BANKING BRIEF
FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

Second Quarter 2007

Profitability declined in all four categories of banks in the second quarter.[1] The common ingredient was declining asset quality, but exactly which assets are weaker depends on the size of the institution. At large organizations, nonperforming loans are mainly concentrated in residential real estate (RRE loans), particularly mortgages, and in consumer loans, especially credit cards (see below). At community banks, the problems are concentrated in commercial real estate (CRE loans).

In addition to the loan quality problems, overhead costs at community banks have begun to increase. The increase in the ratio of noninterest expense to average assets has not been matched by an increase in noninterest income. Increases in noninterest expense were primarily in the category of "other noninterest expense," which includes data processing, advertising and marketing costs, legal fees, and FDIC insurance assessments. The primary drag on noninterest income was asset sales, including loans, other real estate owned (repossessed property), and sales of other nonsecuritized assets.

In spite of the rising rates of nonperforming loans, banks remain well capitalized and, in most cases, well reserved. Loan growth was fairly strong in the second quarter, particularly for commercial and industrial (C&I) loans. But with the heightened volatility in financial markets that began in August, it is not clear that loan growth will continue at its current pace.

[1] See the table on the last page for summary financial numbers and the definitions of community banks and large banking organizations.

Large Organizations

Return on average assets (ROAA) at large banking organizations fell slightly in the second quarter, both locally and nationally. The decreases in profitability were matched by decreases in net interest margins, which, in turn, were driven by higher nonperforming loans.[2] Capitalization remains good, with the ratio of equity to assets remaining unchanged, both locally and nationally. Assets, loans, and deposits all grew at annualized double-digit rates in the quarter, with C&I loans showing particularly strong growth.

Asset quality continued to decline, with the ratio of nonperforming loans to total loans at large banks in the tri-state area increasing over both the quarter and the year. The increase among large banks in the nation was substantially higher, but the 0.57 percent ratio for the tri-state area and 0.91 percent for the nation are still fairly low by historical standards.[3]

The main reason for the decline in asset quality was RRE loans, particularly mortgages on one- to four-family properties. RRE loans make up, by far, the largest portion of the large banking organizations' loan portfolios. At the end of the second quarter of 2007, RRE loans represented 36.7 percent of all loans at tri-state area banks, and RRE loans represented 33.0 percent of loans nationally. Mortgages were

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

[3] The average ratio of nonperforming loans to total loans between 1995 and 2005 for all banks was 1.08 percent. See FDIC Historical Statistics on Banking: www2.fdic.gov/hsob/index.asp.

