Economic Studies at BROOKINGS

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The regional banks: The evolution of the financial sector, Part II

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Executive Summary

The regional banks play an important role in the economy providing funding to consumers and small- and medium-sized businesses. Their model is simpler than that of the large Wall Street banks, with their business concentrated in the U.S.; they are less involved in trading and investment banking, and they are more reliant on deposits for their funding. We examined the balance sheets of 15 regional banks that had assets between $50 billion and $250 billion in 2003 and that remained in operation through 2014.

The regionals have undergone important changes in their financial structure as a result of the financial crisis and the subsequent regulatory changes:

- Total assets held by the regionals grew strongly since 2010. Their share of total bank assets has risen since 2010.
- Loans and leases make up by far the largest component of their assets. Since the crisis, however, they have substantially increased their holdings of securities and interest bearing balances, including government securities and reserves.
- The liabilities of the regionals were heavily concentrated in domestic deposits, a pattern that has intensified since the crisis. Deposits were 70 percent of liabilities in 2003, a number that fell through 2007 as they diversified their funding sources, but by 2014 deposits made up 82 percent of the total.
- Regulators are requiring large banks to increase their holdings of long term subordinated debt as a cushion against stress or failure. The regionals, as of 2014, had not increased their share of such liabilities.
- Like the largest banks, the regionals increased their loans and leases in line with their deposits prior to the crisis. And like the largest banks, this relation broke down after 2007, with loans growing much more slowly than deposits. Unlike the largest banks, the regionals have increased loans strongly since 2010, but there remains a significant gap between deposits and loans.
- The regional banks' share of their net income from traditional sources (mostly loans) has been slowly declining over the period.
- The return on assets of the regionals was between 1.5 and 2.0 percent prior to the crisis. This turned sharply negative in the crisis before recovering after 2009. Between 2012 and 2014 return on assets for these banks was around 1.0 percent, well below the pre-crisis level.

As we saw with the largest banks, the structure and returns of the regional banks has changed as a result of the crisis and new regulation. Perhaps the most troubling change is that the volume of loans lags well behind the volume of deposits, a potential problem for economic growth. The asset and liability structure of the banks has also changed, but there banks have a simpler business model where deposits and loans still predominate.

[1] William Bekker served as research assistant on this project until June 2015 where he compiled and analyzed the data. He was co- author of the first part of this series and his contributions were vital to the findings presented here. New research assistant Nicholas Montalbano has contributed to this paper. We thank Michael Gibson of the Federal Reserve for helpful suggestions.

Introduction

This report is the second installment of a descriptive analysis of the ways in which the financial sector has changed over the period that includes the financial crisis and the changes in financial regulation, notably the Dodd-Frank Act of 2010. Part I of this series examined the Big Four banks; this part examines a panel of fifteen regional banks, banks that held between $50 billion and $250 billion in assets in 2014 and that filed Y-9C reports to the Federal Reserve from 2003 to 2014. Table 1 lists the banks in the sample.

Table 1. Regional Banks in Sample

Bank Name	Total Assets (2014)
TD Bank	$248.1 billion
Suntrust Banks	$190.4 billion
BB&T Corp.	$186.8 billion
Fifth Third Bancorp.	$138.7 billion
Citizens Financial	$133.0 billion
BMO Financial Corp.	$115.9 billion
MUFG Americas Holding Corp.	$113.7 billion
Northern Trust Corp.	$109.9 billion
M&T Bank Corp.	$96.7 billion
Keycorp	$93.9 billion
Bancwest Corp.	$89.8 billion
BBVA Compass Bancshares	$83.2 billion
Comerica Inc.	$69.5 billion
Huntington Bancshares Inc.	$66.3 billion
Zions Bank Corp.	$57.2 billion

