



BANKING BRIEF

FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

SPECIAL REPORT: COMMERCIAL BANKS IN 2004

Profitability decreased in 2004 for both large banking organizations and community banks (though not those in the tri-state area), but there are good reasons to believe that these decreases were not the start of a trend. First, loans, deposits, and capital grew at much higher rates than in recent years. Asset quality continued to improve, and loan losses have decreased accordingly. Also, banks of all sizes increased their capital ratios to the point that capitalizations are at a 10-year high. Finally, both large and small banks have been successful in controlling their overhead expenses.

Large Banking Organizations

For large banking organizations in both the tri-state area and the nation, 2004 was a mixed year.¹ After rising for the past three years, profitability as measured by return on average assets (ROA) and return on average equity (ROE) decreased slightly last year (Figures 1 and 2).² ROA decreased at tri-state area banks from 1.28 to 1.14 percent. For banks in the nation as a whole the decrease was 0.10 percentage point, to 1.32 percent. The decreases in ROE were similar. ROE at tri-state area banks decreased from 15.30 to 12.25

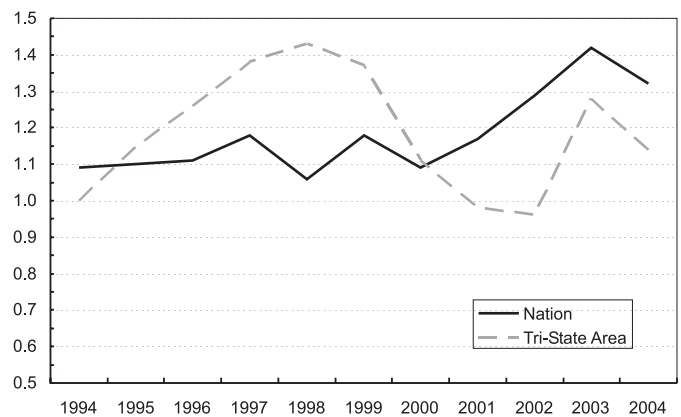
percent, and at banks in the entire nation from 15.97 to 13.89 percent.

Earnings decreased 8.8 percent in 2004 in the tri-state area and increased 0.4 percent in the nation. However, the apparent drop in earnings for the tri-state area is somewhat misleading, because most of that decrease came from one large firm. Of the 23 firms in the tri-state sample, 15 reported increased earnings, and eight reported a decrease.

None reported a loss. The firms that reported increased earnings averaged a 14.6 percent increase, while the firms reporting decreased earnings had an average decline of 8.6 percent.

One reason for the falloff in profitability was smaller net interest margins (Figure 3).³ At large banks in the tri-state area, the net interest margin

Figure 1
Return on Average Assets for Large Organizations



¹ Large banking organizations are determined annually as those firms that are at least as large as the one-hundredth largest bank holding company in the nation at the previous year-end (here 2003), 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 entire region or in any one of the states, or (2) at least 5 percent of the organization's total deposits located in the region. See Appendix A for a description of the methodology used in grouping these banks.

² Data used in Figures 1-26 are from the Federal Financial Institutions Examination Council call reports (FFIEC forms 031 and 041). All ratios are weighted averages of all banks within the sample, meaning the numerator and denominator are summed across all banks, and the resulting totals are divided to obtain the ratio. It should be noted that the ratios as presented are based on different samples, so the inclusion or exclusion of an organization can affect the numbers.

³ Net interest margin is defined as the ratio of net interest income to average earning assets. Earning assets are defined as the sum of interest-bearing 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* at www.philadelphiafed.org/files/bb/bbspecial01.pdf.

