Banking

AUTHORS

Jennifer Miele, PhD
Assistant Professor
Department of Finance & Business Law
California State University, Fresno

Roger Nord, CIMC
Vice President
Senior Investment Strategist
Wells Fargo Private Bank

KEY POINTS

- Central California banks and credit unions have slowed down since last year's impressive 20.2% loan growth, with loan growth of 5.5% for the year ending September 30, 2019. Loan growth decreased from last year in every segment with the worst performing category (residential lending) growing at -8.6%.
- Central California banks' loan growth decreased from 22.8% last year to 5.9% this year, while their peers in the San Francisco FDIC Region and nationwide continue to experience negative growth.
- Central California Credit Unions' loan growth decreased from 7.8% last year to 3.3% this year, driven by negative growth in vehicle loans (-1.3%), which represent 53% of all Central California credit union loans.
- Commercial Real Estate continued as the largest segment for Central California banks at 40.6% of all loans, and commercial loan volume decreased significantly from the last two years.
- Trade uncertainty, unresolved Brexit, simmering geo-political issues, and a dysfunctional government all remain risks to the economy and are likely to make it more challenging for Central California banks and credit unions to return to the impressive growth rates we have seen in the past.

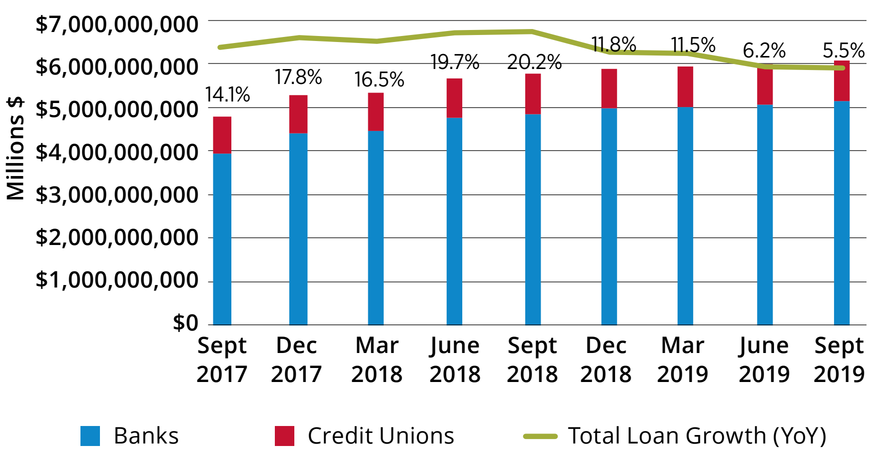
Growth Slows for Central California Banks and Credit Unions

Following national economic trends, Central California banks and credit unions have seen their torrid growth from the past two years slow substantially in 2019, with loan growth falling from 20.2% last year to 5.5% this year as of September 2019 (Figure 1).

Even with slowed growth, Central California banks managed to keep ahead of regional and national peers (institutions with between $100 million and $10 billion in assets in the San Francisco FDIC Region and nationwide). Table 1 shows San Francisco Region and national banks continue to experience negative (or close to zero) loan growth since Q4 2017.

Central California banks' growth in total assets and equity capital slowed to about half of what they were this time last year.

Figure 1
Central California Loans



Data Sources: FDIC & NCUA

Central California banks' growth in total assets and equity capital slowed to about half of what they were this time last year, but still remained positive at 7.3% and 10.2%, respectively (Table 2). Credit unions, on the other hand, experienced increased growth in assets (+3.8% compared to +2.5% last year) and equity capital (+12.6% compared to +3.1% last year). Contributing to these strong numbers were higher levels of loan, investment and other income and relatively stable expenses. Credit unions experienced less growth in assets and more growth in equity capital compared to the banks.

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Table 1
Growth in Loans for Regional and National Banks (Year over Year)

	3Q-2017	4Q-2017	1Q-2018	2Q-2018	3Q-2018	4Q-2018	1Q-2019	2Q-2019	3Q-2019
Central California Banks	14.5%	19.8%	18.4%	22.3%	22.8%	12.5%	12.3%	6.5%	5.9%
San Francisco FDIC Region Banks*	2.2%	-3.1%	-6.7%	-5.5%	-11.7%	-7.2%	-7.2%	-6.7%	-0.6%
National Banks*	-0.1%	0.0%	-1.9%	-1.8%	-1.1%	-0.7%	0.3%	0.5%	-0.2%
*Regional and national banks between $100 million and $10 billion in assets.									

