BANKING BRIEF
FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

First Quarter 2007

NOTE: Beginning with this issue, *Banking Brief* will be published in electronic format only. We will no longer distribute printed versions of this publication. One of the benefits of publishing electronically is that we can be more flexible in how we present and discuss the factors that explain current banking conditions. We hope you will continue to find *Banking Brief* useful and informative.

Compared to the previous quarter, first-quarter profitability fell for most categories of banks in our sample, continuing a trend of declining profitability that began in the first quarter of last year (see the table). This trend is explained by declining net interest margins and increased provisioning for loan losses in response to increases in the ratio of nonperforming loans to total loans.[1]

Some other general trends are that both large and small banks remain well capitalized, the ratios of noninterest expense to average assets and noninterest income to average assets are essentially unchanged, and loan demand remains adequate.

Large Organizations

Among large banks, return on average assets (ROAA) decreased in the first quarter, both nationally and in the tri-state area.[2] Assets decreased at tri-state area banks as a result of a decline in the securities portfolios of some organizations.

Over the year ending March 31, 2007, the ratio of nonperforming loans to total loans increased from 0.39 to 0.53 percent at tri-state area banks and from 0.69 to 0.86 percent nationally (see the table). This ratio remains low by historical standards. The average for all banks from 1995 to 2005 was 1.08 percent.[3] Overall, nonperforming loans increased 82.6 percent at tri-state area banks and 36.3 percent nationwide.[4]

The ratio of net chargeoffs to average loans at tri-state area banks increased from 0.27 percent in March 2006 to 0.57 percent in March 2007.[5] For the nation, the net chargeoff ratio increased from 0.37 percent to 0.50 percent. Historically, this ratio has averaged 0.71 percent between 1995 and 2005.

In the tri-state area, mortgages made up the largest portion of nonperforming loans, followed by credit card loans (Figure 1).[6] Nationally, mortgages accounted for the largest portion of nonperforming loans, followed by commercial real estate (CRE) loans.[7]

Recently, much attention has focused on mortgages because of instability in the residential real estate market, and this is reflected in the nonperforming loan

[1] Nonperforming loans are defined as loans past due 90 days or more plus nonaccruing loans.

[2] See the table for definitions of community banks and large banking organizations.

[3] Historical data are from the FDIC Historical Statistics on Banking, www2.fdic.gov/hsob/index.asp.

[4] Relative to the fourth quarter of 2006, nonperforming loans increased 12 percent among large tri-state area banks and 16.4 percent nationally.

[5] All references to chargeoffs in this document refer to net chargeoffs, that is, the difference between chargeoffs and recoveries.

[6] Note that two of the largest credit card lenders in the country, Bank of America Corporation and Capital One Financial Corporation, are part of the tri-state sample of large banks.

[7] CRE loans are defined as the sum of construction and land development loans, loans secured by multifamily properties, and loans secured by nonfarm, nonresidential properties.

