



# BANKING BRIEF

## FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

### ***SPECIAL REPORT: COMMERCIAL BANKS IN 2002***

In 2002, the performance of both large banking organizations and community banks improved somewhat over that of 2001, particularly in terms of profitability. By the end of 2002, each type of institution still had some problems to overcome, but they faced a different set depending on their size. The larger organizations had asset-quality problems. The smaller institutions appeared to have asset quality under control, but they were having some difficulty generating revenue.

#### ***Large Banking Organizations***

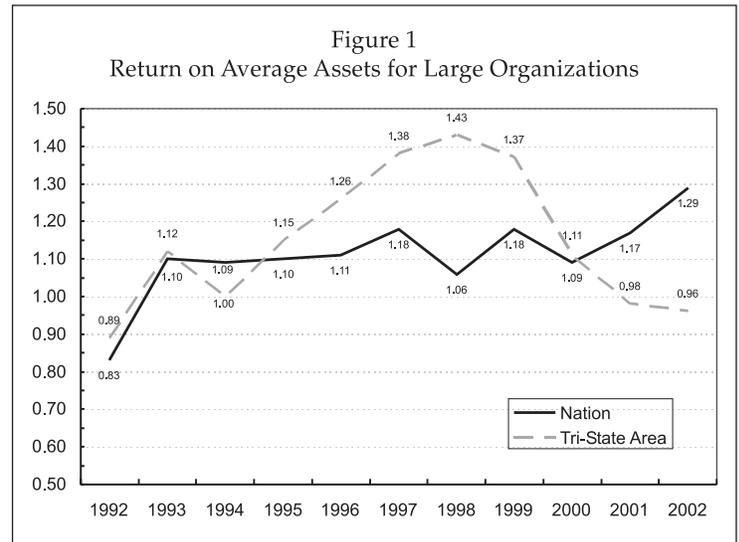
Profitability of large banking organizations in the nation continued to improve in 2002, but organizations operating in the tri-state area lagged behind.<sup>1</sup> In the nation, return on average assets (ROA) increased from 1.17 percent to 1.29 percent (Figure 1), but it was basically flat for banks operating in the tri-state area.<sup>2</sup> Return on average equity increased from 13.68 percent to 14.82 percent for the national sample but decreased from 12.06 percent to 11.73 percent for banks in the area (Figure 2).

The primary problem afflicting the larger banks was asset quality. The ratio of net chargeoffs to average assets continued to increase in 2002, both locally and

nationally (Figure 3). In 2002, the tri-state area figure stood at 0.68 percent, up from 0.60 percent, while the national figure was 0.69 percent, up from 0.63 percent. This ratio has been increasing since 1999, and in 2002 it reached its highest point since the early 1990s. The increase in the ratio of net chargeoffs to average assets was driven by large increases in net chargeoffs. Nationally, net chargeoffs among large banking institutions increased by \$7.7 billion in 2002, a 27.4 percent increase. For large banks operating in the tri-state area,

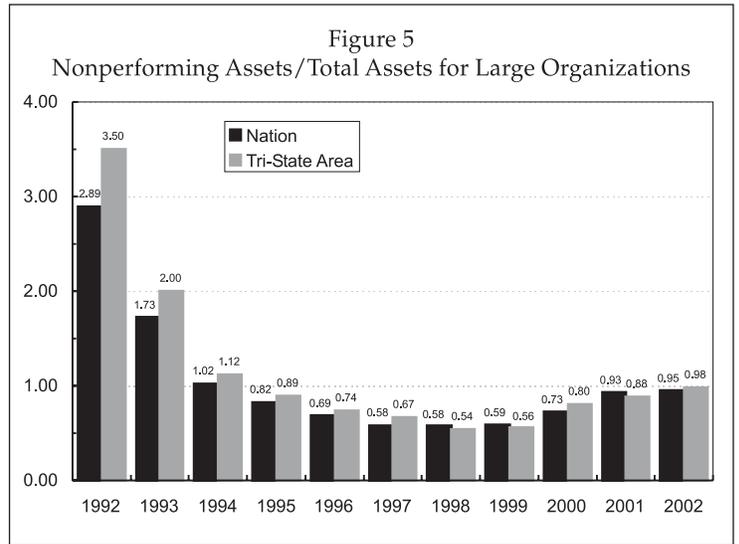
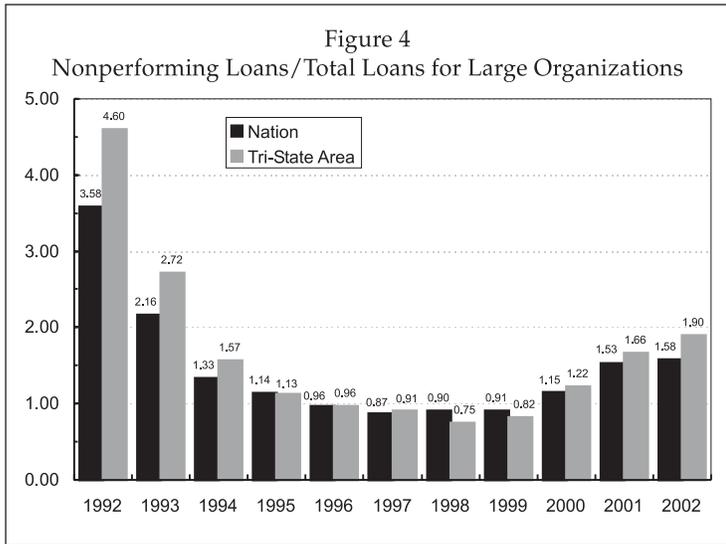
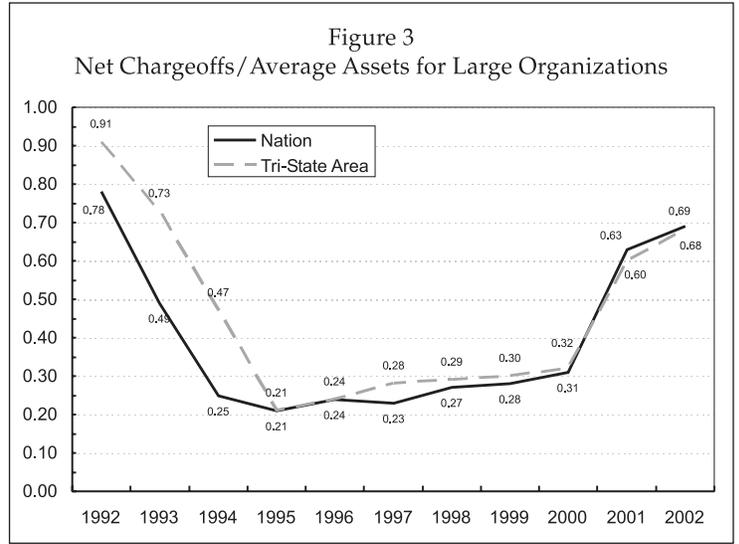
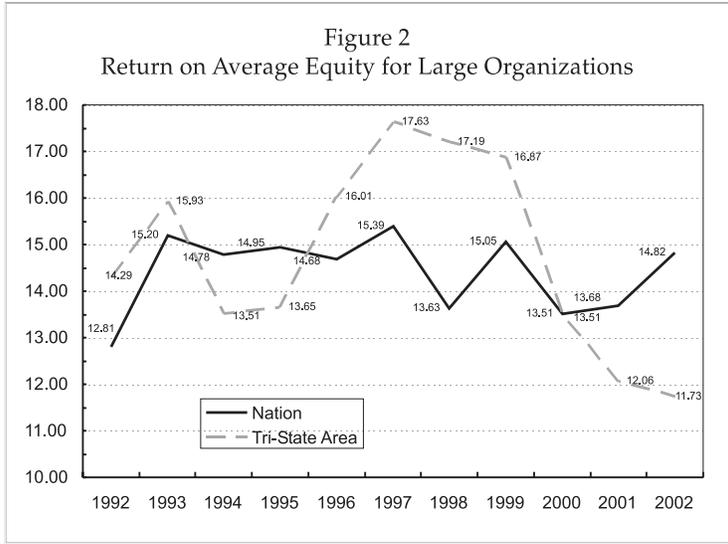
net chargeoffs increased by \$2.3 billion, a 21.7 percent increase.

