# New England Banking Conditions

Federal Reserve Bank of Boston

Regional & Community Bankers Conference

May 18, 2004

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

**How have Regional & Community Banks located in New England performed during the past year? What are the trends?**

**What's on the horizon?**

**Disclaimer: The views expressed in this presentation are mine and do not necessarily represent the views of the Federal Reserve Bank of Boston or the Federal Reserve System.**

# Compare your lead bank's trends via customized charts package in handouts

New England Banking Conditions
Federal Reserve Bank of Boston
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Customized Charts Package
Includes data from the following lead banking institution:

YOUR BANK NAME
Subsidiary of the following bank holding company:

YOUR HC NAME

# Characteristics of New England Regional and Community Banks

## Regional Banks

- Consolidated assets (for multi-bank holding companies) between $1 - $10 billion plus Banknorth and Webster Bank
  - Total assets of $104 billion and 59% of New England R&C combined
  - 36 banks

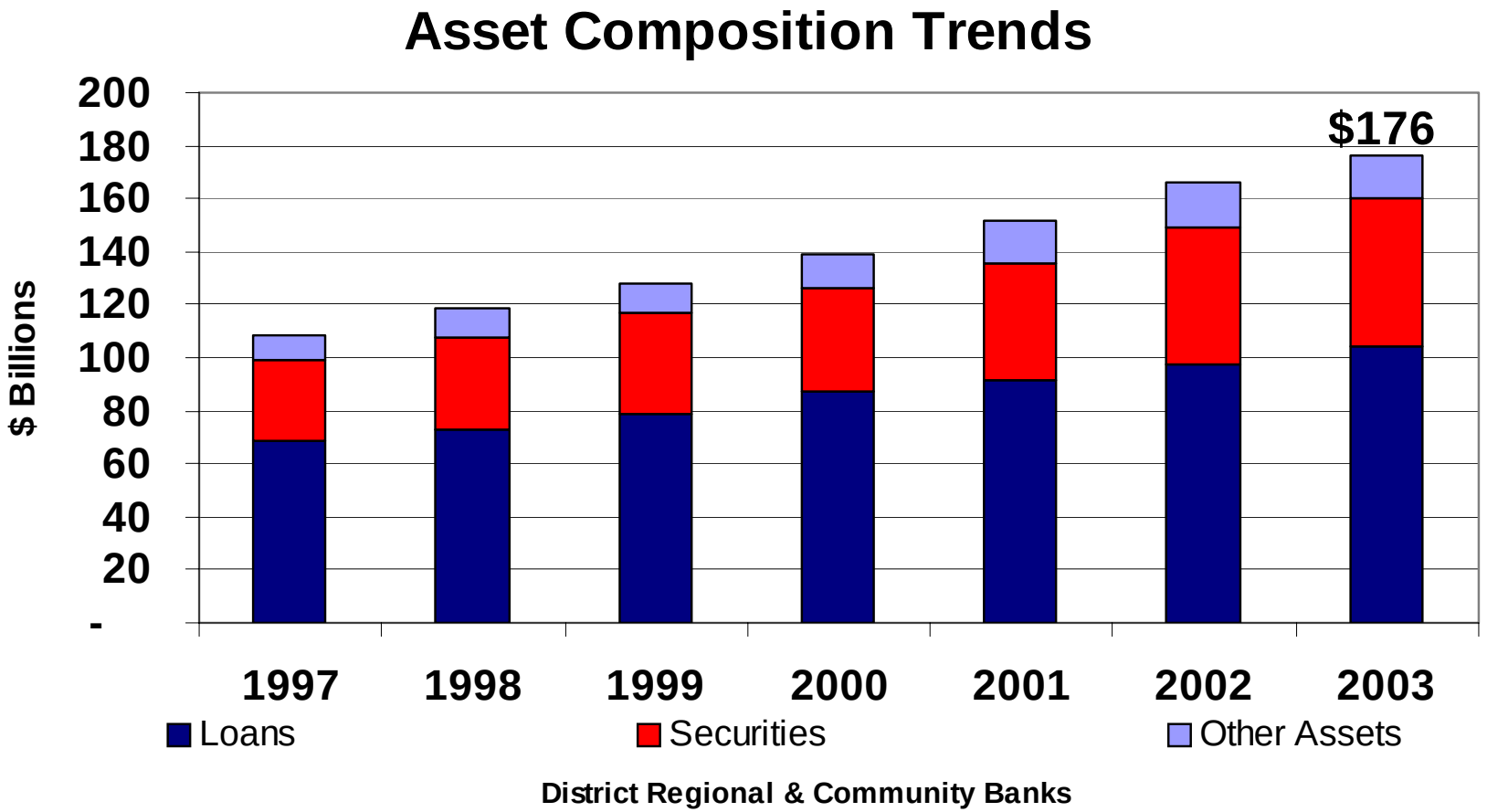
## Community Banks

- Banks with total assets less than $1 billion
  - Total assets of $72 billion and 41% of New England R&C combined
  - 251 banks

## Reminders

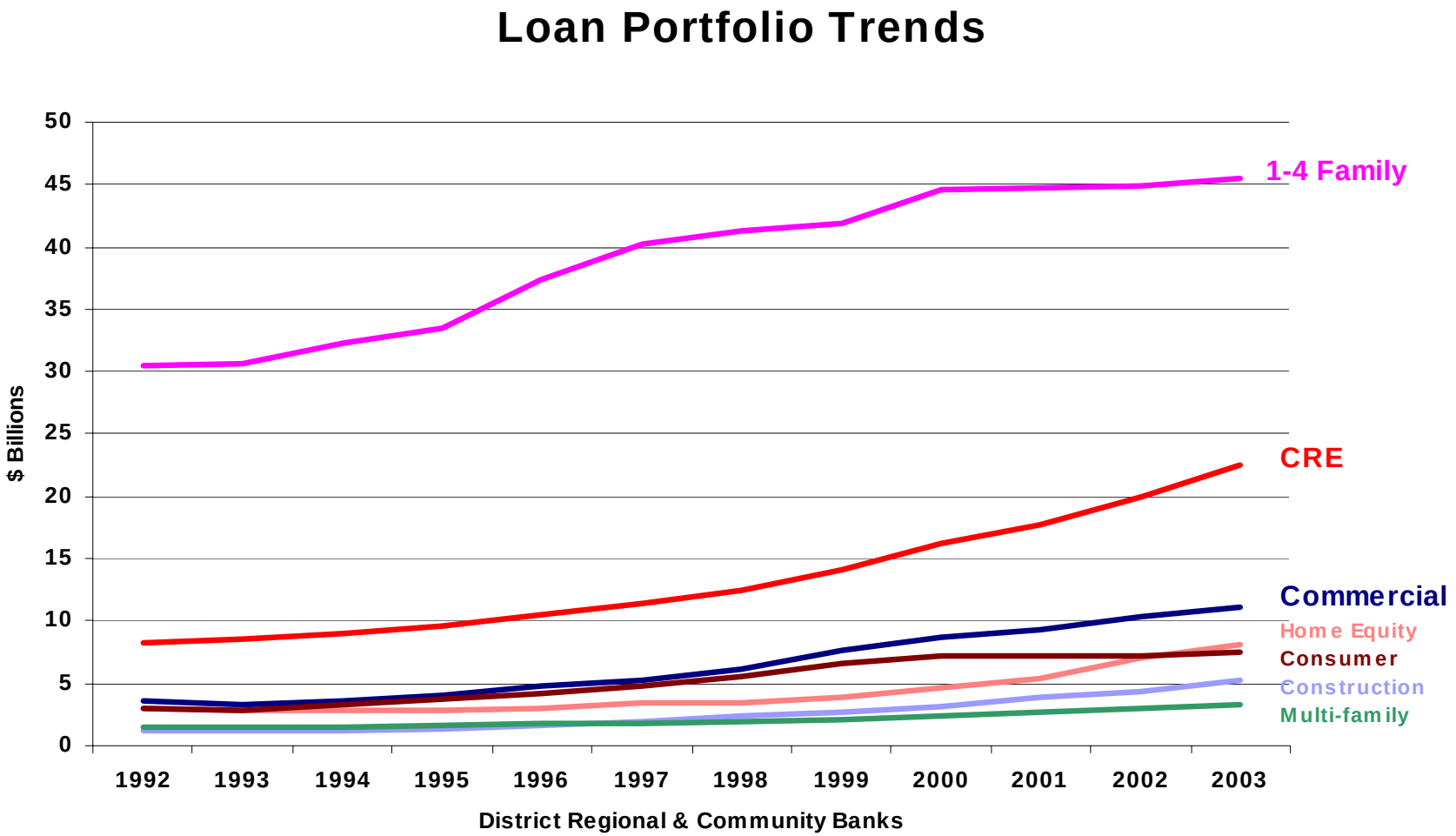
- All bank financial data are merger adjusted (historical data for existing institutions and their legacy banks)
- References between New England and “District” are the same
- S&Ls are excluded

# Loan growth more robust this year, outpacing total asset growth of 6%

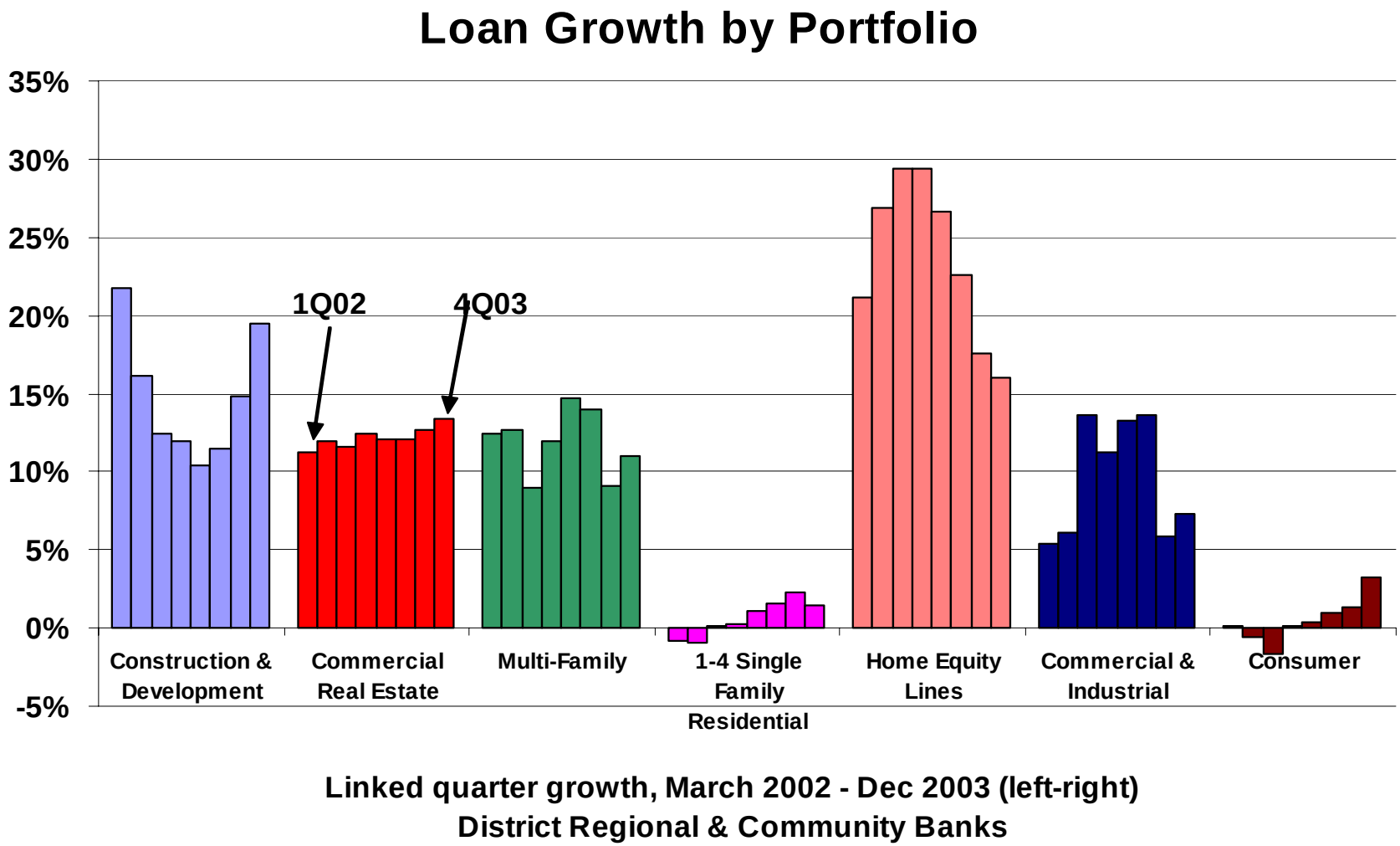



**Source: All bank financial data in this presentation are from call reports obtained via the FDIC Data Access Retrieval Tool or the Federal Reserve's PRISM software.**

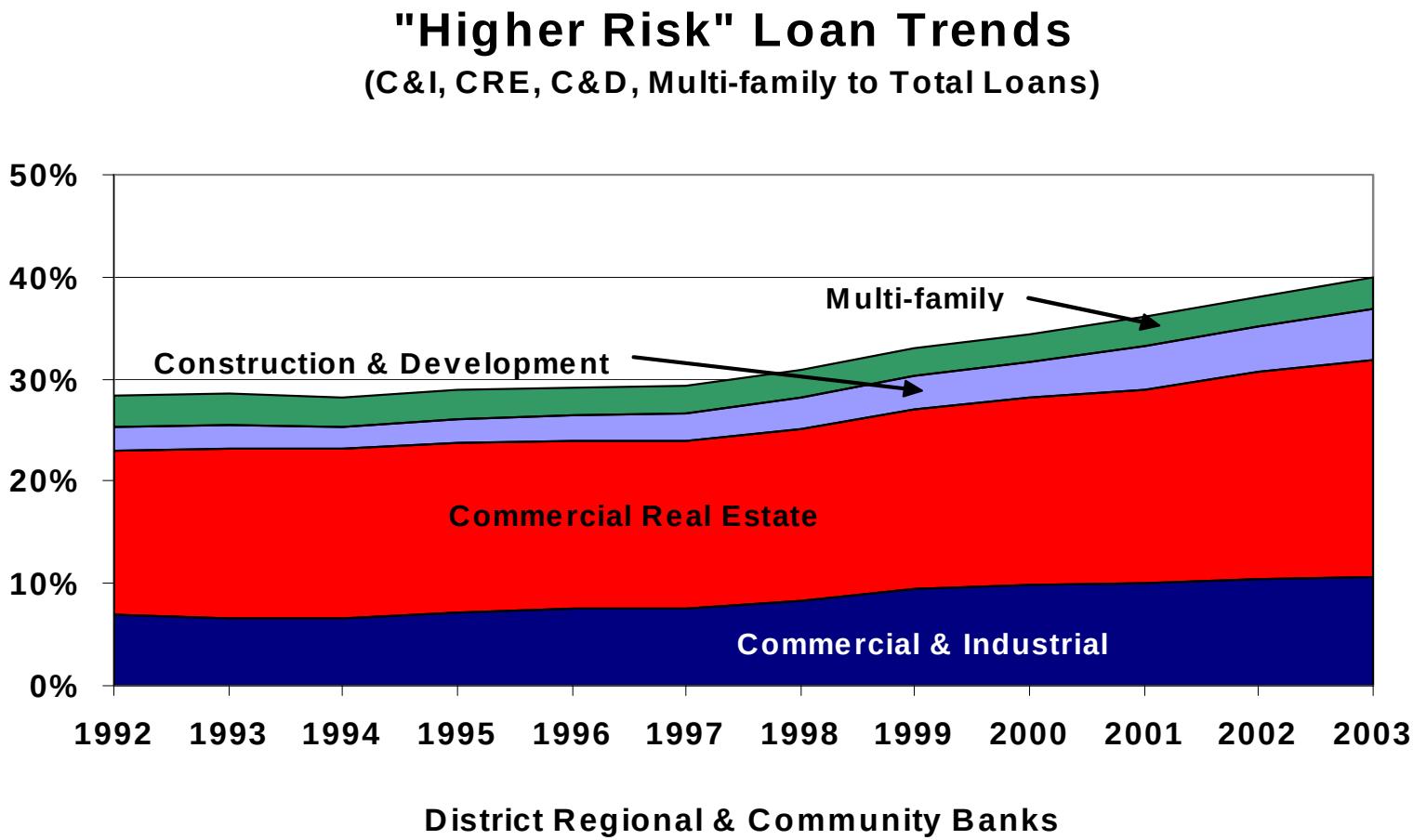
# Loan growth averaged over 7% despite stable single family portfolios



