Banking

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KEY POINTS

- Central California-based banks and credit unions are experiencing strong growth in their loan portfolios, well above peers.
- Banks are funding this loan growth primarily with new deposits, while credit unions are shifting funds from cash and investments.
- Central California credit unions are heavily reliant on vehicle loans, which they may be challenged to continue to grow in the face of projected declining auto sales and a trend of increasingly tighter underwriting standards for auto loans.
- Commercial real estate lending could benefit from a trend away from tighter underwriting standards and potential growth from tax reform.
- Higher interest rates seem inevitable, with both potential positives and negatives for the Central California banking industry. The shape of the yield curve, and the difference between shorter and longer term rates, could be an important factor in the equation.

Banking Trends Strong

The Central California banking business is doing very well, with loan growth for regionally based banks and credit unions exceeding 14 percent on a combined year-over-year (YoY) basis (Figure 1). Banks slightly outpaced credit unions, growing at 14.5 percent versus 12.1 percent for credit unions. These are both better than the San Francisco regional FDIC banking average, which show 2.2 percent YoY loan growth for institutions with assets between $100 million and $10 billion (see Table 3).

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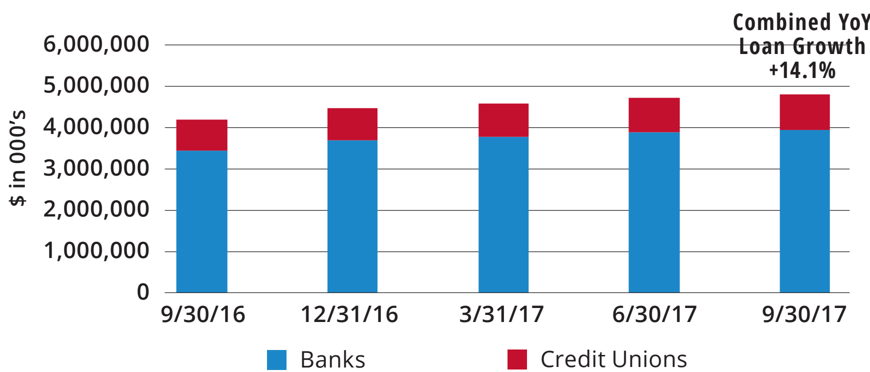
Banks in particular benefited from this rapid loan growth, resulting in double-digit YoY growth in assets and equity capital (Table 1). Credit unions, on the other hand, showed much more modest growth in assets and equity capital. They funded much of the increase in their loan portfolios from existing cash and investments, while banks were able to grow deposits to primarily fund their new loans.

Figure 1
Central California Loans

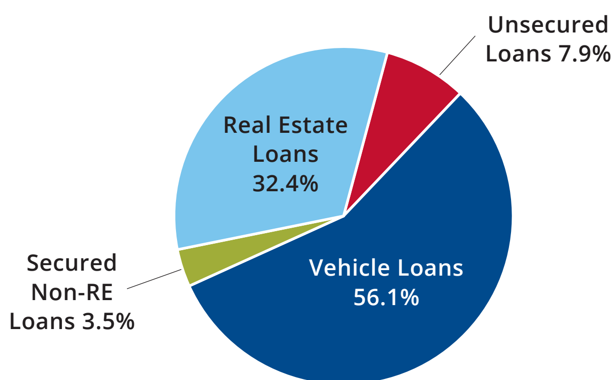


Data Source: FDIC & NCUA

Table 1
Growth in Selected Balance Sheet Items

	4Q-2016	1Q-2017	2Q-2017	3Q-2017	YoY
Central California Banks					
Total Assets	6.1%	3.2%	1.6%	2.3%	13.7%
Total Equity Capital	4.6%	6.7%	2.7%	0.3%	14.9%
Central California Credit Unions					
Total Assets	-0.7%	4.2%	0.3%	0.1%	3.8%
Total Equity Capital	-2.4%	1.4%	1.8%	2.6%	3.4%
Data Sources: FDIC & NCUA					

