BANKING BRIEF

FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

First Quarter 2008

Profitability decreased at large organizations and community banks both locally and nationally, primarily because of continued problems with real estate lending. Of the 98 large organizations in the national sample, 10 percent reported losses in the first quarter of 2008. An additional 27 percent reported a drop in income from the fourth quarter of 2007, and two-thirds of institutions whose income fell reported a drop of at least 50 percent. These numbers are an improvement over those from the fourth quarter, when 20 percent of large banks reported a loss, an additional 58 percent reported a decrease in income, and over half of those reported a decrease of at least 50 percent.[1] Among the 5,661 community banks around the nation, 8 percent reported a loss. An additional 39 percent reported a decrease in income in the first quarter, and half of those institutions reported a decline of 50 percent or more.

At the large organizations, return on average assets (ROAA) fell to 0.65 percent nationally and 0.60 percent locally (see last page). Losses on residential real estate (RRE) continued to increase in the first quarter.[2] These losses were not confined just to first mortgages; they also included mortgages secured by junior liens and home equity lines of credit (HELOCs). The large organizations are also having problems with commercial real estate (CRE) lending, particularly construction loans, and this contributed to a near doubling of the nonperforming loan ratio.[3] There was a large increase in loan-loss provisioning in the first quarter. Capital ratios dropped slightly both locally and nationally, but both remain fairly high. On a more positive note, net interest margins were relatively stable, and nonperforming loans on non-real estate lending actually decreased in the quarter.

Community banks are currently more profitable than large organizations, with ROAAs of 0.92 percent locally and 0.91 percent nationally. But smaller institutions also experienced large increases in their nonperforming loan ratios in the first quarter. The main source of losses at community banks was CRE lending, but they also had losses on RRE lending, mainly first mortgages. The ratio of equity-to-assets dropped slightly at community banks in the tri-state area and was basically unchanged nationwide. Net interest margins and the ratios of noninterest income and noninterest expense to average assets were also nearly unchanged.

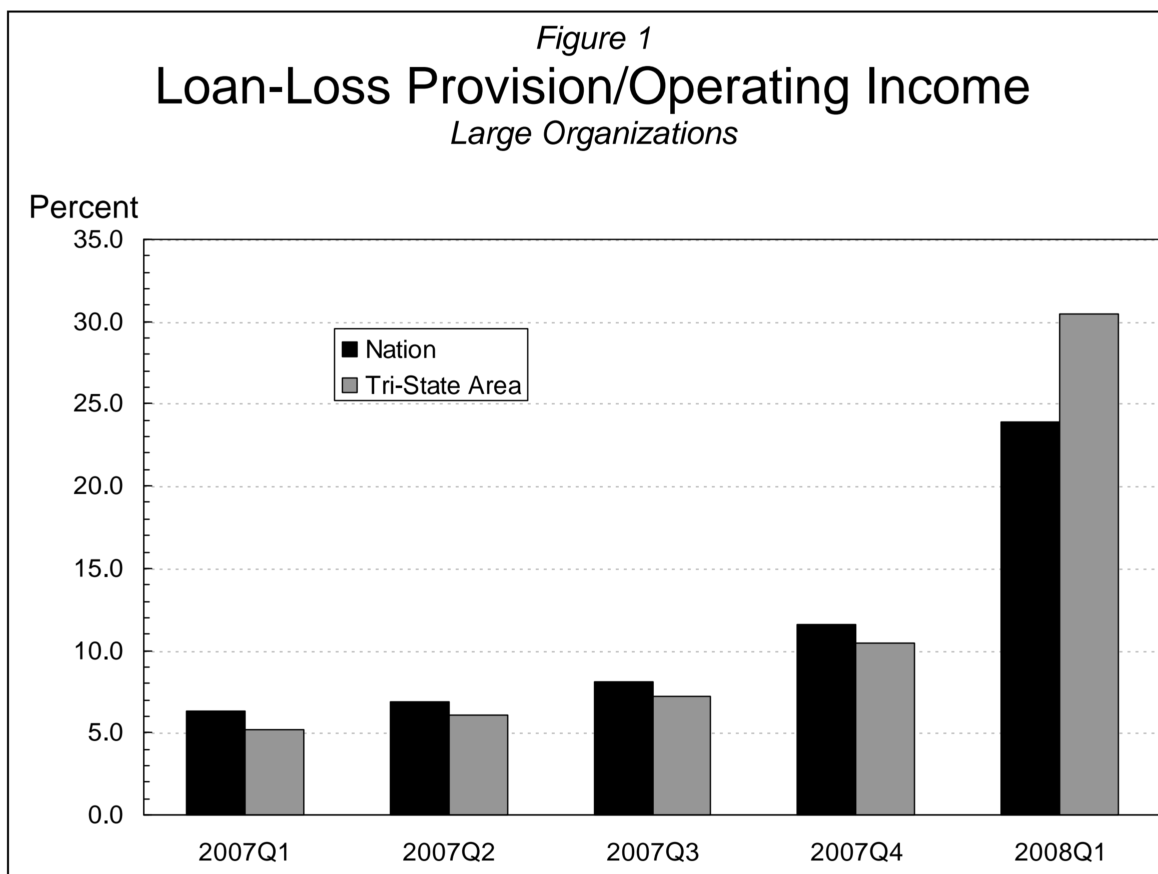
Large Organizations

As noted above, ROAA dropped substantially at large organizations both locally and nationally. It is now nearly as low as it was at the bottom of the last real estate cycle in the early 1990s, when it dropped to

[1] After the previous edition of *Banking Brief* was published, fourth quarter results at a number of banks were revised downwards to reflect write downs of good will. See *Quarterly Banking Profile*, Federal Deposit Insurance Corporation, March 2008, www4.fdic.gov/qbp/2008mar/qbp.pdf.

[2] RRE loans are defined as the sum of mortgages secured by first and second liens, plus home equity loans.

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



0.52 percent.[4] Net interest margins were fairly stable, but the ratio of noninterest income to average assets has dropped considerably in the last year and this decline continued in the first quarter. This was offset somewhat by a drop in the ratio of noninterest expense to average assets. Capital levels dropped slightly in the first quarter but have remained stable over the last year. All but two large banks remain well-capitalized.[5] A number of large banks have obtained infusions of new capital to offset the effects of significant write-offs.

The main reason for falling profits is the very large increases in loan-loss provisions in response to the rising number of nonperforming loans, particularly among loans secured by real estate. Indeed, provisioning for loan losses has consumed a rising share of large banks' operating income over the last several quarters (Figure 1).[6]

The ratio of nonperforming loans to total loans, which had already increased substantially both locally and nationally in 2007, continued to increase in the first quarter. This ratio increased from 1.05 percent to 1.93 percent locally and from 1.28 percent to 2.15 percent nationally.[7]

The ratio of nonperforming RRE loans to total RRE loans was 2.28 percent for the nation and 1.84 percent for the tri-state area (Figure 2). For mortgages only, these numbers were 2.79 percent nationally and 2.08 percent locally. Among these, the nonperforming loan ratios were higher among first lien loans (2.99 percent nationally and 2.19 percent locally) than among second liens (1.61 and 1.28 percent

[4] Source: FDIC Historical Statistics on Banking: www2.fdic.gov/hsob/index.asp. Average ROAA from 1997 to 2007 was 1.24 percent.

[5] Well-capitalized here is defined as an equity-to-assets ratio of at least 6 percent.

[6] Operating income is defined as net interest income plus noninterest income.

[7] Nonperforming loans are defined as loans past due 90 days or more plus nonaccruing loans. For historical perspective, the nonperforming loan ratio for all commercial banks from 1997 to 2007 was 1.07 percent. However, at the bottom of the last real estate cycle in 1991, this ratio was 3.70 percent. Source: FDIC Historical Statistics on Banking: www2.fdic.gov/hsob/index.asp.

