BANKING BRIEF

FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

Fourth Quarter 2007

The condition of large banking organizations and community banks continued to decline in the fourth quarter of 2007, both locally and nationally. In all categories of banks, return on average assets decreased, net interest margins were either flat or decreased, and asset quality worsened. In addition, expense ratios, as measured by the ratio of noninterest expense to average assets, were also either flat or up at all categories of banks.

As in the past several quarters, the primary reason for the decrease in profitability at large organizations has been the need to increase loan-loss provisions because of rising nonperforming real estate loans, particularly residential real estate (RRE) loans. Chargeoffs on commercial real estate (CRE) loans have also been increasing at these institutions. In addition, beginning in the third quarter of 2007, some of these institutions have been hit by substantial losses in their trading accounts.

At community banks, provisions for loan losses are consuming an increasing share of operating income because of continued higher chargeoff rates. The primary source of loan losses at these banks has been chargeoffs of CRE loans. However, this quarter, chargeoffs on RRE loans also increased substantially.

In spite of the decreasing profitability and asset quality, capital ratios remain strong at all categories of banks. However, at several large organizations this is the result of raising additional capital, including one institution that obtained an infusion of $7.5 billion.

Large Organizations

Return on average assets at large organizations decreased from 1.06 percent to 0.82 percent nationally and from 1.09 percent to 0.83 percent locally, the worst results for these banks in 15 years. Overall, net income fell 82.9 percent nationally and 84.9 percent locally from the third to the fourth quarter. Still, the vast majority of banks both locally and nationally reported positive profits in the fourth quarter.

As shown in the table below, assets increased 8.9 percent nationally and 12.3 percent locally.[1] As explained below, this asset growth is somewhat deceiving. Asset quality continued to decline. The ratio of nonperforming loans to total loans increased from 0.75 percent to 1.05 percent for banks in the tri-state area and from 1.07 percent to 1.30 percent for banks in the nation as a whole.[2] Nationally, the ratio of nonperforming loans to total loans is now well above the average for the previous 10 years.

Total nonperforming loans increased 34.6 percent nationally in the fourth quarter. The corresponding figure for tri-state area banks was 48.3 percent. As in the previous several quarters, RRE loans were the

[1] The numbers for both national and tri-state area banks presented in the table on the last page do not reflect the assets and liabilities of Wachovia Corporation. The reported growth in bank assets and deposits for this company was distorted by transfers from a subsidiary with a thrift charter to another with a bank charter. For the results including this institution, see Figure 7.

[2] Nonperforming loans are defined as the sum of loans past due 90 or more days plus nonaccruing loans. For historical perspective, the nonperforming loan ratio for all commercial banks from 1995 to 2005 was 1.08 percent. Source: FDIC Historical Statistics on Banking: www2.fdic.gov/hsob/index.asp.

