BANKING BRIEF

FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

Third Quarter 2007

Profitability continued to decrease in all four categories of banks in the third quarter of 2007.[1] As in previous quarters, the main reason was declining asset quality in real estate loans. Among larger banks the main problem was residential real estate (RRE) loans. Among smaller banks it was commercial real estate (CRE) loans. In addition to credit quality, the problems in RRE lending have begun to adversely affect the securities portfolios of larger banks. Net interest margins also continued to drop but at a slower rate than in the previous few quarters.

With the exception of smaller banks in the tri-state area, bank assets and loans grew rapidly in the third quarter. At large banks, rapid growth in business and consumer loans offset weakness in real estate lending. Deposit growth was modest during the quarter, particularly among banks in the tri-state area. The exception was large banks nationally, where deposits grew 9 percent. A significant part of the discrepancy between loan and deposit growth rates during the quarter was met with advances by the Federal Home Loan Banks. Capital levels remained high at all categories of banks.

Large Organizations

Return on average assets (ROAA) dropped 12 basis points locally and eight points nationally.[2] This represents a steeper decrease than in the previous few quarters. One major reason is that the instability in the markets for residential real estate has affected loan quality, leading to an increased number of nonperforming loans and chargeoffs. It has also affected the securities portfolios of the largest institutions. Noninterest income ratios fell about 10 basis points at large banks, in large part because of declines in trading revenues. In general, tri-state area banks outperformed banks in the nation. This may reflect the relatively better conditions in the residential real estate market locally. But it should be noted that ROA at local banks fell faster than banks nationally, and the ratio of nonperforming loans to total loans also increased more rapidly.

For the quarter, the ratio of nonperforming loans to total loans increased from 0.68 percent to 0.83 percent locally and from 0.87 percent to 1.04 percent nationally (Figure 1). Thus, the national nonperforming loan ratio is now approaching the average for the previous 10 years.[3] For RRE loans this ratio was 1.47 percent for the nation and 0.98

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

[2] Both the local and national numbers were affected by one organization's converting from a large thrift subsidiary to a commercial bank. This thrift is not part of the data for previous quarters, and its inclusion this quarter would have the effect of skewing all of the numbers. Therefore, the data presented in the text and charts below exclude this organization. Additionally, this organization is excluded from the table in the back. For the table numbers including this organization, see Figure 10.

[3] Nonperforming loans are defined as loans past due 90 days or more plus nonaccruing loans. The ratio of nonperforming loans to total loans from 1995 to 2005 was 1.08 percent. Source: FDIC Historical Statistics on Banking: www2.fdic.gov/hsob/index.asp.