Somewhat better news for banks nationally, but not regionally, is that the growth of nonperforming loans and assets was less rapid than in the previous couple of years (Figures 4 and 5). The ratio of nonperforming loans to total loans increased from 1.66 percent to 1.90 percent for banks operating in the tri-state area,



<sup>1</sup> 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 at year-end 2001, ranked by total assets. A large bank defined as being in the tri-state area must have one of the following characteristics: 1) a market share of deposits of at least 5 percent in either the region as a whole or in any one of the states, or 2) at least 5 percent of the organization's total deposits located in the region. It should be noted that the year-to-year ratios presented are based on different samples, so the inclusion or exclusion of an organization can affect the numbers. See the Appendix for a description of the methodology used in grouping these banks.

<sup>2</sup> All data used in Figures 1-26 are from Federal Financial Institutions Examination Council (FFIEC) Call Reports. All ratios are weighted averages of all banks within the sample. This means that the numerator and denominator are summed across banks, with the resulting aggregates divided.



and it increased from 1.53 percent to 1.58 percent nationally.<sup>3</sup> The ratio of nonperforming assets to total assets increased at a similar rate.<sup>4</sup>

The loan-loss coverage ratio for banks both in the tri-state area and the nation continued to decrease, as it has every year since 1998 (Figure 6).<sup>5</sup> The dollar amount of nonperforming loans increased 10.0 percent nationally and 15.6 percent lo-

cally. However, banks in the nation added only \$3.1 billion to loan-loss reserves, a 5.6 percent increase. Tri-state area banks increased their loan-loss reserves by about \$445 million, a 2.2 percent increase. As a result, loan-loss coverage ratios were at their lowest levels since 1993.

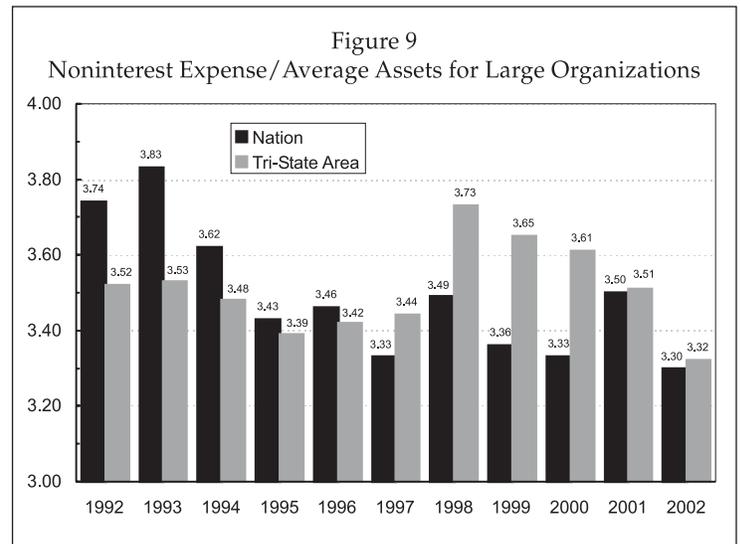
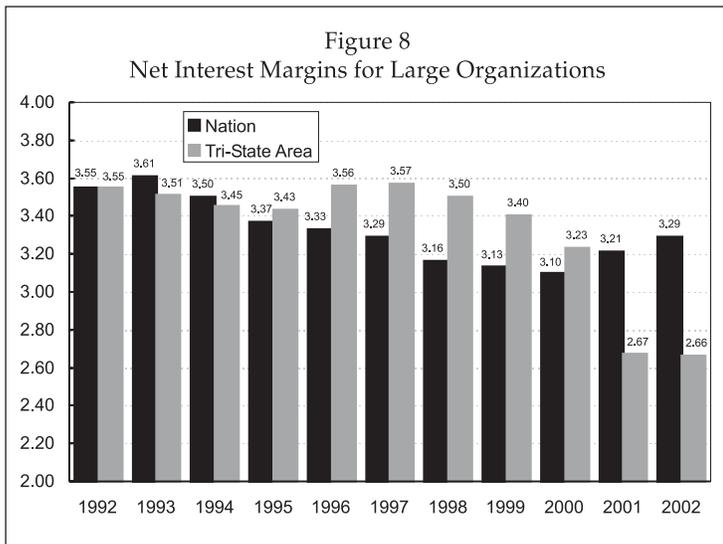
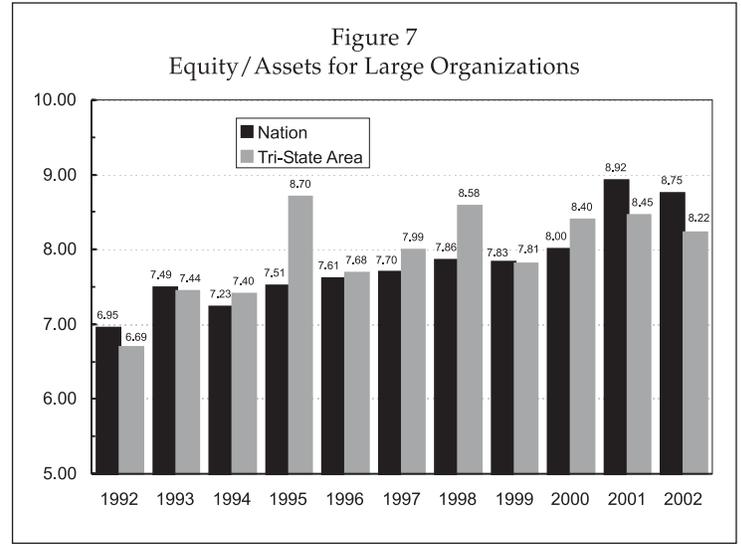
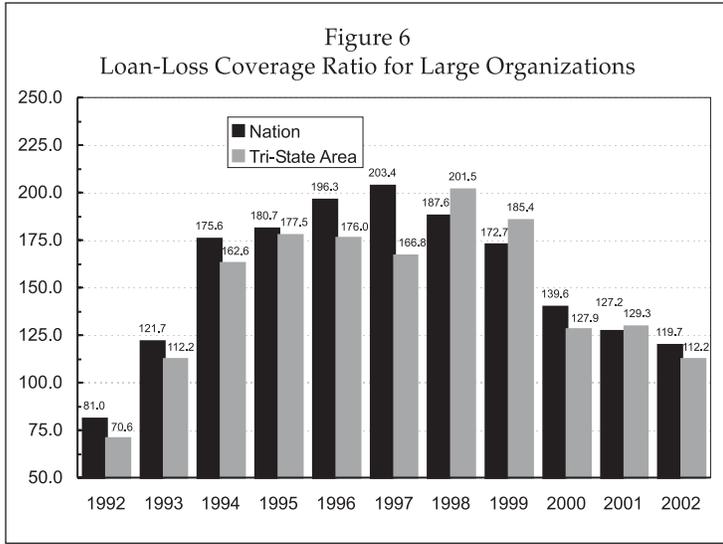
If large banks had chosen to maintain their coverage ratios at year-end 2001 levels, an additional \$3.69 billion in loan-

loss reserves nationally (\$3.16 billion for banks in the tri-state area) would have been necessary. This would have reduced profits by a corresponding amount, and ROA would have been 1.22 percent nationally and 0.80 percent locally. The fact that banks did not maintain their loan-loss coverage ratios suggests that many believed that the asset-quality problem had peaked and expect problem loans and

<sup>3</sup> Nonperforming loans are defined as loans past due 90 days or more plus nonaccruing loans.

<sup>4</sup> Nonperforming assets are defined as nonperforming loans plus other real estate owned.

<sup>5</sup> Loan-loss coverage ratio is defined as the ratio of loan loss reserves to nonperforming loans.



chargeoffs to decrease in 2003. Of course, if nonperforming loans do not begin to decrease, it is unlikely that the profitability reported in 2002 would be sustainable.

