BANKING BRIEF
FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

Second Quarter 2006

Profitability was stable for banks around the nation and among large banks in the tri-state area but fell among community banks in the tri-state area. Nearly half of the banks in this last group, primarily the large ones, also experienced a significant increase in nonperforming loans. This contributed to an 11-basis-point increase in the nonperforming loan ratio compared to the first quarter and a 19-basis-point increase compared to the same period in 2005.

The decline in loan quality occurred primarily in the commercial real estate (CRE) category, in particular, among loans for construction and mortgages on commercial properties.[1] The banks appear to have recognized the problem, as both their loan loss provisioning and net chargeoffs have increased substantially since last year. This has adversely affected their profitability.

Commercial Real Estate Lending

Much recent attention has been paid to the market for single-family homes and the possibility of a future decline in house prices. Much less attention has been focused on developments in commercial real estate (CRE) and, in particular, on the role banks play in financing this investment.

CRE loans are generally considered more risky than other types of real estate loans because their repayment depends on the successful sale or rental of the property after the loan is made. In other types of real estate lending, the borrower's income is usually more predictable. For example, if a developer borrows to build a condominium high-rise, a substantial percentage of the units have to be sold at or above the prices he or she expected at the time the loan was made. If the real estate market subsequently deteriorates, the developer may not be able to repay the loan. If the bank has a large number of these loans in the same market area, its nonperforming loan ratio could increase substantially, with negative consequences for its earnings and capital.

CRE lending is primarily a phenomenon among small and medium-sized banks. Large banks typically have loan portfolios that are more diversified, both in terms of the kinds of loans made and the geographic markets where they are actively lending. Between year-end 1991 and the first quarter of 2006, aggregate CRE loans increased from 11.0 to 13.6 percent of all bank assets, and from 18.5 to 23.1 percent of all bank loans.[2] At banks with less than $5 billion in total assets, aggregate CRE loans increased from 12.6 to 30.7 percent of assets and from 21.9 to 45.5 percent of loans. By comparison, residential real estate loans (mortgages) currently represent 30.8 percent of loans at all banks but only 23.8 percent of loans at banks with assets of less than $5 billion. Additionally, as of March 31, 2006, CRE loans made up at least a quarter of the assets of nearly 40 percent of these banks.

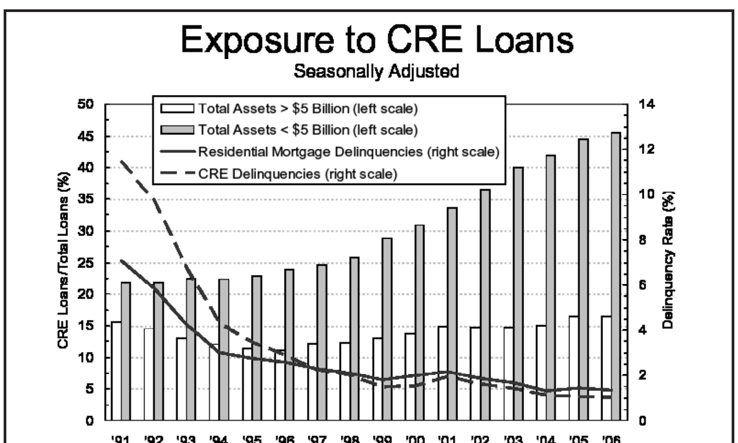
The chart below shows banks' exposure to CRE loans and the performance of those loans. The bars depict the ratio of CRE loans to total loans, and the lines show the delinquency rates on CRE loans and residential loans. For most of the decade, CRE loans have actually performed slightly better than residential mortgages. This may be due to generally strong real estate markets or possibly to better underwriting. Before then, however, CRE loans performed substantially worse, and the high default rates on CRE loans in the late 1980s and early 1990s contributed to a number of bank and thrift insolvencies.

Earlier this year, the Federal Reserve System and the other federal financial regulators proposed revising guidelines on how banks should manage the risks associated with this type of lending.[3] Banks with high concentrations of CRE loans would be singled out for special scrutiny by the regulators. As of March 2006, no bank met the criteria in the proposal, but several were approaching them.

[1] CRE loans are defined here as construction and land development loans, loans secured by multifamily properties, and loans secured by nonfarm, nonresidential property. These data are from FFIEC Call Reports.

[2] Delinquency data are from Board of Governors statistical releases (see www.federalreserve.gov/releases/chargeoff/). The rising percentage of CRE loans at small banks cannot be said to be due to increasing securitizations of other types of loans. Removing mortgages from the calculations yields a similar trend in CRE loans' percentage of total loans and assets.

