

BANKING

B R I E F

Federal Reserve Bank
of Philadelphia

For Pennsylvania,
New Jersey, and Delaware

SPECIAL REPORT: COMMERCIAL BANKS IN 2000

Overview

Overall, the banking industry in both the nation and the tri-state area had a so-so year in 2000. With the economy beginning to slow both nationally and regionally, profits decreased sharply, as shown by Figures 1 and 2, but are still above the levels of the middle of the decade.¹ Also, they are well above what was experienced in the early 1990s, when the economy was last in recession. In the following sections, we will examine the performance of banks in the nation and the region more closely by breaking them into groups by size.

Large Banking Organizations

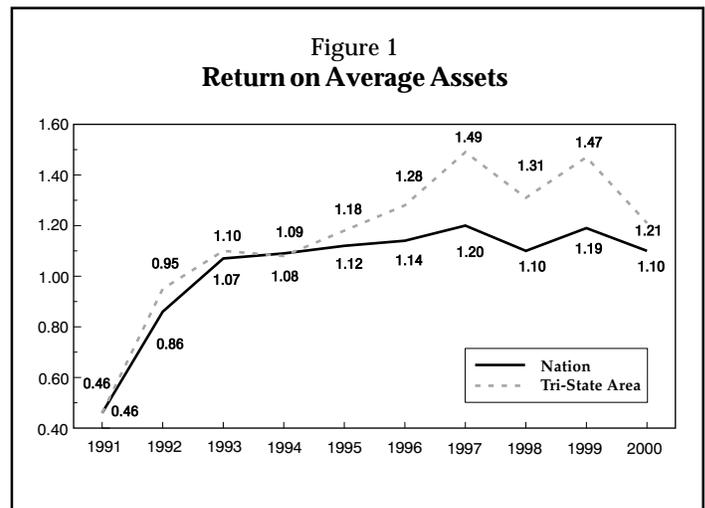
The economy had a dampening effect on the performance of large banking organizations in both the tri-state area and the nation, particularly with regard to asset quality.² As shown in Figures 3 and 4, profitability at these institutions declined, and for institutions with operations in the tri-state area, this decrease was sharp. One of the primary reasons for the drop in profits was increases in loan-loss provisions on large commercial loans, particularly some syndicated loans.³ As shown in Figures 5 and 6, nonperforming loans as a percentage of total loans and nonperforming assets

as a percent of total assets increased significantly in 2000.⁴

Nonperforming loans as a percent of total loans increased from 0.91 percent to 1.15 percent nationally, and for tri-state area banks, the increase was from 0.82 percent to 1.22 percent. These figures are at their highest since 1994, when the area was coming out of the slow economy of the early 1990s.

While charge-offs increased, they did not rise nearly as rapidly as nonperforming loans. Figure 7 shows that the ratio of net charge-offs to average

Figure 1
Return on Average Assets



assets increased slightly at the national level in 2000 but was basically stable at large tri-state area banks. At large banks in the tri-state area, charge-offs rose nearly 9 percent while nonperforming loans increased 28 percent. Even though additional provisioning for loan losses affected bank profitability in 2000, loan-loss coverage ratios decreased substantially for large banks in both the tri-state area and the nation, to the lowest point since 1993

¹ Unless otherwise noted, all data used in this publication are from FFIEC call reports. Figures 1 and 2 are aggregate ratios for all commercial banks within the specified region.

² See the Appendix for a description of the methodology used to define the groups used in this publication.

³ Also, one large but relatively unprofitable firm was added to the tri-state area sample in 2000. This company's inclusion affected a number of performance ratios.

⁴ Nonperforming loans are defined as loans past due 90 days or more plus nonaccruing loans. Nonperforming assets are defined as nonperforming loans plus other real estate owned. All numbers in the charts are aggregate ratios; that is, the numerator and denominator are summed across institutions, then the ratio is calculated from these sums.