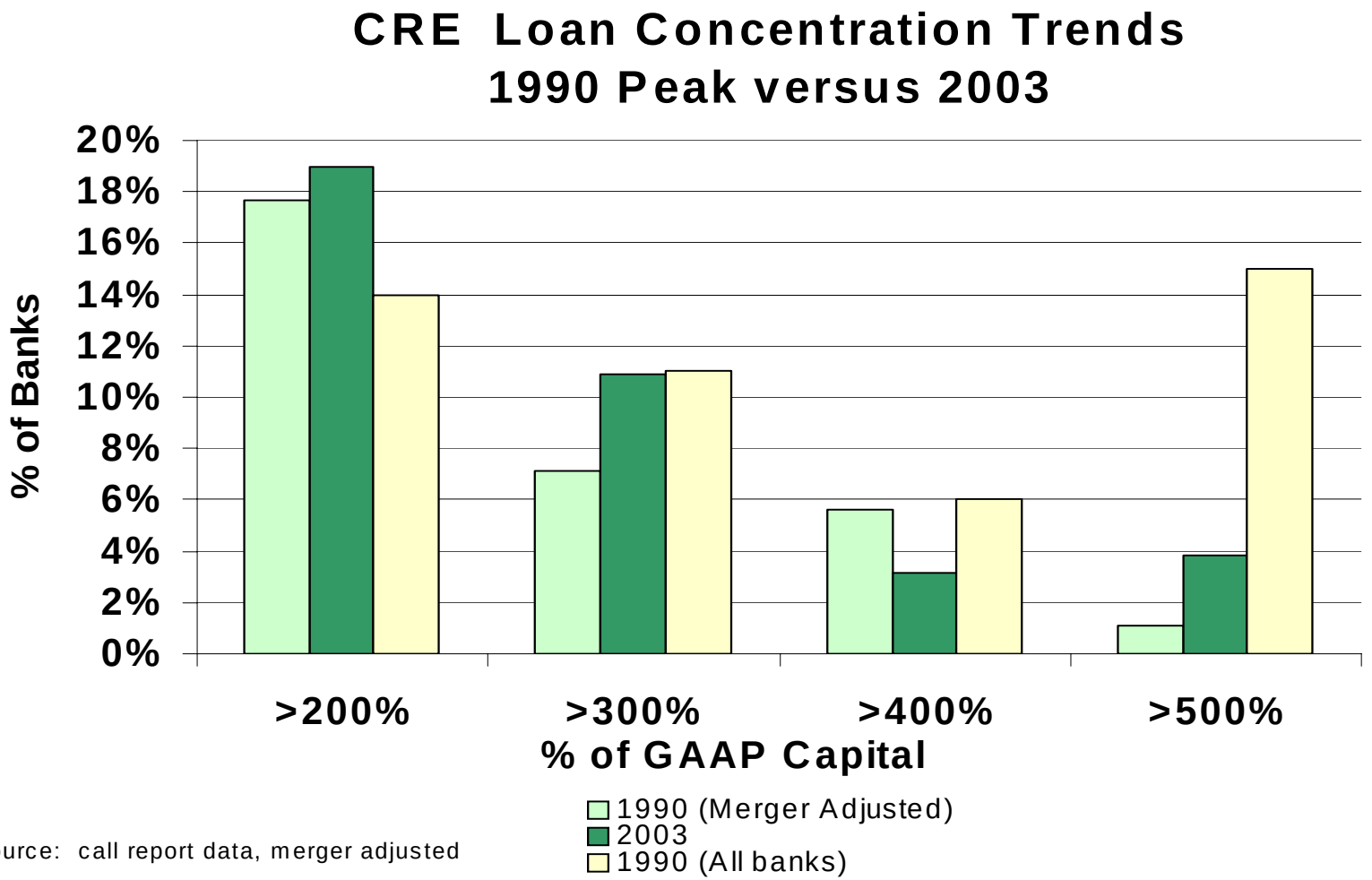
# Loan growth excluding single family residential exceeds 11%, varies by portfolio



# “Higher risk” portfolios continue upward trend....concentrations on the rise

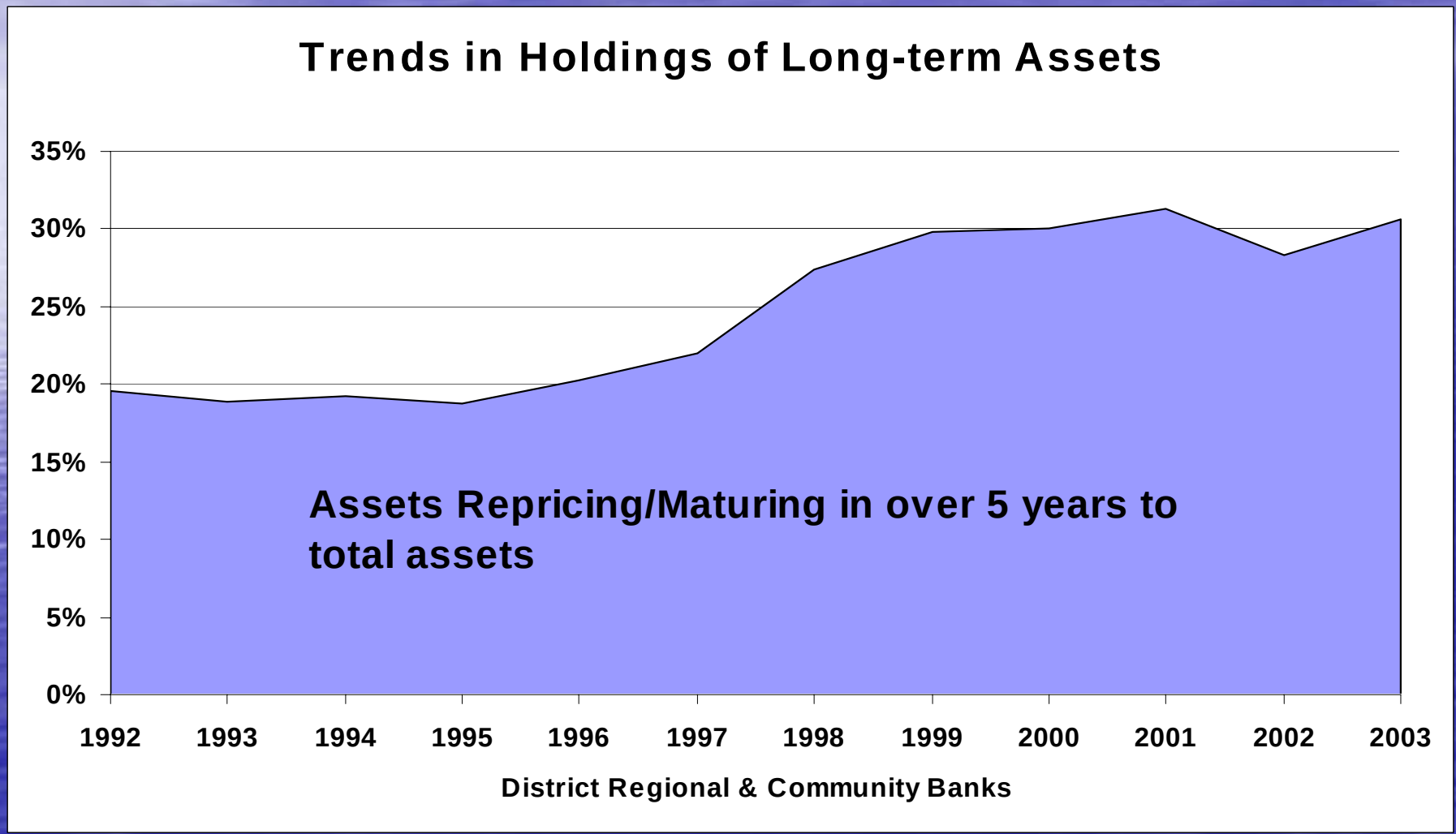


# Current CRE concentrations now meet or exceed levels from 1990 (the 1990 merger adjusted data includes only those banks that survived the 1990 banking crisis)

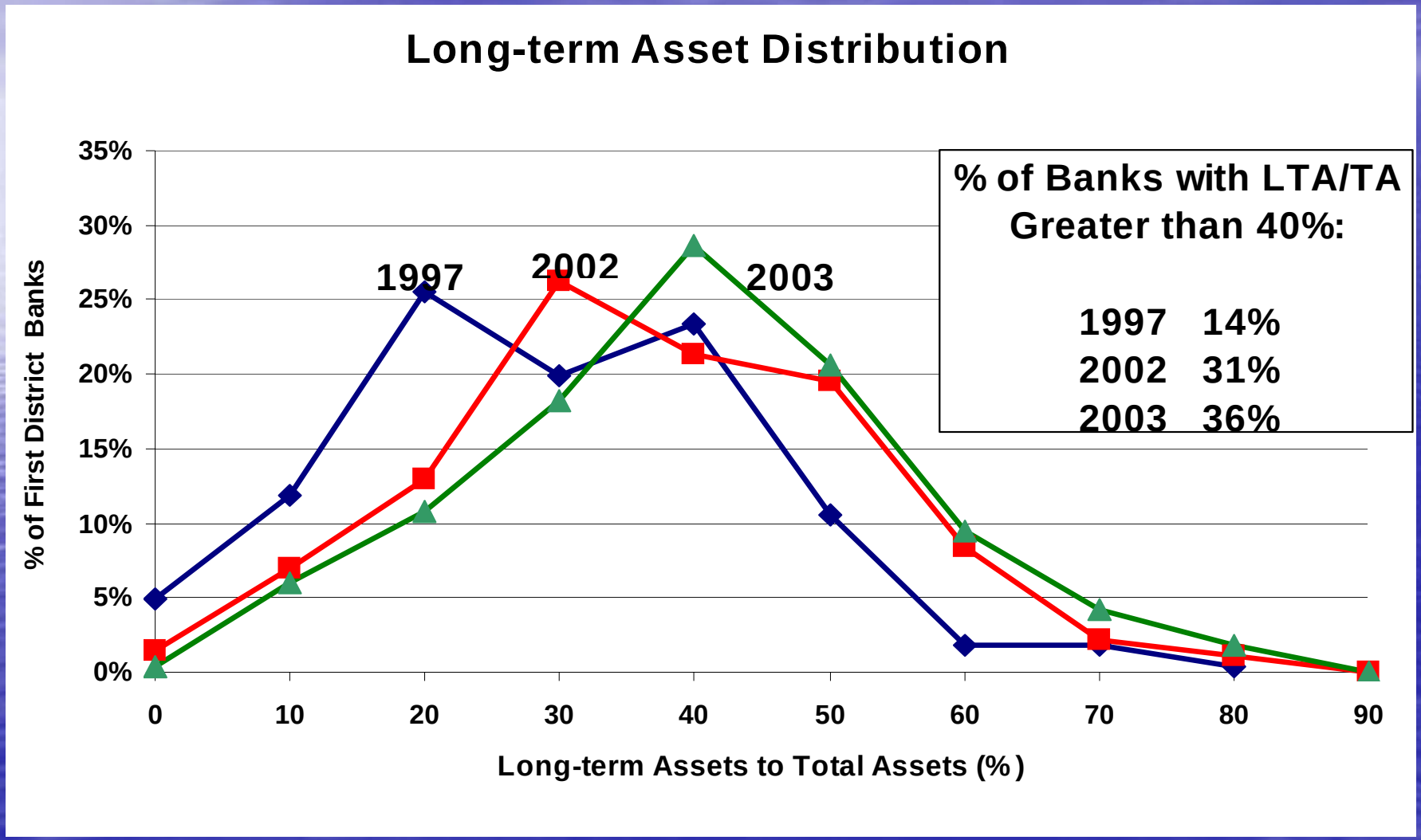



Source: call report data, merger adjusted

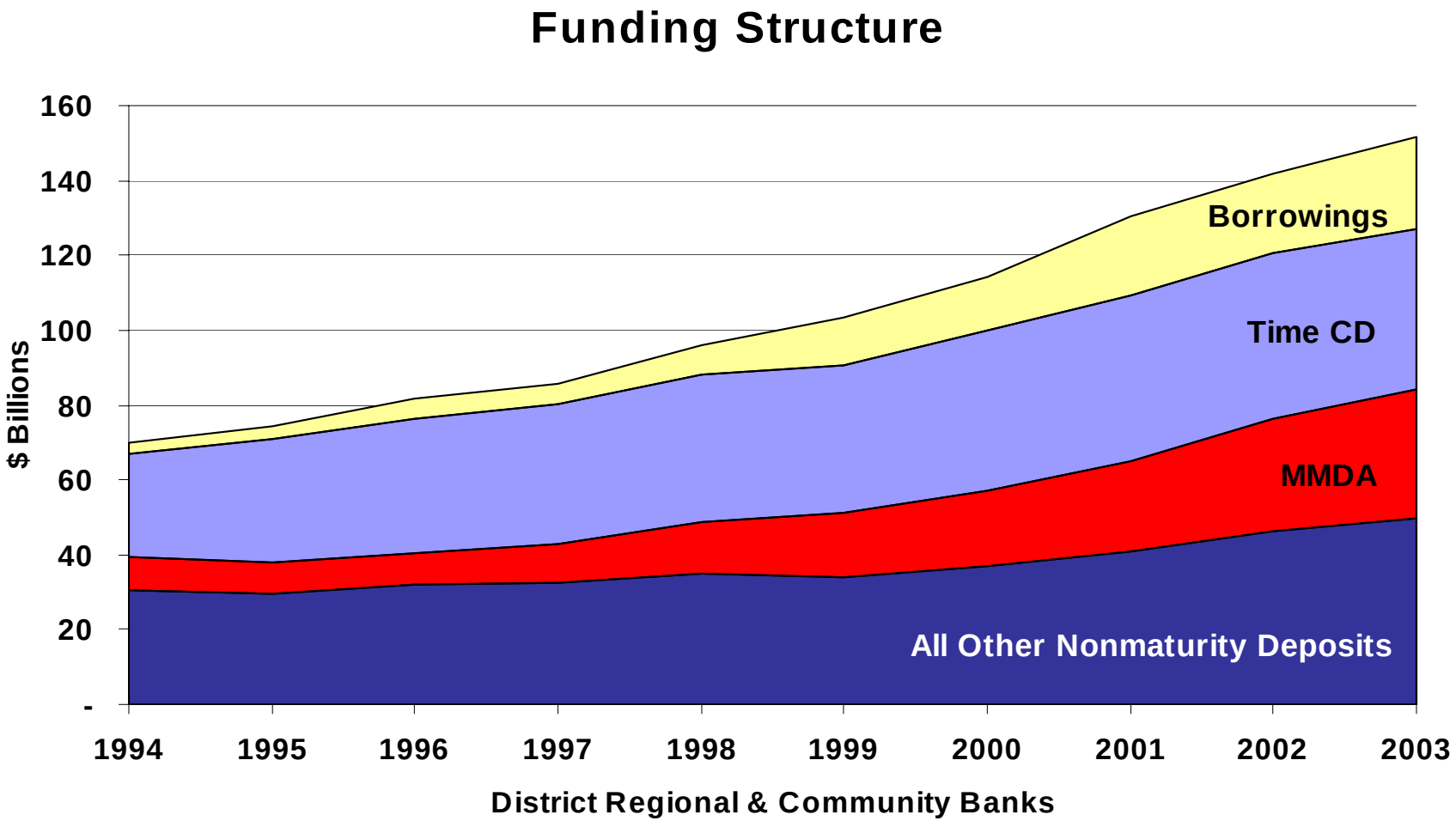
# Banks continued to add long-term product to their balance sheets despite historically low interest rates



