New England Banking Conditions

Federal Reserve Bank of Boston
Regional & Community Bankers Conference
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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

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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 PRI SM software.
Loan growth averaged over 7% despite stable single family portfolios
Loan growth excluding single family residential exceeds 11%, varies by portfolio

Loan Growth by Portfolio

Linked quarter growth, March 2002 - Dec 2003 (left-right)
District Regional & Community Banks
“Higher risk” portfolios continue upward trend....concentrations on the rise

"Higher Risk" Loan Trends
(C&I, CRE, C&D, Multi-family to Total Loans)

District Regional & Community Banks
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)

CRE Loan Concentration Trends
1990 Peak versus 2003

Source: call report data, merger adjusted

- 1990 (Merger Adjusted)
- 2003
- 1990 (All banks)
Banks continued to add long-term product to their balance sheets despite historically low interest rates.

**Trends in Holdings of Long-term Assets**

Assets Repricing/Maturing in over 5 years to total assets
Interest rate risk distribution reflects higher levels and increasing trends, even at the outer extremes.

Long-term Asset Distribution

% of Banks with LTA/TA Greater than 40%:
- 1997: 14%
- 2002: 31%
- 2003: 36%

[Diagram showing the distribution of long-term assets as a percentage of total assets for the years 1997, 2002, and 2003.]
Strong deposit growth led by MMDA inflows.... will they continue?

Funding Structure

- Borrowings
- Time CD
- MMDA
- All Other Nonmaturity Deposits

District Regional & Community Banks

$ Billions

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

Difference between ROA components
Regional versus Community Banks

(Regional Bank averages less Community Bank averages)

2002 2003
NIMs reflect a slight rebound during 4\textsuperscript{th} 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

NonInterest Income Components
Year ending 2003

- Income from Fiduciary Activities
- Service Charges on Dep Accts- Dom Off
- Net gains (losses) on sales of loans
- Income from Other Insurance and Reinsurance Activities
- Investment Banking, Advisory, Brokerage, and Underwriting Fees and Commissions
- Net Servicing Fees
- Net Securitization Income
- Net gains (losses) on sales of OREO & other assets excluding securities

* Excludes Investors Bank & Trust
Credit quality remains strong, charge-offs are low and reserves are holding steady.
Capital levels remain sound

Tier 1 Leverage Capital Ratios
1997-2003 (L-R)

First District Regional Banks
- 1997: 7.9%
- 2003: 7.3%

First District Community Banks
- 1997: 10.5%
- 2003: 9.9%
On the Horizon.....

• Interest Rate Outlook and Implications

• Credit Conditions Outlook

• Risk Management in the 21st century
Who predicted this?

Yield & Spread Comparison

10 Year U.S. Treasury

3 month U.S. Treasury

Spread

Source: Bloomberg
A closer picture of volatility....

10 Year U.S. Treasury Yield

Source: Bloomberg through May 7, 2004
Interest Rate Outlook

• **May 4\textsuperscript{th} 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

Aggregate Funding Structure

$ Billions

- 20 40 60 80 100 120 140 160 180


Borrowings
TCD $100M+
TCD < $100M
MMDA
Other Savings
NOW/ATS
DDA
Deposit growth has been influenced by MMDA growth since late 90’s

Annual Deposit Growth (Merger Adjusted)

District Regional & Community Banks
...quarterly MMDA patterns are less encouraging

![Graph showing deposit growth from prior quarter for District Regional & Community Banks.](image-url)
What pattern is emerging?

Share of Personal Savings in Deposit Institutions and Mutual Fund Vehicles

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

Metrowide Boston Industrial Rent Index

Forecast

2005.4, 5.68

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.

*Probability of Default by Property Type

*Boston Market*

*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

New England OFHEO House Price Index

% change (Left)

NE Index (Right)

1Q1980 = 100
Massachusetts leads New England in price appreciation

OFHEO House Price Index by State

1Q1980 = 100


CT MA ME NH RI VT NE
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.

![Graph showing annual 1-4 family residential charge-off rates for regional banks, community banks, and OFHEO NE Home Price Index. Source: OFHEO (Office of Federal Housing Enterprise Oversight).]
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