Figure 2
Return on Average Equity

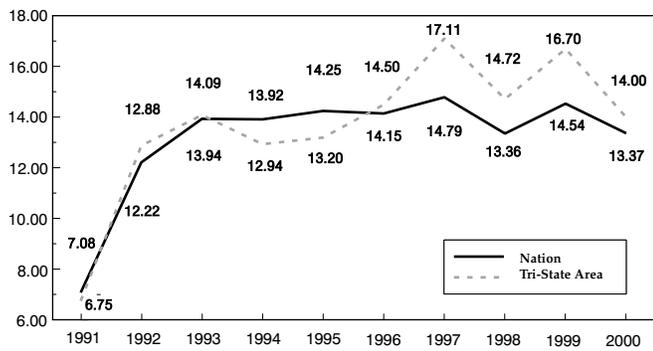


Figure 3
Return on Average Assets for Large Organizations

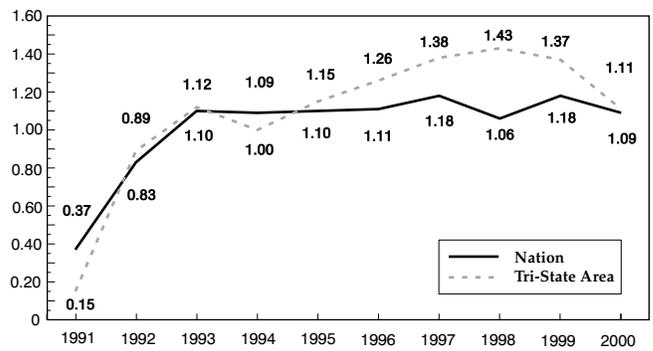


Figure 4
Return on Average Equity for Large Organizations

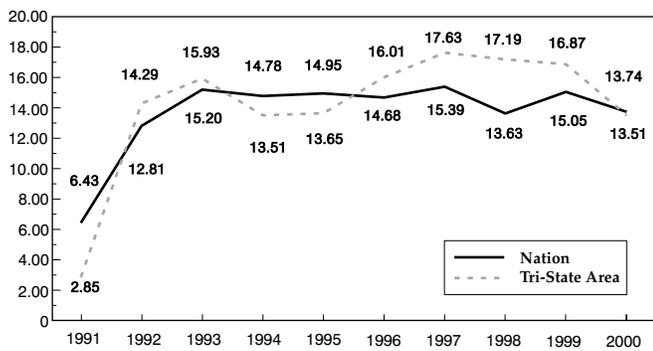


Figure 5
Nonperforming Loans/Total Loans For Large Organizations

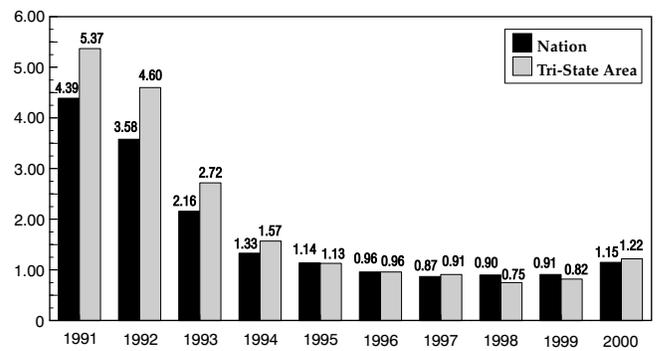


Figure 6
Nonperforming Assets/Total Assets For Large Organizations

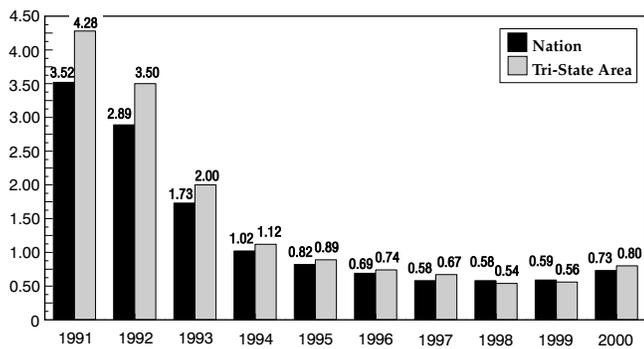
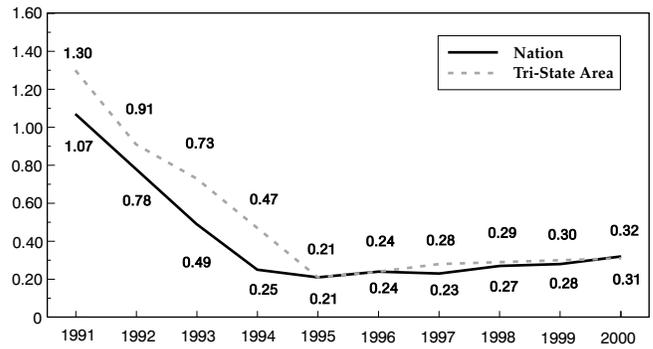
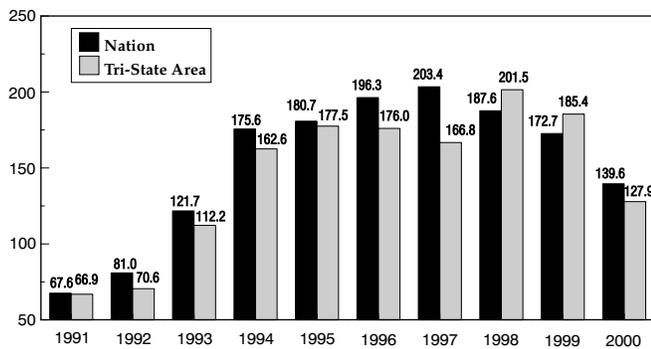


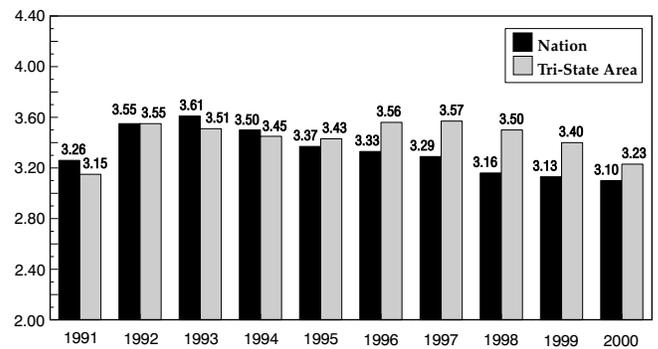
Figure 7
Net Charge-Offs/Average Assets For Large Organizations



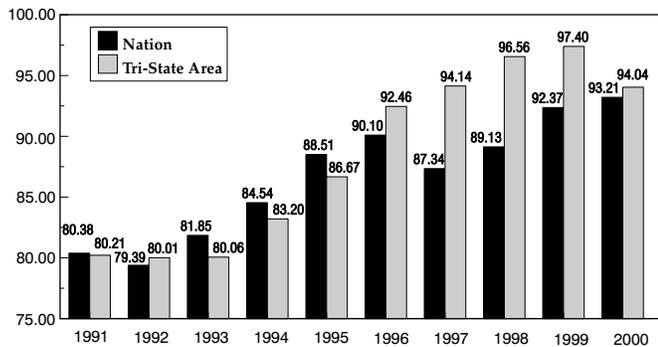
**Figure 8
Loan-Loss Coverage Ratios for Large Organizations**



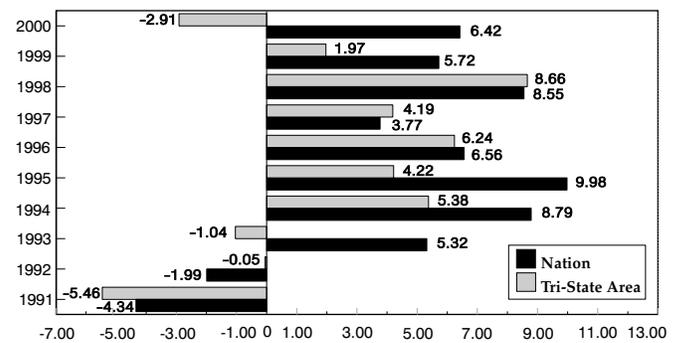
**Figure 9
Net Interest Margins for Large Organizations**



**Figure 10
Loans/Deposits for Large Organizations**



**Figure 11
Percentage Change in Loans Outstanding At Large Organizations**



(Figure 8).⁵ Nonetheless, the loan-loss coverage ratios are still well over 100 percent, meaning that current losses are well covered.

