BANKING BRIEF

FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

Fourth Quarter 2003

Commercial banks continued to report impressive average return on assets (ROA). Large banking organizations in the District, which had previously lagged all other categories of banks, both in the tri-state area and the nation, saw significant improvement in profitability. These banks reported an ROA of 1.37 percent, compared with 1.25 percent in the fourth quarter of 2002.

Compared with last year, deposits grew about 7 percent at community and large banks in the nation and almost 10 percent at large banking organizations in the tri-state area. Banks also reported improvements in loan quality in the fourth quarter of 2003, particularly at large banks. Improvements reflected a decline in business-loan charge-offs, which fell from 1.16 percent in the third quarter of 2003 to 1.1 percent in the fourth quarter.[1] This rate was at its highest in the fourth quarter of 2001, when it reached 2.37 percent. In contrast, the charge-off rates on credit card loans and residential mortgage loans increased during the quarter. Charge-offs for residential mortgages increased from 0.12 percent in the third quarter to 0.35 percent this quarter. Charge-offs for credit card loans rose 0.7 percentage point from last quarter, to 5.9 percent for all banks.

Overall assets increased modestly at the nation's large banks, as commercial and industrial loans continued to decline (more on this below). Additionally, reduced mortgage refinancing activity caused a slowdown in the growth of real estate loans since last quarter, but the year-to-year numbers are still very strong. Community banks experienced a general slowdown in consumer loans, while large banks reported robust growth, almost 8 percent since last year, thanks to strong increases in credit-card loans.

Commercial Loan Outlook

Despite upbeat comments from financial officers, recent bank earnings reports still lack hard evidence of increased commercial lending, particularly at large banks. Over the past year, the volume of commercial loans within this category of banks decreased almost 9 percent.

According to the latest Senior Loan Officer Opinion Survey on Bank Lending Practices, domestic lenders reported stronger commercial and industrial loan demand. The most significant reasons for the strengthening of loan demand in the fourth quarter of 2003 were "increased customer investment in plant and equipment and increased customer needs to finance accounts receivable and inventories." [2]

On the supply side, the survey indicates that many banks made business loans easier to obtain. In the fourth quarter of 2003, 18 percent of domestic banks reported easing their lending standards on commercial and industrial loans for large and middle-market firms, the largest net easing of terms since the latter half of 1993. The most frequently cited reasons for easing terms were competition from other banks and nonbank institutions and overall improvements in economic conditions and the commercial real estate market.

Aggregate lending to businesses often increases during business-cycle expansions and falls during downturns. Economists Allen Berger and Gregory Udell have recently proposed an interesting "institutional memory" hypothesis that might explain why bank lending follows this procyclical pattern.[3] According to this hypothesis, in expansionary times, bank officers' ability to recognize potential loan problems or remember the lessons of past credit problems deteriorates. This results in an easing of credit standards as officers become less able to differentiate lower quality borrowers from higher quality borrowers. This hypothesis implies that banks ease their credit standards as time passes since the last loan bust. Once the loan boom turns to a bust, the institutional memory is restored. Banks tighten their credit standards and do a better job separating bad loans from good loans. According to the authors, as the economy recovers, the cycle repeats itself.

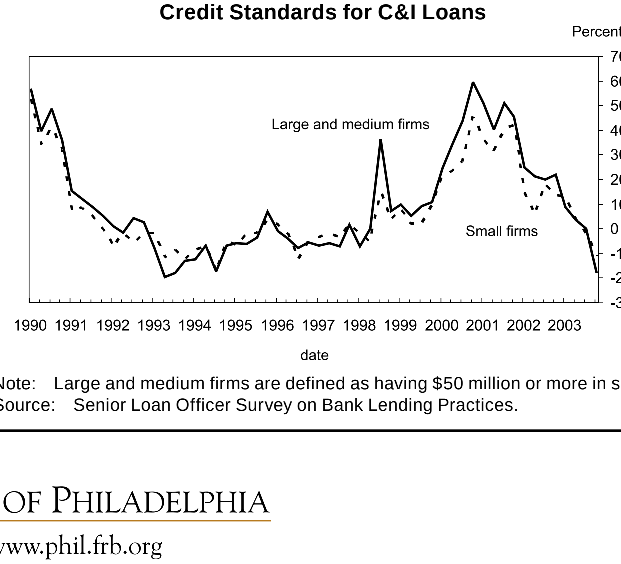
---

[1] The data are compiled from the FFIEC (Federal Financial Institutions Examination Council) Consolidated Reports of Condition and Income and reported in the Federal Reserve Statistical Release *Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks.* Charge-offs are measured as the value of loans removed from the books and charged against loss reserves, net of recoveries. The rates are expressed as a percentage of average loans and annualized.