Figure 1

Nonperforming Loans by Category

Large Organizations

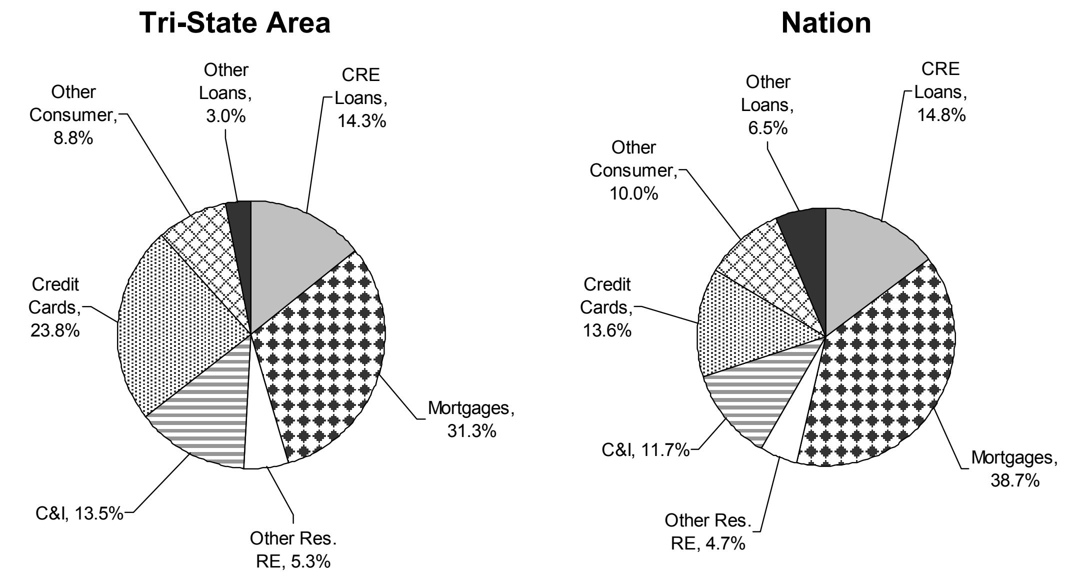


Figure 2

Nonperforming Mortgages/Total Mortgages

Large Organizations

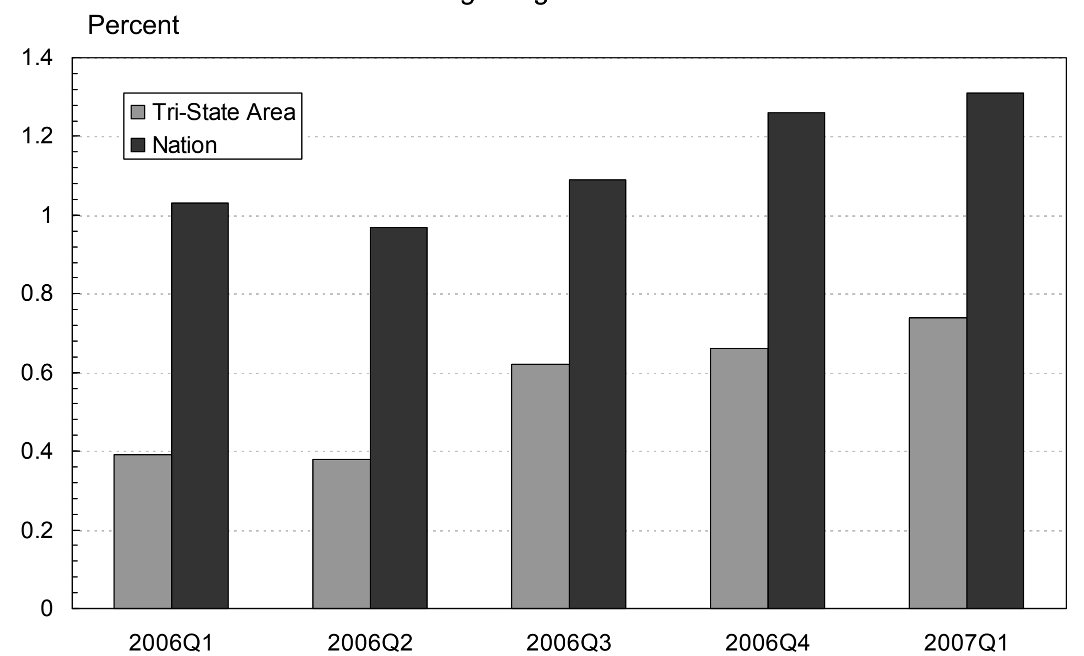
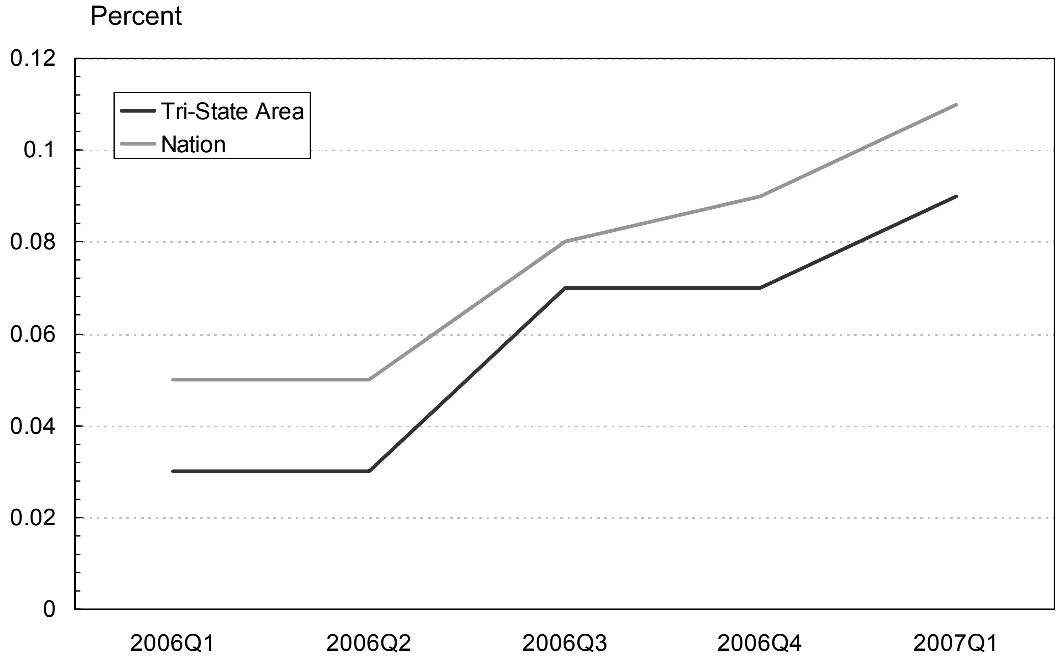


