Bank Asset Quality, Liquidity, and Capital

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Moderator: *Welcome to the Federal Reserve Bank of Atlanta's* Financial Update Focus *podcast. We're speaking with Brian Bowling, assistant vice president in the Atlanta Fed's Supervision and Regulation Department. We're talking today about the banking landscape and what changes banks in the Southeast are seeing with regard to asset quality, liquidity, and capital. Thank you for joining us today, Brian.*Photo of Brian Bowling

Brian Bowling: Thank you.

Moderator: *Brian, based on the second quarter bank call reports, what changes are you seeing with regard to asset quality for banks in the Southeast?*

Bowling: Well, a couple of things come to mind. The two most evident changes in the second quarter data were higher levels of nonperforming loans—significantly higher in some cases—and an increase in the number of unprofitable banks as a result of provisions for loan losses. Neither trend was unexpected. Home sales and construction activity peaked really about two years ago, and there's always a lag between the turning point in the market and the point at which borrowers can no longer service their debts. And we've clearly reached that point for a lot of borrowers in the first part of the year.

To be a little more specific, at district banks, the median, noncurrent loan ratio—and by that I mean loans that are past due 90 days or more—was a 1.1 percent in the second quarter. While that may not sound like a high number, it actually is. It's more than double the level a year ago, and it's well above the peak that we saw during the 2001 recession. Also, keep in mind that that's a median number, so there is a growing subset of banks for which the noncurrent loan ratio is actually well into the double digits, and when a bank has that many loans that aren't paying any interest, it's very difficult to make money, and capital can erode very quickly as those losses start to be recognized.

The other notable trend that I mentioned in the second quarter data was the impact that the weak asset quality is having on bank earnings. Second quarter earnings at district banks fell by more than 50 percent from the level of a year ago, and the number of unprofitable banks more than doubled. In fact, nearly one in three banks in the region reported a net loss in the second quarter, and in most cases this was a direct result of setting aside money for expected future loan losses.

I should point out that not all banks are affected in the same way. There are significant differences in these measures across banks depending on things like the mix of their loan portfolio as well as the geographic markets in which they lend. For example, most of the credit problems in the district are concentrated in land acquisition, development, and construction loans, all of which are directly tied to housing. And from a geographic standpoint, the biggest challenges continue to be in South Florida and metropolitan Atlanta, two areas that saw very high levels of housing construction prior to the downturn.

Moderator: *Would you say that right now liquidity is being stressed and, if so, why?*

Bowling: Yes, it is, it definitely is. In fact, I would say that for many banks, liquidity is an even bigger issue right now than the credit problems that we hear so much about. The two are obviously related. As you know, banks are in the business of taking money, borrowing money from people with excess funds, and lending it out to people who need funds. So banks get their funding, or liquidity, from a wide range of sources. Obviously, individual depositors, but also deposit brokers, the capital markets, other banks, the Federal Home Loan Bank system as well as the Federal Reserve's discount window. So there are a lot of sources of liquidity available to the banking industry, but when banking conditions deteriorate as they have over the last year, and people start to question the health and viability of some institutions, those funding sources can dry up very quickly, and that's what happening. Liquidity tightened considerably in July, particularly after the IndyMac failure. Immediately after IndyMac was taken over by the FDIC, a number of analysts published reports identifying banks that they thought also were at risk. And as you might imagine, that led a lot of depositors to move money—especially uninsured money—out of those banks. At the same time, the deposit brokers, correspondent banks, and other funds providers were assessing their own risks, and reducing their exposure to certain banks that they thought were too risky. And so, all of this has had the effect of making funding more expensive for all banks, and for some, access to funds at any price is very limited right now.

Moderator: *How are the region's banks faring in terms of their capital positions?*

Bowling: Well, despite the problems banks are facing, most of the regions banks are considered well capitalized currently by regulatory standards. Some banks were early to recognize the extent of the problems that were coming, and they were able to raise capital last year, or early this year, when investors were more willing to provide it. Other banks have been aggressive in shrinking their balance sheets, or deleveraging, and also suspending dividends in order to preserve higher capital ratios. So, overall, most banks are okay, but for others, the combination of nonperforming loans, the cost of foreclosures, and having to hold some loans on their balance sheets that they had intended to sell is definitely straining capital. A number of banks are actively seeking capital right now, not just in this region, but nationally. Some are pursuing the sale of trust preferred securities, others are looking at secondary stock offerings, or making direct appeals to their boards of directors, and others are also entertaining interest from private equity groups for new capital.