Figure 1

Nonperforming Loans/Total Loans

Large Organizations

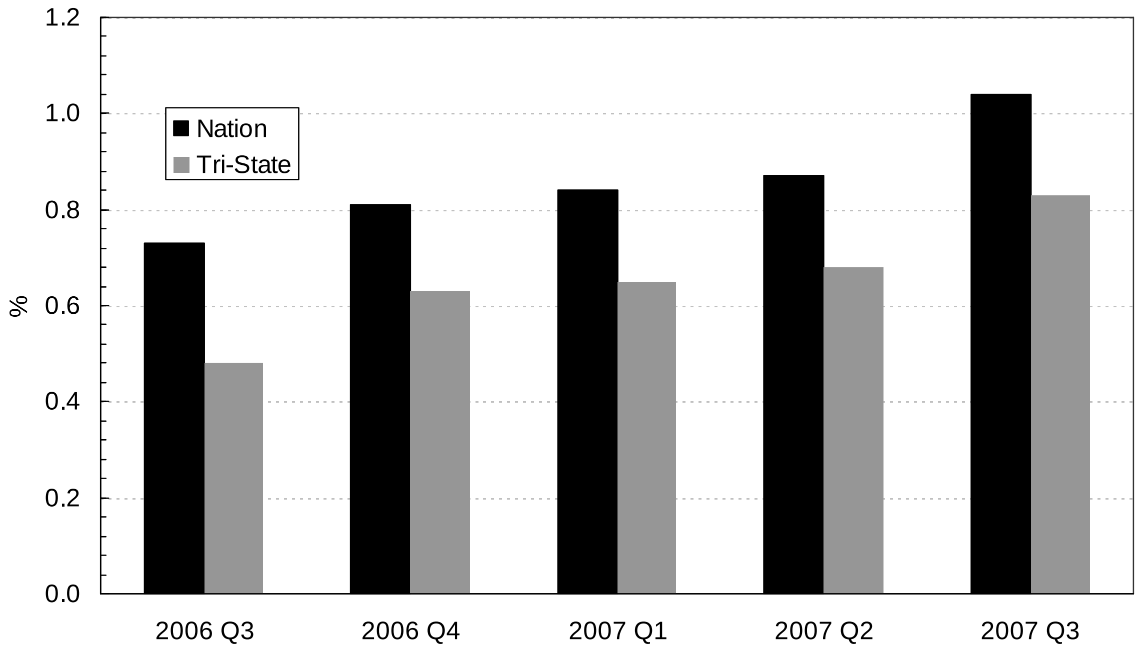
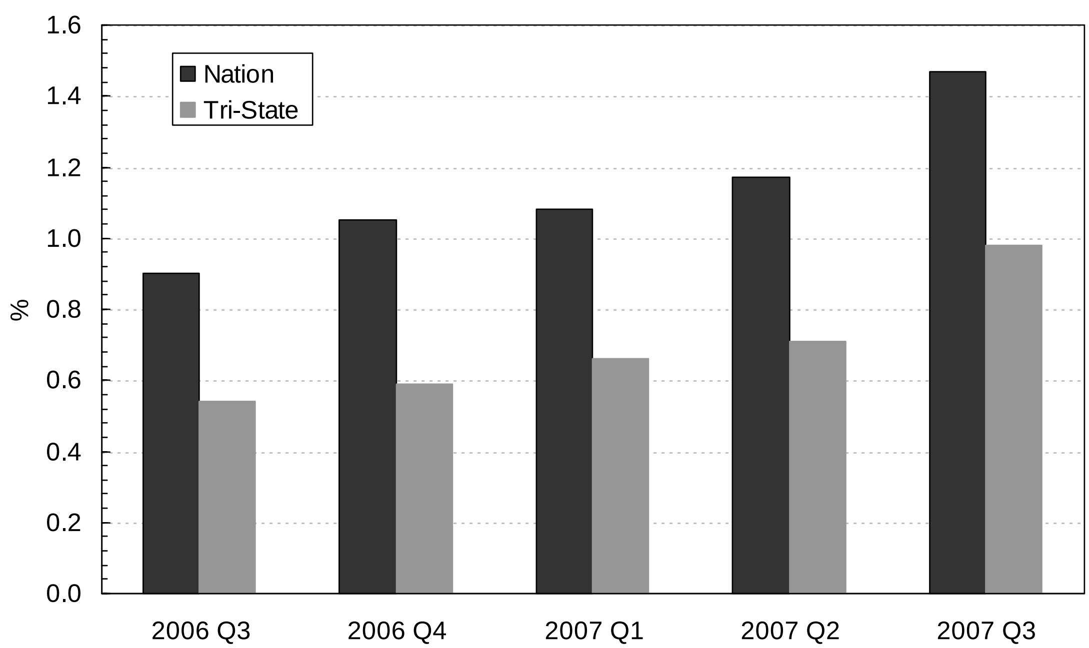
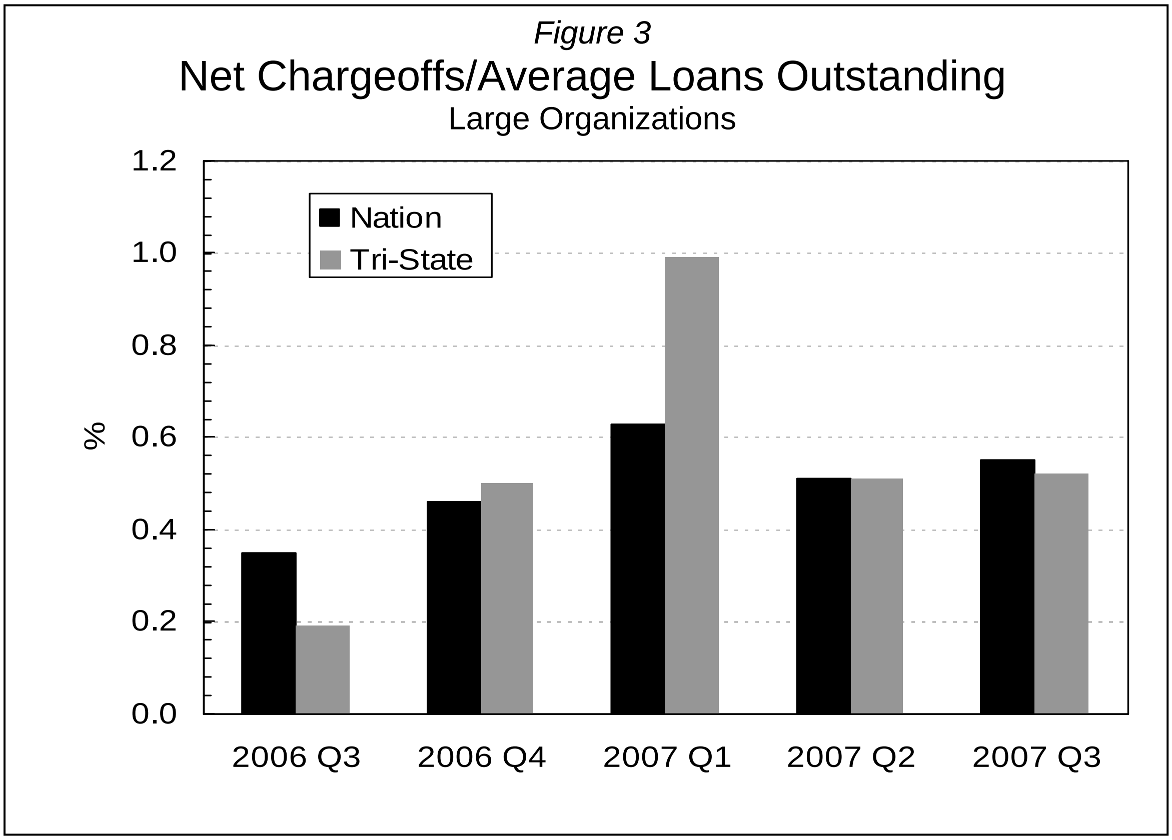


