BANKING BRIEF
FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

First Quarter 2010

Profitability at large banks continued to improve in the first quarter, while community banks continued to experience net losses. However, in many ways the community banks are in better condition than the larger banks. Nonperforming loans (NPLs) as a percent of total loans (the NPL ratio) increased 21 basis points at large organizations, to 6.31 percent. For community banks, this ratio increased 13 basis points nationally, to 4.02 percent; and it increased by 17 basis points locally, to 2.97 percent.[1] Bank failures continued to increase. The Federal Deposit Insurance Corporation reported 41 failures in the first quarter.[2] This is compared with 21 failures in the first quarter of 2009 and 141 failures for all of 2009. There have also been an additional 42 failures in the second quarter as of June 18, 2010. None of these failures were located in the tri-state area.

At large organizations, return on average assets (ROAA) increased 7 basis points, to 0.21 percent.[3] The number of firms reporting losses decreased from 41 to 27 in the quarter. Net interest margins increased slightly, to 2.83 percent. Net charge-offs (NCOs) decreased for the first time in several quarters (Figure 1). Given that NPLs continued to increase both overall and as a percentage of total loans, it is unknown whether this decrease in NCOs is the start of a trend. Most of the large organizations' problems are in real estate loans, with both residential real estate (RRE) loans and commercial real estate (CRE) loans showing continued weakness.[4] Capital ratios increased from 10.46 to 10.62 percent. Much of this growth was due to retained earnings, which increased at an annualized rate of 18.6 percent in the first quarter. The number of firms reporting an equity-to-assets ratio of at least 7 percent increased from 89 to 91, and the number of firms

[1] See Summary Table on Bank Structure and Conditions below. Nonperforming loans are defined as loans past due 90 or more days plus nonaccruing loans. For historical perspective, the nonperforming loan ratio for all commercial banks between 1998 and 2008 was 1.25 percent. At the bottom of the last real estate cycle in 1991, this ratio was 3.80 percent. Source: FDIC Historical Statistics on Banking: http://www2.fdic.gov/hsob/index.asp.

[2] Source: FDIC failed bank list: http://www.fdic.gov/bank/individual/failed/banklist.html.

[3] Unless otherwise noted, all data presented here are from Federal Financial Institutions Examination Council (FFIEC) call reports. All ratios are aggregates; that is, the numerator and denominator are summed over all banks in the sample, then divided. All quarterly changes are annualized (unless otherwise noted), and income statement items, except those in the table on page 2, are for the quarter only.

[4] RRE loans are defined as the sum of mortgages on one-four family properties secured by first liens, mortgages secured by junior liens, and home equity lines of credit (HELOCs). CRE loans are defined as the sum of construction and land development loans (both residential and commercial properties), loans secured by multifamily properties, and loans secured by nonfarm, nonresidential properties.

Summary Table of Bank Structure and Conditions – First Quarter 2010

Community Banking Organizations

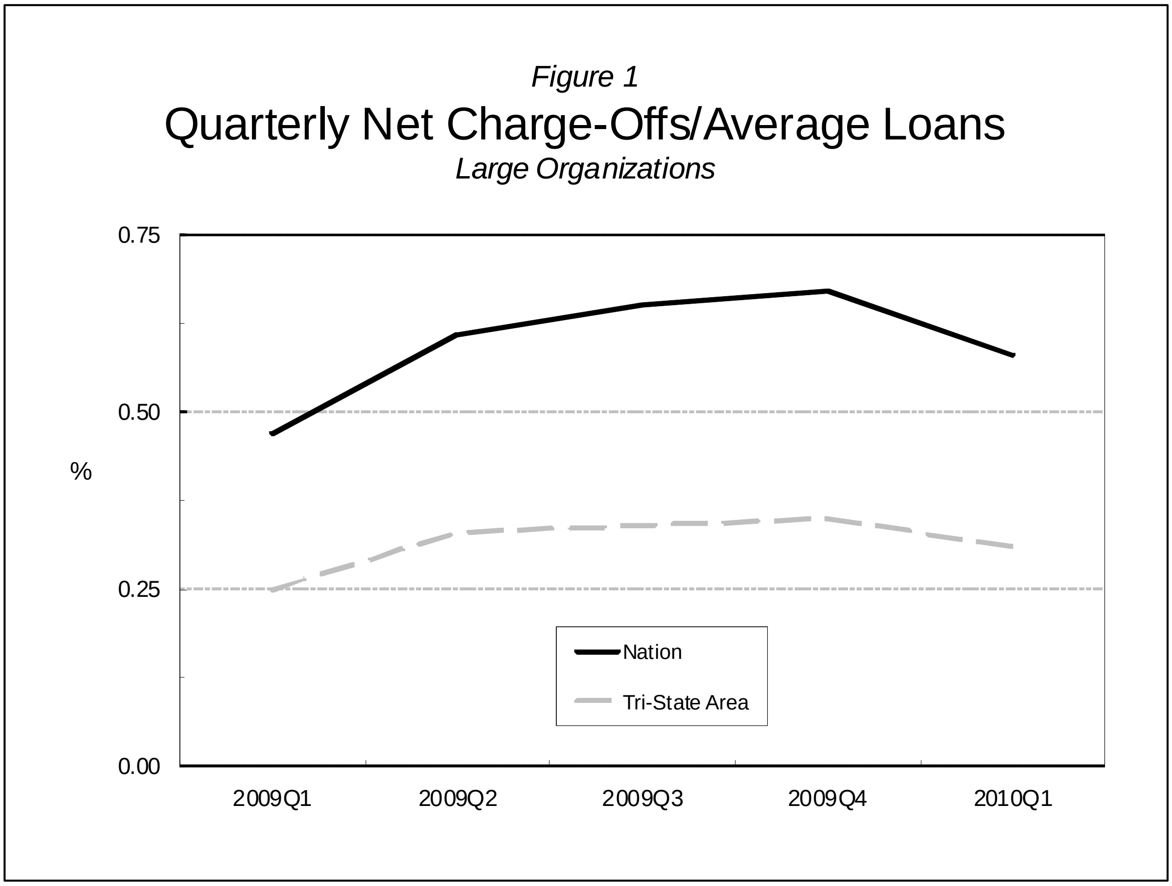
	Tri-State			***Nation***		
	$ Bill	**% Change From**		**$ Bill**	**% Change From**	
	10Q1	**09Q4**	**09Q1**	**10Q1**	**09Q4**	**09Q1**
Total Assets	94.6	4.23	5.70	1,838.0	-0.47	-2.26
Total Loans	63.5	-1.24	2.05	1,221.4	-7.51	-6.76
Business	8.2	-5.52	-1.28	181.1	-8.35	-8.49
Real Estate	51.1	-0.71	2.98	922.2	-6.08	-6.59
Consumer	2.3	-10.52	0.36	57.9	-13.89	-7.91
Total Deposits	77.4	6.43	8.77	1,514.3	1.44	0.04
Ratios (in %)	**10Q1**	**09Q4**	**09Q1**	**10Q1**	**09Q4**	**09Q1**
Net Income/Avg Assets (ROA)	-0.13	-0.18	0.30	-0.21	-0.27	-0.15
Net Interest Inc/Avg Assets (NIM)	3.17	3.14	3.20	3.26	3.23	3.25
Noninterest Inc/Avg Assets	1.16	1.17	1.17	0.89	0.89	0.80
Noninterest Exp/Avg Assets	3.55	3.55	3.12	3.11	3.11	3.01
Loans/Deposits	81.97	83.52	87.37	80.66	82.54	86.54
Equity/Assets	9.56	9.47	9.56	9.90	9.76	9.95
Nonperforming Loans/Total Loans	2.97	2.80	2.07	4.02	3.89	3.37

