Look Into the Crystal Ball

The Business Banking Outlook for New Jersey

by Stuart Hoberman and Susan Storch

The focus of this article is to provide an overview of the conditions that led to the financial crisis and the ensuing changes in government regulations that resulted. Further, this article provides a look at the state of the economy from the view at the presidential level of some of the top banks in New Jersey, the state’s banking commission, and the professional association that represents New Jersey bankers, as of mid-summer.

Background on the Economic Crisis

Upon signing the Wall Street Reform and Consumer Protection Act on July 21, 2010, President Barack Obama commented that the bill will “protect consumers and our entire economy from the recklessness and irresponsibility that led to the worst recession since the Great Depression.”

A little over a year earlier, Federal Reserve Bank Chairman Ben Bernanke stated that “(t)he current crisis has been one of the most difficult financial and economic episodes in modern history. Recently we have seen tentative signs that the sharp decline in economic activity may be slowing, for example, in data on home sales, homebuilding, and consumer spending, including sales of new motor vehicles. A leveling out of economic activity is the first step toward recovery. To be sure, we will not have a sustainable recovery without a stabilization of our financial system and credit markets.”

More recently, on June 16, 2010, Bernanke commented that the “stakeholders in financial firms... must bear the costs of excessive risk-taking or poor business decisions, not the public.” He further added: “Weaknesses in both the private sector and public sector, in the framework for regulation, and in supervisory execution all contributed to the crisis. The crisis in turn led to a severe tightening of credit, a collapse in confidence, and a sharp global economic downturn.”

Robert Khuzami, director of the Division of Enforcement, Securities and Exchange Commission (SEC), announced on July 16, 2010, the “landmark $550 million Goldman Sachs Settlement” included public admissions by Goldman that it misled investors over numerous financial transactions. Khuzami further stated that this is “the largest penalty ever assessed against any investment bank or other Wall Street firm in the history of the SEC.”

Despite stepped-up enforcement measures, bankers throughout New Jersey have expressed trepidation over the rule-making of the more than 2,000-page act. It is expected that the regulations will not be fully implemented until 2014. Many community banks are apprehensive about the strict language of the new law, which may impede their ability to compete effectively in the marketplace. Regional banks have raised doubts over whether they will be able to continue to provide certain services free of charge. National and global banks, perhaps the real targets of the legislation, have speculated that the impending implementation costs could result in increased charges to customers.

State Government View

In light of the current regulatory climate and issues facing the banking industry, we asked New Jersey’s commissioner of banking and insurance, Thomas B. Considine, his views on the state’s economy. The following is a summary of his views.

State of New Jersey, Department of Banking and Insurance

Economic development is a mandate for our state and we are working with businesses to encourage a public-private partnership to move forward. Overall, we find that while the environment for banks is improving, investment returns remain challenged. Banks are being cautious on approving commercial loans for real estate and construction. Small business growth drives the economy, and these businesses continue to struggle to obtain credit. I believe banks should review their analysis of loan-to-value ratio in extending credit. Some current valuations of corporate assets are unreasonably low. Banks need to look...
over a historical period in time and not just low points in the market.

As to the current state of the New Jersey mortgage industry, I believe a moral hazard is created in permitting mortgage debt forgiveness following short sales in the marketplace. We expect to see a double dip in foreclosures over the near future. The current foreclosure time in some counties is taking up to 700 days and we should consider ways to cut down on that time. It creates a risk to the value of other properties in the neighborhood.

With the impending changes in banking regulations, we expect to see a lot of new banking products and will encourage consumers to be very assertive in dealing with the banks to maintain what services they currently have. For instance, totally free checking may move to a thing of the past. Given the stricter regulations, banks will try to recoup revenue in areas like consumer fees. With regard to credit card fees, consumers will have to be proactive in threatening to cancel cards if fees are not waived if they once were in the past. Community banks are to be thanked for the fact that the banking industry returned to profitability in late 2009, according to FDIC Chairman Sheila Baird.

While we are seeing little in the way of banking consolidation at this time, many in the industry expect consolidation to escalate when the financial reform act becomes fully implemented.

Professional Association View

Given the economic downturn and the expectation of stricter financial regulations, we interviewed Jim Silkensen, co-chief executive officer of the New Jersey Bankers Association. The following is a summary of his views.

New Jersey Bankers Association

We have spoken with many of our member banks and believe that there will be some opportunity for new lending as the economy slowly improves. There is some light shining from the end of the tunnel.

There are certainly going to be major changes in terms of what banks will have to deal with under the new federal and state laws. With the passing of the Wall Street Reform and Consumer Protection Act, new regulatory restructuring will place constraints on certain types of operations affecting large banks. We anticipate that small institutions, already under a heavy regulatory compliance burden, are going to face a further challenge as they work to comply with new federal regulations to be issued by the new Consumer Financial Protection Bureau. We could possibly see more mergers or acquisitions of smaller banks in the near future.

