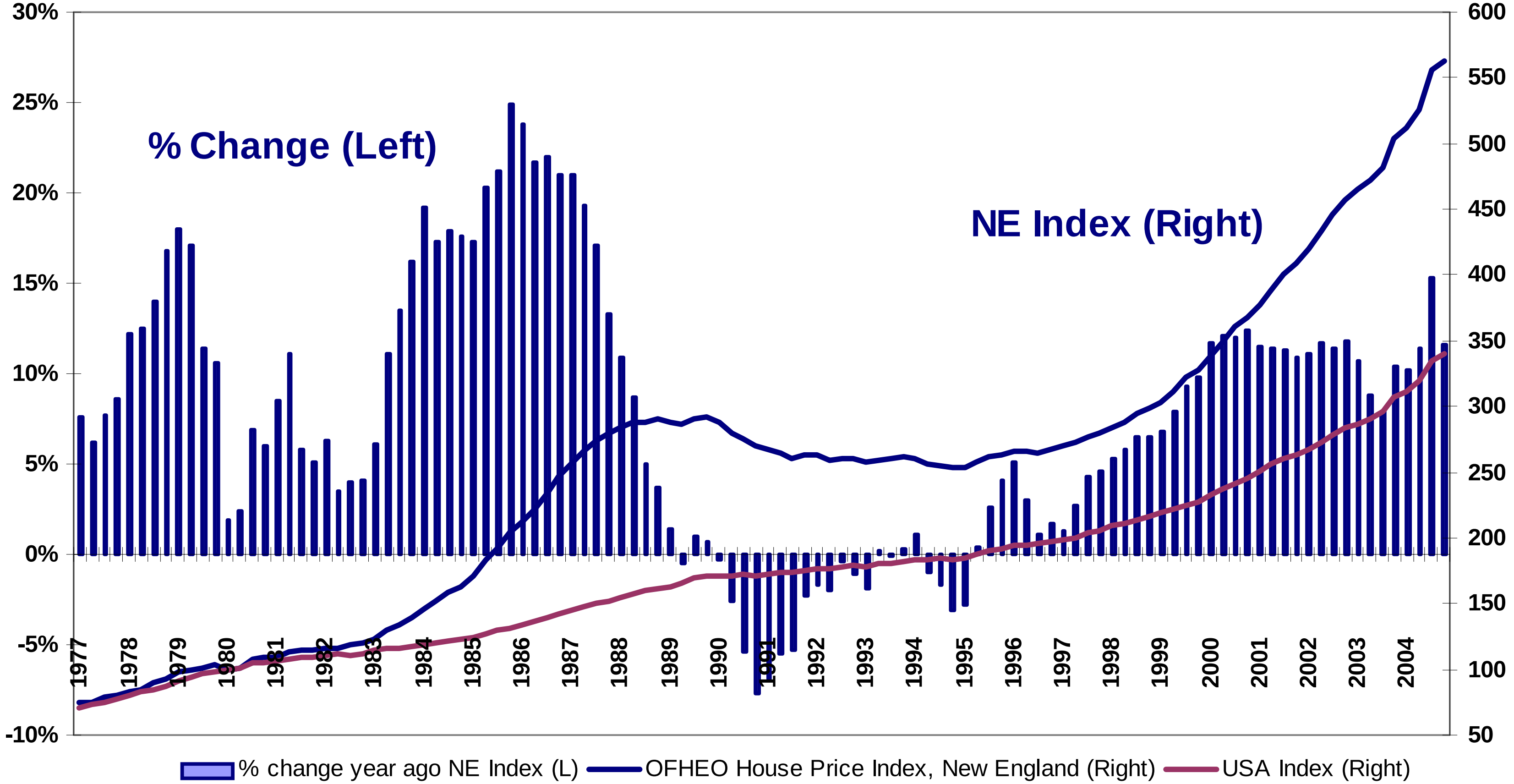
Residential markets still strong but expected to moderate



