BANKING BRIEF

FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

Second Quarter 2004

While average return on assets (ROA) posted by community banks remained unchanged at 1.2 percent nationally, ROA among large banks has declined slightly since last quarter. A rise in long-term interest rates contributed to narrower spreads and lower net interest income. Higher rates also resulted in lower gains realized on the sale of securities during the second quarter of 2004.

Credit quality continued to improve during the quarter, particularly in the commercial loan portfolios of the largest banks. The total ratio of banks' nonperforming loans to total loans fell 0.1 percentage point in the second quarter. C&I loan charge-offs dropped to nearly 0.6 percent, from 0.8 percent last quarter. Responding to improved credit quality, banks lowered their provisions for loan and lease losses 27 percent relative to the second quarter of 2003.

Domestic commercial banks registered strong growth in total loans and leases. Large banks reported a 17 percent rise (at a compound annualized rate) in total loans, only slightly above the rate reported by community banks. Real estate loans continued to drive loan growth at national banks, rising almost 20 percent at the largest 100 banks and nearly 17 percent at the nation's community banks. The total volume of C&I loans rose 5 percent since the first quarter of 2004. The tri-state area community banks witnessed an almost 20 percent rise in these loans. The *Beige Book* attributed growth in commercial loan demand in the Third District to "rising credit needs of service companies and continuing growth in lending to residential construction firms."[1]

Commercial Real Estate Loans

Since 2001, business lending has suffered an average decline of 6 percent per year. Over the same period, commercial real estate (CRE) lending has expanded at an average annual rate of 10 percent. Total loans for construction and land development have increased 20 percent since 2001. This occurred amid a general weakness of CRE market fundamentals over the past few years. Vacancy rates for office buildings nearly doubled between 2001 and 2003, to 16.9 percent, only slightly lower than the 19.2 percent rate of vacant space in 1991, the peak of the last economic downturn. Rents on office buildings fell a total of 20 percent during 2003, a larger decline than the one observed during the early 1990s.

Notably, CRE lending has been growing faster at small banks.[2] Between 2001 and 2003, CRE loans grew 16.8 percent at banks with consolidated assets of $1 billion or more and expanded almost 26 percent at small banks.

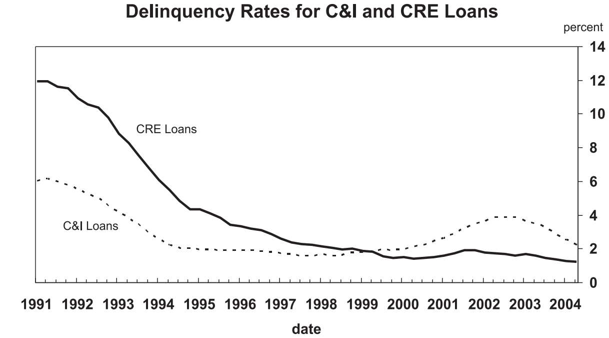
Despite the weak CRE market conditions, banks have not experienced significant asset quality problems. In fact, both delinquency and charge-off rates on commercial real estate loans moved down during 2003 and continued to fall during the first half of 2004. These levels are well below those of the early 1990s (see Figure). A recent *Federal Reserve Bulletin* article attributed these low delinquency rates to two factors: lower interest rates and tighter lending terms and standards on CRE loans.[3] First, lower interest rates allowed many borrowers to refinance mortgages and reduce their debt service requirements. Second, prior to the deterioration in general market conditions, banks were able to tighten lending standards on CRE loans, which may have helped them extend safer loans.

[1] Federal Reserve Board, *Beige Book*, June 16, 2004 (see http://www.federalreserve.gov/fomc/beigebook/2004/20040616/3.htm).

[2] From "The Vitality of the Bank Charter in a Dynamic Financial Marketplace," a speech delivered by Federal Reserve Governor Mark Olson at a Strategic Research Institute conference, May 10, 2004.

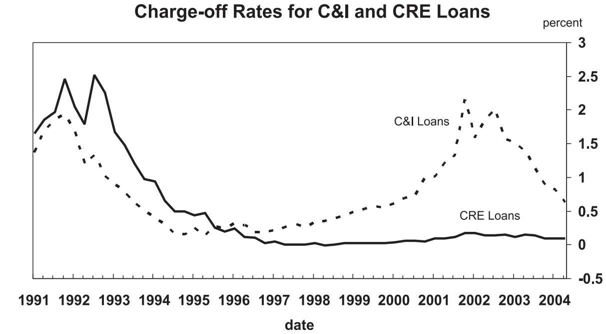
[3] M. Carlson and R. Perli, "Profits and Balance Sheet Developments at U.S. Commercial Banks in 2003," *Federal Reserve Bulletin*, Spring 2004.