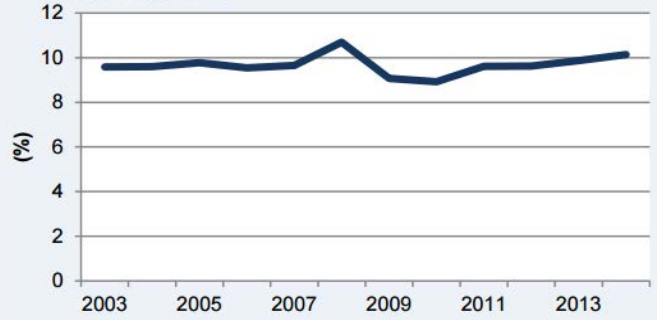
Notes: Charles Schwab excluded from analysis because it drops out of the Y-9C between 2007-2010 due to changes in its operating charter. Dollars rounded to nearest $100 million.
Source: Federal Reserve Board Y-9C data

The regional banks play an important role in the economy providing funding to consumers and small and medium-sized businesses. Their model is simpler than that of the Big Four banks, with their business concentrated in the United States; they are less involved in trading and investment banking; and they are more reliant on deposits for their funding. It is important to note that this sample of banks consists of those that survived the crisis. Some banks were forced into bankruptcy or were merged over this period, an issue we looked at with the Big Four banks and will take up again in later work.

Assets of the Regional Banks

An important issue that has emerged since the crisis is the extent to which banking has become more concentrated. We showed in our earlier paper that the share of total bank assets held by the Big Four had declined after 2010 and in Figure 1 we show that the regional banks have picked up some of that share. These 15 banks accounted for slightly less than 10 percent of total bank assets between 2003 and 2007. Their share jumped to 10.7 percent in 2008 and subsequently declined to a low of 8.9 percent in 2010. Since then it has risen steadily, reaching 10.1 percent in 2014.

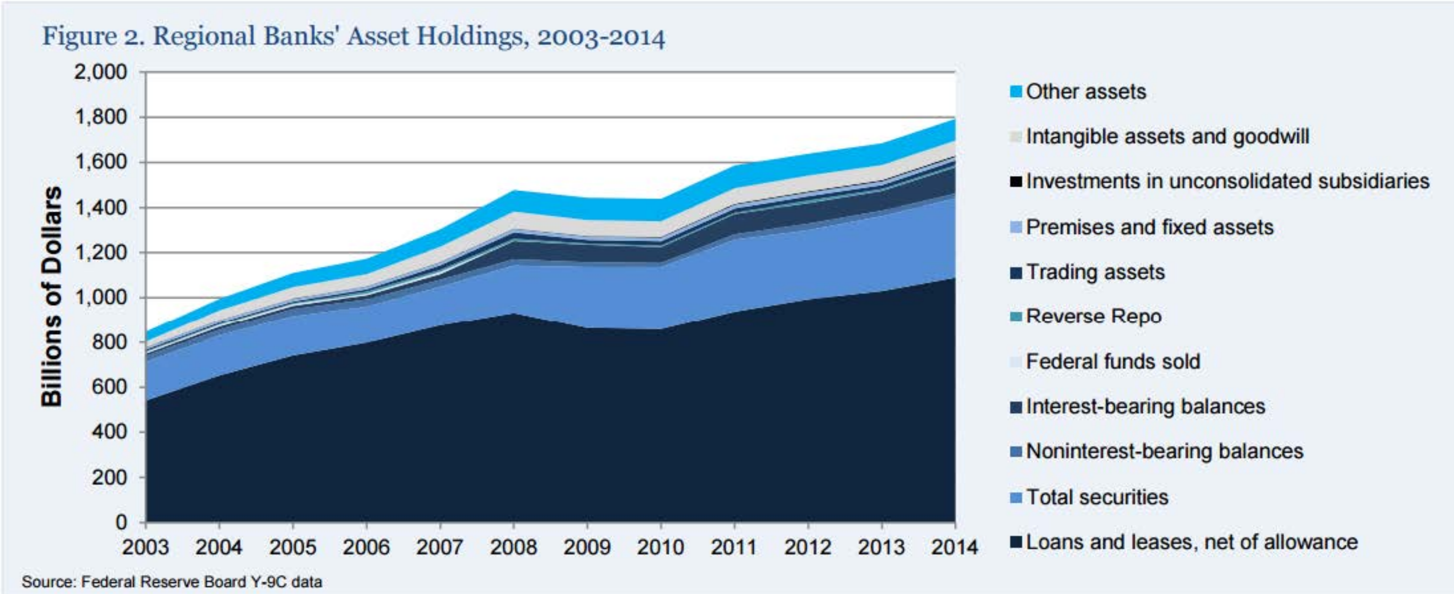
Figure 1. Regional Banks' Share of Total Assets, 2003-2014