Index: 1980Q1=100

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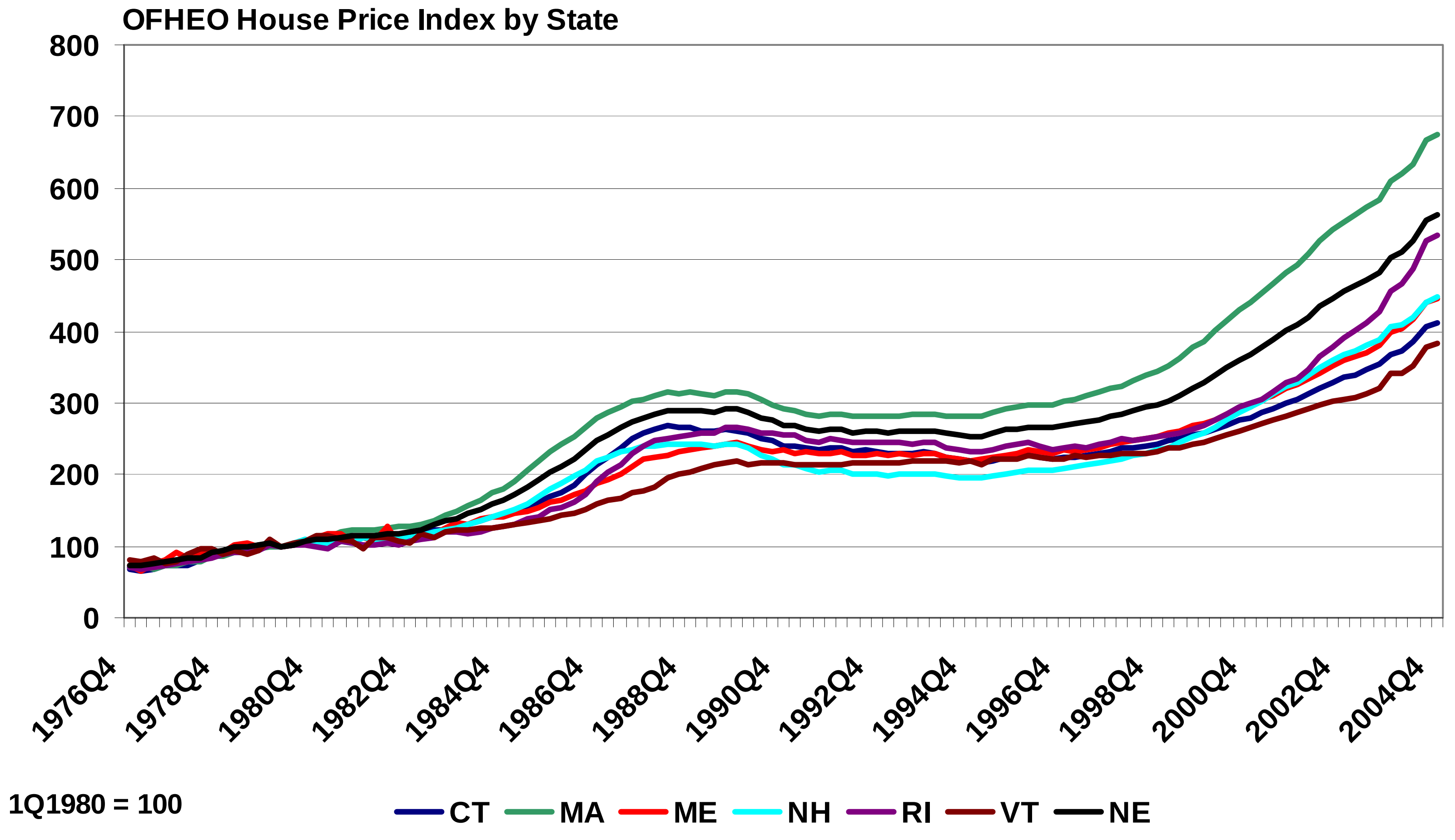