Figure 1

Quarterly Changes in Nonperforming Mortgages

Large Organizations

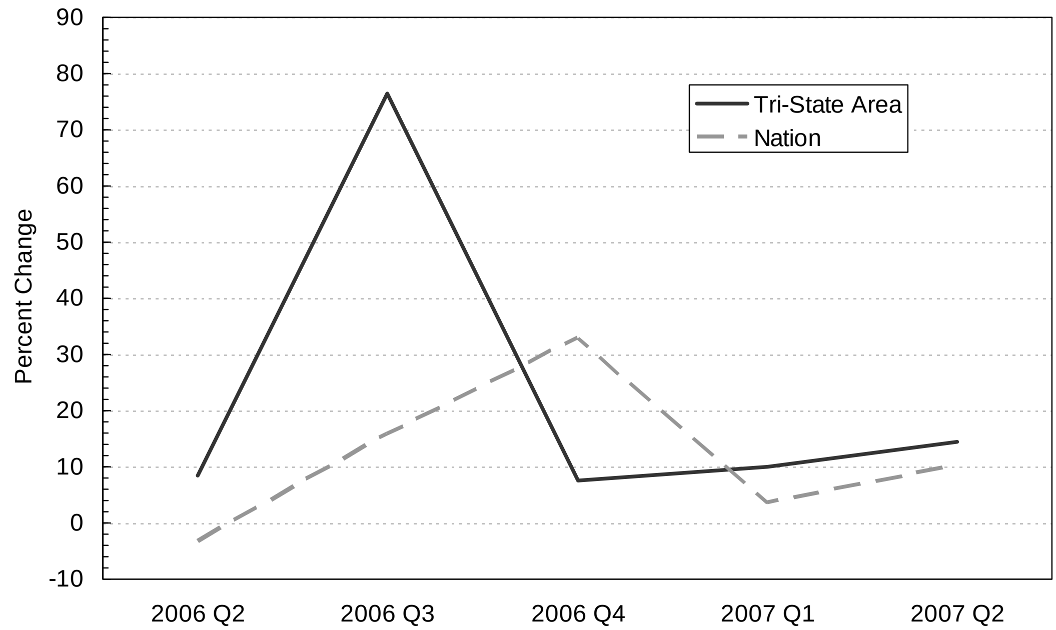
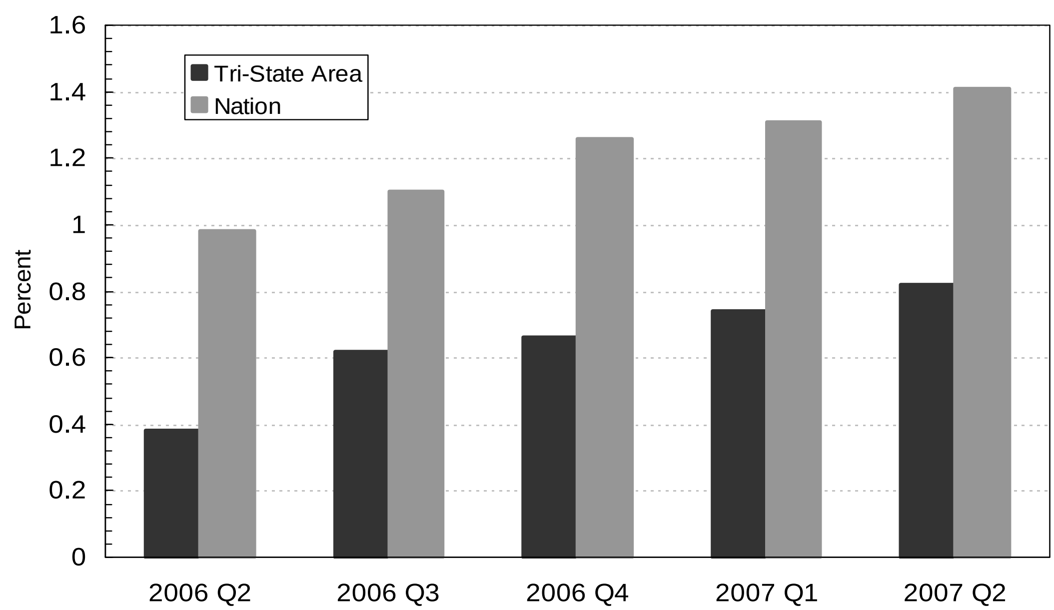
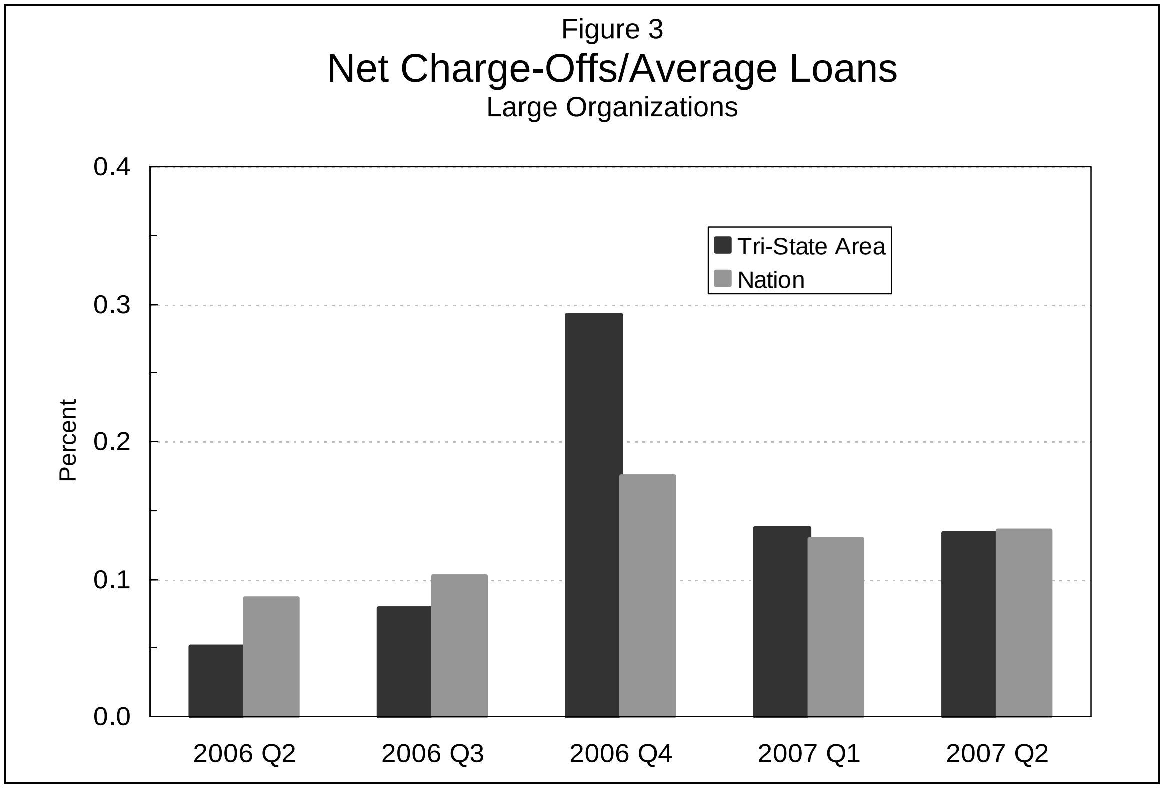


Figure 2

Nonperforming Mortgages/Total Mortgages

Large Organizations





approximately three-quarters of RRE loans, both locally and nationally.[4]

Total nonperforming loans grew 7.1 percent locally and 7.5 percent nationally in the quarter. But nonperforming mortgages grew 14.5 percent and 10.3 percent, respectively. The quarterly growth rates for nonperforming mortgages are illustrated in Figure 1. Also, the ratio of nonperforming mortgages to total mortgages continues to increase both locally and nationally (Figure 2).