Data Source: FDIC

Table 2
Growth in Selected Balance Sheet Items (Year over Year)

	3Q-2017	4Q-2017	1Q-2018	2Q-2018	3Q-2018	4Q-2018	1Q-2019	2Q-2019	3Q-2019
Central California Banks									
Total Assets	13.7%	16.3%	12.0%	12.3%	15.5%	8.8%	10.9%	5.3%	7.3%
Total Equity Capital	14.9%	19.6%	12.9%	11.0%	20.9%	13.9%	16.8%	10.7%	10.2%
Central California Credit Unions									
Total Assets	3.8%	4.1%	3.8%	3.4%	2.5%	2.7%	2.2%	2.9%	3.8%
Total Equity Capital	3.4%	6.3%	4.4%	3.7%	3.1%	6.3%	10.2%	12.8%	12.6%

Data Sources: FDIC & NCUA

Table 3
Growth in Net Income (Year over Year)

	3Q-2018	4Q-2018	1Q-2019	2Q-2019	3Q-2019
Central California Banks	24.2%	23.0%	19.2%	17.9%	14.0%
Central California Credit Unions	13.3%	23.5%	30.4%	66.0%	41.8%
Central California Banks' net income is the pre-tax net income. Quarterly growth based on rolling 1-year net income.					

Data Sources: FDIC & NCUA

Central California banks have also seen a decrease in pre-tax net income growth at 14% compared to last year's growth of 24.2% (Table 3). Credit Unions, however, have experienced 41.8% growth in net income over last year as of September 2019. The growth seems to be driven by increases in non-operating income.

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Central California Banks' loan growth slowed dramatically, from 22.8% to 5.9% on a year-over-year basis as of 9/30/2019 (Table 1). Central California banks continue to outperform when compared to institutions between $100 million and $10 billion in assets in the San Francisco FDIC Region and nationwide at -0.62% and -0.2% respectively.

Commercial Real Estate continued to be the largest loan segment for Central California Banks at 40.6% of all loans (Table 4). Its slowdown mirrored the overall trend, with loan growth slowing from 27% to 6% on a year-over-year basis (Table 5). The tightening of credit

Table 4
Loan Portfolio Allocations as of 9/30/19

Segment	Central Califonia Banks	SF Region 100m-10b Banks	National 100m-10b Banks
Commercial RE	40.6%	34.0%	29.7%
Residential	10.3%	18.7%	27.0%
Commercial & Industrial	13.4%	14.2%	14.6%
Multi-Family Residential	3.9%	10.9%	6.6%
Construction Loans	9.7%	5.9%	7.3%
Farm & Farmland Loans	11.0%	4.1%	6.7%
Loans to Individuals	3.5%	9.8%	5.0%
Other	7.7%	2.4%	3.1%
TOTAL	**100%**	**100%**	**100%**

Data Source: FDIC

Table 5
Central California Loan Growth by Category (YoY)

Segment	3Q-2017	4Q-2017	1Q-2018	2Q-2018	3Q-2018	4Q-2018	1Q-2019	2Q-2019	3Q-2019
Commercial RE	23.7%	26.2%	20.2%	25.3%	27.0%	13.8%	11.8%	5.0%	6.0%
Residential	10.0%	19.4%	19.9%	19.4%	13.6%	-0.3%	-3.1%	-6.4%	-8.6%
Commercial & Industrial	9.9%	15.5%	4.6%	16.4%	24.1%	13.0%	20.2%	11.0%	0.9%
Multi-Family Residential	9.3%	19.5%	17.9%	35.2%	39.9%	26.2%	27.1%	12.3%	10.1%
Construction Loans	34.4%	24.1%	33.5%	29.8%	27.2%	28.6%	22.8%	15.2%	5.1%
Farm & Farmland Loans	1.9%	2.6%	5.1%	14.8%	15.2%	17.5%	14.8%	4.5%	5.2%
Loans to Individuals	20.4%	21.4%	20.3%	16.5%	15.5%	6.3%	7.3%	7.3%	1.6%
Other	-13.0%	19.3%	49.6%	23.2%	15.4%	-5.7%	5.5%	19.9%	56.1%
TOTAL	**14.5%**	**19.8%**	**18.4%**	**22.3%**	**22.8%**	**12.5%**	**12.3%**	**6.5%**	**5.9%**

Data Source: FDIC

standards in this sector each quarter, since Q4 2018, that was reported by the Federal Senior Loan Officer Survey[1] may have contributed to the decrease in growth in this segment. Increased economic uncertainty over the past year, including factors such as the Federal Reserve rates and trade policy, may have also contributed to the slowdown.

