BANKING BRIEF
FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

Fourth Quarter 2010

The condition of banks continued to improve in the fourth quarter at both large organizations and community banks, but the industry's recovery is still fragile. Profits as measured by return on average assets (ROA) at large organizations increased slightly, while the ratio of nonperforming loans to total loans (the nonperforming loan ratio) decreased 29 basis points, to 5.61 percent.[1] At community banks, nationally, ROA increased 22 basis points, to 0.25 percent, while, locally, ROA increased 20 basis points, to 0.38 percent. Nonperforming loan ratios at these banks fell as well, by 13 basis points nationally, to 3.69 percent, and by 25 basis points locally, to 2.93 percent.[2] Total nonperforming loans (NPLs) decreased both in the fourth quarter and year-over-year at both community banks and large organizations, a sign that banks have gotten a handle on their asset quality problems and can now begin improving their balance sheets. Net charge-offs (NCOs) were down as well from the fourth quarter of 2009, although they did increase during the quarter at community banks both locally and nationally. Both the ratio of capital to assets and total equity capital fell in all categories of banks. This was due to increases in unrealized losses on some securities and increases in dividends (see Securities and Regulatory Capital below). Bank failures slowed somewhat in the fourth quarter, but there continued to be a high number of failures. Thirty banks failed nationwide in the fourth quarter, including two in Pennsylvania.[3] In all, 139 banks failed in 2010, including three in the tri-state area. As of March 4, 2011, an additional 23 banks had failed, but none were local.

Of the 99 large organizations in the sample, 80 reported a positive profit in the fourth quarter, unchanged from the third quarter. Additionally, all 99 had equity-to assets ratios of at least 6 percent, while 93 of

[1] See the Summary Table of Bank Structure and Conditions on page 2. Unless otherwise noted, all data are from Federal Financial Institutions Examination Council (FFIEC) call reports. Ratios presented are aggregates. That is, the numerator and denominator are summed then divided. All growth rates are annualized unless otherwise noted. Also, with the exception of the data on page 2, all income statement items reported are for the quarter only.

[2] Nonperforming loans are defined as loans past due 90 days or more plus nonaccruing loans. For historical perspective, the average NPL ratio for all commercial banks between 1999 and 2009 was 1.67 percent. At the bottom of the last real estate cycle in 1991 this ratio stood at 3.70 percent. Source: FDIC Historical Statistics on Banking, http://www2.fdic.gov/hsob/index.asp.

[3] Both failed institutions were relatively small, and their assets and deposits were acquired by other institutions.

Summary Table of Bank Structure and Conditions – Fourth Quarter 2010

Community Banking Organizations

	Tri-State			*Nation*		
	$ Bill	**% Change From**		**$ Bill**	**% Change From**	
	10Q4	**10Q3**	**09Q4**	**10Q4**	**10Q3**	**09Q4**
Total Assets	90.7	-3.81	2.84	1,844.3	-1.33	2.17
Total Loans	61.1	-3.94	1.11	1,196.0	-5.41	-1.90
Business	7.9	-3.01	0.03	177.8	0.66	-2.40
Real Estate	49.4	-3.95	1.69	900.4	-6.23	-1.60
Consumer	2.1	-7.31	-7.13	54.8	-9.78	-7.39
Total Deposits	75.4	-0.87	4.71	1,528.1	1.01	3.24
Ratios (in %)	**10Q4**	**10Q3**	**09Q4**	**10Q4**	**10Q3**	**09Q4**
Net Income/Avg Assets (ROA)	0.38	0.18	0.01	0.25	0.03	-0.23
Net Interest Inc/Avg Assets (NIM)	3.25	3.29	3.15	3.42	3.41	3.23
Noninterest Inc/Avg Assets	1.19	1.22	1.18	0.92	0.90	0.91
Noninterest Exp/Avg Assets	3.24	3.45	3.36	3.09	3.11	3.12
Loans/Deposits	80.99	81.63	83.88	78.27	79.56	82.38
Equity/Assets	9.67	9.87	9.57	10.13	10.30	9.81
Nonperforming Loans/Total Loans	2.93	3.18	2.84	3.69	3.82	3.74

Large Banking Organizations

	Tri-State			*Nation*		
	$ Bill	**% Change From**		**$ Bill**	**% Change From**	
	10Q4	**10Q3**	**09Q4**	**10Q4**	**10Q3**	**09Q4**
Total Assets	491.4	2.52	0.13	9,218.9	-2.42	0.21
Total Loans	253.8	4.40	-2.22	4,578.3	-1.13	-2.77
Business	46.7	5.02	-5.13	880.6	4.93	-3.79
Real Estate	149.5	1.28	-4.02	2,609.9	-2.82	-5.40
Consumer	31.7	-4.54	-1.33	582.8	-17.22	-3.68
Total Deposits	348.9	12.07	2.00	6,517.1	7.76	1.71
Ratios (in %)	**10Q4**	**10Q3**	**09Q4**	**10Q4**	**10Q3**	**09Q4**
Net Income/Avg Assets (ROA)	0.79	0.76	0.59	0.66	0.57	0.17
Net Interest Inc/Avg Assets (NIM)	2.91	3.02	2.95	2.73	2.77	2.73
Noninterest Inc/Avg Assets	2.10	2.16	2.34	1.93	1.95	2.09
Noninterest Exp/Avg Assets	3.01	2.96	2.84	2.89	2.83	2.80
Loans/Deposits	72.73	74.03	75.87	70.25	71.78	73.48
Equity/Assets	10.59	10.82	10.46	10.97	11.02	10.53
Nonperforming Loans/Total Loans	6.94	7.31	7.39	5.61	5.90	6.21

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 — 179 for the tri-state area and 5,538 for the nation; (2) large banking organizations — 25 for the tri-state area and 99 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.

them had equity-to-assets ratios of over 7 percent.[4] The number of institutions with a ratio over 7 percent decreased by five in the fourth quarter. ROA increased at large organizations for several reasons. First, income from asset sales tripled, to over $3 billion. Second, large organizations decreased their loan-loss provision about 5 percent, and third, their cost of funds continued to decrease (see Funding Sources below). As noted above, asset quality continued to improve. The NPL ratio is at its lowest point in more than a year, although it is still quite high by historical standards. Large organizations are also decreasing their inventories of foreclosed real estate (called other real estate owned, or OREO). OREO decreased 11.1 percent in the fourth quarter, although it did increase 15 percent from the fourth quarter of 2009. At least some of this decrease was likely due to a total or partial moratorium on foreclosures that was in effect for part of the fourth quarter. Nonetheless, the decrease in NPLs and OREO led to the lowest ratio of nonperforming assets to total assets in nearly two years (Figure 1).[5] While NCOs decreased, the ratio of NCOs to average loans was flat because loans also decreased (Figure 2). One reason for the decrease in NCOs was that banks are recovering more of the loans they charge off. The recovery ratio, that is, recoveries over charge-offs, increased from 9.84 to 11.98 percent in the fourth quarter (Figure 3). It has nearly doubled in the past year.

Loan quality at community banks both locally and nationally is better than that at large organizations, and it continued to improve in the fourth quarter. In fact, the NPL ratio dropped both nationally and locally for the first time in at least a year. There are still challenges for community banks, however. While asset quality appears better at community banks when measured by the NPL ratio, when OREO is added, small banks nationally are actually somewhat worse off than large organizations (Figure 1). The nonperforming asset (NPA) ratio at small banks nationally was 3.45 percent in the fourth quarter, compared with 2.47 percent for local banks and 3.07 percent for large organizations. This is due to a sizable increase in OREO. While NPLs shrank 17.5 percent nationally and 30.1 percent locally, OREO grew 5.3 percent nationally and 35.7 percent locally. Nonetheless, the NPA ratio did shrink both locally and nationally for the first time in over a year. NCOs increased substantially in the quarter both locally and nationally, by 54.8 and 48.8 percent, respectively, but they have also decreased substantially in the last year, by 36.2 and 15.2 percent. As a result, the NCO ratio at these institutions was nearly flat, increasing by 3 basis points nationally, to 0.34 percent, and 2 basis points locally, to 0.23 percent (Figure 2). Capital ratios dropped both locally and nationally, despite a drop in assets (see below). Out of 5,538 banks in the national sample, 5,313 had a capital-to-assets ratio of at least 6 percent, and 5,144 had a ratio of at least 7 percent. These numbers represent drops of 29 and 100 from the second

[4] Regulation Y defines capital in terms of zones. Institutions in Zone 1 have capital-to-assets ratios above 7 percent, those in Zone 2 are between 6 and 7 percent, and those in Zone 3 have ratios below 6 percent. An institution is considered well capitalized if it is in Zones 1 or 2 and undercapitalized if it is in Zone 3. While total equity capital 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.

[5] Nonperforming assets are the sum of NPLs and OREO. For historical perspective, the average nonperforming asset ratio from 1999 to 2009 was 1.05 percent. At the bottom of the last real estate cycle in 1991 this number was 3.02 percent. Source: FDIC Historical Statistics on Banking, http://www2.fdic.gov/hsob/index.asp.