Figure 2
Central California Credit Union Loans



Data Source: NCUA as of 9/30/17

Credit Unions Rely on Vehicle Loans

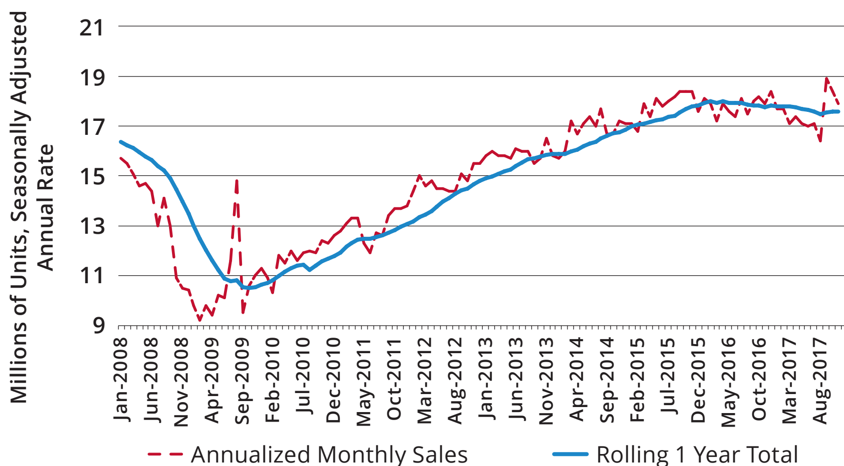
While the size of Central California banks, loan portfolios are considerably larger than the credit unions, there are some notable differences in their loan concentrations. Figure 2 shows the breakdown in loan assets as of 9/30/2017 for credit unions based in Central California, showing that vehicle loans make up over 56 percent of the total loans. This category alone was up 16.9 percent YoY (Table 2), driving much of the growth in credit union loans. Real estate loans, the second-largest category, were up a respectable 7.9 percent, but any significant slowdown in auto loans would be difficult for the region's credit unions to overcome.

Indeed, declining auto sales could present a major challenge for continued Central California credit union loan growth (Figure 3). USA TODAY[1] reported that for 2017 "PricewaterhouseCoopers projected full-year sales of 17.1 million vehicles, below last year's 17.6 million," and that the National Automotive Dealers Assocation "projected 2018 sales of 16.7 million vehicles, while Autotrader.com and Kelley Blue Book projected 16.6 million." This could be offset by better-than-expected economic growth, and tax reform is buoying hopes for continued improvement for growth in 2018, but it is hard to forecast sustaining this type of growth in auto loans going forward. The quarterly pace is slowing, with the most recent quarter being the slowest quarter of the past four, and the fourth quarter of 2016 was the strongest. Additionally, increasingly tighter credit standards for auto loans could begin to negatively impact growth moving forward (Figure 4).

Banking

The Central California banks are doing particularly well versus their regional and national peers.

Figure 3
Total U.S. Vehicle Sales



Data Source: U.S. Bureau of Economic Analysis

Table 2
Central California Credit Union Loan Growth

	4Q-2016	1Q-2017	2Q-2017	3Q-2017	YoY
Unsecured Loans	2.1%	-2.2%	2.0%	1.7%	3.7%
Vehicle Loans	6.4%	3.1%	4.9%	1.5%	16.9%
Secured Non-RE Loans	-0.8%	1.9%	1.6%	-1.7%	1.0%
Real Estate Loans	2.6%	1.1%	2.5%	1.4%	7.9%
Total	**4.4%**	**2.0%**	**3.8%**	**1.4%**	**12.1%**

Data Source: NCUA

Table 3
Bank Loan Growth

	4Q-2016	1Q-2017	2Q-2017	3Q-2017	YoY
Central California Banks	6.9%	2.2%	3.3%	1.5%	14.5%
San Francisco FDIC Region Banks*	2.6%	0.0%	0.7%	-1.1%	2.2%
National Banks*	1.1%	-0.9%	0.3%	-0.6%	-0.1%

* Regional and national banks between $100 million and $10 billion in assets
Data Source: FDIC

Central California Banks Booming

The Central California banks are doing particularly well versus their regional and national peers. Compared to banks with between $100 million and $10 billion in assets, which encompasses all the Central California-based banks, they are bucking the trend of slow and stagnant growth experienced regionally and nationally, as shown in Table 3.