The next two largest segments are where there were more issues. Commercial and Industrial loans, the second largest segment at 13.4%, grew at only 0.9% on a year-over-year basis after last year coming in with 24.1% growth. According to the Federal Senior Loan Officer Survey, banks eased terms on Commercial and Industrial loans over the third quarter of 2018 to help combat a weaker demand and increased competition, and their standards have been left basically unchanged since then. Nationally, banks have reported a weaker demand for Commercial and Industrial loans. They attribute the decrease in demand to customers experiencing a reduced need to finance mergers or acquisitions, accounts receivable, and inventories; reduced investment in plant or equipment; increases in internally generated funds and customer borrowing shifting to other sources.[1]

Residential loans, 10.3% of all loans experienced negative growth (-8.6%) on a year-over-year basis, with four of the last five quarters showing negative growth. Banks reported weaker demand across all residential real estate loan categories and began easing standards on this category over the third quarter of 2018 and have left the standards unchanged since then.[1] For Q3 2019, the San Francisco Region banks experienced negative year-over-year growth in this category (-17.33% and -3.49%, respectively).

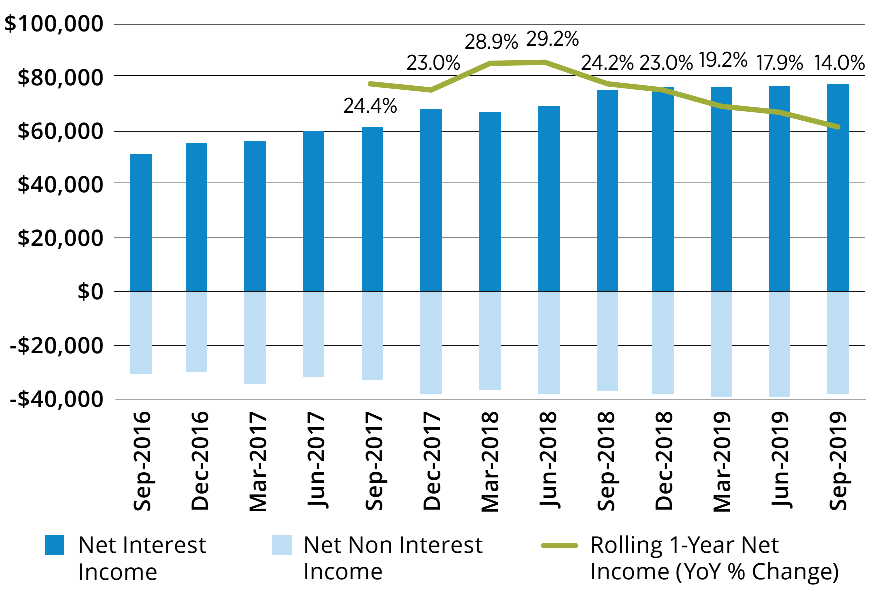
The 2018-2019 year saw a YoY percentage increase in average prices of houses sold.[2] Mortgage rates, however, peaked at an average of 4.95% in Q4 of 2018 and as of Q3 2019 are down to an average rate of 3.71%. The national housing affordability index (HAI)[2] increased 11.5% and the California HAI was up 15.57% from Q3 2018 to Q3 2019, indicating an increase in the ability to afford housing. In terms of Central California, all counties (Fresno, Kings, Madera, Merced, and Tulare) saw an increase in affordability following the state and national trend.[3]

The negative growth in the Central California banks residential real estate loans could be residual impact from the 2018 interest rate increases, resulting in a general softening in real estate in mid-2019. However, it is anticipated that the three Federal Reserve Board (FRB) interest rate cuts in 2019 and subsequent decreases in mortgage rates and increasing HAI should begin to offset that.

The category with the strongest growth this year was the 'Other' category, which makes up 7.7% of Central California bank loans. This category increased from 15.4% growth in Q3 2018 to 56.1% growth in Q3 2019 (Table 5).

