

# San Diego Business Journal

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## Reeling Financial Institutions Stumble Forward Into 2008

By MIKE ALLEN - 12/24/2007

San Diego Business Journal Staff

Despite the fact that most San Diego lenders didn't make subprime loans, the roiling financial markets and the resultant credit crunch in 2007 was felt throughout the industry.

The simple explanation for higher incidents of problem loans, reduced earnings and slower growth in the local financial sector was the continued decline of the area's real estate market.

"Clearly, this is a slowdown that is acting like a broad brush to everything it touches in construction and real estate," said Larry Hartwig, chief executive at Escondido-based California Community Bank.

Usually an optimistic lot, more local bankers said 2008 will be a year of retrenchment and could get worse before it improves.

"The economy is weak. Job generation has been slow, and real estate is high, and both are combining for a weak outlook for 2008," said Vince Siciliano, chief executive of 1st Pacific Bancorp in San Diego.

According to the most recent economic index for the area compiled by University of San Diego economics professor, Alan Gin, the local economy has been declining since early 2006, and shows no signs of turning around anytime soon.

"The housing market may bottom out in the latter half of next year, but a rebound in prices is not expected to begin until 2009," Gin said.

### Opinions Mixed On Recession

Gin continued to say a recession for the area isn't likely, but other economists have predicted it's inevitable, and will likely occur in the first few quarters of 2008.

Christopher Thornberg, of the Beacon Economics research and consulting firm in Los Angeles, said an overheated housing bubble that has been years in the making will take yet another year to work itself out. Combined with a drop in consumer spending, and much tougher underwriting standards that make it harder on both borrowers and lenders, the nation will fall into a recession, or a period of negative growth, in early 2008, he said.

He predicted housing values, which dropped last year by an average of 10 percent in California,

will decrease another 20 percent to 30 percent through the end of 2008. The economy won't begin to pick up again until 2009, Thornberg said in November.

The casualties from the subprime crisis were many and included San Diego-based Accredited Home Lenders Holding Co., which was sold to Lone Star Funds, a Texas investment bank, for \$311 million. Though it survived, the mortgage bank had to stop making loans, lay off about 3,000 employees, and take a discounted price all because the market for the subprime loans it makes basically blew up.

While the economy was slumping on both the local and national levels, many experienced bankers noted things weren't as bad as the catastrophe of the early 1990s, which decimated San Diego's economy for more than four years.

Still, for an industry that enjoyed enormous profits and growth in the past decade, 2007 was rough. Some of the biggest investment banks in the nation, including Citibank, Merrill Lynch and Bank of America, took the biggest hits, writing off billions of dollars in assets because of the rising tide of home foreclosures, and laid off thousands of workers.

The community banks weren't immune from the impacts of the subprime crisis and the housing downturn as many construction loans went sour when possible buyers either were unable to get a loan or decided to wait until the values dropped even further.

At Temecula Valley Bancorp, nonperforming assets grew to 2.47 percent of total assets as of Sept. 30, up from 1.2 percent from the prior year. At San Diego National Bank, nonperforming assets, including \$15 million in real estate-owned, reached 1.5 percent of total assets. Problem assets reached the same 1.5 percent at both 1st Pacific Bank of California and Imperial Capital Bank, both exceeding the levels of problem loans in 2006.

However, some escaped with only minor wounds. Pacific Western Bank, the main subsidiary of San Diego's First Community Bancorp, and the area's largest with more than \$5 billion in assets, reported only 0.59 percent of its portfolio as of Sept. 30 holding nonaccrual loans.

At Pacific Trust Bank, a savings bank holding mainly mortgages but no subprime in Chula Vista, problem loans reached 1.65 percent, compared to zero for the prior year.

"I think we're going to see increased foreclosures for the coming year," said Hans Ganz, chief executive of Pacific Trust, which held about \$800 million in assets.

Where subprime lending was concentrated, as in Ganz's company's back yard of Chula Vista, housing prices could fall another 10 percent. Yet some of those same markets have already bottomed out, and are seeing buyers, he said.

## **Stagflation, Slowdown ... And Opportunity?**

The area is headed for a recession unless the Federal Reserve Board continues to reduce rates, Ganz said. "The question is, how far can they go, because sooner or later inflation could pick up and then we'll be facing stagflation, which is no growth and higher inflation."

Yet even if the Fed cuts short-term interest rates (as it did by a quarter percent Dec. 11), the problems being disclosed by the large investment banks that buy and securitize mortgages, such as the Federal Home Loan Mortgage Corp. (Freddie Mac), BofA and Washington Mutual Bank, have already put a damper on lending, said Mark Reidy, executive director for the Burnham-Moores Center for Real Estate at USD.

And then there's the looming issue surrounding the interest rate resets on millions of adjustable rate mortgages, which will cause even more foreclosures and lead to declining home values, Reidy said.

Although the economic downturn and turmoil in the credit markets was gathering steam at year-end, some lenders were poised to capitalize from the situation.

At the Bank of Internet USA, new Chief Executive Greg Garrabrants said his savings bank has been run conservatively, carried no subprime loans and had no delinquencies.

"I view this time as an opportunity for banks such as ours that will be looking to make some good loans," Garrabrants said. "I'm bullish on our business because of the strong position that we're in."

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