In the tri-state area, nonperforming residential real estate loans made up 39.5 percent of all nonperforming loans. Nonperforming mortgages alone accounted for 33.4 percent of nonperforming loans. The comparable shares for banks around the nation are 44.4 and 39.8 percent, respectively.

In spite of the continuing increases in nonperforming loans, net charge-offs were relatively stable in 2007. After recording large increases in the fourth quarter of 2006, charge-offs fell in the first quarter and rose only modestly (6.8 percent) among large banks nationwide.[5] Among large banks in the tri-state area, net charge-offs were unchanged and net charge-offs of mortgages actually fell 23.2 percent (but increased 14.8 percent nationwide). After rising throughout 2006, the ratio of net charge-offs to average loans has now been essentially flat for two straight quarters, both locally and nationally (Figure 3). There was a slight increase in this ratio for C&I loans, both locally and nationally. The ratio increased for CRE loans nationally but decreased among banks in the tri-state area.

In terms of the composition of loans charged off among large banks, the largest category was consumer loans, particularly credit cards. Most credit card loans are held at large banks. Since these are unsecured loans, when there is a default, recoveries tend to be

[4] Mortgages are all loans secured by one- to four-family properties, including first and junior liens. Residential real estate loans are mortgages plus home equity lines of credit (HELOCs).

[5] Net charge-offs are quarterly only. That is, charge-offs from previous quarters in the year are subtracted.

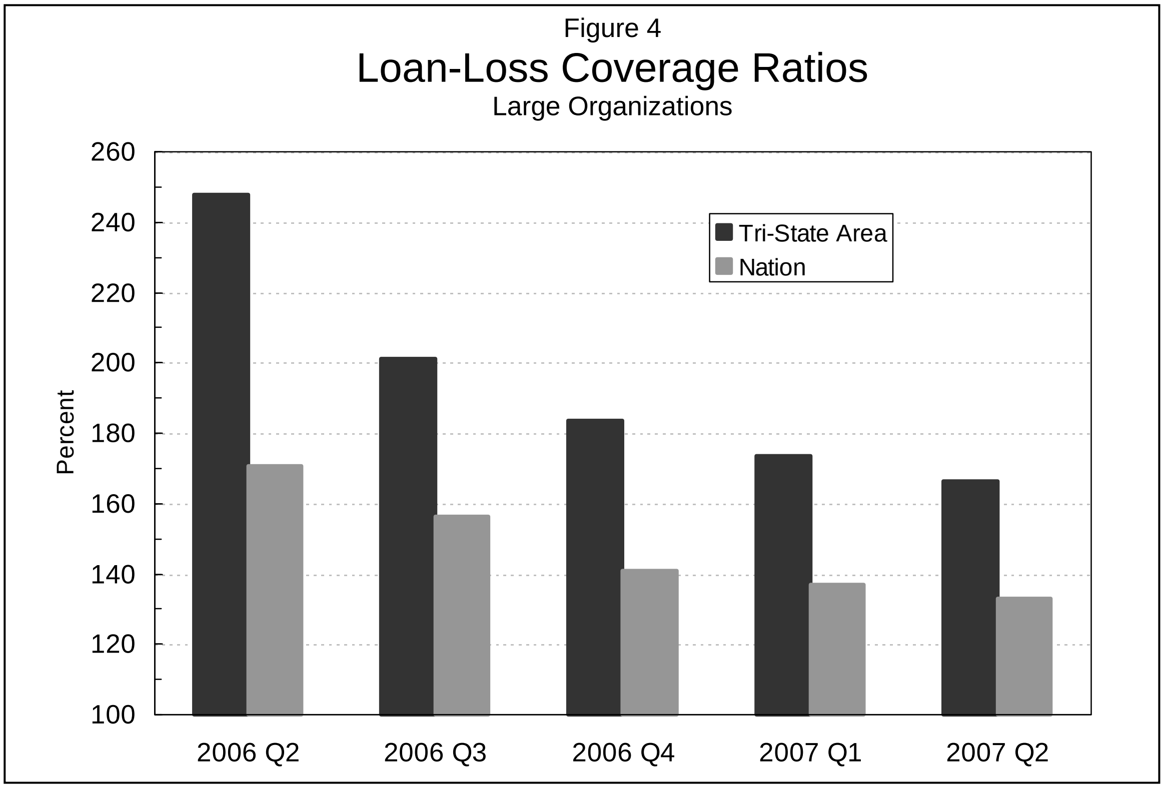


Figure 4
Loan-Loss Coverage Ratios
Large Organizations
Percent
260
240
220
200
180
160
140
120
100
Tri-State Area
Nation
2006 Q2
2006 Q3
2006 Q4
2007 Q1
2007 Q2