Large Banking Organizations

	Tri-State			***Nation***		
	$ Bill	**% Change From**		**$ Bill**	**% Change From**	
	10Q1	**09Q4**	**09Q1**	**10Q1**	**09Q4**	**09Q1**
Total Assets	623.2	-1.99	-2.26	9,031.1	1.05	0.13
Total Loans	351.0	-2.86	-2.78	4,634.7	-2.58	-3.19
Business	71.4	-8.81	-17.01	868.6	-13.42	-19.02
Real Estate	207.8	-3.97	0.99	2,694.3	-5.98	0.94
Consumer	43.1	19.41	10.47	637.4	24.40	6.63
Total Deposits	450.6	-4.01	2.81	6,249.7	-2.51	5.12
Ratios (in %)	**10Q1**	**09Q4**	**09Q1**	**10Q1**	**09Q4**	**09Q1**
Net Income/Avg Assets (ROA)	0.43	0.40	0.30	0.21	0.14	0.06
Net Interest Inc/Avg Assets (NIM)	3.17	3.11	2.17	2.83	2.79	2.43
Noninterest Inc/Avg Assets	2.07	2.07	1.30	2.05	2.07	1.64
Noninterest Exp/Avg Assets	3.07	3.04	2.14	2.86	2.84	2.70
Loans/Deposits	77.89	77.66	82.36	74.16	74.17	80.52
Equity/Assets	11.51	11.15	10.00	10.62	10.46	9.56
Nonperforming Loans/Total Loans	6.25	5.96	3.50	6.31	6.10	3.84

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 special purpose banks such as credit card banks 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, 2009. The community banking organization sample is based on the remaining banking organizations. Tri-state large banking organizations are the balance sheet or income statement items of large banking organizations that have deposits in the region weighted by the percentage 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 — 185 for the tri-state area and 5,668 for the nation; (2) large banking organizations — 26 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 at www.philadelphiafed.org/research-and-data/publications/banking-brief. To subscribe to this publication, please go to www.philadelphiafed.org/philscriber/user/dsp_content.cfm.



reporting an equity-to-assets ratio of less than 6 percent decreased from six to four.[5] Total loans and deposits decreased slightly in the quarter, although there was a substantial increase in consumer lending.

Tri-state area community banks are still in somewhat better condition than banks nationally, but both continued to experience aggregate losses in the first quarter. Locally, ROA was -0.13 percent, up 5 basis points from the fourth quarter of 2009; while nationally, ROA was -0.21 percent, an improvement of 6 basis points from the previous quarter. Net interest margins were basically flat both locally and nationally, while loans dropped in all categories, and deposits increased in both areas. Community banks both locally and nationally continued to have two main problems: CRE loans and loan-loss provisioning. Nonperforming CRE loans increased both locally and nationally after falling for the past couple of quarters, while the need to build up reserves slows the banks' ability to charge off bad loans and hampers profitability.

[5] Regulation Y defines an institution as well capitalized if it has a total capital-to-assets ratio of above 7 percent and as undercapitalized if this ratio is less than 6 percent. While total equity and regulatory capital are not identical, they are close proxies. For further information on capital guidelines, see http://www.federalreserve.gov/bankinforeg/reglisting.htm#Y.

Residential Real Estate Lending

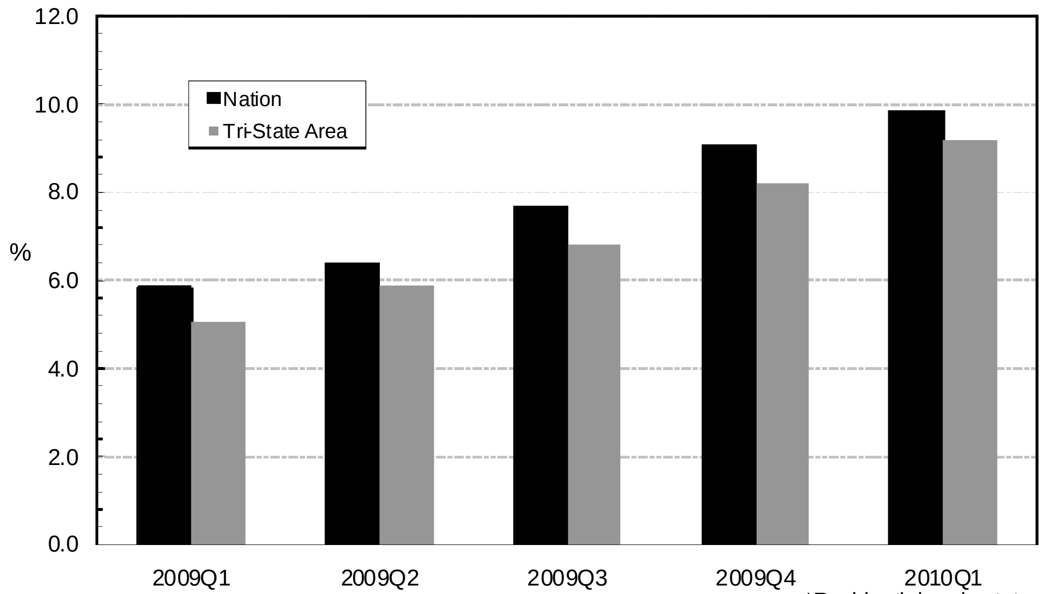
Figure 2
Summary of Residential Real Estate Lending

	Large Organizations	Community Banks	
Nation		Tri-State Area	Nation
Total RRE Loans ($Millions)	1,709,566.4	20,532.6	295,602.2
Change from Last Quarter	-5.5	-2.7	-4.4
Change from Last Year	4.3	-0.6	-2.2
Pct. of Total Loans	36.9	32.3	24.2
Nonperforming RRE Loans	168,027.7	388.1	7,912.3
Change from Last Quarter	31.1	31.5	8.3
Change from Last Year	75.4	62.4	33.2
Pct. of Nonperforming Loans	57.5	20.6	16.1
Nonperforming RRE/RRE Lns	9.83	1.89	2.68
Net RRE Charge-offs	11,782.6	16.9	538.1
Change from Last Quarter	6.1	-64.3	-80.9
Change from Last Year	36.1	102.8	37.8
Pct. of Net Charge-offs	42.9	17.5	15.7
Pct. of Avg. RRE loans	0.70	0.08	0.18

RRE loans continue to drag down asset quality, particularly at large organizations where they represent about 37 percent of total loans but 57.5 percent of NPLs and 42.9 percent of NCOs (Figure 2). The ratios of nonperforming RRE loans to total RRE loans and NCOs on RRE loans to average RRE loans are already very high, and they continue to rise steadily (Figures 3 and 4). The primary problem at large organizations is mortgages, which represent about 68 percent of their RRE loans but 94.1 percent of nonperforming RRE loans.