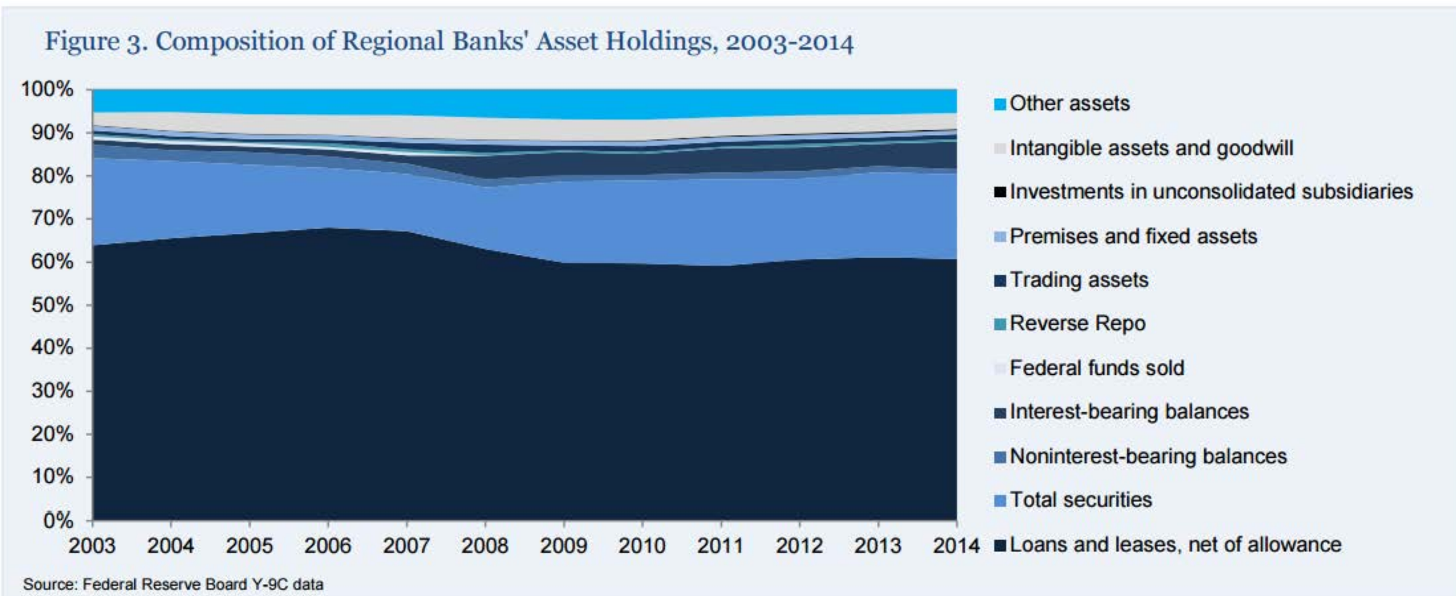


Source: Federal Reserve Board Y-9C data

Figure 2 shows the time pattern of assets holdings from 2003 through 2014. Assets grew rapidly from 2003 through 2008, from $845 billion to $1.475 trillion, an annual rate of increase of 10.6 percent a year. Assets declined by about 2.6 percent to $1.436 trillion between 2008 and 2010 as the regional banks faced the decline in asset values that affected the whole sector. Since then, asset holdings among these regional banks have been on the rise, reaching $1.793 trillion in 2014. Post- crisis has been stronger among the regionals than among the Big Four; as we reported in our last installment of this series, the compounded annual growth rate (CAGR) of the Big Four between 2009 and 2014 was 1.8%.

Figure 3 shows the composition of the assets of the regional banks. By far the largest assets of the regional banks are loans and leases, which rose modestly as of a share of total assets between 2003 and 2006 before declining during the crisis and holding steady since 2009. Securities make up the second- largest asset class. In the pre-crisis years, securities as a share of total assets declined. They grew as a share of total assets during the crisis, and have held steady since 2009. In 2003 these asset classes accounted for over 84 percent of the total assets of the regionals; in 2014 that figure had fallen to just over 80 percent.