Figure 1

Nonperforming Assets/Assets

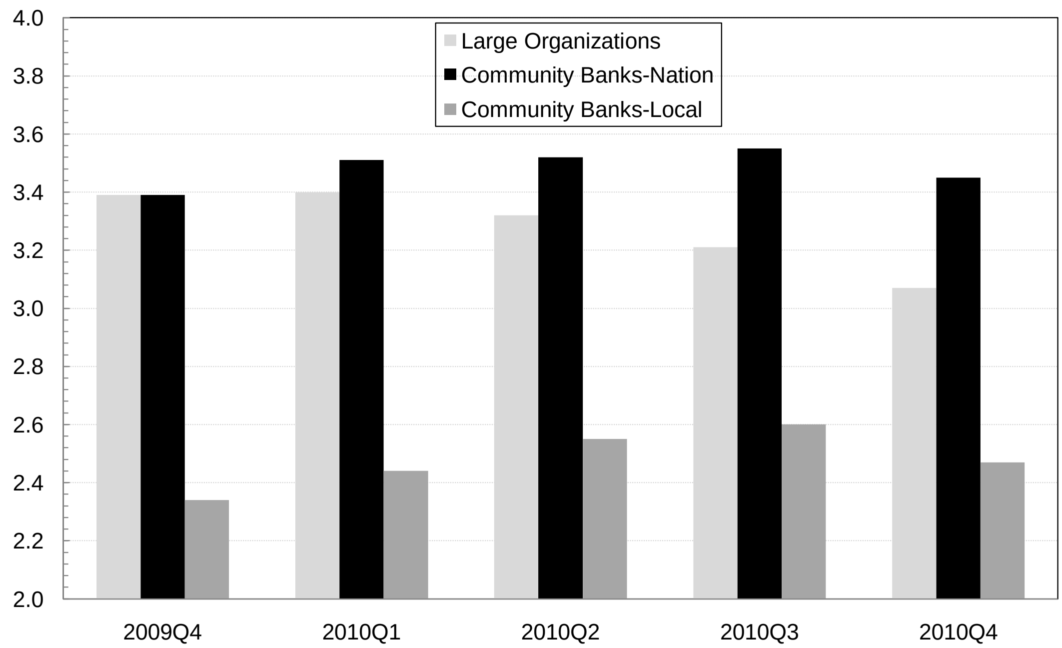
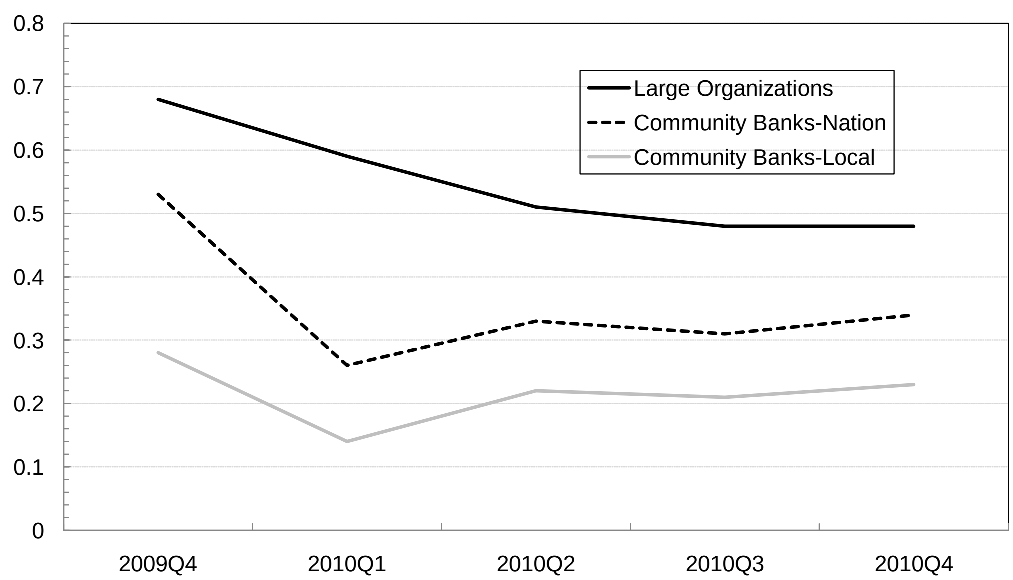
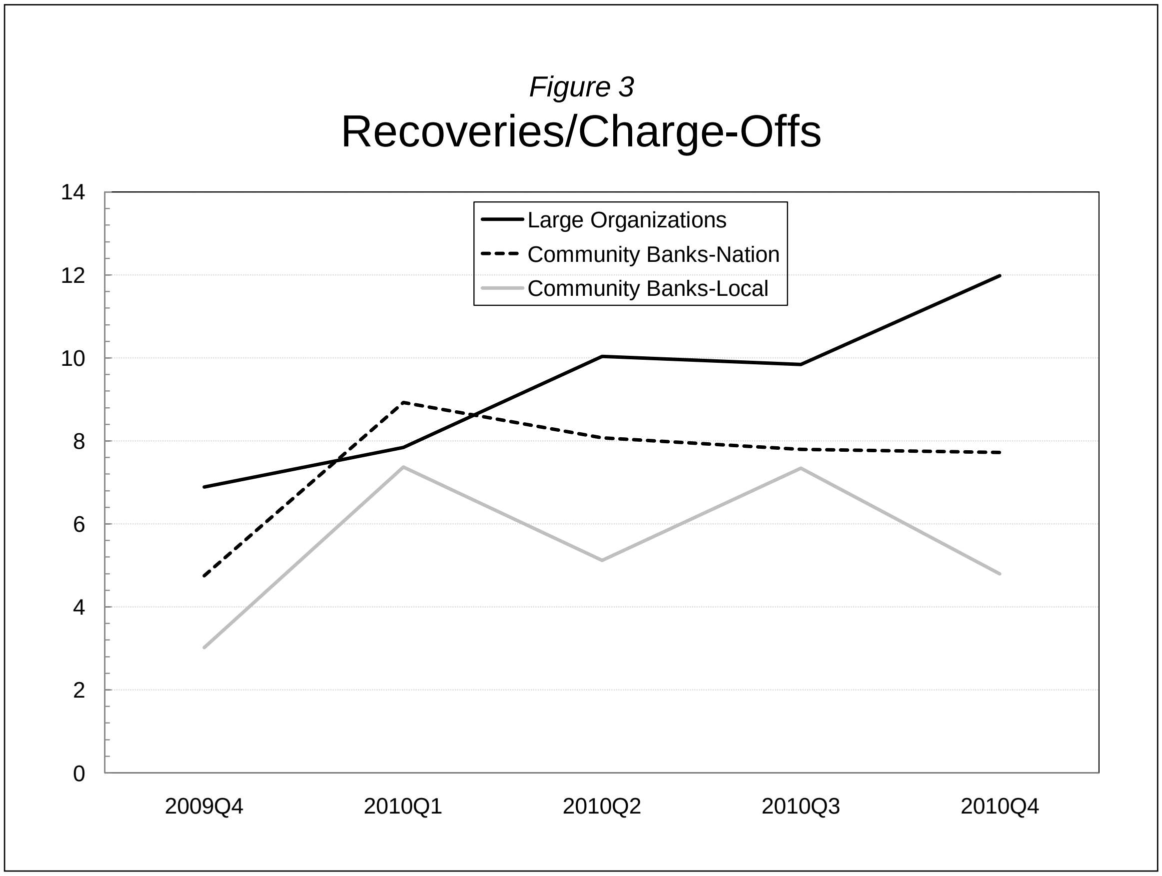


Figure 2

Quarterly NCOs/Average Loans





quarter. Locally, out of 179 organizations, 171 had a ratio of 6 percent or better and 166 were at 7 percent or better, decreases of two and three, respectively. Additionally, while profitability increased both locally and nationally, the number of profitable banks decreased slightly. At tri-state area banks, 148 reported a positive income in the fourth quarter, compared with 150 in the third quarter. Nationally, 4,394 banks reported positive profits in the fourth quarter, down from 4,409 in the third quarter.

Residential Real Estate Lending

Residential real estate loans (RRE loans) continued to be a problem for large organizations, but the situation has improved somewhat.[6] RRE loans are the single largest component of the large organizations' loan portfolios, representing 37.2 percent of loans, 60.9 percent of NPLs, and 41.8 percent of NCOs. The good news is that NPLs decreased slightly in the fourth quarter and year-over year. Thus, the RRE NPL ratio decreased slightly and is now at its lowest point in the last year (Figure 5). NCOs were up sharply in the quarter, but they have declined 23 percent in the last year. The NCO ratio was nearly flat in the fourth quarter (Figure 6). The recovery ratio on RRE loans also increased from 9.84 to 11.98 percent in the fourth quarter. It has nearly doubled in the last year, signaling that the large organizations are finding it somewhat easier to sell off their inventories of foreclosed real estate. However, this situation may change. First, as mentioned above, for much of the fourth quarter, several of the largest banks had a full or partial moratorium on residential

[6] RRE loans consist of loans secured by 1-4 family properties (either first or junior liens) plus home equity lines of credit (HELOCs).