Net income experienced a slowdown, with year-over-year growth dropping from 24.2% to 14% (Figure 2). Slower loan growth was mostly responsible for this change, but it's likely that a yield curve that

Figure 2
California Central Banks
Quarterly Net Interest Income and Net Non-Interest Income (in '000s)



Data Source: FDIC

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flattened and actually inverted for several weeks also contributed to this sharp decline. However, the recent FRB interest rate cuts and the interest rate curve steepening in early October, set expectations that margins may get some relief in the fourth quarter of 2019. (By year end, the 1-10 year yield spread had widened to its largest spread since November 2018.)

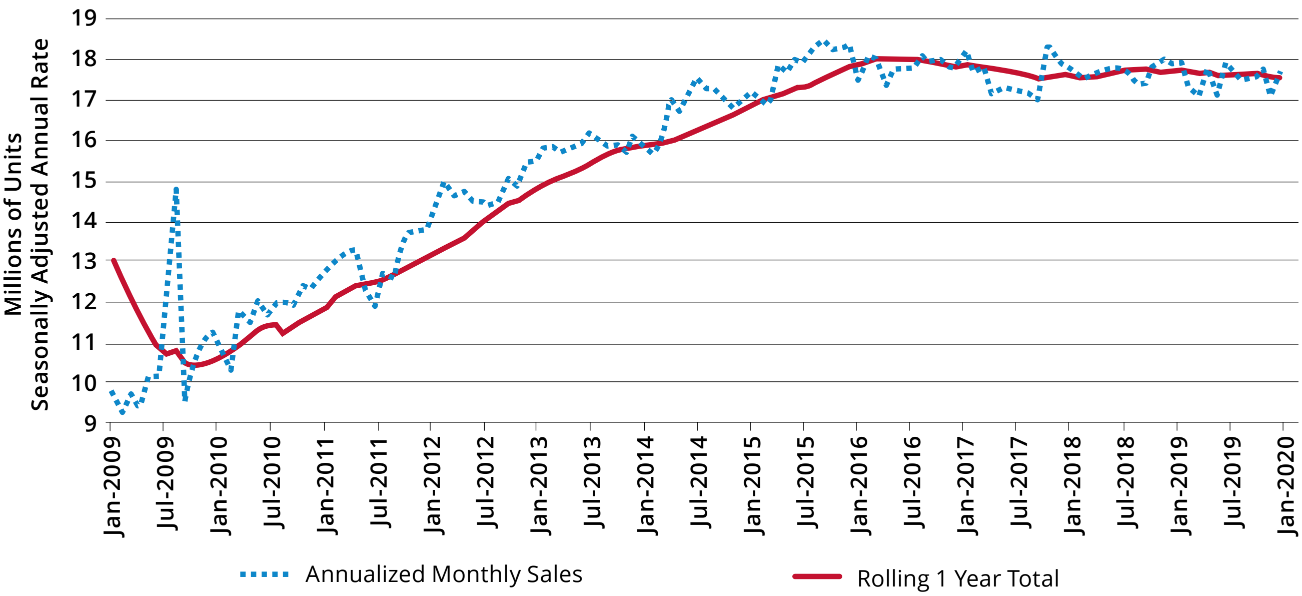
Overall, Central California's banks have experienced a slow down over the past year. There are some factors, including increases in interest rates by the Federal Reserve, trade tariffs and uncertainty around trade policy, a slowing housing market, and a possible contraction from the previous year's boon from tax cuts that may have contributed to a reduction in economic growth.

Credit Unions

Central California Credit Unions are less diverse in lending, making nearly 90% of loans for two types of collateral. Vehicle Loans make up 53% and Real Estate Loans make up 35% of credit union portfolios.

Vehicle loans have been slowing every quarter since Q3 2017, finally going negative on a year-over-

Figure 3
Total U.S. Vehicle Sales



Data Source: U.S. Bureau of Economic Analysis

Table 6
Central California Credit Union Loan Growth (Year over Year)

	3Q-2017	4Q-2017	1Q-2018	2Q-2018	3Q-2018	4Q-2018	1Q-2019	2Q-2019	3Q-2019
Unsecured Loans	3.7%	4.8%	3.6%	4.5%	7.2%	6.5%	8.3%	7.7%	5.2%
Vehicle Loans	16.9%	11.1%	9.8%	6.2%	5.6%	5.5%	2.0%	1.1%	-1.3%
Secured Non-RE Loans	1.0%	4.3%	3.8%	4.3%	6.0%	4.2%	20.9%	19.9%	20.1%
Real Estate Loans	7.9%	6.0%	5.4%	11.4%	11.9%	12.6%	15.0%	7.7%	8.8%
TOTAL	**12.1%**	**8.6%**	**7.6%**	**7.6%**	**7.8%**	**7.8%**	**7.4%**	**4.5%**	**3.3%**