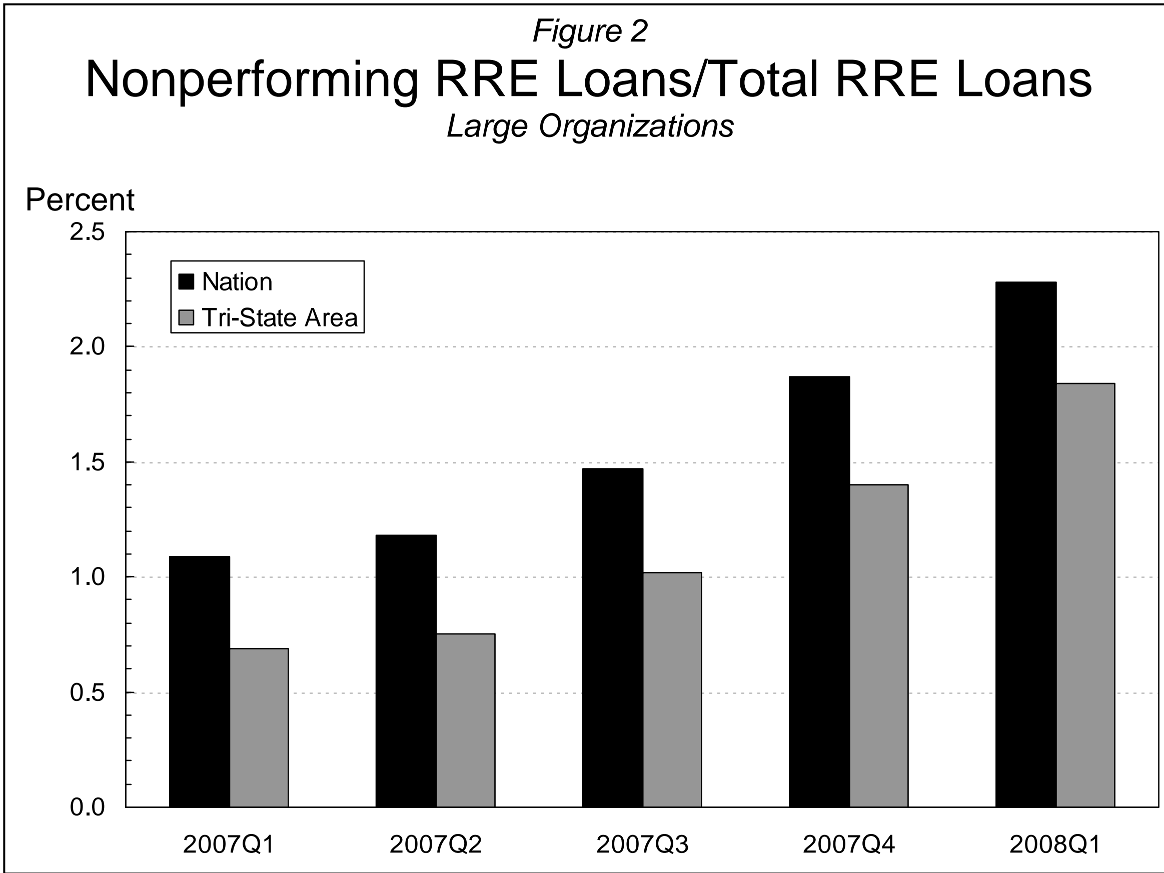


Figure 2
Nonperforming RRE Loans/Total RRE Loans
Large Organizations
Percent
2.5
2.0
1.5
1.0
0.5
0.0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

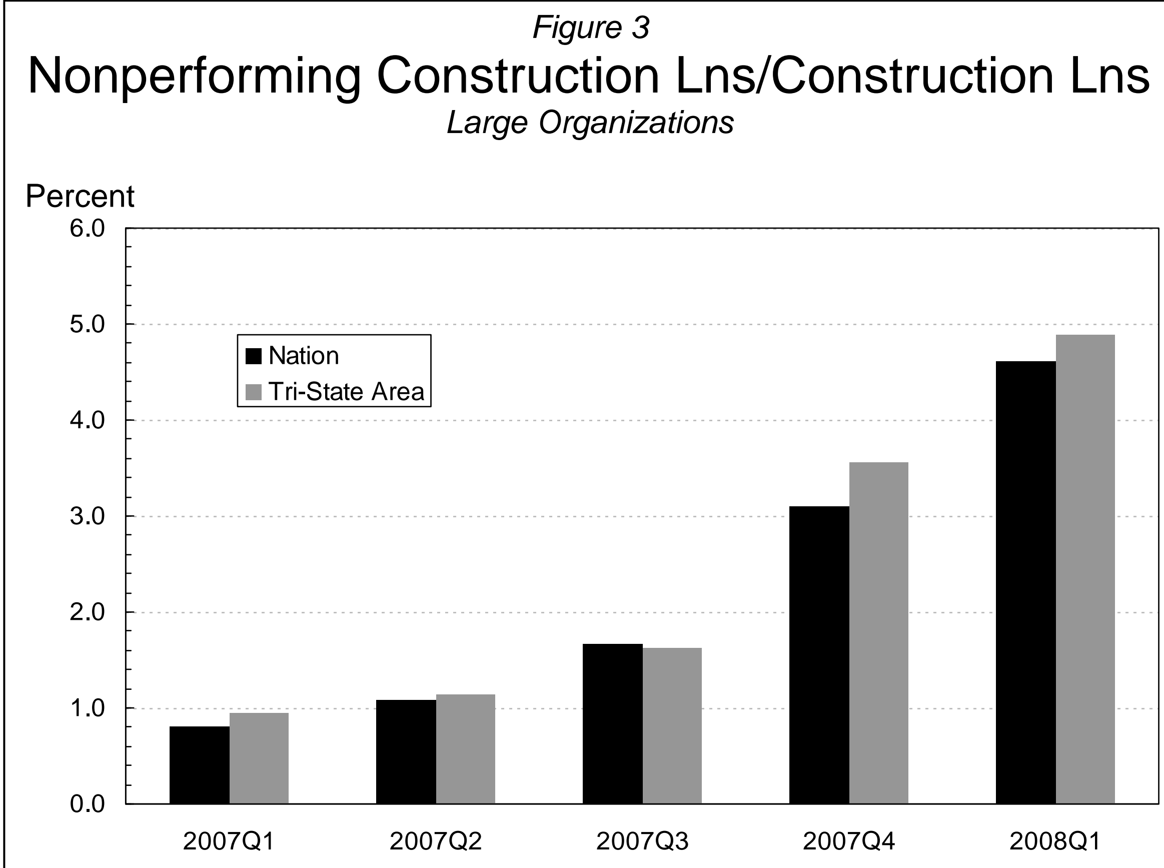
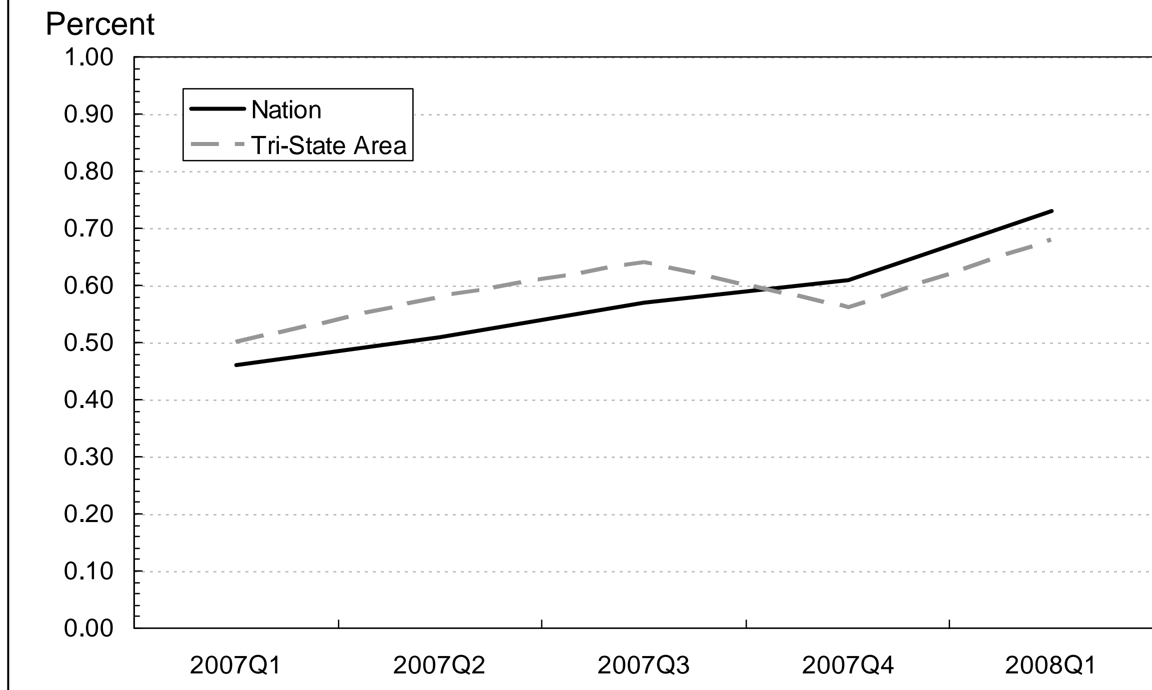