Another, albeit lesser reason profits at tri-state area banks decreased in 2000 is declining net interest margins (Figure 9).⁶ Interest rates on both loans and deposits increased in the first half of 2000, then remained steady for the remainder of the year. However, loan-to-deposit ratios at tri-state area banks

decreased in 2000, while the nation as a whole showed a small increase (Figure 10). These ratios are still high historically, but this is partly because banks have become less dependent on deposits as a source of funds.

Both loans and deposits decreased at large tri-state area institutions in 2000, with loans falling at a faster rate than deposits (Figures 11 and 12). This was in sharp contrast to the nation, where both loans and deposits grew

faster in 2000 than in 1999. The decrease in loans and deposits at the tri-state area banks had several causes. First, some of these institutions sold their credit card portfolios in 2000. This is part of a nationwide trend toward consolidation in the credit card industry. Second, as mentioned above, some firms experienced credit quality problems in their commercial loan portfolios and appear to have reduced their commercial lending in general as a

⁵ Loan-loss coverage ratio is the ratio of loan loss reserves to nonperforming loans.

⁶ Net interest margin is the ratio of net interest income to average earning assets. Earning assets are defined as the sum of fed funds sold, securities, net loans, and interest-earning balances.

Figure 12
Percentage Change in Deposits at Large Organizations

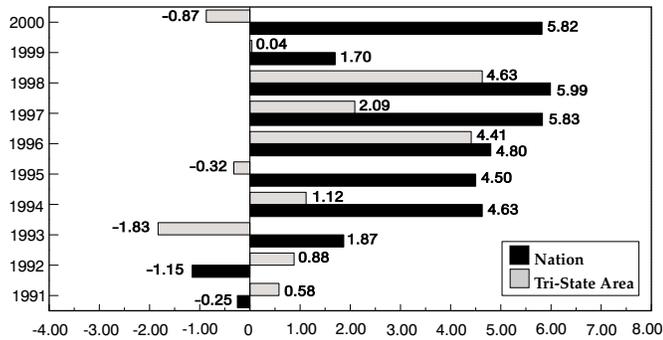


Figure 13
Equity/Assets for Large Organizations

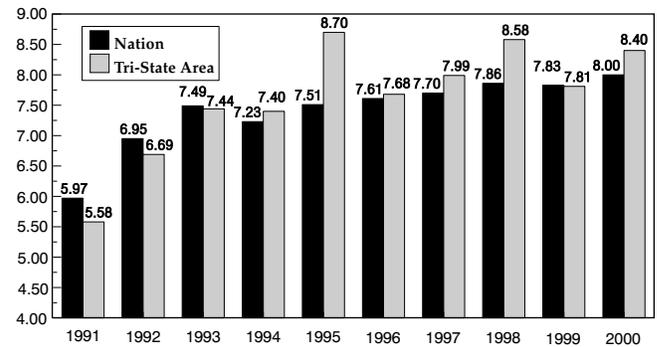


Figure 14
Noninterest Income/Average Assets
For Large Organizations

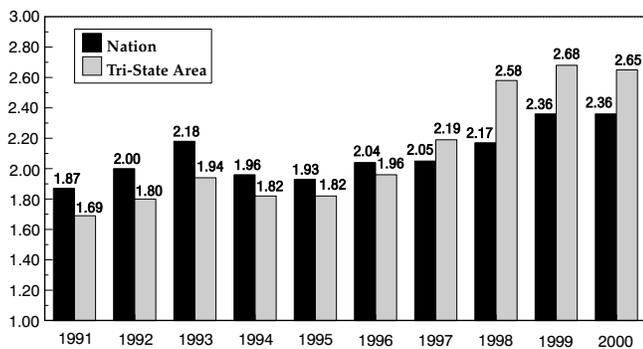
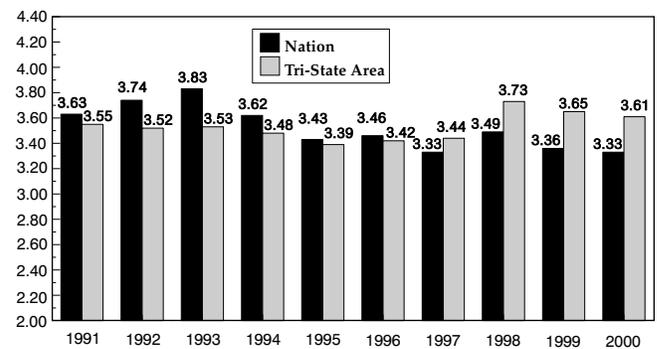


Figure 15
Noninterest Expense/Average Assets
For Large Organizations



result. Finally, as will be shown in the next section, the large institutions have been losing business to smaller banks, which experienced healthy growth of both loans and deposits in 2000.

While large banks experienced asset quality problems in 2000, it has not affected their capital ratios. As Figure 13 shows, total equity to total assets increased last year. Nationally, this has been happening for most of the last decade, and the trend has basically been upward for banks in the tri-state area as well. This trend might reverse

itself if net charge-offs increase substantially in the near future while loan-loss provisions do not. In that case, the charge-offs would have to be taken from equity, but this would require a lasting downturn in the economy.

Noninterest income (fee income) as a percent of average assets was relatively flat in both the tri-state area and the nation (Figure 14). Noninterest expense as a percent of average assets (overhead) was also relatively flat for both the nation and the tri-state area (Figure 15).

In summary, large banking organizations across both the nation and the tri-state area experienced a decline in profitability in 2000, in part because of increased provisions for loan losses. Nonperforming loans grew more rapidly than the banks' loan-loss provisions, so loan loss coverage ratios fell. Still, the large banks remain more profitable, enjoy better credit quality, and are better capitalized than they were for most of the 1990s.

Community banks had a much better year than the larger banks, with profitability increasing in the nation and showing a small decrease in the tri-state area (Figures 16 and 17). By most measures small banks outperformed large institutions in 2000, and the asset quality problems that large banks experienced did not occur at small banks. Small banks still lag large banks in one category: return on average equity.

Equity to asset levels at community banks increased somewhat in 2000 but are still below their levels from the mid-1990s (Figure 18). Compared with large banks, community banks have always carried more capital because it is more difficult for them to raise capital quickly, since many of these banks do not enjoy the same access to capital markets. Also, community banks often have less diversified loan portfolios and are therefore subject to more volatility in terms of credit quality and earnings.