While reserve coverage was decreasing in 2002, capital ratios also decreased slightly (Figure 7). The ratio of total equity to total assets fell both locally and nationally, after increasing for the previous two years. However, the changes were relatively small, and the leverage ratios are

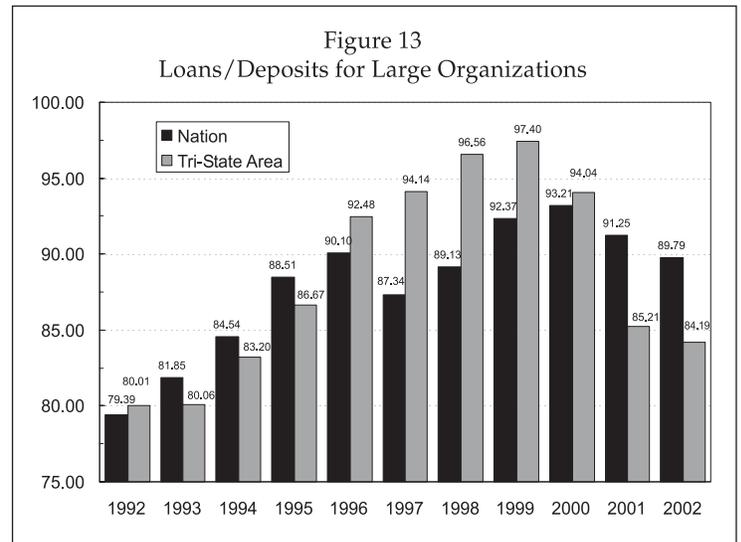
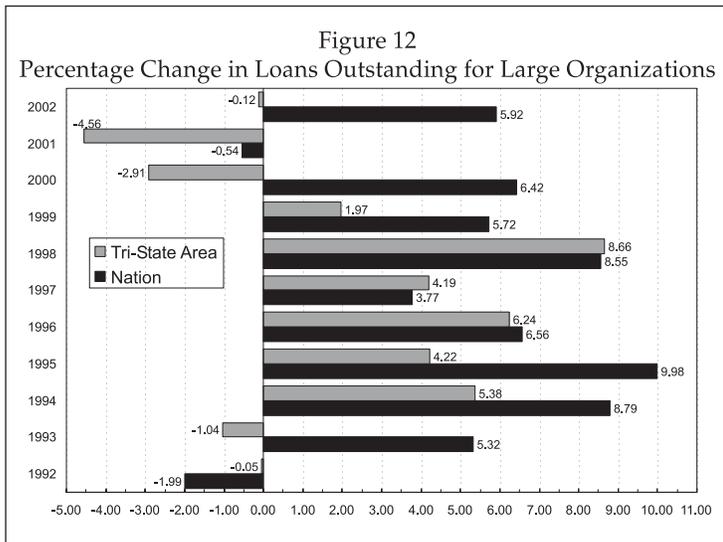
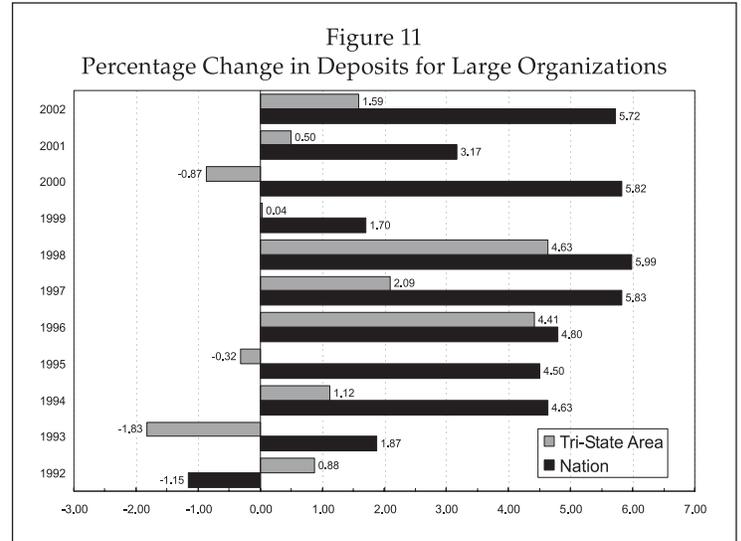
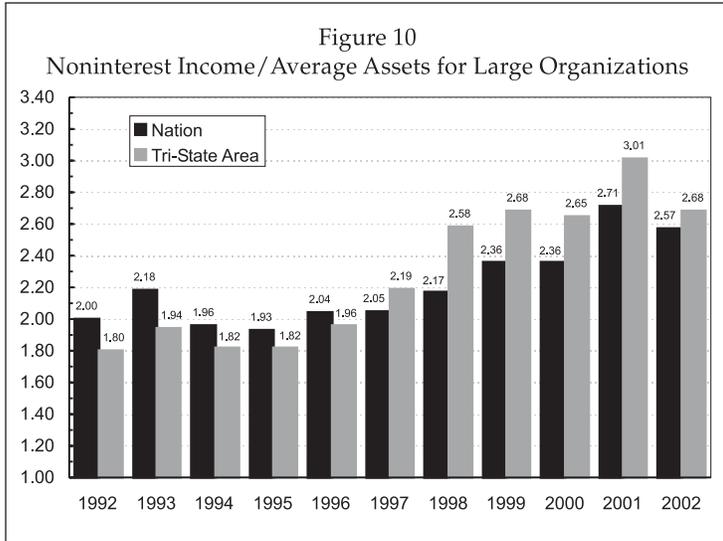
still the second highest reported at any time during the past seven years. Moreover, capital levels did not decrease. The reason for the drop in the ratios was that assets also increased. Equity capital at tri-state area banks increased 5.6 percent in 2002, to \$161.7 billion. Likewise, equity capital increased 8.1 percent nationally, to \$474.2 billion.

Two other factors contributed to increased profitability in 2002: higher net

interest margins and lower noninterest expense. Net interest margins increased nationally in 2002, but they were basically flat locally (Figure 8).<sup>6</sup> Large banking organizations were also successful in controlling overhead in 2002 (Figure 9). Both nationally and locally, the ratio of noninterest expense to average assets was at its lowest level in more than a decade.

The ratio of noninterest (fee) income to average assets decreased in 2002, although

<sup>6</sup> Net interest margin is defined as the ratio of net interest income to average earning assets. Average earning assets are the sum of interest-earning balances, net loans, securities, and fed funds sold and securities purchased under agreements to resell. The large drop in net interest margins for large tri-state area banks in 2001 was due in part to a change in the sample from 2000. For further information, see *Banking Brief Special Report: Commercial Banks in 2001*, Federal Reserve Bank of Philadelphia.



it was higher both locally and nationally than at any point in the 1990s (Figure 10). The decreases last year were primarily due to trading account losses. Weakness in the stock market also led to an increase in bank deposits, as investors shifted from equities to debt securities and bank deposits (Figure 11).

Loan demand remained sluggish locally, but appeared to have rebounded somewhat nationally. Figure 12 shows that loans outstanding increased almost 6 percent nationally while they were basi-

cally flat at banks operating in the tri-state area. Deposits increased faster than loans (compare Figures 11 and 12), resulting in a continued decrease in loans-to-deposits ratios (Figure 13). This could be the result of the weak demand for C&I loans mentioned above. However, given the amount of uncertainty in the financial markets and the banks' asset-quality problems, it is likely the banks would prefer to be relatively liquid.

In summary, large banking organizations had a profitable year in 2002, but the

increased profitability should not be over-emphasized. The high profits were driven by higher net interest margins and decreasing expenses. Two major problems facing banks both locally and nationally are asset quality and reserves. Profits would not have been so high if banks had added more to their reserves. It appears that banks basically stood pat in 2002, waiting for the overall economy to improve. If that happens, banks are well-positioned to take advantage of it.

## Community Banks

Earnings at small community banks increased nationally in 2002, but at banks in the tri-state area they were basically flat. Return on average assets (ROA) was 1.27 percent in 2002 for banks in the nation as a whole, up from 1.15 in 2001 (Figure 14). However, ROA at community banks in the tri-state area was only 1.18 percent, down from 1.20 percent in 2001. The pattern for return on average equity (ROE) was similar (Figure 15). Nationally, ROE increased from 11.99 percent to 13.24 percent, while in the tri-state area it increased only from 12.81 percent to 12.83 percent.

Two factors accounted for the disparity in profitability between tri-state area banks and national banks: loan growth and net interest margins. Nationally, community banks experienced a resurgence in loan demand in 2002, while growth at tri-state area banks was at its lowest since 1993 (Figure 16). It should be noted that community banks both locally and nationally had higher loan demand than the large organizations (see above). The regional economy, upon which many of the community banks depend, has been somewhat weaker than the national economy. Employment in the region declined in 2002, especially in construction. Residential building for the region increased slightly in 2002 but took a downturn in the fourth quarter.<sup>7</sup> Many of the smaller banks depend on residential real estate lending. Net interest margins also dropped at tri-state area community banks (Figure 17). Nationally, margins were stable. Thus, it would appear that tri-state area banks experienced more difficulties generating revenue growth than community banks around the country.