Figure 1

Nonperforming RRE Loans/Total RRE Loans

Large Organizations

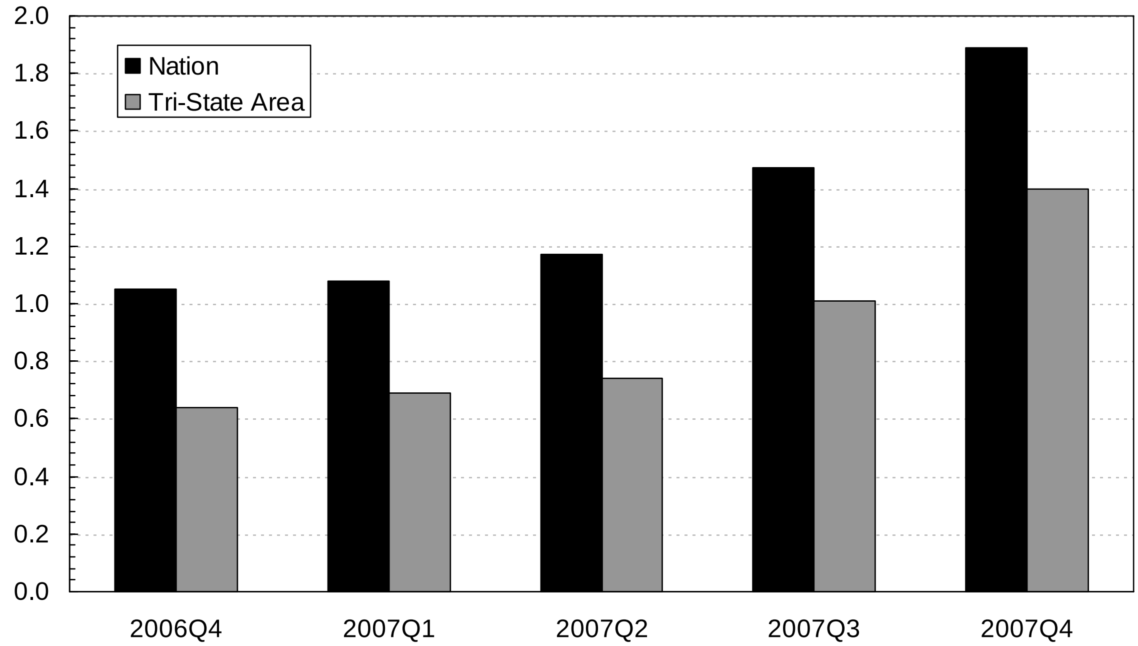
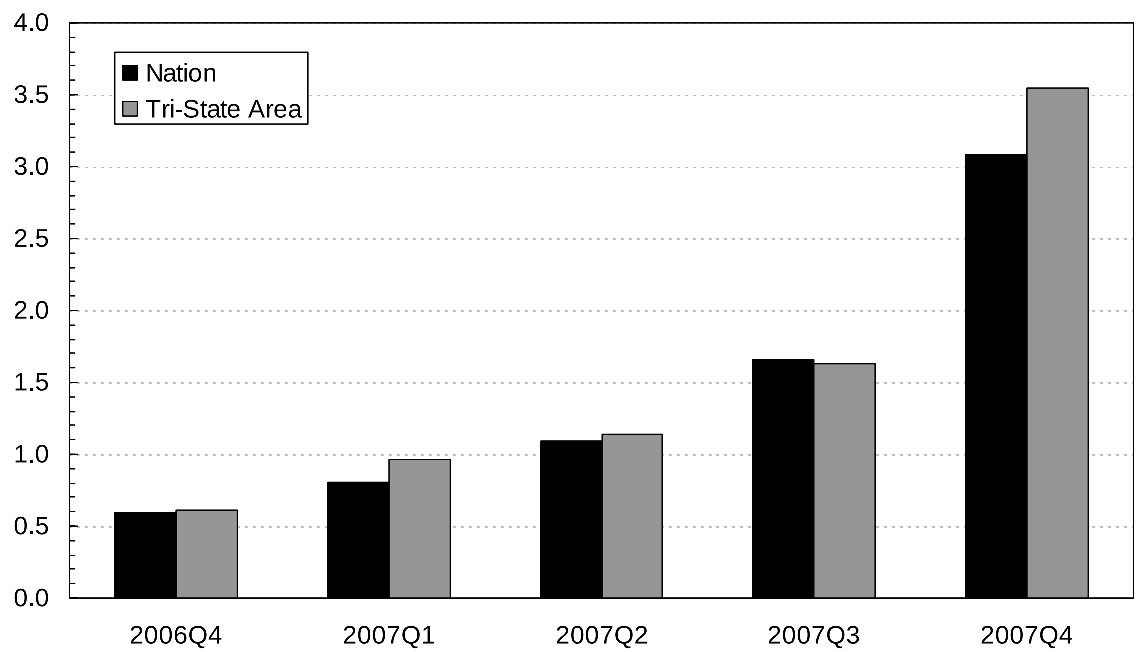
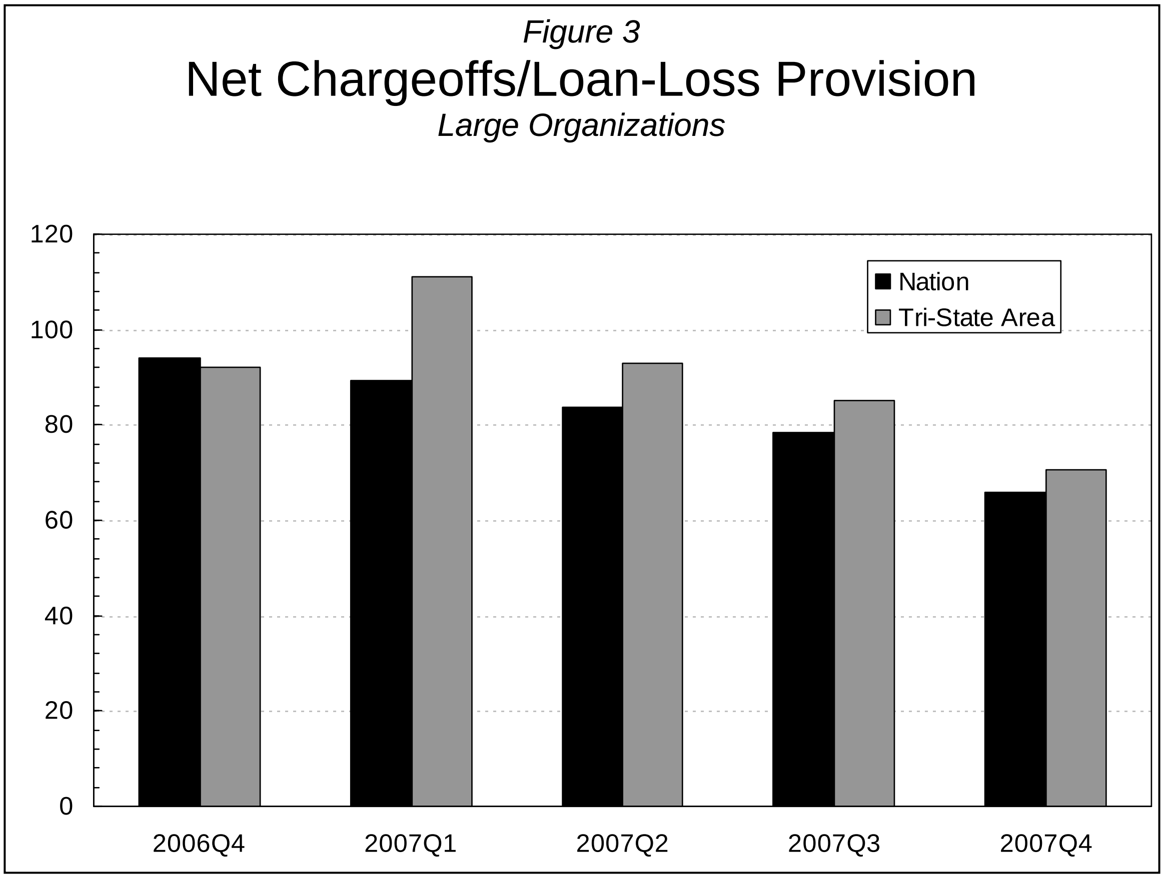


Figure 2

Nonperforming Construction Loans/Const. Loans

Large Organizations





primary reason for the increase in nonperforming loans.[3] Fully 45.2 percent of the nonperforming loans at banks nationally and 44.2 percent at banks locally were RRE loans. The ratio of nonperforming RRE loans to total RRE loans continues to increase dramatically (Figure 1).

The nationwide slump in residential real estate markets is now affecting CRE lending at large organizations.[4] Nonperforming CRE loans grew 58.4 percent nationally and 87.9 percent locally in the fourth quarter. Much of this increase was concentrated in poorly performing construction loans (Figure 2). Construction loans now account for about 15 percent of nonperforming loans among these institutions, about twice the share of a year ago.