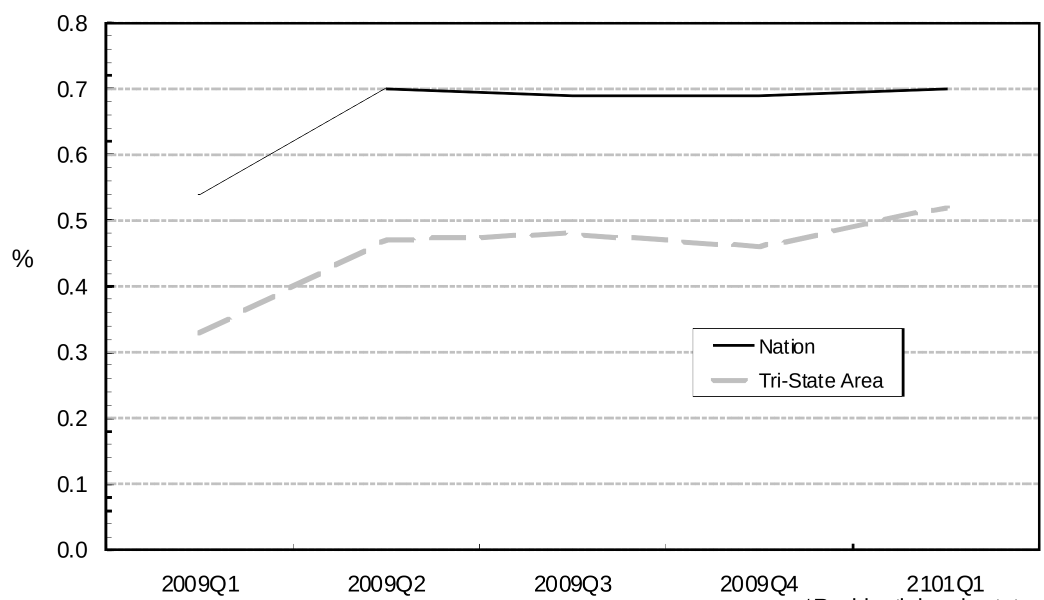
At community banks, the situation is much better, but the condition of RRE loans is still worsening at local community banks (Figure 5). Note that NPLs at local community banks have been increasing at rates similar to large organizations, both quarterly and annually, but the growth rate nationally is much smaller. Also, while RRE NCOs at local banks decreased in the first quarter, they've more than doubled since last year.