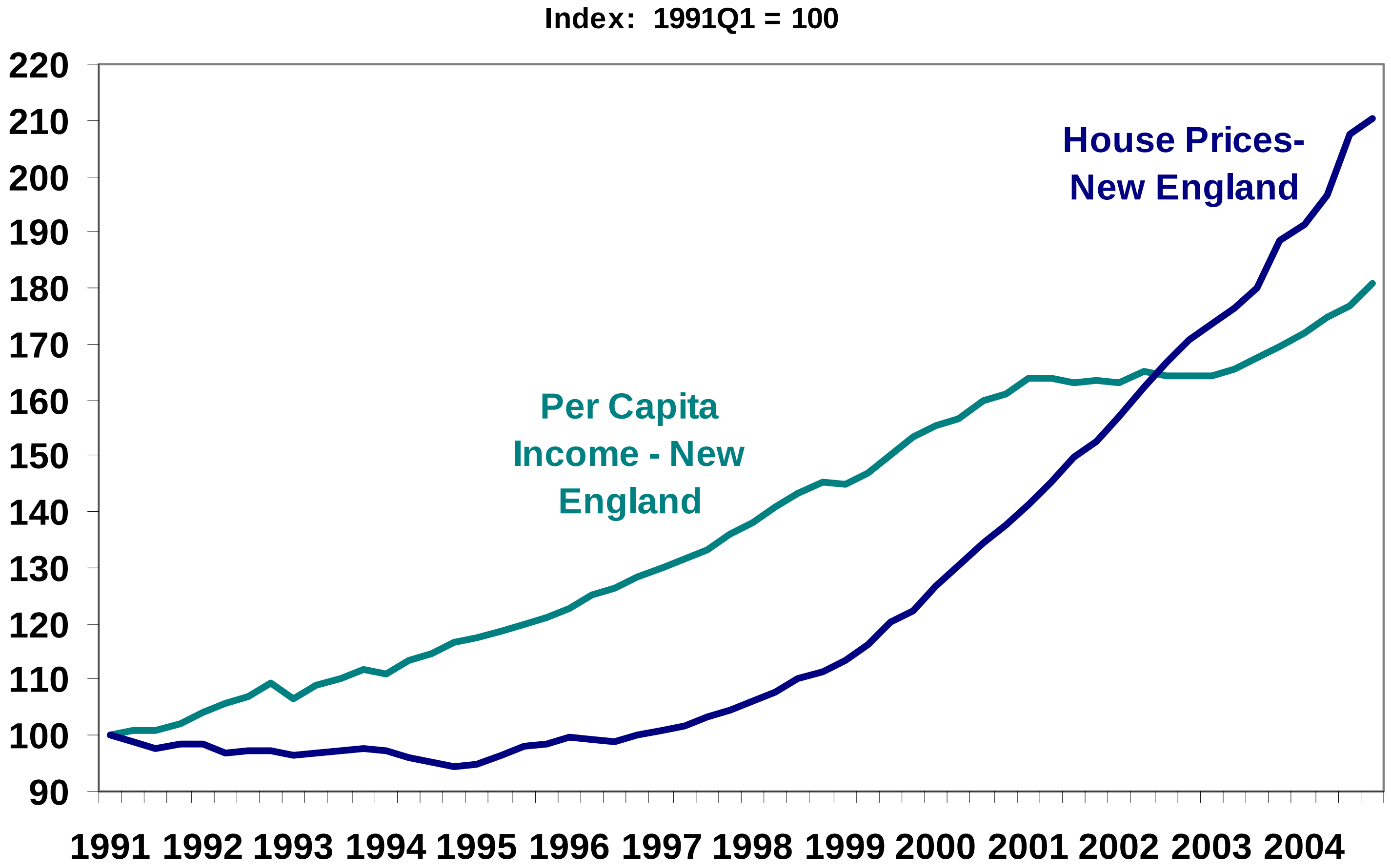
Massachusetts is the leader....and is more exposed to a correction