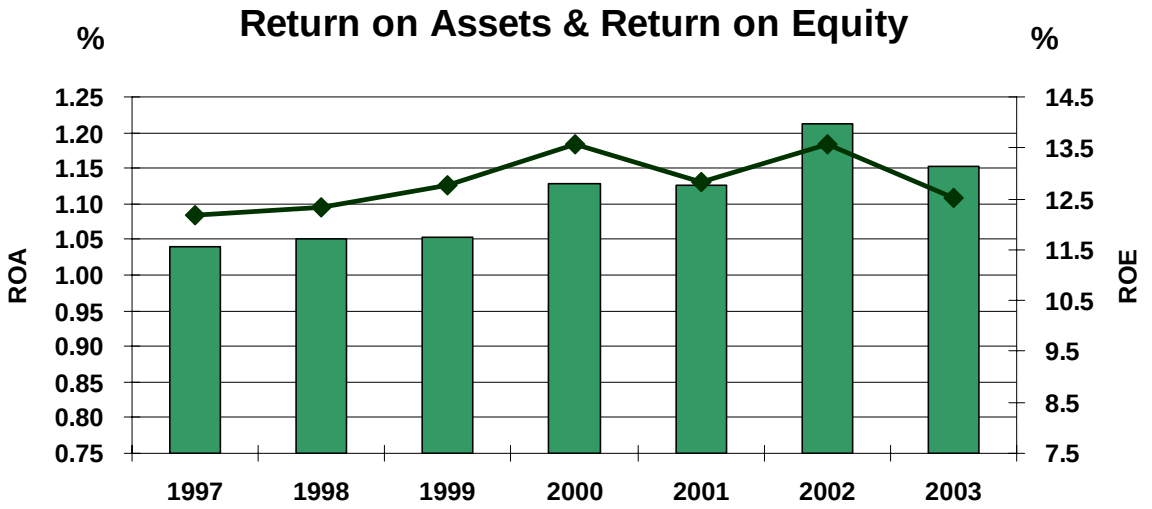
# Interest rate risk distribution reflects higher levels and increasing trends, even at the outer extremes

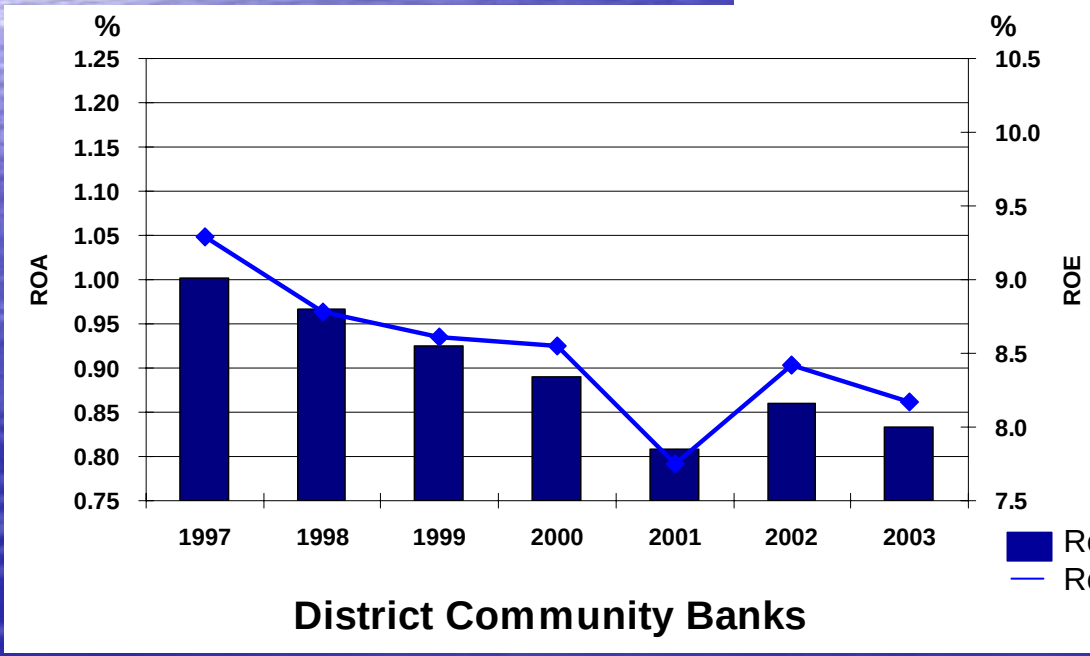


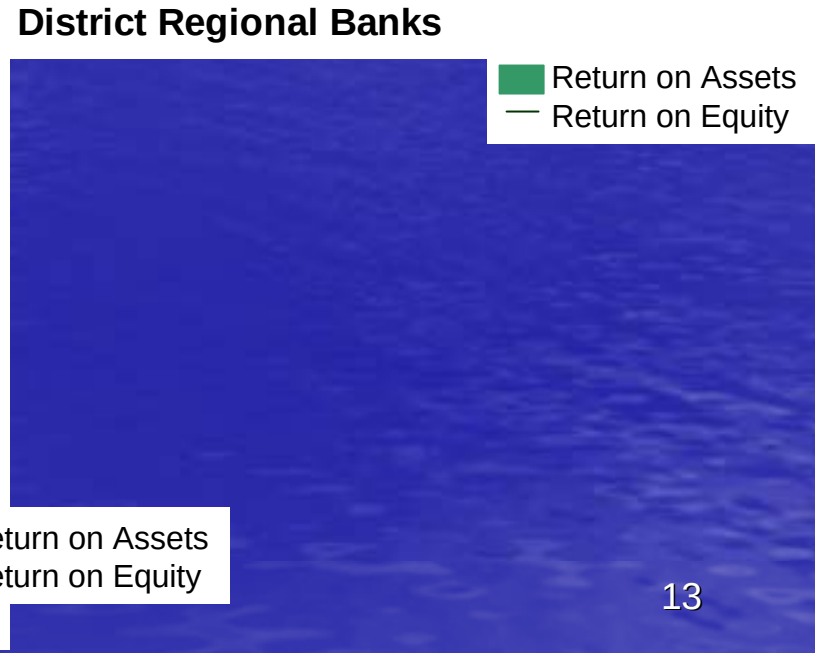
# Strong deposit growth led by MMDA inflows.... will they continue?



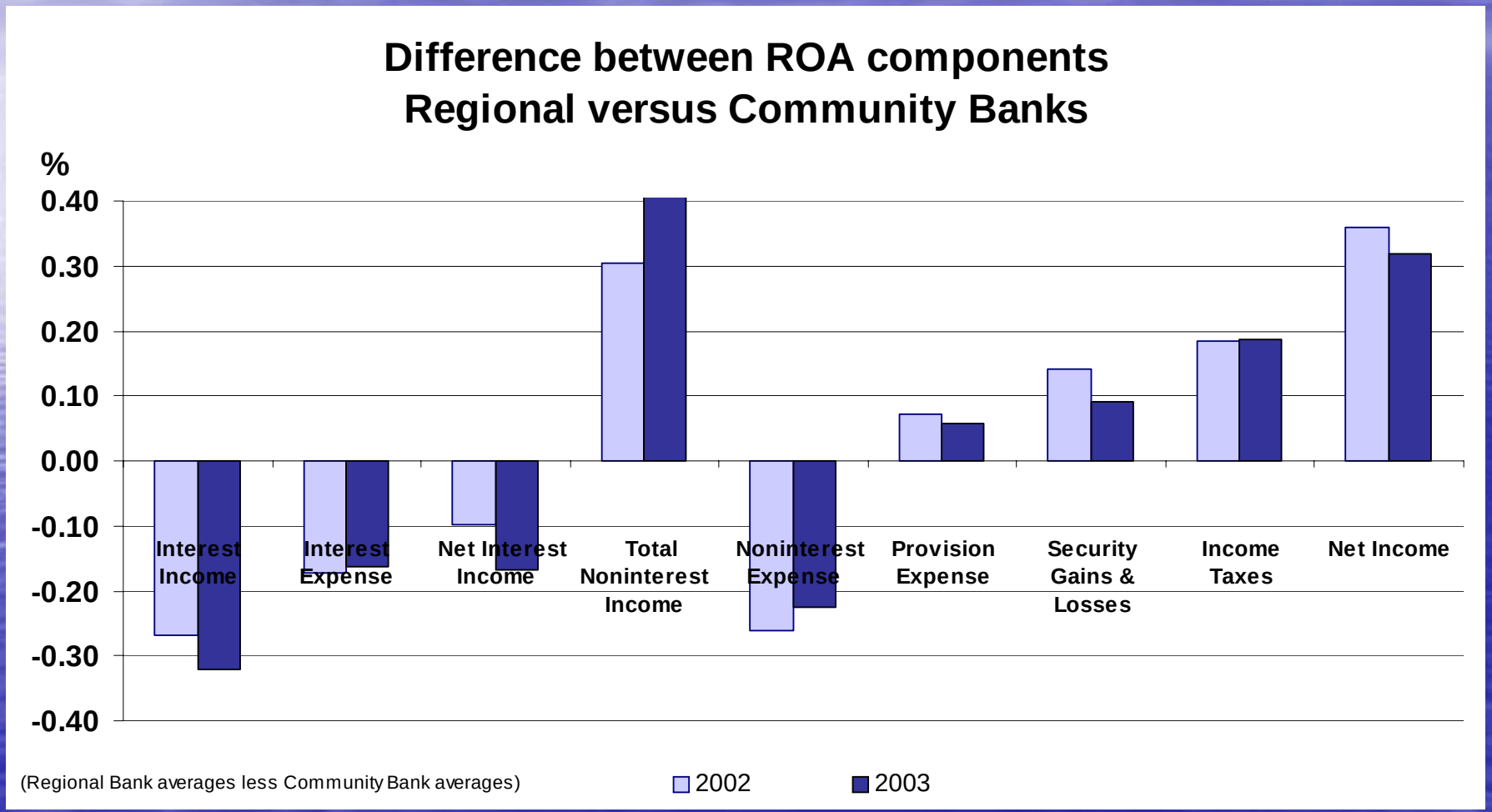
# Net income at record levels but margins and growth under pressure....community banks have a more challenging environment



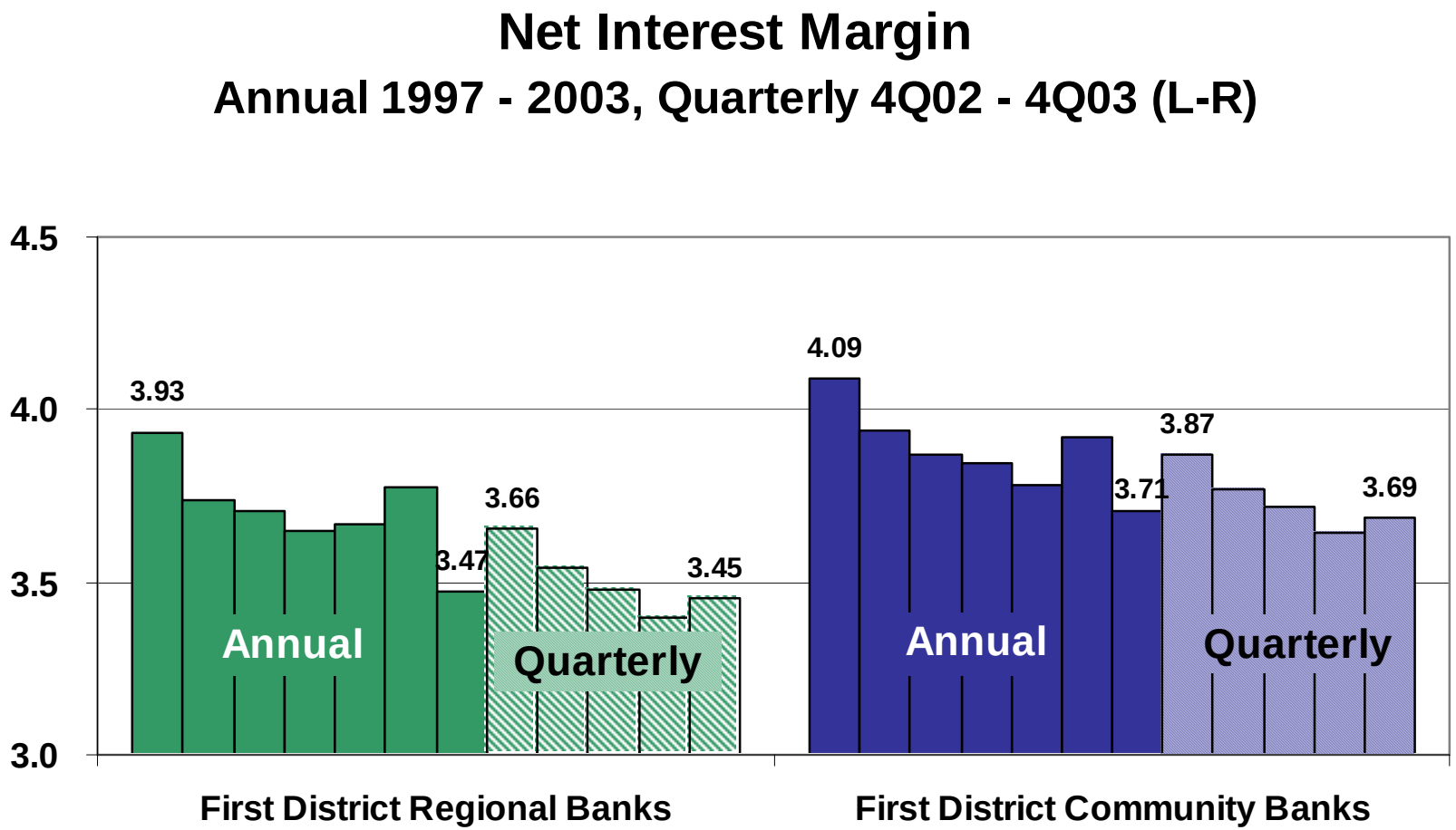



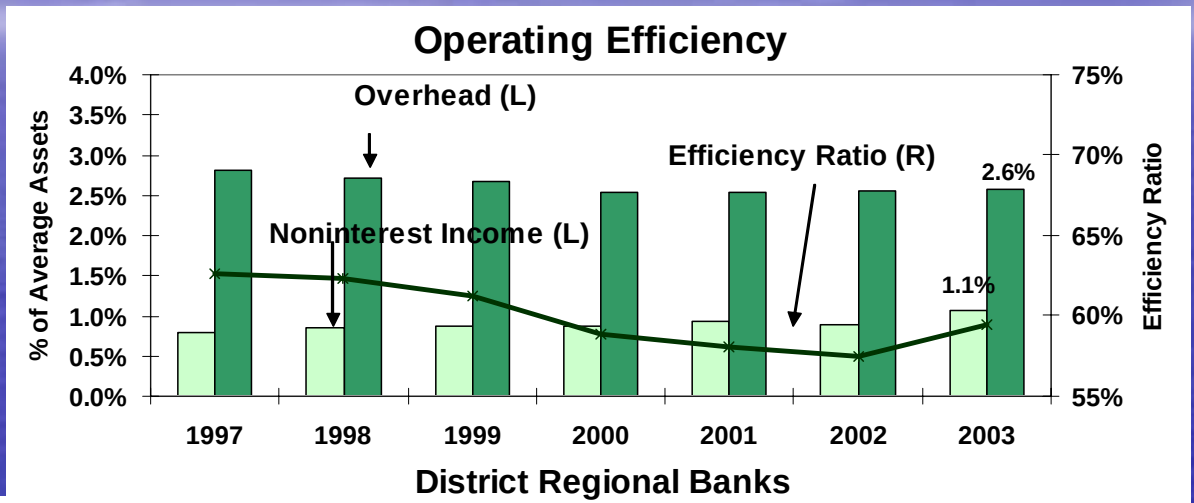
# Why Regional banks are more profitable than community banks

