BANKING BRIEF

FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

Third Quarter 2001

Although bank earnings fell both regionally and nationally in the third quarter, the economic slowdown and terror attacks in September did not have as profound an effect as was initially thought. In anticipation of increased charge-offs, banks set aside close to $11 billion to cover expected loan losses. This additional provisioning reduced net income, causing ROA at the nation's banks to drop from 1.2 to 1.1 percent over the quarter. Banks also charged-off $8.5 billion in loans during the quarter, an increase of more than 60 percent from the same period last year. Losses in the C&I loan portfolio were responsible for roughly a third of all banks' losses. Real estate lending continued to be a bright spot for community banks, rising by almost 12 percent at the national level since the second quarter. Overall, large banks decreased their lending, especially in the business loan category.[1]

Deposits grew rapidly at community banks and large tri-state banks, but not at large national banks. However, total assets grew across all bank categories. The largest factor contributing to asset growth was an increase of 26 percent in available-for-sale securities over the quarter. Mortgage-backed securities (MBSs) accounted for more than half of all securities in banks' portfolios. Compared with the second quarter, the book value of these securities rose by 44 percent, while their market value rose by 55 percent, indicating both net acquisition and appreciation in the value of MBSs.

Mortgage-Backed Securities and the Flight to Quality

Banks manage their exposure to various risks in part by adjusting the composition of their balance sheet, in part by engaging in off-balance-sheet activities like derivatives. For example, banks may adjust the share of MBSs in portfolios in response to changing risks. Currently, the most challenging problem for bankers is managing credit problems that arise in a recession.

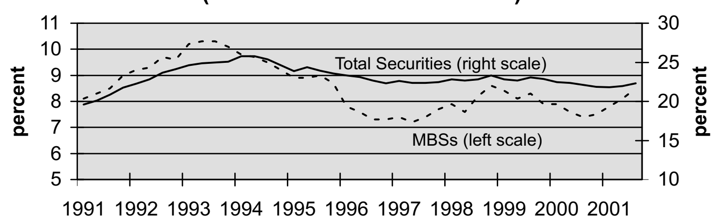
MBSs are securities collateralized by pools of mortgages. Some of the underlying loans are insured by FHA, VA, or FMHA. Also, a large share of all MBSs are issued by agencies (Ginnie Mae, Fannie Mae, and Freddie Mac) that many investors believe have implicit government backing.

The quantity of these securities has grown rapidly, from less than $25 billion in 1981 to over $4 trillion this year, which accounts for 22 percent of total outstanding bond market debt.[2] The current low interest rate environment has stimulated refinancing activity, generating new mortgages that can be packaged into new MBSs. Agency issues of new MBSs rose to $762 billion in the first nine months of 2001, compared to $329 billion in the same period of last year.[3] Clearly, many of these new securities are appearing on the books of commercial banks.

Banks' business strategies change with economic conditions. During an economic downturn, researchers have sometimes observed a phenomenon called "flight to quality," a decline in the share of credit flowing to riskier borrowers (see, for example, Lang and Nakamura, 1992; Gertler and Gilchrist, 1993[4]). Thus, in a recession, it would not be surprising to see slower, or even negative, loan growth, together with increased purchases of safer securities at commercial banks. The types of securities have increasingly shifted from Treasury securities toward MBSs, as MBSs have expanded as a share of total securities.

The flight to quality is evident from the most recent Senior Loan Officer Opinion Survey, which indicates a rise in the fraction of domestic banks tightening standards on C&I loans over the past quarter.[5] Also, almost half of the respondents continued to tighten lending standards on commercial real estate loans during the past quarter, the same percentage as in August. At the same time, many respondents reported declining demand for both business and commercial real estate loans. A combination of softer demand for loans and a flight to safer investments might help us explain a rise in the ratio of securities, particularly MBSs, to assets to 8.5 percent, the highest level reached in three years (see Figure).

Total and Mortgage-Backed Securities (Share of Total Bank Assets)



Source: Federal Reserve Board, Haver.
Note: Total securities and MBSs as percent of total assets at insured commercial banks at the end of the period. The data are seasonally adjusted.

