# BANKING BRIEF
## FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

**First Quarter 2004**

Continued low interest rates and improved credit quality helped banks to report outstanding performance during the first quarter of 2004. The nation's largest banks earned a return on average assets (ROA) of 1.3 percent, while community banks reported an ROA of 1.2 percent. The economic recovery has contributed to improved asset quality, manifested in fewer delinquencies and charge-offs, especially in commercial and industrial (C&I) loans. The Federal Reserve Board recently reported that the delinquency rate on all types of loans declined to 2.19 percent, the lowest level since the end of 2000. The delinquency rate for C&I loans declined from 3.8 percent in 2002 to 2.87 percent last quarter. Similarly, the charge-off rate for C&I loans fell from its recent peak of 2.16 percent in the fourth quarter of 2001 to 0.94 percent last quarter.

The growth rate of total real estate loans was strong during the first quarter of 2004, as consumers continued to take advantage of low interest rates to borrow against the equity in their homes. The total volume of these loans rose 15 percent (at a compound annualized rate) since last quarter and over 10 percent at large banking organizations in the nation. C&I loans continued to fall at large commercial banks, while community banks reported an increase in this type of loan, particularly at banks headquartered in the tri-state area. The most important factor contributing to asset growth among the tri-state's large banking organizations was an increase of 19 percent in securities.

**Economics of Bank Mergers and Acquisitions**

The U.S. banking industry has undergone a significant restructuring since the 1980s. From its peak in the mid-1980s, the number of banking organizations has fallen by almost 7,000, a result of bank mergers and acquisitions and bank failures. This tremendous wave of consolidation can be explained by, among other factors, improvements in bank technology and changes in banking legislation and regulation.

One aspect of the consolidation is the ever-escalating scale of banking mergers. The most recent examples are the consummated merger between FleetBoston Financial Corporation and Bank of America Corporation, and the recently approved merger between J.P. Morgan Chase & Co. and Bank One Corporation. Another aspect of the recent wave of consolidation in financial services has been the expanding scope of banks. As the Glass-Steagall Act's restrictions on affiliations between commercial and investment banking were relaxed during the late 1980s, and later repealed in 1999, there has been an increasing number of bank holding companies expanding their activities mix (for example, the 1998 merger between Citicorp and Travelers Group). Finally, recent mega-mergers are notable for the extensive geographic territories the newly consolidated institutions serve.

Why are banks interested in increasing their scale and scope? The popular financial press and the companies' management offer several reasons for consolidation. First, owing to increased competition from banks and other financial institutions, the need to improve cost efficiencies leads banks to grow bigger to exploit economies of scale. Second, competition has squeezed margins in traditional commercial banking. This causes banks to look for alternative sources of revenue by offering their customers a greater variety of financial services under one roof, presumably at lower cost (scope economies).[1]

A large number of studies have examined economies of scale and scope in banking.[2] The overall conclusion of empirical studies on scale efficiencies is that there appears to be little or no improvement in cost efficiency from bank mergers except at small banks with assets of up to $100 million. The evidence on scale economies at large banks is mixed. On the one hand, greater bank size implies the potential for improved diversification at a given level of return, and enhanced diversification reduces the cost of risk management. On the other hand, the lower cost of risk management may encourage a bank to take on more risk. Thus, the overall level of risk is an endogenous choice made by the bank.[3]

Similarly, there is a lack of empirical evidence that an expansion of scope in banking produces additional efficiencies.[4] Other studies have focused on the effect of bank mergers on bank lending behavior.[5] But the results are also mixed. Mergers between small banks appear to increase lending to small businesses, but mergers between large banks generally decrease small business loans or leave them unaffected. Research on interstate expansion provides evidence of the benefits of geographic diversification in terms of bank safety, particularly interstate mergers that diversify banks' exposure to local economic shocks.[6]

In sum, except for small banks, there is little empirical evidence of pervasive scale economies. There is not enough evidence to conclude that banks that offer a variety of bank products observe significant economies of scope; however, there is evidence of risk diversification arising from geographic expansion. Thus, the available literature suggests that there is still room in the banking industry for both small and large banks, as well as for specialized and universal banks.

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1 T. Milbourn, A. Boot, and A. Thakor, "Megamergers and Expanded Scope: Theories of Bank Size and Activity Diversity," *Journal of Banking and Finance* 23 (1999): 195-214.

2 J. Clark, "Economies of Scale and Scope at Depository Financial Institutions: A Review of the Literature," Federal Reserve Bank of Kansas City, *Economic Review*, Sept.-Oct. 1988; A. Berger, A. Kashyap, and J. Scalise, "The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been," Brookings Papers on Economic Activity 2 (1995): 54-219; A. Berger and L. Mester, "Inside the Black Box: What Explains Differences in the Efficiencies of Financial Institutions?" *Journal of Banking and Finance* 21 (July 1997): 895-947.