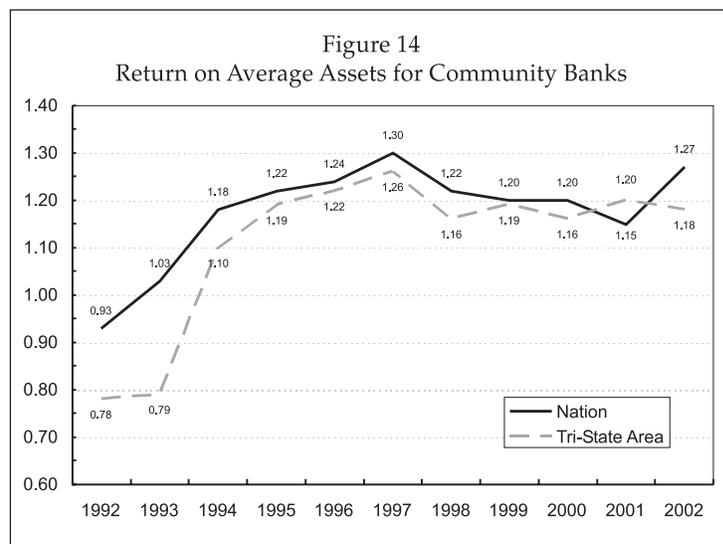
The community banks appear to have avoided the same degree of asset-quality and reserve problems that the larger banks experienced. The ratio of net chargeoffs to average assets decreased substantially for community banks in the tri-state area and the nation (Figure 18). The national figure was still higher than it was throughout

most of the 1990s, but the regional figure returned to 1990s levels. The ratios of nonperforming loans to total loans and nonperforming assets to total assets essentially remained stable nationally and decreased slightly locally (Figures 19 and 20). In each of these ratios, the community banks performed substantially better than the large organizations.

The decline in chargeoffs and stabilization of nonperforming loans permitted the community banks to maintain better loan-loss coverage ratios than the larger banks (Figure 21). Both the national and local figures showed only a slight drop in 2002. Unlike the larger organizations, the smaller banks were also able to maintain their capital ratios in 2002 (Figure 22).

Figure 23 shows the ratio of noninterest income to average assets. After a large increase in 2001, this figure decreased dramatically in 2002. Noninterest income was mainly flat, but assets increased substantially in 2002 (see below). Two items declined last year: fiduciary income and servicing fees. Community banks have historically had lower fees than large organizations, but they have been trying in recent years to increase fee income. This strategy appears to have been somewhat successful on the national level but not yet on the local level.

Deposits grew 10.91 percent nationally, one of the highest rates in the last 10 years, but locally the rate of growth was a more modest 6.96 percent (Figure 24). As with the larger banks, the weakness of the financial markets drove some consumers away from stocks and into bank deposits.

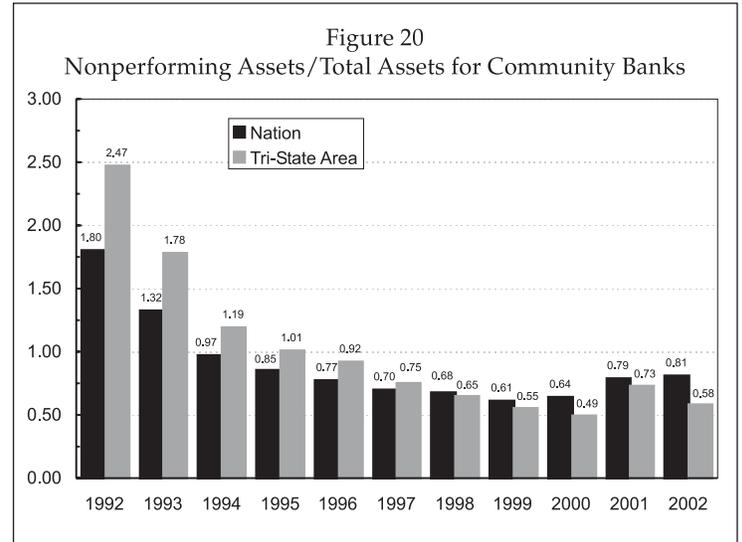
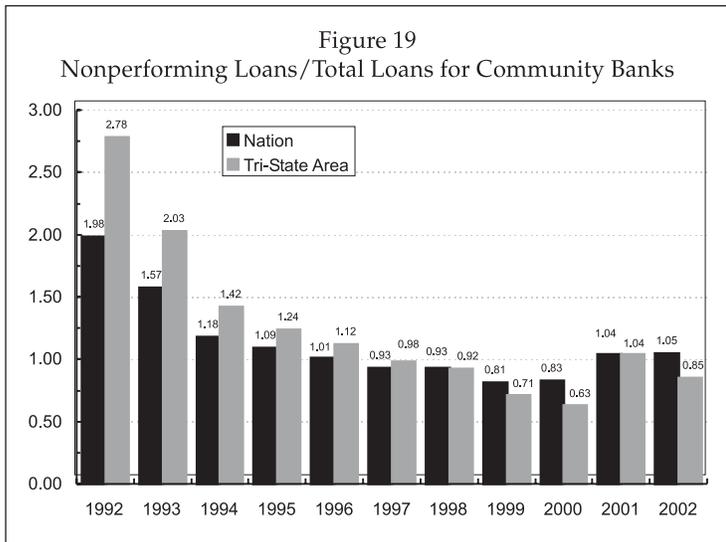
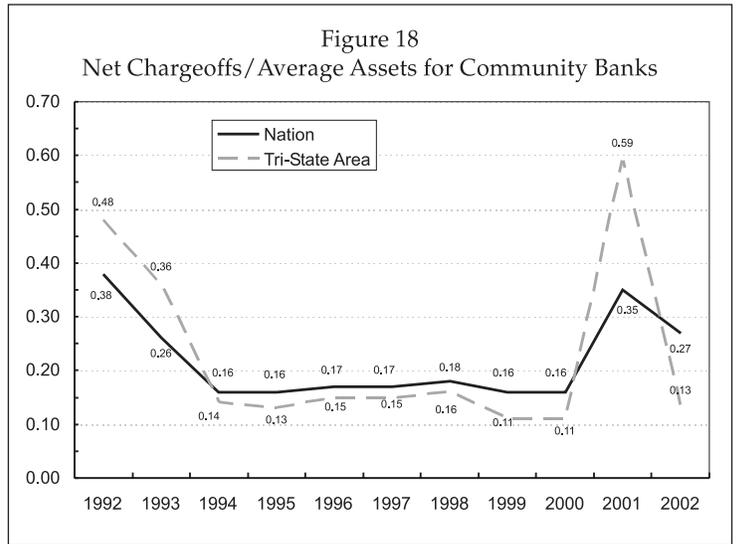
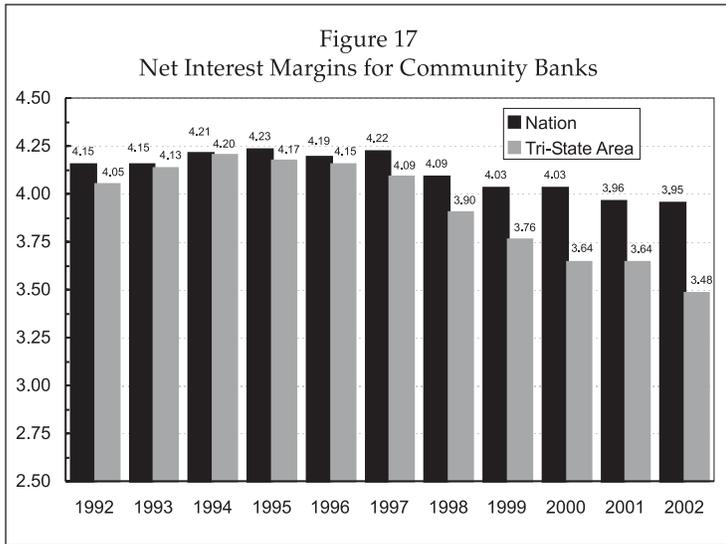
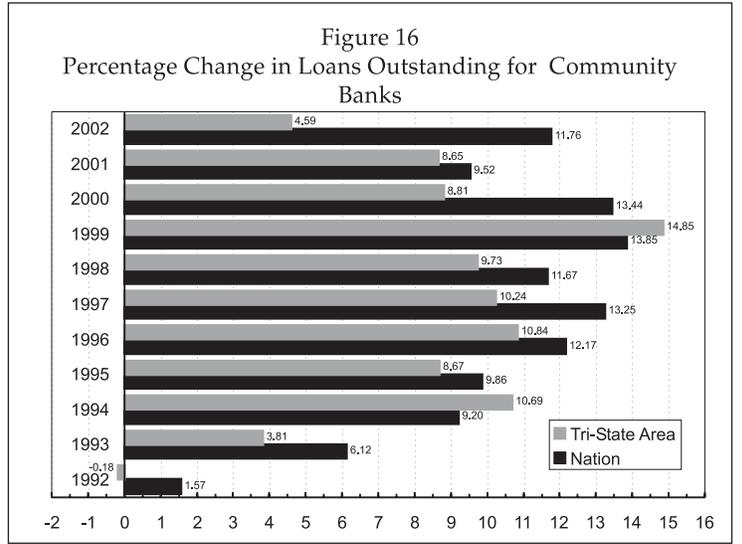
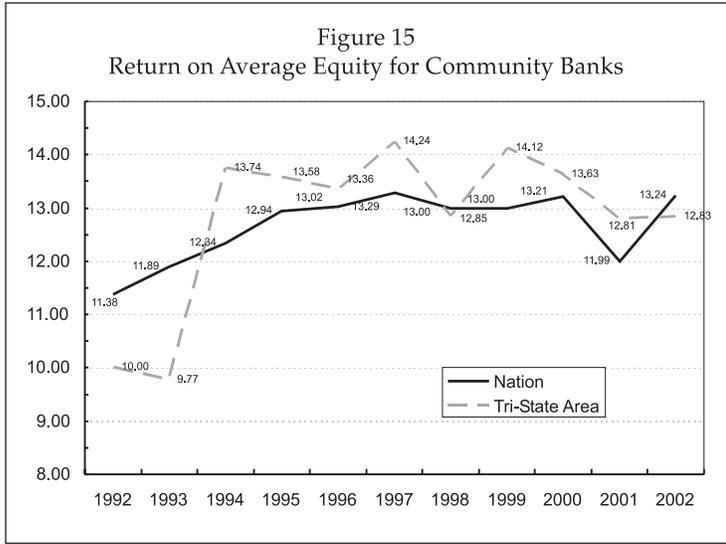