Figure 2

Nonperforming RRE Loans/Total RRE Loans

Large Organizations





percent for banks in the tri-state area (Figure 2). These ratios are now above the 10-year average for RRE loans (0.74 percent).[4]

Total nonperforming loans at large organizations increased 25.1 percent in the third quarter nationally and 28.7 percent in the tri-state area.[5] The largest increases in both areas were in nonperforming CRE loans, which increased 39.1 percent nationally and 49.0 percent locally, and RRE loans, which increased 26.2 percent nationally and 35.2 percent locally. The ratio of nonperforming CRE loans to total CRE loans is now 0.91 percent locally and 1.07 percent nationally. The 10-year average for this ratio is 1.01 percent.[6] The increase in nonperforming CRE loans was primarily in construction loans, while the increase in RRE loans was primarily mortgages. Nationally, RRE loans make up over 45 percent of all nonperforming loans. The corresponding figure for banks in the tri-state area is 42.3 percent.[7] Nonperforming commercial and industrial loans (C&I loans) also increased substantially at these institutions.

Chargeoffs also increased in the quarter, particularly on real estate loans. However, chargeoffs

[4] This is the ratio of nonperforming RRE loans to total RRE loans for all banks from the first quarter of 1995 to the last quarter of 2005. Source: FFIEC Call Report data.

[5] Unless otherwise noted, all changes are straight percentage changes as opposed to the annualized rates shown in the table at the end. Those using income statement data are the change in the quarterly figure only. For example, net chargeoffs are those that occurred in this quarter only, not year-to-date figures as are reported in the Call Reports.

[6] Historical average from the first quarter of 1995 to the last quarter of 2005. Source: FFIEC Call Report data.

[7] RRE loans represent 32.0 percent of all loans nationally and 36.0 percent of all loans at tri-state area banks.

Figure 4

Loan-Loss Coverage Ratio

Large Organizations

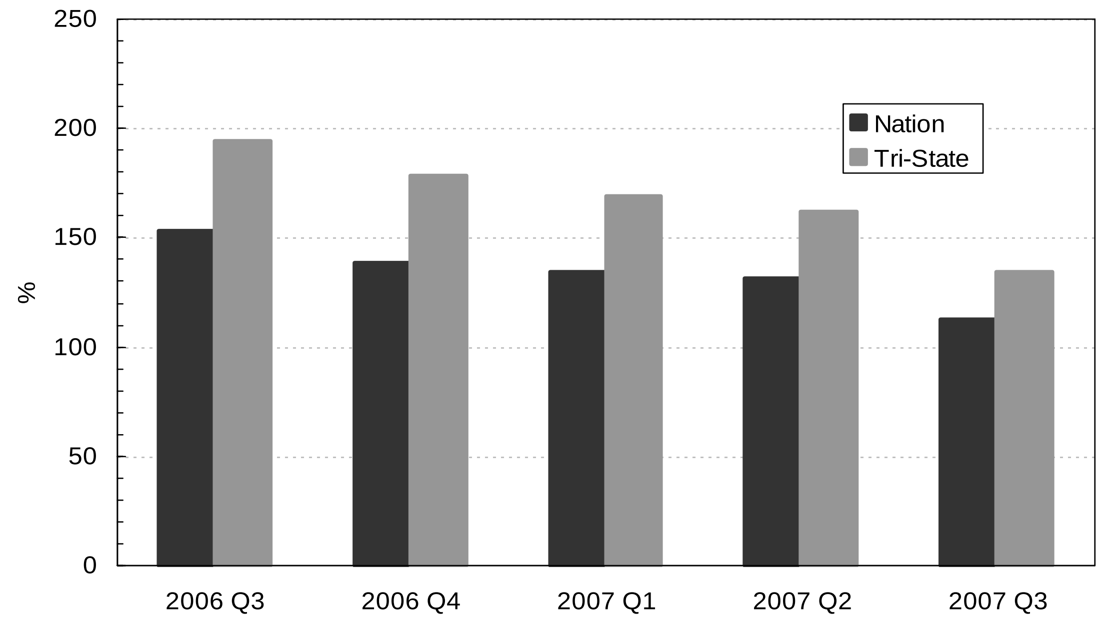
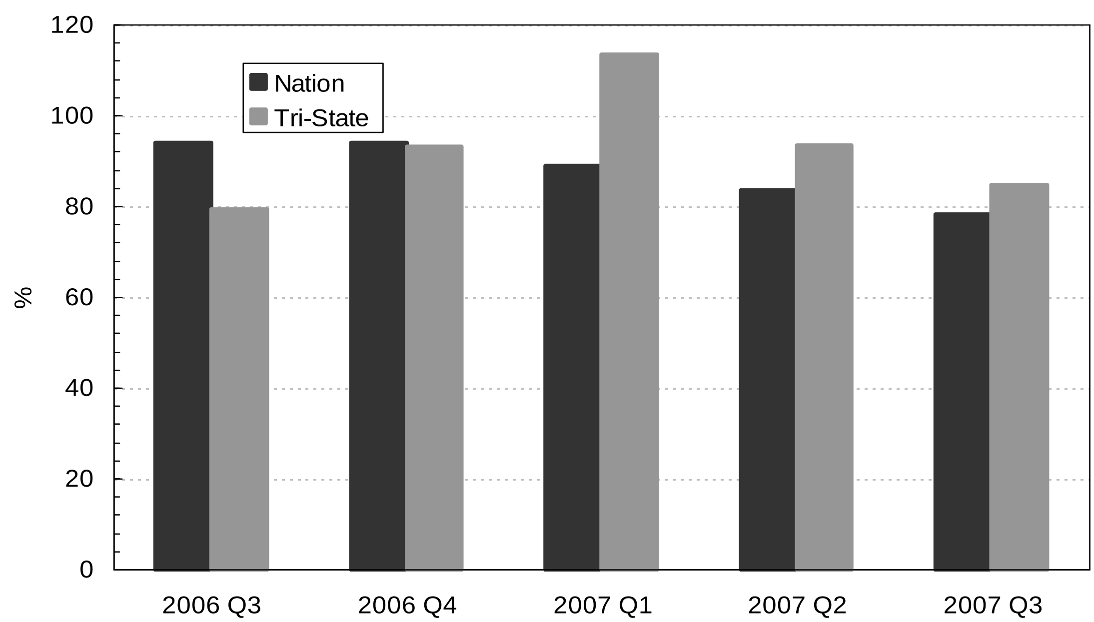


