Banking

AUTHORS

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

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

KEY POINTS

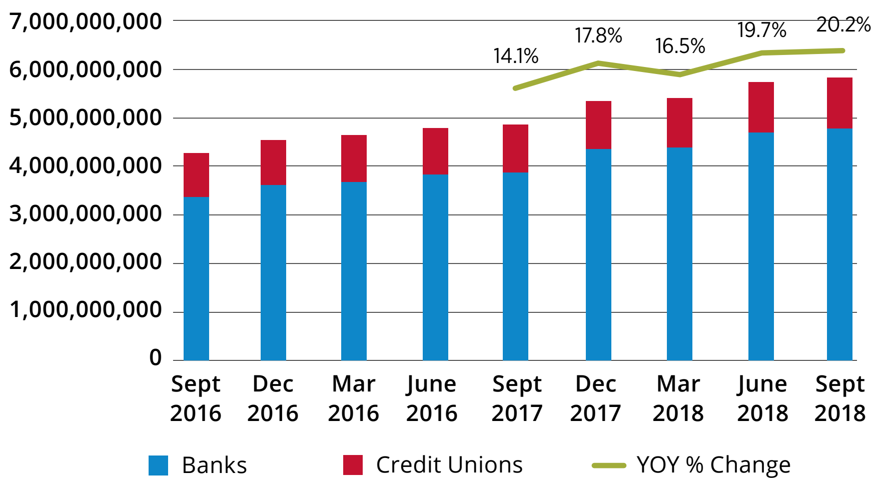
- Central California banks and credit unions improved on last year's impressive 14.1% loan growth, accelerating growth up to 20.2% for the year ending September 30, 2018.
- Central California banks continue to lead the way with 22.8% loan growth. This is in sharp contrast to their peers in the San Francisco FDIC region and nationwide, who experienced negative growth in loan activity.
- Commercial real estate continued as the largest segment for Central California banks at 40.5% of all loans, and increased 27.0% for the year ending September 30, 2018. Loan growth was strong in every segment, with the slowest category (residential) growing at 13.6%, and the strongest category (multi-family residential) growing at 39.9%.
- Central California credit unions reported lower, but still respectable, loan growth at 7.8% for the year ending September 30, 2018, vs. 12.1% for September 30, 2017. Slowing vehicle sales, which represent 55% of all Central California credit union loans, continue to be a headwind.
- Rising interest rates and an expected 2019 reduction in economic growth are likely to make it more challenging for Central California banks and credit unions to continue their impressive growth rates.

Banking Trends Sizzle

Central California banks and credit unions continue to show impressive strength, especially when considering data revealing negative loan growth among their regional and national peers.

Loan growth for Central California banks and credit unions moved up from last year's 14.1% to a sizzling 20.2% on a year-over-year (YoY) basis as of September 2018. (See Figure 1.)

Figure 1
Central California Loans



Data Sources: FDIC & NCUA

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

	3Q-2017	4Q-2017	1Q-2018	2Q-2018	3Q-2018
Central California Banks	14.5%	19.8%	18.4%	22.3%	22.8%
San Francisco FDIC Region Banks*	2.2%	-3.1%	-6.7%	-5.5%	-11.7%
National Banks*	-0.1%	0.0%	-1.9%	-1.8%	-1.1%
*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
Central California Banks					
Total Assets	13.7%	16.3%	12.0%	12.3%	15.5%
Total Equity Capital	14.9%	19.6%	12.9%	11.0%	20.9%
Central California Credit Unions					
Total Assets	3.8%	4.1%	3.8%	3.4%	2.5%
Total Equity Capital	3.4%	6.3%	4.4%	3.7%	3.1%

Data Sources: FDIC & NCUA

Central California banks have experienced tremendous loan growth when compared to institutions with between $100 million and $10 billion in assets in the San Francisco FDIC region and nationwide. As Table 1 indicates, loan growth for the San Francisco region and national banks has been negative since the beginning of 2018, while Central California banks have experienced double-digit growth rates.