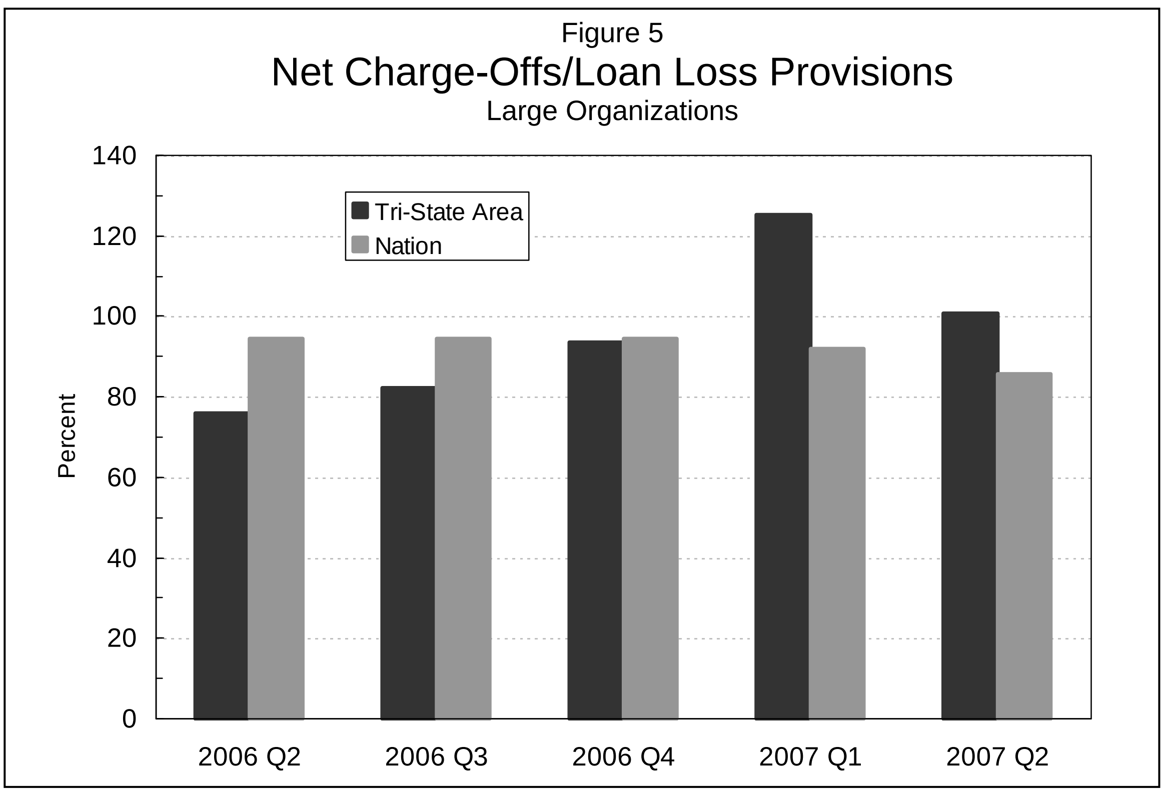


Figure 5
Net Charge-Offs/Loan Loss Provisions
Large Organizations
Percent
140
120
100
80
60
40
20
0
Tri-State Area
Nation
2006 Q2
2006 Q3
2006 Q4
2007 Q1
2007 Q2

relatively small.[6]

It appears that for the time being large banks are fairly well provisioned against losses in their loan portfolios. While loan-loss coverage ratios continue to decline, the current level of reserves is sufficient to cover all nonperforming loans with a margin of safety (Figure 4).[7] Tri-state area banks currently have a loan-loss coverage ratio over 165 percent, much higher than the national ratio of 133 percent.

However, in the last two quarters, large tri-state area banks have been charging off loans at a rate faster than they are adding to their loan loss reserves (Figure 5).[8] Around the nation, for every dollar added to loan loss reserves, large banks are charging off about $0.86 in bad loans. In the tri-state area, this figure is approximately $1.01 charged off for each dollar reserved. Therefore, if loans continue to deteriorate at current rates, large banks will eventually have to increase their provisioning for loan losses, which would have a negative impact on profitability.

Community Banks

Profitability decreased somewhat at community banks around the nation, and it was flat at tri-state area banks. This excludes one institution that was the victim of a case of fraud that resulted in a loss of approximately $180 million in the second quarter.[9] Including that institution in the data results in a decrease in profitability at tri-state area banks to 0.86 percent. Because this one institution had such a large effect on the tri-state area numbers, it will be excluded from all of the data presented in the charts and text below.

The ratio of nonperforming loans to total loans increased among community banks both nationwide and in the tri-state area. Nevertheless, this ratio remains higher among banks in the region. As reported in previous quarters, the asset quality problem at community banks remains concentrated in their portfolios of CRE loans.[10]

CRE loans make up over 47 percent of the loan portfolios of banks nationally and 44 percent of loans at local banks. While total nonperforming loans grew 25.3 percent at tri-state area banks and 14.2 percent nationally from the first quarter of 2007 to the second, nonperforming CRE loans grew 40.5 percent in the tri-state area and 22.3 percent nationally. These loans continue to deteriorate, especially among banks in the tri-state area (Figure 6). The share of nonperforming loans that are CRE loans continues to climb and is now over 50 percent, both locally and nationally, and it well exceeds their portfolio share (Figure 7).