[3] See 71 *Federal Register*, pp. 13215-7 and *Banking Legislation and Policy*, Federal Reserve Bank of Philadelphia, January-March 2006 at www.philadelphiafed.org/econ/blp/index.html.



Second Quarter 2006

Community Banking Organizations

	Tri-State			Nation		
	$Bill	% change from		$Bill	% change from	
	06Q2	06Q1	05Q2	06Q2	06Q1	05Q2
Total Assets	91.1	7.35	6.14	1669.5	7.89	8.69
Total Loans	61.0	12.86	11.00	1141.4	14.54	11.81
Business	8.4	14.38	8.46	177.4	15.36	8.76
Real Estate	48.0	13.38	12.46	834.4	15.94	13.48
Consumer	2.6	-3.31	-4.46	69.6	4.71	0.66
Total Deposits	71.3	9.30	7.49	1328.3	6.13	9.52
Ratios (in %)	**06Q2**	**06Q1**	**05Q2**	**06Q2**	**06Q1**	**05Q2**
Net Income/ Avg Assets (ROA)	1.13	1.16	1.14	1.20	1.20	1.21
Net Interest Inc/ Avg Assets (NIM)	3.40	3.43	3.41	3.79	3.79	3.75
Noninterest Inc/ Avg Assets	1.16	1.18	1.16	0.95	0.96	1.00
Noninterest Exp/ Avg Assets	2.90	2.92	2.93	2.92	2.94	2.94
Loans/Deposits	85.55	84.87	82.85	85.92	84.3	84.16
Equity/Assets	10.16	10.16	9.95	9.69	9.69	9.77
Nonperforming Loans/ Total Loans	0.75	0.64	0.56	0.65	0.66	0.64

Large Banking Organizations

	Tri-State			Nation		
	$Bill	% change from		$Bill	% change from	
	06Q2	06Q1	05Q2	06Q2	06Q1	05Q2
Total Assets	2338.1	14.90	8.70	7288.8	12.73	10.32
Total Loans	1300.1	18.65	14.48	4092.7	10.60	10.46
Business	263.5	6.78	12.13	864.7	8.39	11.51
Real Estate	775.5	29.19	16.31	2224.3	14.73	12.03
Consumer *	104.7	0.25	13.06	507.5	-7.42	2.89
Total Deposits	1501.9	3.06	4.90	4772.8	13.02	10.36
Ratios (in %)	**06Q2**	**06Q1**	**05Q2**	**06Q2**	**06Q1**	**05Q2**
Net Income/ Avg Assets (ROA)	1.29	1.32	1.42	1.22	1.21	1.16
Net Interest Inc/ Avg Assets (NIM)	2.63	2.64	2.78	2.69	2.69	2.70
Noninterest Inc/ Avg Assets	1.96	1.93	1.94	2.24	2.20	2.04
Noninterest Exp/ Avg Assets	2.59	2.58	2.67	2.91	2.93	2.90
Loans/Deposits	86.56	83.57	79.32	85.75	86.21	85.67
Equity/Assets	9.59	9.59	10.09	9.21	9.21	9.58
Nonperforming Loans/ Total Loans	0.40	0.39	0.44	0.65	0.68	0.65

A banking organization is an independent bank or all the banks within a highest-level bank holding company; however, banks less than five years old and those whose credit card loans make up more than 50 percent of their total loans are excluded. The large banking organization sample is based on banking organizations whose total assets were at least as large as those of the 100th largest banking organization in the United States as of December 31, 2005. The community banking organization sample is based on the remaining banking organizations. Tri-state large banking organizations are those large banking organizations that have either at least 5 percent of the deposits of the region or any state therein or at least 5 percent of their deposits in the region. Tri-state community banking organizations are those community banking organizations that are headquartered in the region. The numbers of banking organizations in the categories are as follows: (1) community banking organizations — 183 for the tri-state area and 5802 for the nation; (2) large banking organizations — 18 for the tri-state area and 102 for the nation. Ratios are aggregates, that is, the numerators and denominators are summed across all banks in the group, then divided. Data are adjusted for mergers. Quarterly percentage changes are compound annualized rates.

* The drop in consumer loans nationally was the result of one large institution. Excluding that institution, consumer loans increased at an annual rate of 7.32 percent for the quarter and 8.10 percent for the year.

Any questions or comments should be directed to Jim DiSalvo at (215) 574-3820 or jim.disalvo@phil.frb.org. Detailed documentation on the methodology used in constructing this document, back issues, and the current issue of *Banking Brief* are available on our website at www.philadelphiafed.org/econ/bb/index.html. To subscribe to this publication, please go to http://www.philadelphiafed.org/phil_mailing_list/dsp_user_login.cfm.