Relative to assets, Central California banks again led the way, turning loan portfolio increases into strong growth in assets (15.5%) and equity capital (20.9%). (See Table 2.) As was the case last year, most of the growth for banks was from new deposits, while credit unions redeployed cash and investments to new loans for a significant portion of the increase. This translated to less growth in assets (2.5%) and equity capital (3.1%) for credit unions versus banks.

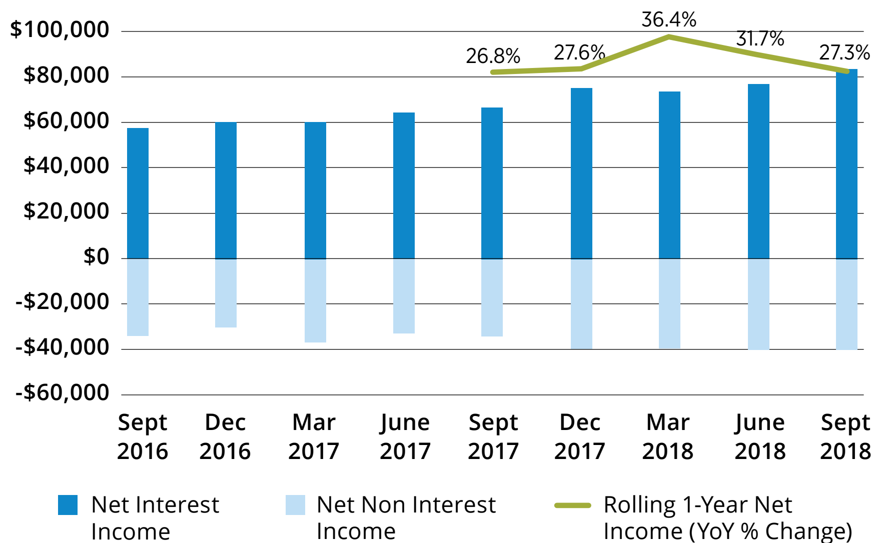
Both Central California banks and credits unions have seen meaningful growth in pre-tax net income with YoY increases of 27.3% and 13.3% respectively for the period 3Q2017 to 3Q2018. (See Table 3.) The table also presents annual changes in income for each quarter. The quarterly figures in Table 3 represent a change from the previous quarter in rolling 12 months of income. The dip in Q2 net income for credit unions seems entirely due to a one-time increase in compensation and benefits, while the Q3 bounce was a combination of a drop in

Table 3
Growth in Net Income

	4Q-2017	1Q-2018	2Q-2018	3Q-2018	YoY (3Q-2017 to 3Q-2018)
Central California Banks	6.6%	8.3%	5.3%	4.7%	27.3%
Central California Credit Unions	0.8%	3.6%	-6.5%	16.2%	13.3%
Central California Banks' net income is the pre-tax net income. Quarterly growth based on rolling 1-year net income.					

Data Sources: FDIC & NCUA

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



Data Source: FDIC

Table 4
Central California Credit Union Loan Growth (YoY)

	3Q-2017	4Q-2017	1Q-2018	2Q-2018	3Q-2018
Unsecured Loans	3.7%	4.8%	3.6%	4.5%	7.2%
Vehicle Loans	16.9%	11.1%	9.8%	6.2%	5.6%
Secured Non-RE Loans	1.0%	4.3%	3.8%	4.3%	6.0%
Real Estate Loans	7.9%	6.0%	5.4%	11.4%	11.9%
TOTAL	**12.1%**	**8.6%**	**7.6%**	**7.6%**	**7.8%**

Data Source: NCUA

compensation and benefits expense back toward the trend line and a sharp increase in loan and other income.

The growth in pre-tax net income for Central California banks is especially impressive with year-over-year growth of at least 26% each quarter since September 2017. (See Figure 2.)