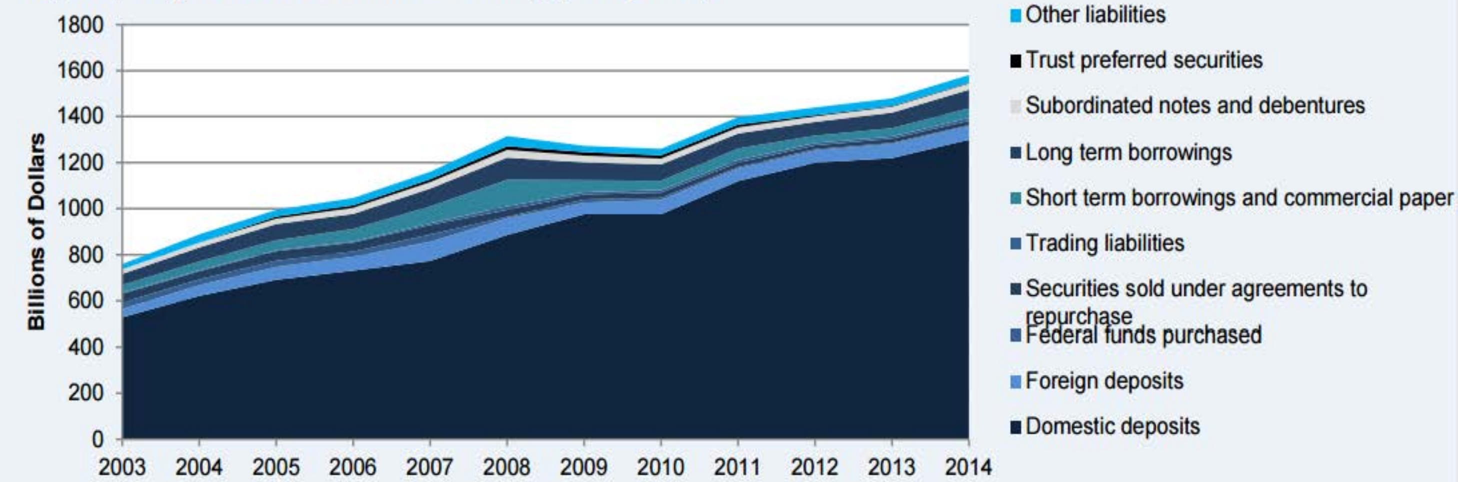
Additionally, noteworthy changes in the share of total assets attributable to interest-bearing and noninterest- bearing balances occurred between 2003 and 2014. In 2003 interest-bearing balances accounted for just over 1.2 percent of total assets; by 2014, that figure had more than quintupled, to 6.5 percent. On the other hand, in 2003 noninterest-bearing balancing accounted for just over 3.1 percent of total assets; by 2014, that figure had fallen to less than 1.2 percent. As shown in Figure 3, the bulk of these changes occurred during the crisis.

Liabilities of the Regional Banks

Figure 4 shows the path of liabilities of the regional banks over time and Figure 5 shows the composition of those liabilities. Liability holdings more than doubled between 2003 and 2014, from $760 billion to $1.578 trillion. With the exception of a brief downturn during the crisis, this increase in holdings has been relatively constant.