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[1] Consumer loans fell sharply at the large tri-state banks, as one bank sold a large consumer credit card portfolio.

[2] Fannie Mae, *Mortgage-Backed Securities Product Information*. See http://www.fanniemae.com.

[3] The Bond Market Association, *Research Quarterly*, November 2001.

[4] W. Lang and L. Nakamura, "'Flight to Quality' in Banking and Economic Activity," *Journal of Monetary Economics*, 36, pp. 145-64 (1995). M. Gertler and S. Gilchrist, "The Role of Credit Market Imperfections in the Monetary Transmission Mechanism: Arguments and Evidence," *Scandinavian Journal of Economics*, 95, pp. 43-64 (1993).

[5] Federal Reserve Board, *Senior Loan Officer Opinion Survey on Bank Lending Practices*, October 2001.

Third Quarter 2001

Community Banking Organizations

	Tri-State			Nation		
	$Bill	% change from		$Bill	% change from	
	01Q3	01Q2	00Q3	01Q3	01Q2	00Q3
Total Assets	78.6	9.2	9.0	1217.9	11.2	10.6
Total Loans	48.1	7.6	7.9	782	8.7	9.5
Business	6.5	8.7	11.2	139.2	0.5	8.8
Real Estate	34.9	7.7	8.6	512.4	12.8	11.9
Consumer	5.1	2.1	-1.8	82.2	0.5	-0.3
Total Deposits	61.8	10.5	9.5	987.2	9.6	10.1

Ratios (in %)	01Q3	01Q2	00Q3	01Q3	01Q2	00Q3
Net Income/ Avg Assets (ROA)	1.1	1.1	1.2	1.1	1.2	1.2
Net Interest Inc/ Avg Assets (NIM)	3.5	3.6	3.7	3.9	3.9	4.1
Noninterest Inc/ Avg Assets	1.1	1.1	1.1	1.1	1.0	1.0
Noninterest Exp/ Avg Assets	3.0	3.0	3.0	3.1	3.1	3.1
Loans/Deposits	77.9	78.4	79.0	79.2	79.4	79.6
Equity/Assets	9.1	9.1	8.6	9.6	9.6	9.1
Nonperforming Loans/ Total Loans	0.8	0.7	0.7	1.0	1.0	0.8

Large Banking Organizations

	Tri-State			Nation		
	$Bill	% change from		$Bill	% change from	
	01Q3	01Q2	00Q3	01Q3	01Q2	00Q3
Total Assets	962.5	14.9	3.5	4853.3	12.9	6.3
Total Loans	584.7	-0.5	-2.2	2781.6	-1.9	-0.4
Business	193.5	-9.2	-8.4	837.0	-7.5	-5.4
Real Estate	240.2	0.2	-0.4	1166.1	-3.8	1.4
Consumer	55.3	-20.4	-3.2	346.5	2.0	5.9
Total Deposits	628.3	12.5	3.6	3051.5	2.7	4.2

Ratios (in %)	01Q3	01Q2	00Q3	01Q3	01Q2	00Q3
Net Income/ Avg Assets (ROA)	1.2	1.4	1.1	1.1	1.2	1.1
Net Interest Inc/ Avg Assets (NIM)	3.1	3.3	3.4	3.0	3.1	3.1
Noninterest Inc/ Avg Assets	2.5	2.8	2.8	2.3	2.3	2.4
Noninterest Exp/ Avg Assets	3.2	3.4	3.9	3.2	3.2	3.4
Loans/Deposits	93.1	96.0	98.7	91.2	92.2	95.4
Equity/Assets	9.6	9.6	8.5	8.4	8.4	8.1
Nonperforming Loans/ Total Loans	1.5	1.5	1.1	1.5	1.5	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 —189 for the tri-state area and 6022 for the nation; (2) large banking organizations —17 for the tri-state area and 94 for the nation. Ratios are aggregates, that is, the numerators and denominators are summed across all banks in the group, then divided.

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.

FEDERAL RESERVE BANK OF PHILADELPHIA