MID-YEAR 2016 U.S. BANKING OUTLOOK

U.S. Financial Institutions | **Mid-Year 2016 U.S. Banks Outlook: Stable**

While some operational and credit headwinds face KBRA's rated bank universe, which largely consists of regional and super-community banks, overall the rating outlook continues to be stable. This outlook takes into account a myriad of factors that are both internal and external to the institutions themselves. Internal factors include solid funding structures and improved asset quality metrics resulting from conservative underwriting and a thorough understanding of their respective operating footprints. External factors include stability in real estate asset values, slightly improved home sales data, and moderately stable economic operating conditions overall. Broadly, the growth rate of the U.S. economy is forecast to remain moderate at best with possible downward pressure originating internationally. Rating constraints include concentrated exposure to real estate as well as a large reliance upon spread-derived income. Also, KBRA notes an increasing trend of capital deployment into lending that is driving downward pressure on capital levels, though all investment grade institutions remain above the regulatory minimums for well capitalized.

The domestic economic environment has seen slow improvement and, as a result, central bank monetary policy has remained largely accommodative with a single 25 basis point increase coming at the end of 2015. Additionally, international events, including the Brexit vote in June 2016, have put downward pressure on domestic bond yields as there has been a concerted drive towards U.S. investments and away from those in Europe and elsewhere; the yield on the U.S. 10-year treasury has dropped from 2.24% in January 2016 to 1.62% in August 2016, though future rate changes initiated by the Federal Reserve may push those rates up. This, in turn, has been both a blessing and a curse. The low interest rate environment has put pressure on margins, particularly for those banks whose focus is on retail and residential mortgage. Additionally, competitive pressures on interest rates remain high within the commercial lending space, though KBRA rated Banks continue to fare well in this space with increasing market share. Given all of this, however, funding costs have remained low for both core and noncore funding sources. As such, many of the regional institutions within the KBRA rated universe have enjoyed stable, if not slightly improving, net interest margins. Many have positioned themselves as asset sensitive, with moderate durations on investments as well as relatively high levels of repricing within their loan portfolios so as to hedge for future interest rate increases.

In many markets across the country, asset values have stabilized and, combined with more stringent underwriting standards, have led to an overall improved outlook for nonperforming assets. There are, however, several segments within the economy that continue to pose problems, particularly within the energy sector where a prolonged supply glut has perpetuated low prices. Many of the rated institutions have limited or eliminated exposure

Key Financial Ratios by Rating Category	A	A-	BBB+	BBB	BBB-
Total Loans / Total Assets	55.02%	71.66%	74.68%	75.10%	74.77%
Nonperforming Assets / Total Assets	0.85%	0.32%	0.54%	0.60%	1.09%
Nonperforming Assets / Tangible Equity + Reserves	8.84%	3.56%	6.43%	6.69%	12.20%
Reserves / Total Assets	0.68%	0.57%	0.70%	0.69%	0.64%
Reserves / Nonperforming Assets	79.76%	180.05%	236.16%	249.93%	86.52%
Net Charge-Offs / Average Total Assets	0.18%	0.05%	0.09%	0.07%	0.15%
Net Charge-Offs / Provisions	104.00%	49.77%	28.58%	145.20%	69.63%
Loan Loss Provisions / Average Total Assets	0.18%	0.11%	0.17%	0.13%	0.23%
Total Deposits / Total Assets	67.52%	71.97%	77.32%	78.71%	78.28%
Total Loans/ Total Deposits	81.41%	99.50%	96.91%	96.17%	95.94%
Tier 1 / RWA	12.20%	11.42%	11.14%	11.33%	10.97%
Total Equity - Intangible Assets / Total Assets	9.00%	8.40%	8.48%	8.21%	7.80%
Net Interest Margin	2.69%	3.75%	3.67%	3.49%	3.49%
Net Interest Income / Total Revenue	55.05%	74.78%	79.18%	80.34%	62.70%
Noninterest Income / Total Revenue	44.95%	25.22%	20.82%	19.66%	37.30%
Return on Average Assets	1.13%	1.07%	1.07%	0.96%	0.89%
Return on Equity	9.61%	9.86%	9.66%	9.80%	8.73%
Efficiency Ratio	61.32%	62.73%	59.79%	63.93%	72.55%
Double Leverage	100.37%	108.95%	108.61%	112.06%	113.77%

Data Source: June 30, 2016 FR Y-9C and FR Y-9LP
Ratings refer to BHC senior debt

Average Trends in Key Financial Ratios	
Nonperforming Assets / Total Assets	+
Total Loans/ Total Deposits	–
Tier 1 / RWA	–
Total Equity - Intangible Assets / Total Assets	–
Net Interest Margin	+
Noninterest Income / Total Revenue	↔
Return on Average Assets	↔
Efficiency Ratio	↔
Double Leverage	–

Trends based upon previous data reported September 30, 2015

to energy companies throughout the energy supply chain. KBRA has also noted some concern regarding commercial real estate capitalization rates as perpetually low interest rates have driven down these rates. However, many rated Banks have adjusted for this by further tightening their loan-to-value (LTV) requirements and conducting stress testing for higher rates as part of the underwriting process. It should also be noted that this can vary widely from market to market and, as many of the rated institutions are regional and super-community banks, they often have in-depth knowledge of both their markets and their borrowers that helps to offset this risk. Additionally, renewed regulatory focus on the capital concentration "guidance" limits of 300% for non-owner occupied commercial real estate and 100% for construction and development have tempered many of the rated institutions' appetite within these spaces, with those Banks that choose to exceed the guidance limits doing so with very strong credit, risk, and portfolio management systems in place to counterbalance.