In New Jersey we have had only two bank failures—both small banks—and our current failure rate is not nearly as bad as other states like Florida, California or Georgia. The 9.51 percent aggregate capital ratio for New Jersey banks at the end of March is strong, up from 9.33 percent at the end December.

In terms of loan demand, we find that it is still pretty low. There is demand from companies that do not have the strongest credit in this market and, with regulators watching what banks are doing, bank loan officers are not inclined to make loans unless they are confident they will be repaid. The strongest companies are holding back on making large investments until they are certain that the economy is, in fact, improving. Thus, loan demand remains stagnant for most banks. Interest rates have dropped slightly from December 2009 to March 2010, and banks do have a lot of cash available to make loans. The commercial real estate market has been relatively dead, particularly the construction end. A lot of banks are trying to work their way out of loans that have become non-performing as a result of the recession.

In the residential market, banks seem to be encouraging short sales, and some may actually consider forgiving the remainder rather than face a long, drawn-out foreclosure process.

In our review of national data on delinquencies, we find that there is some improvement in that people are saving more and starting to pay down on their debt. Bank credit card delinquencies have been reduced from 4.9 to 3.8 percent between March 2010 and December 2009. Delinquencies on home equity lines of credit are down, as are delinquencies on direct and indirect auto loans.

With regard to construction lending, our members tell us that construction of homes, retail businesses and office buildings is largely dormant, while construction of multiple-family units continues to be stable.

Overall, we should see some growth over the coming year, as the economy continues to slowly improve, and while banks continue to adjust to new rules and regulations.

Views From the Private Banking Sector

We arranged interviews with a number of national, regional and community banks in New Jersey. We found that several banks, while interested in being interviewed, declined comment as this issue of New Jersey Lawyer Magazine goes to press for reasons such as talks of an acquisition or merger, recent reports of severe losses, or a possible federal compliance audit. Essentially, we learned that as fluctuations in the economy continue, bankers seem to raise a cautious eyebrow.

Several of the banks interviewed for this issue spoke of the frustration of being victims of the economic slowdown brought on in part by the lax credit lending of other institutions in the industry. Many of them did not participate in the subprime or Alt A market, which helped to create these financial problems. Therefore, they did not benefit from the windfall income produced by selling these loans, as did many of the offending
lenders. Since the bubble burst, they are being hurt by the fallout, with even some of their good, highly qualified borrowers being forced into bankruptcy and foreclosure due to high and long-term unemployment, and the staggering losses in both home and securities equity. In turn, the government is encouraging these same responsible lenders to be more lax in their dealings with delinquent and underwater homeowners.

One of the areas we discussed with the banks was the mortgage crisis. Some opine that the crisis was caused by lax lending standards, which allowed people who otherwise would not have been able to purchase a home to do so. This created a much higher demand than would have existed in a normal market. Creditworthy borrowers were forced into situations where they purchased homes at inflated prices. Once the financial bubble burst, however, these same individuals found themselves upside down on their mortgages and, if they are lucky, still employed.

Easy credit created an unsustainable housing market that has nearly brought the financial markets to their knees.

In a normal recession, homeowners would be able to sell their homes, recoup their equity and either downsize or rent until the economy recovered. Due to the magnitude of both the rise and fall of the housing market and the financial market burst, thousands of people lost their jobs in not only the banking industry but those sectors that support banking, including the legal field, retail service, auto manufacturing and construction, tourism, and luxury industries, among others.

Also in a ‘normal’ recessionary cycle, the Federal Reserve would use lower interest rates and espouse a loosening of credit standards to spur the economy by freeing up and increasing household discretionary spending. In this recession, which was, in part, caused by already lax credit standards, the knee-jerk reaction has been to tighten credit standards, making even highly qualified borrowers jump through hoops to obtain a mortgage, which slows down the process and delays the recovery. So despite historically low interest rates, the housing rebound has been slow to take effect and cause the desired boost to the overall economy.

We find that the primary areas of concern facing the banking industry are: the new regulatory environment, loan demand, expansion of business services, the housing market, and the impact of the recession on a bank’s clientele and their industries. With these concerns in mind, the following is a summary of our individual discussions on these issues with Bill Moss, president and chief executive officer of Two River Community Bank; Gerry Lipkin, chairman, president and chief executive officer of Valley National Bank; Ron Hermance, chief executive officer of Hudson City Bancorp Inc.; Linda Bowden, regional president of PNC Bank; and Bob Koar, head of Citibank’s Atlantic Division.