Net chargeoffs continue to rise as well. Overall, net chargeoffs increased 40.6 percent nationally and 46.1 percent locally in the fourth quarter.[5] For RRE loans, the increases were 84.2 percent and 135.0 percent, respectively, and for CRE loans the increases were 141.6 percent and 66.1 percent. There was also a significant increase in chargeoffs of commercial and industrial loans (C&I) during the quarter. Not surprisingly, the composition of chargeoffs also changed — residential mortgages and commercial real estate accounted for an increasing share, while the share of chargeoffs that were consumer loans fell.

As noted above, capitalization at large organizations remains good. However, there are increasing concerns about their levels of reserves. While large banks have been adding to their loan

[3] RRE loans are defined as all loans secured by one- to four-family residential properties. These include mortgages, home equity loans, and home equity lines of credit whether secured by first or junior liens.

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

[5] Unless otherwise noted, all income statement items are on a quarterly basis. That is, they include only the income (loss) incurred in the quarter.

Figure 4

Loan-Loss Coverage Ratios

Large Organizations

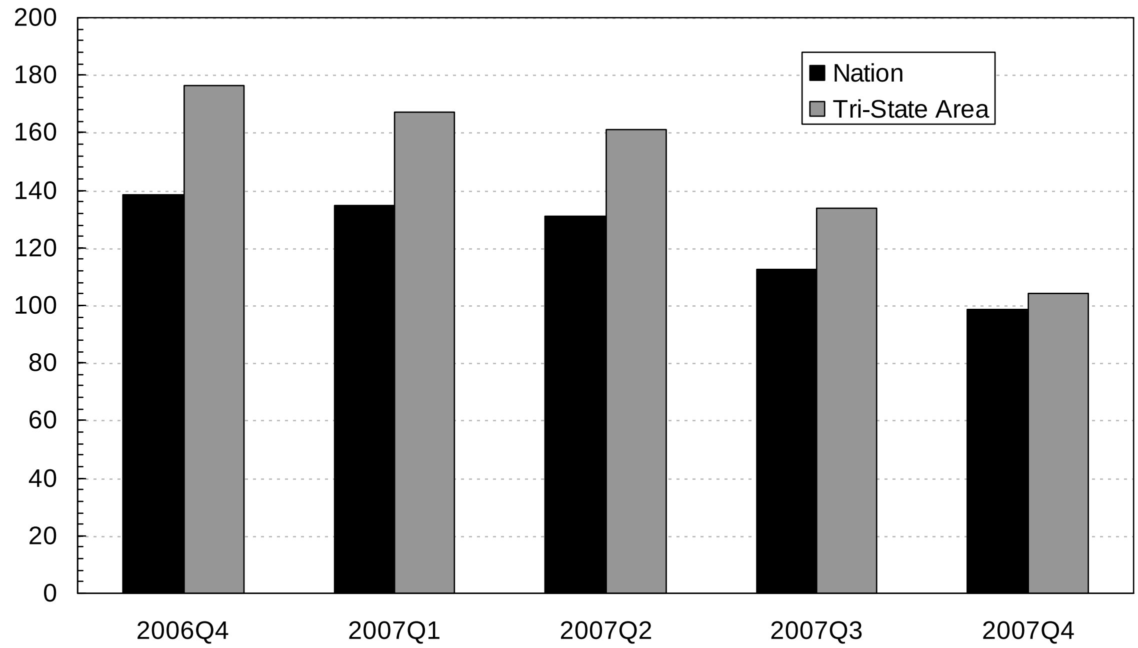
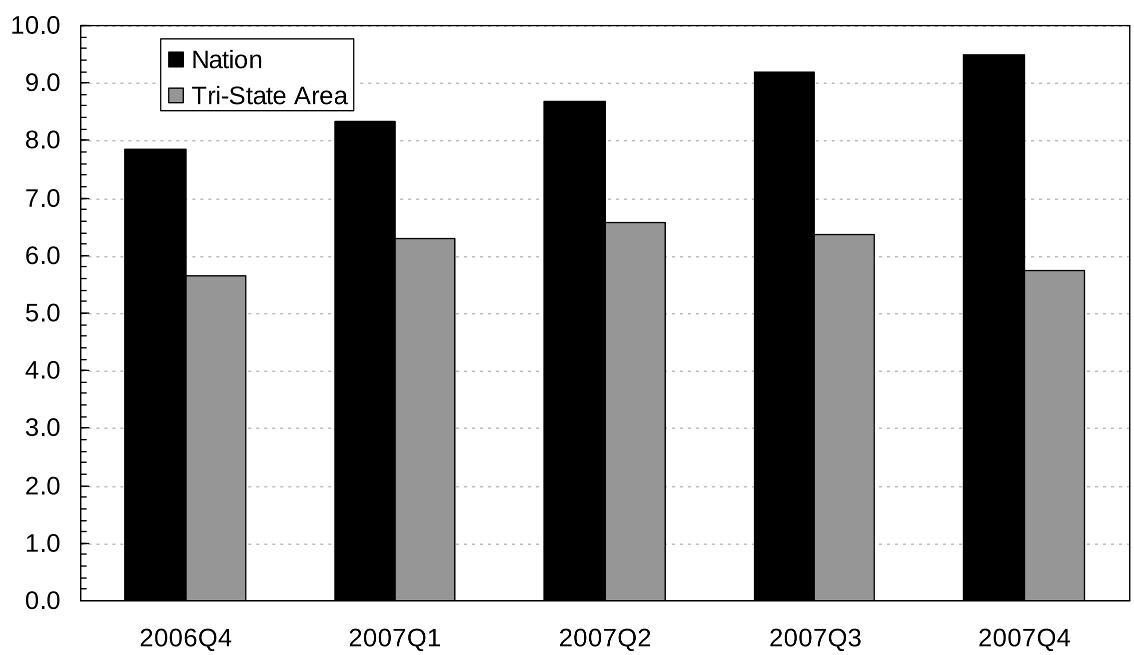
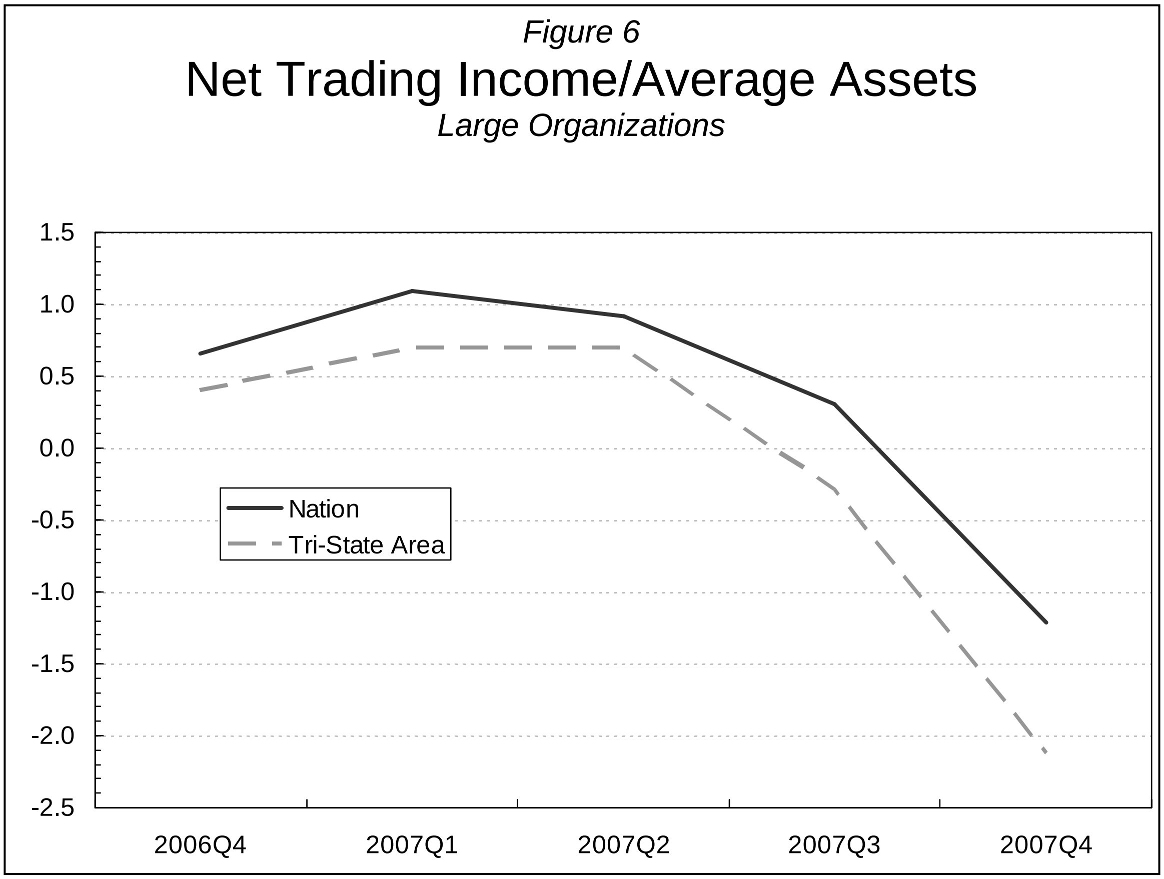