Figure 2
Return on Average Equity for Large Organizations

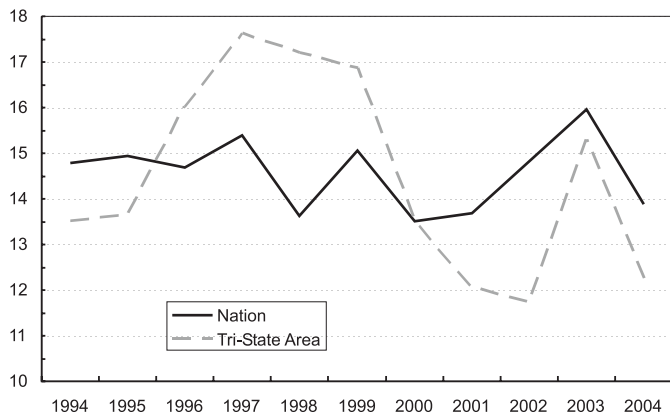


Figure 3
Net Interest Margins for Large Organizations

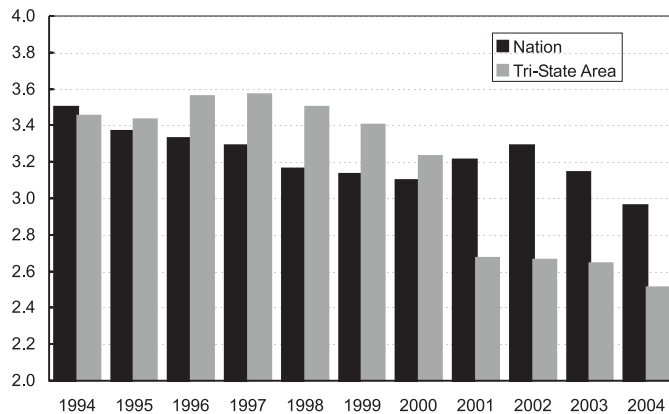


Figure 4
Percentage Change in Deposits for Large Organizations

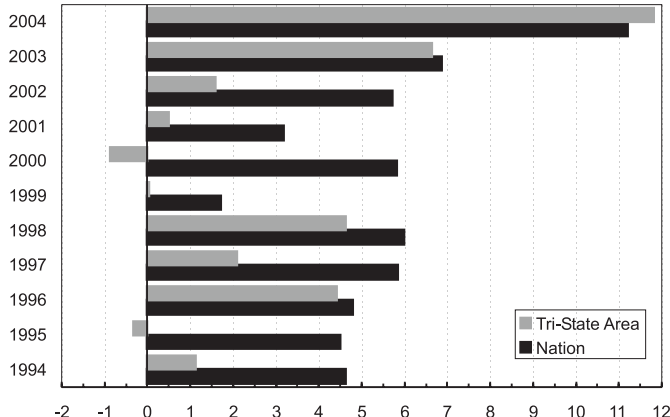
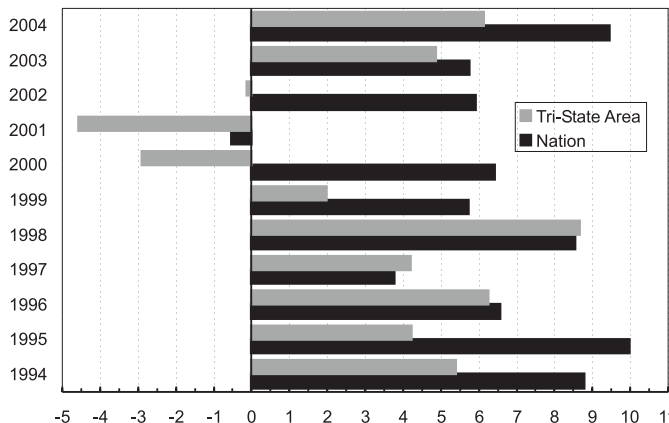


Figure 5
Percentage Change in Loans Outstanding for Large Organizations



declined from 2.64 to 2.51 percent, while for the entire nation the decrease was from 3.14 to 2.96 percent. As Figure 3 demonstrates, net interest margins have been decreasing for several years now, and both of the numbers for year-end 2004 are at least at 10-year lows.

Deposits grew nearly 12 percent at tri-state area banks in 2004 and at over 11 percent in banks nationwide (Figure 4). Growth in money market accounts and time deposits at several of the largest banks accounted for much of the growth. At the same time, loan growth was 6.1 percent for tri-state area banks and 9.4 percent for banks nationwide