Figure 4
Summary of Residential Real Estate Lending

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Total RRE Loans ($Millions)	1,703,512.1	20,167.0	306,704.1
Change from Last Quarter	3.7%	-4.0%	-5.4%
Change from Last Year	-2.0%	4.3%	4.1%
Pct. of Total Loans	37.2	33.0	25.6
Nonperforming RRE Loans	156,409.2	383.0	7,978.5
Change from Last Quarter	-2.1%	-19.0%	-1.0%
Change from Last Year	-3.1%	12.2%	8.4%
Pct. of Nonperforming Loans	60.9	21.4	18.1
Nonperforming RRE/RRE Lns	9.18%	1.90%	2.60%
Net RRE Charge-offs	9,332.1	22.9	665.6
Change from Last Quarter	18.3%	52.7%	90.0%
Change from Last Year	-23.0%	-3.3%	-16.2%
Pct. of Net Charge-offs	41.8	16.1	16.0
Pct. of Avg. RRE loans	0.55%	0.12	0.22%

foreclosures after flaws in their foreclosure procedures were found. This had the effect of reducing the supply of foreclosed properties for sale. However, this moratorium is no longer in effect. Moreover, prices on RRE, after rising for a time earlier this year, appear to have begun falling again. Figure 7 shows three national indices of RRE prices, the National Association of Realtors (NAR) median home price index, the Federal Housing Finance Agency (FHFA) home price index, and the Case-Schiller (C-S) composite index from Standard and Poor's.[7] All fell or were flat in the third and fourth quarters. The NAR did report small increases in most of the metropolitan areas in its survey, but these were countered by decreases elsewhere. An increase in foreclosures will likely put downward pressure on RRE prices.

At community banks the RRE situation is somewhat better. RRE loans represent a substantially smaller portion of community banks' loan portfolios, especially nationally, and they are performing better. NPLs on RRE loans were basically flat nationally and fell 19 percent locally from the third quarter, although both numbers increased from the fourth quarter of 2009. Likewise the RRE NPL ratio was flat nationally and showed a small decrease locally (Figure 5). NCOs on RRE loans increased substantially both locally and nationally, but this is likely just noise in the data, since smaller organizations book charge-offs less often than larger ones. NCOs decreased both locally and nationally from the fourth quarter of 2009, as did the RRE NCO ratio (Figure 6). One problem community banks are having is selling foreclosed properties. The recovery ratio at

[7] The NAR data are not seasonally adjusted and are available at http://www.realtor.org/research/research/metroprice. The FHFA data are seasonally adjusted and are available at http://www.fhfa.gov/Default.aspx?Page=14. The Case-Schiller data are also seasonally adjusted and are available at http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us----.

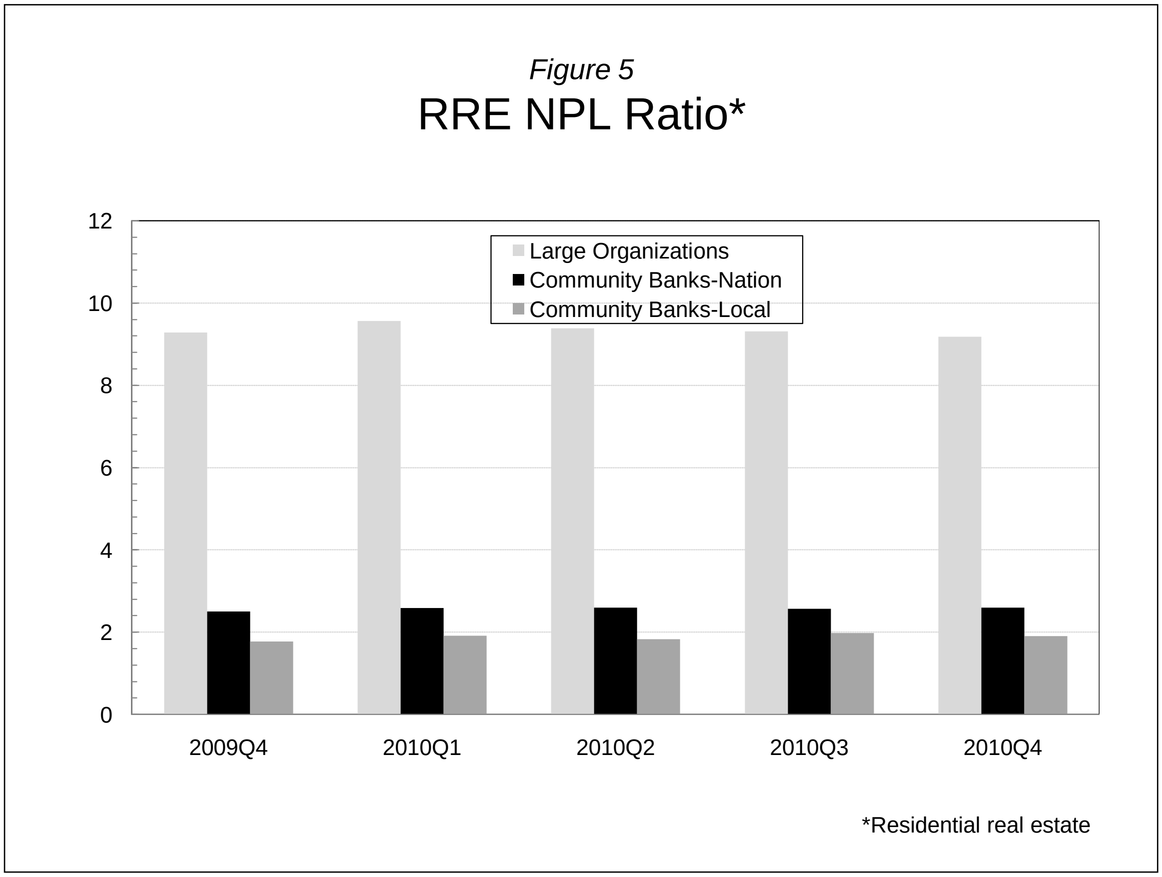


Figure 5
RRE NPL Ratio*
12
10
8
6
4
2
0
Large Organizations
Community Banks-Nation
Community Banks-Local
2009Q4
2010Q1
2010Q2
2010Q3
2010Q4
*Residential real estate

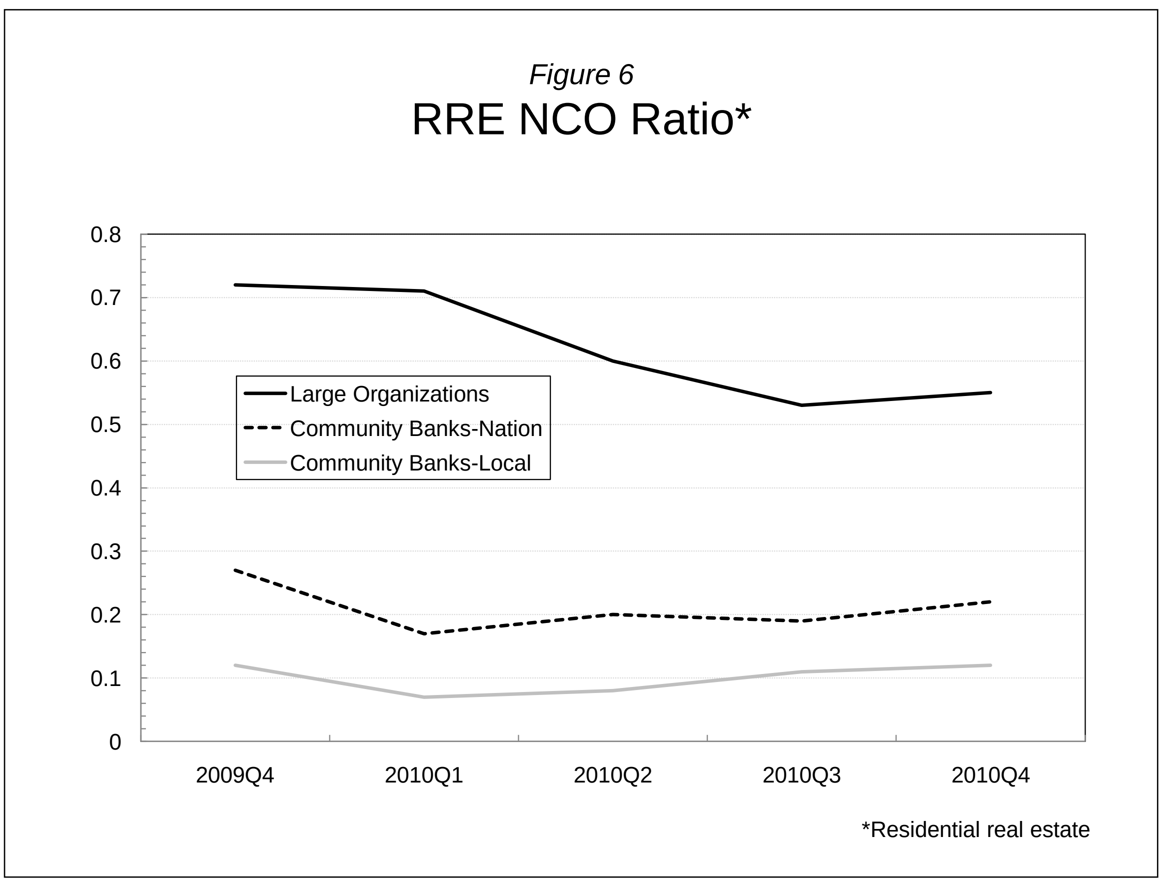
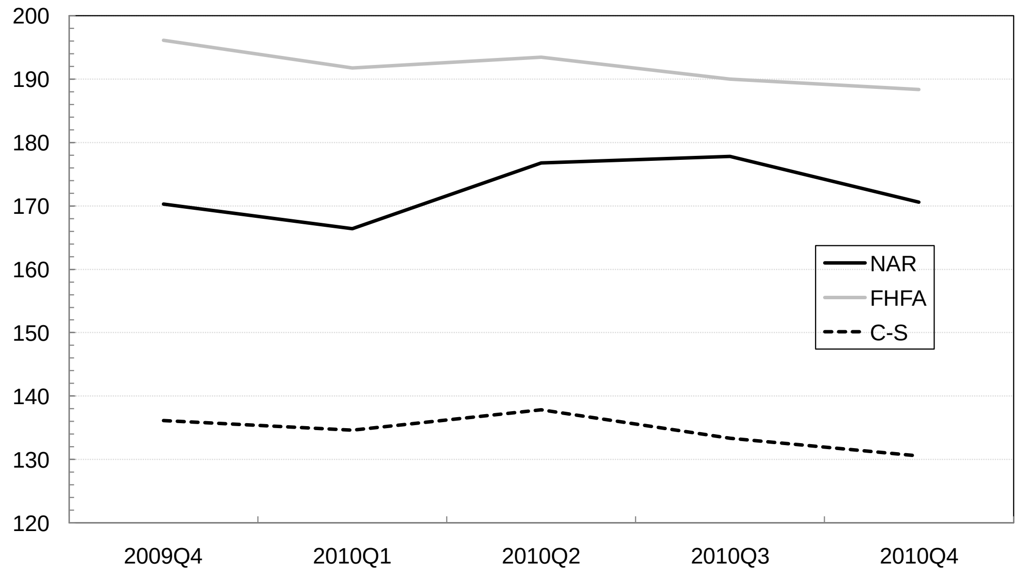