Figure 3

Net Chargeoffs on Mortgages/Average Mortgages

Large Organizations



and chargeoff ratios for these loans. The ratio of nonperforming mortgages to total mortgages increased substantially in the last year (Figure 2), and chargeoffs are starting to reflect this as well (Figure 3).

Additional information on the mortgage market can be found in the Mortgage Bankers Association's (MBA) most recent survey, which reports that loan delinquencies decreased in the first quarter.[8] While foreclosures continue to rise, the increase was concentrated in seven states: Arizona, California, Florida, Indiana, Michigan, Nevada, and Ohio.

While most of the attention has focused on residential mortgages, the fastest growing category of nonperforming loans both nationally and locally is commercial real estate (CRE) loans, which increased 21.4 percent nationally and 18.1 percent locally from the fourth quarter of 2006 to the first quarter of 2007. The increase in nonperforming mortgages, on the other hand, was 3.7 percent for the nation and 9.9 for the tri-state area. The ratio of nonperforming CRE loans to total CRE loans is increasing as well (Figure 4).

In spite of the increasing problems with real estate loans, large banking organizations both locally and nationally are still well provisioned against loan losses. Figure 5 shows the loan-loss coverage ratio for the past five quarters.[9] Although it has decreased since the first quarter of 2006, it is still well over 100 percent, meaning that banks have ample reserves to cover their current nonperforming loans. Net chargeoffs exceeded additions to loan-loss reserves at large organizations in the tri-state area this quarter. The ratio of net chargeoffs to loan-loss provisions at these banks was 101.2 percent. Nationally, this ratio was 93.9 percent.

Overall loan growth at large banks was weak during the quarter; total loans increased at an annual rate of 2.5 percent in the tri-state area and 3.3 percent nationwide. However, there was considerable variation by category of loan. Real estate loans barely grew at all, while commercial loans grew at double-digit rates and consumer loans also showed healthy growth.[10] Also, the

[8] See MBA press release dated June 14, 2007, www.mortgagebankers.org/newsandmedia/presscenter/55132.htm.

[9] The loan-loss coverage ratio is defined as the ratio of loan-loss reserve to nonperforming loans.

[10] This trend is not due to atypical securitization activity among banks. Securitization activity was fairly constant in the quarter; thus, the growth rates for managed loans were similar to those for held loans.