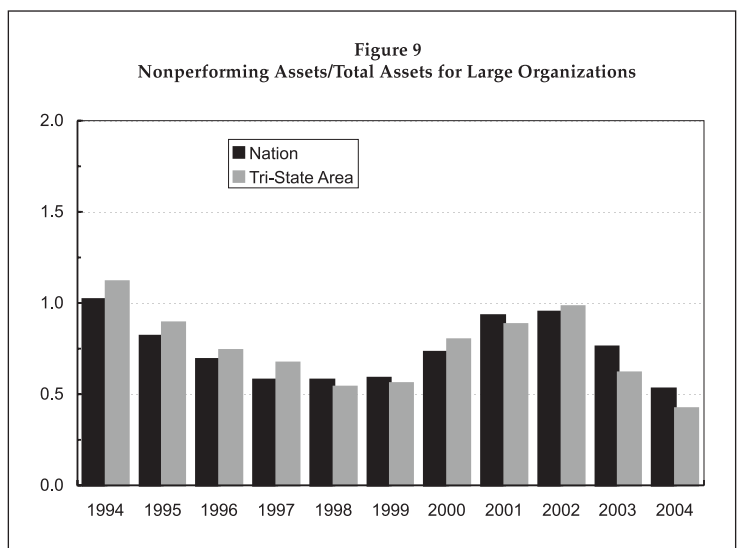
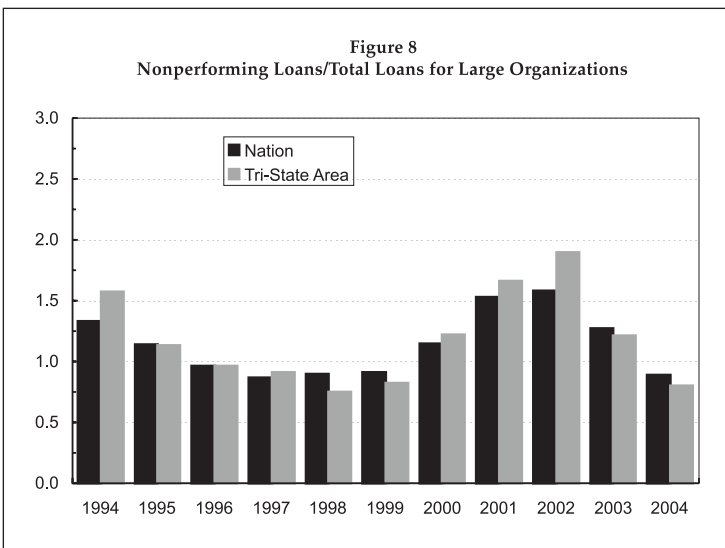
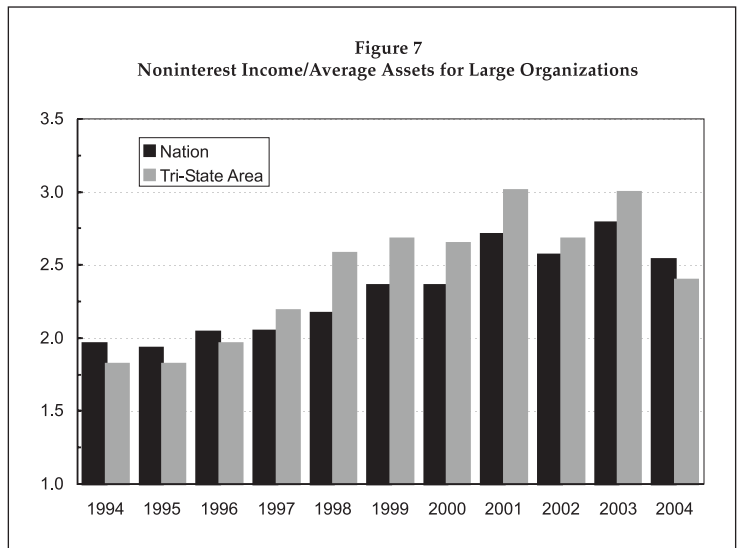
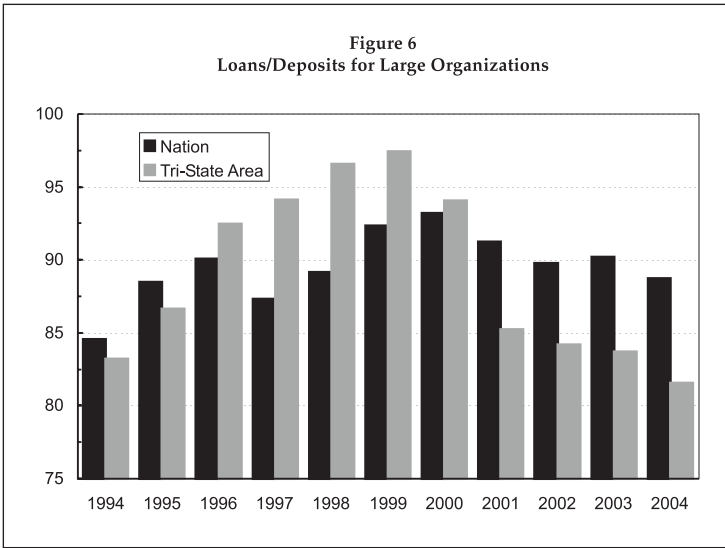
(Figure 5). Much of the loan growth was in three categories: real estate loans, commercial and industrial loans, and credit cards. The growth in real estate loans can be explained by continued demand for refinancings on residential mortgages because of low interest rates. Additionally, there is some evidence that banks are not securitizing as much of their mortgage portfolio as in the past. Some of the growth in commercial and industrial (C&I) loans can be attributed to relaxed lending standards. The January 2005 Senior Loan Officer Opinion Survey conducted by the Federal Reserve Board reported that many banks were easing

their lending standards for C&I loans and commercial real estate loans, but very few were doing so for other real estate loans or consumer loans.⁴ Real estate lending now makes up nearly half of the loans at large banking organizations, both in the tri-state area and nationally, but C&I loans still comprise a substantial percentage of loans as well.⁵ Since deposits increased faster than loans in 2004 (see above), loan-to-deposit ratios dropped in 2004 in both the tri-state area and the nation (Figure 6), indicating that banks are more liquid.

Another factor affecting profits in 2004 was a decrease in noninterest (fee)

⁴ See www.federalreserve.gov/boarddocs/SnLoanSurvey/200501/default.htm.