Figure 6
RRE NCO Ratio*
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
Large Organizations
Community Banks-Nation
Community Banks-Local
2009Q4
2010Q1
2010Q2
2010Q3
2010Q4
*Residential real estate

Figure 7
Residential Real Estate Price Indices



community banks nationally was 7.72 percent, a decrease of 8 basis points from the third quarter. Locally, this ratio was 4.80 percent, down 254 basis points from the third quarter. For large organizations, this ratio was 9.18 percent, but it also decreased.

Commercial Real Estate Lending

At large organizations, commercial real estate (CRE) NPLs dropped nearly 40 percent in the quarter and nearly 20 percent since last year, resulting in the third consecutive quarterly decrease in the CRE NPL ratio (Figure 9). CRE NCOs also dropped slightly, but because CRE loans outstanding decreased as well, the CRE NCO ratio increased by 2 basis points (Figure 10). CRE loans decreased in all categories of banks both from the third to the fourth quarter and from the fourth quarter of 2009.[8] Nearly all of this drop is due to construction loans. At large organizations, construction loans represent 21.9 percent of CRE loans but 50.6 percent of CRE NPLs and 51.8 percent of CRE NCOs. Construction loans at these organizations dropped 36 percent in the quarter and nearly 31 percent from last year. The good news is that quality is improving. Construction NPLs dropped 47 percent in the quarter and nearly 32 percent since last year. Nonetheless, a high percentage of construction loans are nonperforming. The construction NPL ratio fell 71 basis points in

[8] CRE loans consist of construction and land development loans, loans secured by multifamily properties, and loans secured by nonfarm, nonresidential properties (commercial mortgages).

Figure 8
Summary of CRE Lending

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Total CRE Loans ($Millions)	833,774.4	28,656.9	544,317.9
Change from Last Quarter	-12.0%	-4.2%	-7.5%
Change from Last Year	-11.3%	-0.2%	-5.0%
Pct. of Total Loans	18.2	46.9	45.5
Nonperforming CRE Loans	60,629.7	1,191.1	29,932.1
Change from Last Quarter	-39.6%	-37.1%	-22.0%
Change from Last Year	-19.8%	-0.6%	-6.1%
Pct. of Nonperforming Loans	23.6	66.5	67.8
Nonperforming CRE/CRE Lns	7.27%	4.16%	5.50%
Net CRE Charge-offs	5,743.2	83.4	2,355.7
Change from Last Quarter	-2.9%	148.0%	45.0%
Change from Last Year	-21.1%	-10.8%	-41.5%
Pct. of Net Charge-offs	25.7	58.4	56.7
Pct. of Avg. CRE loans	0.65%	0.29%	0.42%

the fourth quarter, but it is still at 16.78 percent (Figure 11). Likewise construction NCOs fell substantially in the fourth quarter, down 33.1 percent from the third quarter of 2010 and 39.6 percent from the fourth quarter of 2009. Because of the steep drop in loans outstanding, the construction NCO ratio was basically flat (Figure 12).

At community banks, CRE loans are by far the largest part of their loan portfolios, with commercial mortgages making up the bulk of CRE loans both locally and nationally. CRE NPLs were down sharply both locally and nationally, as was the CRE NPL ratio (Figure 9). NCOs increased substantially in the fourth quarter (Figure 10), but this ratio is volatile from quarter to quarter. NCOs are down sharply nationally and decreased somewhat locally from the fourth quarter of 2009. As with the large organizations, most of the CRE loan problems at community banks are due to construction loans. Nationally, construction loans represent 20 percent of CRE loans but 49.9 percent of CRE NPLs and 53.1 percent of CRE NCOs. Locally, construction loans represent 16 percent of CRE loans, 42.6 percent of CRE NPLs, and 34.6 percent of CRE NCOs. The construction NPL ratio decreased both locally and nationally, a positive sign (Figure 11). By far the largest part of CRE lending at community banks is commercial mortgages. These represent 72.3 percent of all CRE loans nationally and 76.8 percent locally. Commercial mortgage quality had been deteriorating over the past year, but it appears that quality improved somewhat in the fourth quarter.

Commercial mortgage NPLs decreased 6.5 percent nationally and 32.9 percent locally, although they both show increases year-over-year. After increasing for the past year, the NPL ratio for commercial mortgages fell a bit in the fourth quarter (Figure 13). Locally NCOs on commercial mortgages more than doubled in the past year, while they were falling nationally. This is likely a strong contributing factor to the large increase in OREO at local banks both in the quarter and the year.

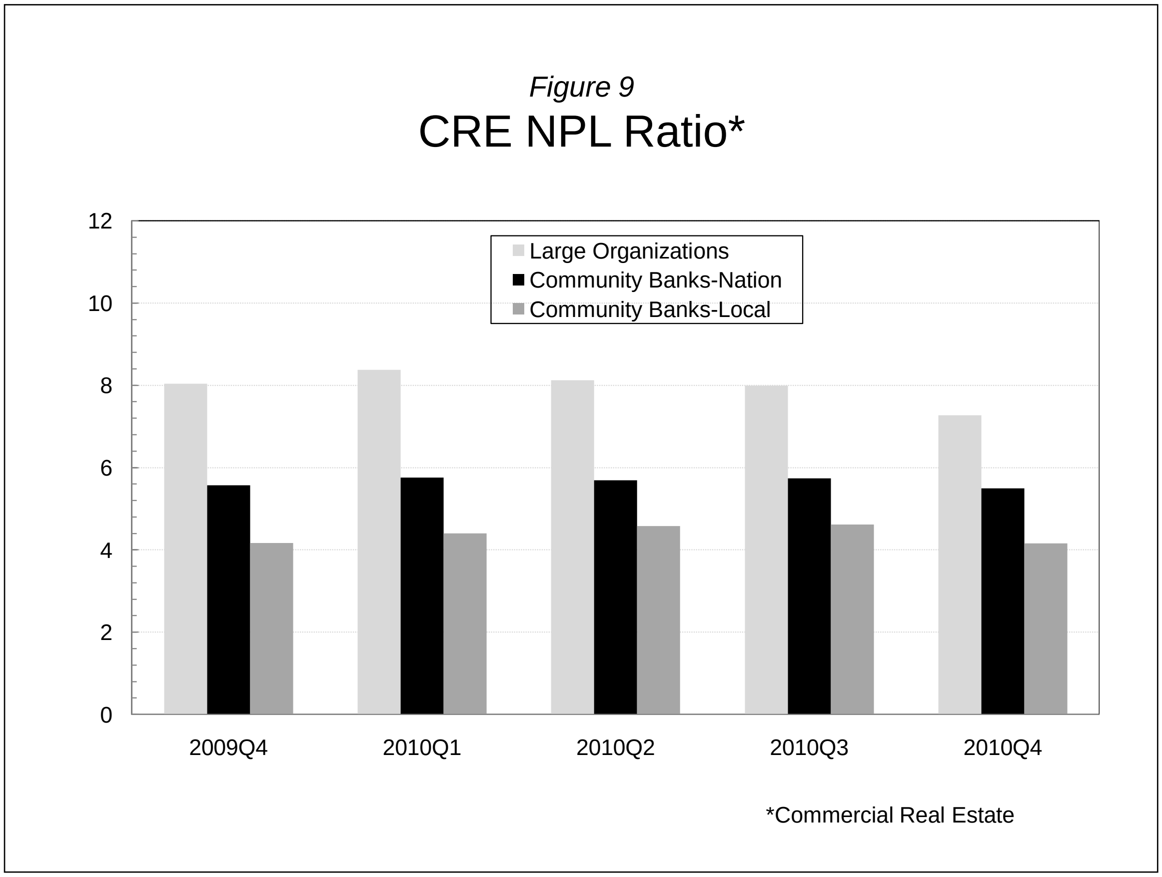


Figure 9
CRE NPL Ratio*
12
10
8
6
4
2
0
Large Organizations
Community Banks-Nation
Community Banks-Local
2009Q4
2010Q1
2010Q2
2010Q3
2010Q4
*Commercial Real Estate