Figure 4

Nonperforming CRE Loans/Total CRE Loans

Large Organizations

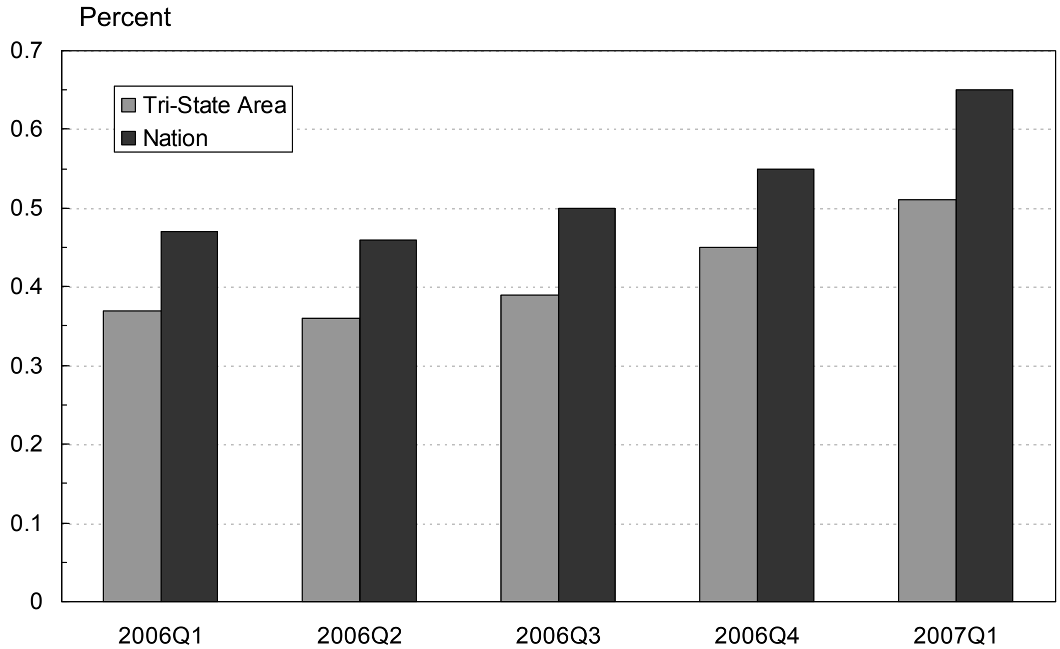
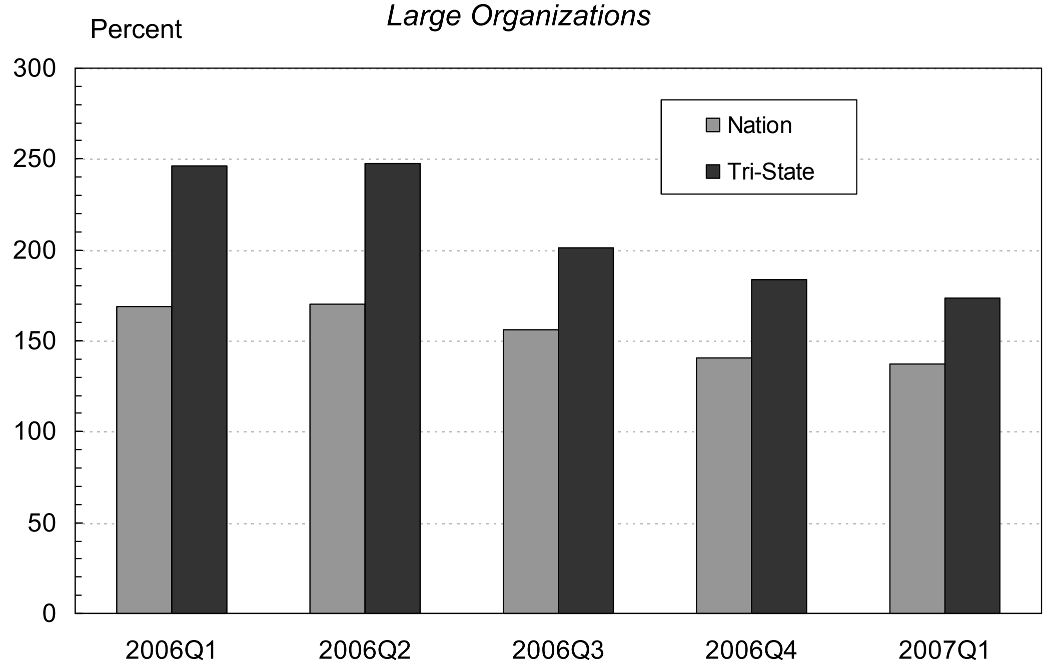


Figure 5

Loan-Loss Coverage Ratio

Large Organizations



bulk of consumer loan growth was in installment loans, not credit card lending. The 10-Q forms of several companies in the tri-state sample cite strong demand for commercial and automobile loans and weak demand for real estate loans of all types.

Community Banks

Over the last quarter and year over year, return on average assets declined among community banks in the tri-state area but held steady among community banks in other parts of the country. Again, the general causes are a decline in net interest margins and increased provisioning for loan losses. The ratio of nonperforming loans to total loans increased sharply both locally and nationally (see the table, but both are still well below the historical averages cited above.