Figure 5

Net Chargeoffs/Loan-Loss Provision

Large Organizations



on C&I loans also increased substantially. Overall net chargeoffs increased 24.5 percent nationally from the second to the third quarter. In the tri-state area, the increase was 21.5 percent. Nationally, net chargeoffs on CRE loans, RRE loans, and C&I loans increased 54.0, 47.7, and 31.9 percent, respectively. The corresponding numbers for the tri-state area were 237.3, 55.0, and 25.0 percent. According to the quarterly reports of several of the firms in the tri-state area sample, the large increase in charged-off CRE loans was the result of construction loans on new residential real estate in Florida. Interestingly, net chargeoffs on consumer loans fell during the quarter.

While the increase in chargeoffs in the third quarter was quite large, so was the growth in loans. As a consequence, the ratio of annual net chargeoffs to average loans changed very little from the previous quarter. At 0.56 percent nationally and 0.55 percent locally (Figure 3), these ratios remain below the 10-year average of 0.71 percent.[8]

Despite the increase in nonperforming loans and chargeoffs, large banks are currently relatively well-reserved against credit losses. While the loan-loss coverage ratio continues to drop both nationally and locally (Figure 4), it is still above 100 percent.[9] Total loan-loss reserves increased both locally and nationally in the third quarter: 11.5 percent locally and 8.9 percent nationally. Additionally, the ratio of net chargeoffs to loan-loss provision is now decreasing (Figure 5).

A significant problem that will affect some large banks in future quarters will be markdowns on asset-backed securities (in particular, ones that rely on principal and interest payments from subprime mortgages) in their portfolios. A number of large banks have already announced large write-downs that will be reflected on income statements in the fourth quarter. Additional write-downs may result from currently unrealized losses on assets in their trading accounts. In addition, to conform with accounting rules, some banks may have to include the assets of some unconsolidated affiliates on their own books. This would lead to a slight reduction in capital ratios and possibly increase banks' demand for liquidity.

<u>Community Banks</u>

Profitability as measured by ROAA dropped slightly nationally at community banks and was basically flat locally.[10] This was mainly due to increases in loan-loss provisions in response to credit quality problems in CRE lending (Figures 6 and 7). Loans grew over 12 percent (annualized) nationally at smaller banks but at only half that rate locally. Among those banks, C&I lending growth was particularly anemic during the quarter.

Overall nonperforming loans continued to increase in the third quarter. At banks around the nation, nonperforming loans increased 11.0 percent from the second quarter, and nonperforming CRE loans increased 23.6 percent. There was good news in other types of lending, though, as nonperforming RRE and C&I loans decreased 0.3 percent and 25.7 percent, respectively. Overall nonperforming loans increased only 4.0 percent at tri-state area community banks, after increasing 25 percent in the second quarter. Nonperforming CRE loans increased 4.6 percent, after increasing 40 percent in the second quarter.

