Banking Conditions in the 12th District: *Has the Recovery Taken Hold?*

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On September 20, 2010 the National Bureau of Economic Research announced that the longest and deepest recession since the Great Depression officially ended in June 2009. Yet, here we are more than a year later and many banks throughout the nation are still struggling mightily to recover from this downturn. This is even more pronounced in the 12th Federal Reserve District (comprised of Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington) where 42 banks and thrifts failed in 2008 and 2009, and another 31 banks have failed so far in 2010. Why has this recession had such a profound impact on banking conditions in the 12th District? In this article, we'll address some of the issues that contributed to the still-prevalent banking crisis, discuss some emerging signs of improving banking conditions, and consider the headwinds that the banking industry will continue to face as it mounts its recovery.

12th District Profile

Currently, roughly 520 banks are headquartered within the 12th District. A vast majority of these banks (83 percent) are small, community banks with total assets of less than $1 billion. Over the last two decades, the loan portfolios of these community banks in particular have become less diversified as they focused on certain niches that enabled them to effectively compete against credit unions and large banking organizations. Community banks found their competitive advantage in commercial real estate (CRE) financing, which includes funding the acquisition of income producing properties such as office buildings, retail centers, and apartment buildings, as well as funding the acquisition of land for future development and the construction of residential and commercial buildings.

With appropriate risk management practices in place, CRE lending itself is not a concern, especially when market conditions are benign. However, ever increasing concentrations of CRE loans do pose a risk to financial institutions when market conditions turn. Historically, commercial property values are more sensitive to adverse economic and real estate market conditions because the value of these properties are in large part driven by rents, vacancy rates, and the investor's rate of return expectations. In an economic downturn, it is inevitable that rents decline, vacancy rates increase, and rate of return expectations rise. Combined, these factors place significant downward pressure on property values and borrower repayment capacity. More importantly, land values (which typically generate no income until development and construction is complete) also often fall dramatically when economic conditions weaken, as demand for future development quickly stalls.

The increase in CRE lending in the 12th District is also the direct result of the strong growth that many parts of the District have experienced in recent years. Areas like Las Vegas, Phoenix, the Inland Empire of Southern California, and many others, were experiencing strong growth that was largely financed by community banks. Both residential and commercial property values in these markets were far more exposed when the downturn hit, as the pipeline of new and pending construction quickly outpaced waning demand. Over a very short timeframe, property values plummeted, as did the financial strength of the real estate developers and investors.

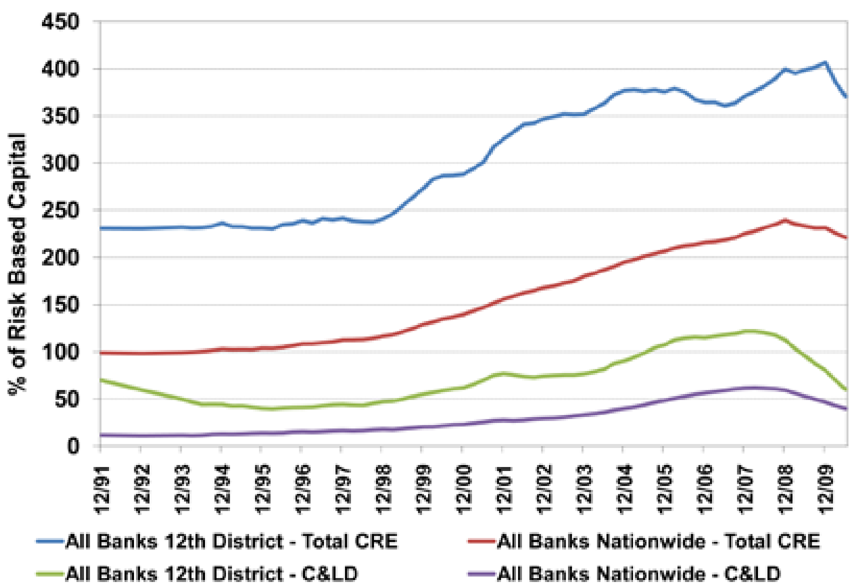
Rising CRE Concentrations

Figure 1 illustrates the extent to which CRE concentrations have increased since 1991 for all banks nationwide and those within the 12th District. Note that in the 12th District, before abating somewhat in 2010, total CRE peaked at over 400 percent of Risk Based Capital in 2009.[1] This was close to double the nationwide concentration, which was around 225 percent at the same time. Meanwhile, the overall levels of CRE lending are notably higher than they were in 1991.

We observe a similar trend in loans to finance Construction & Land Development (C&LD). Beginning in the mid-1990s, the concentration of C&LD loans in the 12th District increased from less than 50 percent of Risk Based Capital, to approximately 120 percent in late 2007. However, as the real estate market crashed and the recession began in late 2007, the concentration of C&LD loans dropped quickly; in the 12th District, the C&LD concentration has fallen back to a level last seen in 2000. Even more dramatic, the concentration of residential C&LD in the 12th District declined from just under 40 percent of risk based capital, to approximately 15 percent since late 2007.