Figure 5

Trading Assets as a Percentage of Total Assets

Large Organizations





loss reserves more rapidly than they are charging off bad loans (Figure 3), the loan-loss coverage ratios continue to fall and are now slightly below 100 percent nationally (Figure 4).[6] The ratio for large banks in the tri-state area is only slightly above 100 percent, and it too has been decreasing for at least a year. Thus, nonperforming loans have been increasing consistently more rapidly than reserves. Large banks may need to increase their provisioning for loan losses in future quarters, reducing income.

As mentioned above, asset growth was relatively high both locally and nationally, particularly real estate loans. This growth is at odds with data on housing sales and the performance of these assets. The sample used to construct the financial data presented here is only for the bank subsidiaries of large organizations, but many of them have multiple other consolidated and unconsolidated affiliates within their corporate structure. Thus, much of this asset growth is actually assets of unconsolidated affiliates that were previously booked off their balance sheets being brought back onto their balance sheets, rather than new originations or purchased loans.

One type of off-balance-sheet entity previously favored by many of the large banking organizations is the structured investment vehicle (SIV). An SIV is essentially an unconsolidated affiliate that sells commercial paper (short-term debt) and purchases securities, particularly mortgage-backed securities (MBS). The recent decline in real estate markets has affected the SIVs and their bank sponsors in several ways. First, the value of the SIVs' MBS portfolios has dropped, and they can no longer sell their commercial paper to raise funds. This has forced SIVs to sell illiquid assets or to seek bank financing. In a number of instances banks have either purchased these assets or provided other means of support that meant the SIVs had to be consolidated on the banks' books. Some of these securities are now found in the banks' trading accounts, where their value is

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

Figure 7

Table Numbers for All Large Organizations

Including Wachovia

	Tri-State			***Nation***		
	$Bill	**% change from**		**$Bill**	**% change from**	
	07Q4	**07Q3**	**06Q4**	**07Q4**	**07Q3**	**06Q4**
Total Assets	2,936.3	22.66	13.15	8,435.1	16.77	12.25
Total Loans	1,630.1	24.88	12.42	4,693.5	16.37	11.49
Business	353.7	9.45	17.37	1,067.0	16.52	20.51
Real Estate	957.1	36.08	10.16	2,526.0	17.12	6.93
Consumer	135.7	-1.34	15.80	574.7	8.64	15.24
Total Deposits	1,907.4	30.00	10.49	5,464.1	20.68	10.03
Ratios (in %)	**07Q4**	**07Q3**	**06Q4**	**07Q4**	**07Q3**	**06Q4**
Net Income/Avg Assets (ROA)	0.83	1.09	1.23	0.82	1.06	1.18
Net Interest Inc/Avg Assets (NIM)	2.37	2.42	2.50	2.56	2.57	2.62
Noninterest Inc/Avg Assets	1.59	1.81	1.98	1.83	1.98	2.11
Noninterest Exp/ Avg Assets	2.50	2.48	2.54	2.78	2.73	2.81
Loans/Deposits	85.46	86.33	83.99	85.90	86.68	84.78
Equity/Assets	10.29	9.84	10.03	9.56	9.42	9.41
Nonperforming Loans/Total Loans	1.05	0.75	0.49	1.30	1.07	0.74

typically marked to market prices. This contributed to significant losses in the trading accounts of some of the largest banks during the quarter.