Small banks also experienced strong gains in both loans and deposits in 2000 (Figures 19 and 20). In part, they appear to be taking some of the business away from large banks. Also, the composition of their loans is somewhat different, as small banks tend to concentrate on consumer installment loans and mortgages. These types of loans have been less affected by the uncertain economy, which was another factor that contributed to the relative stability of profits at small banks. Still, loan growth at community banks in the tri-state area was 8.8 percent in 2000, compared with a rate of 14.9 percent in 1999.

Net interest margins were stable nationally but decreased somewhat at tri-state area banks (Figure 21). Tri-state area banks also had lower margins than small banks in the nation as a whole, but both significantly outperformed the large banks. Loan-to-

deposit ratios increased slightly for community banks nationally and were virtually unchanged at tri-state area banks (Figure 22).

The ratios of nonperforming loans to total loans and nonperforming assets to total assets were virtually identical in 1999 and 2000 for the nation as a whole and decreased slightly for the tri-state area (Figures 23 and 24). Likewise, the ratio of net charge-offs to average assets at these banks remained stable in 2000, with tri-state area banks charging off slightly fewer loans than banks in the nation as a whole (Figure 25). The ratios for nonperforming loans, nonperforming assets, and net charge-offs are also roughly half those of large banks.

The stable asset quality experienced by small banks enabled them to, at a minimum, maintain their loan-loss provisions. The loan-loss coverage ratios for community banks remained relatively stable nationally but increased substantially at banks in the tri-state area (Figure 26). In absolute terms, nonperforming loans actually decreased about 3 percent in 2000, while loan-loss reserves increased more than 4 percent. The

increase in loan-loss reserves is one reason earnings decreased slightly at tri-state area banks in 2000. More than half the loans made by these banks are real estate loans, especially home mortgages and construction loans. This reliance on a single sector of the economy increases the riskiness of community banks' loan portfolios, and higher reserves are necessary to balance the extra risk. Thus, as with capital, small banks generally keep larger reserves on hand than large banks. This is also likely a further

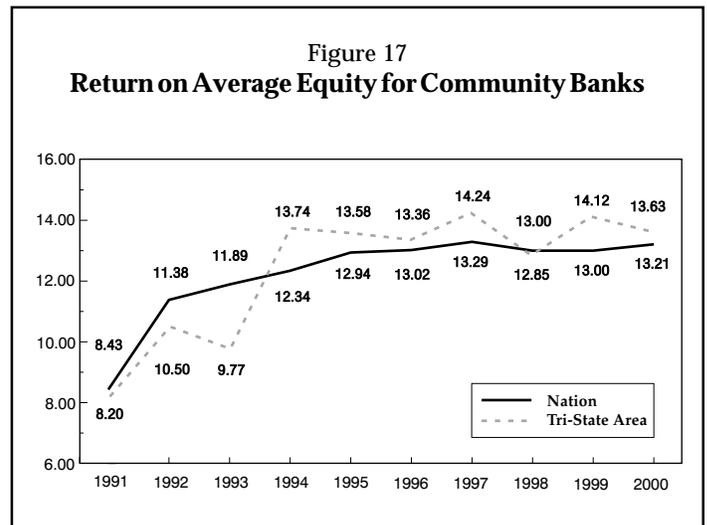
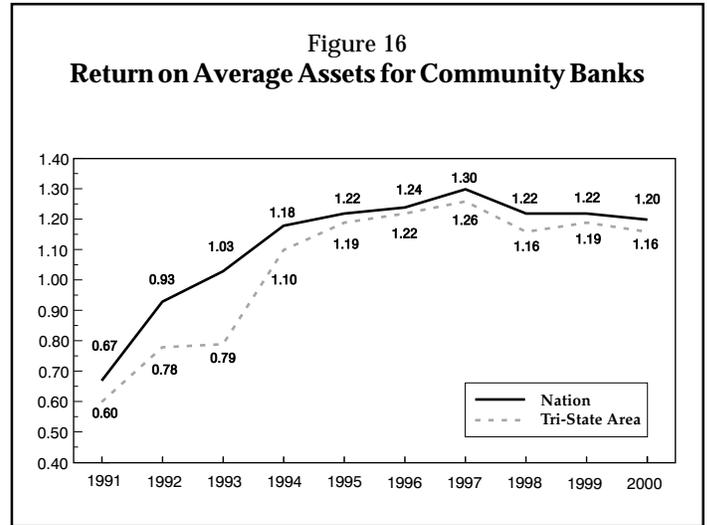


