Banking Brief

For Pennsylvania, New Jersey, and Delaware

First Quarter 2001

Community banks in the tri-state area and large banking organizations in both the tri-state area and the nation reported a slightly lower average return on assets during the first quarter of 2001 compared with the same period last year. The decline was primarily due to a decrease in net interest margins. Total loans and deposits at large banks declined, especially in the tri-state area. On the other hand, total loan volume at community banking organizations, fueled by real estate lending, rose at a healthy clip in the first quarter. Informal interviews with local bankers provide evidence of greater home equity lending, resulting from individuals' consolidating debt and borrowing against home equity credit lines for car purchases and home improvements. Mortgage refinancing was also strong. Overall, the housing market has been resilient despite the recent economic slowdown, particularly because of favorable mortgage rates.

The nonperforming loan ratio at tri-state area banks remained low and actually declined from one year ago. Nationally, however, the ratio of nonperforming loans is on the rise. This trend is concentrated among larger banks that deal primarily with large- and middle-market borrowers: more than two-thirds of our large tri-state area banks reported higher nonperforming loans than in the previous quarter. According to the Federal Reserve Board, over the past quarter many banks tightened credit terms on business loans for large- and middle-market borrowers in response to a less favorable or more uncertain economic outlook, industry-specific problems, and a lower tolerance for risk.[1]

Economics of *De Novo* Entry

There has been an unprecedented level of merger activity within the U.S. banking industry since 1980. From 1980 to 2000, there were almost 9000 mergers. This tremendous wave of consolidation can be explained by changes in banking legislation and regulation, and changes in technology, among other factors. While thousands of banks consolidated, and a number of others failed, thousands of newly chartered, de novo banks were formed. These new institutions could conceivably increase competition in local banking markets.

A de novo's decision to enter a market is based on its expectation of profitability. Some researchers have suggested certain local market factors that might stimulate entry by de novos: 1) strong economic growth, 2) weak competition among existing banks in highly concentrated banking markets, and 3) a relative scarcity of small banks, which are potential competitors of de novos.[2] That would suggest that de novo banks are more likely to target local markets in which mergers have reduced the number of competitors and small businesses are underserved or dissatisfied with banking services provided by larger, and frequently out-of-area, institutions.[3] These smaller new entrants might be better positioned than larger incumbents to provide personal service to small businesses.

But it is only recently that researchers began investigating these phenomena, and there is still no consensus on the results. For instance, according to one study of banks and thrifts between 1995 and 1997, merger activity in the local market deterred de novo entry.[4] In contrast, another study finds that the probability of de novo entry is higher in local markets that have experienced mergers or acquisitions, particularly those involving large commercial banks.[5]

Mirroring the pattern observed in the nation, the tri-state area experienced an upsurge in the number of consolidations and new entries in the past five years. Over this short period of time, 55 new area banks opened their doors for business. Amazingly, all but two of these de novo banks still exist today. (The two disappeared because of corporate reorganization.) In terms of performance, de novo banks, like any typical start-up businesses, are vulnerable to failure in the early years of operation. Financial statements can fluctuate rapidly and dramatically during the first few years of business.[6] In our sample, the median de novo bank was unprofitable in its first year but attained profitability by its third year (ROA of –2.7 percent in the first year and 0.3 percent in the third). The trend in the return on average equity was similar (ROE of –10.6 percent in the first year and 2.3 percent in the third).[7]

Recent research suggests that a de novo bank must survive long enough (estimated at seven years) to become financially viable and stable so that it can become a reliable source of credit and compete effectively with other banks (see DeYoung, 1999). The recent rise in de novos dates mostly to the second half of the 1990s, so we will soon be able to look for evidence of their effect on competition in local banking markets.

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1 See the Federal Reserve Board's Senior Loan Officer Opinion Survey on Bank Lending Practices, May 2001.

2 R. Moore and E. Skelton, "New Banks: Why Enter When Others Exit?" Federal Reserve Bank of Dallas *Financial Industry Issues* (First Quarter 1998), pp. 1-7.

3 R. DeYoung, "Birth, Growth, and Life or Death of Newly Chartered Banks," Federal Reserve Bank of Chicago *Economic Perspectives* (Third Quarter 1999), pp. 18-35.

4 S. Seelig and T. Crotchfield, "Determinants of De Novo Entry in Banking," Working Paper 99-1, Federal Deposit Insurance Corporation (January 1999).

5 A. Berger, S. Bonime, L. Goldberg, and L. White, "The Dynamics of Market Entry: The Effects of Mergers and Acquisitions on De Novo Entry and Customer Service in Banking," *Proceedings from a Conference on Bank Structure and Regulation*, Federal Reserve Bank of Chicago (1999).