In the past year, the trading account assets of banks nationwide grew 38.4 percent, and they now represent nearly 10 percent of all assets (Figure 5). At large tri-state area banks, the figures are lower, with trading account assets growing 19.2 percent in the last year and representing only 5.7 percent of assets. At the same time, trading income has plummeted. In the fourth quarter alone, banks nationwide had trading losses, including interest income, of over $3.6 billion, and banks in the tri-state area had losses of $2.3 billion. Excluding interest income, these figures were $9.7 billion in the nation and $3.9 billion locally. These trading losses make up nearly half of the difference in net income between the fourth quarter of 2007 and the fourth quarter of 2006. Moreover, at tri-state area banks, as a percentage of average assets trading losses now exceed 2 percent; nationally, as a percentage of average assets the losses are greater than 1 percent (Figure 6).

To summarize, loan quality continued to deteriorate at large organizations in the fourth quarter, as both nonperforming loans and net chargeoffs increased substantially. The main problem continues to be RRE loans, but the organizations are beginning to have more problems with their CRE loans, particularly construction loans. In spite of large increases in their loan-loss provisions, reserves are not keeping pace with nonperforming loans.[7] This is due in part to the large quantity of loans that were previously off their balance sheets and that were brought back on as nonperformers. In addition, the performance of securities at some off-balance-sheet entities affiliated with some of the large banks has contributed to large losses in their trading accounts.

Community Banks

Return on average assets (ROAA) at community banks decreased in the fourth quarter. Profitability continued to drop, from 1.13 percent to 1.04 percent nationally and from 1.00 percent to 0.96 percent at tri-state area banks. As in the previous few quarters, the main reason for decreasing profitability is declining asset quality, particularly CRE loans. Tri-state area banks appear to have experienced problems with their CRE loans somewhat earlier than banks around the nation, but the deterioration has recently slowed. As with the large banks, nonperforming residential mortgages have increased at smaller banks over the last few quarters.

The ratio of nonperforming loans to total loans increased from 1.08 to 1.12 percent at tri-state area banks and from 1.04 to 1.23 percent nationally. For CRE loans, the figures are much higher (Figure 8), but at tri-state area banks the ratio decreased slightly. Total nonperforming loans increased 24.33 percent nationally but only 5.47 percent locally. The nonperforming CRE loans at community banks increased 36.56 percent nationally but were essentially unchanged locally. Moreover, while nonperforming construction loans increased nearly 55 percent nationally, they decreased over 10 percent locally. This sector is very important for these banks because CRE loans represent a very large share of their portfolios: 47.6 percent at community banks nationally and 44.5 percent locally. Interestingly, in recent quarters the CRE share of loans has remained stable at community banks locally, but it has been rising among community banks nationally.

The ratio of nonperforming RRE loans to total RRE loans is higher nationally than locally (Figure 9), but this ratio has been rising for both categories of banks over the last several quarters. Nonperforming RRE loans increased 14.07 percent nationally and 17.33 percent locally in the fourth quarter. The vast majority of RRE loans in both cases are mortgages. But community banks in the tri-state area are relatively more exposed: residential mortgages account for 29 percent of loans locally but only 19 percent nationally.

[7] Loan-loss reserve refers to the total amount set aside on a bank's balance sheet to cover loan losses. Loan-loss provision refers to the quarterly addition to the reserve reported on the income statement.