Figure 3
Nonperforming Construction Lns/Construction Lns
Large Organizations
Percent
6.0
5.0
4.0
3.0
2.0
1.0
0.0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1



respectively). Among the second lien mortgages, the nonperforming loan ratio was higher for closed-end loans than for home equity lines of credit. But it should be noted that when junior lien mortgages are charged off, the bank typically recovers nothing. When a first lien mortgage is charged off, part of the loan is usually recovered through foreclosure and sale.

Large organizations, both in the tri-state area and the nation, are also experiencing difficulties with CRE loans. The ratio of nonperforming CRE loans to total CRE loans increased from 1.66 percent to 2.38 percent nationwide in the first quarter. In the tri-state area, the increase was from 1.64 to 2.28 percent. In both cases, the vast majority of nonperforming CRE loans were construction loans. Construction loans make up about one-third of all CRE loans both locally and nationally, but they represent over 70 percent of nonperforming CRE loans. The nonperforming loan ratio among construction loans is more than twice that of all CRE loans, and it has continued to increase (Figure 3).

Net charge-offs continued to rise in the first quarter, both in levels and as a percent of average loans outstanding. The ratio of annual net charge-offs to average loans increased from 0.61 percent to 0.73 percent nationally and from 0.56 to 0.68 percent locally (Figure 4). Total quarterly net charge-offs at large organizations increased 23.2 percent nationally to $12.5 billion and 31.0 percent locally to $4.2 billion. For RRE loans, the rate of increase was much higher: 94.6 percent nationally, to $3.78 billion, and 157.9 percent locally, to $1.30 billion.

Nationally, among real estate loans most net charge-offs ($1.45 billion) are from HELOCs, followed by first mortgages ($1.36 billion); locally the largest segment is first mortgages ($553.4 million) followed by HELOCs ($499.3 million). In both cases the fastest growing category of net charge-offs is first mortgages, which increased 111.3 percent nationally and 159.5 percent locally. In a positive development, net charge-offs on CRE loans dropped substantially, showing a 94.8 percent decrease nationally and a 97.6 percent decrease locally. However, given the continued increase in nonperforming CRE loans discussed above, these lower charge-offs are unlikely to continue.

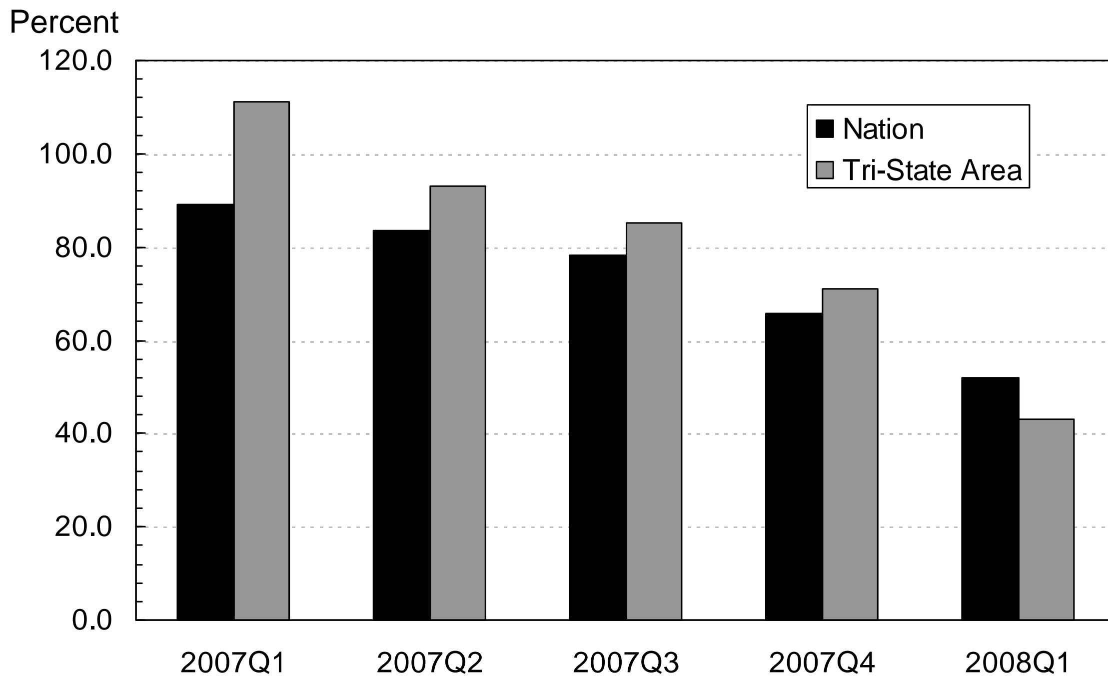


Figure 5
Net Charge-Offs/Loan-Loss Provision
Large Organizations
Percent
120.0
100.0
80.0
60.0
40.0
20.0
0.0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