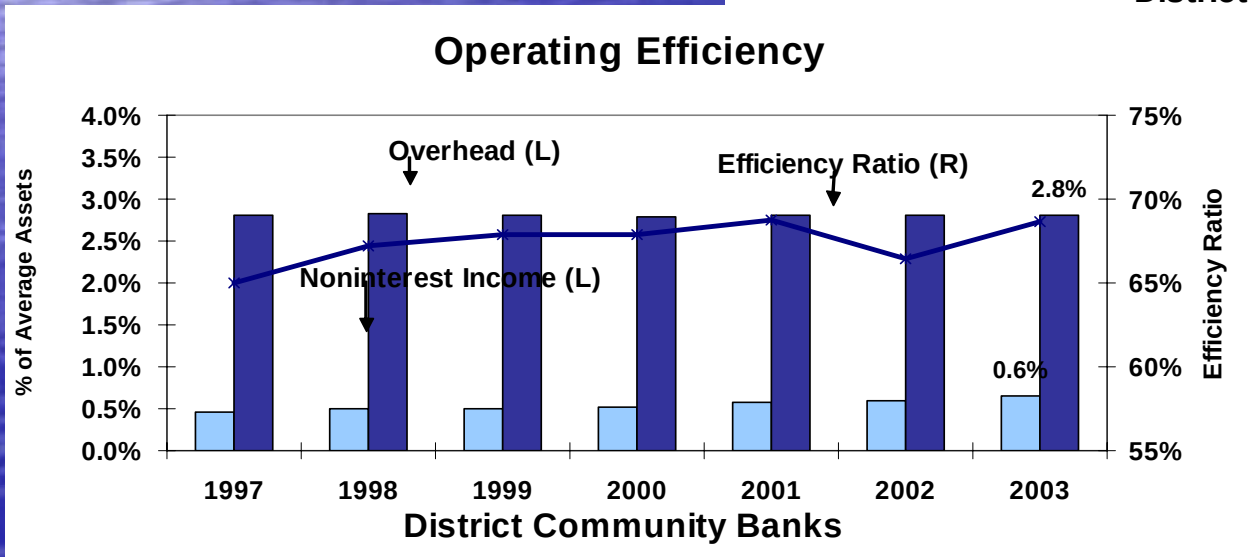


# NIMs reflect a slight rebound during 4th quarter, but many banks are beginning 2004 at very low levels

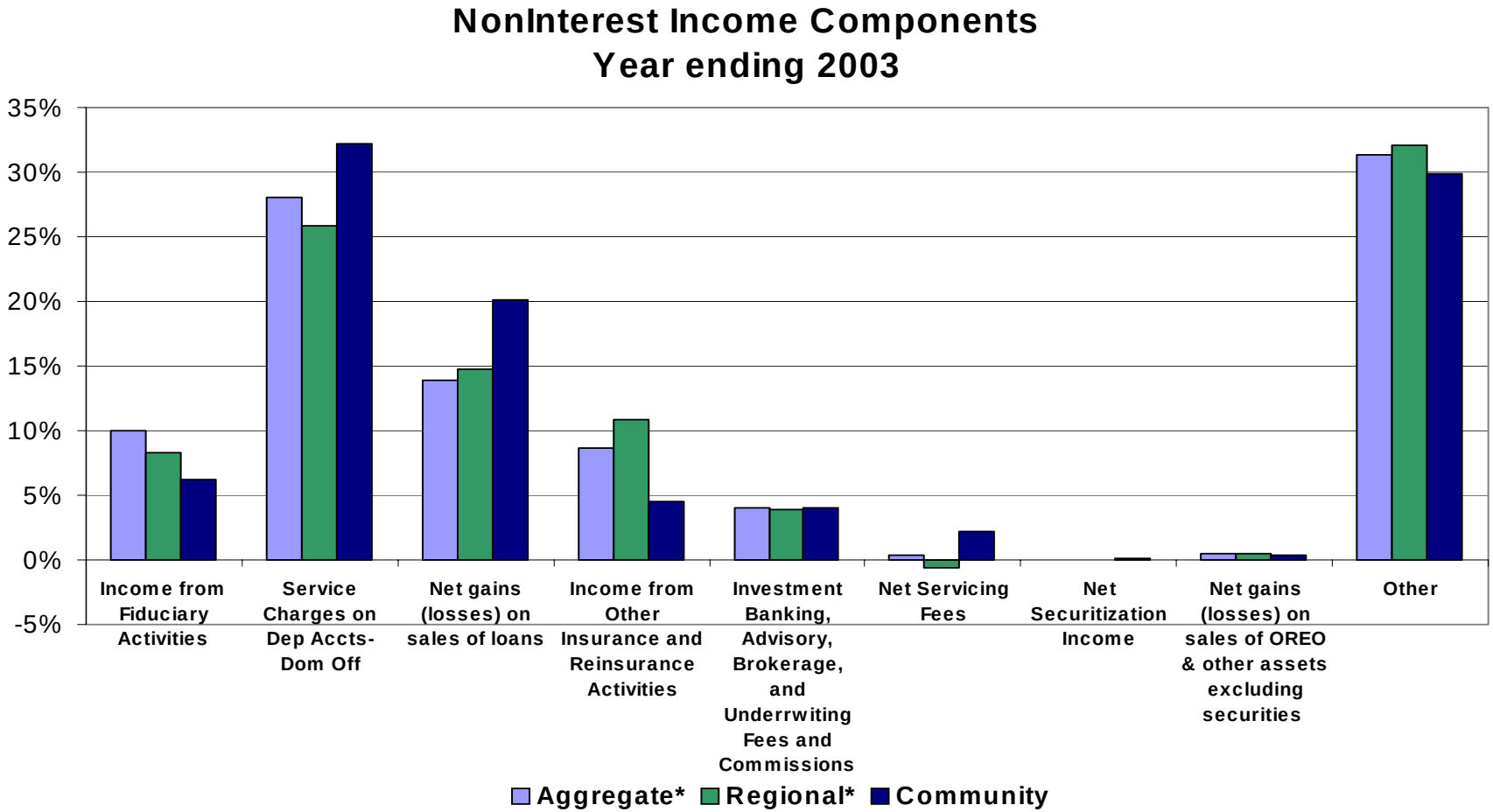


# Overhead expenses held steady, noninterest revenues grew slightly...NIM pressure caused weakening of efficiency ratios



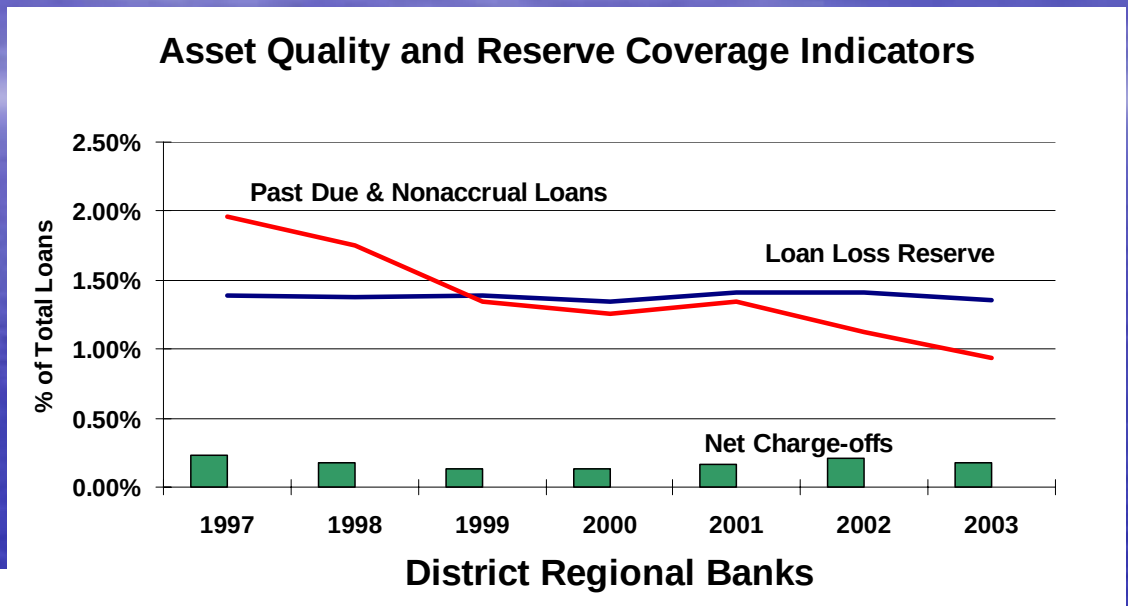



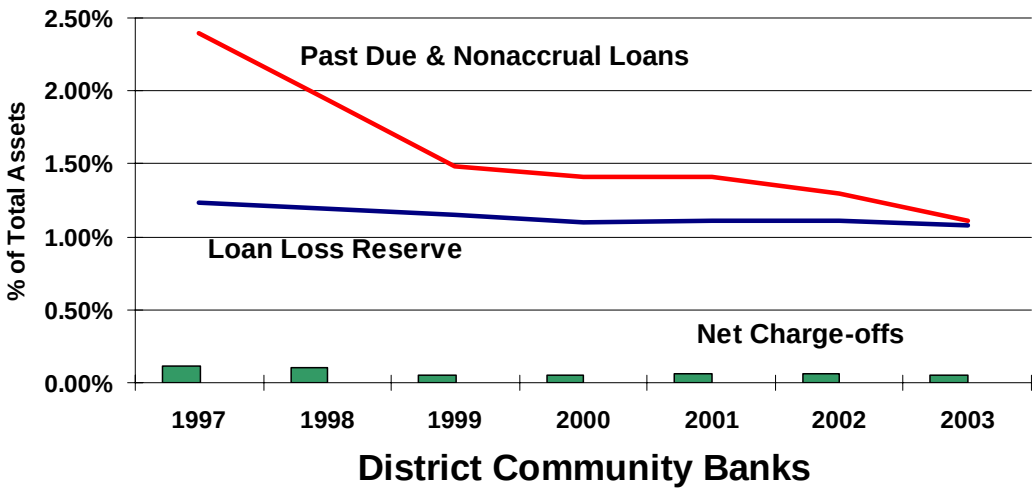
# Noninterest revenues sources



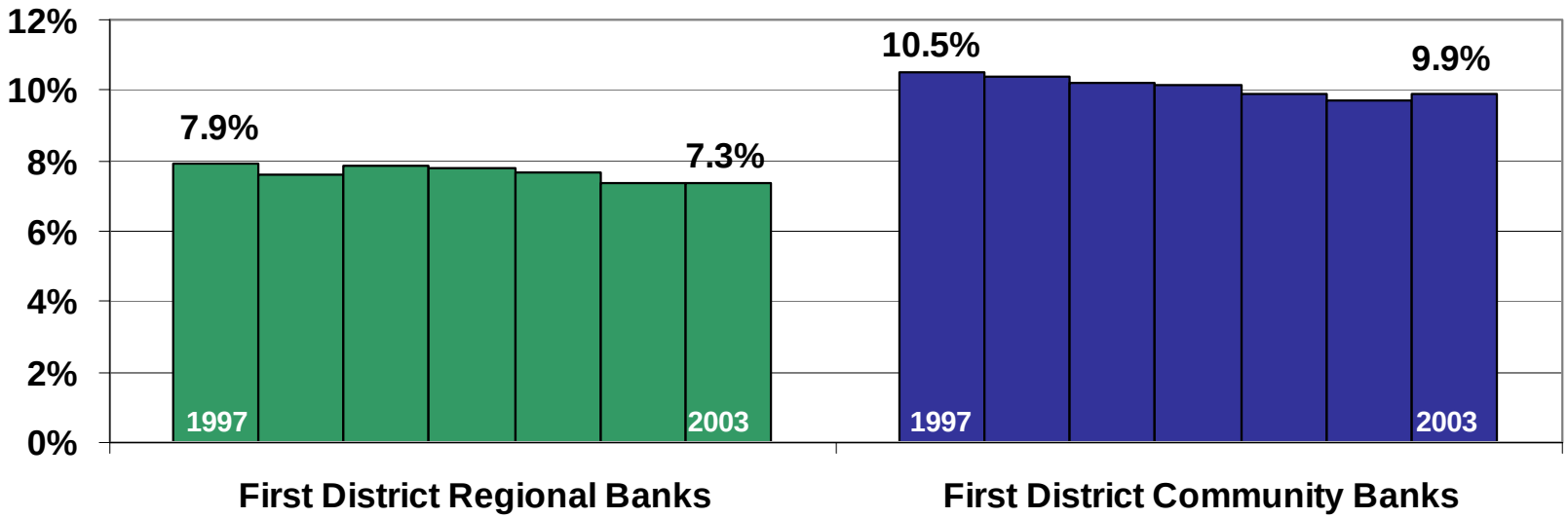

* Excludes Investors Bank & Trust

# Credit quality remains strong, charge-offs are low and reserves are holding steady



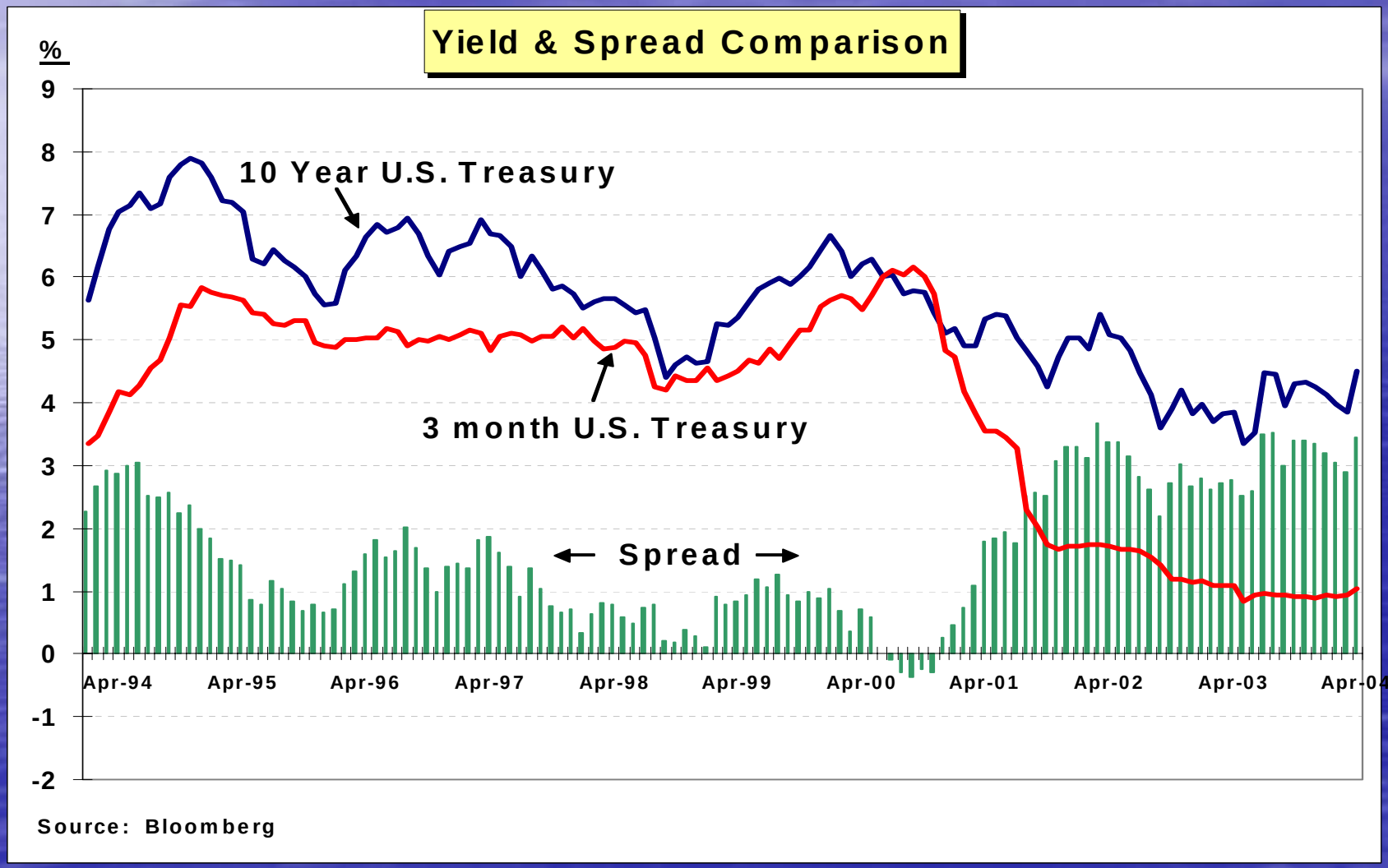
# Capital levels remain sound



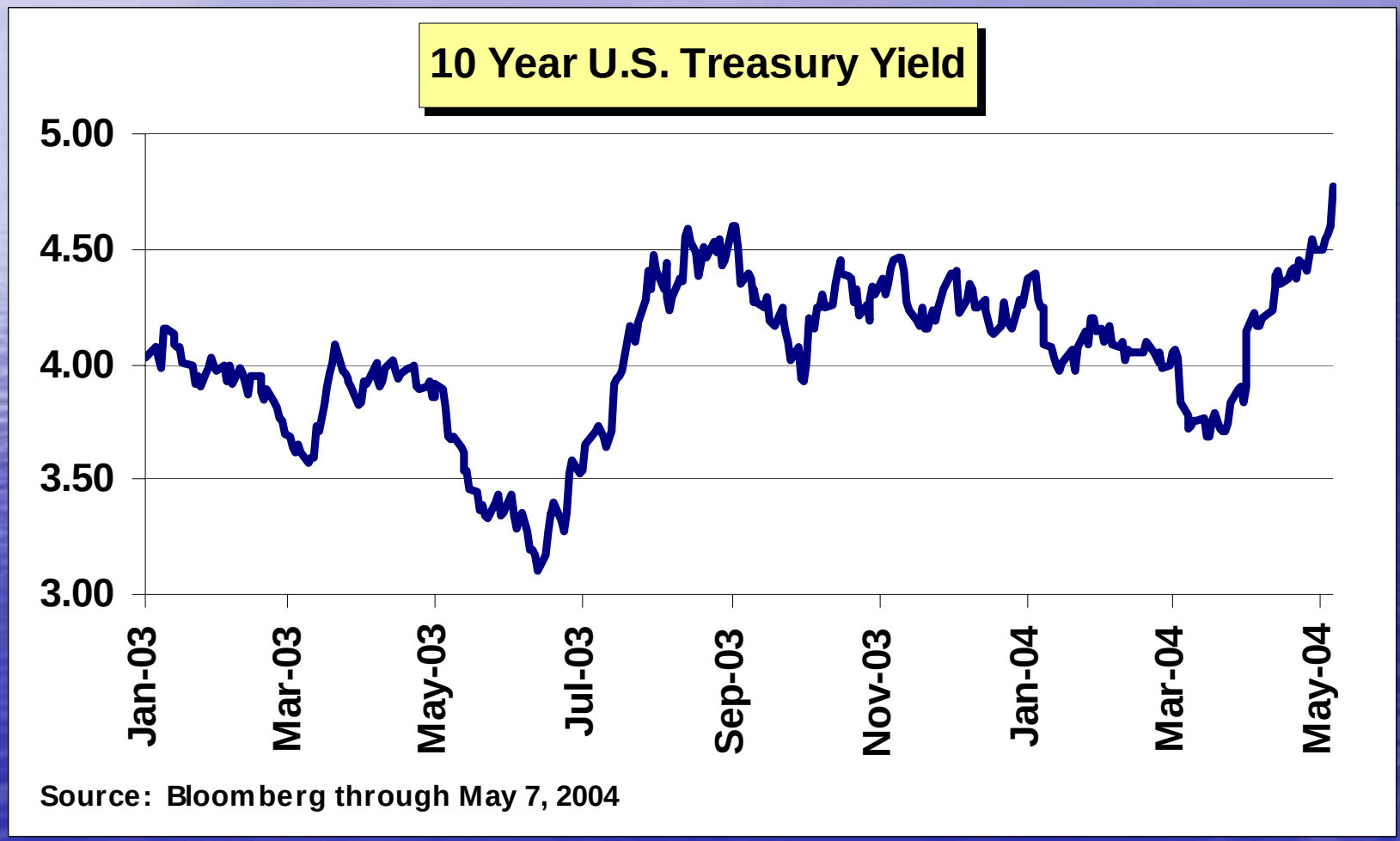
# On the Horizon.....

- Interest Rate Outlook and Implications
- Credit Conditions Outlook
- Risk Management in the 21st century

# Who predicted this?



# A closer picture of volatility....



# Interest Rate Outlook

- May 4th FOMC Statement:

  Accommodative stance is providing important support to economic activity. Output is continuing to expand and hiring appears to have picked up. Long-term inflation expectations appear to have remained well contained. Upside and downside risks to sustainable growth for the next few quarters are roughly equal. Risks to the goal of price stability have moved into balance. With inflation low and resource use slack, policy accommodation can be removed at a pace that is likely to be measured.