Relative to the first quarter of 2006, nonperforming loans increased 2.9 percent in the tri-state area and 5.0 percent nationwide. In contrast to large banks, by far the largest segment of nonperforming loans at community banks was CRE lending. CRE loans make up 54.2 percent of nonperforming loans at tri-state area banks and 49.5 percent nationwide (Figure 6). The only other type of lending that represented a substantial part of nonperforming loans was residential real estate, at 15.4 and 18.4 percent, respectively, for community banks in the tri-state area and the nation. The bulk of the nonperforming residential loans were home equity loans and home equity lines of credit (HELOCs).

Overall, CRE loans were the fastest growing category of nonperforming loans, increasing at an annual rate of 56.0 percent in the tri-state area and 88.4 percent nationwide. Also, the ratio of nonperforming CRE loans to total CRE loans continues to increase, especially at tri-state area banks (Figure 7). For tri-state area banks, the nonperforming loan ratio for CRE loans is now greater than the overall nonperforming loan ratio.

The increases in nonperforming CRE loans are especially worrisome for smaller banks because they have come to depend on CRE lending.[11] Smaller banks are no longer significant providers of credit card loans and other consumer loans. Over time, they have focused more and more on CRE and small business lending. This pattern is evident in the loan growth data in the table. Consumer loans continued to shrink both nationally and locally, and real estate loans and commercial loans continued to grow.

Compared to larger organizations, smaller banks are faring substantially better with chargeoffs. For the tri-state area, the ratio decreased from 0.85 percent to 0.23 percent between March 31, 2006, and March 31, 2007. Nationally, this ratio decreased from 0.92 percent to 0.16 percent. Banks both nationally and locally showed decreases in overall net chargeoffs compared to the same quarter last year.

Chargeoffs on CRE loans are not increasing substantially at community banks. Nationally, net chargeoffs on CRE loans increased only 6.7 percent, chargeoffs of residential real estate loans decreased 5.4 percent, and mortgage chargeoffs increased 3.0 percent. Locally, net chargeoffs on CRE loans increased 13.3 percent, residential real estate loans showed a 3.0 percent drop, and mortgage chargeoffs were basically flat. The ratio of net chargeoffs on CRE loans to average CRE loans is not high either (Figure 8), and the ratio of net chargeoffs on mortgages to average mortgages has dropped substantially in the past year (Figure 9).

Community banks also appear to be well provisioned against further loan losses. As shown in Figure 10, both nationally and locally loan-loss coverage ratios are at or over 150 percent. Moreover, chargeoffs at these banks represent a smaller portion of loan-loss provisions than at the larger banks. The ratio of net chargeoffs to loan-loss provisions was 64.2 percent nationally and 48.8 percent locally.

[11] For a further analysis of CRE lending at small banks, see *Banking Brief,* Second Quarter 2006, at www.philadelphiafed.org/files/bb/2q06.pdf.