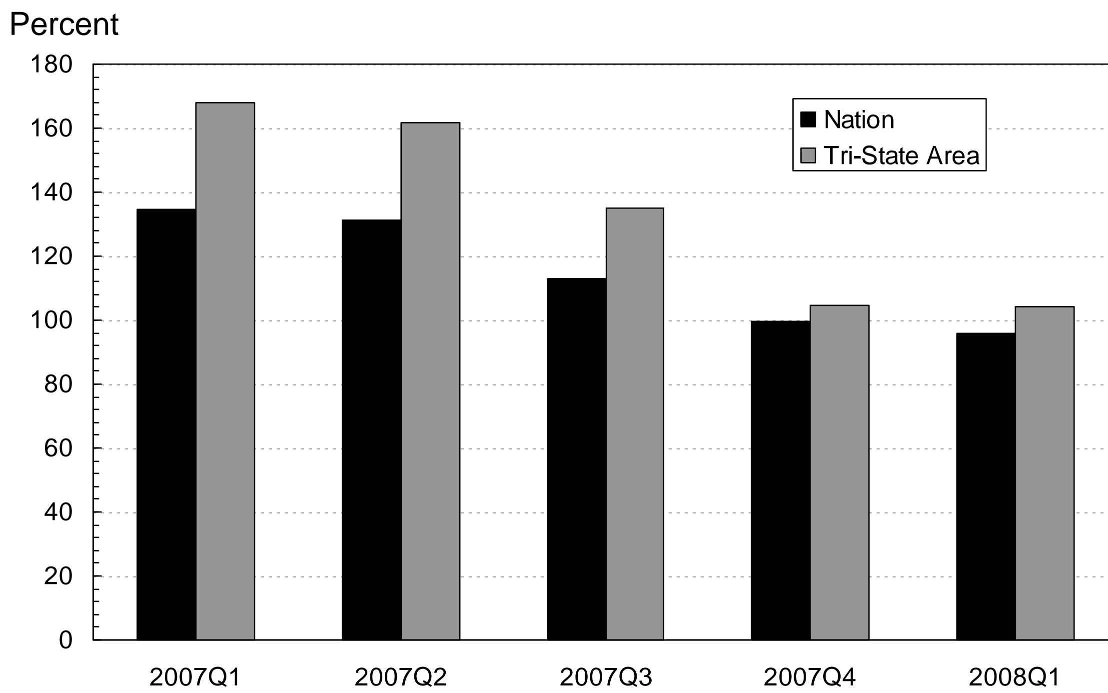
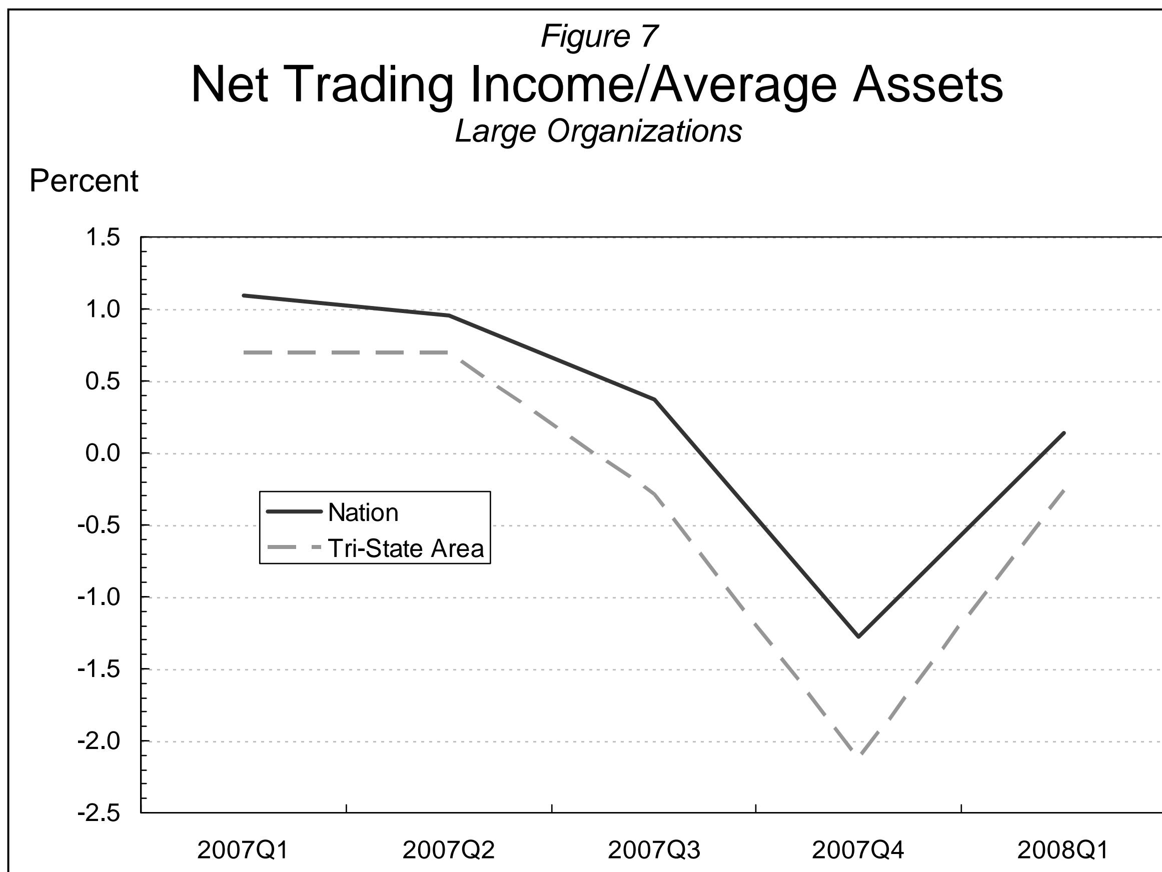


Figure 6
Loan-Loss Coverage Ratios
Large Organizations
Percent
180
160
140
120
100
80
60
40
20
0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1



On a managed loan basis, the numbers are much the same.[8] The ratio of nonperforming managed loans to total managed loans was 1.63 percent nationally and 1.48 percent locally. The numbers for RRE loans were 2.06 percent for the nation and 1.90 percent for the tri-state area; for mortgages they were 2.29 percent and 2.14 percent, respectively. At the same time, the ratio of annualized net charge-offs to average managed loans increased from 0.60 percent to 0.71 percent nationally and from 0.72 percent to 0.83 percent in the tri-state area.

While total nonperforming loans continued to increase, the rate of increase slowed in the first quarter. This was true both nationally and locally and for nearly every type of loan except commercial and industrial (C&I) loans. Additionally, as banks continue to increase their loan-loss provisioning and reserves, the ratio of net charge-offs to loan-loss provision has decreased dramatically (Figure 5).

Loan-loss reserves grew 18.9 percent nationally and 27.4 percent locally in the first quarter. Loan-loss coverage ratios continued to fall, but the rate of decline has slowed (Figure 6).[9] For banks in the nation, loan-loss coverage is below 100 percent for the second quarter in a row, and in the tri-state area this ratio is barely above 100 percent at 104.6 percent.[10] This indicates that further increases in loan-loss reserves are still necessary, which will have a negative impact on earnings for at least several more quarters.

As mentioned in the previous issue, much of the growth in assets has been in banks' trading accounts as assets, particularly mortgage-backed securities or

[8] Managed loans include outstanding balances of loans carried on a bank's balance sheet and loans securitized and sold with recourse. Therefore, managed loans include loans that, although banks no longer report them on their balance sheets, can still expose a bank to losses.

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

[10] For some historical perspective, the loan-loss coverage ratio for all commercial banks from 1997 to 2007 was 146.36 percent. However, at the bottom of the last real estate cycle in 1991, this ratio was 72.55 percent. Source: FDIC Historical Statistics on Banking: www2.fdic.gov/hsob/index.asp.

derivatives based on them, previously booked at unconsolidated affiliates are now being brought back onto the banks' balance sheets. This trend continued in the first quarter. Total trading assets grew 15.4 percent at banks nationwide and 23.1 percent at banks in the tri-state area. Trading assets now represent nearly 11 percent of assets at large banking organizations in the nation and 6.8 percent of assets at banks in the tri-state area.

It appears that not all assets being returned to the banks' balance sheets are nonperforming. Where losses on trading accounts were over $10 billion at banks in the nation in the fourth quarter of 2007, trading income was approximately $1.3 billion in the first quarter of 2008.[11] Banks in the tri-state area did not perform as well, but they reduced a $3.9 billion loss in the fourth quarter to a $521 million loss this quarter. As a percent of average assets, these numbers are now nearly zero (Figure 7). However, there may still be substantial unrealized losses on some securities.[12]

In summary, large organizations continue to experience problems with earnings due to asset quality both on and off balance sheet. Nonperforming loans continue to increase, but, for the first quarter in the past year, they did so at a decreasing rate. There was a large increase in net charge-offs as well. In the previous several quarters these institutions made substantial increases to their loan-loss reserves. But there remains at least some concern about potential future losses resulting from the off-balance-sheet activities of these institutions and their parent companies in previous quarters.

Community Banks

Community banks were more profitable than the large organizations, but they are not dealing as well with their problem loans. It also appears that community banks in the tri-state area are not as affected by the instability in the real estate markets as banks in the rest of the country. ROAA at community banks decreased from 1.01 to 0.91 percent in the nation and was basically flat at 0.92 percent in the tri-state area. Net interest margins remained relatively stable, as did the ratios of noninterest income and noninterest expense to average assets. The ratio of equity-to-assets dropped 12 basis points at banks in the tri-state area and dropped slightly nationwide. In both areas the vast majority of banks are still considered well-capitalized.

The main problem facing community banks continues to be increasing nonperforming loan ratios. The ratio of nonperforming loans to total loans increased nearly a full percentage point nationwide, from 1.32 percent to 2.25 percent. In the tri-state area the increase was half of that, from 1.15 percent to 1.64 percent. Total nonperforming loans increased 25.9 percent nationally and 15.3 locally. The ratio of nonperforming CRE loans to total CRE loans was 2.40 percent nationwide and 1.95 percent in the tri-state area (Figure 8). Also, nonperforming CRE loans increased 34.2 percent nationally in the first quarter and 15.7 percent locally.