Slowing Vehicle Sales Impact Credit Unions

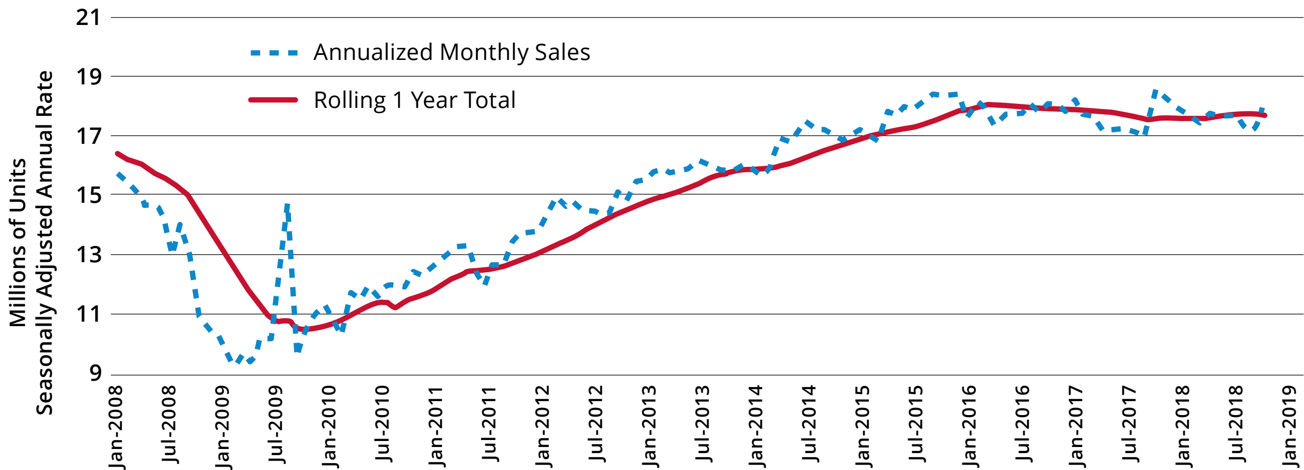
Similar to last year, vehicle loans still make up the largest segment of credit union loans, representing 55% of all loans. Real estate loans make up the other major segment at 33.6%.

After slowing from last year's sizzling 16.9% growth, auto loans cooled to a still respectable 5.6% growth rate. (See Table 4.) Helping to offset that reduction was an improvement in all other segments. As the second-largest segment, real estate loans, which saw an increase from 7.9% growth to 11.9% as of September 30, 2018, made the biggest difference.

As we had forecasted in last year's report, slowing auto sales were a powerful trend that made it difficult for credit unions to sustain their growth in vehicle loans. With the outlook for car sales on a national basis stagnant at best, this will remain a challenge going forward. (See Figure 3.)

The Center for Automotive Research 2018 Management Briefing: *Forecasting the North American Sales and Production Footprint in Uncertain Times* indicates that, for U.S. light vehicle sales, "Forecasts vary – yet all reflect declining sales."

Figure 3
Total U.S. Vehicle Sales



Data Source: U.S. Bureau of Economic Analysis

The announcement by General Motors in November that it is stopping production of some car lines and closing plants is an indicator of the sluggish nature of vehicle sales.[1]

While the U.S. is benefiting from positive economic news and a healthy economy, headwinds from higher interest rates as well as trade and tariff uncertainties are resulting in a continued trend of lower expected auto demand. This will remain the largest challenge for Central California credit unions.

Banks Experienced Record Growth

Commercial real estate retained its position as the largest segment with 40.5% of all bank loans (See Table 5.) and as one of the top performing segments with 27% growth over the year ending September 30, 2018. (See Table 6 on the following page.)

Commercial real estate retained its position as the largest segment with 40.5% of all bank loans.