Figure 8

Nonperforming CRE Loans/Total CRE Loans

Community Banks

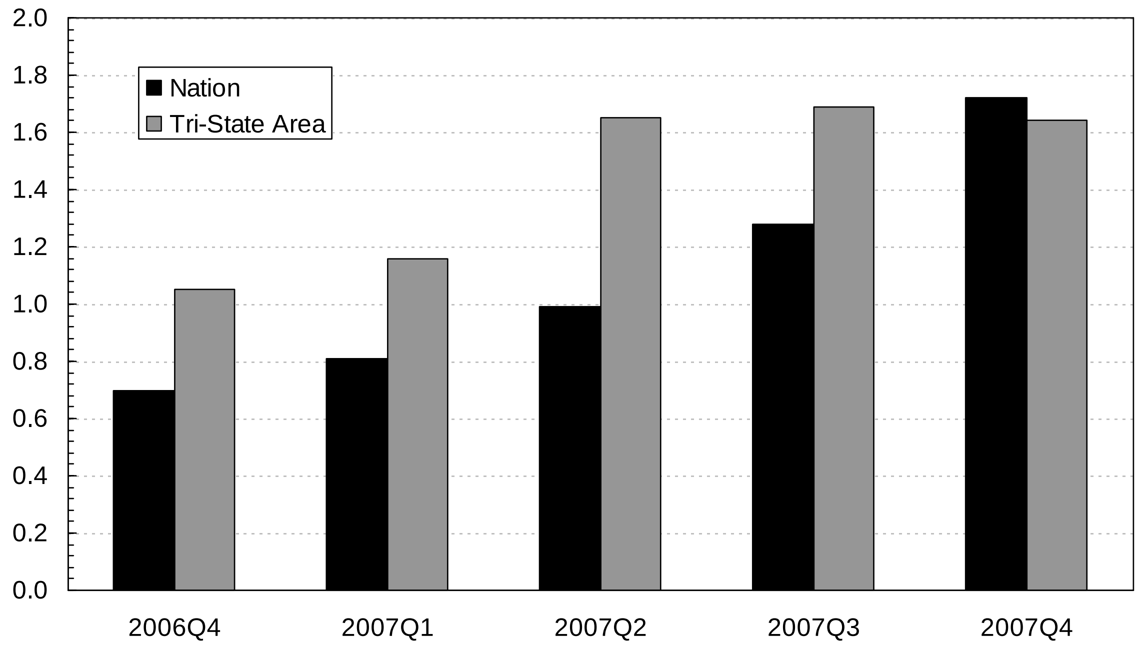
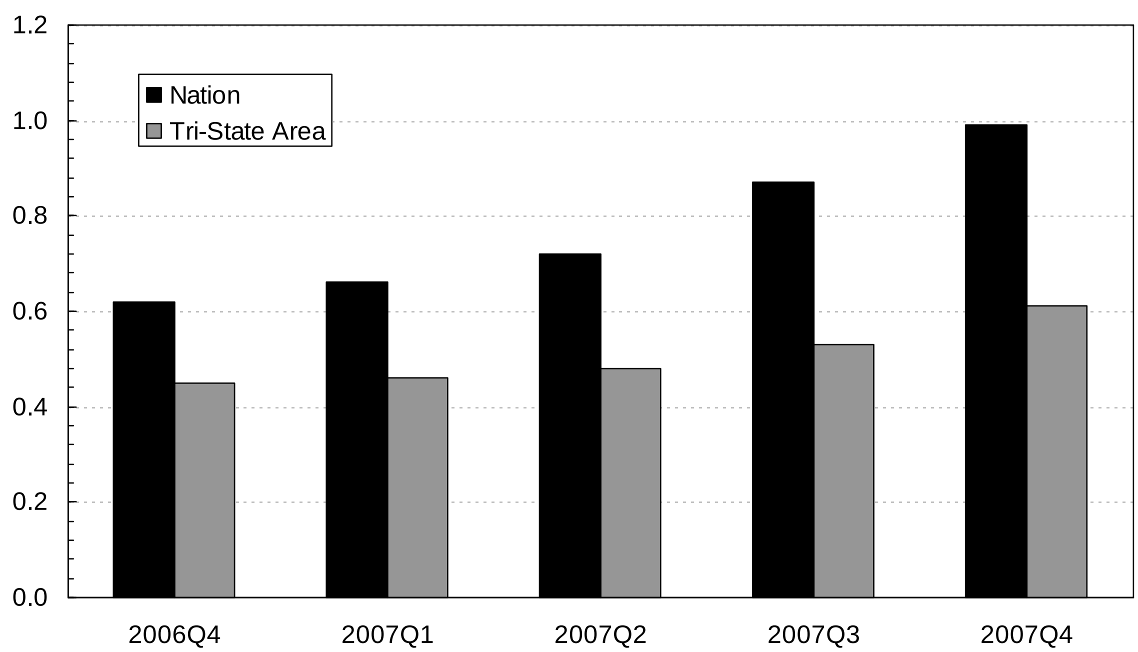
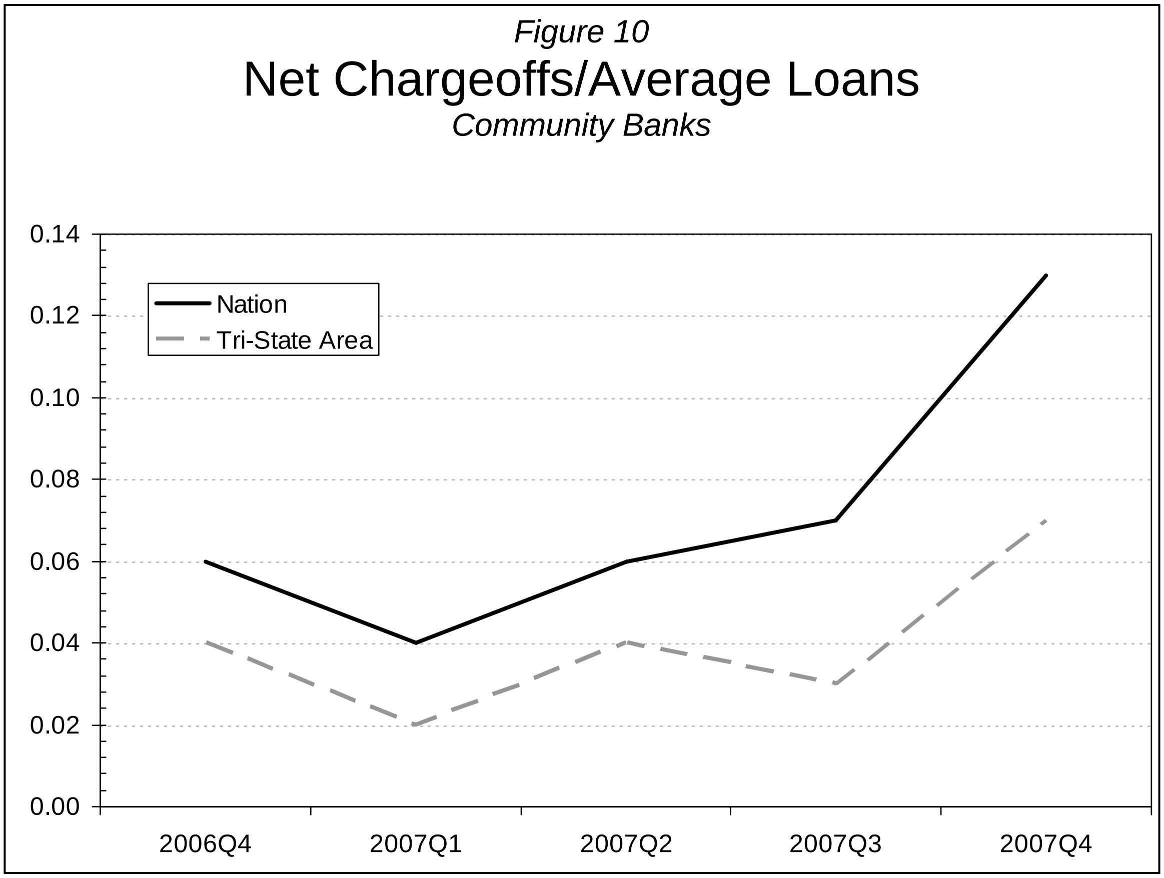