⁵ Real estate loans were 48.2 percent of total loans for large organizations in the tri-state area. C&I loans were 15.7 percent of total loans, and consumer loans were 19.3 percent. For the nation as a whole, real estate loans were 48.6 percent of total loans, C&I loans were 15.9 percent, and consumer loans were 19.8 percent.



income. Not only did noninterest income as a percentage of average assets decline (Figure 7), but total noninterest income declined as well. Fee income at large banks in the tri-state area fell 2.7 percent in 2004, and it was basically flat nationally, decreasing 0.6 percentage point. Noninterest income fell at 10 of the 23 institutions in the tri-state area sample, including the three largest. No single factor can explain the decrease, since several categories of fee income saw decreases.⁶

In spite of the decrease in profitability, there are many signs that the longer term prospects for large banking organizations continue to improve. First, asset quality appears to have recovered from the problems experienced in the early 2000s. The ratio of nonperforming loans to total loans in both the tri-state area and nationwide is now about the same as in the late 1990s (Figure 8).⁷ Also, as a result of the improvement in loan quality and the continued strength of both local and national real estate markets, the ratio of

nonperforming assets to total assets is now at its lowest point in 10 years (Figure 9).⁸ The decrease in nonperforming loans contributed to an increase in the loan-loss coverage ratio (Figure 10) and a decline in the ratio of net charge-offs to average assets (Figure 11).⁹ The latter measure has been decreasing since reaching a high in 2002 but has not yet returned to its low point in the mid-1990s.

The increase in loan-loss coverage ratios happened even though loan-loss reserves decreased 5.6 percent for banks

⁶ Noninterest income consists of revenue from fiduciary activities, service charges, trading revenue, investment banking, brokerage, venture capital, servicing fees, loan securitizations, insurance, asset sales, and other income.

⁷ Nonperforming loans are defined as loans 90 days or more past due plus nonaccruing loans.

⁸ Nonperforming assets are defined as nonperforming loans plus other real estate owned.

⁹ Loan-loss coverage ratio is defined as the ratio of loan-loss reserves to nonperforming loans.

Figure 10
Loan-Loss Coverage Ratio for Large Organizations

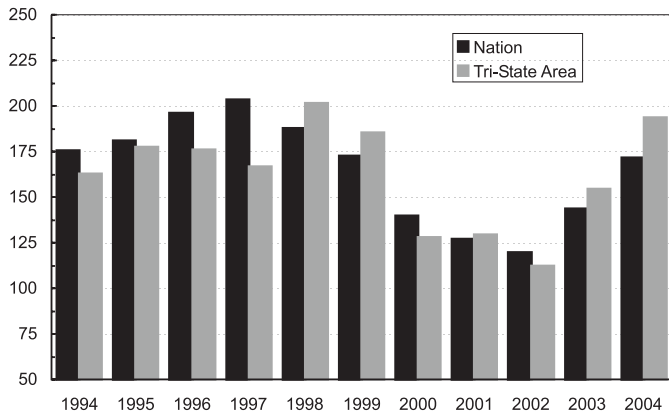


Figure 11
Net Charge-offs/Average Assets for Large Organizations

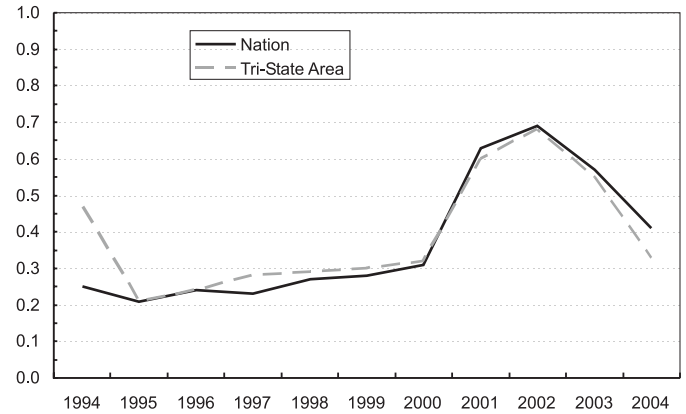


Figure 12
Equity/Assets for Large Organizations

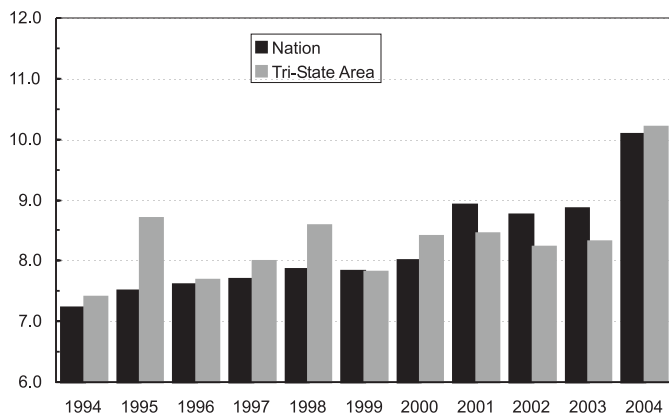
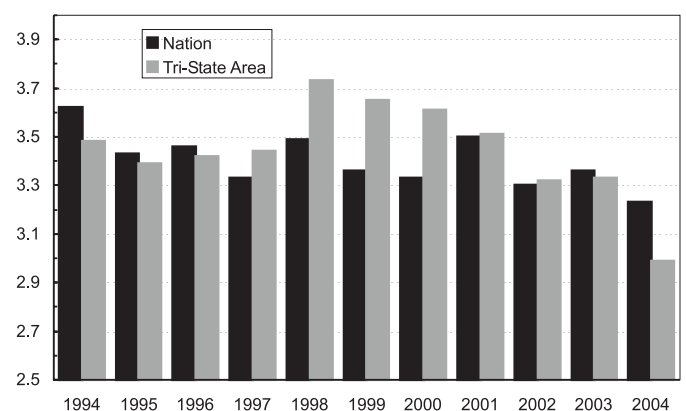


Figure 13
Noninterest Expense/Average Assets for Large Organizations



in the tri-state area and 7.3 percent for banks in the nation as a whole. In essence, this means that the amount of loans charged off (net of recoveries) exceeded the amount added to loan-loss reserves in 2004.