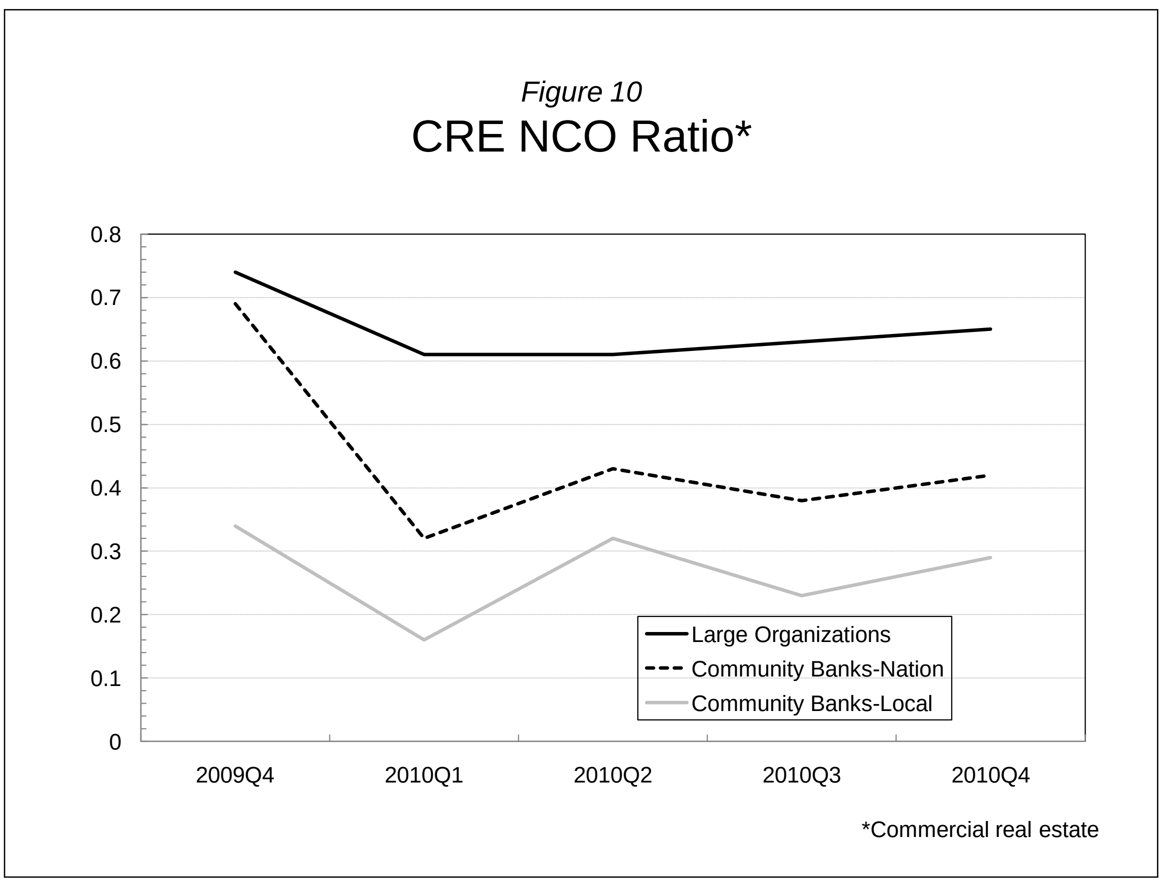


Figure 10
CRE NCO Ratio*
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
Large Organizations
Community Banks-Nation
Community Banks-Local
2009Q4
2010Q1
2010Q2
2010Q3
2010Q4
*Commercial real estate

Figure 11
Construction NPL Ratios

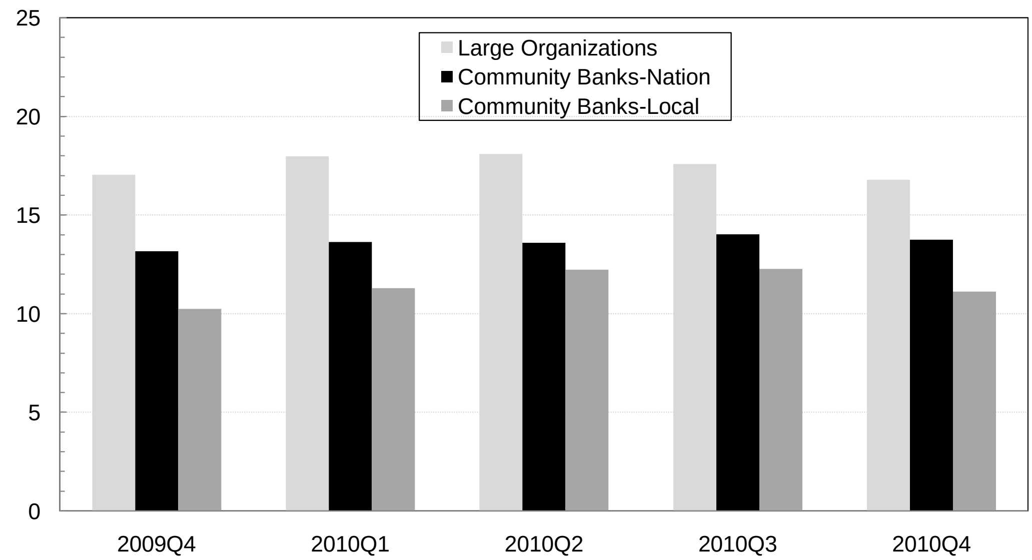
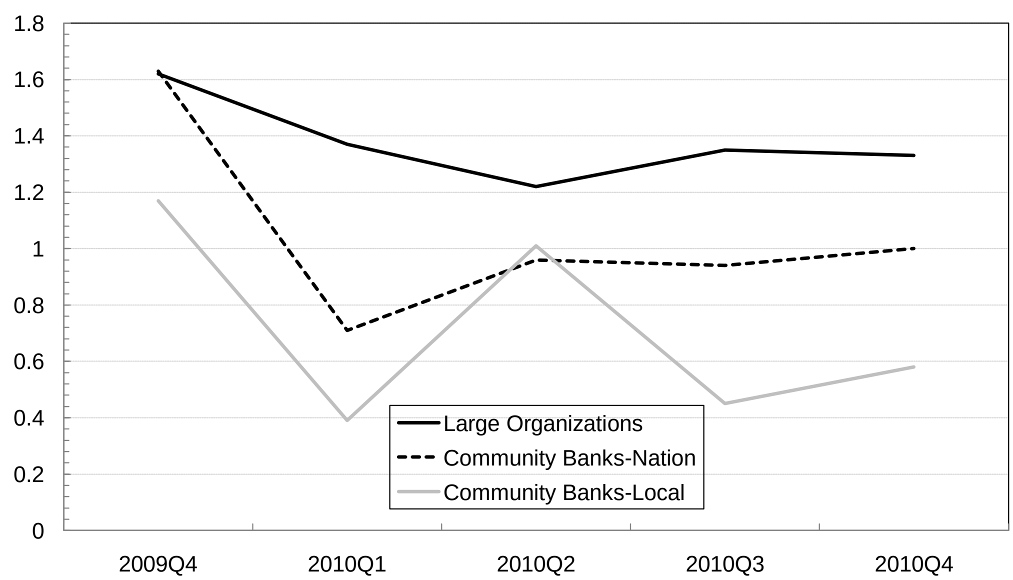
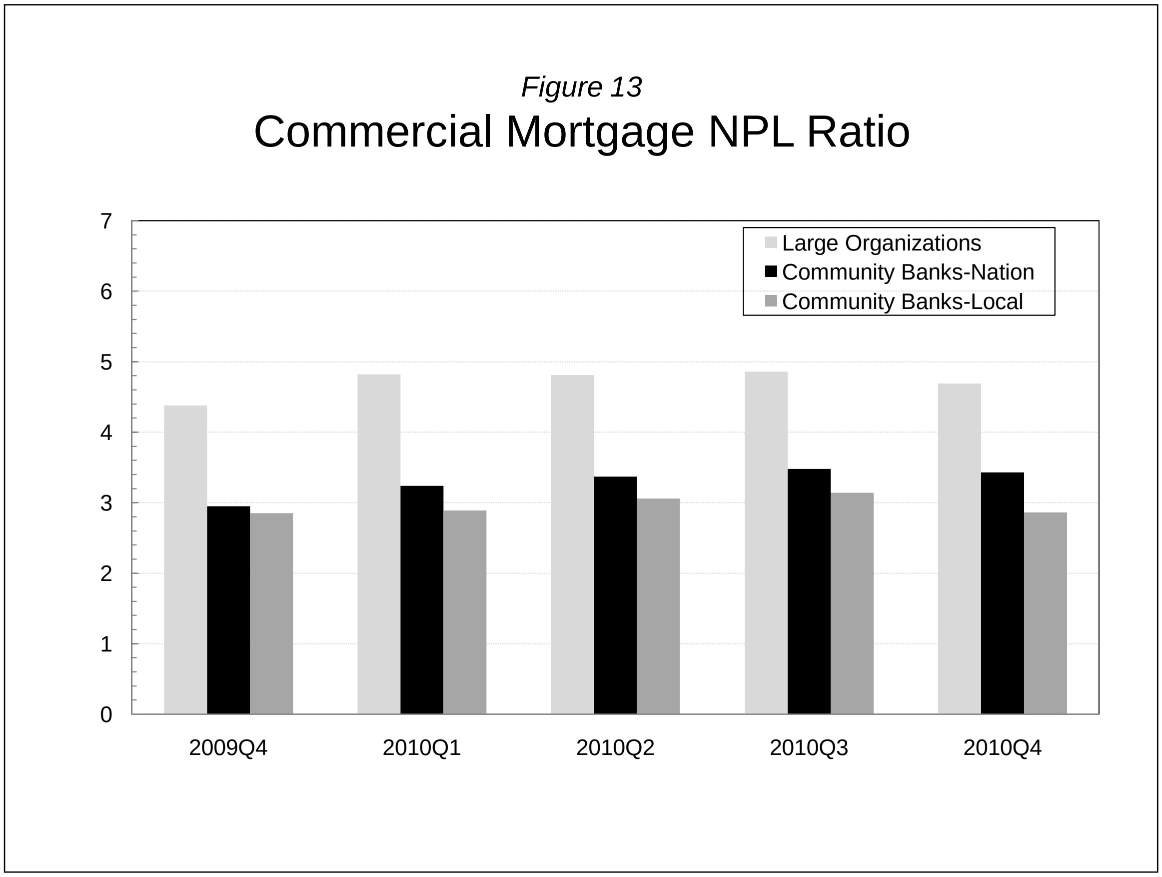