Like their peers, Central California banks rely heavily on real estate in their loan portfolios, both commercial, residential, multi-family, and construction. One difference is that Central California banks have more farm and farmland loans in their portfolios, especially when compared to regional peers (Table 4). This is certainly understandable, given the location and the agricultural focus of the local economy.

Table 5 highlights the rolling (YoY) growth rate of the various segments of the Central California banks. Looking at a rolling YoY number smooths out the quarterly variability and makes it easier to identify trends. Looking first at the largest category of loans in Central California banks, commercial real estate (36.3%), we see that growth has increased dramaticly from 2016. It did dip in the last quarter, but still grew at an impressive 23.7 percent. Commercial and industrial

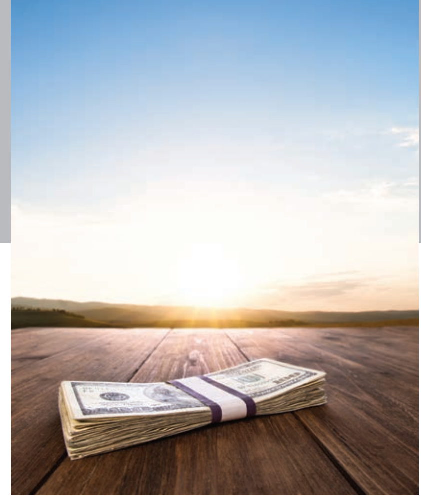


Table 4
Loan Portfolio Allocations as of 9/30/17

Segment	Central California Banks	All California 100m-10b Banks	National 100m-10b Banks
Commercial RE	36.3%	45.1%	31.6%
Residential	13.5%	14.8%	23.3%
Commercial & Industrial	14.5%	13.9%	15.6%
Multi-Family Residential	3.5%	13.2%	5.6%
Construction Loans	8.1%	4.9%	7.5%
Farm & Farmland Loans	13.3%	3.1%	7.4%
Loans to Individuals	3.6%	3.1%	5.7%
Other	7.3%	1.9%	3.4%
Total	**100.0%**	**100.0%**	**100.0%**

Data Source: FDIC

COMMERCIAL RE LOANS increased dramaticlly from 2016

Table 5
Central California Bank Loan Growth by Category

Segment	YoY 12/31/15	YoY 3/31/16	YoY 6/30/16	YoY 9/30/16	YoY 12/31/16	YoY 3/31/17	YoY 6/30/17	YoY 9/30/17
Commercial RE	8.0%	6.1%	2.7%	8.8%	18.4%	29.7%	30.6%	23.7%
Residential	10.8%	4.6%	10.6%	7.1%	12.7%	9.7%	4.7%	10.0%
Commercial & Industrial	5.6%	-1.7%	2.0%	-3.0%	5.9%	16.4%	7.0%	9.9%
Multi-Family Residential	43.4%	45.3%	35.9%	48.3%	38.3%	38.7%	26.1%	9.3%
Construction Loans	16.0%	15.8%	9.1%	10.6%	31.0%	18.1%	26.1%	34.4%
Farm & Farmland Loans	16.7%	20.0%	20.4%	20.2%	4.7%	5.2%	4.4%	1.9%
Loans to Individuals	14.9%	24.3%	33.5%	28.2%	27.7%	24.6%	22.6%	20.4%
Other	60.6%	-14.5%	13.7%	28.6%	-2.9%	-21.8%	-15.5%	-13.0%
Total	**13.5%**	**6.7%**	**8.8%**	**11.0%**	**14.1%**	**17.3%**	**15.5%**	**14.5%**

Data Source: FDIC

(14.5%) has gone from flat to declining to a solid YoY growth the past few quarters. Residential (13.5%) has been a relatively consistent performer, while farm and farmland loans (13.3%) have slowed from 20 percent down to low single digits. Construction (8.1%) and loans to Individuals (3.6%) have been consistent stars, while the catch-all other category (7.3%) has shown the most volatility and worst performance. Multi-family residential (3.5%) had been the strongest performer, but cooled considerably in the past year to just under 10 percent.