6 P. Brislin and A. Santomero, "De Novo Banking in the Third District," Federal Reserve Bank of Philadelphia *Business Review* (January / February 1991), pp. 3-12.

7 These ratios are calculated from our sample of de novo banks that entered the tri-state area in 1996 and 1997.

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First Quarter 2001

Community Banking Organizations

	Tri-State			*Nation*		
	$Bill	**% change from**		**$Bill**	**% change from**	
	01Q1	**00Q4**	**00Q1**	**01Q1**	**00Q4**	**00Q1**
Total Assets	$80.0	6.3%	7.5%	$1175.9	9.7%	10.5%
Total Loans	49.6	5.1	7.7	752.0	6.8	11.6
Business	6.7	1.9	10.8	137.6	8.9	12.5
Real Estate	35.9	6.9	8.2	487.1	9.7	13.4
Consumer	5.4	-5.0	3.1	82.5	-3.8	3.0
Total Deposits	63.1	5.9	8.2	960.2	9.5	10.1
Ratios (in %)	**01Q1**	**00Q4**	**00Q1**	**01Q1**	**00Q4**	**00Q1**
Net Income/ Avg Assets (ROA)	1.1%	1.1%	1.2%	1.2%	1.2%	1.2%
Net Interest Inc/ Avg Assets (NIM)	3.6	3.7	3.8	4.0	4.0	4.1
Noninterest Inc/ Avg Assets	1.1	1.1	1.0	1.0	1.0	1.0
Noninterest Exp/ Avg Assets	3.0	3.0	3.0	3.1	3.1	3.2
Loans/Deposits	78.7	78.9	79.1	78.3	78.8	77.2
Equity/Assets	8.9	8.9	8.3	9.4	9.4	9.0
Nonperforming Loans/ Total Loans	0.6	0.6	0.8	1.0	0.8	0.8

Large Banking Organizations

	Tri-State			*Nation*		
	$Bill	**% change from**		**$Bill**	**% change from**	
	01Q1	**00Q4**	**00Q1**	**01Q1**	**00Q4**	**00Q1**
Total Assets	$867.4	-4.7%	-1.9%	$4678.1	2.9%	5.2%
Total Loans	538.5	-1.9	-3.0	2781.8	-0.7	4.6
Business	188.6	-5.5	-3.8	876.7	-3.0	2.7
Real Estate	216.8	-4.2	-2.4	1151.5	4.6	6.3
Consumer	46.0	-6.1	-12.4	334.6	3.6	4.8
Total Deposits	567.1	-6.6	-1.1	2979.7	-4.1	4.2
Ratios (in %)	**01Q1**	**00Q4**	**00Q1**	**01Q1**	**00Q4**	**00Q1**
Net Income/ Avg Assets (ROA)	1.1%	1.1%	1.2%	1.1%	1.1%	1.2%
Net Interest Inc/ Avg Assets (NIM)	3.2	3.3	3.3	3.1	3.1	3.2
Noninterest Inc/ Avg Assets	2.8	2.8	2.9	2.3	2.3	2.4
Noninterest Exp/ Avg Assets	3.7	3.7	3.8	3.3	3.3	3.4
Loans/Deposits	95.0	93.8	96.8	93.4	92.6	93.0
Equity/Assets	8.8	8.8	8.3	8.1	8.1	7.9
Nonperforming Loans/ Total Loans	1.5	1.2	1.1	1.5	1.1	1.0

A banking organization is an independent bank or all the banks within a highest-level bank holding company; however, banks less than five years old and those whose credit card loans make up greater than 50 percent of their total loans are excluded. The large banking organization sample is based on banking organizations whose total assets were at least as large as those of the 100th largest banking organization in the United States as of December 31, 2000. The community banking organization sample is based on the remaining banking organizations. Tri-state large banking organizations are those large banking organizations that have either at least 5 percent of the deposits of the region or any state therein or at least 5 percent of their deposits in the region. Tri-state community banking organizations are those community banking organizations that are headquartered in the region. The numbers of banking organizations in the categories are as follows: (1) community banking organizations —195 for the tri-state area and 6099 for the nation; (2) large banking organizations —17 for the tri-state area and 97 for the nation. Ratios are aggregates, that is, the numerators and denominators are summed across all banks in the group, then divided. Data are adjusted for mergers.

Any questions or comments should be directed to Victoria Geyfman at (215) 574-6431 or victoria.geyfman@phil.frb.org. Detailed documentation on the methodology used in constructing this document, back issues, and the current issue of *Banking Brief* are available on our web site at www.phil.frb.org/econ/bb/index.html. To subscribe to this publication, please contact the Publications Desk at (215) 574-6428 or lois.newell@phil.frb.org.