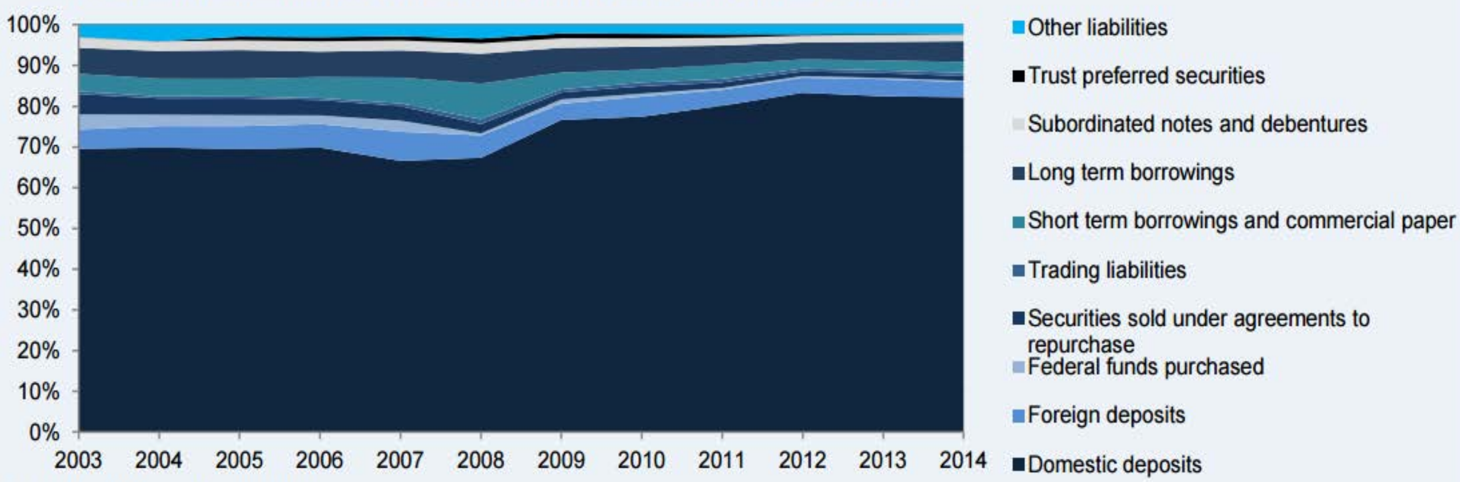
Over the entire period, the liability structure is dominated by domestic deposits. Domestic deposits as a share of total liabilities remained fairly constant in the years leading up to the crisis, 69.5 percent in 2003 and 66.6 percent in 2007. This share rose dramatically after the crisis, however, reaching 82.2 percent in 2014. As was the case with the Big Four banks, the regionals were flooded with deposits after the crisis as there was a rush to safety. This increase in deposits has been termed ”surge deposits.” This trend, coupled with what we saw on the asset side, paints a picture where banks were the recipients of large volumes of deposits but they were either reluctant to make a corresponding increase in loans, or they faced a decline in the demand for loans, given the weak economy.

Figure 4. Regional Banks' Liabilities Holdings, 2003-2014



Source: Federal Reserve Board Y-9C data

Figure 5. Composition of Regional Banks' Liabilities Holdings, 2003-2014



Source: Federal Reserve Board Y-9C data

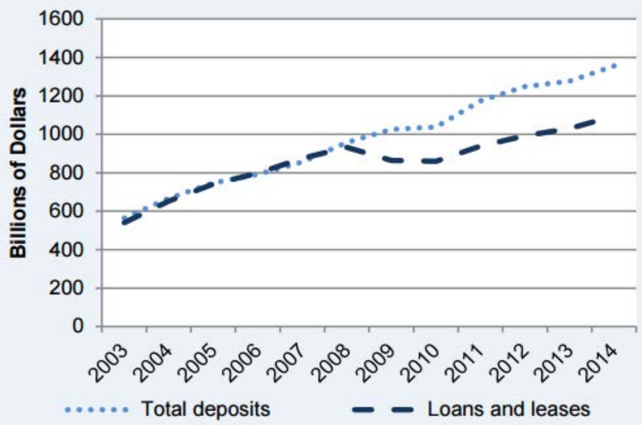
The decline in the demand for loans was surely the most important factor during the recession and the early part of the recession. After the recession, banks may have been wary that these surge deposits would exit following an increase in interest rates, thereby making them reluctant to translate these deposits into loans. It will be worthwhile, then, to follow the trajectory of deposits and loans when interest rates rise.