Figure 6

Nonperforming Loans by Category

Community Banks

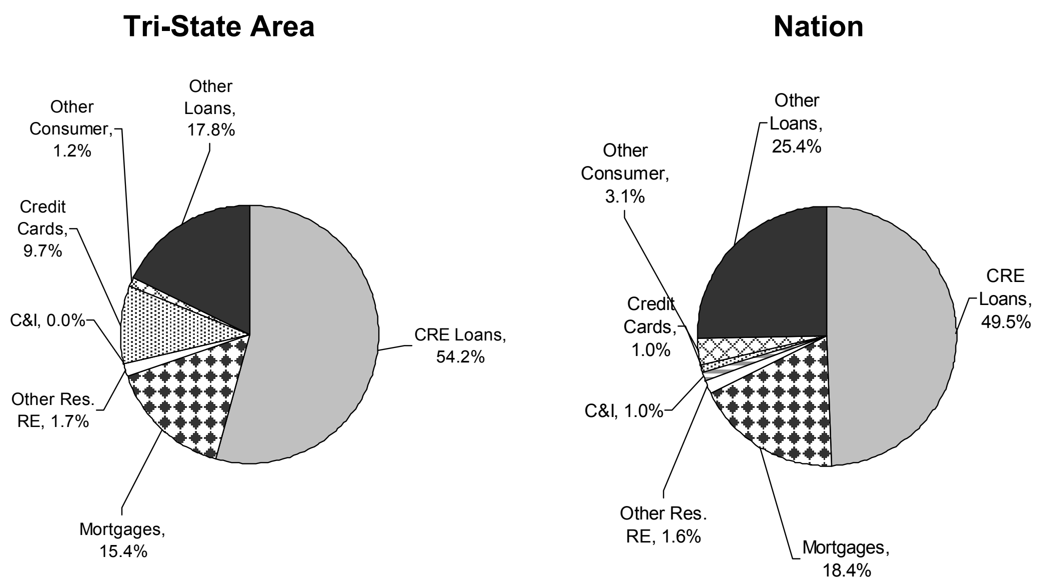


Figure 7

Nonperforming CRE Loans/Total CRE Loans

Community Banks

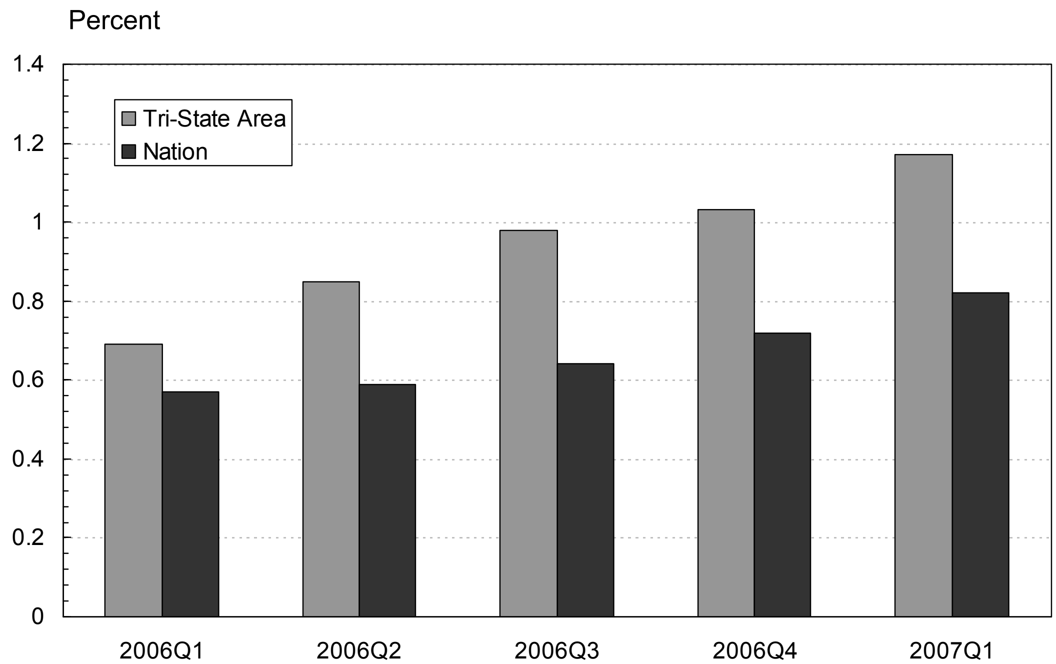


Figure 8