Figure 18
Equity/Assets for Community Banks

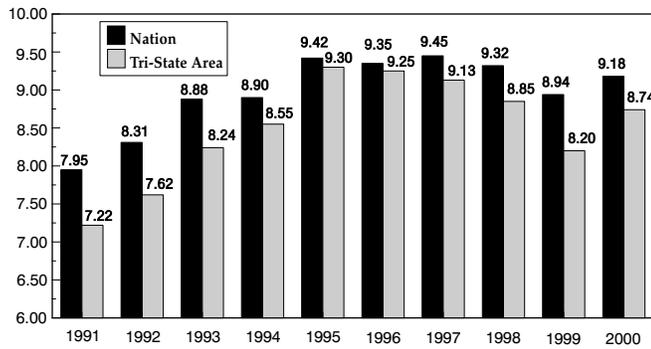


Figure 19
Percentage Change in Loans Outstanding At Community Banks

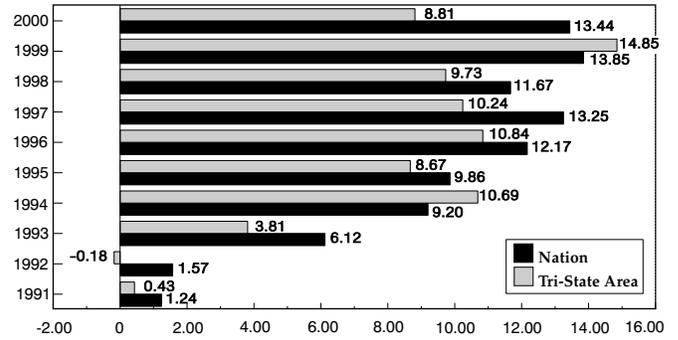


Figure 20
Percentage Change in Deposits at Community Banks

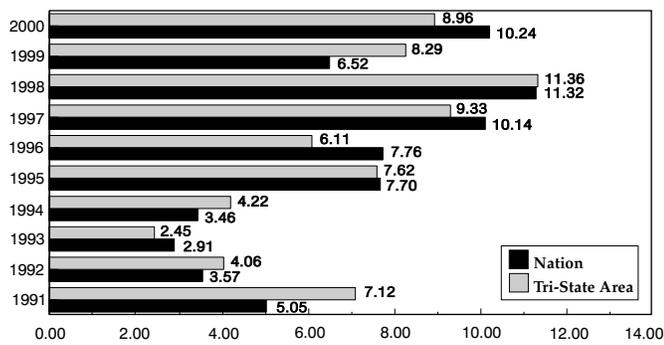


Figure 21
Net Interest Margins for Community Banks

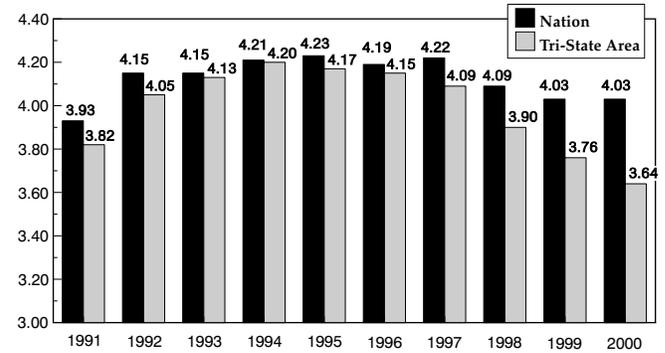


Figure 22
Loans/Deposits for Community Banks

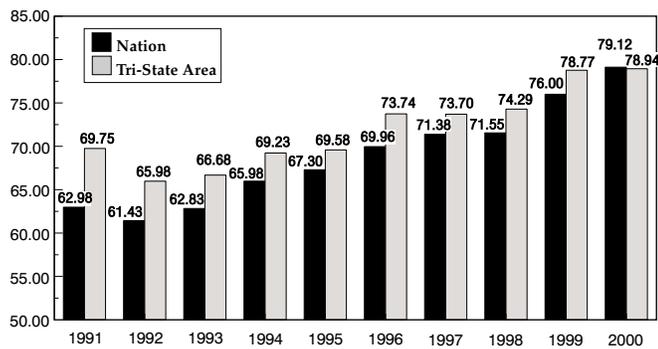


Figure 23
Nonperforming Loans/Total Loans For Community Banks

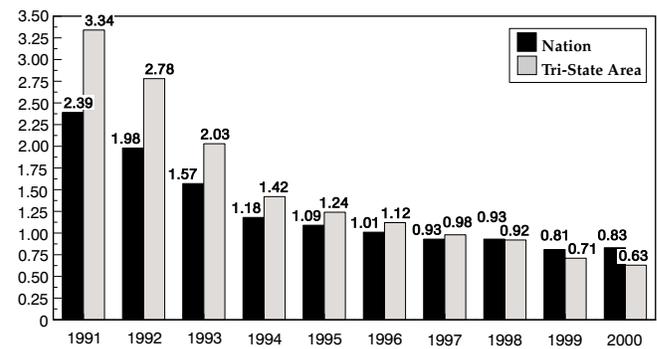


Figure 24
**Nonperforming Assets/Total Assets
 For Community Banks**

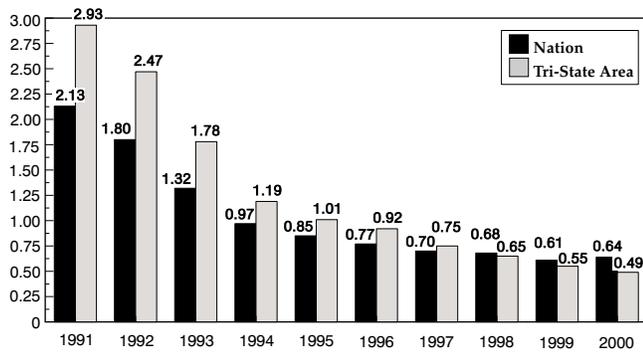


Figure 25
Net Charge-Offs/Average Assets for Community Banks

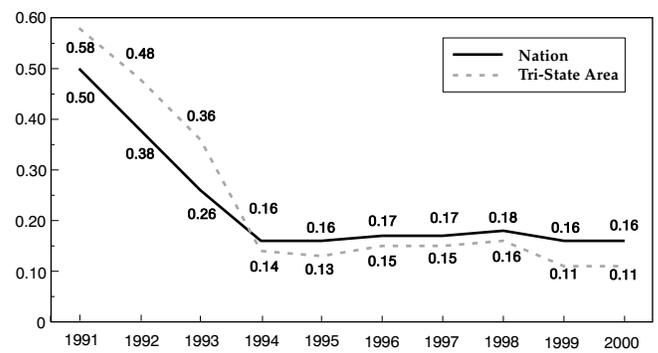


Figure 26
Loan-Loss Coverage Ratio for Community Banks

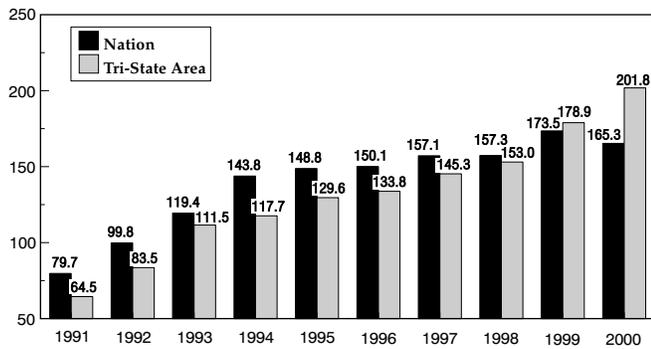


Figure 27
**Noninterest Income/Average Assets
 For Community Banks**

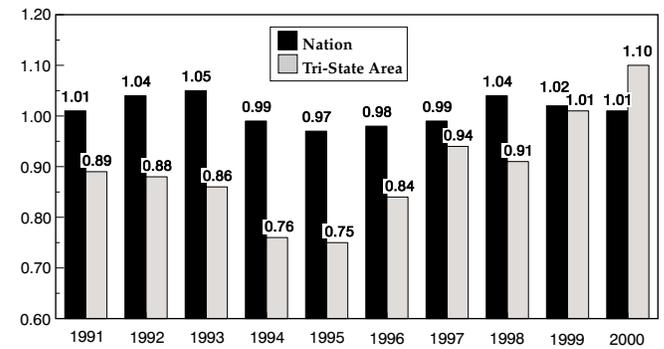
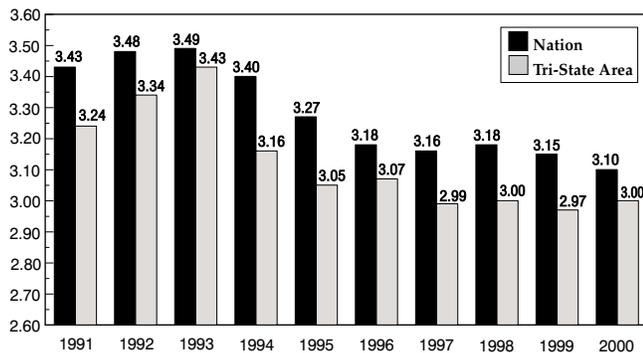


Figure 28
**Noninterest Expense/Average Assets
 For Community Banks**



reflection of the difficulties they face in raising funds quickly.

Community banks were able to maintain their noninterest income in 2000. For the nation as a whole, the ratio of noninterest income to average assets has been stable for the past three years (Figure 27). Tri-state area banks experienced a small increase in noninterest income to average assets in 2000. In part, this reflects the fact that the banks in this category in the tri-state area are, on average, nearly twice as large in size than those in the nation as a whole, and the area is more urban in character. The average size of a community bank in the tri-state area is \$344.8 million in total assets, while in the nation as a whole the average size is \$177.4 million. Thus, these banks are able to generate more fee income. The community banks were also able to control their

expenses relatively well in 2000, as evidenced by their ratio of noninterest expense to average assets (Figure 28). Tri-state area banks had a lower ratio than the nation as a whole, and their overhead was nearly flat last year.

Community banks in both the tri-

state area and the nation were generally able to maintain their performance of the previous several years in 2000. At the national level, the problems that affected the larger banks, declining asset quality and net interest margins, have not affected the community banks

as yet. In the tri-state area, community banks continue to enjoy high asset quality, but net interest margins are declining. Finally, community banks across the nation and in the tri-state area enjoy relatively high levels of capital and reserves.

Consolidation of the Banking Industry

The 1990s saw substantial consolidation of the banking industry. This was mostly in the form of mergers, but there were a number of failures early in the decade. Figure 29 shows the number of commercial banks for year-end 1990 and year-end 2000. The number of banks in the United States decreased by approximately 4000 in that 10-year period, a decline of 32.6 percent. While the number of banks in the tri-state area has actually increased slightly in the past two years, over 150 banks disappeared in the 1990s, a decline of 34.5 percent. The number of branches in the nation showed a slight increase, about 0.6 percent, but in the tri-state area, the number of branches decreased nearly 3.5 percent. As a result, the population per bank and the population per branch has increased between 1990 and 2000, both at the national level and in the tri-state area (Figures 30 and 31).⁷ However, we also know that changes in technology, for example, automated teller machines, debit cards, and direct deposit, have changed how people use bank branches, as well as the kinds of products and services offered by banks. Another way to think about changes in the structure of the banking industry is to examine changes in the distribution of market shares, i.e., the concentration of a market. Put another way, how have the shares of the largest and smallest firms