The other elements on the liability side, while interesting, are not large enough to tell a major story for these banks. There was an increase in foreign deposits before the crisis: these deposits accounted for $36 billion in liability holdings, or about 4.8 percent of total liabilities, in 2003. By 2007 those figures had risen to $83 billion and 7.1 percent, respectively. This trend did not continue after the crisis, however, and by 2014 foreign deposits had fallen to $59 billion, about 3.7 percent of total liabilities. Additionally, as regulators seek to develop and implement rules that will help the financial sector avoid a repeat of the 2007-09 crisis, some observers anticipate new long-term unsecured debt requirements that would apply to all banks with more than $50 billion in assets. In 2008, these 15 banks held $130 billion of long term and subordinated debt. This number fell after the crisis, bottoming out at $84 billion in 2012, but has since risen to $108 billion in 2014.

Relation of Loans to Deposits

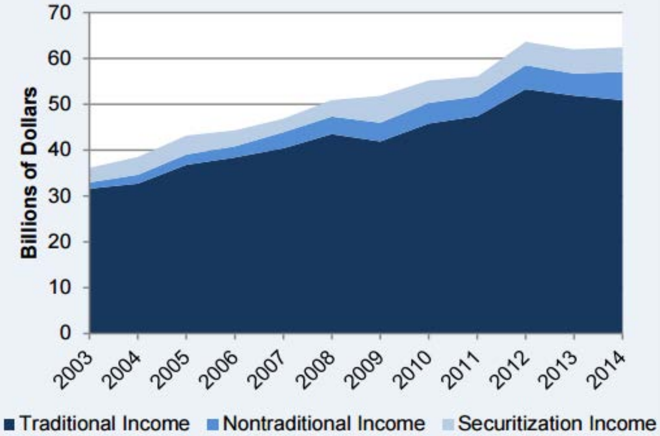
We have already remarked on the fact that loans grew more slowly than deposits and we reinforce this message with Figure 6 which plots loans and deposits directly on the same figure. It is dramatic that from 2003 through 2008 the dollar value of loans moved one to one with the value of deposits. The regionals were doing what we expect banks to do; they were taking in deposits from their communities and loaning the money out to borrowers. The collapse of the housing market produced a huge change in this pattern, as deposits continued to increase but loans dropped sharply through 2010.

Figure 6. Growth of Deposits versus Loans and Leases among the Regional Banks, 2003-2014



Source: Federal Reserve Board Y-9C data

Figure 7. Regional Banks' Sources of Income, 2003-2014



Note: Interest deducted from each category on a pro rata basis.
Source: Federal Reserve Board Y-9C data

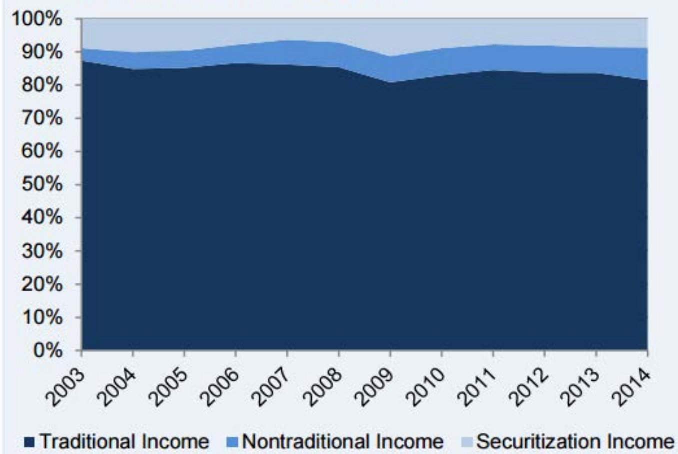
An important difference between the regionals and the Big Four banks, however, is that the value of loans started to rise again after 2010, not at the same pace as the increase in deposits, but at a solid rate. Loans and leases grew at 11.5 percent a year 2003-08 and at 6.3 from 2010 to 2014. Recall that the economy was growing more slowly over the latter period than the former, so that the growth of loans by the regionals in relation to GDP growth was quite strong. The loan pattern of the regionals contrasts with the loan pattern of the Big Four seen in our prior paper, where the value of loans has stayed almost flat. A greater regulatory squeeze on the biggest banks could account for this disparity. Additionally, the biggest banks may not have seen much profitability in loans and leases, leaving them to seek out alternative options in order to recover from the crisis.