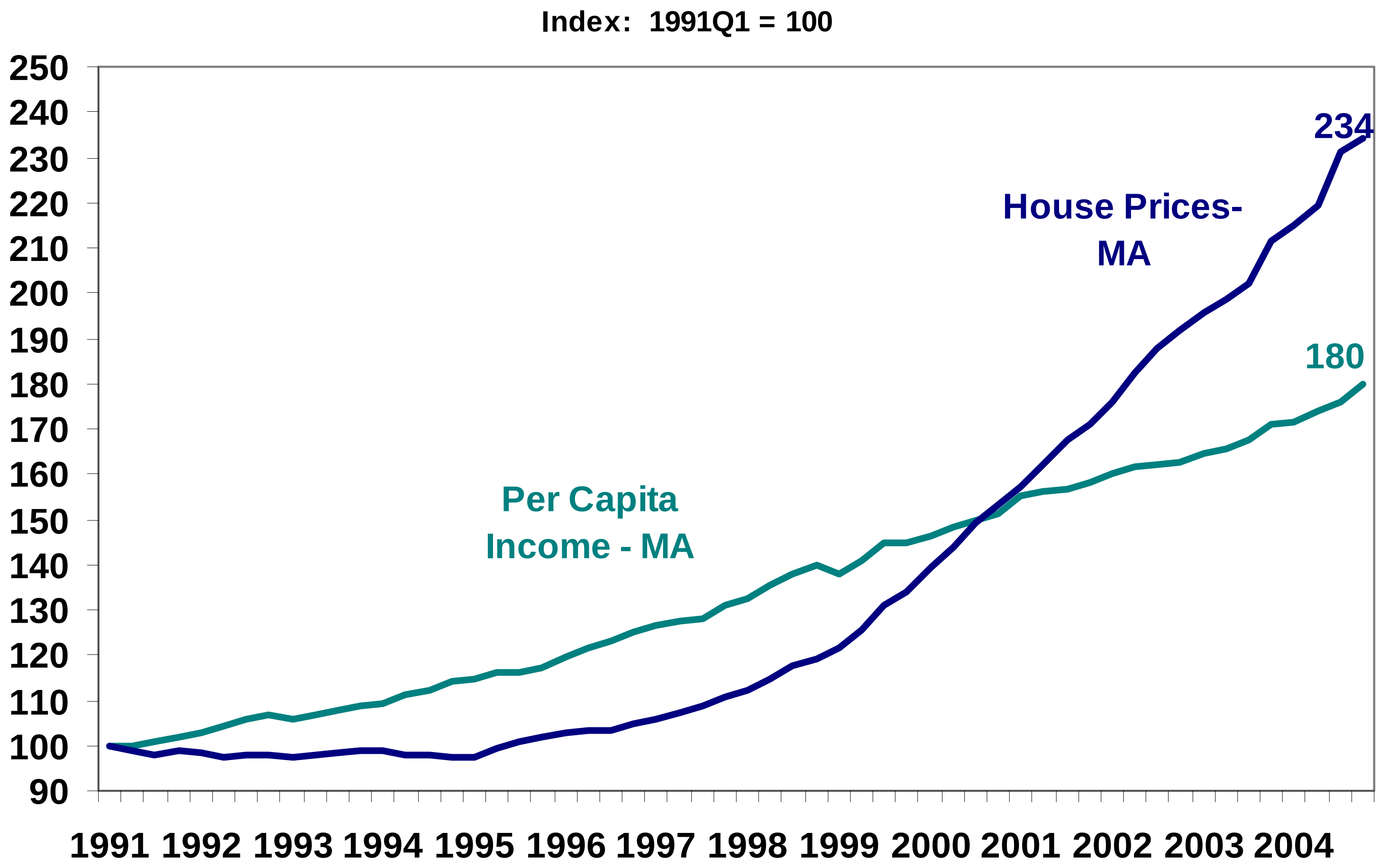


New England house price increases are, on average, out of line with income growth