In the last issue of *Banking Brief* we reported a significant decline in net charge-offs, relative to the fourth quarter of 2006, despite the increase in nonperforming CRE loans.[11] In the second quarter, however, net charge-offs increased significantly (Figure 8). Indeed, CRE loans represent the largest category of loans charged off — 34.8 percent at tri-state area banks and 31.4 percent nationwide.

The charge-off rate at community banks, compared to that at large banking organizations, is relatively low. This is true despite the fact that community banks currently have higher rates of nonperforming loans. This discrepancy is explained in part by the fact that community banks carry very few consumer loans on their books. But community banks may also be holding bad loans longer before they write them down. If that is the case, it is likely their charge-off rates will increase substantially in the near future.

---

[6] For large organizations nationwide in the second quarter of 2007, recoveries on credit card loans were approximately 17.5 percent of charge-offs, while recoveries on all loans were about 22.1 percent. Between 1995 and 2005 the ratio of recoveries to charge-offs at all banks was approximately 21 percent. See FDIC Historical Statistics on Banking: www2.fdic.gov/hsob/index.asp.

[7] The loan-loss coverage ratio is the ratio of loan-loss reserves to nonperforming loans.

[8] Loan-loss reserves are a balance-sheet item representing the amount set aside from which loan losses are charged off. Loan-loss provisions are an income-statement item representing additions to loan-loss reserves in the quarter. They also represent a deduction from current income.

[9] That institution is in the process of being acquired by a large organization. Data in the table at the end exclude this institution. Data for tri-state area community banks including this institution are in Figure 11 below.

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

[11] See *Banking Brief*, First Quarter 2007, Federal Reserve Bank of Philadelphia, www.philadelphiafed.org/files/bb/bb1q07.pdf.

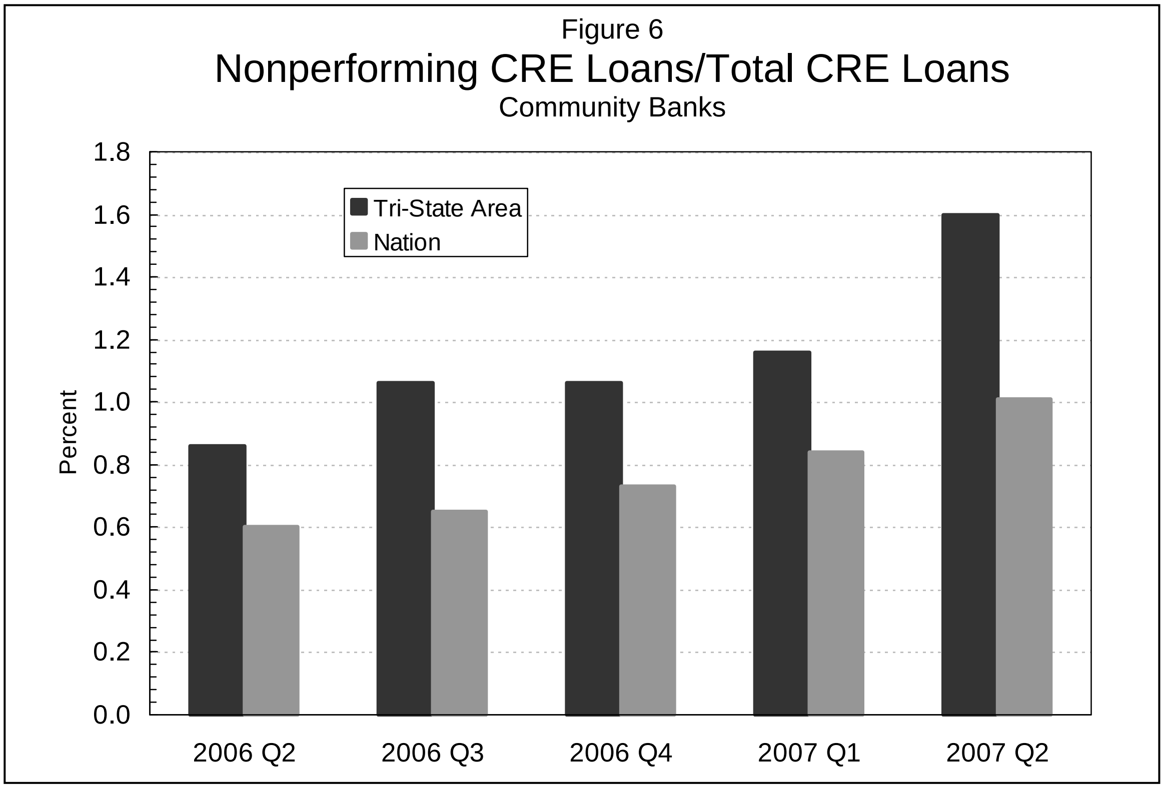


Figure 6
Nonperforming CRE Loans/Total CRE Loans
Community Banks
Tri-State Area
Nation
Percent
1.8
1.6
1.4
1.2
1.0
0.8
0.6
0.4
0.2
0.0
2006 Q2
2006 Q3
2006 Q4
2007 Q1
2007 Q2