The major increase in nonperforming loans at tri-state area banks was among RRE loans, which increased 10.9 percent. RRE loans represent a substantially higher portion of the loan portfolios of tri-state area banks than banks nationwide (32.8 versus 22.3 percent), so the instability in the housing markets is having more of an effect on local banks.

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[8] Source: FDIC Historical Statistics on Banking: www2.fdic.gov/hsob/index.asp.

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

[10] The numbers for tri-state area community banks exclude one larger institution that was the victim of fraud in the second quarter of 2007. This fraud continues to adversely affect the institution's financial statements and tends to skew the overall numbers, so it is excluded from both the table at the back and any numbers cited in the text and charts here. This institution is in the process of being acquired and will disappear from the data in either the fourth quarter of 2007 or the first quarter of 2008. For the table numbers including this bank, see Figure 10.

Figure 6

Nonperforming Loans/Total Loans

Community Banks

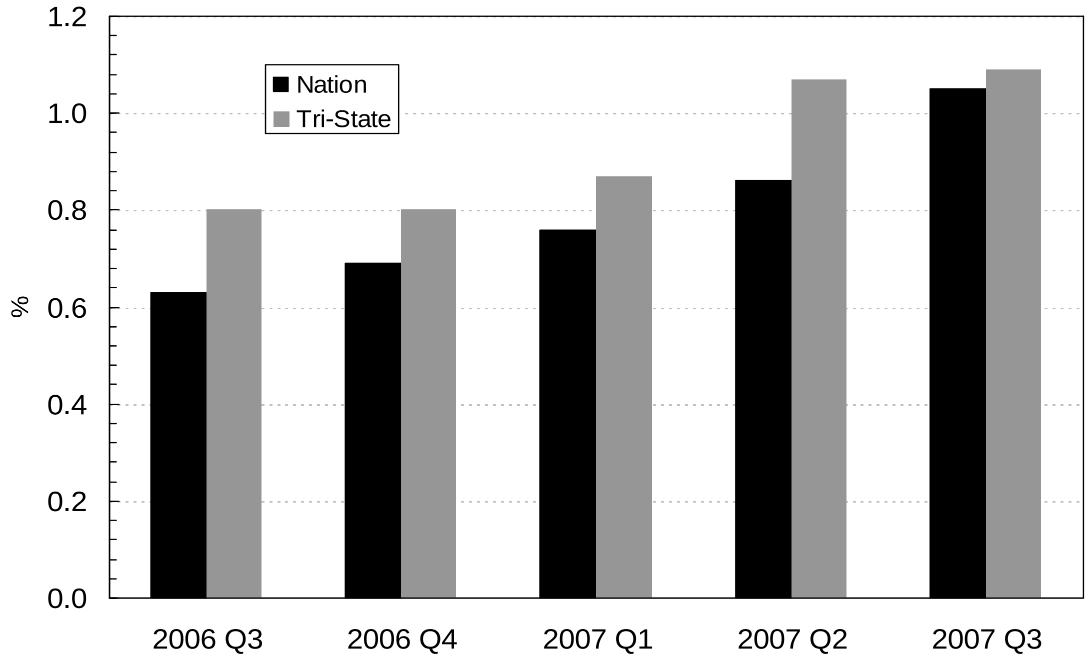
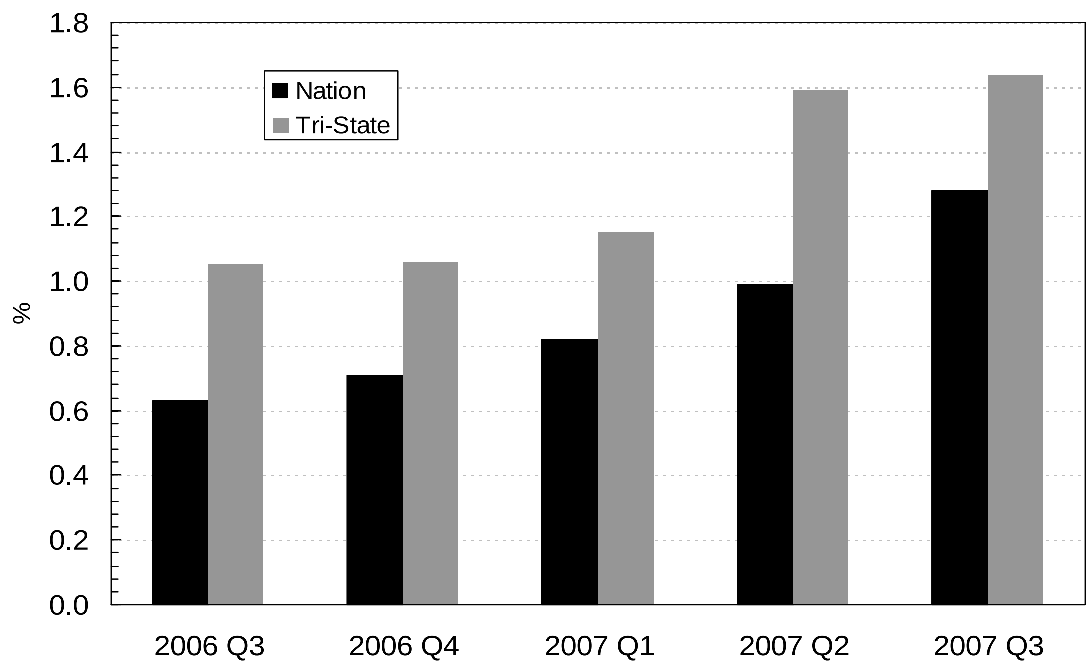
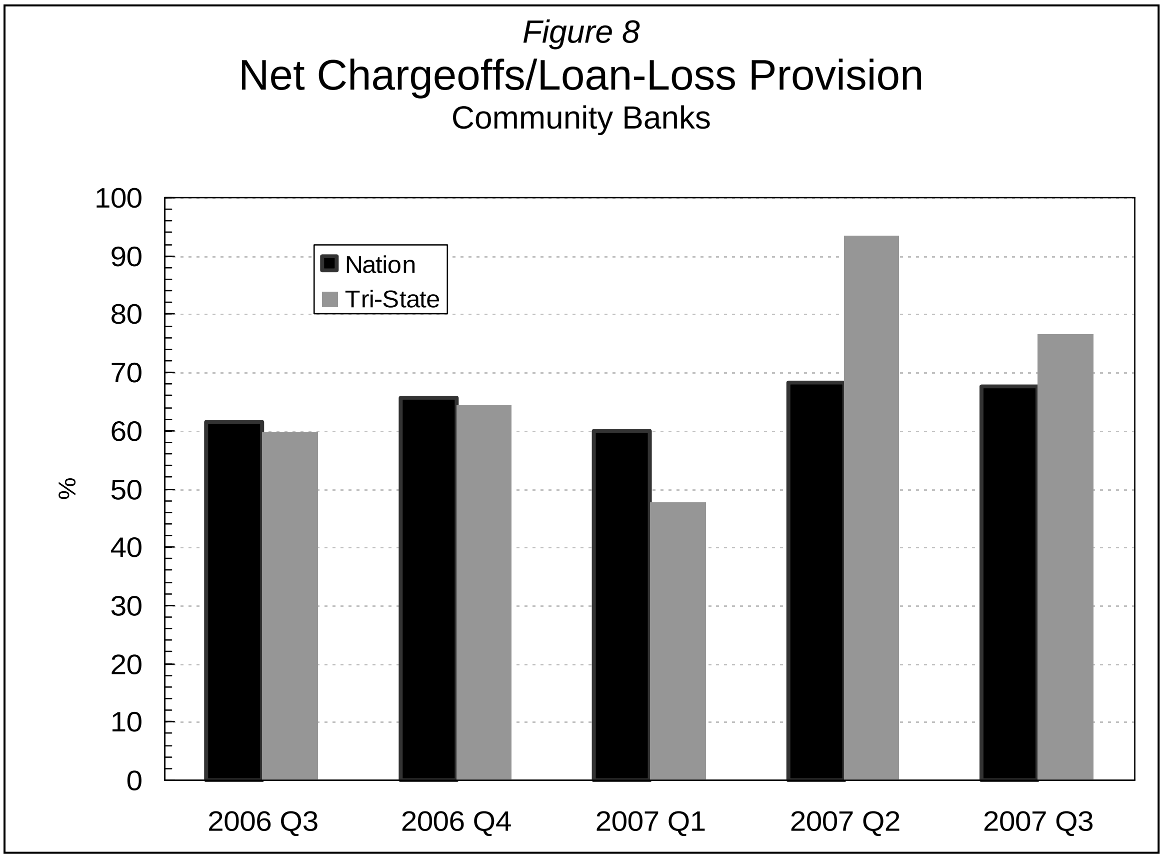


Figure 7

Nonperforming CRE Loans/Total CRE Loans

Community Banks





Net chargeoffs at community banks around the nation increased significantly in the second quarter (59.2 percent) but only modestly in the third quarter (5.9 percent). The pattern was more amplified among banks in the tri-state area, with net chargeoffs rising 155 percent in the second quarter and falling 29.1 percent in the third quarter. Net chargeoffs of mortgages increased another 21.8 percent nationally but fell 5.9 percent locally. The deceleration in net chargeoffs is reflected in the ratio of net chargeoffs to loan-loss provision (Figure 8).