In addition to better asset quality, large banks improved their balance sheets in other important ways in 2004. In the tri-state area and the nation, capital ratios increased substantially (Figure 12). The ratio of total equity to total assets for banks in the tri-state

area at year-end 2004 was 10.20 percent, while the ratio for banks in the nation was 10.09 percent. In addition, banks both nationally and locally were more successful in controlling their overhead expenses in 2004 (Figure 13). The ratio of noninterest expense to average assets decreased slightly nationally, from 3.36 to 3.23 percent, and decreased more substantially at tri-state area banks, from 3.33 to 2.99 percent. In both cases, actual noninterest expenses grew slightly, but assets grew faster.¹⁰

In summary, profitability decreased at large banking organizations in 2004 both locally and nationally because of declining net interest margins and fee income. However, in most ways banks improved their fundamental positions on their balance sheets. Both loans and deposits grew at healthy rates, asset quality continued to improve, loan losses decreased, capital ratios improved, and banks kept their overhead expenses under control.

¹⁰ Noninterest expenses increased 1.2 percent for large banks in the tri-state area and 4.9 percent nationally. Noninterest expenses consist of salaries and employee benefits; premises and fixed assets; goodwill; amortization; data processing; advertising; directors' fees; printing, stationery, and supplies; postage; legal fees; and FDIC insurance assessments.

Community banks headquartered in the tri-state area outperformed both large banks and community banks nationally. Community banks in the nation as a whole had higher ROAs than large banks nationally, but their ROEs were slightly lower. ROA and ROE increased at tri-state area banks, but they decreased slightly for the nation as a whole (Figures 14 and 15). Overall, net income increased 23.1 percent in the tri-state area and 14.3 percent in the entire nation.

Profitability ratios decreased nationally because of large increases in assets and equity. Total assets at all community banks increased over 12 percent in 2004. Tri-state area banks' assets were up 7.6 percent. Much of the increase was in loans. Total loans outstanding increased over 15.7 percent nationally in 2004 and over 12 percent at area banks (Figure 16). Community banks' loan portfolios are generally heavily weighted toward real estate loans, and these grew at healthy rates both locally and nationally (13.8 and 19.2 percent, respectively).¹¹ Continued low interest rates sustained the demand for mortgages, home equity loans, and mortgage refinancings. Commercial and industrial loans also grew rapidly, with growth rates both nationally and locally over 22 percent. Consumer loans actually decreased at tri-state area banks and were basically flat nationally. As was the case for the larger banks, at least some of the increases in loans can be attributed to relaxed lending standards. The Federal Reserve Board's Senior Loan Officer Opinion Survey, cited in the previous section, found that smaller banks had also lowered their requirements for C&I and commercial real estate lending, but not for other types of loans.

Another reason tri-state area community banks outperformed their counterparts in the nation as a whole

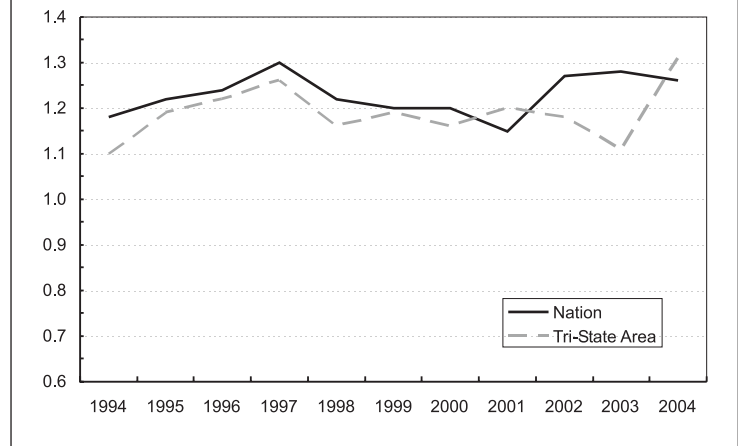
is that the tri-state banks managed to increase their net interest margins slightly, while nationally margins declined (Figure 17). However, deposit growth was stronger at community banks nationally than locally (Figure 18). While deposits grew 7.7 percent locally and nearly 11 percent nationally, net interest income grew 8.5 percent at tri-state area banks

and 10.8 percent nationally. Total equity also grew at an accelerated pace in 2004. In addition to its effect on ROE, this also led to higher capital ratios (Figure 19). Thus, community banks both nationally and locally now have their highest equity-to-asset ratios in at least a decade.

