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Digging Out

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Here's the bad news: L.A.'s banks have had a year they would like to forget.

Here's the sort-of-good news: The banks have learned a lesson they're not about to forget anytime soon – and they're changing their ways, fast.

Wracked by the mortgage crisis, credit crunch and now an economic downturn, most of L.A.'s banks have taken sharp hits to their bottom lines. Many have posted losses, while others have watched their share prices wither.

Even L.A.'s smaller community banks, which had expected to ride out the storm because they didn't make the riskiest home loans, are now feeling the pain.

"This will be a time that most of us in the industry will forever remember," said Robert Sweeney, president of L.A.-based Far East National Bank. "When you have some institutions where you know the management teams well and you watch their market value melt down by 85 percent in the course of a year, that's dramatic. That's a heck of a ride."

Of course, L.A.'s banks are not alone.

It's been a difficult year for banks across the nation and L.A.'s banks generally appear to be falling in line with national averages in key indicators like return on assets, loan losses and net income – in some cases better, in others worse.

L.A. County-based banks saw a 24 percent drop to 0.29 in the first quarter average return on assets, compared with a year ago. By contrast, the average return on assets nationally fell 29 percent during the same period to 0.62, according to figures compiled for the Business Journal by Irvine-based Carpenter & Co. Investment Bankers.

The local banks' poorer performance reflects L.A.'s high number of startups, which for several years tend not to perform well by this measure of net income as a percentage of assets. Even so, return on assets below 1 percent are considered poor.

Meanwhile, in another key indicator, the ratio of nonperforming loans (more than 90 days past due) to total loans, also has been worsening. L.A.-based banks – which had been faring slightly better than their national counterparts – now have dropped to the same level. The local banks posted a nonperforming loan ratio of 1.21 percent in the first quarter 2008, more than double a year ago – and just under the 1.24 percent national average.

While L.A. banks escaped some of the worst home mortgage losses, they are now facing rising delinquencies on construction and development loans. Many local banks plunged into this market as the housing boom was peaking, especially in the fast-growing Inland Empire and high desert communities, now among the nation's worst housing markets.

And it's not just real estate-related loans. Credit card delinquencies are rising as consumers are being hit by high gas and food prices and are unable to tap additional home equity, another loan market that has dried up.

All this has resulted in a 48 percent plunge in net income at L.A.-based banks in the first quarter of 2008, compared with a year ago, outstripping the 36 percent drop in net income nationwide, according to Carpenter & Co. The worst may lie ahead.

"The critical question is whether or not we have peaked relative to nonperforming loans. There are some data to indicate additional losses over the next year's time, particularly in the commercial real estate area," said Ed Carpenter, chairman of Carpenter & Co.

The prospect of more loan losses is bad news for shareholders. Several community banks have already seen their stock prices drop by more than 50 percent over the past 12 months, with a few banks down more than 90 percent, including Culver City-based Alliance Bank.

All this doesn't bode well for the local economy. Banks with rising loan losses tend to pull back on the new loans they make. "Most of the capital that small businesses raise comes from banks. If the banking industry isn't in a position to do a lot of lending, it will stagnate the economy until things turn around," said Alliance Bank President Curtis Reis.

Roots in subprime

For much of this decade, well into 2007, L.A.'s banks enjoyed a prosperous run. They had shaken off the recession and consolidation of the 1990s. More than a dozen new banks were launched, mostly targeting the vast numbers of small and middle market businesses in the L.A. basin. As the local economy boomed, bank assets increased, as did the number of branches.

Trouble first appeared in early 2007 with the crisis in subprime loans, mortgages made to high-risk borrowers who often put no money down and were dependent on ever-rising home values to make their payments. When home values flattened in late 2006, subprime borrowers, who had expected to refinance their mortgages but were unable to do so, began missing loan payments at rates far higher than many projected. A spike in foreclosures soon followed.

At first, it appeared the fallout would be contained to the county's two major subprime lenders, Calabasas-based Countrywide Financial Corp. – the nation's largest mortgage lender – and the now-bankrupt Fremont General Corp. Even when the damage spread to Pasadena-based IndyMac Bancorp Inc., a savings and loan that specialized in nonprime "Alt-A" mortgage loans, the betting was that most smaller banks would not be impacted.

Late last year, however, conditions began deteriorating at some of the region's smaller banks. Even though many had already curtailed construction and home equity loans, they still had plenty of these loans on the books.