But despite the relatively strong growth of loans for the regionals, the gap between loans and deposits has remained. The increase in total securities (Figure 3) might provide additional insight into the reason for the persistence of the gap. From 2008 to 2014 total securities grew from $211 billion, or 14.3 percent of total assets, to $351 billion, or 19.6 percent of total assets. This increase in securities is concurrent with the decrease in composition of loans and leases. The increase in securities may have been due to banks seeking to preserve margins by investing in securities with longer maturities. It may also have been in response to recent liquidity regulation requirements; the liquidity coverage ratio (LCR) requires banks to hold sufficient high-quality liquid assets to cover its total net cash outflows for 30 days. The LCR then may be leading banks to hold more securities as a liquidity buffer, which would reduce the amount of capital available for loans and leases.

Regional Bank Income

Figure 7 shows the sources of regional bank revenues net of interest expense, which has shown a steady

Figure 8. Composition of Regional Banks' Sources of Income, 2003-2014

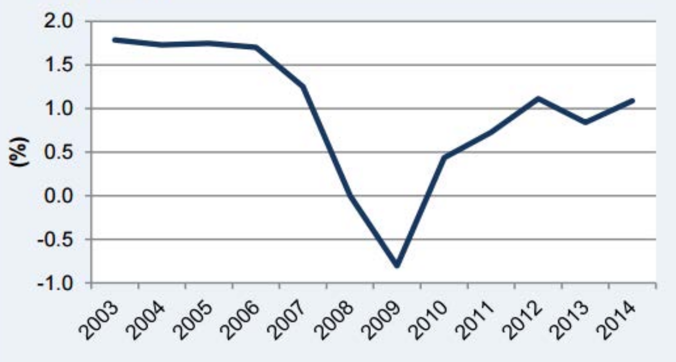


Note: Interest deducted from each category on a pro rata basis.
Source: Federal Reserve Board Y-9C data

increase over time, with the exception of 2009. Figure 8 shows the composition of income over the same time period. Traditional income has provided the bulk of this measure of income, although there has been a decline in the share of income from this source in recent years. Nontraditional income has risen significantly since 2003 in both absolute and relative terms. In 2003 nontraditional income accounted for about $1 billion, or 3.8 percent of total income. By 2007 those figures had grown to $3.5 billion and 7.5 percent, respectively, and by 2014 they had reached $6 billion and 9.9 percent, respectively.

Of course the income net of interest expense does not give a picture of profitability, which can be seen more clearly from profits as a percent of assets. Figure 9 shows how return on assets has moved over this period and the impact of the crisis is very clear. In the pre-crisis years, return on assets hovered around 1.7 percent. It dropped sharply during the crisis, falling to -0.8 percent in 2009. In the years since the crisis the return on

Figure 9. Regional Banks' Return on Assets, 2003-2014



Source: Federal Reserve Board Y-9C data

assets has improved and returned to positive numbers, but it remains around 1.0 percent, significantly below pre-crisis levels. This story is nearly identical to the one we told about return on assets among the Big Four, although the Big Four had higher returns than the regionals in the years before the crisis, and had their lowest returns in 2008, rather than 2009.

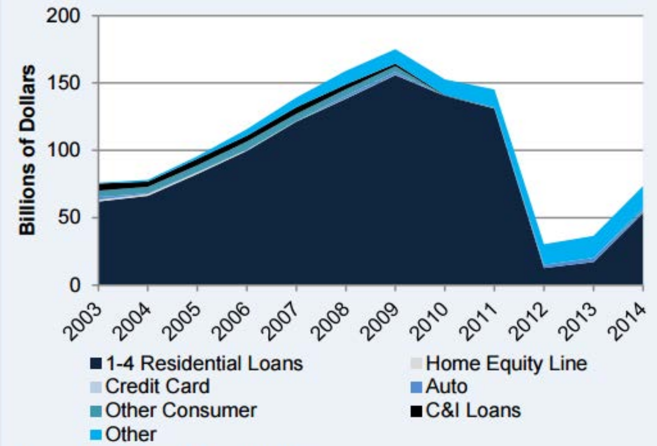
The reasons for the lower level of return on assets will be explored more fully as our study continues. The years of the crisis, 2008-09 triggered widespread defaults on mortgages, credit cards debts and other loans. The regional banks, of course, are being required to hold additional capital and liquidity, and they may have been subject to a squeeze on interest margins because of the very low interest rate environment. In addition, there are much tighter rules on fees. Banks, large and small, were making significant returns from overdraft and other fees that have been restricted under the new rules.