In spite of the increases in provisioning, overall loan-loss reserves continued to drop nationally, although locally they showed a slight increase. The reserve for loan losses at community banks in the nation decreased 5.5 percent in the third quarter, and it is down 7.5 percent from the third quarter of 2006. However, at local banks reserves increased 2.2 percent in the quarter and are up 4.5 percent from last year. The loan-loss coverage ratios continued to drop both locally and nationally (Figure 9). At tri-state area banks in particular, this ratio is now at 107.9 percent, only slightly above the 100 percent mark needed to cover potential losses on current nonperforming loans.

In summary, it appears that the deterioration in asset quality at smaller banks is beginning to slow. They still have significant problems, however. First, although nonperforming loans aren't increasing substantially, they are still increasing. While the commercial real estate market, on which smaller banks rely, has not been as unstable as the residential real estate market, there is still a possibility that this could change. This is particularly true for construction loans. Second, loan-loss coverage ratios continue to decrease, and they are particularly low at local community banks. Thus, in the near term these banks will likely be forced to sacrifice profits to increase their reserves.

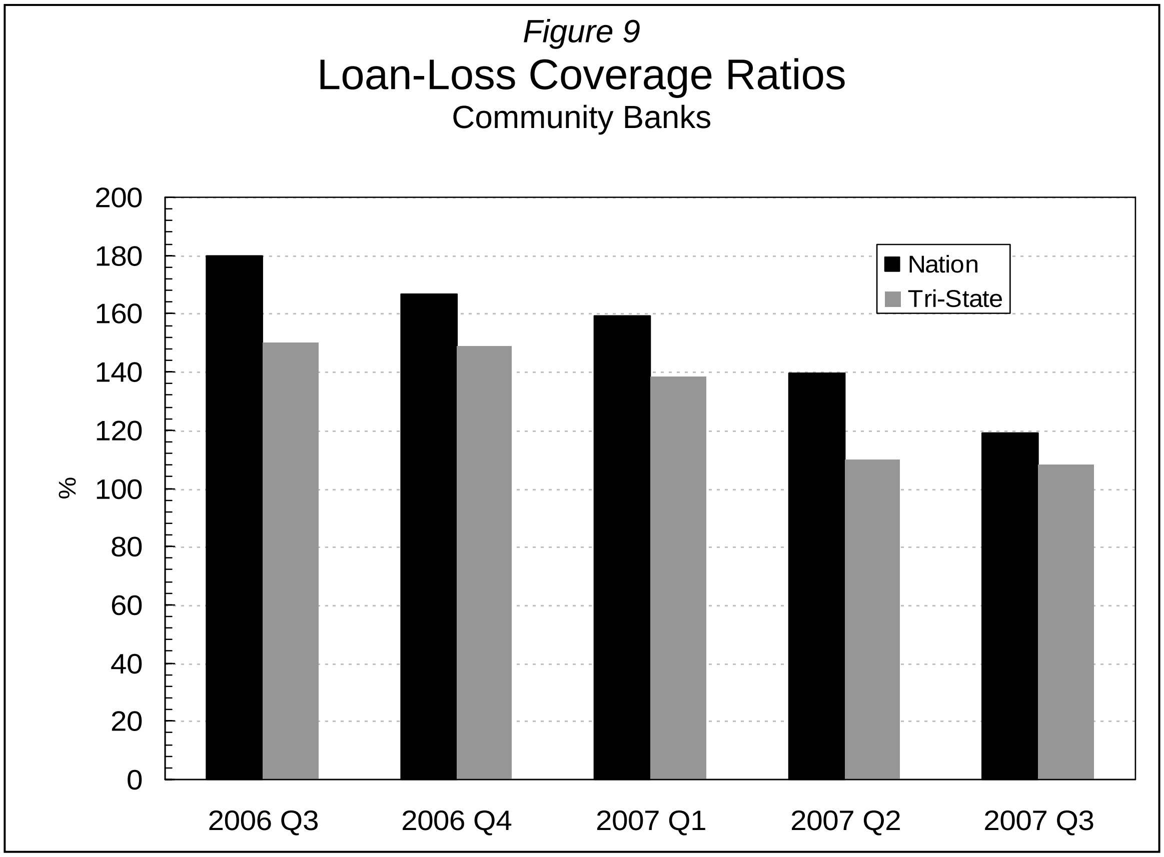


Figure 9
Loan-Loss Coverage Ratios
Community Banks
200
180
160
140
120
100
80
60
40
20
0
%
Nation
Tri-State
2006 Q3
2006 Q4
2007 Q1
2007 Q2
2007 Q3