Data Source: NCUA

year basis in Q3 2019 (Table 6). At 53% of the total loan portfolio, declining vehicle loans makes any growth in Credit Union loans a challenge. Secured non-real estate loans jumped 20.1% over the last year, but only account for about 4% of total loans. Real Estate Loans continued to be positive, although growing more slowly than last year. They still managed 8.8% growth and account for 35% of the loan portfolio at quarter end. This enabled Central California Credit Unions to grow total loans at a 3.3% year-over-year basis, versus 7.8% last year.

Slowing U.S. total vehicle sales will continue to be a headwind for the Credit Unions. Figure 3 shows that since their 2015 peak, U.S. vehicle sales have been gradually declining, and few expect that trend to change. In Jim Henry's 6/27/19 forbes.com article[4] he warns of slowing sales, with "record-setting new-vehicle prices and economic uncertainty over issues like tariffs and trade acting as a brake." In the same article he writes, "For 2020, Cox Automotive predicted U.S. auto sales would decline again."

Overall, despite slowing loan growth, Central California Credit Unions showed healthy improvements in growth of Total Assets and Total Equity Capital. Growth in Total Assets rose from 2.5% last year to 3.8% on a year-over-year basis. Growth in Total Equity Capital was even more impressive, increasing from 3.1% to 12.6% by 3Q 2019.

Forecast

There are headwinds that resulted in slower growth last year for Central California Banks and Credit Unions, some of which remain, at least for the time being. Trade uncertainty is still with us, which has a potentially larger impact on agriculturally led economies such as Central California's. An unresolved Brexit, simmering geo-political issues, and a dysfunctional government also still remain risks to the economy.

The one change is the interest rate outlook. Last year at this time we were looking at a Federal Reserve Board projection of a December 2018 rate hike along with three additional interest rate increases in 2019. After three rate decreases in 2019, today we are looking at a FRB projection of no hikes or cuts in 2020. Even more telling is a market perception of a relatively high hurdle for interest rate increases versus a relatively low hurdle for more cuts. This benign outlook might be the key to keeping growth on an upward track.

The wildcard in all this is the presidential election. While Obama's re-election in 2012 and Trump's election in 2016 were both viewed as potentially disruptive events, both experienced positive market reactions. In fact, the year after Obama's 2012 election (2013) turned out to be one of the stronger years for the stock market. Trump's 2016 election was feared to be the harbinger of a severe market correction, and it turned out just the opposite. Again, the year after the election (2017) was a very strong year. However, there seems to be a wider spread between the policies of the incumbent and his challengers than ever before, and certainly a more partisan atmosphere. It remains to be seen if the fears of either party come true and what the impact of that might be, but the potential for volatility seems high.

Notes

- Central California is defined as the following counties: Fresno, Kings, Madera, Merced, and Tulare.
- Banks headquartered in Central California are: Central Valley Community Bank, Premier Valley Bank, United Security Bank, Fresno First Bank, Murphy Bank, Bank of the Sierra, and Suncrest Bank.
- Credit Unions headquartered in Central California are: First California, Greater Valley Credit Union, United Local, Fresno Fire Department, San Joaquin Power Employees, Fresno Grangers, Kinds, Families and Schools Together, Tulare County, Merced Municipal Employees**, and Merced School Employees.
- **Merced Municipal Employees credit union closed and the last reported data is December 2018. Losing this data point did not significantly impact any of the reported results.

Endnotes

1 The Federal Reserve, 11/04/2019, "The October 2019 Senior Loan Officer Opinion Survey on Bank Lending Practices," https://www.federalreserve.gov/data/files/sloos-201910-fullreport.pdf

2 National Association of Realtors, "Housing Affordability Index," https://www.nar.realtor/research-and-statistics.

3 California Association of Realtors, "Housing Affordability Index-Traditional," https://www.car.org/marketdata/data/haitraditional

4 Forbes, 06/27/2019, "U.S. Auto Sales Likely Slow Further In The Second Half Of 2019, Forecasters Say" https://www.forbes.com/sites/jimhenry/2019/06/27/us-auto-sales-likely-slow-further-in-the-second-half-of-2019-forecasters-say/#787606326dc3