- ***Market*** **Interpretation**: The Fed is getting everyone ready for a rate hike this year. Fed funds futures prices pushed up the likelihood of tightening at the June meeting to a 92% chance of a 25 basis point increase, with successive 25bp hikes in August, September and November.

***The author has no involvement in or insider knowledge of the FOMC process!***

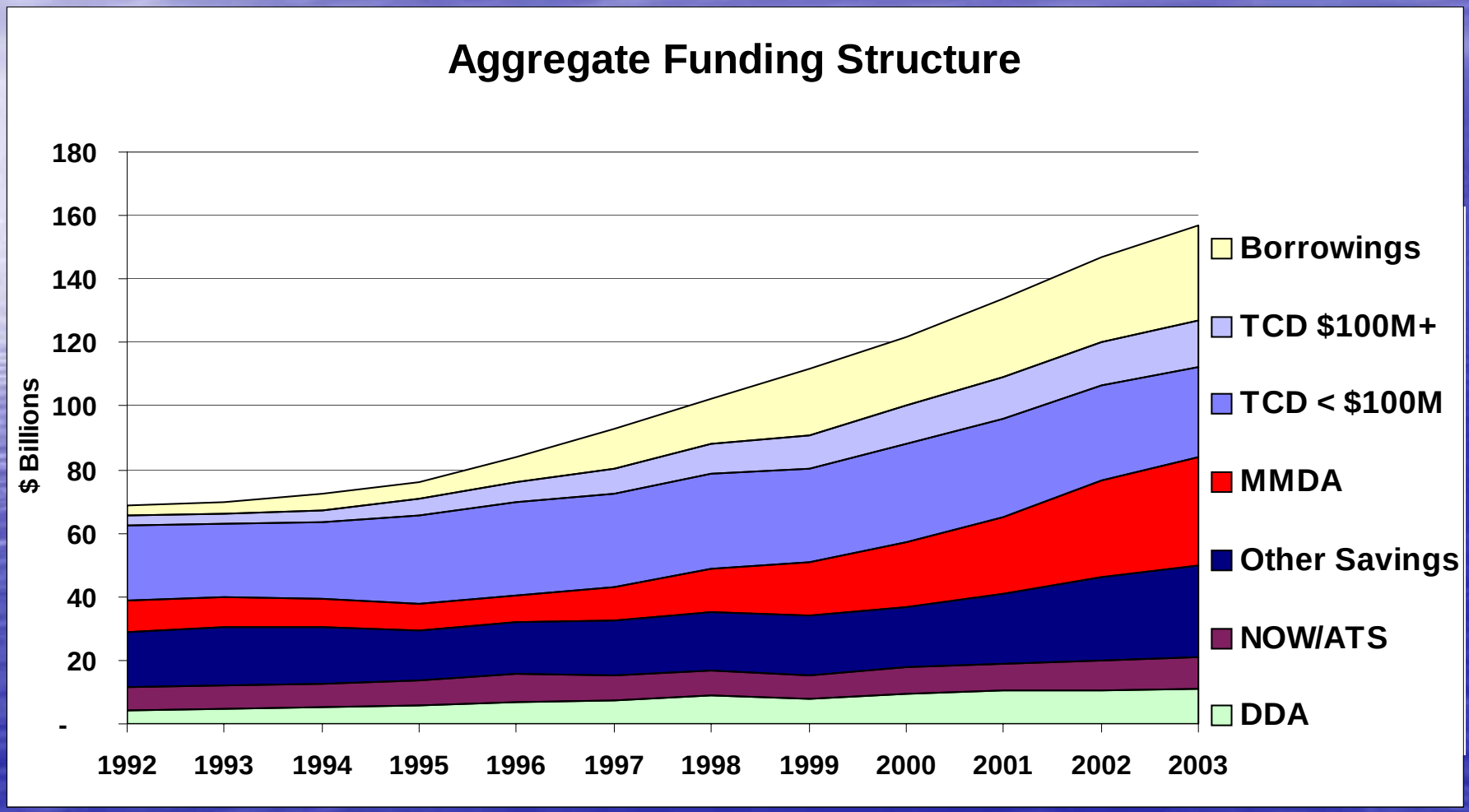
# Interest Rate Outlook: what to watch

- Short term rates:
  - FOMC decisions
- Long-term rates:
  - inflation indicators (market consensus- modest this year)
  - tighter than predicted job markets
  - twin deficits...outlook is not favorable (budget and trade)
- Volatility:  expect continued volatility this year
  - beware risks in trying to “time” the market
- Will the economy prove more sensitive to rate increases than historically?

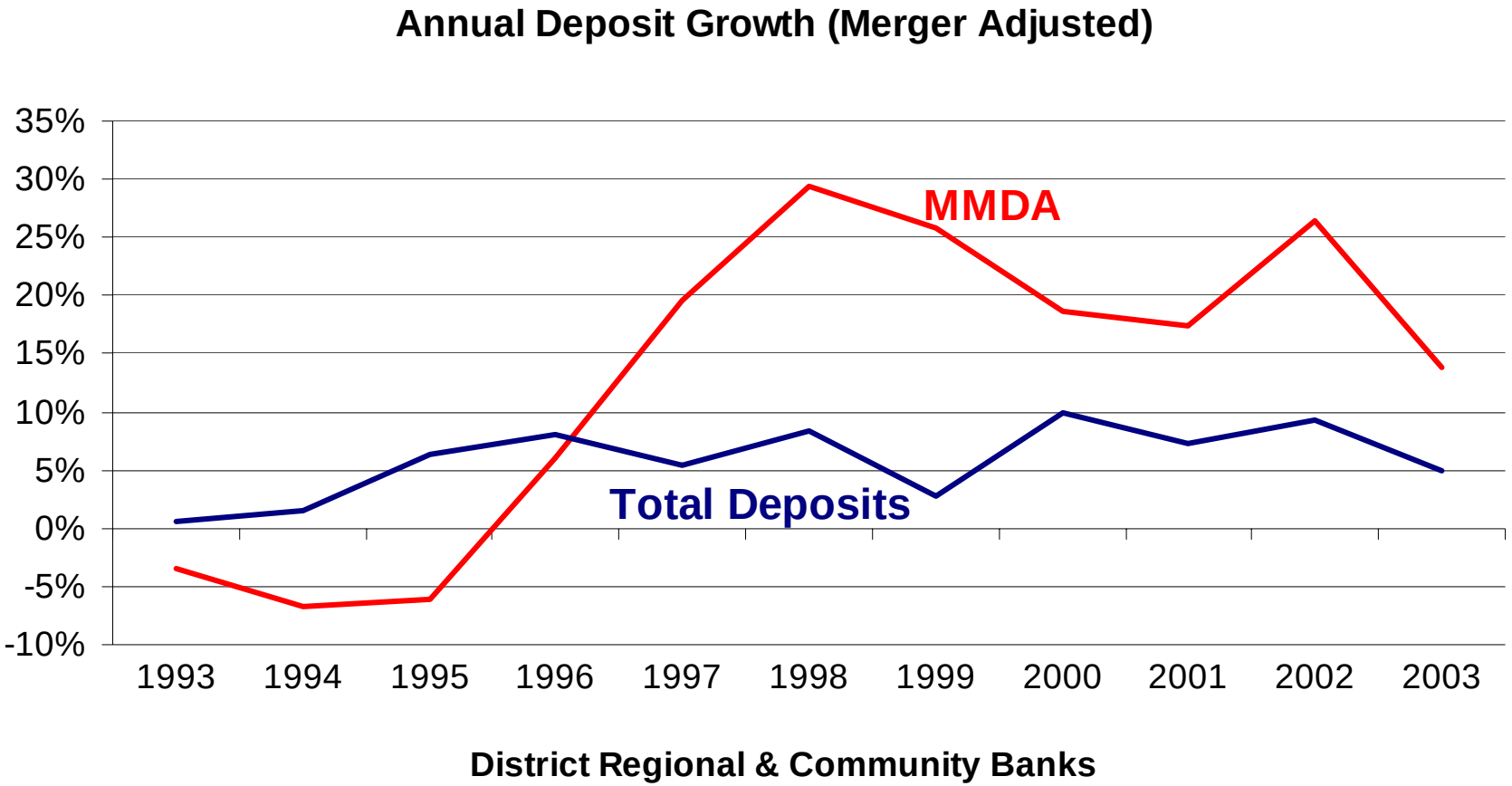
# Interest Rate Risk and Profitability

- Magnitude of rate increases and shape of the yield curve are critical issues
  - In general, the more rapid the increase and the flatter the yield curve the more difficulty in managing margins
  - Do you understand your “worst nightmare” scenario? Have you identified your strategy should it occur?
  - Beware the risks in trying to “time” the market
- Are you running nonparallel rate shocks?
- How much fixed rate long-term product have you booked over the last year at historically low rates?
  - know your risk and options if you’re out in the “tail”
- Have you reviewed your deposit pricing assumptions recently?