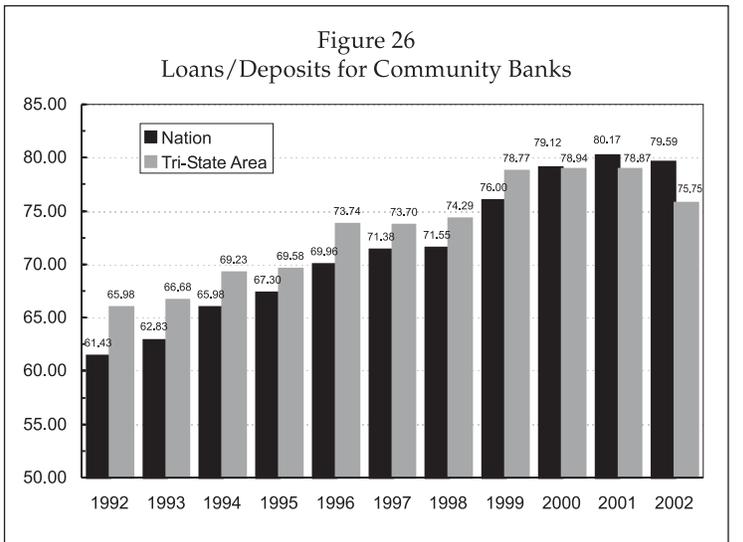
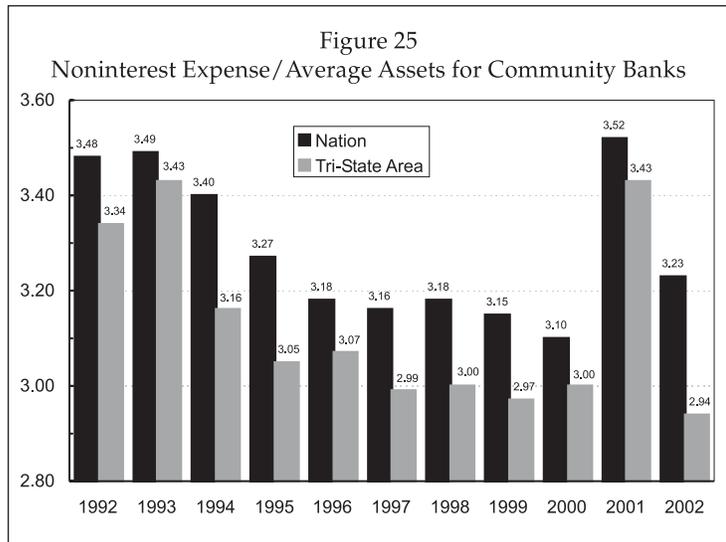
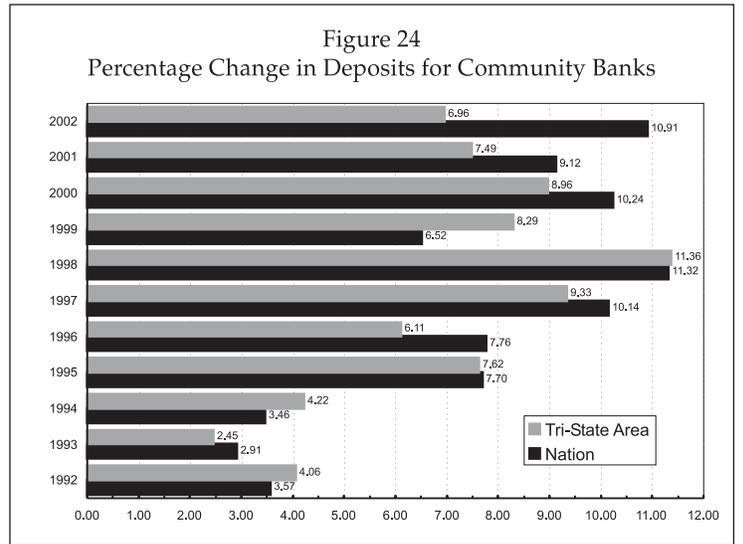
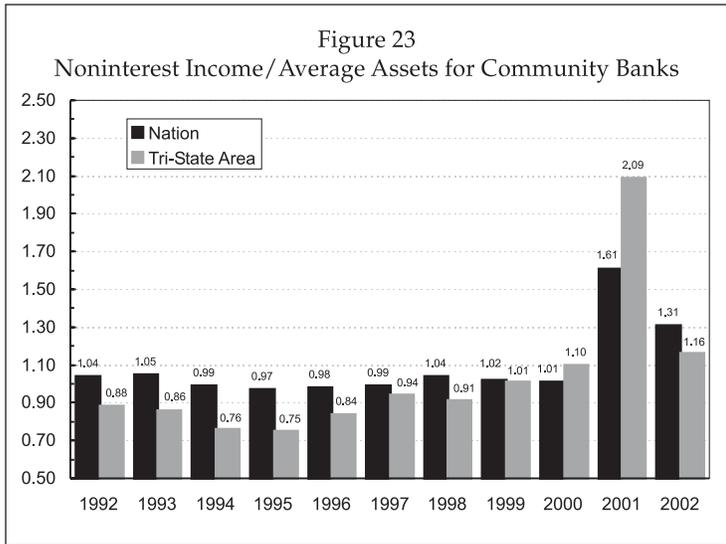
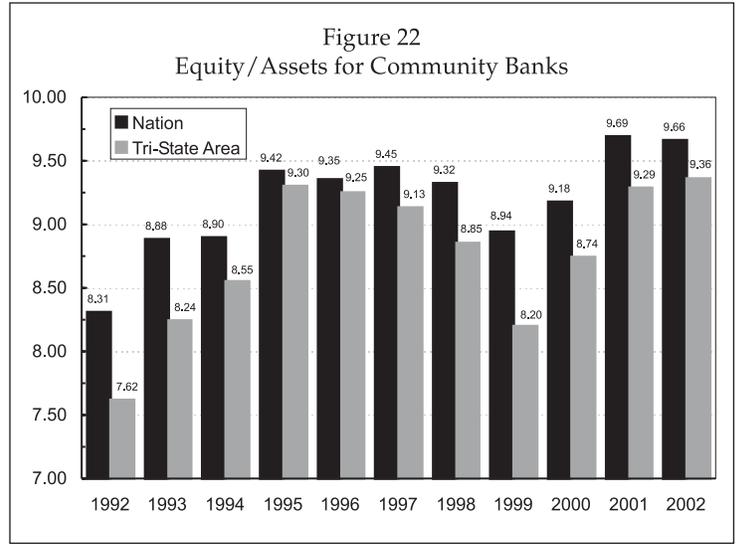
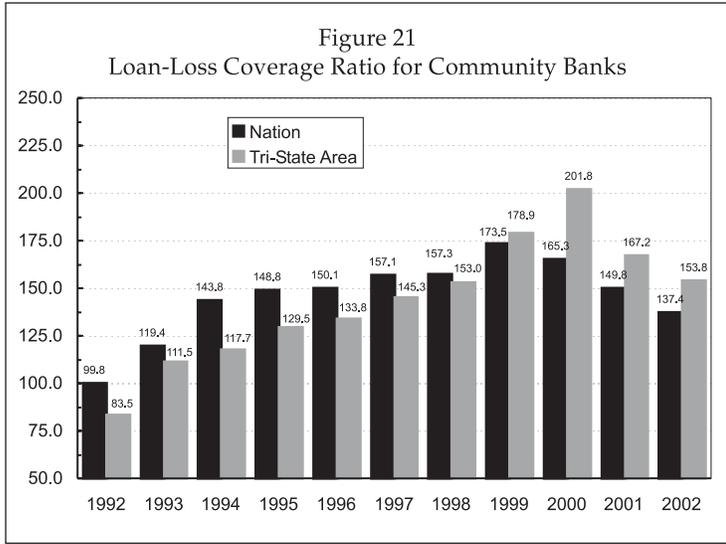
Smaller banks also tried to control overhead expenses, and in that they were somewhat successful. The ratio of noninterest expense to average assets fell substantially for banks nationally in 2002 (Figure 25). The local figure was lower than the national figure, and it dropped substantially relative to banks in the nation. This was due in part to an increase in assets. Assets at community banks in the tri-state area increased 7.8 percent, while overhead increased 5.8 percent. The corresponding national figures are 7.0 percent for assets and 4.0 percent for noninterest expense. Banks in the tri-state area have usually had lower costs than banks nationally.