Figure 3
Nonperforming RRE* Loans/Total RRE Loans
Large Organizations

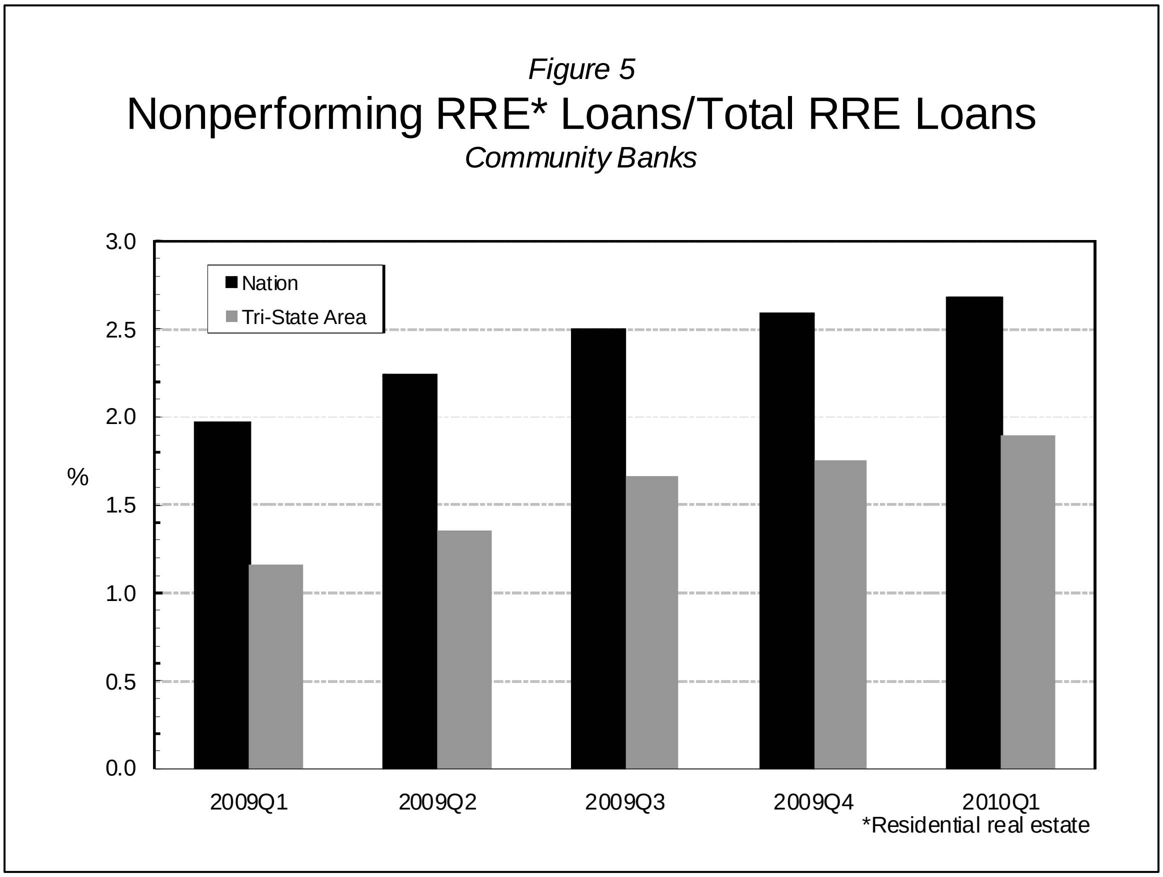


*Residential real estate

Figure 4
Net Charge-Offs on RRE* Lns/Avg RRE Lns
Large Organizations



*Residential real estate



Commercial Real Estate Lending

Figure 6
Summary of Commercial Real Estate Lending

	Large Organizations	Community Banks	
Nation		Tri-State Area	Nation
Total CRE Loans ($Millions)	905,869.9	30,027.6	578,031.5
Change from Last Quarter	-7.3	0.6	-7.5
Change from Last Year	-4.8	5.4	-9.5
Pct. of Total Loans	19.6	47.3	47.3
Nonperforming CRE Loans	74,894.2	1,282.2	34,527.5
Change from Last Quarter	9.6	21.3	6.0
Change from Last Year	63.1	49.0	2.6
Pct. of Nonperforming Loans	25.6	68.0	70.3
Nonperforming CRE/CRE Lns	8.27	4.27	5.97
Net CRE Charge-offs	5,686.4	53.7	2,008.9
Change from Last Quarter	-65.0	-88.3	-92.9
Change from Last Year	63.6	39.7	11.2
Pct. of Net Charge-offs	20.7	55.7	58.6
Pct. of Avg. CRE loans	0.61	0.18	0.33

CRE loans have been a problem at community banks for several years, but now they are an even bigger problem for large organizations as well (Figure 6). The main problem with CRE lending continues to be construction and land development loans. At large organizations, these loans represent 26.4 percent of all CRE loans but 57.0 percent of nonperforming CRE loans and 65.8 percent of NCOs on CRE loans. The NPL ratio for construction loans is nearly 18 percent at large organizations and has nearly doubled in the past year (Figure 7).

At community banks, construction loans represent 18.0 percent of CRE loans in the tri-state area and 23.7 percent nationally, but they account for 64.4 and 56.6 percent of CRE NPLs, respectively, and 48.8 and 60.7 percent of CRE NCOs, respectively. If not for construction loans, the NPL ratio on CRE loans would be a little more than half of what it is now. The NPL ratio at community banks is now 11 percent locally and over 14 percent nationally, and it has shown a substantial increase in the tri-state area in the past several quarters (Figure 8).

The largest part of CRE lending is commercial mortgages, representing about 60 percent of CRE loans at large organizations but over 75 percent of all CRE loans at local community banks and about 70 percent nationally. Nationally, the commercial mortgage NPL ratio was 3.31 percent in the first quarter, an increase of 29 basis points (Figure 9). Locally, this ratio was nearly flat at 2.82 percent. Since commercial mortgages represent such a large portion of total lending at community banks, as long as NPLs in this category continue to rise, the condition of community banks will not likely improve substantially.