Moderator: *How stressed are banks in the Southeast region because of the deepening foreclosure problem?*

Bowling: For the most part, all of the challenges that I mentioned—from asset quality to earnings to liquidity and capital—are related to what's happening in the housing market, and obviously foreclosures are certainly a big part of that. I think it's important to understand that foreclosures impact banks differently depending on which stage of the housing supply chain you are financing. For example, for banks that primarily originate mortgages, particularly those that have offered nontraditional products like option ARM loans, or alt-A mortgages, or loans with little or no documentation, home foreclosures are a significant and growing problem. However, many banks in the Sixth District actually don't have large mortgage portfolios on their balance sheets, and even fewer were involved in the subprime and all-day lending, where most of the foreclosure problems have been concentrated so far. Instead, many of these banks, their focus has been on financing the construction and development of housing rather than the actual sale of the homes. Unfortunately, the risks in that type of lending can be as great, or perhaps greater, when the market stalls. When a bank forecloses on a house, on a mortgage, it takes back one house, but when a bank forecloses on a builder or developer, it may take back an entire subdivision or condominium project often incomplete, and so the cost associated with carrying that, and then with completing the project, and ultimately disposing of it can be overwhelming, particularly for smaller institutions.

Moderator: *Are there any bright spots right now for the region's banks? Are there risk-appropriate lending opportunities?*

Bowling: Yeah, actually there are some bright spots. I should start by emphasizing that the issues we've been discussing affect a subset of the broader banking industry. There are still more than 7,000 banks in the U.S., and there are more than 1,000 in the sixth district, and most of them are going to manage through this and be fine. The banking problems today are mostly tied to housing, either through mortgages or construction lending, but there are a lot of banks that aren't overly exposed to housing and instead focus more on lending to small and medium-sized businesses and a number of industries are still doing quite well, and fortunately some of those have a presence in the region. Two, in particular, are energy and health care. Banks continue to tell us that loan growth opportunities are still strong there, and credit concerns are really minimal right now. Also, even within the real estate sector nonresidential real estate—this would be things like office, retail, apartments, or industrial space—there's still growth opportunities there, although there are some concerns that the longer housing remains in decline, the greater the likelihood of some spillover effects into those sectors, particularly retail and office space.

One other bright spot, if you could call it that, is that banks in some markets are at least starting to see a pickup in sales of foreclosed homes in recent months. We've heard this from banks in South Florida, along the west coast of Florida, and around metro Atlanta. Of course, these are distressed sales, and they do have the undesired effect of bringing down prices in those local markets. Nonetheless, it's a necessary first step toward reducing the excess housing inventory and finding a market-clearing price.

Moderator: *What are you hearing from bankers in terms of their concerns for the rest of this year and into 2009?*

Bowling: From my perspective, I think bankers are not very hopeful of seeing any kind of turnaround this year. One of the concerns for 2009 is that it will look a lot like 2008. I don't think there's any question that 2009 will be another difficult year for banks, not just in the Southeast, but nationally. And, while this sounds pretty negative, I will say that most bankers recognize the challenges that they're facing, and they're responding as you would expect them to by working with their problem borrowers, raising liquidity and capital to carry through the rough period, and being disciplined in underwriting new credits. In my opinion, the banks that are taking those steps are going to benefit in the long run from having a strong risk management discipline, and their also likely to pick up market share as conditions improve because some of the weaker competitors simply aren't going to be there.

Moderator: *Thank you again, Brian.*

Bowling: Thank you, it was my pleasure.

Moderator: *We've speaking with Brian Bowling of the Atlanta Fed. This concludes our* Financial Update Focus *podcast on banking issues. For more information, please see* Financial Update *on the Atlanta Fed's Web site. Thank you for listening, and please return for more podcasts. If you have comments, please e-mail us at podcast@frbatlanta.org.*