Table 5
Loan Portfolio Allocations as of 9/30/18

Segment	Central California Banks	SF Region 100m-10b Banks	National 100m-10b Banks
Commercial RE	40.5%	32.3%	29.6%
Residential	12.0%	22.5%	27.9%
Commercial & Industrial	14.0%	13.7%	14.2%
Multi-Family Residential	3.8%	10.2%	6.6%
Construction Loans	9.8%	5.9%	7.1%
Farm & Farmland Loans	11.1%	3.9%	6.5%
Loans to Individuals	3.6%	9.4%	5.0%
Other	5.2%	2.1%	3.0%
TOTAL	**100%**	**100%**	**100%**

Data Source: FDIC

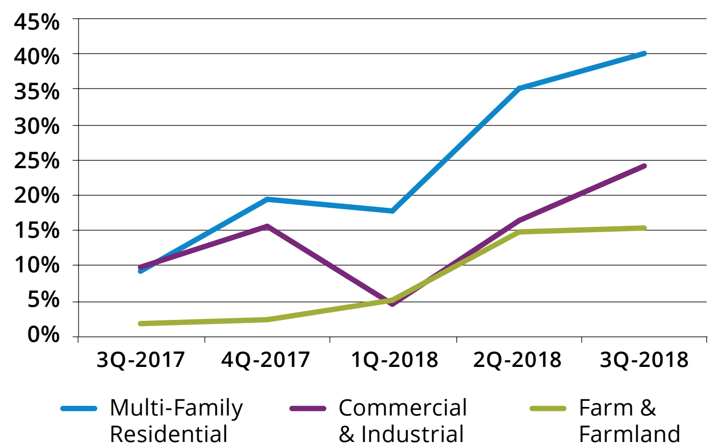
Table 6
Central California Loan Growth by Category (YoY)

Segment	4Q-2015	1Q-2016	2Q-2016	3Q-2016	4Q-2016	1Q-2017	2Q-2017	3Q-2017	4Q-2017	1Q-2018	2Q-2018	3Q-2018
Commercial RE	8.0%	6.1%	2.7%	8.8%	18.4%	29.7%	30.6%	23.7%	26.2%	20.2%	25.3%	27.0%
Residential	10.8%	4.6%	10.6%	7.1%	12.7%	9.7%	4.7%	10.0%	19.4%	19.9%	19.4%	13.6%
Commercial & Industrial	5.6%	-1.7%	2.0%	-3.0%	5.9%	16.4%	7.0%	9.9%	15.5%	4.6%	16.4%	24.1%
Multi-Family Residential	43.4%	45.3%	35.9%	48.3%	38.3%	38.7%	26.1%	9.3%	19.5%	17.9%	35.2%	39.9%
Construction Loans	16.0%	15.8%	9.1%	10.6%	31.0%	18.1%	26.1%	34.4%	24.1%	33.5%	29.8%	27.2%
Farm & Farmland Loans	16.7%	20.0%	20.4%	20.2%	4.7%	5.2%	4.4%	1.9%	2.6%	5.1%	14.8%	15.2%
Loans to Individuals	14.9%	24.3%	33.5%	28.2%	27.7%	24.6%	22.6%	20.4%	21.4%	20.3%	16.5%	15.5%
Other	60.6%	-14.5%	13.7%	28.6%	-2.9%	-21.8%	-15.5%	-13.0%	19.3%	49.6%	23.2%	15.4%
TOTAL	**13.5%**	**6.7%**	**8.8%**	**11.0%**	**14.1%**	**17.3%**	**15.5%**	**14.5%**	**19.8%**	**18.4%**	**22.3%**	**22.8%**

The tightening of credit standards for commercial real estate loans reported by the Federal Senior Loan Officer Survey[2] in 2015 and 2016 was somewhat loosened in 2017 and has for the most part remained unchanged over the past year, likely helping to contribute to the continued growth to date in this segment.

Notably, the most dramatic increases when compared to the same time last year came from farm and farmland, commercial and industrial, and multi-family residential loans. These categories increased from single-digit YoY growth in Q3 2017 to double-digit YoY growth in Q3 2018 as shown in Figure 4.

Figure 4
Fastest Growing Loan Categories • YoY Change



According to the Federal Senior Loan Officer Survey[2], over the third quarter of 2018, banks eased terms on commercial and industrial loans to help combat a weaker demand and increased competition. As the standards decreased on average nationally, the Central California banks have seen a large surge in growth in the commercial and industrial category.