**Two River Community Bank, Monmouth/Union Counties**

As for the state of the economy, from our vantage point indicators show a slight improvement, but it will take some time for significant improvement. Unemployment is still an overhanging issue; the housing market is still weak; and the rate at which foreclosures are coming on the market is increasing. Another concern is the increase in credit card debt. We have a client whose company is involved in handling distressed credit card portfolios, and his business is booming, based on an increase in credit card defaults. For the first time in 18 months, however, we are seeing some higher end, residential construction, mostly starting with deep-pocket builders and some small construction projects. Pricing seems to be stabilizing, and there appears to be a slight sales uptick in certain price levels.

With regard to the mortgage crisis, we have never participated in the sub-prime market, and do not believe policies toward debt forgiveness following mortgage foreclosures will come to fruition in the marketplace. Our bank competes with all major players; however, we continue to refine our residential mortgages business.

Although the economy has been fairly steady with all industries, it appears that the biggest activity is in the medical/healthcare field. Physicians and healthcare facilities continue to be fairly steady in terms of growth and stability. Medical professionals are utilizing business loans for equipment, office space, etc., but we do not see them taking on any speculative-type projects.

With regard to commercial loans, companies that are doing well are taking a wait-and-see attitude toward expansion or new projects. We are not seeing organic lending growth in the economy.

In the beginning of 2010, we saw our loan business as flat, with delays causing many closings to be pushed off for up to several months at a time. We expect that our loan pipeline will deliver strong growth for us in the second half of the year, and expect that we will continue to benefit from the flow of customers continuing to leave the large banks in 2011.

**Valley National Bank**

We are supportive of Governor Chris Christie’s attempts to curtail fiscal spending to manage the hemorrhaging of the economy. We do, however, believe that certain business areas need to be re-examined. In terms of which businesses seem to be improving in the state, we find that auto sales tend to be increasing while the state’s housing market may be rebounding as a result of lower mortgage rates at the present time. We are, however, concerned that new federal legislation and state regulations will have detrimental effects on small businesses in the state.

As to changes in banking services, it...
appears the passing of the Wall Street Reform and Consumer Protection Act will have a negative impact on customer service. For instance, banks may be forced to impose fees for services that traditionally were considered free. New state regulations also are having harmful effects on traditional banking services.

Generally, banks like ours earn income on deposits and dormancy fees. Bank gift cards, for instance, will now have higher fees to purchase them imposed and some banks, like ours, will no longer be issuing them because they will no longer be profitable. The new regulations impose unforeseen costs, such as our inability to charge and retain fees for certain services. For example, we estimate that the inability to charge dormancy fees on gift cards will cause a significant drop in revenue during the coming year, which led to our decision to stop issuing the cards. It seems the governor may not have been fully aware that the new state banking regulation will have the unintended consequence on banks in terms of eliminating products.

Over the past year, commercial lending in the state has been sporadic. Banks are willing to lend money but want assurances that loans can and will be repaid. Further, new government regulations require us to show that the borrower has the financial ability to repay the business loan.

With regard to residential lending, debt forgiveness on outstanding mortgage loans affects the value of all homes in the community and is sending the wrong message. Personally, my heart goes out to homeowners who were caught up in the mortgage crisis by unscrupulous mortgage lenders; however, debt obligations should be repaid. Since we were not involved with subprime lending, our bank was not impacted by that crisis in the banking industry.

Overall, businesses in the state could greatly benefit from tax incentives such as a tax credit for hiring new staff or conducting business expansion. Our greatest non-interest expense is employee costs. Thus, if a tax incentive were offered, we might open new branches and hire more unemployed state residents. Further, we believe the state’s financial outlook will greatly benefit by increasing the number of new businesses moving to New Jersey. Although we are concerned about industries that are being negatively impacted by the economy, the state has a wealth of resources for new businesses in terms of our commercial ports for shipping and distribution as well as prime sites for manufacturing. It would advantageous for the administration to consider new ways to attract foreign businesses to New Jersey rather than seeing more businesses leave the state because of our high tax structure.

**Hudson City Bancorp, Inc.**

In the residential market, we see that property values have bottomed; however, we are seeing some bidding wars in a few communities. The question remains whether the real estate prices are as low as they’re going to be. Years ago we viewed sellers in two categories: those who had to sell to relocate or upgrade while others thought they would like to sell. People would pull their property off the market if they refused to sell at a particular price. We now find that those people are reentering the market because price reality has hit and they literally need to sell quickly.

With regard to mortgage foreclosures, we find that the sheriff’s offices in most counties are inundated with backlogs in processing. We are disillusioned by the high number of these sales. While some government leaders may be advocating debt forgiveness following a mortgage foreclosure, you won’t see that at our bank. We go well beyond the guidelines to try and work with homeowners to keep them in their homes, but while we do not want to own anyone’s home, a contract is a contract.