The ratio of loans-to-deposits decreased slightly locally and was basically unchanged nationally (Figure 26). This ratio has been between 75 and 80 percent for both sets of banks for several years now.

In summary, community banks appear to be healthier than the large organizations. It appears they have any asset-quality problems under control. They have relatively strong capital positions and are aggressively seeking new customers. There are some problems with revenue, particularly interest income, which could adversely affect profitability in the future.

<sup>7</sup> See *Regional Highlights*, Fourth Quarter 2002, Federal Reserve Bank of Philadelphia.





Changes in state and federal laws in the mid- to late 1980s and early 1990s made possible an unprecedented consolidation in the industry. Between 1992 and 1998, there were nearly 3,000 mergers involving banks in the United States, resulting in a net decrease in the overall number of banks of approximately 500 per year.<sup>8</sup> There has been much debate about the possible effects of this rapid consolidation on various interested parties, i.e., customers, shareholders, management, communities, and the banks themselves.

One phenomenon observed by the banks themselves is deposit runoff. That is, the deposits of the combined entity in a merger are often less than the sum of the two merging banks' deposits in the previous year. As shown in Figure 27, *pro forma* deposit growth at banks that engaged in mergers during the previous year consistently lagged that of other banks during the 1990s.<sup>9</sup> In some years the merging banks actually experienced a decrease in deposits. This is important for several reasons. Deposits represent a bank's least expensive source of funds. Moreover, unlike equity funding, the bank's management doesn't give up any control to depositors.

Using these data as a starting point,

this section will examine the effects of bank mergers on deposit growth. Of particular interest will be levels of service; that is, are changes in the number of employees, spending on buildings and equipment, the deposit fee structure, and employee wages associated with deposit growth?

The first service variable examined was employee wages, salaries, and benefits (Figure 28a).<sup>10</sup> Wages can be viewed as a quality measure for employees. To attract higher-quality employees, i.e., those that provide more and/or better service, we would expect a bank to pay them higher wages. Therefore, we would expect the relationship between wages and deposit growth to be positive. As Figure 28a shows, this is the case. Moreover, this relationship is more sensitive for merging banks than for those that did not merge. Figure 28b shows the changes in wages, salaries, and benefits for merging and nonmerging banks. In all but two years, the growth of wages was substantially lower at merging banks than at banks that did not merge. This could indicate that merging banks are losing some of their highly skilled and experienced workers. As the figures show, this has a negative impact on deposit growth.

Figure 29a shows that there is a positive

relationship between changes in the number of full-time equivalent employees and deposit growth for banks that engaged in mergers and banks that did not. This means that an increase in the number of employees is correlated with higher deposit growth rate, and vice versa. This makes sense because more employees can provide better service to customers, such as better recordkeeping or a shorter wait for service. However, as shown by the steeper slope of the trend line for merging banks, the relationship is more strongly positive for banks that engaged in mergers. This means that these banks' deposits are more sensitive to changes in the number of employees.

As shown in Figure 29b, in all the years of the sample except two (1992 and 1994), banks that engaged in mergers the previous year had lower employment growth than banks that didn't merge. This is because in some mergers, duplicate functions at the acquiring and selling banks are combined. Examples of this are the combined bank needing only one accounting department instead of two or the closing of branches that serve the same area. Since merging banks are more likely to cut employees, all other things being equal, this accounts for some of the slower deposit growth at the banks that merged.