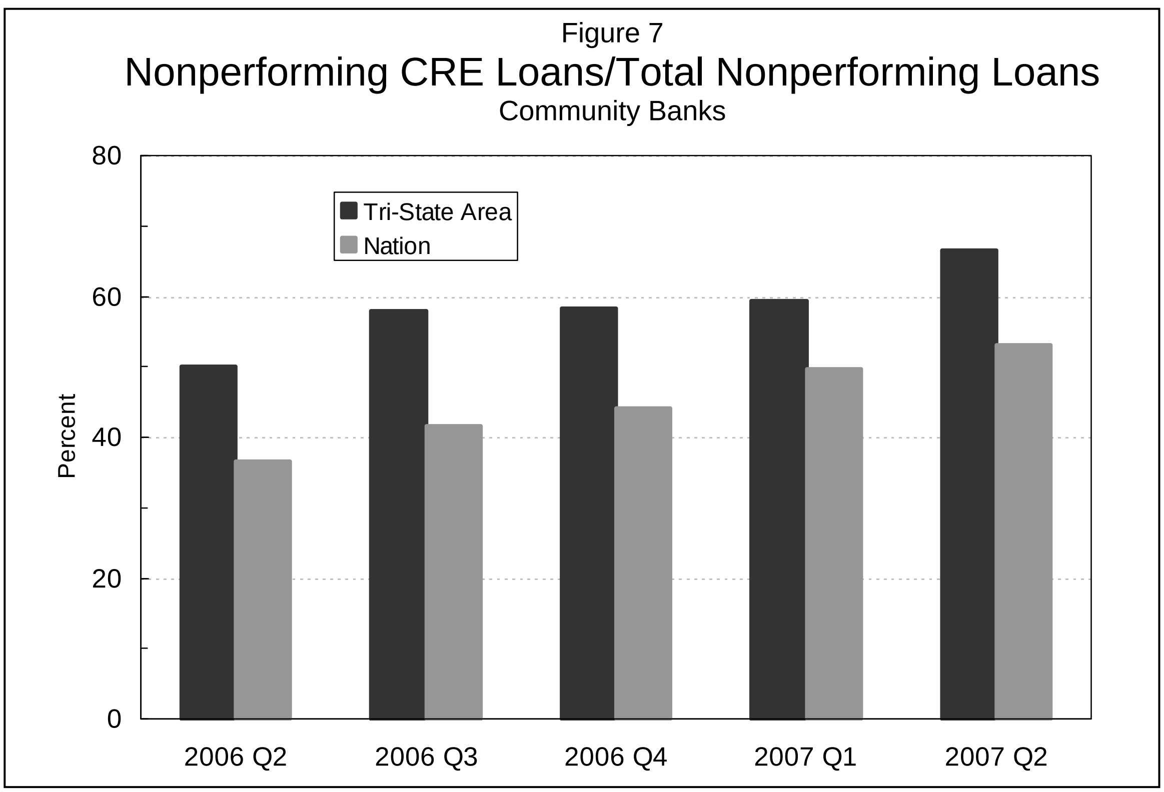


Figure 7
Nonperforming CRE Loans/Total Nonperforming Loans
Community Banks
Tri-State Area
Nation
Percent
80
60
40
20
0
2006 Q2
2006 Q3
2006 Q4
2007 Q1
2007 Q2