A key question for 2018 is whether the third-quarter dip in Central California commercial real estate lending was the beginning of a slowdown or if it will continue to drive outperformance. The Federal Reserve Senior Loan Officer Survey (Figure 5) points to a recent reduction in the number of banks tightening credit standards for commercial real estate loans that may bode well for continued growth. In 2015 and 2016 we saw a large jump in the banks tightening on commercial real estate, but as it began to decline our Central California banks saw growth surge in the past year. Further reductions in the banks tightening standards for commercial real estate would be a tailwind for next year, as would increased growth from tax reform.

Negatively, there could be some slowdown in local construction as more resources are directed toward rebuilding in Napa Valley and Sourthern California as a result of the record-breaking wildfires in 2017.

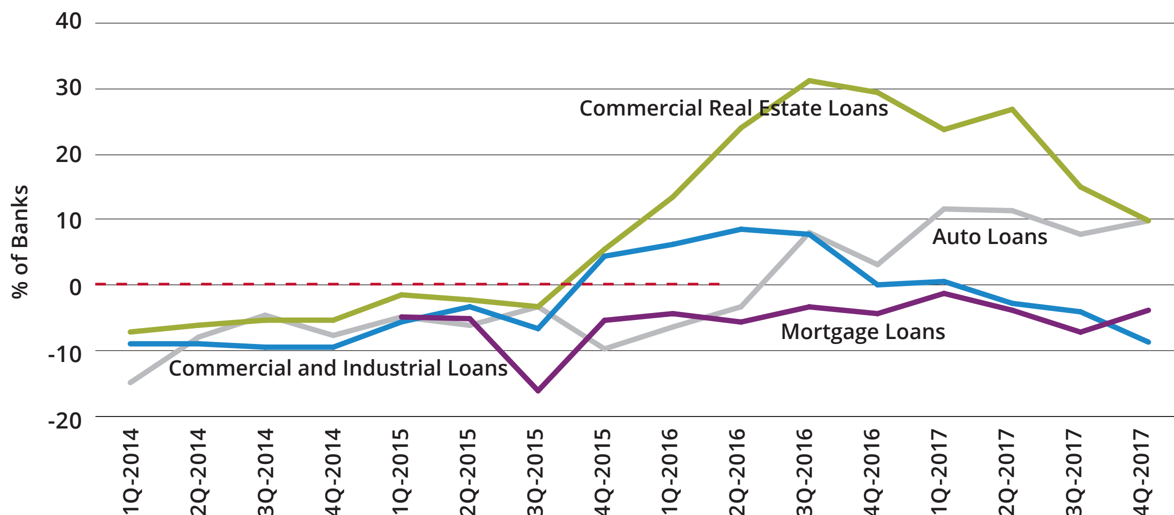
The Impact of Higher Interest Rates

Although rates are still relatively low compared to prior periods, the Federal Reserve raised rates three times in 2017, and they have forecasted three more increases for 2018. The market seems less convinced, with Fed Funds futures indicating less than a 50 percent chance of a third interest rate increase by December 2018. While it is debatable if there will be three increases in 2018, it seems clear that short-term rates will continue to climb. Figure 5 shows a 20-year chart comparing the 10-year U.S. Treasury Note yield (blue), the two-year U.S. Treasury Note Yield (red), and the Fed Funds Target Rate (green). The two-year has tracked closely with the Fed Funds rate, and it currently trades at about half a percentage point premium to the current Fed Funds Target, implying two more quarter point increases in the target rate, in line with Fed Fund Futures pricing.

> *This seemingly inevitable increase in interest rates has both positive and negative implications for Central California financial institutions.*

This seemingly inevitable increase in interest rates has both positive and negative implications for Central California financial institutions. On the positive side, higher interest rates are generally thought to be good for banks, offering the potential to widen spreads and increase net interest income. Banks generally pay interest rates on short-term deposits and much of their interest income is reliant on loans that earn the longer-term rates. But longer-term interest rates continue to be depressed, and a flattening yield curve (a declining difference between short- and long-term interest rates) is not a positive trend for bank profits. If we don't see some increases in longer-term rates, higher interest rates are

Figure 4
Net Percentage of Banks Tightening Standards for Loan Categories



Data Source: FRED Senior Loan Officer Survey

not likely to provide the boost to banking profits that is sometimes assumed.