The declining CRE concentrations, and in particular the declining C&LD concentrations, are not the result of these loans being repaid. Instead, the declining concentrations are largely the result of banks charging-off and restructuring more of these loans. At the end of 2007, the

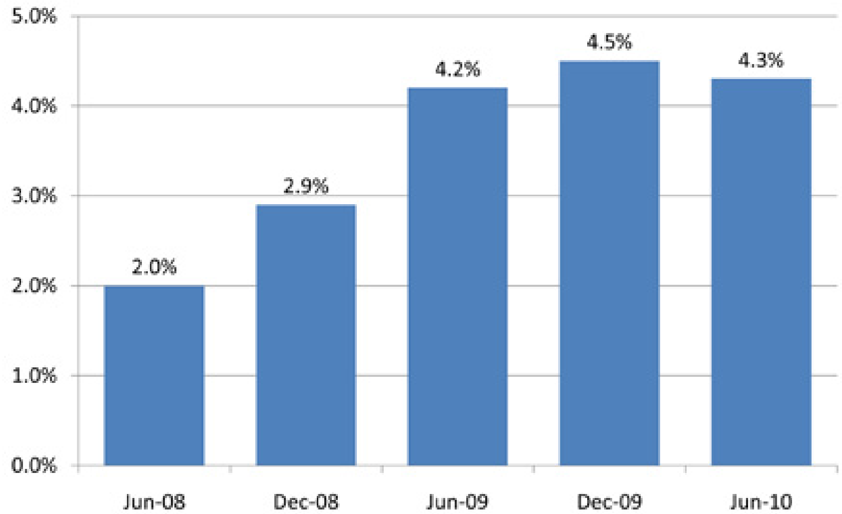
Figure 1 *Loan Concentration History*



"... total CRE peaked at over 400 percent of Risk Based Capital in 2009."

"In the last quarter of 2009, 54 percent of 12th District banks lost money. In the first quarter of 2010, this percentage fell to 38 percent; it then fell again to 37 percent in the second quarter."

Figure 2 *District Noncurrent Loan Ratio Edging Downward*
12th District Bank Noncurrent Loan Ratio (Aggregate)*



** Aggregate data for all District commercial banks with <$50B in loans*
Source: Federal Reserve Bank of San Francisco 12th District Banking Profile, September 2010

net charge off rate for C&LD loans in the 12th District was 0.26 percent. This net charge off rate ballooned to 3.75 percent by the end of 2008—the highest loss rate since 1991. Then, in 2009 it swelled to 8.55 percent, and for the first six months of 2010, the net charge off rate remained high at an annualized 6.05 percent. The numbers are even more striking if we focus specifically on residential construction loans.

These hefty losses on large volumes of CRE loans have directly led to declining profits for the banking industry, particularly for the banks located in the 12th District. The second quarter of 2010 marked the seventh consecutive quarter of negative Return on Average Assets (ROAA) for the 12th District. The average quarterly ROAA in the 12th District on June 30, 2010 was -0.11 percent. Further illustrating the disparate impact on smaller banks, the ROAA for community banks was -0.28 percent; for banks with total assets of $1 billion to $10 billion it was 0.08 percent, and for banks larger than $10 billion it was a relatively strong 0.99 percent.

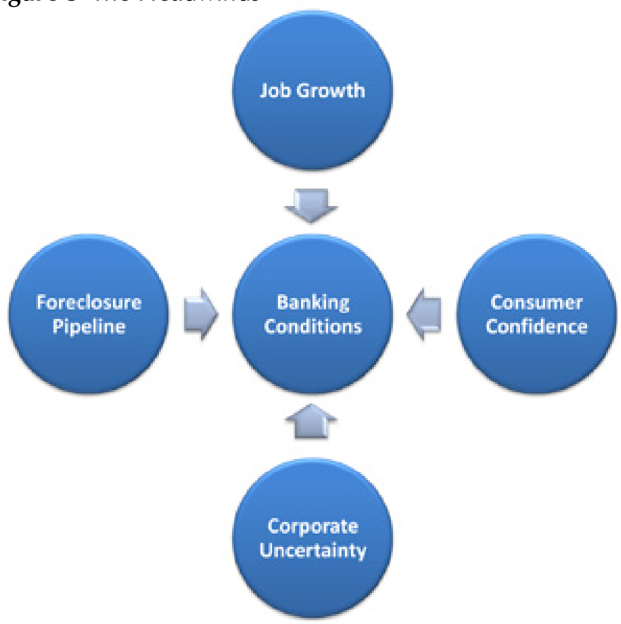
Some Signs of Stabilization

Despite the sizeable losses that many banks in the 12th District incurred as a result of their significant concentrations of loans secured by CRE and more specifically, C&LD, there are some signs that banking conditions have stabilized and may improve. For example, the volume of problem loans is beginning to recede, an increasing number of banks have returned to profitability, there are some signs of emerging loan growth, and an increasing number of banks have successfully raised capital in recent quarters. Consider the following trends:

- The total noncurrent loan rate (loans past due 90 days or on nonaccrual status) has been relatively flat over the last three quarters and has actually inched down in the latest quarter (see Figure 2). At June 30, 2010 the percentage of total noncurrent loans was 4.3 percent.
- The noncurrent rate for C&LD loans dropped from 15.7 percent in the first quarter of 2010 to 14.6 percent in the second quarter of 2010. This is still at a very high level, but it appears to have peaked.
- In the last quarter of 2009, 54 percent of 12th District banks lost money. In the first quarter of 2010, this percentage fell to 38 percent; it then fell again to 37 percent in the second quarter.
- Although the annual loan growth in the District is still negative, some loan segments are now showing positive loan growth. Of note, loans secured by apartment buildings are increasing at an eight percent annual rate. Credit card loans are increasing at a five percent annual rate.
- At June 30, 2010, almost 10 percent of 12th District banks successfully raised capital over the prior 12 month period. This is up from 7.7 percent at mid-year 2009 and 6.6 percent at mid-year 2008. Meanwhile, capital ratios are improving in the District.

These are just a few of many positive developments noted in the June 30, 2010 data. However, improving trends need to be kept in perspective. Although we see signs of improving profitability, it is still negative on

Figure 3 *The Headwinds*



average for the District. Although noncurrent loans are starting to decrease, the level still remains extremely high and although capital ratios have improved, they still need to improve further. Moreover, as addressed in the next section, there are headwinds facing the industry that could reverse some of these positive trends, or more likely, make the recovery in banking conditions a long and slow one.

The Headwinds

Although we may have technically exited the recession in mid-2009, the economy has clearly not yet fully recovered. Until the economy gains strength, it will be difficult for the banking industry to fully recover. Many of the factors that are now impeding the economic recovery also contribute to the uncertain banking environment. These so-called headwinds make it difficult for us to conclude that banking conditions have definitely turned the corner. At the very least, these headwinds strongly suggest that it will be some time before the banking industry is back at full strength.

The first headwind is low job growth and high unemployment. Without a substantial uptick in hiring, consumers and businesses will continue to hold back on spending. Consumers do not spend money if they are out of work or fear that they may soon be. Also, in the face of unemployment and reduced income, borrowers are less able to repay any loans that they may already have.

A second challenge is that consumer confidence remains weak. Consumer confidence will improve as unemployment falls, but consumers continue to worry about their housing situations and their own balance sheets. Even with improving job prospects, consumers may still be slow to spend until they feel they have appropriately replenished their own net worth.

Third, there is still a great amount of corporate uncertainty. Corporations are slow to expand operations in periods of uncertainty. Political issues, tax issues, consumer confidence, and the changing regulatory environment together create a cloud of uncertainty. Even when this cloud clears, it may be some time before businesses actually need credit because corporate balance sheets are now flush with cash.

A fourth headwind is the significant volume of residential mortgage loans that is still working its way through the foreclosure pipeline. Even as housing conditions improve (albeit gradually), home prices will continue to face downward pressure as an ever increasing number of distressed properties are put on the market. It will be some time before the market fully absorbs this inventory and home prices begin to show any notable improvement. The current moratorium on foreclosures by some banks—prompted by concerns over their foreclosure processing systems—may also affect the housing recovery.

The Outlook

Given these headwinds, the outlook for banking conditions remains uncertain. There is strong evidence to suggest that the industry has turned the corner and that the worst is behind us. Nevertheless, the industry is still facing significant challenges. Community banks in particular are still struggling to recover from losses in their CRE portfolios, and although capital is improving throughout the District, banks will need to continue to strengthen their capital positions as problem loans remain high and significant uncertainties remain.

In the coming quarters, we will likely see incremental improvement in banking conditions at the community bank level and continued profitability at the larger institutions. However, until there is more clarity around the headwinds noted above and other uncertainties affecting the industry, it is more than likely that it will be well into 2011 before the banking industry is back on sound footing.

If you're interested in learning more about banking conditions in the 12th District, you can find additional reports by the Division of Banking Supervision and Regulation on their website at http://www.frbsf.org/publications/banking/index.html.

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Endnotes

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1. For regulatory purposes, capital is divided into two segments, Tier 1 (core capital) and Tier 2 (supplemental capital). Tier 1 (or core capital) includes: common equity, surplus, and undivided profits (retained earnings); qualifying non perpetual preferred stock; and minority interest in the equity accounts of consolidated subsidiaries; less any amounts of goodwill, other intangible assets, interest only strip receivables and non financial equity investments that are required to be deducted, and unrealized losses on Available for Sale investment equity portfolio, as well as any investments in subsidiaries that the Federal Reserve determines should be deducted from Tier 1 capital. Tier 2 capital consists of a limited amount of the allowance for loan and lease losses; perpetual preferred stock that does not qualify for inclusion in Tier 1 capital; certain other hybrid capital instruments; mandatory convertible securities; long-term preferred stock with an original term of 20 years or more; and limited amounts of term subordinated debt, intermediate term preferred stock, including related surplus, and unrealized holding gains on qualifying equity securities.

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