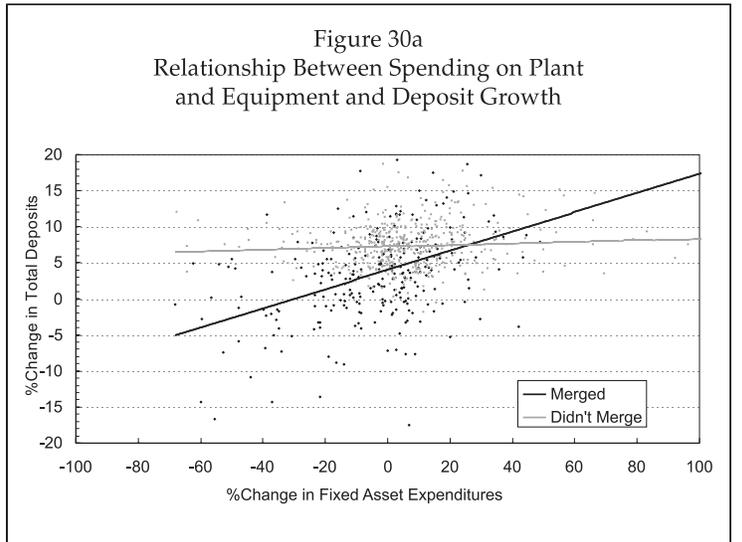
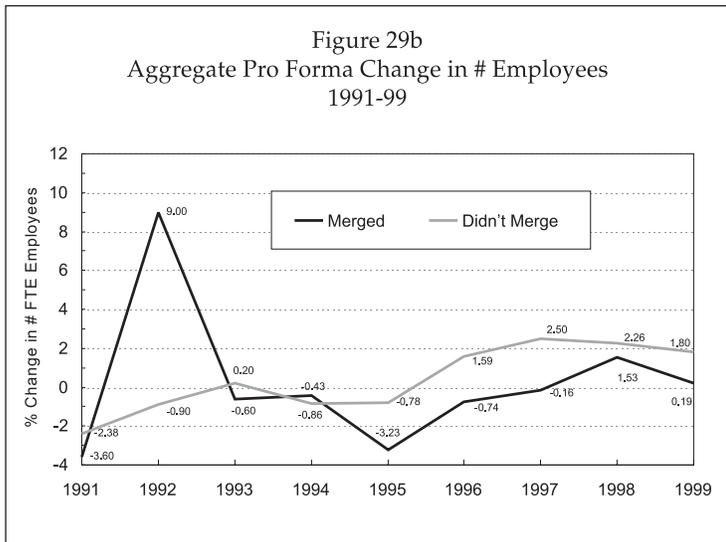
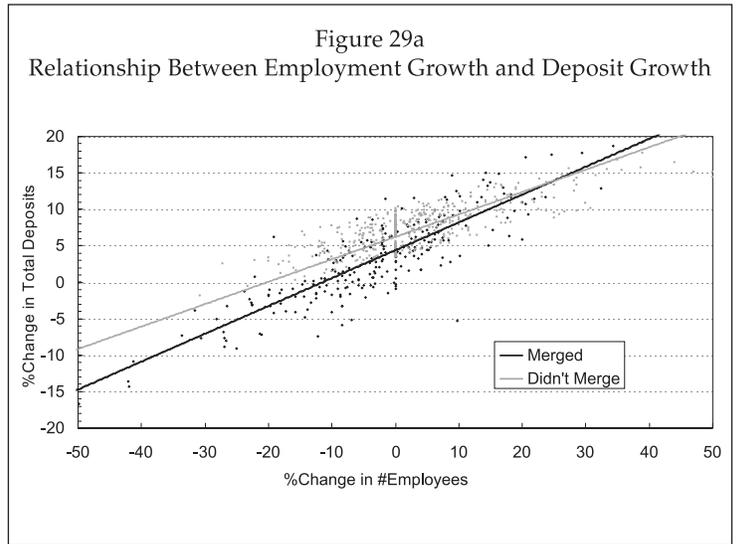
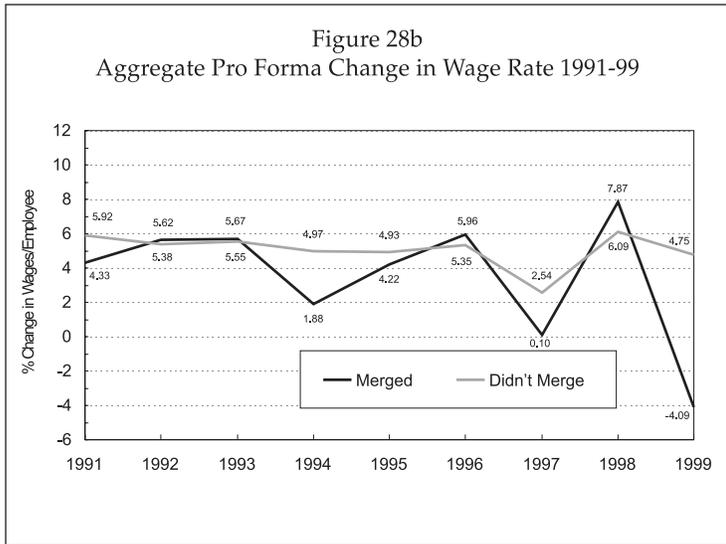
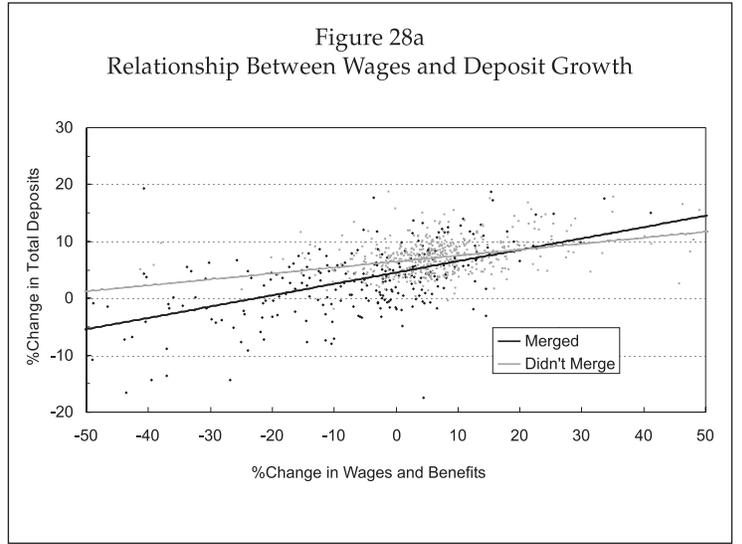
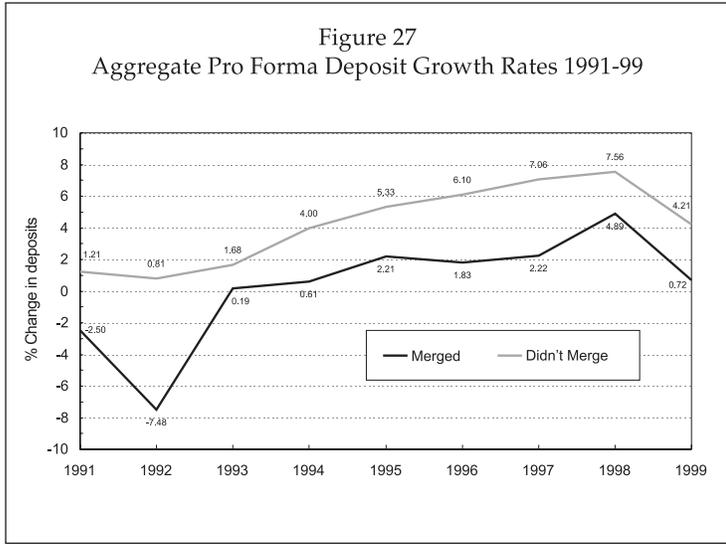
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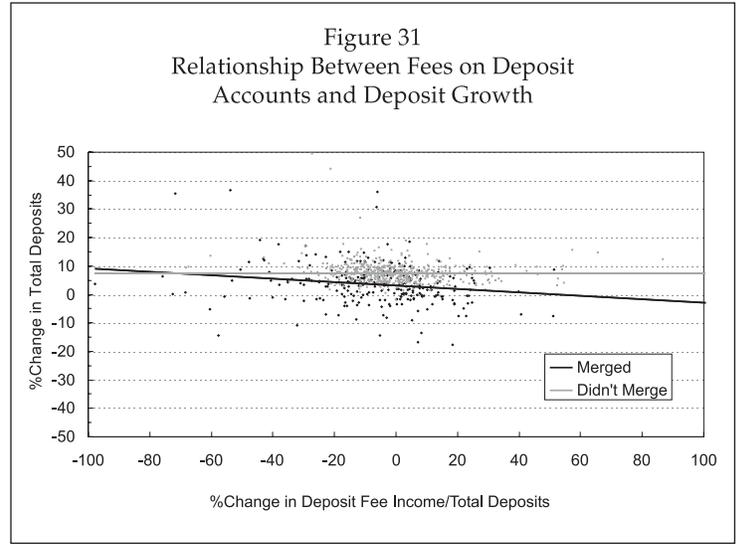
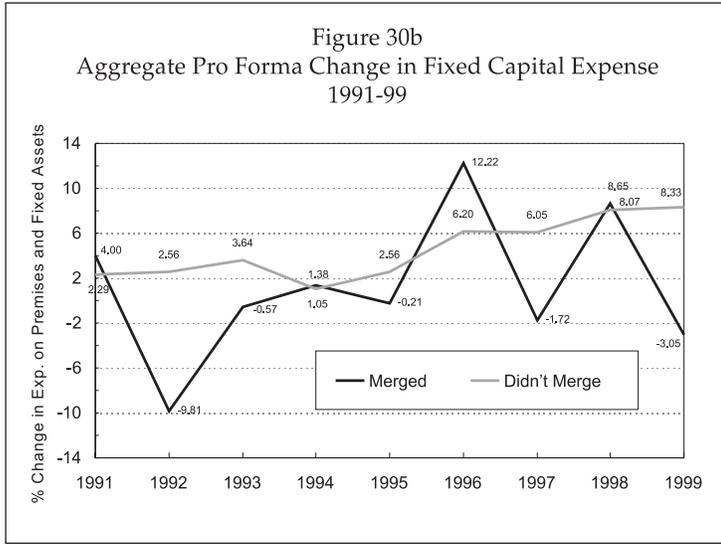
<sup>8</sup> See Stephen A. Rhoades, "Bank Mergers and Banking Structure in the United States, 1980-98," Board of Governors of the Federal Reserve System Staff Study #174, August 2000, for a detailed breakdown of these mergers.