We do see some segments in the economy improving, particularly healthcare. While only nine percent of our state’s workforce is in financial services, over 20 percent are employed in the healthcare field, followed by education. At the present time, education is taking a beating as the state and municipalities are coping with budgetary deficits. Generally, we are seeing the state’s economy improving over time. If we are looking for property values to stabilize and go up, then consideration has to be given to the combined debt, a combination of principal, interest or a tax component. If taxes take too much of the combined percentage, municipalities need to be aware that property prices will have to be lower. Careful attention needs to be placed on the municipal tax situation to help improve the overall economy.

**PNC Bank**

With regard to the economic outlook, our economists have shown us that New Jersey is, at best, at half-speed recovery, a very protracted shape of recovery. We conducted an economic outlook survey this year of our small business owners and found that New Jersey businesses are slightly more pessimistic than the nation. This may be attributable to the overall economy in the state, as well as weak sales. From a timing perspective, businesses are reporting a noticeable improvement overall. In general, one in two businesses believes a full recovery in the state is more than a year away.

As to our banking services, we have avoided the pitfalls of subprime lending, thus avoiding the meltdown in that market, and we don’t have the proprietary derivatives that other banks had. We maintain a modest profile of quality loans, which we continue to make. The biggest challenge we currently see affecting our bank is simultaneously maintaining financial stability while achieving business growth with a modest risk profile.

As to the mortgage crisis, PNC understands that the federal government is trying to help people caught in a negative
equity situation by pushing for economic reforms that include debt forgiveness. Our bank, however, had not gotten involved with that type of lending, which caused the downturn spiral in the residential mortgage industry. We are continuing to offer banking services to low- and moderate-income areas throughout the state.

We appreciate that industries like automobile or heavy manufacturing located in other parts of the country have been the hardest hit in the economy; however, we find that a few industries did well despite the recession. We also note that retail and consumer spending have been slower to come out of the gate. Generally speaking, we find that industries in New Jersey are in better shape overall than they were in the past year or so.

**Citibank Business and Commercial Banking Group**

Overall, Citibank has observed an increase in government regulation over the banking industry during the last two years. While we continue to strive to meet the needs and expectations of our customers, the bank has also worked in a positive and progressive manner with regulators to ensure that it is always in compliance with their policies.

Our economists advise that based largely on the combination of a less supportive financial backdrop, and new evidence that housing activity is weakening more than anticipated following the expiration of temporary tax incentives, we have cut our second half estimates for economic growth from three to two and a half percent. Recovery still has the support of a moderate pick-up in labor demand and rising business spending.

With regard to commercial loans, we have not seen very strong loan demand from our existing business clients as of late. One reason may be that buy decisions are deferred when the economy is negative. Another reason may be that the media continues to perpetuate a negative outlook and to sensationalize the downturn. Additionally, discretionary spending has been down, as small and commercial businesses look to cut costs, stabilize their operations and monitor their revenue base. As the economy stabilizes, it is likely that businesses will look to grow again. The bank would then expect to see, perhaps later this year, the demand for loans increasing.

One of the bank’s focus areas has been to keep its customers in their homes throughout the mortgage crisis by reducing monthly payments to affordable levels. Historically, the bank has found that in most cases, an affordable payment can be obtained by interest rate reduction, term extension and/or forbearance. However, in the rare circumstance where an affordable payment cannot otherwise be achieved, Citi does, and has, written down principal. In addition, with the Home Affordable Modification Program (HAMP) changes announced by the Treasury Department, we anticipate the number of principal reductions to increase. In addition, the bank also regularly does short sales and has a unit dedicated to expediting them. Often they result in forgiveness of part or all of the remaining balance. Short sales have increased over the past year or so, and Citi anticipates they will do more of them in the future.

But despite the market’s recent downturn, we have noticed that our business clients may be starting to look at opportunities with more optimism. There are a number of New Jersey industries that are picking up speed and may be good targets for lending, including government contractors and service industries. Our customers are slowly spending again and seem more willing to commit to inventory. They are at least focused on their business again, and not just in survival mode.

**Summary: Future Prediction?**

Despite contradictions among the private bankers and the public sector regulators, it remains to be seen whether housing prices in the state will continue to fall, commercial loan demand will increase, debt forgiveness following a short sale will become an across-the-board reality, consumers will be forced to pay for currently free services or even if new banking regulations will actually curtail risky financial investments. One thing is certain, however, as the regulatory platform gradually transforms the banking industry, the economic outlook for the state remains volatile.

**Endnotes**

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**Stuart A. Hoberman** is the shareholder/director and chair of the financial services department at Wilentz, Goldman & Spitzer, P.A.; former president of both the New Jersey State Bar Association and New Jersey State Bar Foundation; and a member of the Bank Lawyers Council of the New Jersey Bankers Association. **Susan Storch** is a member of the editorial board of New Jersey Lawyer Magazine and has built a specialty practice in employer compliance audits for businesses and corporations.

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