in banking markets changed?

Banking is usually characterized by local geographic markets. That is, the area over which the prices of most bank services that would affect consumers and small businesses are determined has been shown, in most cases, to be relatively small. How small is a matter of debate in economic research, and some products, such as mortgages, may have a larger geographic market. However, the bulk of research done on the subject has shown that consumers and small businesses by and large go to banks in their immediate area for most services (checking and savings accounts, small business loans, installment loans, etc.).⁸ This area is usually approximated by metropolitan statistical areas, which are urban areas defined by the census, or, in the case of more rural areas, counties.

Each geographic market has its own particular structure, i.e., how many firms there are and how the market shares are divided, as well as the potential for new entrants. If a small number of firms, relative to all the firms in the market, have large market shares, the market will likely be less competitive and consumers will have fewer alternatives. When attempting to measure the structure of a market, economists usually use a tool called a Herfindahl-Hirschman index (HHI). This is defined as the sum of squared

market shares. Thus, a perfectly competitive market, i.e., one with a large number of firms each with a very small market share, would have an HHI near zero while a monopoly would have an HHI of 10,000. HHIs measure not only how concentrated a market is at the top but also the dispersal of shares throughout the market; but basically, the higher the market shares of the top few firms, the higher the HHI.

The Antitrust Division of the Department of Justice classifies markets according to their HHIs. An unconcentrated market is one with an HHI less than 1000. A moderately concentrated market has an HHI between 1000 and 1800, and a heavily concentrated market has an HHI above 1800. In general the higher the post-merger HHI, and the greater the change in the HHI as a result of a merger, the more scrutiny a merger is likely to receive.

In applying this measure to banking, we see that the industry overall has become more concentrated, but not substantially so. Figure 32 shows the median HHI for MSAs and counties in both the nation and tri-state area for 1990 and 2000. Figures 33 and 34 show the number of markets classified as unconcentrated, moderately concentrated, and concentrated for the same time frame. As shown, the median HHI has increased by roughly 300 in metropolitan and rural markets for both

⁷ Population data are from the United States Census. Bank and branch data are from FDIC Summary of Deposits data representing the number of banks and branches operating in each metropolitan statistical area (MSA) and non-MSA county.

⁸ See, for example, the Federal Reserve Board's National Survey on Small Business Finances and National Survey on Consumer Finances. Both are available at the Board of Governors' web site: <http://www.federalreserve.gov/boarddocs/surveys>.

Figure 29
Number of Banks and Branches in 1990 and 2000

Year-End	Banks in Nation	Banks in Tri-State Area	Branches in Nation	Branches in Tri-State Area
1990	12,230	449	80,597	7,725
2000	8,242	294	81,048	7,456

the tri-state area and the nation. Also, the number of heavily concentrated markets increased in both the tri-state area and the nation, while nationally the number of unconcentrated rural markets increased at the expense of moderately concentrated rural markets. This number did not change in the tri-state area.