Figure 9

Nonperforming RRE Loans/Total RRE Loans

Community Banks





The ratio of net chargeoffs to average loans continues to rise both locally and nationally (Figure 10). Total net chargeoffs increased 82.21 percent at banks nationally and 136.17 locally. Chargeoffs of CRE and RRE loans increased even more rapidly. CRE loans are accounting for an increasing share of chargeoffs at community banks. Nationally, 39 percent of chargeoffs consisted of CRE loans in the fourth quarter. The comparable share among community banks locally was 30 percent. In comparison, residential mortgages accounted for 12 to 14 percent of chargeoffs at community banks.

Despite the rapid increase in chargeoffs, total loan-loss reserves increased 4.10 percent nationally and 4.25 percent locally. The ratio of net chargeoffs to loan-loss provision barely changed nationally in the fourth quarter, and it decreased at local banks (Figure 11). Among community banks in the tri-state area, the loan-loss coverage ratio is just above 100 percent; nationally it is now slightly below 100 percent (Figure 12). At these levels it is likely that community banks will have to increase their provisioning for loan losses, with the attendant negative effect on net income.

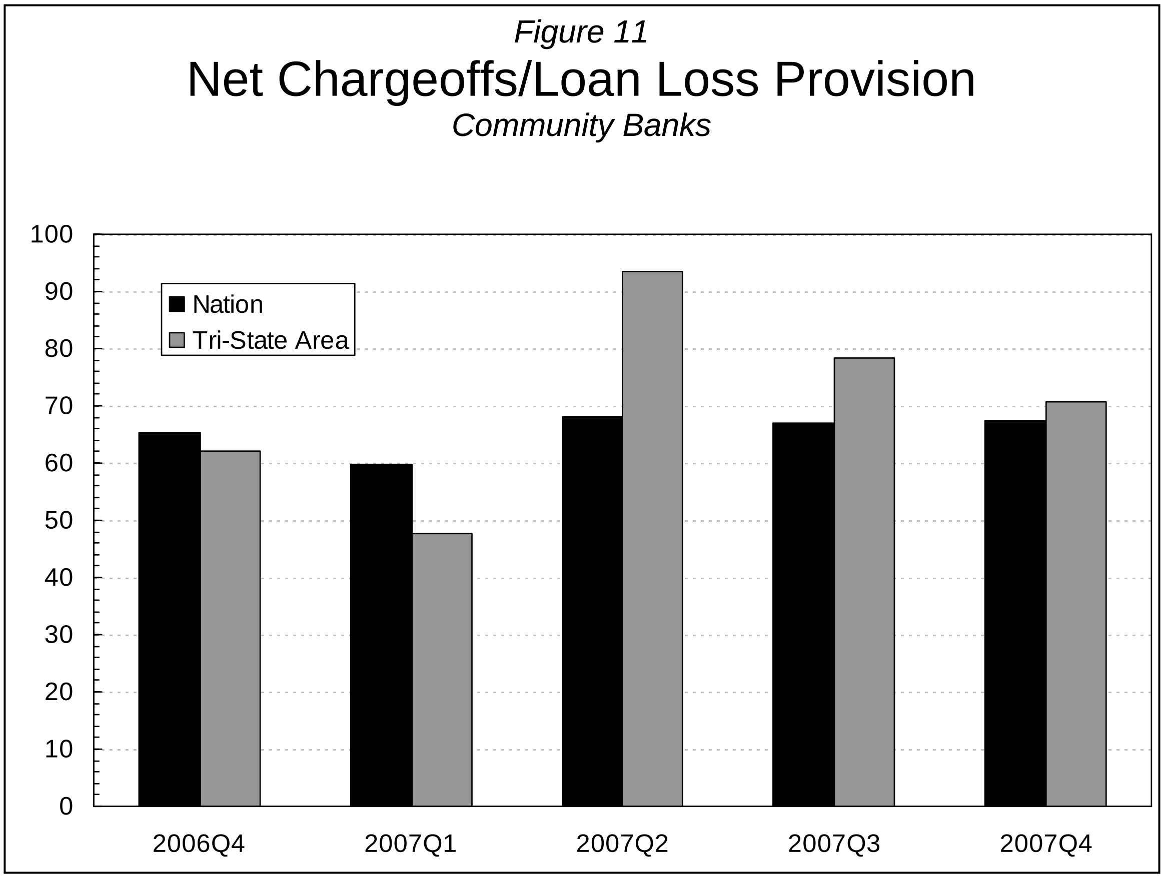


Figure 11
Net Chargeoffs/Loan Loss Provision
Community Banks
100
90
80
70
60
50
40
30
20
10
0
Nation
Tri-State Area
2006Q4
2007Q1
2007Q2
2007Q3
2007Q4