The main reason for the disparity between tri-state area banks and banks nationwide is the composition of their CRE loan portfolios. At banks nationwide, CRE loans account for over 48 percent of all loans. In the tri-state area, this number is over 45 percent. However, nationally, construction loans account for nearly 36 percent of CRE loans, while locally these loans account for only 23 percent of CRE loans.[13] Additionally, construction loans at tri-state area banks seem to be performing somewhat better (Figure 9), though both sets of banks have performed dismally in this area. Nonperforming construction loans increased 44.2 percent in the first quarter nationally and grew 33.6 percent in the tri-state area. It appears that banks in the tri-state area experienced their problems sooner than banks in the nation as a whole, and problem

[11] Numbers on trading income exclude interest income.

[12] The most recent issue of the FDIC's *Quarterly Banking Profile* reports that changes in the call report line item "Other Comprehensive Income" (Schedule RI-A), which includes net unrealized gains (losses) on available-for-sale securities, were negative $12.1 billion in the first quarter. For further information, see www4.fdic.gov/qbp/2008mar/qbp.pdf.

[13] The three components of CRE lending break down as follows: for the nation – construction loans account for 35.8 percent of CRE loans, loans secured by multifamily properties are 6.0 percent, and 58.4 percent are loans secured by nonfarm, nonresidential properties. For the tri-state area, construction loans are 23.4 percent of CRE loans, loans secured by multifamily properties are 5.0 percent, and loans secured by nonfarm, nonresidential properties are 71.8 percent.

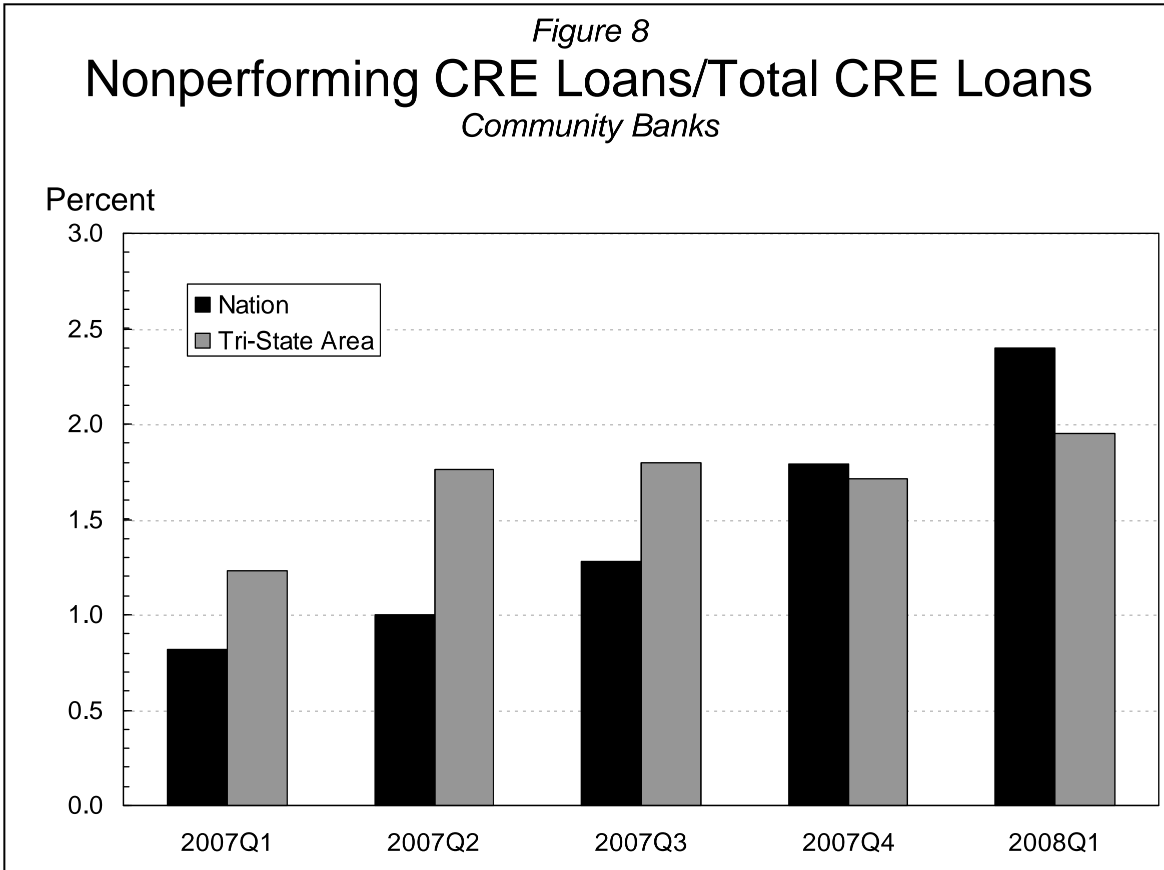


Figure 8
Nonperforming CRE Loans/Total CRE Loans
Community Banks
Percent
3.0
2.5
2.0
1.5
1.0
0.5
0.0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

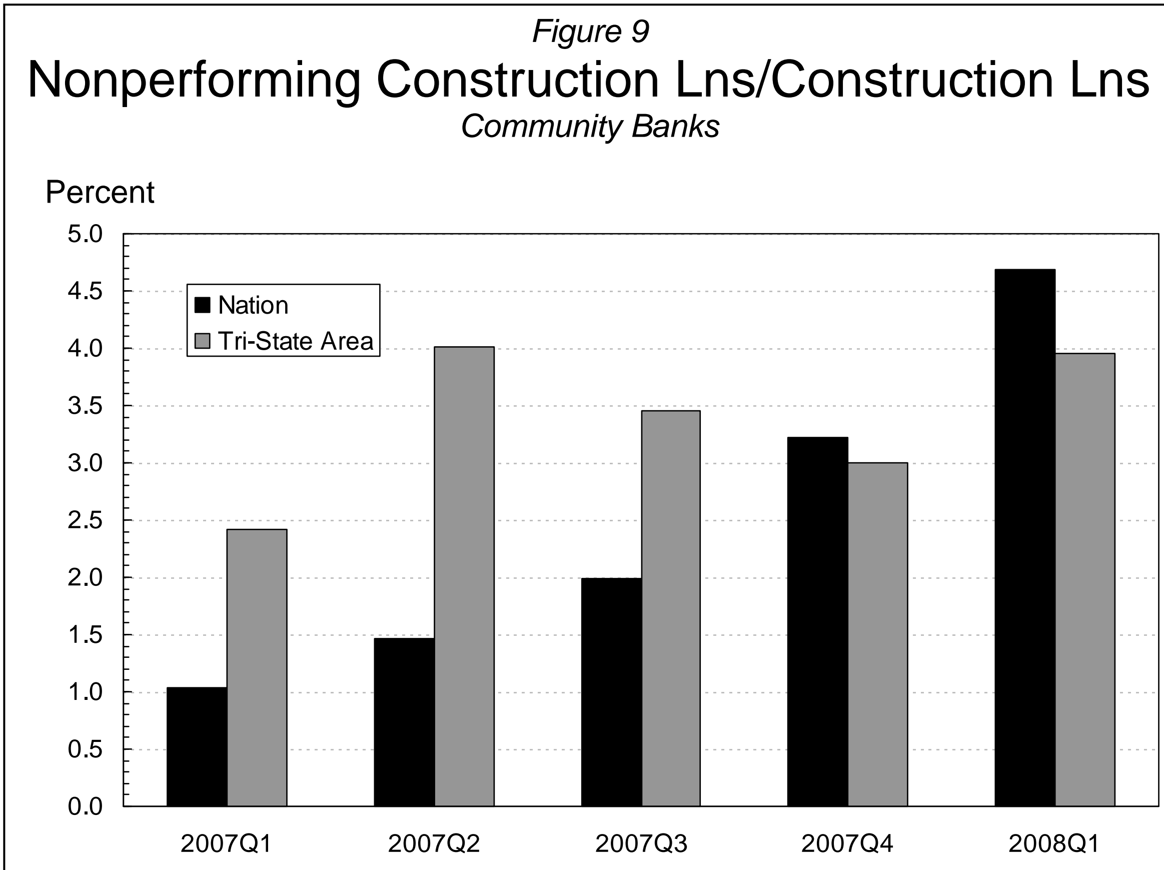


Figure 9
Nonperforming Construction Lns/Construction Lns
Community Banks
Percent
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