Figure 8
Net Charge-Offs/Average Loans
Community Banks

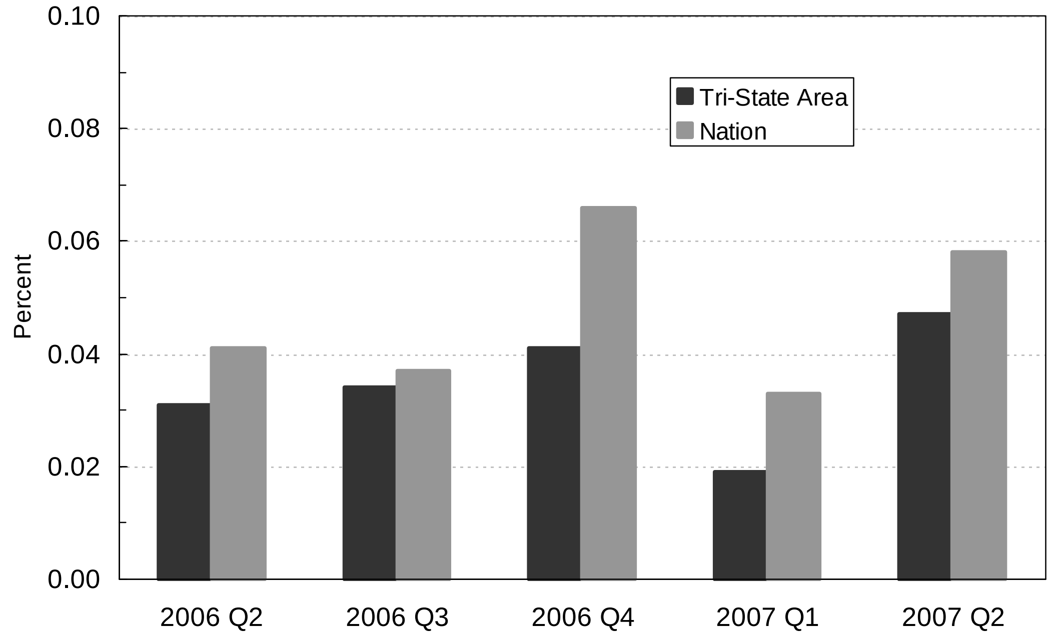


Figure 9
Loan-Loss Coverage Ratios
Community Banks

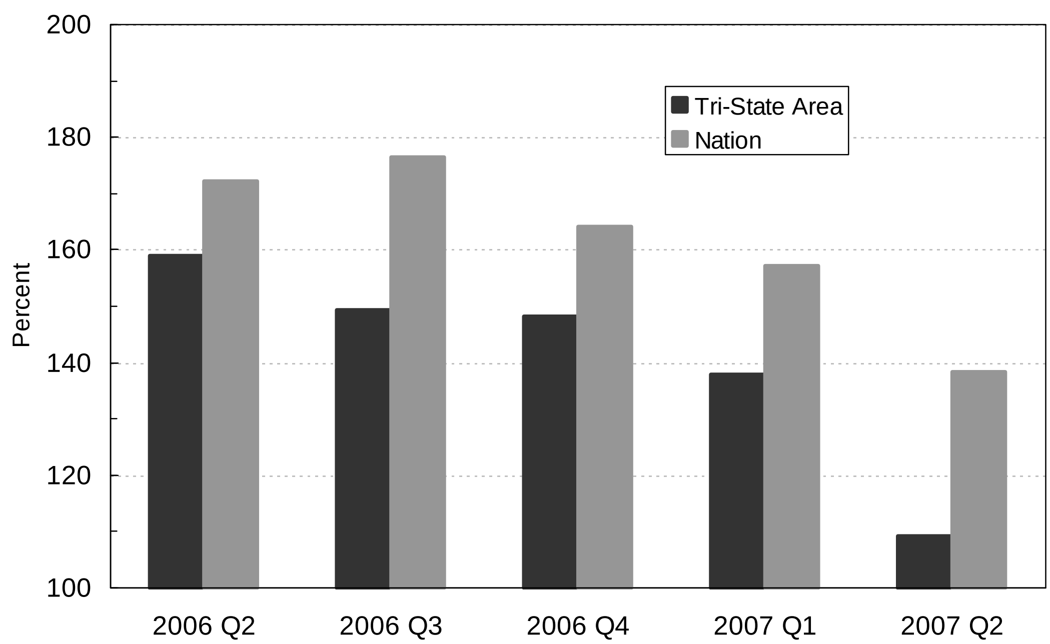


Figure 10

Net Charge-Offs/Loan-Loss Provisions

Community Banks

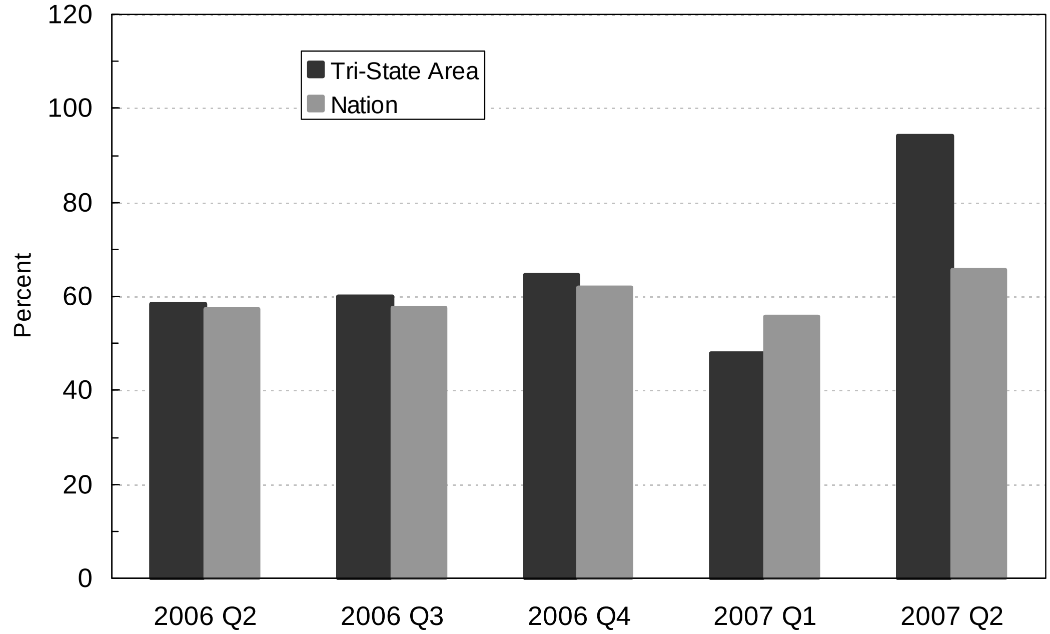


Figure 11

Table Numbers for All Tri-State Area Community Banks

	$Bill	% change from	
	07Q2	**07Q1**	**07Q2**
Total Assets	98.3	2.53	98.3
Total Loans	67.2	4.35	67.2
Business	9.4	-4.93	9.4
Real Estate	52.6	5.88	52.6
Consumer	2.9	1.54	2.9
Total Deposits	77.3	2.91	77.3
Ratios (in %)	**07Q2**	**07Q1**	**07Q2**
Net Income/Avg Assets (ROA)	0.86	1.04	0.86
Net Interest Inc/Avg Assets (NIM)	3.24	3.25	3.24
Noninterest Inc/Avg Assets	1.23	1.19	1.23
Noninterest Exp/Avg Assets	3.22	2.92	3.22
Loans/Deposits	86.85	86.32	86.85
Equity/Assets	10.33	10.39	10.33
Nonperforming Loans/Total Loans	1.19	0.88	1.19