3 J. Hughes, W. Lang, L. Mester, and C-G. Moon, "The Dollars and Sense of Bank Consolidation," *Journal of Banking and Finance* 23 (Feb. 1999): 291-324.

4 A. Berger, W. Hunter, and S. Timme, "The Efficiency of Financial Institutions: A Review and Preview of Research Past, Present and Future," *Journal of Banking and Finance* (special issue, Efficiency in Banking) 17 (1993): 221-49.

5 A. Berger, A. Saunders, J. Scalise, and G. Udell, "The Effects of Bank Mergers and Acquisitions on Small Business Lending," *Journal of Financial Economics* 50 (1998): 187-229.

6 See J. Hughes et al. (1999) in footnote 3.

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*First Quarter 2004*

| | Community Banking Organizations | | | | | |
|---|---|---|---|---|---|---|
| | Tri-State | | | Nation | | |
| | $Bill | % change from | | $Bill | % change from | |
| | 04Q1 | 03Q4 | 03Q1 | 04Q1 | 03Q4 | 03Q1 |
| Total Assets | 86.4 | 5.5 | 8.0 | 1476.3 | 9.6 | 9.0 |
| Total Loans | 52.1 | 9.4 | 10.3 | 943.4 | 10.5 | 10.3 |
| Business | 7.2 | 16.7 | 14.8 | 157.8 | 6.4 | 6.3 |
| Real Estate | 39.8 | 10.3 | 11.4 | 665.1 | 15.4 | 13.5 |
| Consumer | 3.5 | -9.1 | -5.0 | 72.4 | -5.8 | -2.2 |
| Total Deposits | 67.1 | 5.7 | 6.9 | 1176.2 | 9.4 | 7.9 |
| **Ratios (in %)** | **04Q1** | **03Q4** | **03Q1** | **04Q1** | **03Q4** | **03Q1** |
| Net Income/ Avg Assets (ROA) | 1.1 | 1.1 | 1.1 | 1.2 | 1.2 | 1.2 |
| Net Interest Inc/ Avg Assets (NIM) | 3.4 | 3.4 | 3.6 | 3.7 | 3.7 | 3.9 |
| Noninterest Inc/ Avg Assets | 1.2 | 1.2 | 1.1 | 1.1 | 1.2 | 1.1 |
| Noninterest Exp/ Avg Assets | 3.0 | 3.0 | 3.0 | 3.0 | 3.1 | 3.1 |
| Loans/Deposits | 77.7 | 77.1 | 75.3 | 80.2 | 80.0 | 78.4 |
| Equity/Assets | 9.4 | 9.4 | 9.2 | 9.8 | 9.8 | 9.7 |
| Nonperforming Loans/ Total Loans | 0.9 | 0.8 | 0.9 | 0.9 | 0.9 | 1.1 |

| | Large Banking Organizations | | | | | |
|---|---|---|---|---|---|---|
| | Tri-State | | | Nation | | |
| | $Bill | % change from | | $Bill | % change from | |
| | 04Q1 | 03Q4 | 03Q1 | 04Q1 | 03Q4 | 03Q1 |
| Total Assets | 1053.3 | 8.3 | 7.0 | 5776.9 | 13.1 | 7.7 |
| Total Loans | 583.7 | 2.4 | 1.9 | 3162.0 | 4.3 | 4.4 |
| Business | 132.0 | -7.6 | -13.4 | 669.6 | -5.4 | -8.4 |
| Real Estate | 316.2 | 7.9 | 9.8 | 1583.7 | 10.9 | 9.3 |
| Consumer | 57.5 | -4.2 | 4.2 | 447.7 | -3.8 | 6.9 |
| Total Deposits | 718.4 | 12.8 | 9.7 | 3755.1 | 14.2 | 8.6 |
| **Ratios (in %)** | **04Q1** | **03Q4** | **03Q1** | **04Q1** | **03Q4** | **03Q1** |
| Net Income/ Avg Assets (ROA) | 1.4 | 1.4 | 1.2 | 1.3 | 1.3 | 1.2 |
| Net Interest Inc/ Avg Assets (NIM) | 3.0 | 3.1 | 3.2 | 2.9 | 3.0 | 3.2 |
| Noninterest Inc/ Avg Assets | 2.5 | 2.4 | 2.4 | 2.3 | 2.3 | 2.3 |
| Noninterest Exp/ Avg Assets | 3.2 | 3.2 | 3.3 | 3.1 | 3.1 | 3.2 |
| Loans/Deposits | 81.3 | 83.2 | 87.5 | 84.2 | 86.1 | 87.5 |
| Equity/Assets | 9.1 | 9.1 | 9.2 | 8.4 | 8.4 | 8.6 |
| Nonperforming Loans/ Total Loans | 0.6 | 1.1 | 1.5 | 0.9 | 1.2 | 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, 2003. 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—202 for the tri-state area and 6034 for the nation; (2) large banking organizations—19 for the tri-state area and 100 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 go to www.phil.frb.org/forms/orderform.htm, and scroll down to Economic Research Publications.