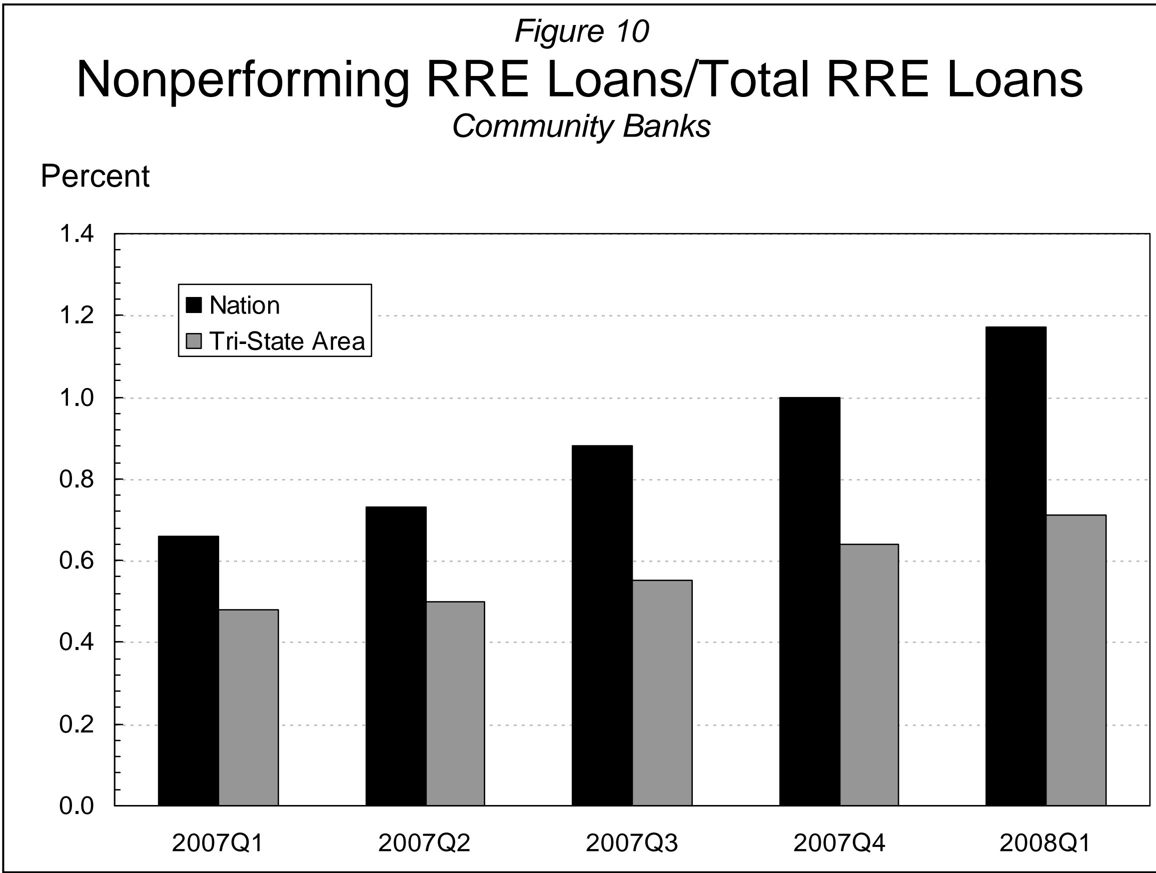


Figure 10
Nonperforming RRE Loans/Total RRE Loans
Community Banks
Percent
1.4
1.2
1.0
0.8
0.6
0.4
0.2
0.0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

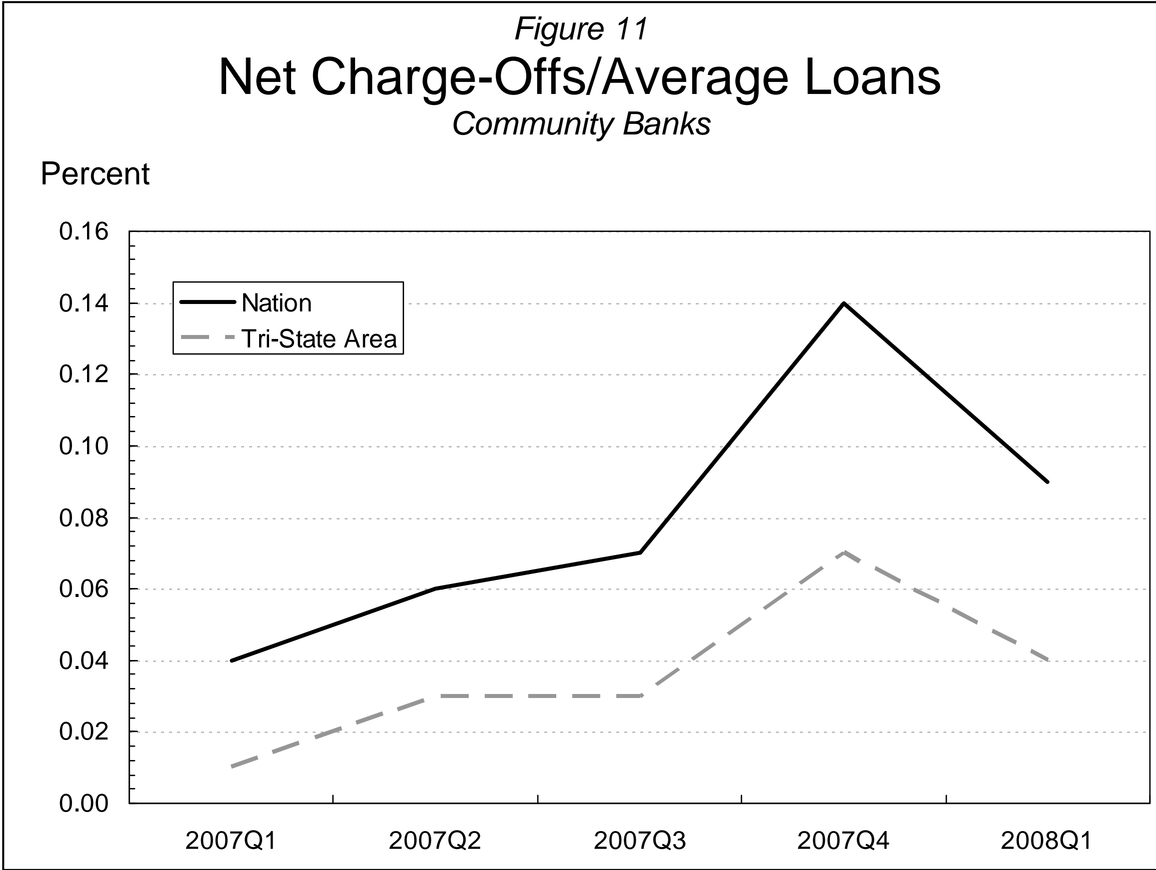


Figure 11
Net Charge-Offs/Average Loans
Community Banks
Percent
0.16
0.14
0.12
0.10
0.08
0.06
0.04
0.02
0.00
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

construction loans at banks nationally have now caught up to those at tri-state area banks.

Tri-state area banks are also doing better than their national counterparts on RRE loans. The most likely reason for this is the nature of the local residential real estate markets. This region experienced a smaller increase in housing prices in earlier years, and, so far, home prices have fallen only slightly in the tri-state area.[14] RRE loans make up a significantly higher proportion of local banks' portfolios, roughly one-third compared to one-fourth nationwide. In the first quarter, the ratio of nonperforming RRE loans to total RRE loans was 1.26 percent nationally and 0.71 percent locally (Figure 10). Nonperforming RRE loans grew 21 percent nationally and 31.6 percent locally. These rates of increase are also slower than those in the fourth quarter of 2007.

Net charge-offs decreased substantially in all loan categories both nationally and locally in the first quarter, resulting in a decrease in the ratio of net charge-offs to average loans (Figure 11). Net charge-offs shrank 34.2 percent nationally, to $1.15 billion, and 48.9 percent locally, to $16.7 million. Tri-state area banks had zero net charge-offs on CRE loans in the first quarter, while banks nationally had $26.6 million, a decline of 96 percent.