Figure 12
Construction NCO Ratio





Commercial & Industrial Lending

Commercial and industrial (C&I) lending remains in a slump, but there are some positive indicators of future growth. At large organizations, C&I loans increased slightly in the fourth quarter but are down from the previous year. However, there is some anecdotal evidence that the C&I loan situation is improving. The Federal Reserve System's Beige Book reported generally flat C&I lending in the latter part of the fourth quarter of 2010, but manufacturers and other nonfinancial businesses surveyed pointed to somewhat improved business conditions.[9] This could be an indicator of increased demand in future quarters. Regardless, what C&I loans are being made are generally of good quality as both NPLs and NCOs on C&I loans are down substantially, and the NPL and NCO ratios are much lower than those for real estate loans.

At community banks the story is much the same. C&I loans were basically flat nationally and shrank slightly locally in the fourth quarter, and they haven't grown at all in the past year. One potential trouble indicator is the 15 percent increase in C&I NPLs at tri-state area banks from the fourth quarter of 2009.

[9] For additional information, see http://www.federalreserve.gov/FOMC/BeigeBook/2011/.

Figure 14
Summary of Commercial & Industrial Lending

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Total C&I Loans ($Millions)	880,638.6	7,885.8	177,833.9
Change from Last Quarter	4.9%	-3.0%	0.7%
Change from Last Year	-3.8%	0.0%	-2.4%
Pct. of Total Loans	19.2	12.9	14.9
Nonperforming C&I Loans	21,691.3	157.9	4,179.9
Change from Last Quarter	-39.6%	-20.9%	-11.8%
Change from Last Year	-35.0%	15.1%	-1.1%
Pct. of Nonperforming Loans	8.5	8.8	9.5
Nonperforming C&I/C&I Lns	2.46%	2.00%	2.35%
Net C&I Charge-offs	2,473.2	32.3	901.7
Change from Last Quarter	-40.4%	-19.8%	76.7%
Change from Last Year	-51.9%	-20.4%	-31.3%
Pct. of Net Charge-offs	11.1	22.6	21.7
Pct. of Avg. C&I loans	0.28%	0.41%	0.50%

Consumer Lending

Consumer lending also decreased somewhat in the quarter at both large organizations and community banks. This decrease was mainly due to loans in the category of "other loans to individuals," which are essentially installment loans such as auto loans. Credit card balances at large organizations increased nearly 21 percent in the fourth quarter.[10] Credit card loans represent about 22.7 percent of consumer loans at large organizations but are an insignificant portion of community banks' consumer loan portfolios. This also explains the disparity in NPL and NCO ratios between large organizations and community banks.

[10] The data are not seasonally adjusted so this increase is from holiday shopping. Year-over-year credit card balances increased 2.8 percent.

Figure 15
Summary of Consumer Lending

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Total Co. Loans ($Millions)	582,774.4	2,065.7	54,845.0
Change from Last Quarter	-17.2%	-7.3%	-9.8%
Change from Last Year	-3.7%	-7.1%	-7.4%
Pct. of Total Loans	12.7	3.4%	4.6
Nonperforming Co. Loans	9,460.5	16.9	419.2
Change from Last Quarter	-35.8%	162.7%	5.2%
Change from Last Year	-13.5%	63.8%	-12.4%
Pct. of Nonperforming Loans	3.7	0.9	1.0
Nonperforming Co/Co Lns	1.62%	0.82%	0.76%
Net Co Charge-offs	4,207.2	3.3	169.3
Change from Last Quarter	0.1%	-71.1%	87.3%
Change from Last Year	-36.8%	-54.4%	-28.6%
Pct. of Net Charge-offs	18.9	2.3	4.1%
Pct. of Avg. Co loans	0.69%	0.15%	0.30%

Provisioning and Reserves

Figure 16
Provision for Loan Losses and Loan-Loss Reserves

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Loan-loss Reserve ($Millions)	139,561.1	1,008.2	24,298.5
Change from Last Quarter	-13.1%	-5.3%	-6.1%
Change from Last Year	-8.4%	3.7%	1.3%
Net Charge-Offs/LL Provision	128.9%	83.1%	98.6%
LL Provision/Operating Inc.	16.5%	18.1%	21.0%
Loan-loss Coverage Ratio	54.4%	56.3%	55.1%

With decreasing NPLs and higher recovery rates, it appears that banks are forgoing some additions to their loan-loss reserves.[11] This is consistent with the view that banks expect asset quality to improve in the next several quarters. The data support this conclusion somewhat. At large organizations, loan-loss provisioning decreased by roughly $220 million, but most of the ratios weren't substantially affected. The ratio of NCOs to loan-loss provision decreased 4 basis points, but at 129 percent, the banks are charging off more than they are provisioning for (Figure 17). The ratio of loan-loss provision to operating income decreased 12 basis points, to 16.53 percent, in spite of a decrease of about $878 million

[11] As reported here, loan-loss reserves are the balance-sheet item, and loan-loss provisions are from the income statement.