In both the nation and the tri-state area, the number of moderately concentrated markets showed a slight decrease. The vast majority of concentrated markets are sparsely populated rural areas that can profitably support only a few banks, thus the high HHIs there. The average metropolitan market is moderately concentrated. Thus, while we can say that consumers on average have fewer choices because of consolidation, the vast majority of consumers in both the nation as a whole and the tri-state area still have a substantial number of choices. Also, it is still the case that the United States banking industry is far less concentrated than that of any western nation.

The wave of consolidation begun in the 1980s and 1990s has several causes. First, the laws permitting banks to branch and merge have been relaxed substantially. In the early 1980s, most states permitted only limited branching and merging within the state and did not permit out-of-state banking organizations to enter the state at all. Throughout the 1980s, individual states began allowing out-of-state banks to merge with instate banks, usually on a reciprocal basis. In 1993, the Interstate Banking and Branching Act was passed

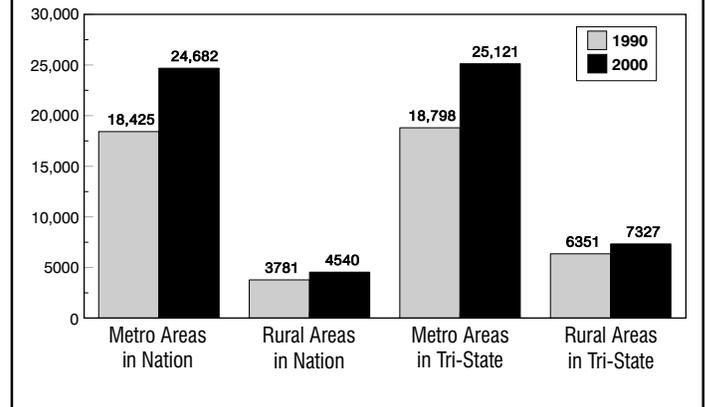
by Congress, effective in 1997. This permitted any bank in the United States to branch into or merge with a bank in any other state.

The law merely permitted the consolidation to take place, but there are economic forces underlying this consolidation. The first of these is scale economies.

Scale economies can be defined simply: the larger the firm, the less expensive it is for it to do business, at least up to a certain point. Until the mid-1980s, it was thought that scale economies in banking were pretty much exhausted at a very small size, roughly \$250-500 million in total assets. More recent research has suggested that there are substantial scale economies for banks well above that size. This is because larger banks can spread their fixed costs over a wider customer base. They can also afford to take more risk in individual transactions, because this risk is diversified over a wide number of transactions.

For example, large banks have the resources to offer a wider array of products over a larger geographic area. Thus, where 15 years ago consumers could get little from a bank other than

Figure 30
Population per Bank



deposit accounts and loans, today they can make investments in the form of stocks, bonds, and mutual funds and buy insurance and annuities. Also, 15 years ago, people's access to their bank was limited to a few geographic areas within the same state, and if they relocated, they had to change banks. Today, with some banks, consumers can use the same bank nearly nationwide.

A second force underlying consolidation is the declining importance of traditional bank products in the marketplace. The least expensive source of funds for banks—indeed, their main competitive advantage over other financial firms—has been core deposits, i.e., checking and savings accounts. These now make up around 12 percent of household financial assets, whereas in 1980 they made up about 32 percent

Figure 31
Population per Branch

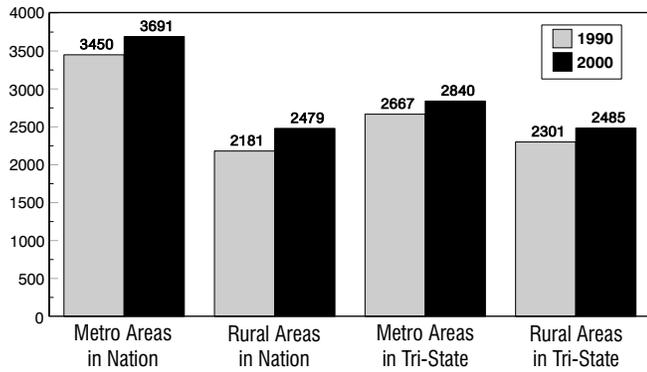


Figure 32
Median HHIs in Urban and Rural Areas

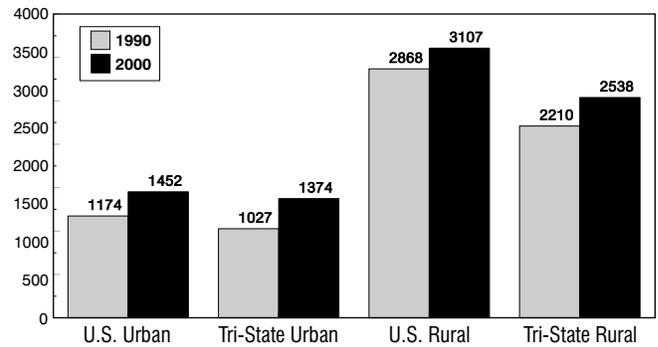


Figure 33
Changes in Market Concentration for Nation

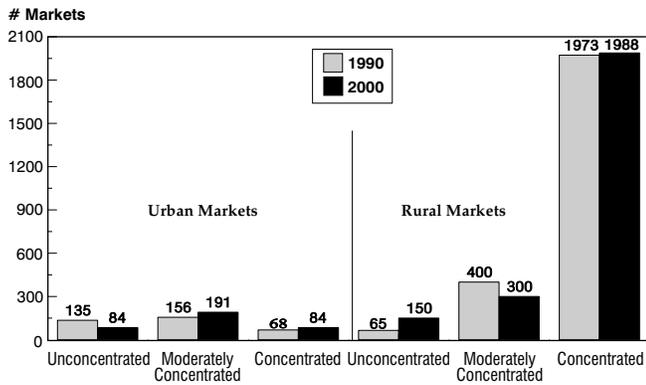
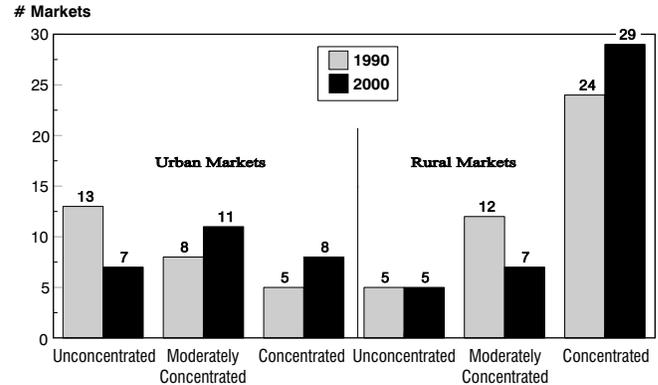