Net Chargeoffs on CRE Loans/Avg. CRE Loans

Community Banks

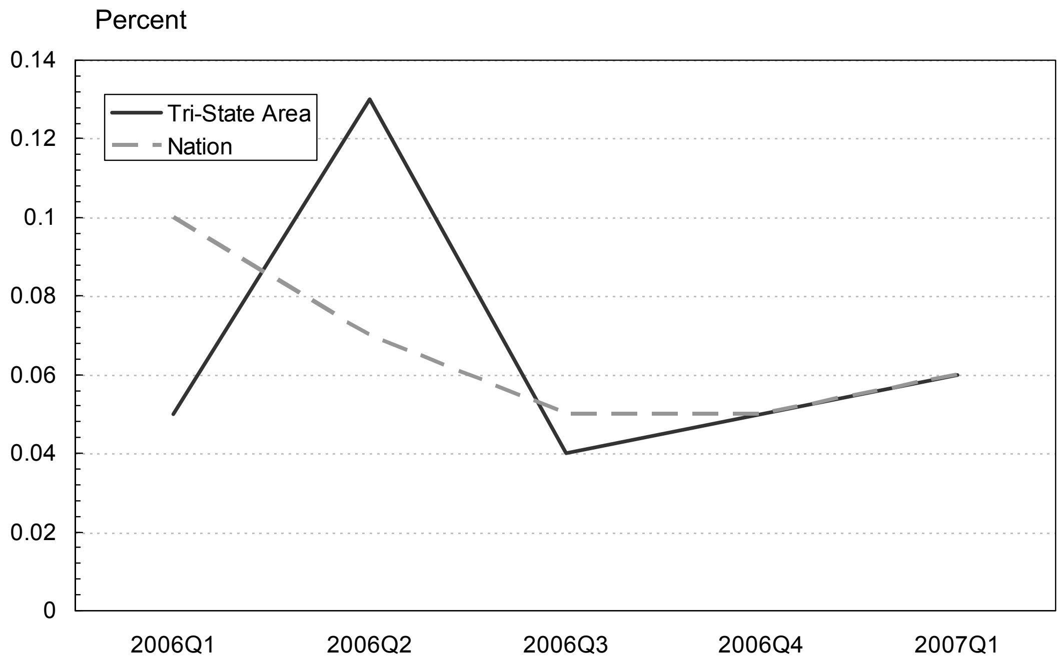


Figure 9

Net Chargeoffs on Mortgages/Avg. Mortgages

Community Banks

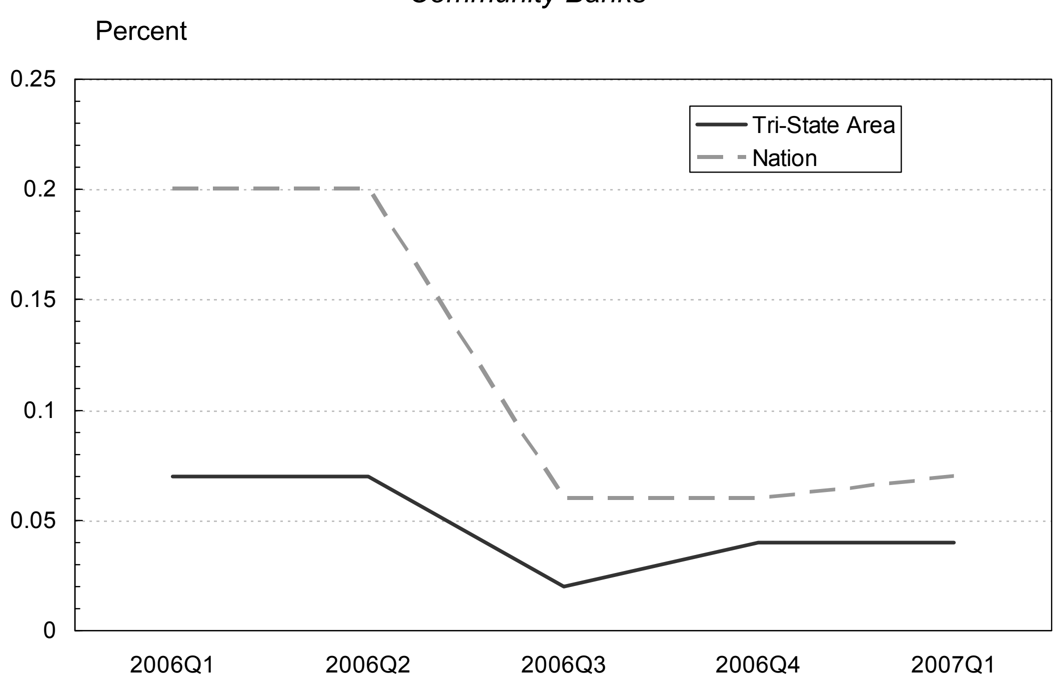
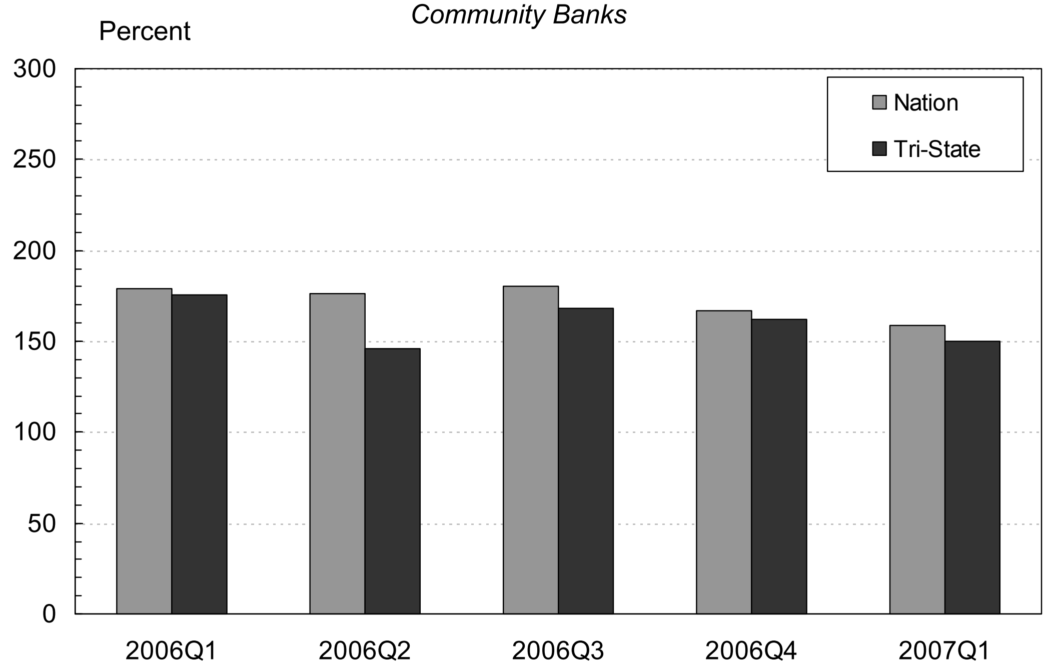