"As housing prices flattened and ultimately fell … some builders were left with inventory while other builders could no longer perform on their construction loans," said Stuart Gabriel, finance professor at UCLA Anderson School of Management and director of the UCLA Ziman Center for Real Estate.

At Alliance Bank, for example, delinquency rates began shooting up. As of this past March 31, Alliance had one of the highest ratios of nonperforming loans to total loans of any bank in the county, at 7.1 percent.

"We really stopped doing construction loans in the second quarter of 2007, we sensed things were slowing down and the prices were too high," said Alliance's Reis. "(But) we made a lot of construction loans in 2005 and 2006 to good long-term customers."

Some of the projects did get completed, but only after market conditions had turned and the units had to be steeply discounted, which meant the bank had to absorb some of the loss on its loans. "Other projects never even got off the ground. They were stopped in the planning stages," Reis said.

Alliance was hardly alone. Banks all over the region had financed the construction boom and are now watching their loan delinquencies rise.

One of the most severely impacted regional banks was PFF Bank & Trust. The Rancho Cucamonga-based bank was slammed by the April bankruptcy filing of Empire Land, an Ontario-based land developer.

It reported a $159 million loss for its fiscal fourth quarter ended March 31 and announced it was raising capital through a $460 million private placement that would have severely diluted existing shareholder value. Instead, on June 16 it said it had agreed to be purchased by Oak Park, Ill.-based FBOP Corp., parent of California National Bank.

But not all banks rushed into the home and construction loan markets. Farmers and Merchants Bank briefly waded into the construction loan market in the early years of this decade, but scaled back in 2004, well before many of its competitors.

“We did not compete in the construction lending market because we felt it was moving too fast and construction loans are generally more risky than loans on completed properties,” said Henry Walker, chief executive of the Long Beach-based bank.

As a result, Farmers and Merchants’ ratio of nonperforming loans has only risen from 0.2 in the first quarter of 2007 to 0.41 in the first quarter of 2008. Net income has been virtually flat during that time, while the average net income of the county’s banks plunged 48 percent.

Uncertain future

Walker said, however, that neither his bank nor other community banks are out of the woods yet.

Last summer’s credit crunch – though it directly hit the bigger banks loaded with securitized loans sold off on the secondary market – had ripple effects that were felt by smaller banks. One example: With other sources of capital cut off, big mortgage lenders like Countrywide and Washington Mutual Inc. began luring in depositors to their banking operations with high rates of return on certificates of deposit. To remain competitive, smaller local banks were unable to lower their CD rates even as the Federal Reserve cut interest rates. This put a squeeze on interest income generated by bank loans, according to James Barth, senior fellow at the Milken Institute in Santa Monica.

And banks seeking to raise capital to strengthen their balance sheets are running into trouble as losses mount and share prices on recent capital offerings have plummeted. That means banks will have to sweeten the deal to raise more funds.

“It’s getting very expensive to raise capital,” said Alliance Bank president Reis.

An example of one recent loss that has soured investors: In April, Pasadena-based East West Bancorp issued 175,000 shares of preferred stock at a conversion price of $15.39 per share, a 22.50% premium based on the initial closing price. As of June 24, the common share price was $7.16, leaving the investors with little to show for their money.

And there’s been an uptick in consumer credit and business loan delinquencies as the economy has softened and gas and commodity prices have soared. What’s more, the unemployment rate in L.A. County has soared from below 5 percent 18 months ago to 6.8 percent as of May.

“Right now, the biggest threat we’re looking at is the rising unemployment rate,” said Walker of Farmers and Merchants.

As a result, many L.A. County banks have now become stingier with money, trimming portfolios wherever possible and tightening credit standards.

“We’re doing stress-testing of our portfolios much more frequently than before,” said Far East National Bank President Robert Sweeney. That includes updating appraisals on real estate-related loans and being more conservative in the risk ratings for loans.

At Beverly Hills-based City National Bank, the largest bank headquartered in L.A. County, Chief Executive Russell Goldsmith said the bank is now giving “very careful scrutiny” to all real estate-related loans. “We’ve got a rapidly deteriorating set of prices that we’re watching.”

Indeed, the prospect of a weakening economy on the edge of recession, more delinquent real estate loans, squeezed interest rate margins and difficulty in raising capital all point to tough times possibly extending into 2009.