Figure 7

Nonperforming Construction Lns/Construction Lns

Large Organizations

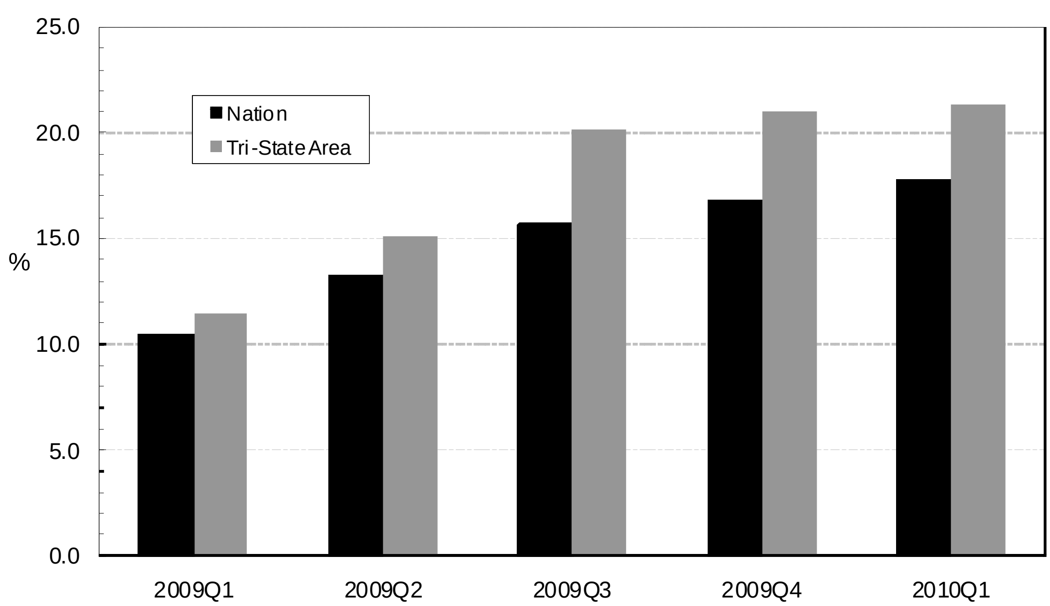


Figure 8

Nonperforming Construction Lns/Construction Lns

Community Banks

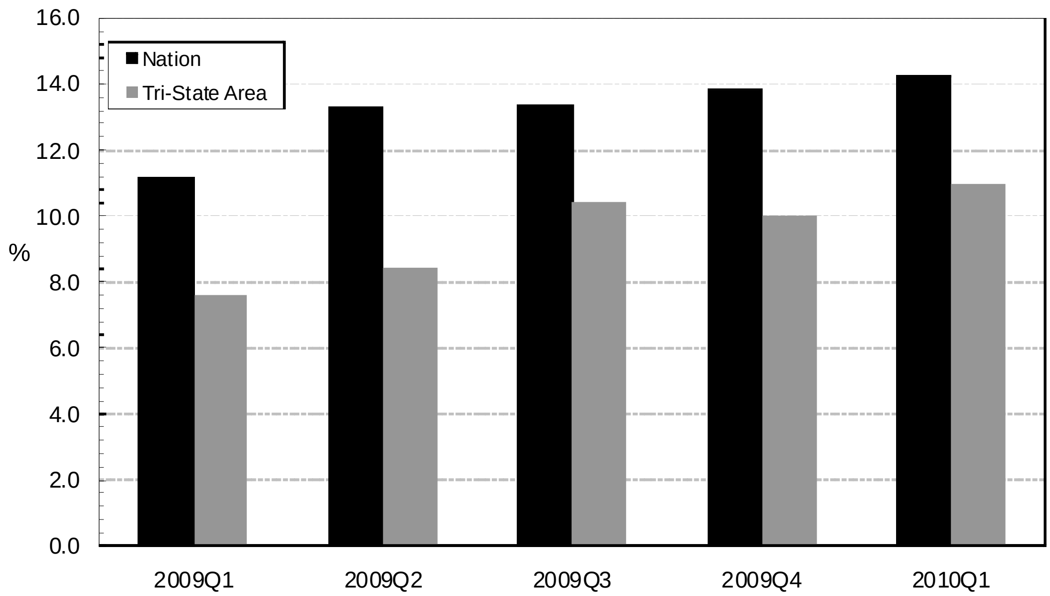
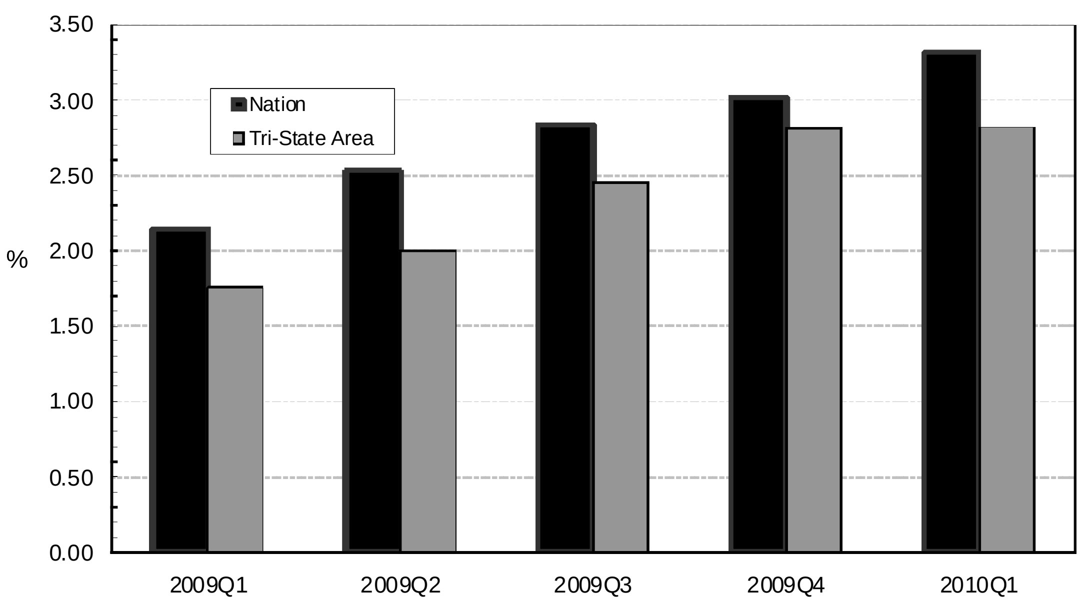


Figure 9

Nonperforming Commercial Mortgages/ Commercial Mortgages

Community Banks



Commercial & Industrial Lending

Figure 10
Summary of Commercial and Industrial Loans

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Total C&I Loans ($Millions)	868,610.3	8,214.4	181,123.9
Change from Last Quarter	-13.4	-5.5	-8.4
Change from Last Year	-19.0	-1.3	-8.5
Pct. of Total Loans	18.7	12.9	14.8
Nonperforming C&I Loans	28,323.0	156.3	4,434.2
Change from Last Quarter	-47.5	28.5	11.1
Change from Last Year	23.1	4.9	12.9
Pct. of Nonperforming Loans	9.7	8.3	9.0
Nonperforming C&I/C&I Lns	3.30	1.90	2.45
Net C&I Charge-offs	3,561.4	20.6	696.9
Change from Last Quarter	-76.7	-91.2	-91.7
Change from Last Year	-16.1	11.1	7.7
Pct. of Net Charge-offs	13.0	21.3	20.3
Pct. of Avg. C&I loans	0.37	0.25	0.37

Commercial and industrial (C&I) loans are performing much better than real estate loans, and for the most part, their condition is stable (Figure 10). At large organizations, the C&I NPL ratio actually decreased 44 basis points from the fourth quarter of 2009 to the first quarter of 2010, although it has increased substantially in the past year. The C&I NCO ratio also decreased 14 basis points. At community banks, the NPL ratio increased 12 basis points nationally and 14 locally, while the C&I NCO ratios both dropped, by 30 and 20 points, respectively. However, at both large and small banks, C&I loans continued to drop substantially.

Consumer Lending

Figure 11
Summary of Consumer Lending

	Large Organizations	Community Banks	
Nation		Tri-State Area	Nation
Total Co. Loans ($Millions)	637,376.1	2,257.4	57,877.9
Change from Last Quarter	24.4	-10.5	-13.9
Change from Last Year	6.6	0.4	-7.9
Pct. of Total Loans	13.8	3.6	4.7
Nonperforming Co. Loans	11,377.7	15.2	425.5
Change from Last Quarter	7.2	157.3	-41.1
Change from Last Year	13.7	42.1	-4.6
Pct. of Nonperforming Loans	3.9	0.8	0.9
Nonperforming Co./Co. Lns	1.79	0.67	0.74
Net Co Charge-offs	5,305.9	4.9	176.3
Change from Last Quarter	-33.9	-83.4	-72.7
Change from Last Year	-1.9	-13.1	-28.2
Pct. of Net Charge-offs	19.3	5.0	5.1
Pct. of Avg. Co. loans	0.87	0.21	0.29

The major reason for the disparate performance of consumer loans between large organizations and community banks was credit cards. At large organizations, credit cards represent over 20 percent of all consumer loans but almost 36 percent of consumer NPLs and 52.6 percent of consumer NCOs. By contrast, very few consumer loans at community banks are credit card loans. Nationally, about 3.6 percent of consumer loans are credit cards; locally this number is 2.1 percent. Given the increase in consumer lending at large organizations and the decreases at community banks, it appears that most new consumer lending has been in the form of credit card charges. (See Figure 11.)

Provisioning and Reserves

Figure 12
Provision for Loan Losses and Loan Loss Reserves

	Large Organizations	Community Banks	
Nation		Tri-State Area	Nation
Loan-loss Reserve ($Millions)	153,543.5	1,077.8	24,907.8
Change from Last Quarter	6.0	11.5	1.4
Change from Last Year	28.3	27.5	10.7
Net Charge-Offs/LL Provision	95.8	77.4	84.4
LL Provision/Operating Inc.	26.3	12.4	20.9
Loan-loss Coverage Ratio	52.5	57.1	50.7

Loan-loss provisioning and reserves at both large organizations and community banks have been inadequate to cover losses for some time now, and this trend continued in the first quarter (Figure 12).[6] At large organizations, the loan-loss coverage ratio decreased 64 basis points, to 52.5 percent (Figure 13).[7] The ratio of NCOs to loan-loss provision is over 95 percent now, and it has steadily grown in the past year (Figure 14). If NPLs and NCOs continue to grow at the rate they did in the first quarter, large organizations would need to add $178.4 billion to their loan-loss reserves in the next quarter in order to raise the coverage ratio to 100 percent. This represents 163.5 percent of their operating income this quarter and 18.6 percent of their total equity. The ratio of loan-loss provision to operating income dropped nearly 9 percentage points in the first quarter (Figure 15), as both operating income and loan-loss provisioning decreased.[8]

It also appears that community banks are forgoing charging off some NPLs to maintain income. The ratio of loan-loss provision to operating income fell substantially both locally and nationally (Figure 16). In spite of the decrease in NCOs, the ratio of NCOs to loan-loss provision increased somewhat nationally and was flat locally (Figure 17). Total loan-loss reserves were basically flat nationally and grew only 11.4 percent locally. Thus, after increasing slightly in the fourth quarter of 2009, the loan-loss coverage ratio decreased by 44 basis points at community banks nationally and fell by over 1.5 percentage points locally (Figure 18). In order to bring loan-loss coverage up to 100 percent, community banks nationally would

[6] For purposes of this document, loan-loss reserves refer to the item reported on the banks' balance sheets, while loan-loss provision refers to what is reported on the income statements (that is, what was added to loan-loss reserves in the quarter).