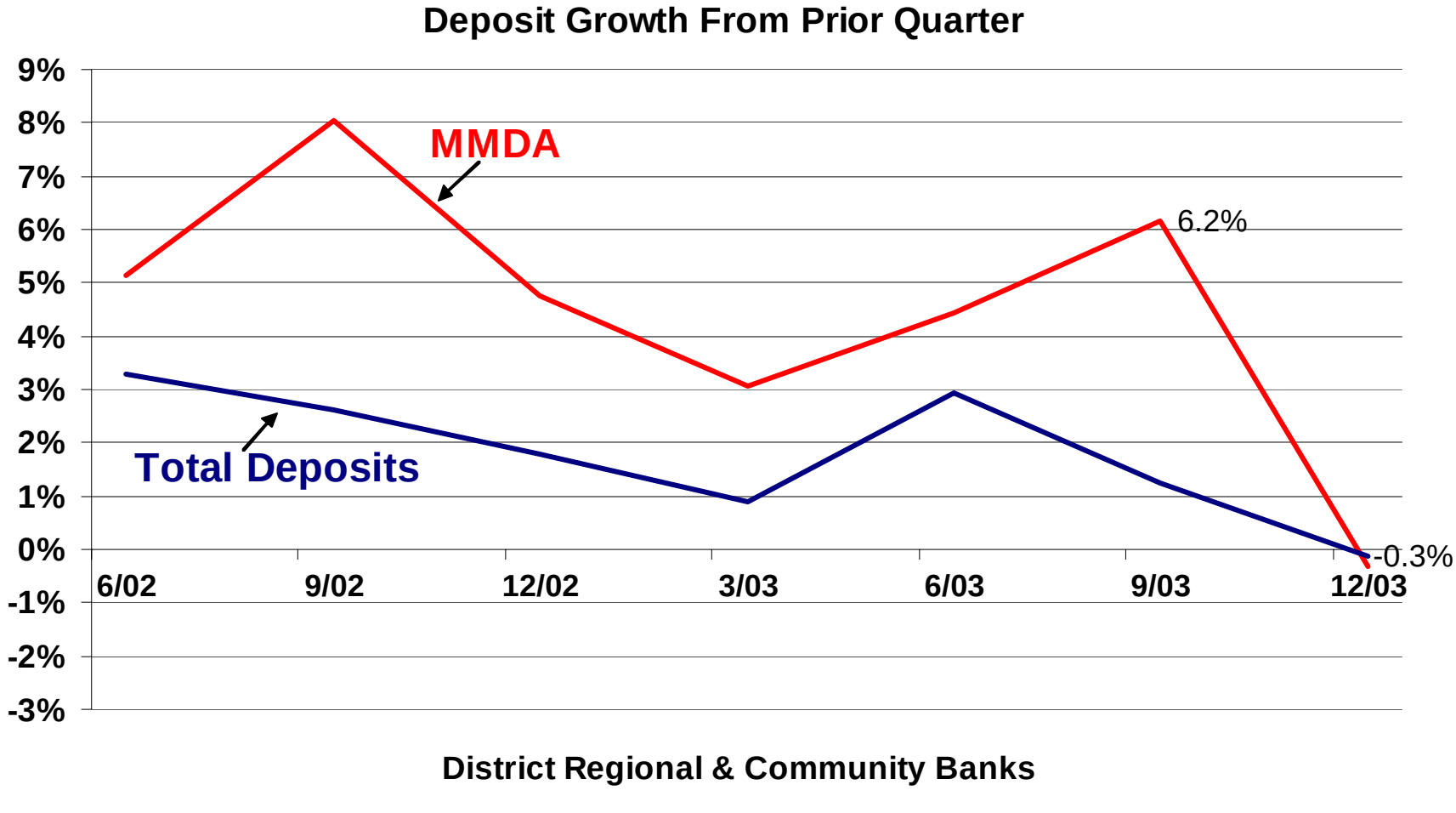
# Funding patterns and hidden risks



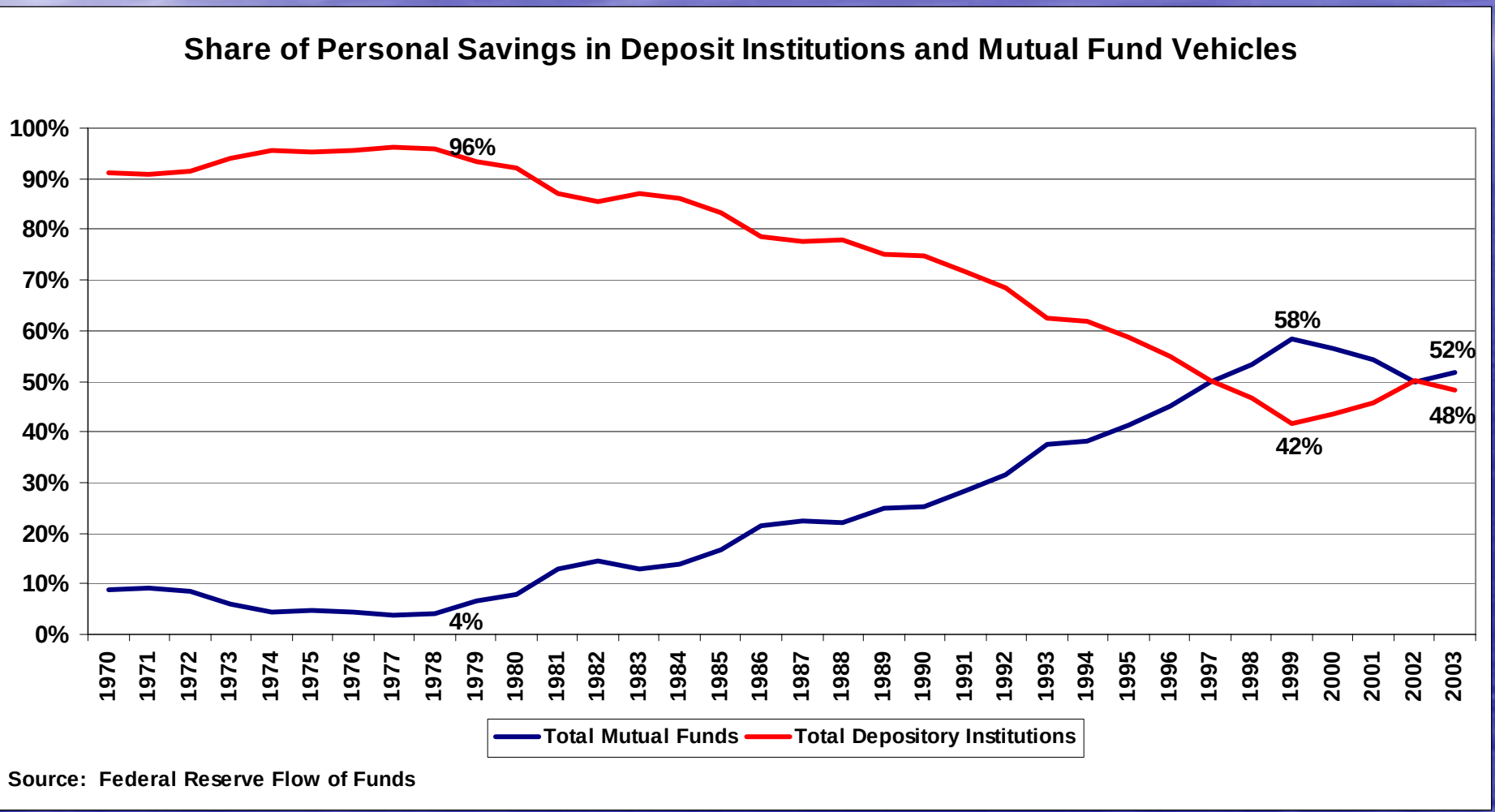
# Deposit growth has been influenced by MMDA growth since late 90's



# ...quarterly MMDA patterns are less encouraging



# What pattern is emerging?

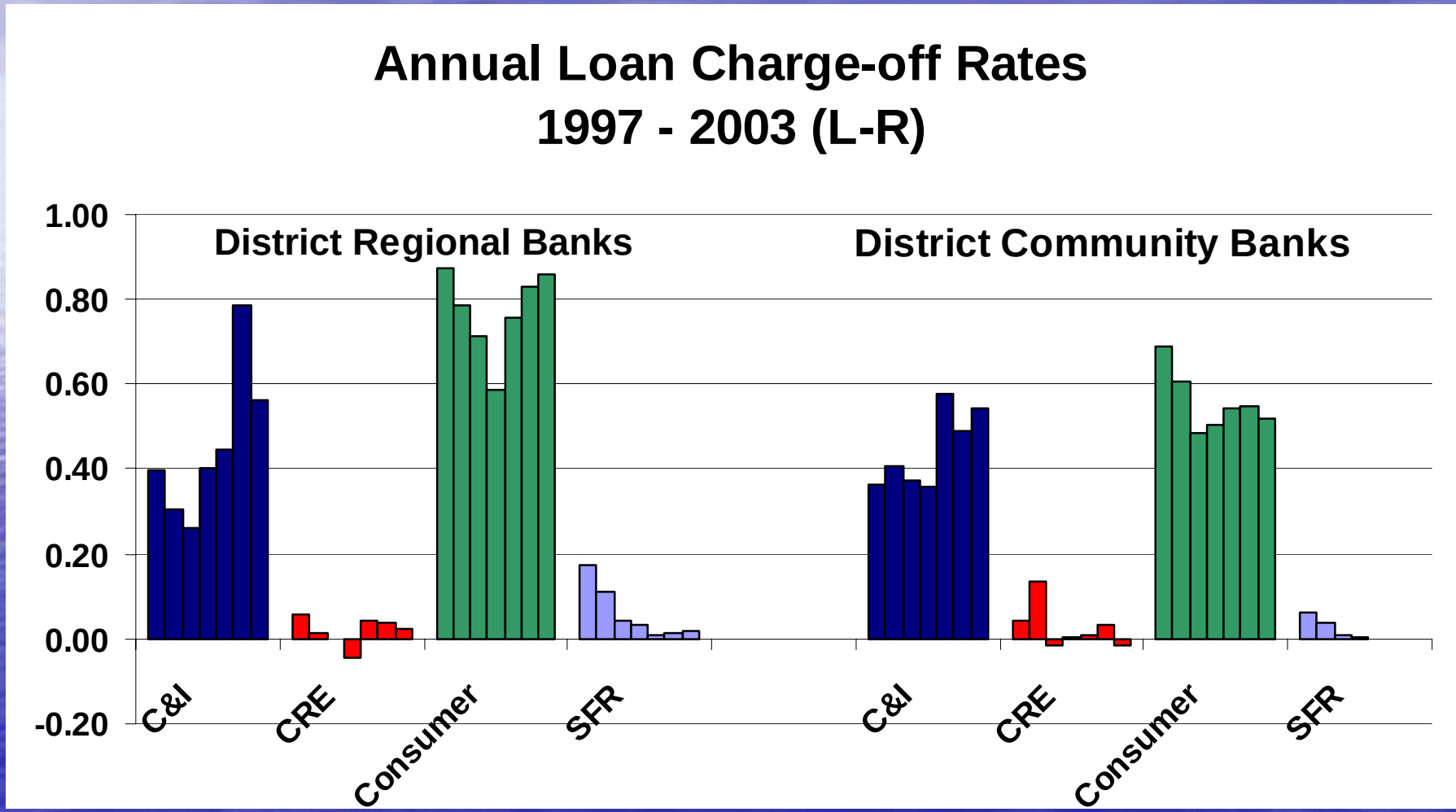



Source: Federal Reserve Flow of Funds

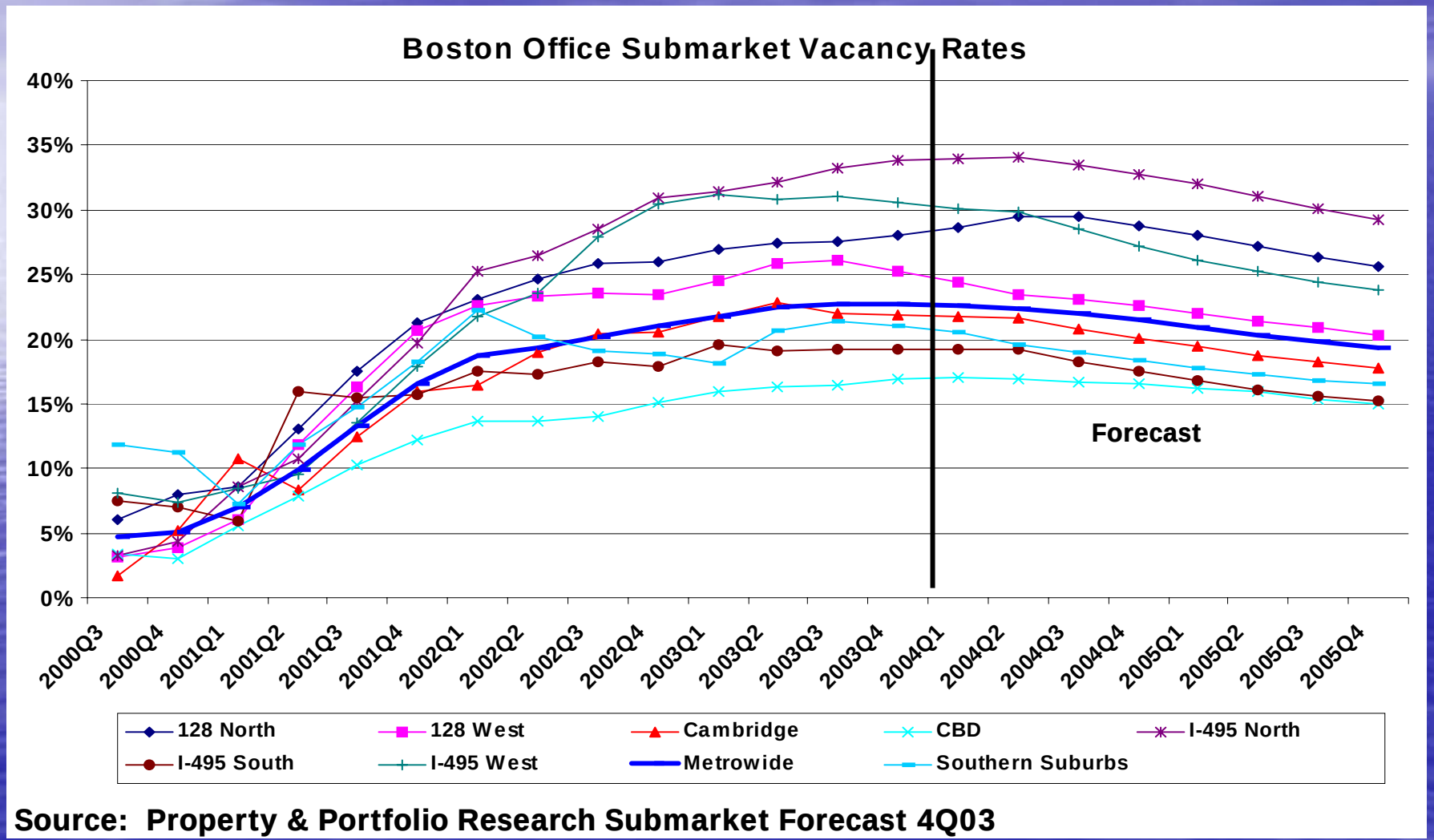
# Do you have liquidity/interest rate risk hiding in your deposit base?