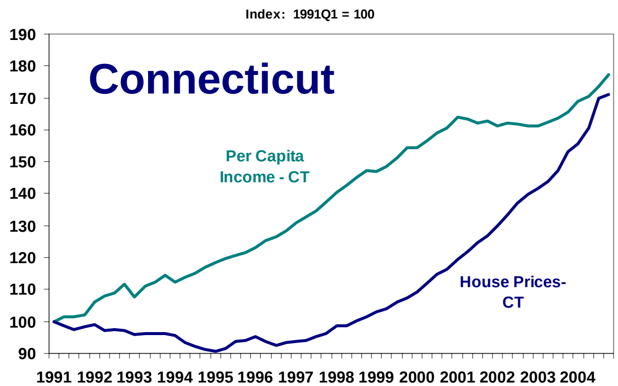
Source: OFHEO, BEA & U.S. Census Bureau

Although Massachusetts is the clear outlier

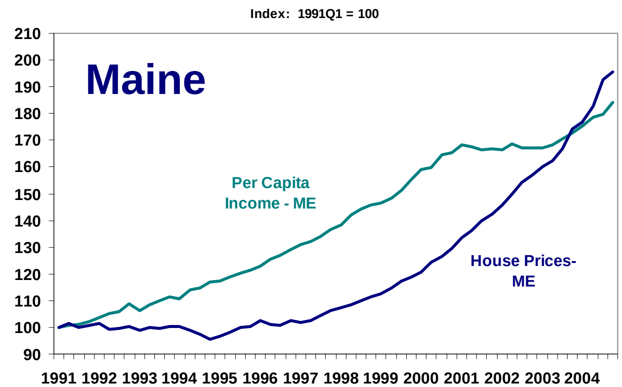


Source: OFHEO, BEA & U.S. Census Bureau

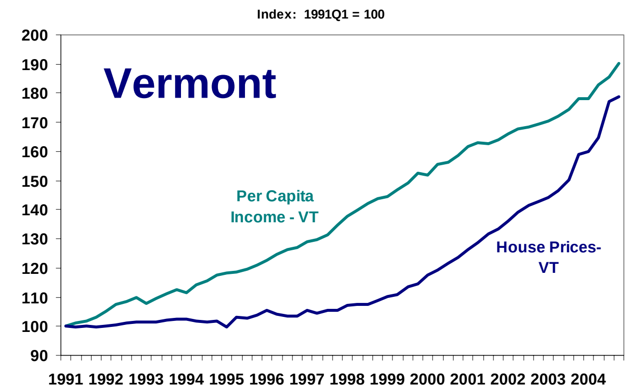
Other NE states show different pictures, some vulnerable but not as severe