Delinquency Rates for C&I and CRE Loans



Note: Data are quarterly and seasonally adjusted. The delinquency rate is the end-of-period level of delinquent loans divided by the end-of-period level of loans outstanding. Delinquent loans are loans that are not accruing interest and those that are accruing interest but are more than 30 days past due. Source: *Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks*, Federal Reserve Statistical Release.

Charge-off Rates for C&I and CRE Loans



Note: Data are quarterly and seasonally adjusted. The net charge-off rate is the annualized amount of charge-offs over the period, net of recoveries, divided by the average level of outstanding loans over the period. Source: *Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks*, Federal Reserve Statistical Release.

RESEARCH DEPARTMENT FEDERAL RESERVE BANK OF PHILADELPHIA

Ten Independence Mall, Philadelphia, PA 19106-1574 • 215-574-6428 • www.phil.frb.org

Second Quarter 2004

Community Banking Organizations

	Tri-State			*Nation*		
	$Bill	**% change from**		**$Bill**	**% change from**	
	04Q2	**04Q1**	**03Q2**	**04Q2**	**04Q1**	**03Q2**
Total Assets	84.0	9.7	7.8	1494.9	9.5	8.8
Total Loans	51.6	15.5	11.8	967.9	15.3	11.0
Business	7.3	19.5	16.3	160.7	11.4	7.2
Real Estate	39.6	15.6	12.4	683.5	16.8	14.0
Consumer	3.0	2.6	-2.0	72.6	2.8	-1.6
Total Deposits	65.0	8.2	6.9	1184.9	7.2	7.4
Ratios (in %)	**04Q2**	**04Q1**	**03Q2**	**04Q2**	**04Q1**	**03Q2**
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	3.5	3.7	3.7	3.8
Noninterest Inc/ Avg Assets	1.2	1.2	1.2	1.1	1.1	1.2
Noninterest Exp/ Avg Assets	3.0	3.0	3.0	3.0	3.0	3.1
Loans/Deposits	79.5	78.2	76.0	81.7	80.2	79.1
Equity/Assets	9.1	9.1	9.4	9.5	9.5	9.7
Nonperforming Loans/ Total Loans	0.7	0.8	0.9	0.8	0.9	1.1

Large Banking Organizations

	Tri-State			*Nation*		
	$Bill	**% change from**		**$Bill**	**% change from**	
	04Q2*	**04Q1**	**03Q2**	**04Q2**	**04Q1**	**03Q2**
Total Assets	1833.3	14.2	6.7	5970.0	12.9	6.2
Total Loans	962.8	3.0	1.6	3298.8	17.1	6.4
Business	194.2	0.6	-10.4	678.8	5.0	-4.5
Real Estate	545.4	7.5	5.0	1663.6	19.5	8.9
Consumer	93.3	-8.1	1.4	450.1	2.0	7.3
Total Deposits	1245.5	10.7	8.8	3886.7	13.4	8.2
Ratios (in %)	**04Q2**	**04Q1**	**03Q2**	**04Q2**	**04Q1**	**03Q2**
Net Income/ Avg Assets (ROA)	1.4	1.4	1.4	1.2	1.3	1.2
Net Interest Inc/ Avg Assets (NIM)	2.8	3.0	3.1	2.9	2.9	3.1
Noninterest Inc/ Avg Assets	2.2	2.3	2.3	2.3	2.3	2.3
Noninterest Exp/ Avg Assets	2.9	3.1	3.1	3.1	3.1	3.2
Loans/Deposits	77.3	78.7	82.8	84.9	84.2	86.3
Equity/Assets	9.5	9.5	8.5	8.6	8.6	8.3
Nonperforming Loans/ Total Loans	0.5	0.4	1.3	0.8	0.9	1.4

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—198 for the tri-state area and 5987 for the nation; (2) large banking organizations—20 for the tri-state area and 98 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.

*The reported levels are affected by the recent merger between Bank of America Corporation (Charlotte, NC) and FleetBoston Financial Corporation (Boston, MA), consummated on April 1, 2004.

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.PhiladelphiaFed.org/econ/bb/index.html. To subscribe to this publication, please go to www.PhiladelphiaFed.org/forms/orderform.htm and scroll down to Economic Research Publications.