[2] Senior Loan Officer Opinion Survey on Bank Lending Practices, January 2004.

[3] Allen Berger and Gregory Udell, "The Institutional Memory Hypothesis and the Procyclicality of Bank Lending Behavior," *Finance and Economic Discussion Series*, Board of Governors of the Federal Reserve System, 2003-02.

Net Percentage of Domestic Banks That Tightened Credit Standards for C&I Loans



Note: Large and medium firms are defined as having $50 million or more in sales.
Source: Senior Loan Officer Survey on Bank Lending Practices.

Fourth Quarter 2003

Community Banking Organizations

	Tri-State			Nation		
	$Bill	% change from		$Bill	% change from	
	03Q4*	03Q3	02Q4	03Q4	03Q3	02Q4
Total Assets	96.6	7.2	8.6	1436.1	9.4	8.7
Total Loans	58.2	11.6	9.5	915.4	11.0	8.7
Business	8.1	17.5	13.8	153.5	10.7	5.6
Real Estate	42.9	12.7	10.0	638.1	14.5	11.5
Consumer	4.7	-3.8	-2.9	74.2	-3.5	-2.7
Total Deposits	74.2	6.4	7.0	1145.0	8.2	7.6
Ratios (in %)	**03Q4**	**03Q3**	**02Q4**	**03Q4**	**03Q3**	**02Q4**
Net Income/ Avg Assets (ROA)	1.1	1.1	1.2	1.2	1.2	1.2
Net Interest Inc/ Avg Assets (NIM)	3.4	3.4	3.6	3.7	3.8	3.9
Noninterest Inc/ Avg Assets	1.1	1.1	1.1	1.1	1.2	1.1
Noninterest Exp/ Avg Assets	2.9	2.9	3.0	3.0	3.1	3.1
Loans/Deposits	78.4	77.5	76.6	80.0	79.5	79.1
Equity/Assets	9.1	9.1	9.1	9.6	9.6	9.7
Nonperforming Loans/ Total Loans	0.8	0.8	0.8	0.9	1.0	1.0

Large Banking Organizations

	Tri-State			Nation		
	$Bill	% change from		$Bill	% change from	
	03Q4	03Q3	02Q4	03Q4	03Q3	02Q4
Total Assets	1021.5	1.6	7.4	5580.5	3.9	6.5
Total Loans	573.0	-2.8	1.6	3112.4	3.0	4.4
Business	133.4	-6.8	-12.7	676.0	-8.9	-8.5
Real Estate	306.3	-4.6	10.9	1539.5	-6.3	8.5
Consumer	56.9	17.0	5.1	443.7	26.5	7.9
Total Deposits	689.6	12.7	9.7	3617.1	9.1	7.1
Ratios (in %)	**03Q4**	**03Q3**	**02Q4**	**03Q4**	**03Q3**	**02Q4**
Net Income/ Avg Assets (ROA)	1.4	1.3	1.3	1.3	1.2	1.2
Net Interest Inc/ Avg Assets (NIM)	3.1	3.1	3.3	3.0	3.0	3.2
Noninterest Inc/ Avg Assets	2.4	2.4	2.5	2.3	2.3	2.3
Noninterest Exp/ Avg Assets	3.2	3.2	3.3	3.1	3.1	3.2
Loans/Deposits	83.1	86.2	89.7	86.1	87.3	88.3
Equity/Assets	9.0	9.0	9.2	8.4	8.4	8.6
Nonperforming Loans/ Total Loans	1.1	1.2	1.5	1.2	1.3	1.6

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, 2002. 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—198 for the tri-state area and 5982 for the nation; (2) large banking organizations—17 for the tri-state area and 99 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. Quarterly percentage changes are compound annualized rates.
* This quarter's sample excluded one bank in Delaware as a data outlier.

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.