[7] Loan-loss coverage ratio is defined as the ratio of loan-loss reserves to nonperforming loans. For historical perspective, the average loan-loss coverage ratio for all commercial banks between 1998 and 2008 was 144.2 percent. At the bottom of the last real estate cycle in 1991, this number was 72.6 percent. Source: FDIC Historical Statistics on Banking: http://www2.fdic.gov/hsob/index.asp.

[8] Operating income is defined as the sum of net interest income and noninterest income. The average ratio of loan-loss provision to operating income for all commercial banks from 1997 to 2007 was 8.08 percent. At the bottom of the last real estate cycle in 1991, this ratio was 18.89 percent. Source: FDIC Historical Statistics on Banking: http://www2.fdic.gov/hsob/index.asp.

need to add $31.2 billion to loan-loss reserves at the current rate of growth for NPLs and NCOs. Local banks would need to add nearly $1.1 billion. These numbers represent about 160.5 percent of the current quarterly operating income for banks nationally and 108 percent for banks locally and 17.1 and 12.0 percent of their total equity, respectively.

Figure 13

Loan-Loss Coverage Ratios

Large Organizations

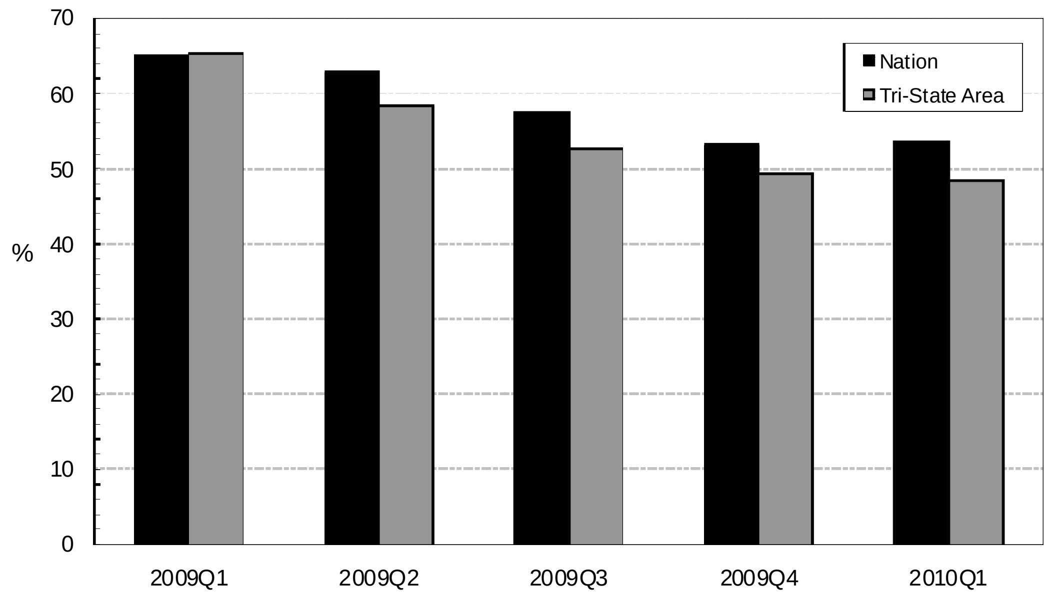


Figure 14

Net Charge-Offs/Loan-Loss Provision

Large Organizations

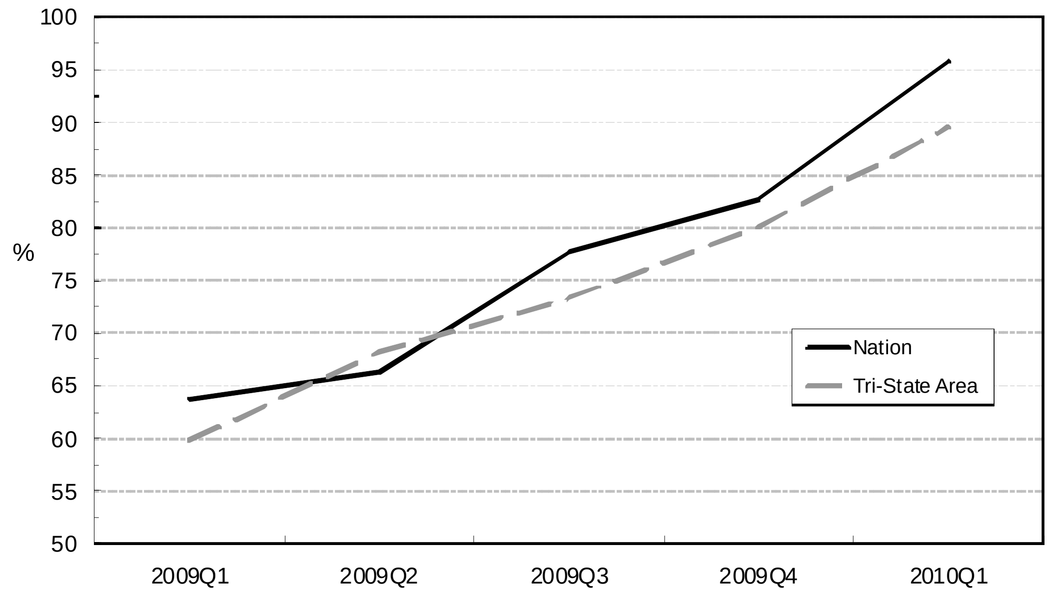


Figure 15

Loan-Loss Provision/Operating Income

Large Organizations

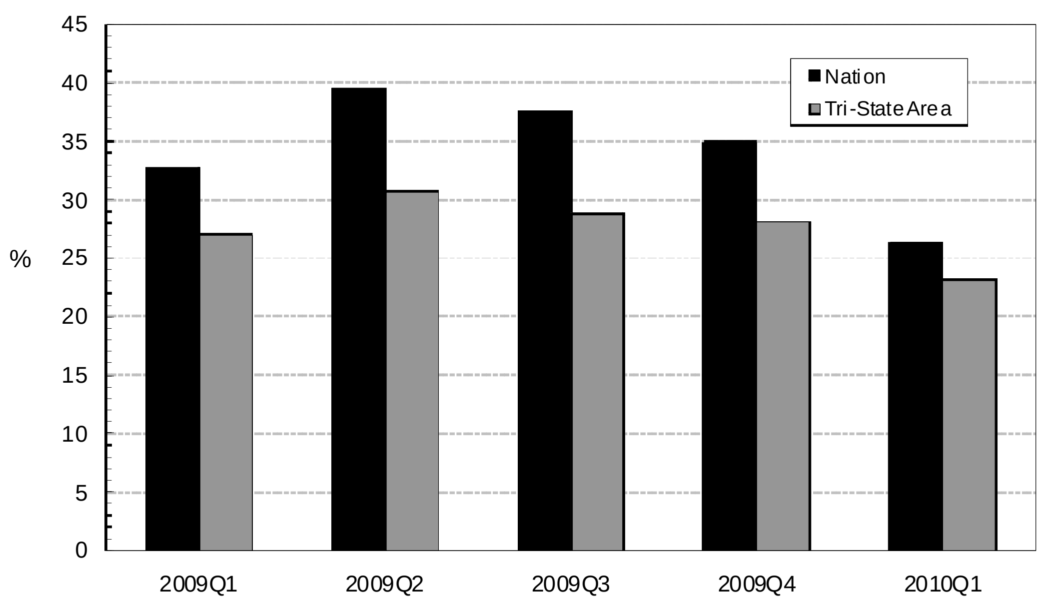


Figure 16

Loan-Loss Provision/Operating Income

Community Banks

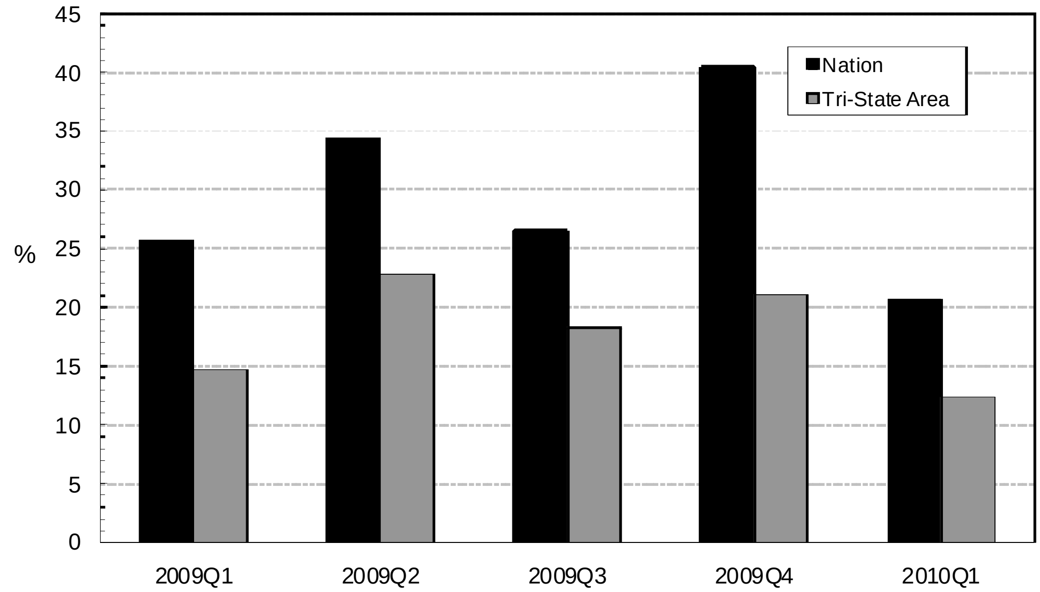


Figure 17

Net Charge-Offs/Loan-Loss Provision

Community Banks

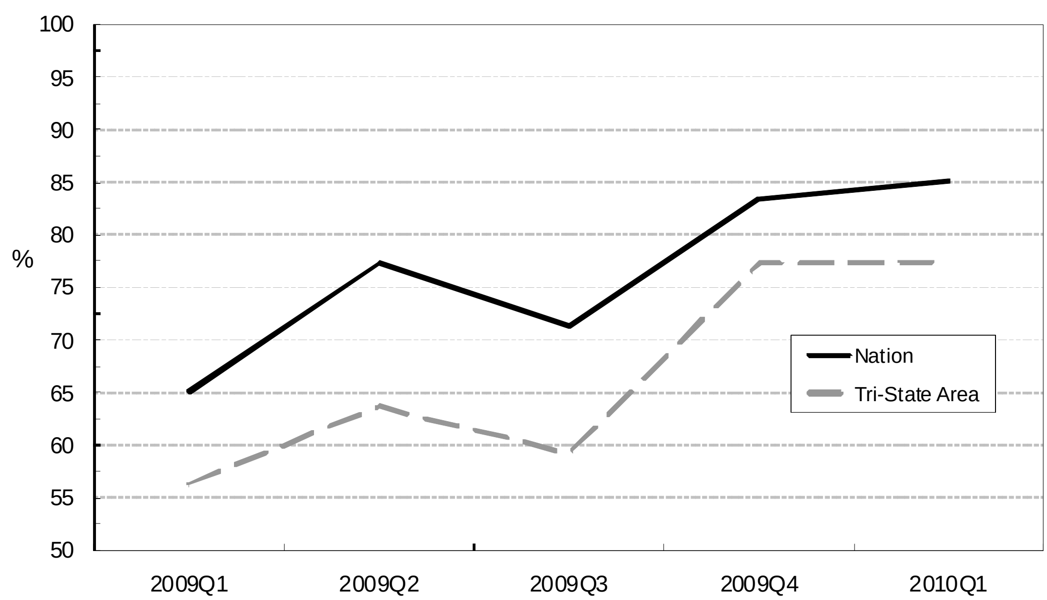
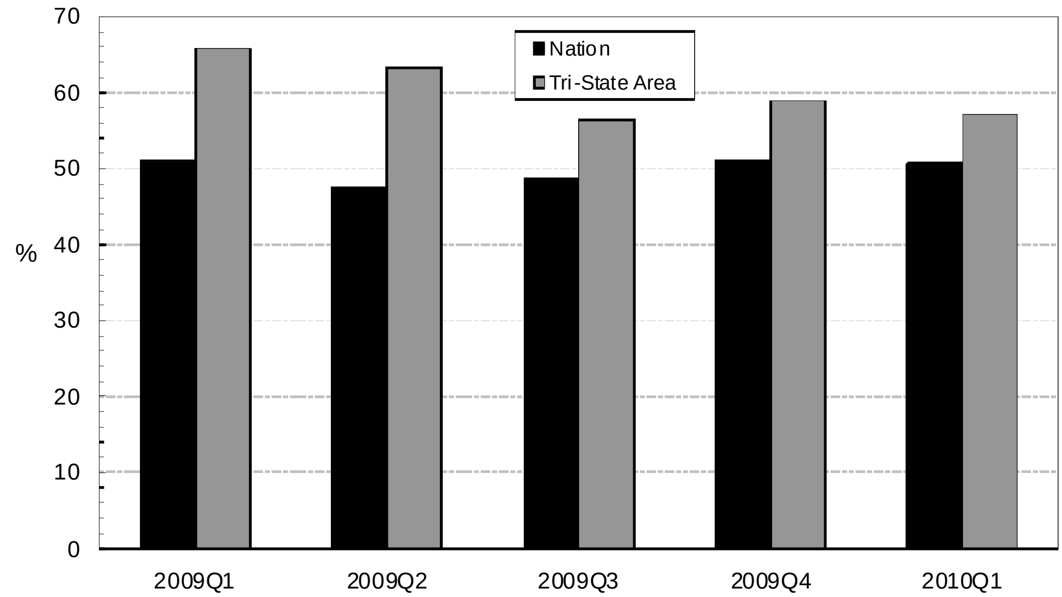