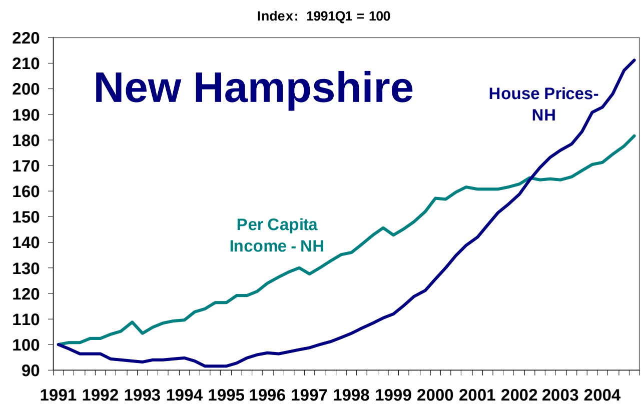
Source: OFHEO, BEA & U.S. Census Bureau



Source: OFHEO, BEA & U.S. Census Bureau



Source: OFHEO, BEA & U.S. Census Bureau



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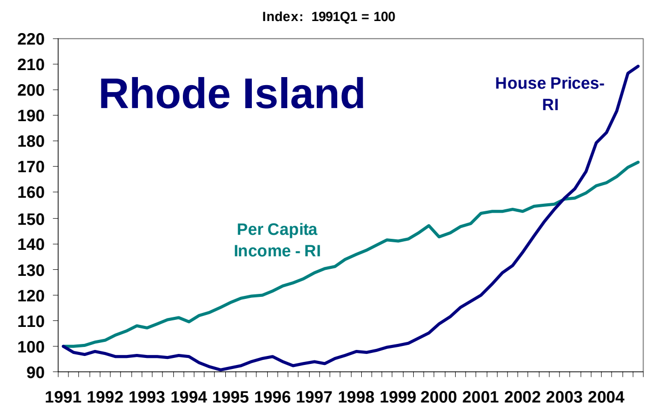
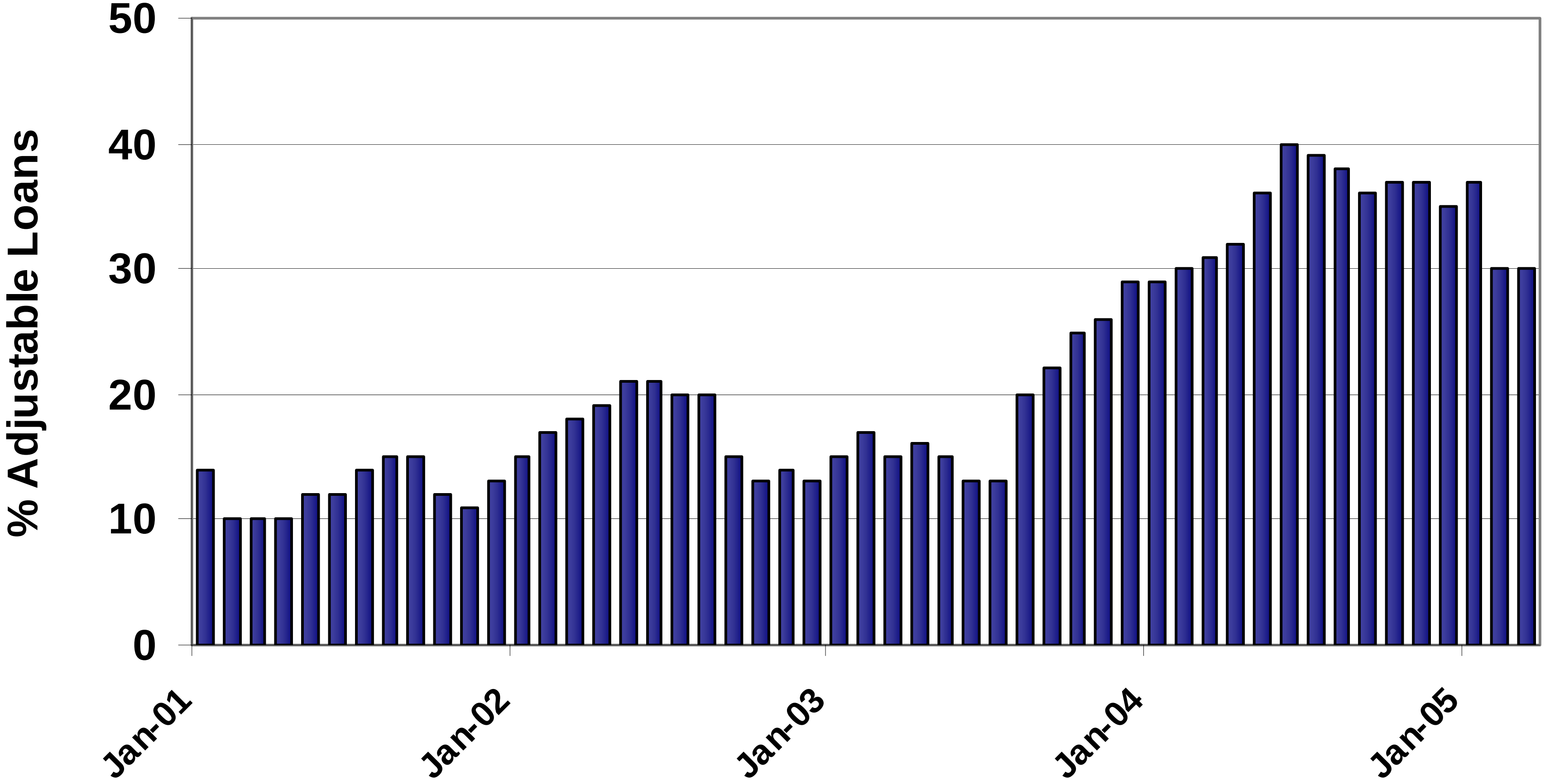


Source: OFHEO, BEA & U.S. Census Bureau

ARM originations on the rise...good for lenders interest rate risk...may lead to higher consumer credit risk in rising rate environment