Asset quality continued to improve at community banks both locally and nationally. The ratios of nonperforming loans to total loans and nonperforming assets to total assets decreased for the second straight year and are now at or below their pre-recession levels in the late 1990s (Figures 20 and 21). Additionally, net charge-offs as a percentage of average assets decreased in 2004 (Figure 22). The decrease in nonperforming loans allowed banks both locally and nationally to increase their loan-loss coverage ratios (Figure 23), even though loan-loss reserves actually decreased slightly in both cases.

One other reason tri-state area community banks performed better than banks in the nation as a whole is that they were somewhat better at controlling overhead

Figure 14
Return on Average Assets for Community Banks



costs and generating fee income. The ratio of noninterest expenses to average assets at banks in the tri-state area was stable while for the nation as a whole it fell (Figure 24). The ratio of noninterest income to average assets declined at both tri-state area banks and nationally, but the ratio for local banks was slightly better than that for the nation (Figure 25). Finally, the ratio of total loans to total deposits was basically stable both locally and nationally (Figure 26).

In summary, tri-state area banks outperformed their counterparts nationwide in 2004. Both sets of banks experienced strong growth in loans, especially real estate, and commercial and industrial loans. Banks in the nation as a whole had stronger deposit growth than tri-state area banks but had lower net interest margins. Tri-state area banks had more success controlling costs and generating fee income than banks in the rest of the nation. Asset quality continued to improve at both local and national banks.

¹¹ For community banks in the tri-state area, real estate loans were 75.7 percent of total loans, C&I loans were 10.7 percent, and consumer loans comprised 6.7 percent. The corresponding figures for the nation as a whole are 70.9 percent real estate, 9.7 percent C&I, and 7.6 percent consumer.