<sup>9</sup> The term *pro forma* means that, in calculating deposit growth, the merging banks' deposits were combined in the year before the merger as if the merger had already taken place. Thus, the growth rates are those of the combined institutions. Also, the dates used are arbitrary, but there is no reason to believe that subsequent merging parties have performed differently. The data represent a random sampling of all banks in the United States with the following exceptions: banks fewer than five years old, banks that merged with failing banks during a particular year, banks that merged with affiliated banks (i.e., owned by the same parent company) during a particular year, and banks that merged with thrift institutions during a particular year. Each bank is counted singly each year regardless of the number of mergers it engaged in.

<sup>10</sup> On all of the scatter charts (Figures 28a, 29a, 30a, and 31) on the following pages, the points are the actual value of the variable on the horizontal axis, and an estimated value of deposit growth using a linear regression of deposit growth on the four service variables, and some control variables (time, market structure, economic growth). The line charts (Figures 28b, 29b, and 30b) are annual aggregates for banks that engaged in mergers versus banks that didn't.

<sup>11</sup> This item includes rent, data processing equipment, furniture, insurance, repairs, and cleaning, among other things.





There is also a positive relationship between deposit growth and spending on plant and equipment, with merging banks being more affected than other banks (Figure 30a).<sup>11</sup> The intuition for the overall positive relationship also seems sensible. Banks that, for example, buy more and newer ATMs or other equipment could be expected to gain deposits. Likewise, banks whose offices appear run-down or that are using outdated equipment could expect to lose customers. However, cutting capital spending might also be seen as a way of increasing short-term profits. The savings could also be used to increase advertising, which could increase deposits.

Figure 30b shows the change in capital spending for merging and nonmerging banks. In five of the nine years, spending on plant and equipment at merging banks grew at a substantially lower rate than that of nonmerging banks, and the rates were nearly identical in two other years. Thus, while capital spending and deposit

growth are positively related, there is only weak evidence that merging banks had slower growth in capital spending than nonmerging banks.

Figure 31 shows that the relationship between fees on deposits and deposit growth is negative for merging banks, and it was nearly flat for nonmerging banks.<sup>12</sup> One might expect that there would also be a more negative relationship for the nonmerging banks as well, but this is not the case.<sup>13</sup> An increase in fees either directly (for example, a \$1 increase in the monthly service charge) or indirectly (for example, the minimum balance to avoid paying a service charge increases by \$100) is essentially a price increase. An increase in price should decrease deposits regardless of whether a merger occurred. It is also possible that increases in fees after a merger are intended to reduce the number of customers. Reasons for doing this could be to get rid of unprofitable accounts or to focus on customers likely to use other

services the acquiring bank offers, such as mutual funds.

In conclusion, we can say that deposit runoff is associated with bank mergers. It can be partially explained by changes in service and fees following a merger. Some of these variables, such as employees and deposit fees, appear more likely to change after a merger. It may also be true that consumers are more likely to notice a change when a merger occurs. Other factors not examined here, such as the number and size of competitors, the financial condition of the banks, and the state of the local economy, also affect deposit growth. Of course, maximizing deposits or minimizing runoff is not an acquiring bank's primary goal — maximizing profits or shareholder wealth is. Since deposits represent one of the least expensive sources of funding for banks, at some point a large decrease in deposits cannot help but have a negative effect on profits.

<sup>12</sup> Fees in this case are service charges on deposits. This is not the same as total noninterest income described in the previous sections, but it is a component of noninterest income.

<sup>13</sup> It is possible that higher fees might be associated with more services, such as more various types of accounts. Consumers trading off fees for services might account for the flat slope of the line for nonmerging banks.

## ***Legal Developments***

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Two of the Third District states enacted banking legislation in 2002. On July 9, Delaware Governor Ruth Ann Minner signed two pieces of legislation into law. The first allowed individuals to sue licensed check-cashing agencies for charging unlawfully high fees on checks or money orders. Check-cashers could be liable for between \$250 and \$500 for the first offense, \$500 and \$1000 for the second offense, and treble the consumer's loss for subsequent offenses. The second

bill established guidelines with regard to short-term loans (sometimes referred to as payday loans). The bill defined short-term loans as those for \$500 or less and for a period of 60 days or less. One provision of the bill gave consumers a one-business-day right of rescission. A second provision set a maximum of four rollovers on any short-term loan.

New Jersey also enacted several pieces of legislation in 2002. On April 23, Governor McGreevey signed a bill into law that

would allow mortgage insurers to insure 100 percent of the fair market value of the real estate securing the mortgage. The previous limit was 97 percent. A second bill, signed on July 1, reduced from 10 years to three years the amount of time the state must wait before it could claim an inactive bank account. The three-year period begins at the later of the maturity of a time deposit or the last customer-initiated transaction with the financial institution.

## ***Mergers and Acquisitions***

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Last year was a slow year for merger and acquisition activity, but there were some in-state and out-of-state transactions. In Pennsylvania, Sovereign Bancorp, Inc. (Wyomissing) acquired Main Street Bancorp, Inc. (Reading); S&T Bancorp, Inc. acquired Peoples Financial Corporation (Ford City); and Northwest Bancorp, MHC (Warren) acquired Prestige Bank, FSB (Pittsburgh). Also, Earthstar Bank (Upper Southampton) merged with Cornerstone Savings Association (Glenside); First Federal Savings and Loan Association of Hazleton (Hazleton) merged with Schuylkill Savings and Loan Association (Schuylkill Haven); and Parkvale Savings Association merged with Second National Bank (Masontown).

In New Jersey, United National

Bancorp, Inc. (Bridgewater) acquired Vista Bancorp, Inc. (Phillipsburg); Oritani Financial Corporation, MHC (Hackensack) acquired Hamilton Bancorp, MHC (Union City); and Kearny Federal Savings and Loan Association (Kearny) merged with Pulaski Savings Bank (Springfield).

There were also a number of interstate and out-of-area transactions involving institutions either headquartered in the tri-state area or with significant operations here. First, F.N.B. Corporation (Naples, Florida) merged with Promistar Financial Corporation (Johnstown, Pennsylvania). Also, Mercantile Bankshares Corporation (Baltimore, Maryland) acquired Sparks State Bank (Sparks, Maryland); Hudson United Bancorp, Inc. (Union City, New Jersey) acquired Con-

necticut Bank of Commerce (Stamford, Connecticut); Sky Financial Group, Inc. (Bowling Green, Ohio) acquired Three Rivers Bancorp, Inc. (Monroeville, Pennsylvania); and Citizens Financial Group, Inc. (Providence, Rhode Island) acquired Medford Bancorp, Inc. (Medford, Massachusetts). Citizens Financial is a subsidiary of Royal Bank of Scotland (Edinburgh, Scotland, United Kingdom).

One major transaction was announced in 2002 but has not yet been completed: the merger of M&T Bancorp, Inc. (Buffalo, New York) and AllFirst Financial, Inc. (Baltimore, Maryland). AllFirst is currently the domestic subsidiary of Allied Irish Banks (Dublin, Ireland). Both of these companies have substantial operations in central and southern Pennsylvania.

## ***Appendix-Methodology for Selecting Bank Categories***

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This publication splits banks into two categories: large banking organizations and community banks. It further splits these categories into the tri-state area and the nation. First, all credit card banks (defined as any bank with more than 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 at the beginning of that year, ranked by total assets. Thus the banks in the 2002 sample are selected based on their year-end 2001 total assets, updated for mergers that occurred in 2002. A large bank defined as being in

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

Prepared by the Research Department. For further information, contact Jim DiSalvo at 215-574-3820 or at [jim.disalvo@phil.frb.org](mailto:jim.disalvo@phil.frb.org). Detailed documentation on the methodology used in constructing this document is available on our web site, [www.phil.frb.org](http://www.phil.frb.org). To subscribe to this publication, cancel a subscription, or notify us of a change of address, contact the Publications Desk at 215-574-6428 or [lois.newell@phil.frb.org](mailto:lois.newell@phil.frb.org).