Source: Federal Housing Finance Board

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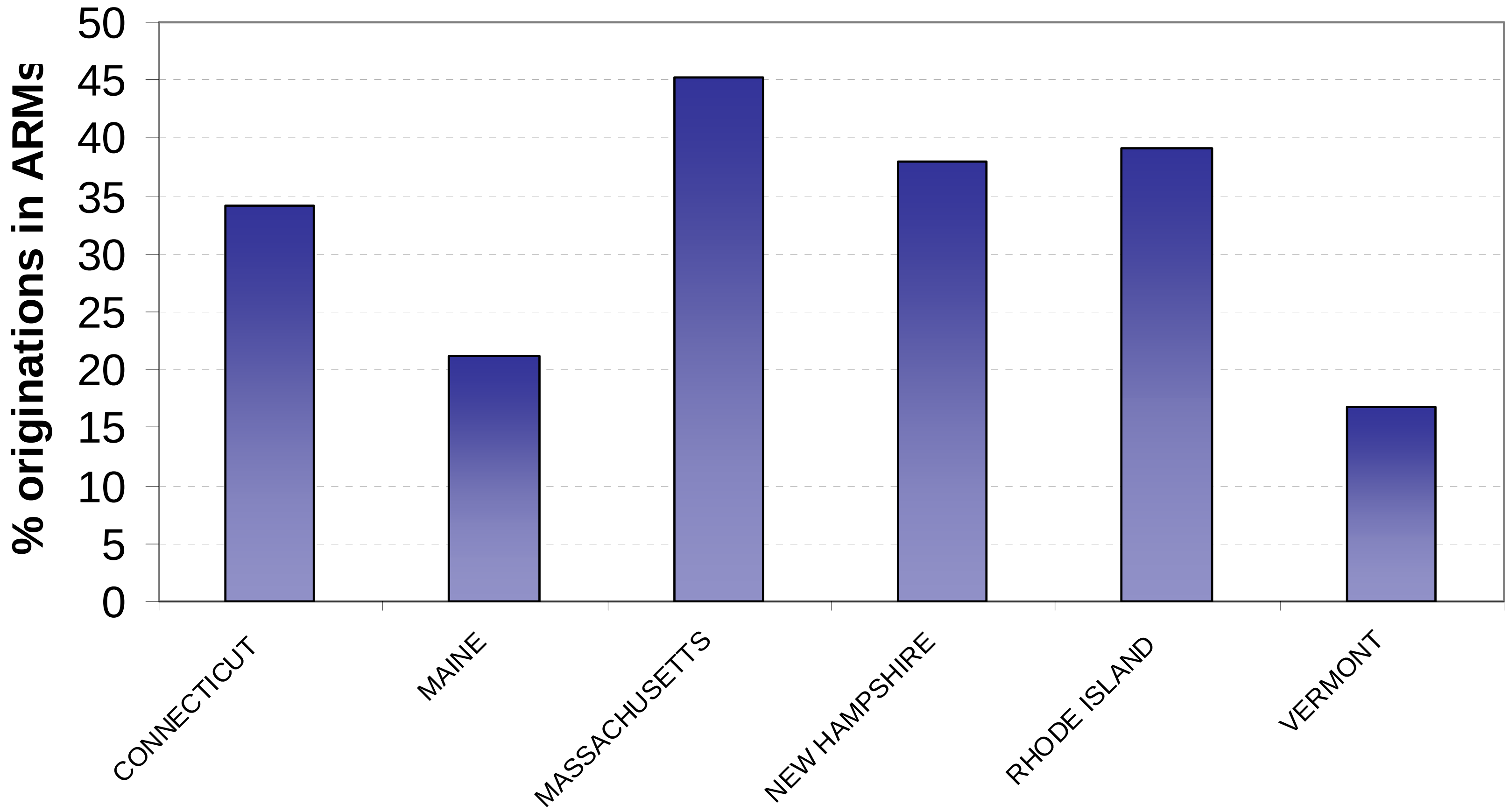
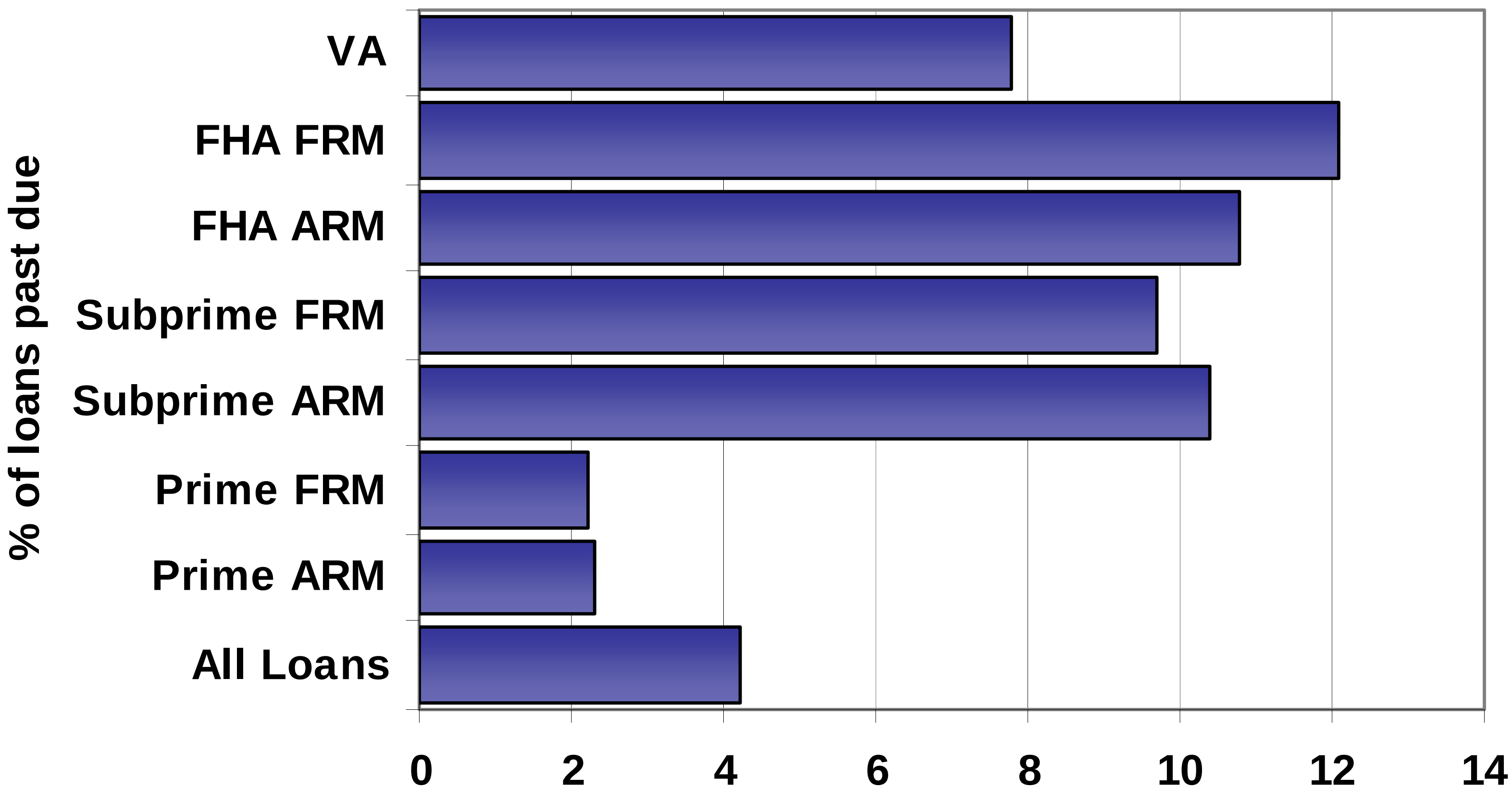
Use of ARMs higher in states with eroding affordability



Source: Federal Housing Finance Board, as of year end 2004

Not all residential loans have the same default risk



Source: Mortgage Bankers Association, 4Q04

How to prepare for the unknown?

- Know your exposure to vulnerable markets
- Know exposure to various products
- Incorporate into underwriting standards
- Stress test your portfolio
- Update ALLL methodology to incorporate hightened risk from vulnerable markets and differentiate by product
- Review new joint HELOC guidance

"History cautions that people experiencing long periods of relative stability are prone to excess. We must thus remain vigilant against complacency...."

Alan Greenspan
Monetary Policy Report to the Congress
February 2005

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