Around the nation, the loan-loss coverage ratio for community banks stands at 138 percent, which is comparable to what we reported for large banks (see above). But the coverage ratio is lower for community banks in the tri-state area (Figure 9). Over the last year, community banks have generally been adding to their reserves for loan losses at a faster rate than they have been charging off loans. However, for every dollar added to reserves by community banks in the tri-state area in the second quarter, those banks charged off 94 cents in bad loans (Figure 10). Therefore, if asset quality continues to deteriorate, these banks will be forced to increase their provisioning for loan losses, which will have an adverse impact on profits. In spite of the increases in nonperforming loans and charge-offs, community banks, both locally and nationally, remain well capitalized and well reserved. Equity-to-assets ratios haven’t changed since the first quarter, and they’ve increased since June 2006.

Second Quarter 2007

	Community Banking Organizations						*Large Banking Organizations*						
	Tri-State*			***Nation***				***Tri-State***			***Nation***		
	$Bill	**% change from**		**$Bill**	**% change from**			**$Bill**	**% change from**		**$Bill**	**% change from**	
	07Q2	**07Q1**	**06Q2**	**07Q2**	**07Q1**	**06Q2**		**07Q2**	**07Q1**	**06Q2**	**07Q2**	**07Q1**	**06Q2**
Total Assets	95.1	3.13	4.55	1717.6	5.09	7.47	Total Assets	2537.7	16.85	5.69	7957.2	12.59	8.87
Total Loans	65.0	6.26	6.65	1204.5	10.45	9.06	Total Loans	1405.3	12.35	5.27	4449.9	13.17	9.21
Business	8.9	5.75	8.35	193.3	11.30	9.74	Business	291.1	14.15	8.71	961.1	18.55	11.69
Real Estate	51.2	6.20	6.72	883.2	9.92	9.68	Real Estate	843.0	13.06	5.51	2472.1	8.49	12.15
Consumer	2.8	1.95	-5.91	66.7	4.59	-0.07	Consumer	122.3	8.88	11.02	545.8	19.60	7.05
Total Deposits	74.7	2.90	5.51	1382.6	3.13	7.64	Total Deposits	1682.4	14.17	8.55	5168.2	10.29	7.84
Ratios (in %)	**07Q2**	**07Q1**	**06Q2**	**07Q2**	**07Q1**	**06Q2**	**Ratios (in %)**	**07Q2**	**07Q1**	**06Q2**	**07Q2**	**07Q1**	**06Q2**
Net Income/ Avg Assets (ROA)	1.04	1.04	1.11	1.16	1.20	1.21	Net Income/ Avg Assets (ROA)	1.21	1.24	1.28	1.14	1.15	1.22
Net Interest Inc/ Avg Assets (NIM)	3.22	3.25	3.35	3.74	3.78	3.86	Net Interest Inc/ Avg Assets (NIM)	2.44	2.47	2.60	2.57	2.59	2.70
Noninterest Inc/ Avg Assets	1.21	1.19	1.15	0.95	0.95	0.96	Noninterest Inc/ Avg Assets	2.04	2.02	1.95	2.09	2.08	2.22
Noninterest Exp/ Avg Assets	2.92	2.92	2.86	2.93	2.92	2.98	Noninterest Exp/ Avg Assets	2.56	2.56	2.58	2.77	2.77	2.91
Loans/Deposits	87.02	86.32	86.08	87.11	85.63	85.98	Loans/Deposits	83.53	83.87	86.13	86.1	85.55	85.02
Equity/Assets	10.40	10.39	10.19	10.18	10.18	9.86	Equity/Assets	9.65	9.65	9.71	9.27	9.27	9.22
Nonperforming Loans/ Total Loans	1.07	0.88	0.75	1.01	0.92	0.63	Nonperforming Loans/ Total Loans	0.57	0.53	0.40	0.91	0.87	0.66

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 numbers of banking organizations in the categories are as follows: (1) community banking organizations — 179 for the tri-state area and 5683 for the nation; (2) large banking organizations — 18 for the tri-state area and 101 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 numbers for tri-state area community banks were affected by a case of fraud at one of the larger banks in the sample. The numbers presented here exclude this institution. See Figure 11 in the text to view the figures for Tri-State area community banks that include this bank.

Any questions or comments should be directed to Jim DiSalvo at (215) 574-3820 or jim.disalvo@phil.frb.org. Detailed documentation of 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/philscriber/user/dsp_content.cfm