Growth prospects for the KBRA rated Banks remain a healthy mix of organic and acquisition strategies, with the latter proving to be more alluring in the face of increased regulatory cost burden as well as cost efficiencies to be realized. To date, the rating implications of acquisitions have been generally neutral to positive. Bank acquisitions have helped diversify lending/depository franchises, increase market share, and, in some cases, diversify revenue streams by adding additional business segments to boost fee income. Acquisition-related risks have been well contained to date. Most acquisitions have been relatively small to moderate-scale transactions in markets known well by management teams. Larger acquisitions within KBRA's rated universe have been primarily in-market transactions with considerable cost saving opportunities. It is anticipated that the rated Banks will continue to be active acquirers going forward.

Capital levels have trended downward slightly for KBRA rated Banks while double leverage has trended up slightly. Much of this can be attributed to shareholder pressure for greater performance, though there has not been an observed shift to more accommodative dividend policies. This comes as regulatory pressures on institutions to maintain higher capital levels are elevated while the Dodd-Frank regulations surrounding capital and liquidity stress testing (DFAST) appear to be trickling downward toward smaller institutions, including those in the rated universe. These banks, nonetheless, remain significantly above the minimum level required for the well-capitalized designation with most, if not all, performing well in the stressed scenarios.

Key Financial Ratios - BBB Rated Unweighted Averages

Key Statistics	1H 2016	2015	2014	2013	2012	2011
Total Loans / Total Assets	74.76%	73.80%	73.42%	70.58%	68.91%	65.22%
Nonperforming Assets / Total Assets	0.58%	0.61%	0.80%	1.08%	1.66%	1.78%
Nonperforming Assets / Tangible Equity + Reserves	6.54%	6.99%	8.13%	11.02%	19.73%	19.16%
Reserves / Total Assets	0.69%	0.70%	0.83%	0.91%	1.00%	1.05%
Reserves / Nonperforming Assets	262.47%	210.47%	251.96%	131.20%	98.01%	90.68%
Net Charge-Offs / Average Total Assets	0.07%	0.08%	0.11%	0.21%	0.40%	0.69%
Net Charge-Offs / Provisions	145.21%	505.98%	106.08%	95.91%	116.35%	137.96%
Loan Loss Provisions / Average Total Assets	0.12%	0.12%	0.17%	0.20%	0.44%	0.63%
Total Deposits / Total Assets	78.75%	79.22%	80.53%	81.87%	82.00%	82.80%
Total Loans/ Total Deposits	95.68%	94.04%	91.78%	86.65%	85.02%	79.54%
Tier 1 / RWA	11.34%	11.69%	12.16%	13.42%	12.87%	13.87%
Total Equity - Intangible Assets / Total Assets	8.17%	8.14%	8.80%	9.21%	8.47%	9.16%
Net Interest Margin	3.49%	3.56%	3.64%	3.60%	3.63%	3.66%
Net Interest Income / Total Revenue	80.13%	79.85%	81.13%	78.55%	78.71%	85.05%
Noninterest Income / Total Revenue	19.87%	20.15%	18.87%	21.45%	21.29%	14.95%
Return on Average Assets	0.95%	0.91%	0.76%	0.96%	0.76%	0.46%
Return on Equity	9.83%	8.82%	7.37%	8.98%	7.79%	4.50%
Efficiency Ratio	64.35%	65.88%	69.75%	71.10%	69.02%	70.66%
Double Leverage	112.44%	109.91%	104.98%	102.98%	107.31%	105.53%

Data Sources: FR Y-9C and FR Y-9LP
Ratings refer to BHC senior debt

Going forward, KBRA expects that capital levels will continue to trend downward over time, particularly Common Equity Tier 1 capital levels (CET1) as rated institutions pursue growth opportunities to maximize both profitability as well as shareholder value. KBRA will continue to monitor this very closely, particularly should there be any deterioration in capital markets that would impact access for these institutions.

Drivers of an Outlook Change

With few exceptions, the banks within the KBRA rated universe are well situated in their respective rating categories. Based upon analysis completed in accordance with the KBRA Global Bank and Bank Holding Company Methodology published on February 19, 2016, the current ratings assigned are forward looking and already reflect the expectation for sound profitability, stable asset quality, comfortable liquidity, and resilient capital. Consequently, a positive rating outlook for the sector is unlikely. However, the Rating Outlook could turn negative if significant signs of a pending domestic economic slowdown emerge or if there are signs of domestic contagion should an international economic slowdown take place. In fact, IMF Chief Christine Lagarde recently commented that "[global growth] recovery remains too slow, too fragile, and risks to its durability are increasing", adding that persistent low growth can be self-reinforcing through negative effects on potential output that can be hard to reverse leading to the threat of a "new mediocre" of weak economic progress.[1] Additionally, though asset prices have largely stabilized, given the relatively large exposure to real estate of Banks within the KBRA rated universe, significant devaluation of real estate assets could negatively affect ratings. That said, current ratings accommodate a certain degree of asset quality stress after applying KBRA's stress test scenarios during the rating process. In an effort to drive earnings growth, management teams will continue to be tempted to take on additional risk. The Rating Outlook could deteriorate if the following negative trends become more significantly evident across the sector including: overly shareholder friendly capital management, aggressive acquisition strategies including large out-of-market acquisitions or significant ventures into business segments without commensurate management experience, riskier lending activities or a significant loosening of credit quality standards, outsized growth in construction and development exposures, tighter liquidity management, or riskier investment portfolios in an effort to boost NIMs.

[1] "Decisive Action to Secure Durable Growth". Lecture by Christine Lagarde, IMF Managing Director. Bundesbank and Goethe University, Frankfurt, Germany. April 5, 2016.

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