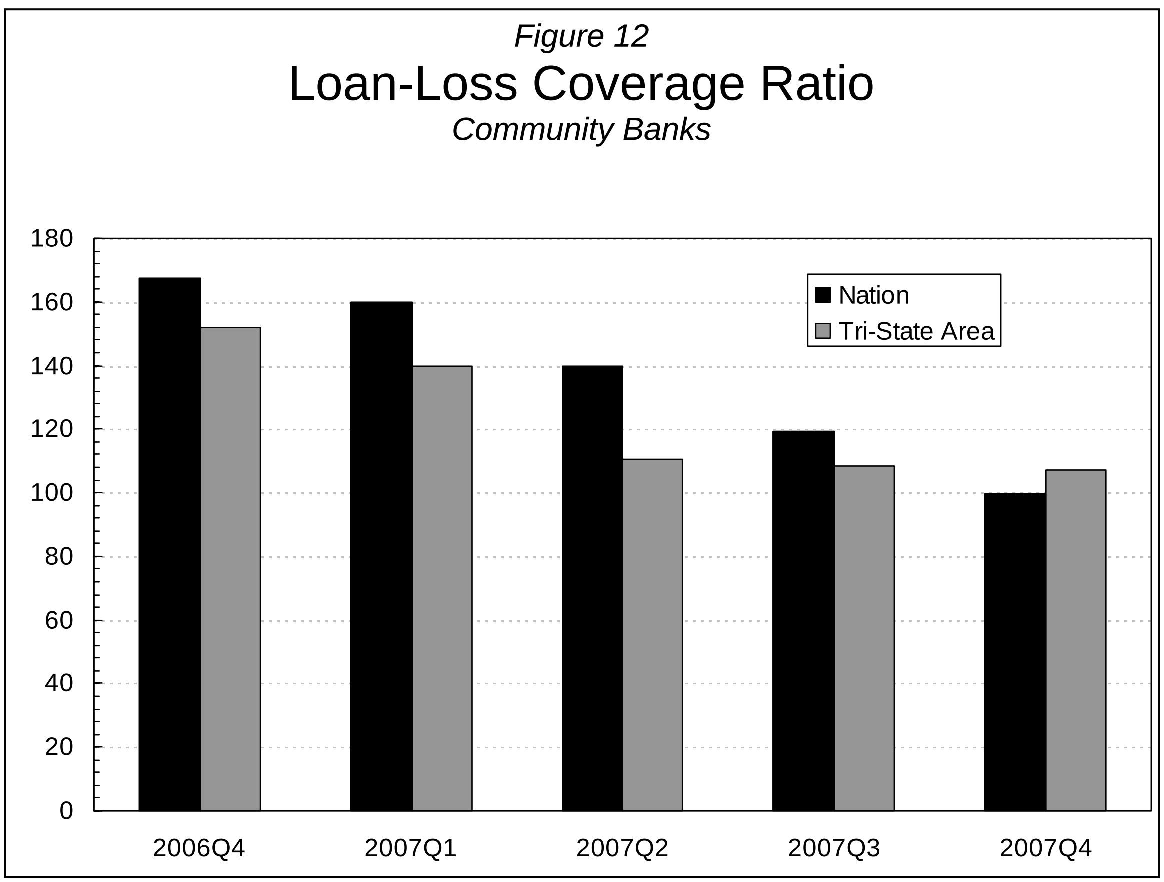


Figure 12
Loan-Loss Coverage Ratio
Community Banks
180
160
140
120
100
80
60
40
20
0
Nation
Tri-State Area
2006Q4
2007Q1
2007Q2
2007Q3
2007Q4

*Fourth Quarter 2007**

Community Banking Organizations

	Tri-State $Bill	Tri-State % change from		Nation $Bill	Nation % change from	
	07Q4	07Q3	06Q4	07Q4	07Q3	06Q4
Total Assets	94.1	4.22	4.55	1,900.1	7.61	7.21
Total Loans	64.6	5.72	6.40	1,341.2	9.20	9.56
Business	8.7	3.92	6.64	215.9	13.24	11.47
Real Estate	50.9	7.32	6.92	973.6	10.04	9.78
Consumer	2.8	-4.21	-6.23	85.6	-0.90	3.18
Total Deposits	73.1	0.13	2.71	1,480.2	6.23	5.50

Ratios (in %)	**07Q4**	**07Q3**	**06Q4**	**07Q4**	**07Q3**	**06Q4**
Net Income/ Avg Assets (ROA)	0.96	1.00	1.06	1.03	1.12	1.19
Net Interest Inc/ Avg Assets (NIM)	3.16	3.15	3.29	3.59	3.63	3.72
Noninterest Inc/ Avg Assets	1.30	1.30	1.25	0.96	0.96	0.98
Noninterest Exp/ Avg Assets	3.04	3.01	2.97	2.87	2.86	2.89
Loans/Deposits	88.36	87.17	85.30	90.61	89.99	87.25
Equity/Assets	10.26	10.22	10.06	10.52	10.60	10.43
Nonperforming Loans/ Total Loans	1.12	1.08	0.79	1.24	1.04	0.7

Large Banking Organizations

	Tri-State $Bill	Tri-State % change from		Nation $Bill	Nation % change from	
	07Q4	07Q3	06Q4	07Q4	07Q3	06Q4
Total Assets	2,278.2	8.93	9.89	7,777.0	12.32	11.22
Total Loans	1,214.1	4.57	6.03	4,277.5	9.92	9.54
Business	271.8	9.30	16.05	985.1	17.08	20.40
Real Estate	703.1	2.38	1.74	2,272.1	5.65	4.00
Consumer	98.9	-1.37	14.16	537.9	9.36	14.90
Total Deposits	1,445.0	6.78	5.46	5,001.7	13.26	8.50

Ratios (in %)	**07Q4**	**07Q3**	**06Q4**	**07Q4**	**07Q3**	**06Q4**
Net Income/ Avg Assets (ROA)	0.82	1.08	1.22	0.81	1.05	1.17
Net Interest Inc/ Avg Assets (NIM)	2.29	2.35	2.41	2.55	2.56	2.60
Noninterest Inc/ Avg Assets	1.08	1.29	2.00	1.29	1.42	2.13
Noninterest Exp/ Avg Assets	2.43	2.41	2.49	2.78	2.72	2.81
Loans/Deposits	84.02	84.46	83.56	85.51	86.16	84.71
Equity/Assets	10.06	9.84	9.97	9.44	9.39	9.34
Nonperforming Loans/ Total Loans	1.06	0.79	0.52	1.33	1.04	0.77

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, 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 — 175 for the tri-state area and 5,592 for the nation; (2) large banking organizations — 16 for the tri-state area and 94 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 data for large organizations exclude Wachovia Corporation, whose balance sheet was significantly affected by the transfer of assets and deposits from a large thrift it had acquired. For the data including Wachovia, see Figure 7 in the text.

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