Figure 17

NCOs/Loan-Loss Provision

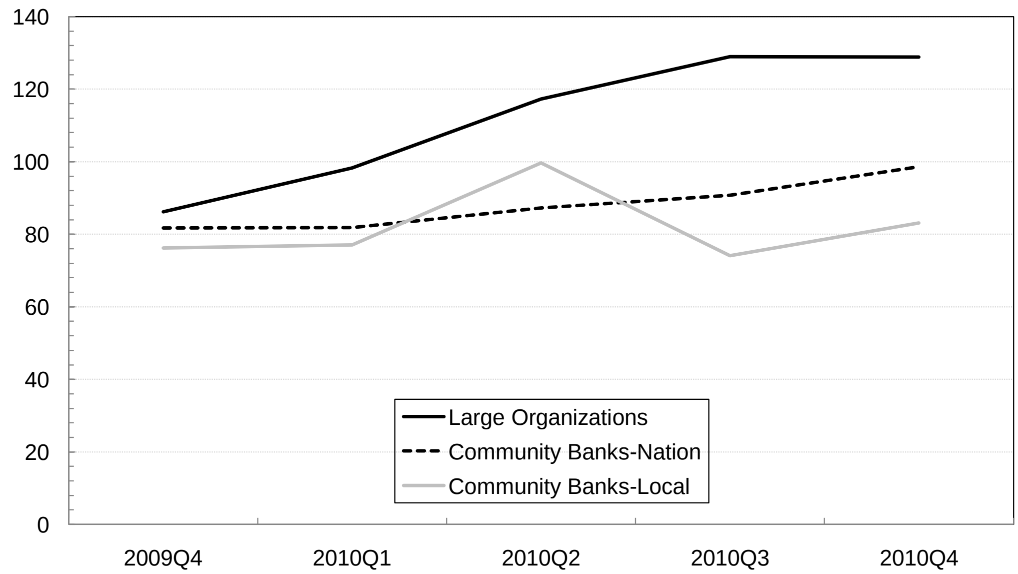
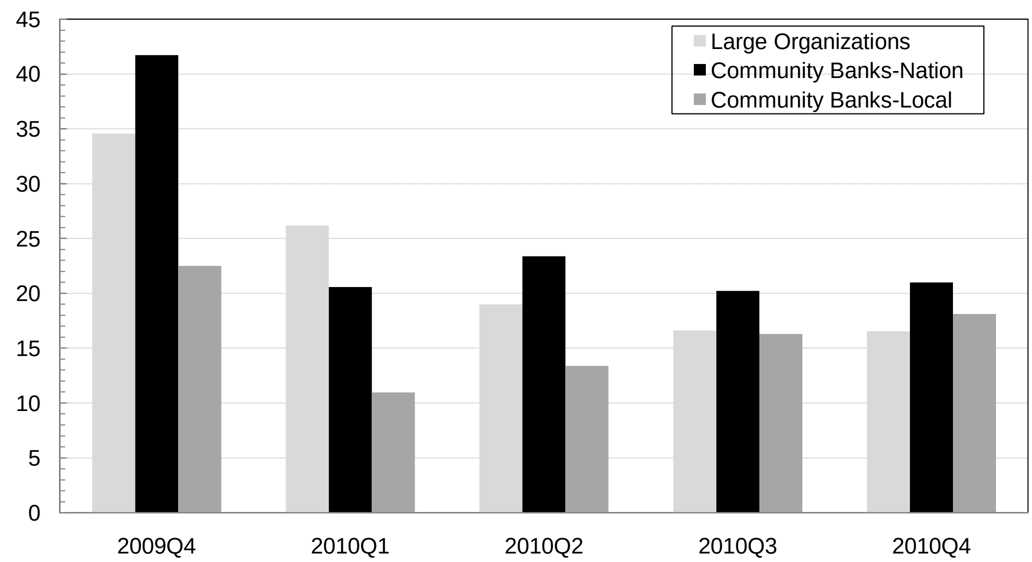
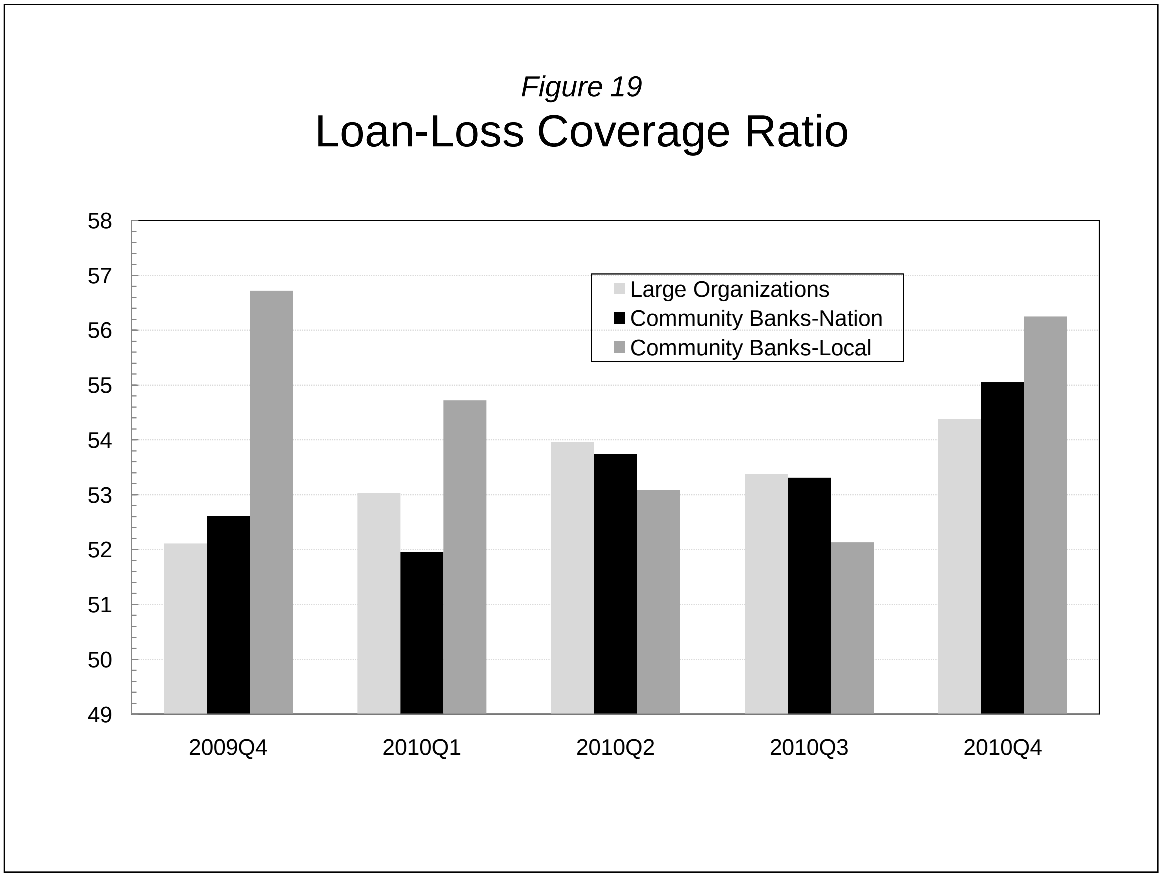


Figure 18

Loan-Loss Provision/Operating Income





in operating income (Figure 18).[12] The loan-loss coverage ratio increased by 100 basis points in the quarter, to 54.4 percent, and it has now been rising or steady for at least a year (Figure 19).[13] This means that banks have sufficient reserves to charge off about 54 percent of the NPLs on their books.

Community banks nationally increased their loan-loss provisioning by about $100 million in the fourth quarter, while local banks decreased theirs by $2.6 million. Nationally, reserves still decreased because of the increase in NCOs. As noted above, NPLs at smaller banks are decreasing, but they are not recovering as much from their charge-offs. The ratio of NCOs to loan-loss provision increased nearly 8 percentage points at community banks nationally, and it is now approaching 100 percent (Figure 17). Operating income fell nationally by about $202 million. Most of this decrease was due to tri-state area banks, where it fell by about $122 million. The ratio of loan-loss provision to operating income increased 76 basis points nationally, to 21.0 percent, and by 182 basis points locally, to 18.1 percent (Figure 18). The loan-loss coverage ratio increased for the third consecutive quarter nationally, by 174 basis points (Figure 19).

[12] Operating income is defined as the sum of net interest income and noninterest income.

[13] Loan-loss coverage is the ratio of loan-loss reserves to NPLs.

Securities

Figure 20
Summary of Securities Portfolios

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Securities/Assets	20.6%	20.8%	20.6%
Market Value ($Millions)	1,899,441.6	18,895.0	380,097.4
Change from Last Quarter	-1.6%	4.1%	20.0%
Change from Last Year	7.5%	6.6%	12.4%
Realized Gain/Loss	1,909.6	3.5	191.8
Pct of Average Securities	0.10	0.02	0.05
MarketValue/Book Value	100.89%	99.96%	100.37%

At large organizations, the market value of most classes of securities held by those institutions declined in value.[14] The only classes that showed an increase in value were mortgage-backed securities (MBS) and state and local government securities (munis). MBS (57.1 percent) and foreign securities (12.5 percent) represent the two largest classes of securities in the large organizations' portfolios, with no other class over 10 percent. Large organizations reported a realized gain on the value of their securities of $1.9 billion. This is lower than the gain in the third quarter ($2.2 billion) but more than double the gain in the fourth quarter of 2009 ($735 million). However, the large organizations also had unrealized losses on available-for-sale securities of almost $10 billion. This follows an unrealized loss of about $2.4 billion in the third quarter but is much less than the unrealized loss of $23.1 billion in the fourth quarter of 2009. This unrealized loss contributed to a decrease in total equity.

At community banks nationally, nearly every class of security except private-label MBS and mutual funds showed an increase in market value. MBS (mainly government-backed), debt securities of government-sponsored enterprises (GSEs – Fannie Mae and Freddie Mac), and munis make up over 90 percent of community banks' portfolios nationally. Community banks nationally reported a realized gain of $191.8 million on securities in the fourth quarter. This was down from $410 million in the third quarter but substantially more than the fourth quarter of 2009 ($15.5 million).[15] Community banks nationally also had an unrealized gain on available-for-sale securities of only $58,000 in the fourth quarter. This was a substantial decrease from both the third quarter ($4.4 billion) and the fourth quarter of last year ($1.3 billion).

[14] The figure for percent of assets uses the value of securities as reported on the banks' balance sheets. Securities there are reported at book value if they are held to maturity and market value if they are available for sale. Changes in market value can either be indicative of increases in the value of securities that were already owned or due to purchases or sales of securities.

[15] Realized and unrealized gains and losses are net positions. Thus, the tri-state area sample can have larger gains or losses than the national sample even though the tri-state sample is a subset of the national sample.

This drop in unrealized gains contributed to the decrease in total equity.

At tri-state area banks, Treasuries, securities of United States government agencies, MBS, and other domestic securities all showed substantial gains, while debt securities of GSEs and munis decreased in value. MBS, munis, and GSE debt securities make up 89.5 percent of the local banks' portfolios. Local community banks reported a realized gain of $3.5 million on their securities. This follows a $10.4 million loss in the third quarter of 2010 and a $17.2 million loss in the fourth quarter of 2009. They also had an unrealized loss on available-for-sale securities of $164.1 million. This follows an unrealized gain of $55.2 million in the third quarter of 2010 and an unrealized loss of $145.8 million last year. This loss was a contributing factor to the decrease in equity at tri-state area banks.