Figure 10
Table Numbers Including Omitted Banks

	Community Banks			Large Banking Organizations					
	Tri-State			Tri-State			Nation		
	$Bill	% change from		$Bill	% change from		$Bill	% change from	
	07Q3	07Q2	06Q3	07Q3	07Q2	06Q3	07Q3	07Q2	06Q3
Total Assets	99.5	5.05	4.35	2,674.3	18.89	8.99	8,119.3	14.53	11.01
Total Loans	68.2	6.41	6.01	1,470.1	11.65	7.60	4,516.4	13.73	11.78
Business	9.4	-0.79	5.27	318.7	35.24	18.02	1,026.9	37.08	19.12
Real Estate	53.5	7.41	6.46	844.4	-5.79	3.07	2,425.9	0.31	11.10
Consumer	3.0	3.10	-5.08	135.7	36.72	16.60	562.8	25.62	10.73
Total Deposits	77.6	1.55	4.12	1,707.9	2.80	7.15	5,219.3	9.39	9.67
Ratios (in %)	**07Q3**	**07Q2**	**06Q3**	**07Q3**	**07Q2**	**06Q3**	**07Q3**	**07Q2**	**06Q3**
Net Income/Avg. Assets (ROA)	0.84	0.86	1.11	1.10	1.21	1.27	1.06	1.14	1.21
Net Interest Income/Avg. Assets	3.21	3.24	3.37	2.42	2.44	2.56	2.57	2.57	2.67
Noninterest Income/Avg. Assets	1.26	1.23	1.19	1.86	2.04	1.99	1.98	2.10	2.20
Noninterest Expense/Avg. Assets	3.24	3.22	2.89	2.51	2.57	2.58	2.72	2.78	2.89
Loans/Deposits	87.87	86.85	86.31	86.08	84.32	85.72	86.53	85.70	84.90
Equity/Assets	10.40	10.40	10.39	9.79	9.79	9.95	9.41	9.41	9.35
Nonperforming Loans/Total Loans	1.11	1.19	0.78	0.74	0.58	0.44	1.07	0.92	0.72

Third Quarter 2007

Community Banking Organizations

	*Tri-State**			*Nation*		
	$Bill	% change from		$Bill	% change from	
	07Q3	**07Q2**	**06Q3**	**07Q3**	**07Q2**	**06Q3**
Total Assets	96.3	5.22	4.46	1875.6	10.38	7.68
Total Loans	66.1	6.88	6.52	1318.9	12.12	9.20
Business	9.0	1.15	8.33	210.4	11.81	11.27
Real Estate	52.2	7.60	6.54	956.9	11.97	9.62
Consumer	2.8	3.24	-5.12	86.1	16.12	2.79
Total Deposits	74.9	1.09	3.95	1465.7	4.88	7.04
Ratios (in %)	**07Q3**	**07Q2**	**06Q3**	**07Q3**	**07Q2**	**06Q3**
Net Income/ Avg Assets (ROA)	1.05	1.04	1.10	1.11	1.15	1.20
Net Interest Inc/ Avg Assets (NIM)	3.21	3.22	3.34	3.63	3.65	3.75
Noninterest Inc/ Avg Assets	1.24	1.21	1.16	0.96	0.97	0.98
Noninterest Exp/ Avg Assets	2.93	2.92	2.87	2.87	2.87	2.91
Loans/Deposits	88.24	87.02	86.11	89.99	88.50	88.21
Equity/Assets	10.49	10.40	10.38	10.61	10.61	10.47
Nonperforming Loans/ Total Loans	1.09	1.07	0.79	1.05	0.97	0.65

Large Banking Organizations

	*Tri-State**			*Nation**		
	$Bill	% change from		$Bill	% change from	
	07Q3	**07Q2**	**06Q3**	**07Q3**	**07Q2**	**06Q3**
Total Assets	2577.7	17.75	9.04	8022,7	14.13	11.06
Total Loans	1411.6	9.17	7.84	4457.9	12.94	11.92
Business	308.4	33.53	17.65	1016.7	36.62	19.01
Real Estate	811.2	-5.90	4.40	2392.7	0.35	11.74
Consumer	122.9	8.86	10.93	550.0	19.15	9.42
Total Deposits	1638.4	0.85	6.76	5149.9	8.81	9.57
Ratios (in %)	**07Q3**	**07Q2**	**06Q3**	**07Q3**	**07Q2**	**06Q3**
Net Income/ Avg Assets (ROA)	1.13	1.25	1.27	1.07	1.15	1.21
Net Interest Inc/ Avg Assets (NIM)	2.44	2.49	2.57	2.58	2.59	2.68
Noninterest Inc/ Avg Assets	1.90	2.10	2.04	2.00	2.12	2.21
Noninterest Exp/ Avg Assets	2.53	2.61	2.62	2.73	2.79	2.91
Loans/Deposits	86.15	84.46	85.29	86.56	85.76	84.75
Equity/Assets	9.37	9.17	9.66	9.27	9.08	9.25
Nonperforming Loans/ Total Loans	0.83	0.68	0.45	1.04	0.87	0.70

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, 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 — 178 for the tri-state area and 5639 for the nation; (2) large banking organizations — 15 for the tri-state area and 95 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 these data exclude certain institutions that were deemed to be outliers. For community banks in the tri-state area, one institution was the victim of fraud. For large organizations, one institution converted a large thrift subsidiary to a commercial bank. See the text above for a more detailed explanation. For the numbers including all omitted banks, see Figure 10.

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 www.philadelphiafed.org/philscriber/user/dsp_content.cfm.