While residential real estate continued to grow over this time last year, it did experience a dip in the third quarter of 2018 and the smallest YoY growth at 13.6% of all loan segments. Banks reported weaker demand across all residential real estate loan categories and began easing standards on this category over the third quarter of 2018. Specifically, for Q3 2018, the San Francisco region banks experienced -10.82% and national banks experienced -1.53% YoY growth in this category. The 2017-2018 year saw a YoY percentage increase in average prices of houses sold in the U.S. followed by increasing mortgage rates. This combination of a national trend in decreased residential real estate demand, increased prices, and increasing mortgage rates may have contributed to the dip in Q3 residential real estate growth, which may indicate an overall growth slowdown in this category.

Interestingly, while residential was the slowest-growing category, the category that experienced the strongest growth, at 39.9% over last year, was multi-family residential. This may indicate that demand is shifting from individuals purchasing homes to moving to rental properties instead. The national housing affordability index (HAI)[3] decreased 8.2% and the California HAI[4] was down 6.07% from Q3 2017 to Q3 2018, indicating a decline in the ability to afford housing.

In terms of Central California, other than Madera County (10.33% increase in affordability) and Fresno County (0.39%), the other counties (Kings, Merced, and Tulare) all saw a decrease in affordability, following the state and national trend.[4] While the economy overall has experienced growth, it is important to note that the income gap between high- and low-income households has continued to increase. The mean household income compound annual growth rate from 2000-2017 was -8.56% for the lowest and 9.24% for the highest quintiles of income.[5] This combined with an increase in housing prices may, in part, be driving the growth in the multi-family residential segment.

One category that has been experiencing declining growth is the loans to individuals with YoY growth of 28.2% in 2016, 20.4% in 2017, and 15.5% in 2018. The "other" category, which has typically been the worst-performing category, has gone from negative YoY growth at the same time last year to 15.4% growth this year.

Overall, Central California's economy has experienced significant growth over the past year.[6] There are some factors, including potential increases in interest rates by the Federal Reserve, trade tariffs, a slowing housing market, and possible contractions in growth following last year's boon from tax cuts that may indicate a reduction in economic growth. However, the strong economic growth specific to Central California, which includes solid job growth and much lower unemployment rates than in the past, may help to balance out some of those risk factors.[6]

Macro Forces Provide Challenge

The primary challenges for Central Valley banks and credit unions are likely to be an economy whose growth is likely to slow down from last year and rising interest rates. While the Fed may be considering slowing the pace of its interest rate hikes, it appears at this time that it is not a matter of if rates will go up, but only of how many times. And with the impact of tax cuts felt primarily in the 2018 economic numbers, it will be difficult to maintain the same pace of growth in 2019.

On December 5, 2018, the three-year and five-year rates inverted and the spread between the 10-year and one-year rates decreased and looks poised to invert in the near future. A sustained 10-year and one-year inversion has preceded almost every recession since the 1970s and is an indicator that we may be facing an economic downturn within the next few years. (See Figure 6.) In terms of bank lending, an inversion in the yield curve will likely lead to tightened lending standards across all categories of loans.[2]

Notes

- Central California is defined as the following counties: Fresno, Kings, Madera, Merced, and Tulare.
- Banks headquartered in the 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.

BANKING

Endnotes

1 Car and Driver, 11/27/2018, "GM Closing Plants, Ending Production of Multiple Models; President Trump Threatens Retribution," www.carand driver.com/news/a25306076/GM-plant-closing-production-cars/

2 The Federal Reserve, 11/13/2018, "The October 2018 Senior Loan Officer Opinion Survey on Bank Lending Practices," https://www.federalreserve.gov/data/files/sloos-201810-fullreport.pdf

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

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

5 U.S. Census Bureau - Income and Poverty in the United States:2017, 09/12/2018, "Table A-2. Selected Measure of Household Income Dispersion: 1967 to 2017," https://www.census.gov/library/publications/2018/demo/p60-263.html

6 U.S. Department of Labor – Bureau of Labor Statistics, "Economy at a Glance – California," https://www.bls.gov/eag/eag.ca.html