- Do you have significant “parked” funds that may flow to alternative investments once the economy expands?
- Historical patterns regarding nondeposit retention and pricing may not be as relevant.
- How will you fund potential outflows or otherwise attempt to maintain deposits in-house?
- Analysis of your deposit base and scenario analysis of potential outcomes are valuable risk management exercises.

# Credit risk outlook is favorable. Even modest increases in credit problems would be unwelcome in light of margin pressure.

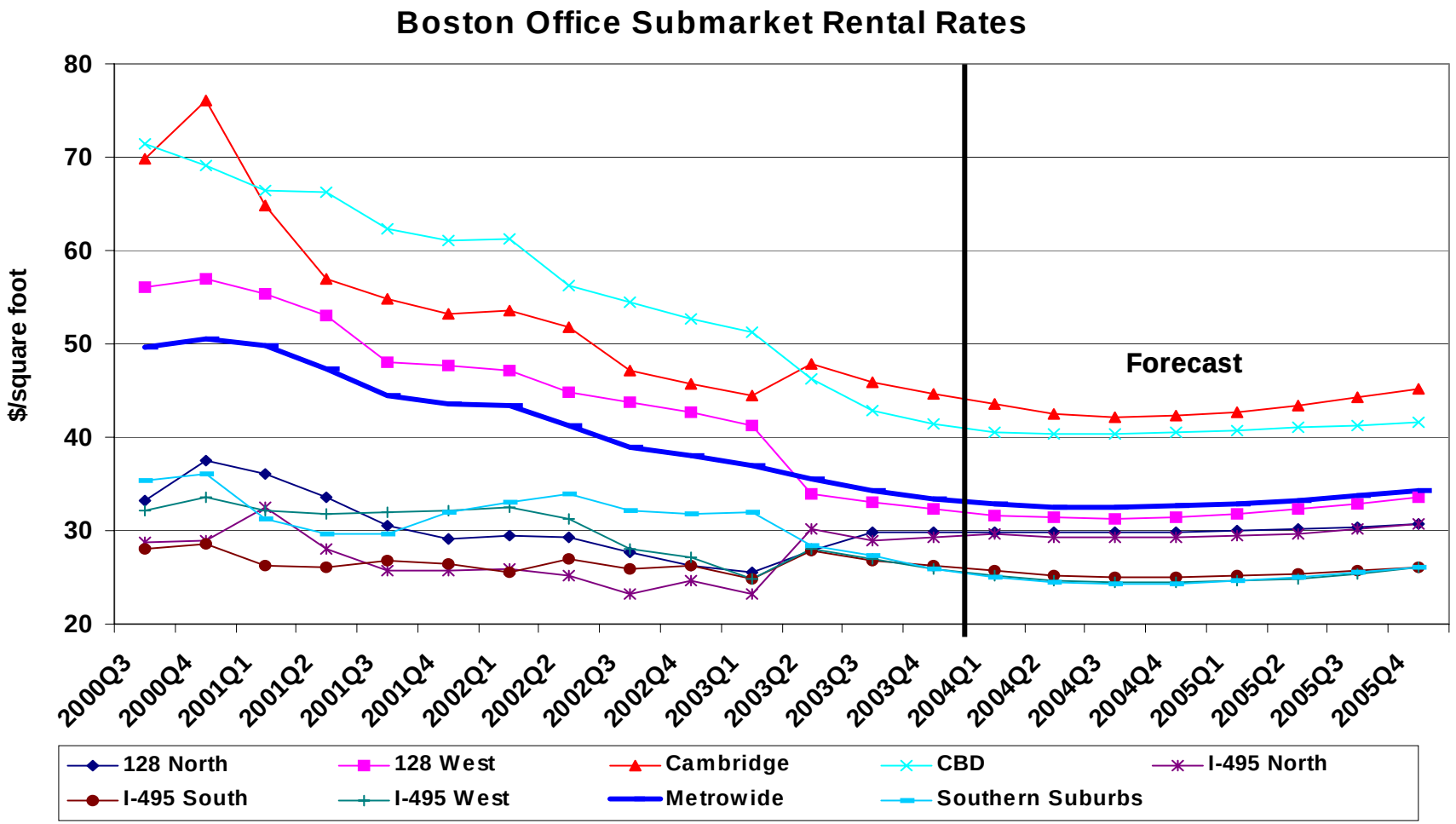


# Boston office vacancies at peak and forecasted to trend down. Boston markets (employment) are lagging nationwide recovery.



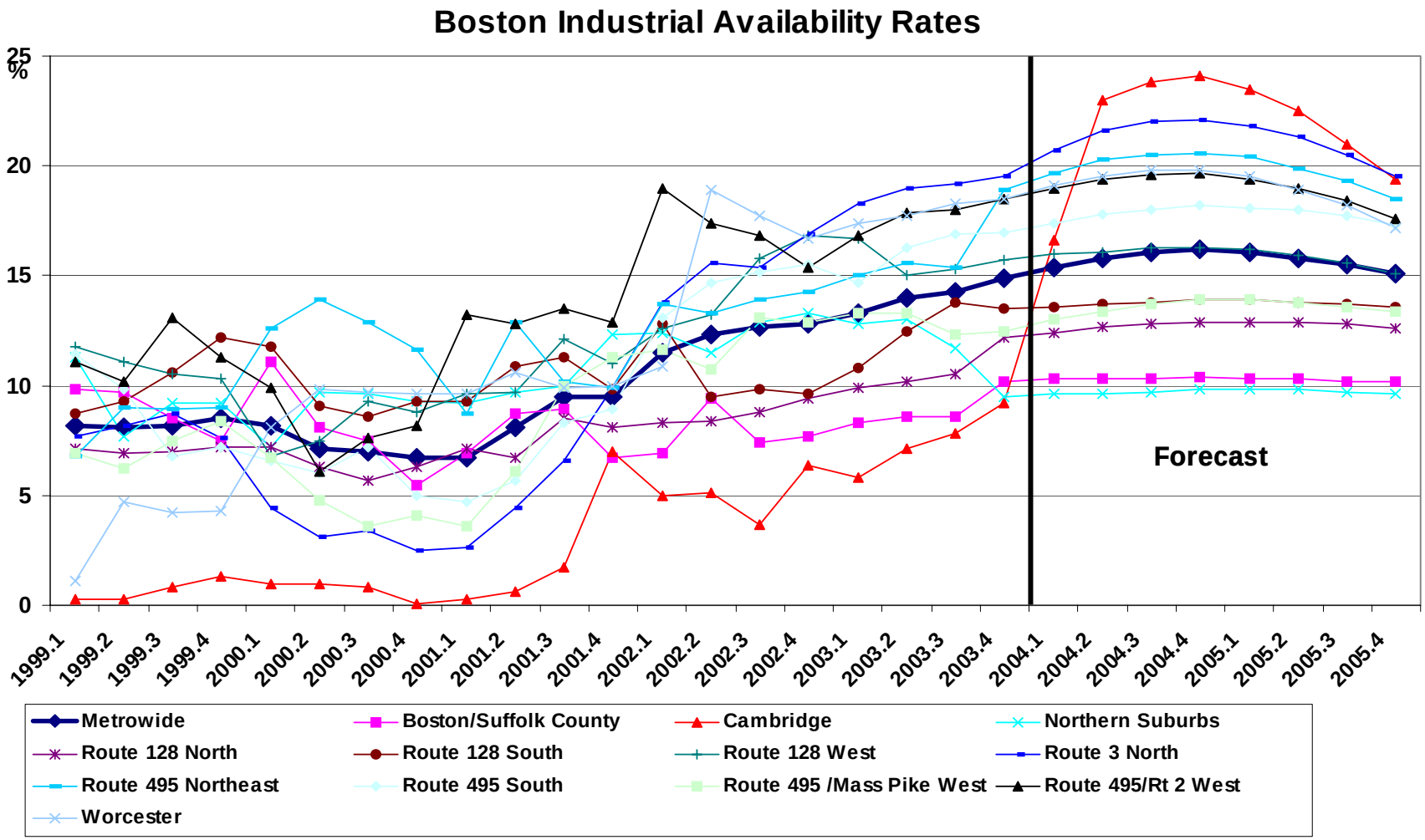

**Source: Property & Portfolio Research Submarket Forecast 4Q03**

# Rent bubbles varied significantly across submarkets...rent inflation stays low over forecasted period



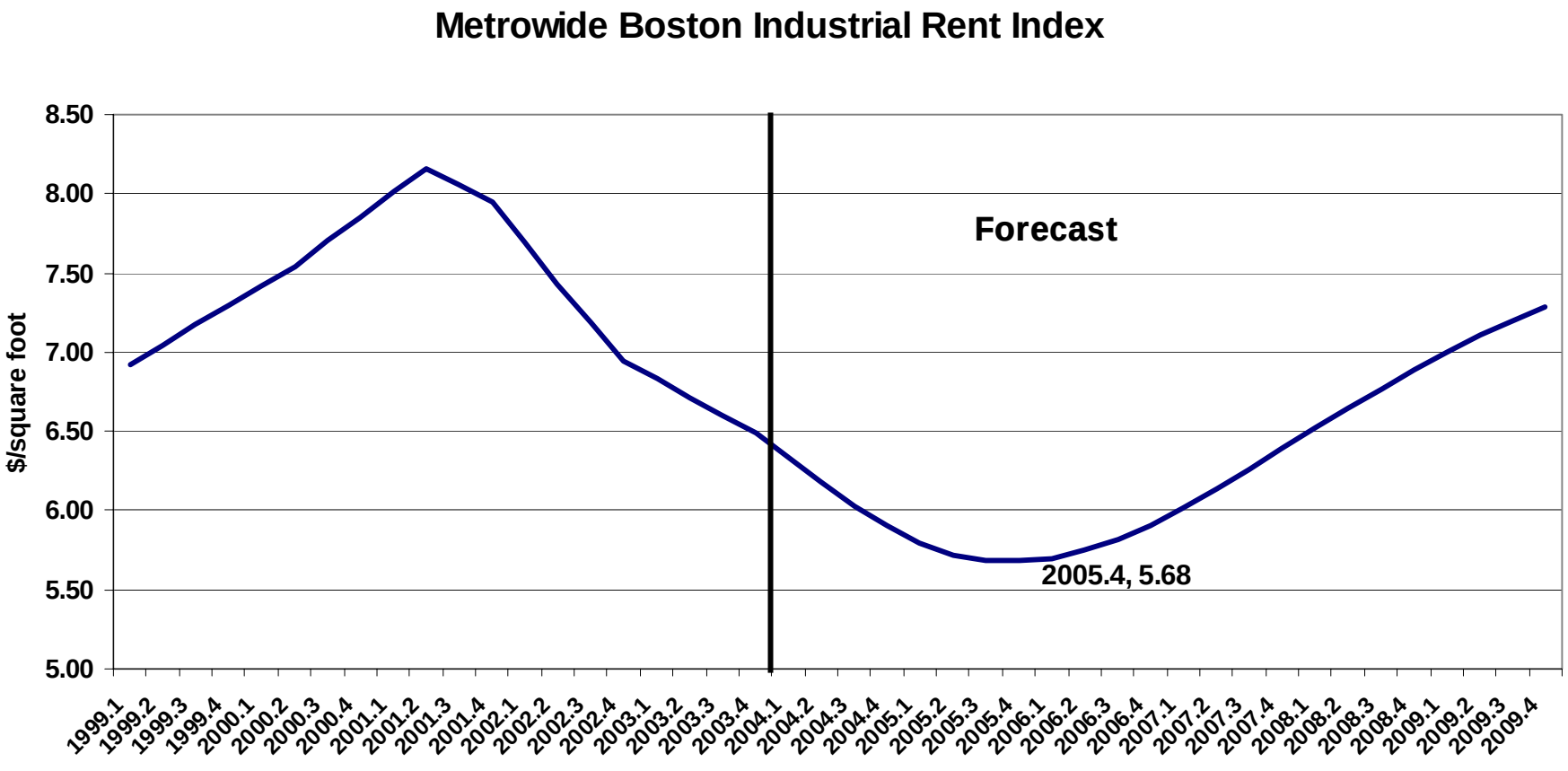

**Source: Property & Portfolio Research Submarket Forecast 4Q03**

# Boston industrial markets are still experiencing rising vacancies




**Source: Torto Wheaton Research 1Q04 Industrial Outlook**

# Boston industrial rent levels not projected to bottom out until 4Q05

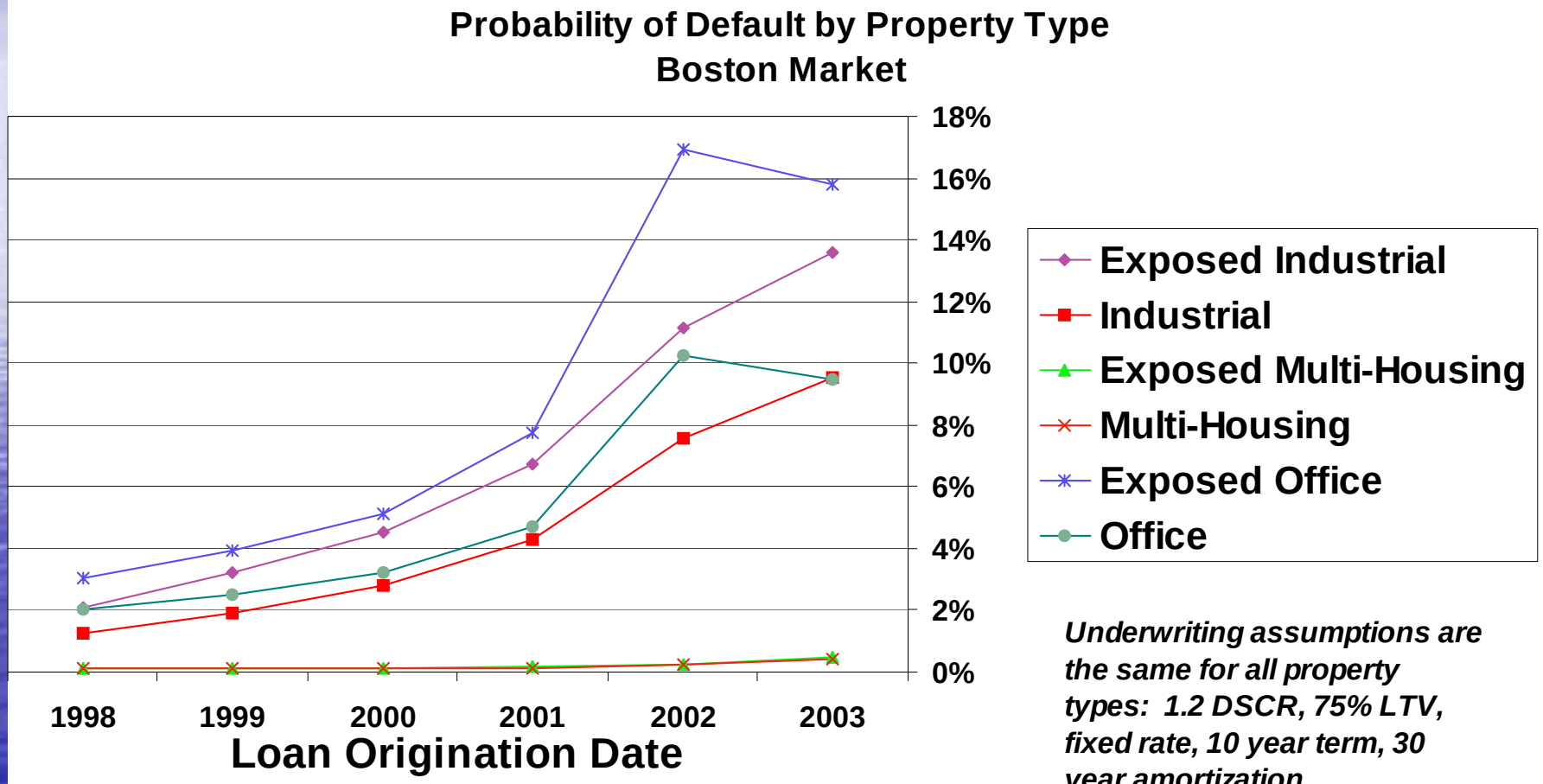



**Source: Torto Wheaton Research 1Q04 Industrial Outlook**

# Risk is unique to your portfolio, collateral and underwriting....some broader issues to consider

- No significant rent inflation in the forecasts, do not expect vacancies to fall to the levels of the late 1990s anytime soon.
- How sensitive are your debt service coverage ratios in a rising rate environment?
- Will cap rates increase with interest rates and/or continuing market weaknesses? How much would this narrow your collateral protection?
- Rent profiles flow directly into debt risk; not all markets are created equal.
  - In what markets/property types are you lending? Where is your exposure?
  - Do you have loans coming up for renewal in markets/property types experiencing weakness? How will your underwriting criteria factor in this risk?
  - What is the seasoning of your loan portfolio? Do your current loans have more risk of default than seasoned loans? Did your underwriting criteria consider this?
  - Does your ALLL allocation criteria account for different property type and market risk characteristics? (Should it?)