But that leads us to the potentially negative implication of higher interest rates: They could be a drag on economic growth, particularly as the longer-term interest rates increase. Up until now, rising interest rates have had limited impact on fixed mortgage rates, which are more closely linked to 10-year Treasury rates. If we see the longer-term rates rise more quickly and further than anticipated, this could negatively impact mortgage rates and the real estate market. Real estate values are an important factor of economic health, especially in California. The effects would likely be first evident in the higher-priced Bay Area and Southern California markets, while Central California typically lags, but eventually follows their lead.

Another reason to keep a close eye on the yield curve is that a flat or inverted yield curve is sometimes followed by a recession within 12-24 months. As seen in Figure 5, there have been two times in the past 20 years when the two and 10-year rates have converged, the late '90s and 2005-2007. Both times were closely followed by recessions. Since the start of 2014, the two-year U.S. Treasury note yield has risen from under 0.50 percent to near 2 percent. During that same time period, the 10-year yield has fallen from 3 percent to 2.5 percent. If the two rates do converge or invert it could potentially indicate that the next recession is near.

Endnotes

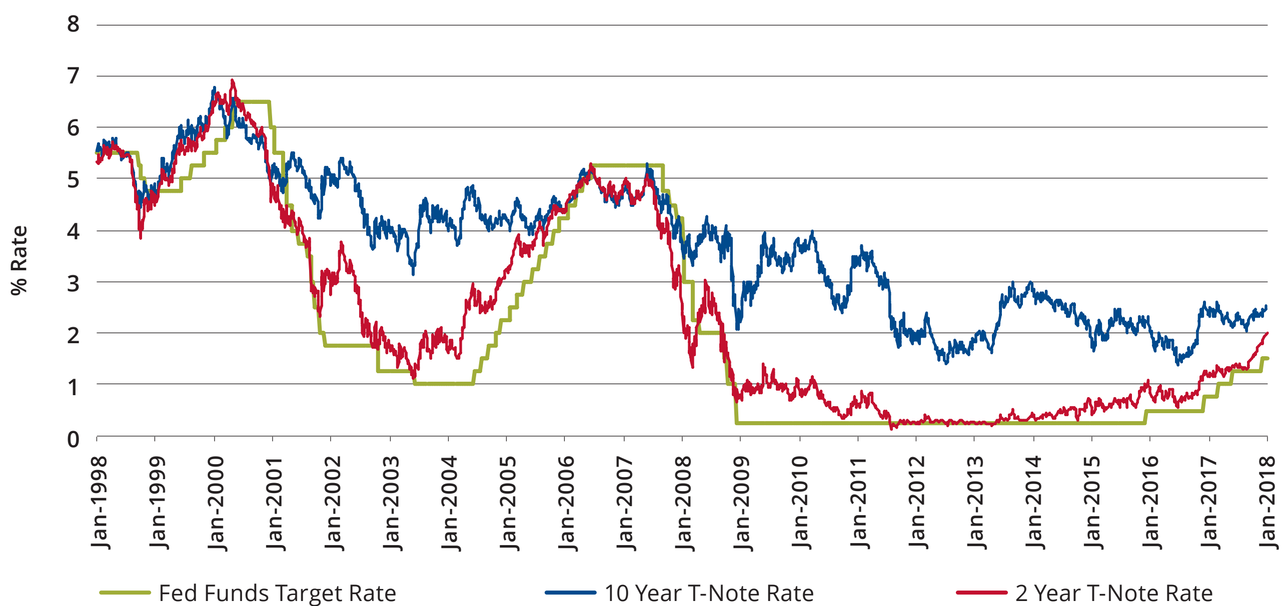
1 USA TODAY, 12/1/2017, "U.S. auto sales: 2017 likely to mark the first fall since Great Recession" www.usatoday.com/story/money/cars/2017/12/01/november-u-s-auto-sales/912590001/

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, Kings, Families and Schools Together, Tucoemas, Tulare County, Merced Municipal Employees, and Merced School Employees.

Figure 5
10-Year & 2-Year U.S. Treasury Note Yields vs. Fed Funds Rate



Data Source: FactSet