Figure 34
Changes in Market Concentration for Tri-State Area



of household financial assets.⁹ This is because households have shifted their funds to mutual funds and other investments, seeking higher returns. Thus, with banks competing to attract a shrinking share of the financial sector, it is much less expensive for banks to

grow by buying more core deposits through mergers, than by raising rates or using promotions to attract deposits.

Finally, for those who desire a small bank, either for lower fees or personalized service, a large number of these institutions remain. A substantial

number have merged, but mainly with other small banks. Also, the wave of consolidation has left a niche in the market that is being filled by newly formed "boutique banks." In 2000 alone, nearly 200 of these banks opened their doors.

⁹ These figures come from Federal Reserve Flow of Funds data.

Legal Developments

No major federal banking legislation was enacted in 2000, but many regulations were promulgated to implement the Gramm-Leach-Bliley Act of 2000.¹⁰

Only a few minor pieces of banking legislation were enacted by Third District states in 2000. On July 13, Governor Whitman of New Jersey signed a bill into law reducing the minimum number of directors required for a savings bank from nine to five. The bill also required that two-thirds of these directors be New Jersey residents only during a savings bank's first five

years of existence. Previously, this two-thirds requirement applied to all savings banks. Also, on November 1, New Jersey enacted a law prohibiting financial institutions, except banks, savings institutions, and their affiliates, from acting as agents, brokers, and consultants in the sale of title insurance. The bill had an anti-tying provision prohibiting the conditioning of a mortgage on the purchase of title insurance from a particular agent or broker.

In November, Pennsylvania's Governor Ridge signed into law a bill equalizing the powers of Pennsylvania

state-chartered banks and national banks. The bill required that 30 days' notice be given to the state's banking department before a bank engages in a new activity and that the bank use accounting standards at least as stringent as those required of federally chartered institutions. The bill also permitted corporations with fiduciary powers in other states to act as fiduciaries in Pennsylvania as long as the institutions' home states grant reciprocal powers to Pennsylvania fiduciaries.

Mergers and Acquisitions

There were many mergers and acquisitions involving institutions with greater than \$1 billion in total assets that have operations in the tri-state area. First, in one of the largest mergers in history, Chase Manhattan Corporation (New York, New York) merged with J.P. Morgan & Company, Inc. (New York, New York) to form J.P. Morgan Chase & Company, Inc. Also, M&T Bank Corporation (Buffalo, New York) merged with Keystone Financial, Inc. (Harrisburg, Pennsylvania). NBT Bancorp, Inc. (Norwich, New York) made two acquisitions last year: Lake Ariel Bancorp, Inc. (Lake Ariel, Pennsylvania) and Pioneer American Holding Company Corporation (Carbondale, Pennsylvania). Summit Bancorp, Inc. (Princeton, New Jersey) acquired NMBT

Corporation (New Milford, Connecticut). In March 2001, Summit was itself acquired by FleetBoston Financial Corporation (Boston, Massachusetts). FleetBoston also sold approximately 350 branches in Connecticut, Massachusetts, New Hampshire, and Rhode Island to Sovereign Bancorp, Inc. (Wyomissing, Pennsylvania) in 2000. Fulton Financial Corporation (Lancaster, Pennsylvania) acquired Skylands Financial Corporation (Hackettstown, New Jersey). Waypoint Financial Corporation (Harrisburg, Pennsylvania, formerly Harris Bancorp) acquired York Financial Corporation (York, Pennsylvania). Sterling Financial Corporation (Lancaster, Pennsylvania) merged with Hanover Bancorp, Inc. (Hanover, Pennsylvania) in 2000.

Finally, Mercantile Bancorporation (Baltimore, Maryland) acquired Union National Bancorp, Inc. (Westminster, Maryland). There was one divestiture of note in 2000. USBANCORP, Inc. (Johnstown, Pennsylvania) spun off its subsidiary, Three Rivers Bank (Jefferson Boro, Pennsylvania).

In addition to the FleetBoston - Summit merger mentioned above, several notable mergers have taken place thus far in 2001. National Penn Bancshares, Inc. (Boyertown, Pennsylvania) acquired Community Independent Bank, Inc. (Bernville, Pennsylvania), and M&T Bank Corporation (Buffalo, New York) acquired Premier National Bancorp, Inc. (Lagrangeville, New York).

¹⁰ For full details of all federal and state (Pennsylvania, New Jersey, and Delaware) legislation and regulations see *Banking Legislation and Policy* at <http://www.phil.frb.org/econ/blp/index.html>.

Appendix - Methodology for Selecting Bank Categories

This publication splits banks into two categories, large banking organizations and community banks, then further splits those categories into the tri-state area and the nation. First, all credit card banks (defined as any bank with at least 50 percent of its loans classified as credit card loans), other limited-purpose banks, banks less than five years old, and wholesale banks (defined as any bank whose ratio of retail deposits to total deposits is less

than 5 percent) have been dropped from the sample.

Large banking organizations are determined annually as those firms that are at least as large as the 100th largest bank holding company in the nation as of the beginning of that year, ranked by total assets. Thus, the banks in the 2000 sample are selected based on their year-end 1999 total assets, updated for mergers that occurred during 2000. A large bank defined as

being in the tri-state area must also have at least one of the following characteristics: 1) a market share of deposits of at least 5 percent, either in the region as a whole or in any of the states or, 2) at least 5 percent of the organization's total deposits are located in the region.

Community banks in the tri-state area are either headquartered here or are subsidiaries of bank holding companies that are headquartered here.

NOTE: This report is not a statement of the Federal Reserve System's opinion of the condition of any banking firm or firms, but rather a summary of the results as the banking organizations themselves have reported them.

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