Funding Sources

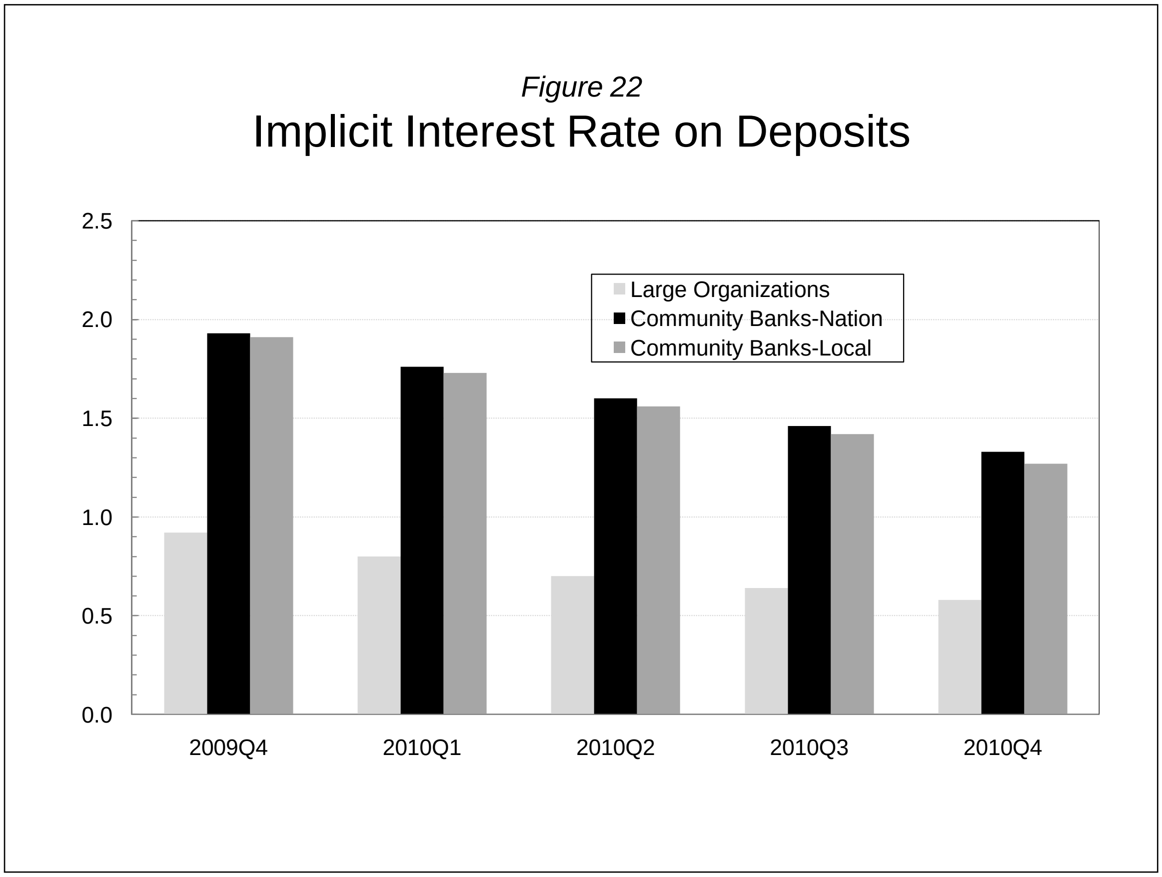
Figure 21
Structure of Liabilities

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Deposits ($millions)	6,517,141.3	75,429.2	1,528,119.2
Pct. of Assets	70.7	83.2	82.9
Change from Last Quarter	4.9%	-0.9%	1.0%
Change from Last Year	1.7%	4.7%	3.2%
Core Deposits/Deposits	55.6%	83.2%	82.3%
Implicit Rate on Deposits	0.58%	1.27%	1.33%
Nondeposit Debt ($millions)	1,114,549.3	5,575.2	115,190.4
Pct. of Assets	12.1	6.2	6.3
Change from Last Quarter	-34.9%	-20.7%	-14.9%
Change from Last Year	-14.4%	-18.6%	-14.5%
Implicit Rate on Debt	1.61%	2.97%	2.69%

At large organizations, deposits grew slightly but have been basically flat for a year. Reliance on debt funding continued to shrink substantially. As a percent of assets, debt funding has decreased 205 basis points since the fourth quarter of 2009. Core deposits increased 4.9 percent in the quarter but decreased 1.2 percent year-over-year.[16] The main growth in deposits was from transaction accounts, which increased 61.4 percent in the quarter and have increased 8.1 percent since last year. This growth was from both demand and nondemand deposits. In the nontransaction accounts, savings deposits grew 14.1 percent in the quarter, while time deposits shrank 22.4 percent. Brokered deposits barely grew at all, increasing 2.2 percent, and foreign deposits increased 4.2 percent. All forms of debt decreased substantially.[17] The implicit

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

[17] Debt funding consists of fed funds purchased and securities sold under agreements to repurchase, subordinated debt, Federal Home Loan Bank advances, and other borrowings.



interest rate on deposits decreased 6 basis points, to 0.58 percent (Figure 22), and the implicit interest rate on debt shrank only 3 basis points, to 1.61 percent.[18]

At community banks both locally and nationally, deposits were basically flat in the fourth quarter and debt decreased substantially. Core deposits were also flat nationally and grew just 2.2 percent locally. Nationally, transaction accounts, particularly nondemand accounts, increased 22 percent in the quarter, savings deposits increased 6.6 percent, and time deposits fell substantially. Brokered deposits were down 25.3 percent. Foreign deposits make up a very small share of total deposits but they also fell. For debt funding, fed funds increased somewhat, while nearly all other forms of debt fell. This was particularly true for Federal Home Loan Bank (FHLB) advances, which decreased nearly 24 percent. At local community banks, demand deposits showed the most increase, rising nearly 17 percent. Time deposits fell substantially and savings deposits were nearly flat, increasing just 2.8 percent. Brokered deposits fell 32 percent. In debt funding, securities sold under agreements to repurchase (repos) showed the largest decrease, but there were also substantial decreases in subordinated debt and FHLB advances. Both locally and nationally, implicit interest rates fell. Nationally, the rate on deposits fell 13 basis points, to 1.33 percent, and the rate on debt fell 11 basis points, to 2.69 percent. Locally, the rate on deposits fell 15 basis points, to 1.27 percent, and the rate on debt fell 9 basis points, to 2.97 percent. Note that these rates are much higher than those paid by large organizations, illustrating the dramatic cost advantage the larger organizations have over community banks.

[18] Implicit interest rate is computed by dividing annualized interest paid by the average total balance.

Regulatory Capital

Figure 23
Capitalization Measures

	Large Organizations	Community Banks	
	Nation	Tri-State Area	Nation
Total Equity ($millions)	1,010,885.4	8,760.3	186,842.5
Pct. of Assets	10.97%	9.66%	10.13%
Change from Last Quarter	-4.3%	-11.8%	-7.8%
Change from Last Year	4.3%	3.8%	5.5%
Tier 1 Capital ($millions)	743,550.9	8,183.8	171,638.2
Tier 1 Leverage Ratio	8.24%	9.15%	9.34%
Change from Last Quarter	-2.6%	-2.7%	1.4%
Change from Last Year	5.2%	5.7%	5.8%
Risk-Based Capital ($millions)	935,486.9	9,064.8	187,620.4
Risk-Based Capital Ratio	14.79%	14.05%	14.72%
Change from Last Quarter	-3.6%	-3.3%	0.7%
Change from Last Year	2.1%	4.9%	4.9%

Capital levels and most ratios decreased in all categories of banks; however, all categories are in a much better capital position than they were a year ago. At large organizations, the equity-to-assets ratio decreased 5 basis points from the third quarter, the tier 1 leverage ratio decreased 21 basis points, and the risk-based capital ratio decreased 10 basis points.[19] At community banks, nationally, the equity-to-assets ratio decreased 17 basis points, the tier 1 leverage ratio decreased 2 basis points, and the risk-based capital ratio increased 18 basis points. Locally, the equity-to-assets ratio decreased 21 basis points, but the tier 1 leverage and risk-based capital ratios were essentially flat.

The reasons for the drop in capital were pretty much the same in every category. First, institutions are paying out more dividends. At large organizations, dividends nearly doubled from the third quarter, from $9.5 billion to $18.4 billion.[20] The situation was much the same at community banks nationally, where dividends increased from $1.2 billion to $2.0 billion. Locally, the increase was smaller. Here dividends increased from $103.4 million to $109.3 million. The increased dividend payments resulted in lower retained earnings. The second reason was the unrealized losses on securities mentioned above. This would not have affected tier 1 capital, since unrealized gains and losses are not included in tier 1, but it did affect total equity and risk-based capital.

[19] Tier 1 leverage and risk-based capital are the two main ratios regulators use to determine if a bank is adequately capitalized. For further information, see the call report instructions at http://www.ffiec.gov/forms031.htm.

[20] This figure includes dividends paid on both common and preferred stock.