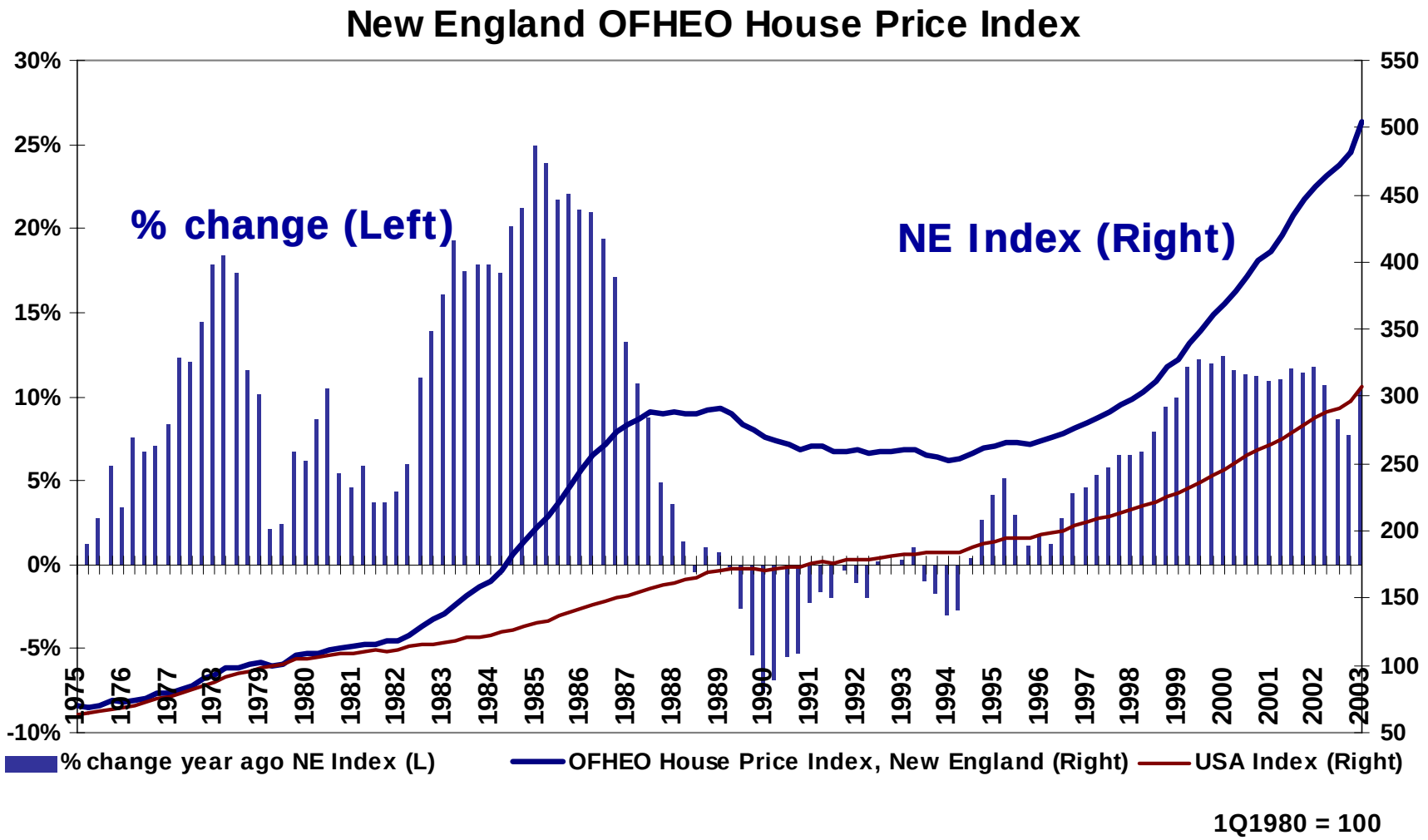
# Conventional wisdom- default risk rises for first four (or so) years of a loan's life. Boston market conditions are not yielding typical results.



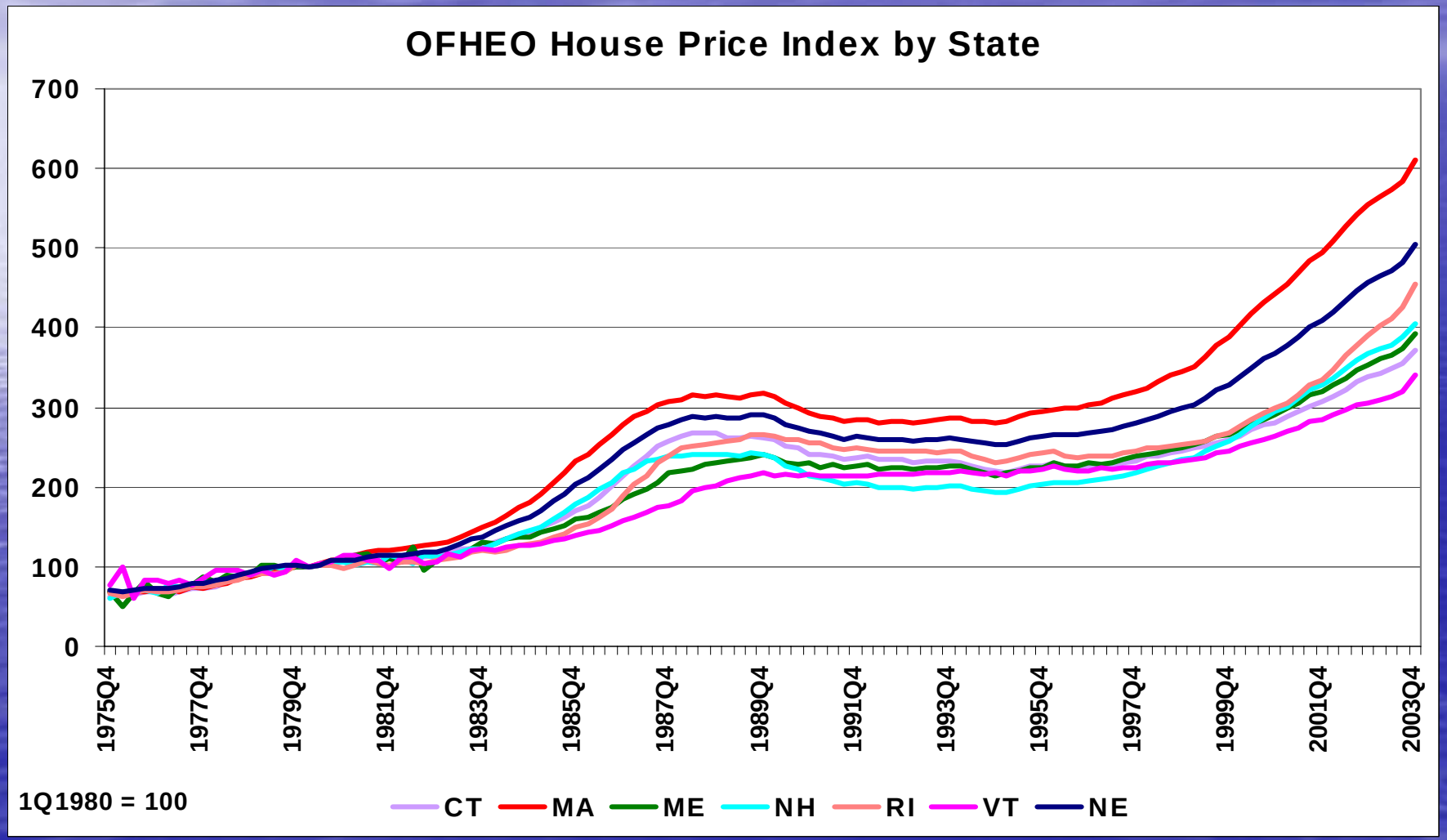

*Underwriting assumptions are the same for all property types: 1.2 DSCR, 75% LTV, fixed rate, 10 year term, 30 year amortization.*

Source: Torto Wheaton Research Spring 2003 Outlook

# Housing markets still going strong



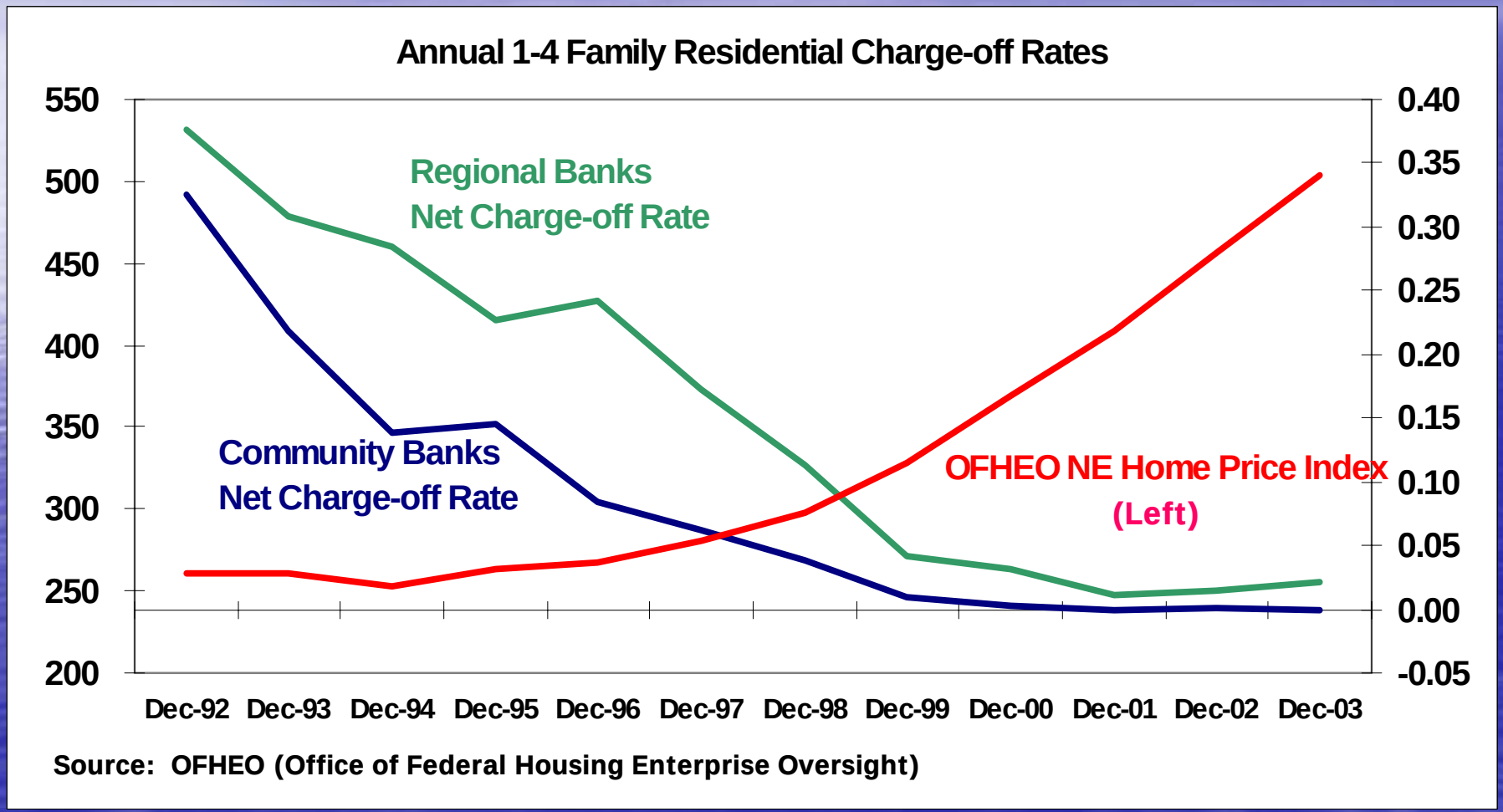
# Massachusetts leads New England in price appreciation



# The experts have spoken....there is no nationwide housing “bubble” but some markets are more exposed to a correction than others

- Aggregate losses throughout New England should remain relatively low and manageable this year
- Have you identified whether you are lending in a market that might be more vulnerable to price decline?
- How many ARMs and HELOCs have you written in the past year?  How rigorous were your underwriting standards?
- Does your ALLL methodology consider the risk in your market, product and underwriting criteria?

# Prior recession where speculation was far more evident and housing prices fell, residential losses were manageable



# Risk Management in the 21st Century

- Executing strategies and competing more effectively comes from strong risk management.
- A more rigorous disciplined process to risk management (and decision making) is emerging.
- Banks that improve their processes that provide decision making information are destined to make better decisions.

# Risk Management Myths

1. **Data or analytical tools are not readily available**

   •Many banks have the information and processes, they just aren't used to their fullest.

2. Risk management is too expensive versus its benefits

   •Scale down processes and therefore cost to meet needs.

3. The best decisions are made by intuition

   •Decisions made based on numbers without experience can lead to disaster…those made by experience without any numbers may prove incorrect….those made based on both are optimal.

4. Forecasting imprecision makes scenario analysis difficult to rely upon

   •Forecasts can't predict the future, but they can give you a reasonable idea of what to expect under varying conditions. Its the assumptions you have to understand.

# Risk spectrum: the greater the risk, the greater the need for more developed risk management.
# What you can do....

- Quantify and analyze the data that are available.
- Run scenario analyses *prior* to making decisions
  - Use the tools that you may already have.
- Don't assume that the past is the precursor to the future.
  - Question/verify your assumptions, processes and results periodically.
- As you grow in size and sophistication, grow your risk management program (people, processes and systems).
- Don't forget to take a look at your long-term trends to keep risk profiles and performance in perspective.

"The challenge of banking, and its art, lie in finding the appropriate balance between risk and return."

Kevin Koontz and John Walker, BNK Advisors