Figure 10

Loan-Loss Coverage Ratio

Community Banks



First Quarter 2007

Community Banking Organizations

	Tri-State			*Nation*		
	$Bill	**% change from**		**$Bill**	**% change from**	
	07Q1	**06Q4**	**06Q1**	**07Q1**	**06Q4**	**06Q1**
Total Assets	98.7	5.04	5.53	1713.9	6.10	8.21
Total Loans	67.1	6.96	8.40	1187.5	6.17	10.33
Business	9.6	17.97	11.49	189.5	7.50	11.05
Real Estate	52.4	6.49	8.57	873.0	7.21	10.94
Consumer	2.9	-19.09	-6.94	66.3	-5.70	0.07
Total Deposits	77.7	5.25	7.09	1385.3	7.55	8.39

Ratios (in %)	**07Q1**	**06Q4**	**06Q1**	**07Q1**	**06Q4**	**06Q1**
Net Income/ Avg Assets (ROA)	1.06	1.09	1.14	1.21	1.21	1.20
Net Interest Inc/ Avg Assets (NIM)	3.28	3.33	3.41	3.78	3.82	3.86
Noninterest Inc/ Avg Assets	1.21	1.20	1.19	0.95	0.95	0.97
Noninterest Exp/ Avg Assets	2.95	2.92	2.91	2.92	2.95	3.00
Loans/Deposits	86.43	86.08	85.38	85.72	86.00	84.22
Equity/Assets	10.41	10.41	10.23	10.26	10.26	9.91
Nonperforming Loans/ Total Loans	1.07	0.80	0.66	0.94	0.72	0.64

Large Banking Organizations

	Tri-State			*Nation*		
	$Bill	**% change from**		**$Bill**	**% change from**	
	07Q1	**06Q4**	**06Q1**	**07Q1**	**06Q4**	**06Q1**
Total Assets	2440.8	-0.16	5.20	7708.8	5.40	8.83
Total Loans	1365.0	2.50	6.66	4302.8	3.30	8.36
Business	281.6	16.73	6.85	920.6	12.58	9.26
Real Estate	817.6	0.84	8.97	2412.5	2.74	13.48
Consumer	119.8	23.11	8.92	521.7	6.85	0.43
Total Deposits	1627.6	-2.26	5.81	5031.2	0.84	8.41

Ratios (in %)	**07Q1**	**06Q4**	**06Q1**	**07Q1**	**06Q4**	**06Q1**
Net Income/ Avg Assets (ROA)	1.24	1.25	1.30	1.15	1.18	1.21
Net Interest Inc/ Avg Assets (NIM)	2.47	2.49	2.62	2.59	2.61	2.70
Noninterest Inc/ Avg Assets	2.03	2.03	1.92	2.08	2.10	2.19
Noninterest Exp/ Avg Assets	2.56	2.56	2.57	2.77	2.79	2.93
Loans/Deposits	83.87	82.87	83.2	85.52	85.01	85.56
Equity/Assets	10.06	10.06	10.03	9.46	9.46	9.36
Nonperforming Loans/ Total Loans	0.53	0.46	0.39	0.86	0.73	0.69

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 greater 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, 2006. 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 number of banking organizations in each category is as follows: (1) community banking organizations — 184 for the tri-state area and 5740 for the nation; (2) large banking organizations — 18 for the tri-state area and 100 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.

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: 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.