Regional Bank Securitization

Analysis of these banks' securitization business also reveals fascinating changes in their practices. As Figure 10 shows, securitization business rose swiftly and steadily between 2003 and 2009, driven mostly by 1-4 unit residential loans. In 2004 total securitization business was just under $80 billion, with 1-4 residential loans accounting for over 80 percent of that. By 2009, total securitization business was approaching $180 billion, with 1-4 residential loans accounting for nearly 90 percent of that. Between 2009 and 2011, total securitization business fell by about $30 billion. The most significant change came in 2011, when total securitization business fell by about $115 billion, to less than half of 2004 levels. In 2012, securitization business was at about $30 billion, of which only about 42 percent was made up of 1-4 residential loans. Since 2012, total securitization business has been on the rise, in 2014 coming just shy of 2004 numbers.

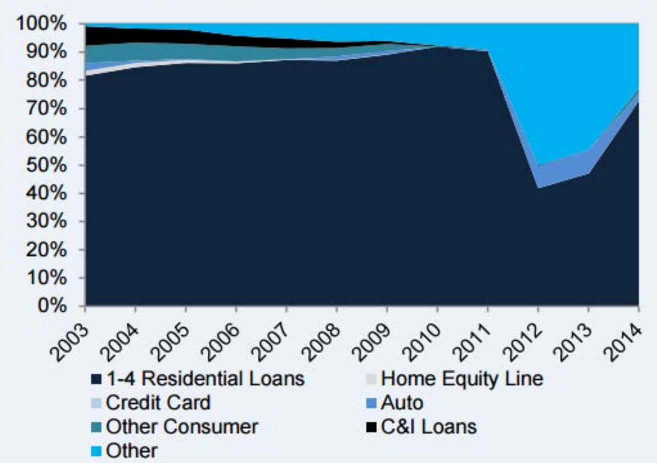
Figure 11 shows that the composition of these banks' securitization business has also been changing.

Figure 10. Regional Banks Securitization Business



Source: Federal Reserve Board Y-9C data

Figure 11. Composition of Regional Banks' Securitization Business



Source: Federal Reserve Board Y-9C data

Between 2003 and 2011, the share of 1-4 residential loans and "other" securitization business rose steadily while all other forms of securitization business declined steadily. After that the share of 1-4 residential loans fell sharply – from over 90 percent in 2011 to under 45 percent in 2012 – and "other" securitization business filled most of this void. Since 2012, the share of 1-4 residential loans has been rebounding, passing 72 percent in 2014, while "other" securitization business has fallen.[2]

Conclusions

Since the crisis, the regional banks have gone through a period of adjustment, and many of them have updated their business models. Generally, they seem to be leaving behind securitization and other complex areas of finance, content to let the largest institutions dominate those areas (and take on most of the attendant risk).

The regional banks have focused on realigning their businesses to take advantage of their intermediate size, which affords them the economies of scale necessary to respond to new regulatory challenges as well as the flexibility to focus on lending to niche commercial and industrial businesses.

In the first part of this series, we reported a concern that the Big Four banks were lending below the levels to be expected based on the amount of deposits. A similar trend is present among these regional banks: deposits and loans grew steadily and equally between 2003 and 2008 but have diverged since then, with the gap between deposits and lending growing every year. Nevertheless, the regional banks are showing substantial growth over time in the amount of loans they are making, whereas the Big Four bank loans were pretty flat. Concerns about risk and/or new regulatory pressures may be behind the gap between deposits and loans for the regionals as well as the Big Four. The trend, especially since we have shown that it applies not just to the very largest banks, deserves additional attention so that policymakers, consumers, and industry experts can be alert for future problems in the financial sector and the needs of a growing economy.

[2] The "other" securitization business category includes all other loans, all leases, and all other assets. In this case, "all other loans" includes loans that are not 1-4 residential loans, home equity lines, credit card receivables, auto loans, other consumer loans, or commercial and industrial loans.