However, it does not appear that the community banks are provisioning enough given that nonperforming loans are still increasing. While the ratio of net charge-offs to loan-loss provision is dropping (Figure 12), the drop is not as steep as that for the larger banks. Also, the ratio of loan-loss provision to operating income remains low compared to the larger banks (Figure 13).

There is evidence that community banks need to substantially increase their provisioning at the expense of earnings. A worrying number is the loan-loss coverage ratio for these institutions (Figure 14). Both locally and nationally this number is well below 100 percent, meaning they do not have reserves sufficient to cover charging off all of the nonperforming loans they currently hold. In the case of banks nationally, this ratio is now below 80 percent. Since nonperforming loans are still rising, these institutions are under-reserved.

Additionally, community banks locally and nationally continue to pay dividends at the expense of reserves. The dividend payout ratio of these institutions has barely changed in the past year, and it actually rose this quarter at banks nationally (Figure 15).[15] At the same time, however, a decreasing number of small banks are paying dividends. Roughly 3,300 community banks nationwide had positive dividends in the first quarter, down from over 5,100 in the fourth quarter of 2007. Locally, 90 institutions continued to pay dividends, a decrease of 20 from the fourth quarter of 2007. Thus it seems that although a smaller number of institutions are increasing their dividends, those that are have increased them substantially enough to offset the cuts at the other institutions.

Thus, there was some improvement in the situation for community banks this quarter. For instance, nonperforming loans had a smaller increase than in the previous several quarters and less than the increase at larger banks. Also, net charge-offs decreased, if only temporarily. However, given that the problems with CRE lending are not over, and that more provisioning is needed, it is difficult to see community banks continuing at their current level of profitability.

[14] The Office of Federal Housing Enterprise Oversight publishes a number of state and national indices of housing prices. For further information see www.ofheo.gov/hpi.aspx?Nav=335.

[15] The dividend payout ratio is defined as the ratio of dividends on common stock to net income.

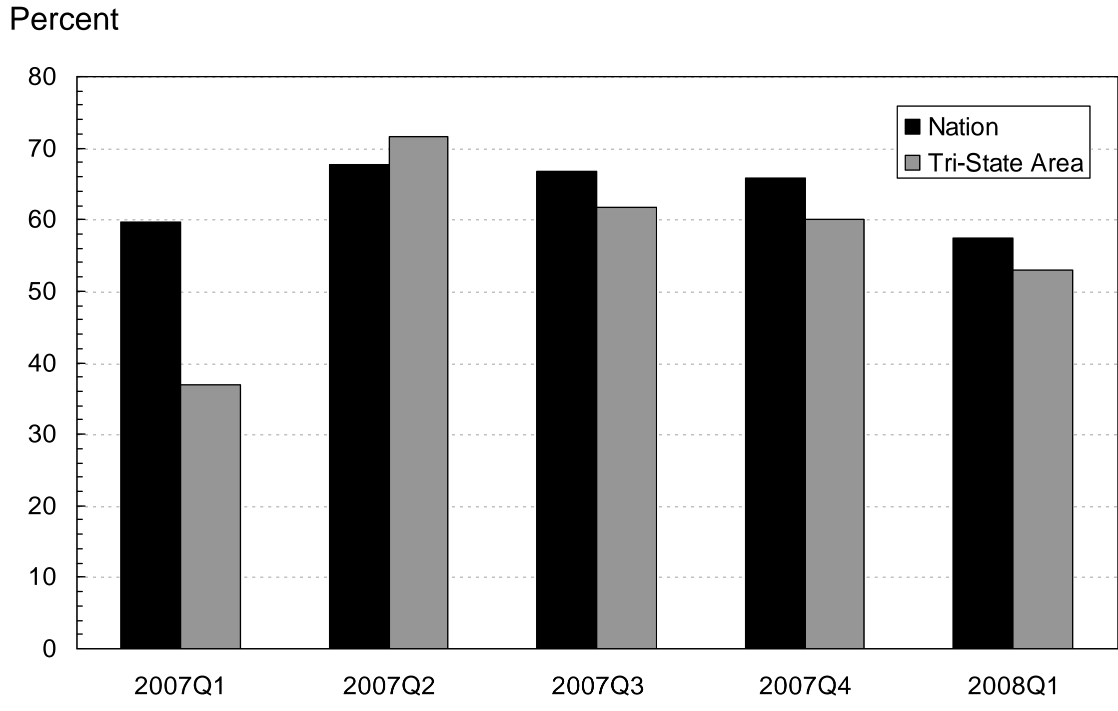


Figure 12
Net Charge-Offs/Loan Loss Provision
Community Banks
Percent
80
70
60
50
40
30
20
10
0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

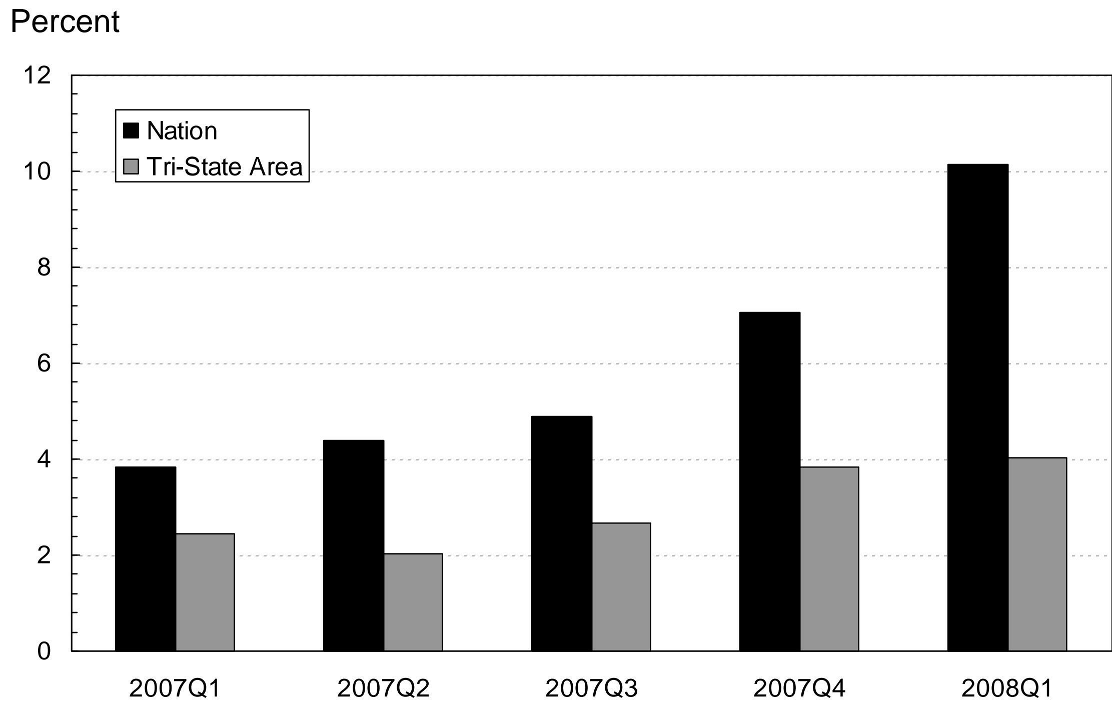


Figure 13
Loan-Loss Provision/Operating Income
Community Banks
Percent
12
10
8
6
4
2
0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