Figure 18

Loan-Loss Coverage Ratios

Community Banks



Securities

Figure 19
Summary of Securities Portfolios

	Large Organizations	Community Banks	
Nation		Tri-State Area	Nation
Securities/Assets 19.7		19.6	19.0
Market Value ($Millions)	1,785,120.0	19,106.1	350,433.4
Change from Last Quarter	5.4	4.7	8.1
Change from Last Year	21.1	9.2	2.9
Realized Gain/Loss	1,053.6	2.7	205.7
Pct. of Average Securities	0.06	0.01	0.06
Market Value/Book Value	100.9	100.4	101.2

At large organizations, Treasury securities, securities of states and municipalities, other domestic debt, and foreign securities all increased in value, while securities of U.S. agencies, government-sponsored enterprises (GSEs), mortgage-backed securities (MBS), asset-backed securities (ABS), and mutual funds all declined in value. MBS, at 56.9 percent, were the single largest part of the large organizations' portfolios. Foreign securities are the only other category that makes up more than 10 percent.

At community banks, Treasuries, securities of U.S. agencies, state and local debt securities, securities of GSEs, and securities of state and local governments make up nearly 90 percent of the community banks' securities portfolios both locally and nationally. Both large and small institutions had a relatively small realized net gain on their securities portfolios in the first quarter.

Funding Sources

Figure 20
Structure of Liabilities

	Large Organizations	Community Banks	
Nation		Tri-State Area	Nation
Deposits ($millions)	6,249,727.8	77,444.8	1,514,279.8
Pct. of Assets	69.2	81.9	82.4
Change from Last Quarter	-2.5	6.4	1.4
Change from Last Year	5.1	8.8	0.0
Debt ($millions)	1,323,615.5	7,155.2	127,929.1
Pct. of Assets	14.7	7.6	7.0
Change from Last Quarter	13.9	-21.1	-26.9
Change from Last Year	-19.6	-1.8	-22.0
Core Deposits/Deposits	41.1	71.3	68.6
Implicit Rate on Deposits	0.80	1.74	1.72

At large organizations, core deposits were virtually flat, while debt funding was increased.[9] Among deposits, transaction accounts, particularly demand deposits, shrunk substantially, as did time deposits. Most other types of deposits had little or no growth. In debt funding, securities sold under agreements to repurchase (repos) increased substantially, as did other borrowings, while Federal Home Loan Bank (FHLB) advances fell nearly 50 percent. The implicit interest rate large organizations pay on deposits continued to fall (Figure 21).[10]

At community banks, core deposits showed increases both locally and nationally, rising 7.6 and 18.7 percent, respectively. However, demand deposits fell. The main reason for slow growth in deposits both locally and nationally was time deposits, particularly those in denominations of less than $100,000 and all brokered deposits. Small banks nationally have somewhat cut their relatively heavy dependence on "hot money," that is, brokered deposits and high-denomination deposits, but there is still a way to go. Brokered deposits make up 5.9 percent of deposits, down from 8.6 percent last year, and time deposits greater than $100,000 make up 21.0 percent of deposits at those banks, barely changed from last year.[11] Locally, these numbers are 4.7 and 15.9 percent, respectively, while for large organizations they are 2.6 and 7.7 percent. Thus, small banks pay a somewhat higher implicit interest rate on their deposits than larger organizations (Figure 22).

[9] Core deposits are defined as total domestic deposits less brokered deposits in denominations less than $100,000 and all deposits in denominations greater than $100,000.

[10] Implicit interest rate is defined as the annualized quarterly interest expense divided by the quarterly average balance.

[11] It is highly likely that there is substantial crossover between brokered deposits and large time deposits.

Figure 21

Implicit Interest Rate on Deposits

Large Organizations

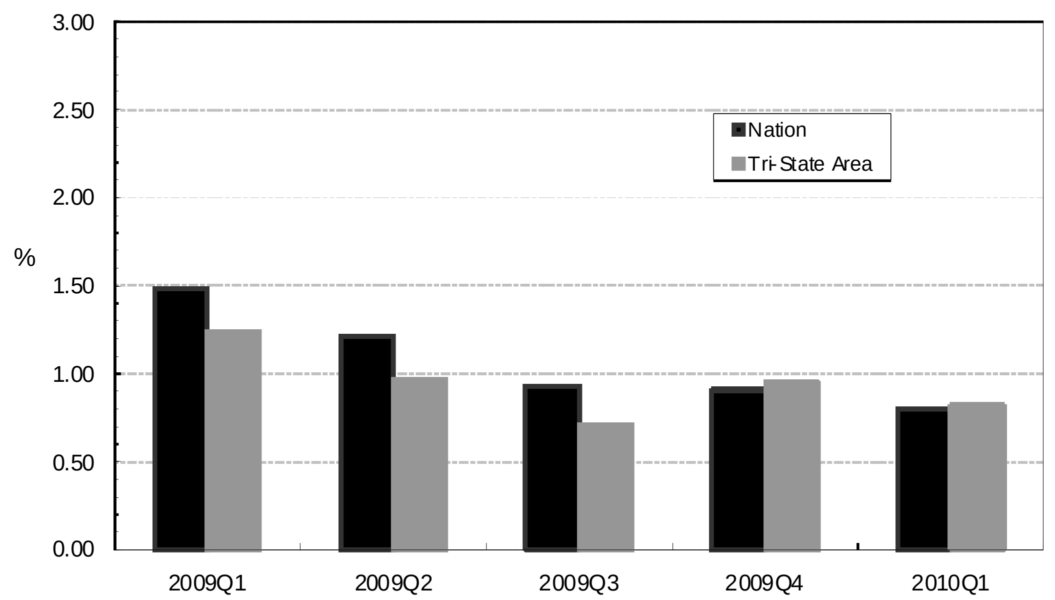


Figure 22

Implicit Interest Rate on Deposits

Community Banks