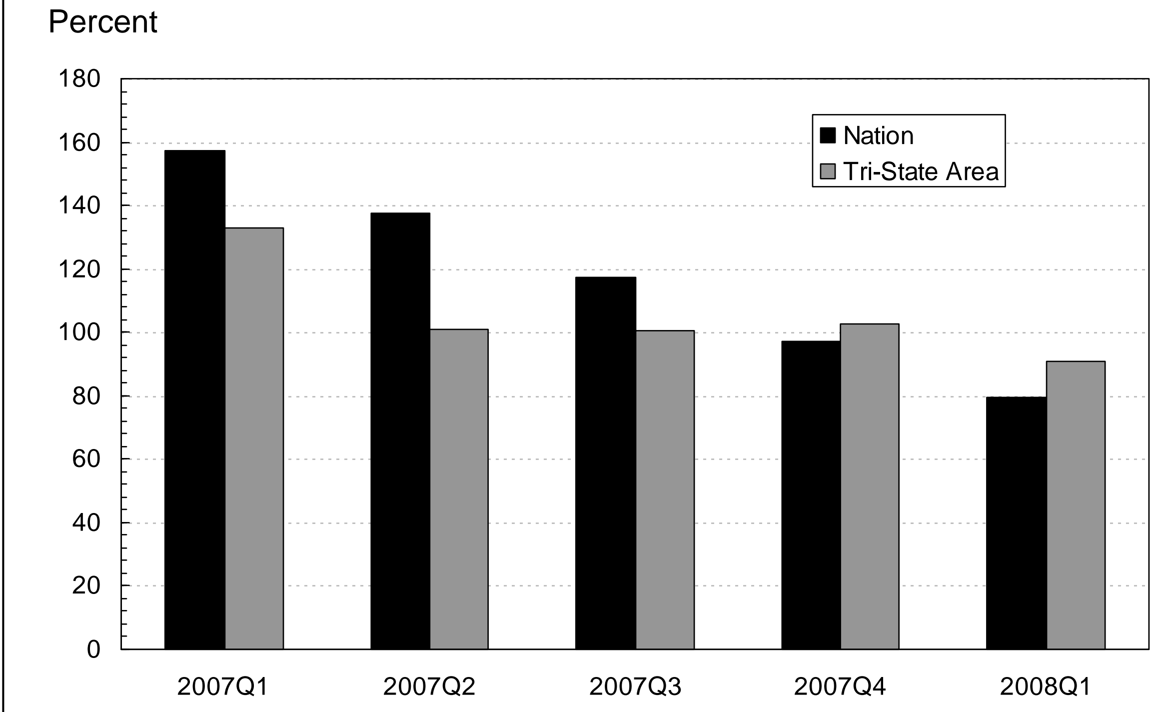


Figure 14
Loan-Loss Coverage Ratio
Community Banks
Percent
180
160
140
120
100
80
60
40
20
0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

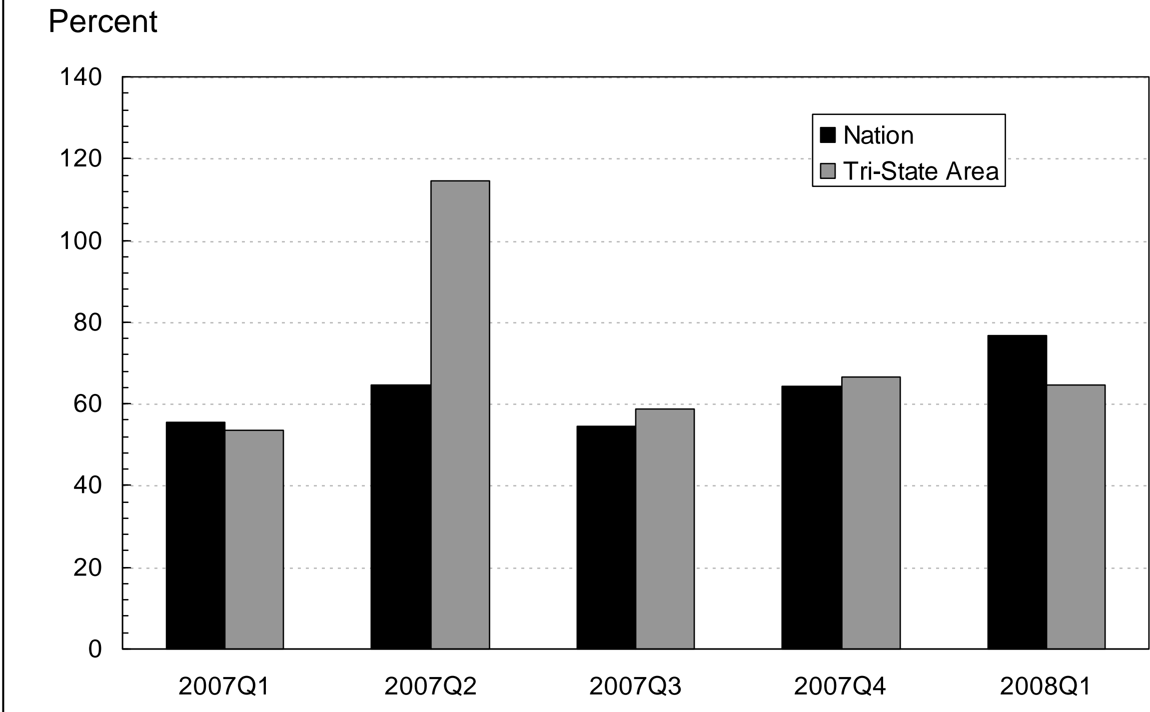


Figure 15
Dividend Payout Ratio
Community Banks
Percent
140
120
100
80
60
40
20
0
Nation
Tri-State Area
2007Q1
2007Q2
2007Q3
2007Q4
2008Q1

First Quarter 2008

Community Banking Organizations

	Tri-State			*Nation*		
	$ Bill	**% Change From**		**$ Bill**	**% Change From**	
	08Q1	**07Q4**	**07Q1**	**08Q1**	**07Q4**	**07Q1**
Total Assets	83.2	8.54	5.71	1,761.3	9.21	7.85
Total Loans	56.7	5.99	6.57	1,240.8	7.00	9.23
Business	7.3	6.28	1.30	196.3	9.55	10.03
Real Estate	45.2	5.63	7.48	921.7	8.76	10.00
Consumer	2.1	-5.12	-1.56	63.3	-6.60	0.57
Total Deposits	65.2	7.51	3.49	1,393.6	7.64	5.20
Ratios (in %)	**08Q1**	**07Q4**	**07Q1**	**08Q1**	**07Q4**	**07Q1**
Net Income/Avg Assets (ROA)	0.92	0.93	0.97	0.91	1.01	1.19
Net Interest Inc/Avg Assets (NIM)	3.16	3.17	3.31	3.61	3.66	3.79
Noninterest Inc/Avg Assets	1.37	1.37	1.41	0.94	0.94	0.95
Noninterest Exp/Avg Assets	3.16	3.16	3.18	2.97	2.95	2.94
Loans/Deposits	86.87	87.18	84.35	89.04	89.17	85.75
Equity/Assets	9.87	9.99	9.99	10.25	10.28	10.24
Nonperforming Loans/Total Loans	1.64	1.15	1.09	2.25	1.32	0.92

Large Banking Organizations

	Tri-State			*Nation*		
	$ Bill	**% Change From**		**$ Bill**	**% Change From**	
	08Q1	**07Q4**	**07Q1**	**08Q1**	**07Q4**	**07Q1**
Total Assets	3,037.5	12.10	16.77	8,919.8	14.34	14.47
Total Loans	1,669.1	7.43	13.55	4,882.5	4.79	12.00
Business	367.6	14.56	16.67	1,129.9	13.97	21.09
Real Estate	963.1	-0.29	9.68	2,602.9	-0.46	6.26
Consumer	151.4	51.86	22.03	617.0	14.92	16.96
Total Deposits	1,928.2	1.91	11.61	5,666.0	5.73	11.36
Ratios (in %)	**08Q1**	**07Q4**	**07Q1**	**08Q1**	**07Q4**	**07Q1**
Net Income/Avg Assets (ROA)	0.60	0.83	1.21	0.65	0.81	1.15
Net Interest Inc/Avg Assets (NIM)	2.36	2.38	2.48	2.57	2.57	2.60
Noninterest Inc/Avg Assets	1.46	1.59	1.97	1.69	1.81	2.07
Noninterest Exp/Avg Assets	2.43	2.50	2.55	2.71	2.78	2.77
Loans/Deposits	86.56	85.43	85.09	86.17	86.37	85.68
Equity/Assets	10.22	10.30	10.12	9.43	9.62	9.52
Nonperforming Loans/Total Loans	1.93	1.05	0.55	2.15	1.28	0.87

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, 2007. 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 5661 for the nation; (2) large banking organizations — 17 for the tri-state area and 98 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 at www.philadelphiafed.org/econ/bb/index.html. To subscribe to this publication, please go to www.philadelphiafed.org/philscriber/user/dsp_content.cfm.