Figure 15
Return on Average Equity for Community Banks

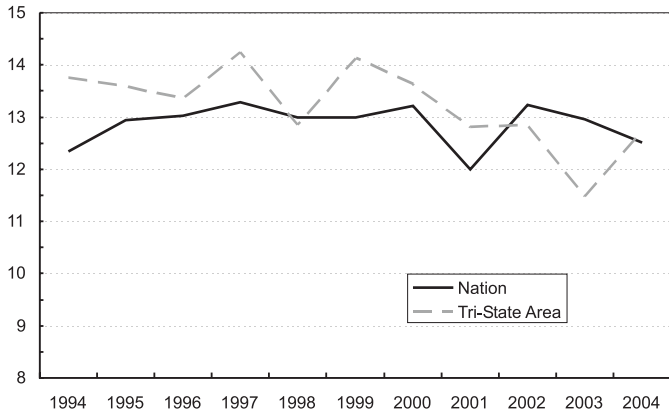


Figure 16
Percentage Change in Loans Outstanding for Community Banks

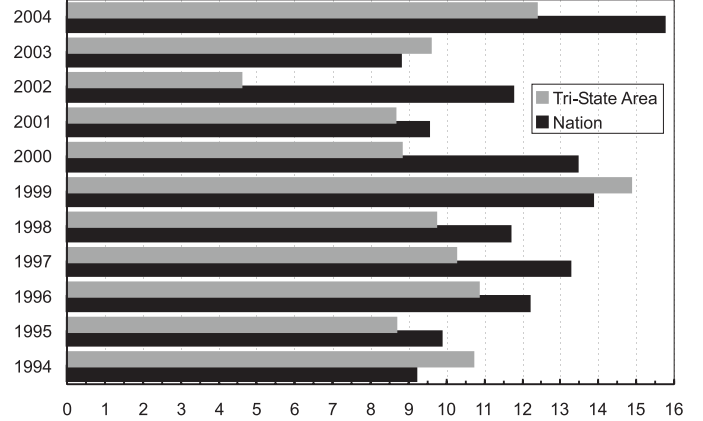


Figure 17
Net Interest Margins for Community Banks

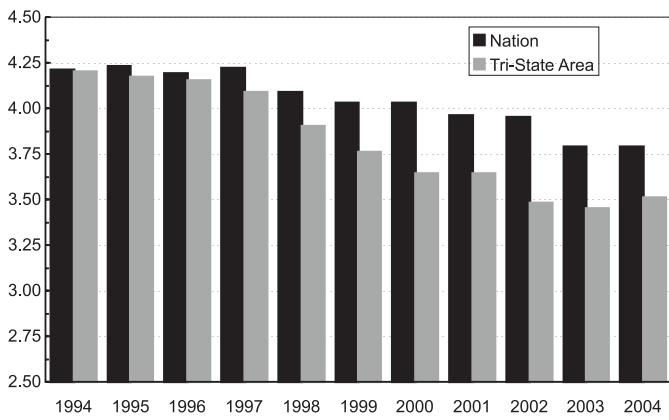


Figure 18
Percentage Change in Deposits for Community Banks

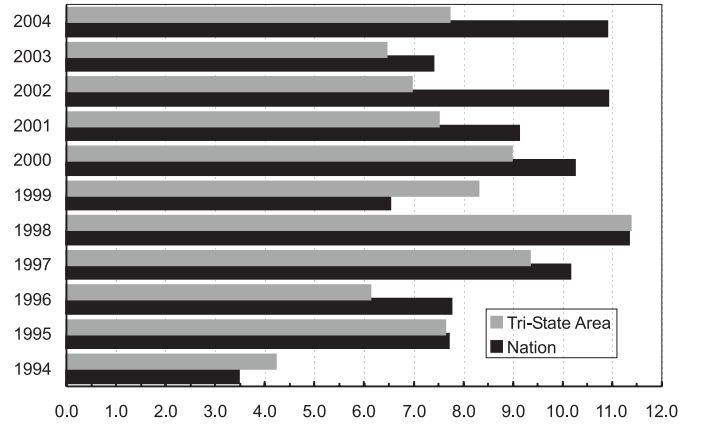


Figure 19
Equity/Assets for Community Banks

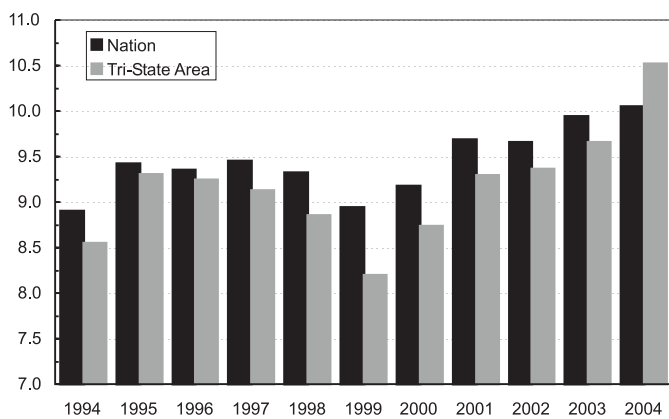


Figure 20
Nonperforming Loans/Total Loans for Community Banks

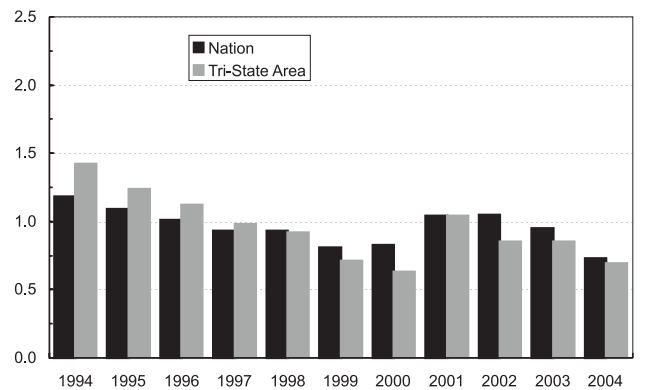


Figure 21
Nonperforming Assets/Total Assets for Community Banks

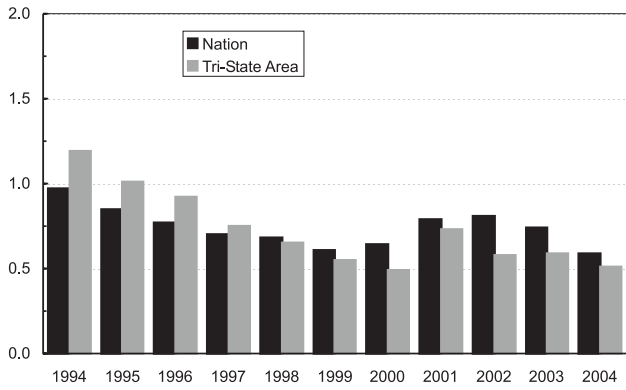


Figure 22
Net Charge-offs/Average Assets for Community Banks

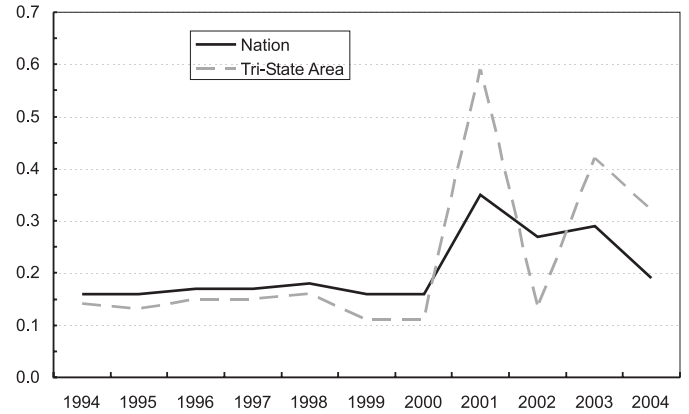


Figure 23
Loan-Loss Coverage Ratio for Community Banks

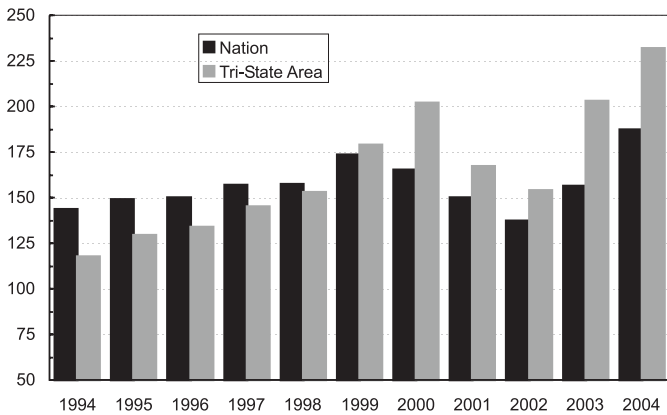


Figure 24
Noninterest Expense/Average Assets for Community Banks

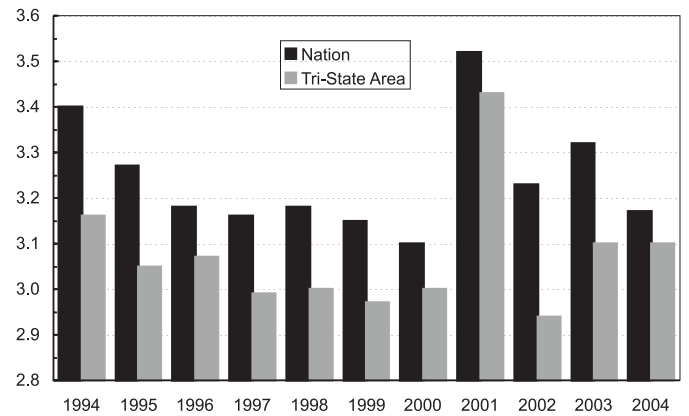


Figure 25
Noninterest Income/Average Assets for Community Banks

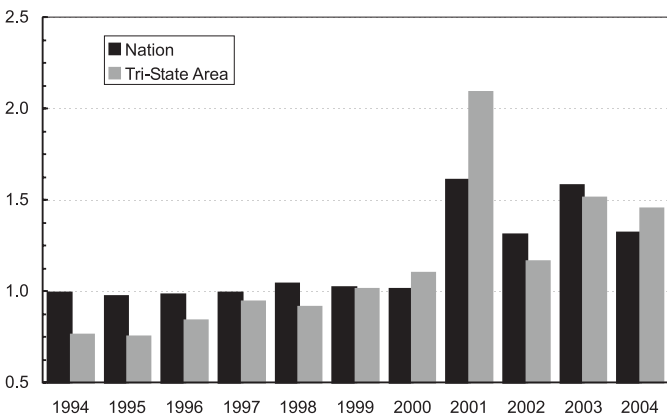
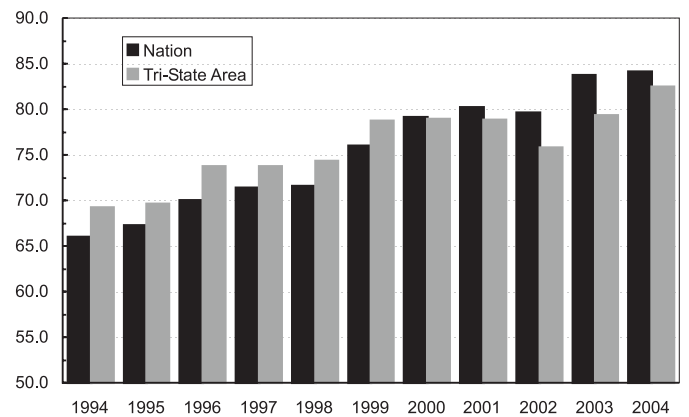


Figure 26
Loans/Deposits for Community Banks



For much of the 20th century, the non-banking activities (i.e., activities other than deposit-taking and lending) of banks and bank holding companies (BHCs) were fairly restricted. Laws such as the Glass-Steagall Act of 1933 limited these activities to business that was incidental to traditional banking. Over time, the law was relaxed so that banks and BHCs could engage in investment banking on a limited scale, primarily discount brokerage activities, offering financial advice, and underwriting government bonds. National banks could engage in insurance agency activities in small towns (populations less than 3,000), and BHCs were permitted to reinsure life, accident, and health insurance if they were related to extensions of credit. State-chartered banks could engage in other activities on a state-by-state basis (provided they had a charter from that state). Merchant banking activities were prohibited for both banks and bank holding companies.¹²

On November 12, 1999, the Gramm-Leach-Bliley Act (GLBA) was signed into law. It largely repealed the prohibitions and limitations described above. Under GLBA, BHCs were permitted to convert to “financial holding companies” (FHCs), which could engage in a variety of financial activities, including securities underwriting and dealing, insurance underwriting and portfolio investment activities, and merchant banking. Through direct operating subsidiaries, nationally chartered banks were permitted to engage in the same activities as BHCs.

The law provides that each of the nontraditional activities be regulated on a functional basis. That is, banking regulators continue to regulate bank subsidiaries of FHCs, but securities subsidiaries are regulated by the Securities and Exchange Commission, and insurance

subsidiaries are regulated by state insurance agencies. The Federal Reserve has responsibility for oversight of the finances of FHCs. The law also permitted FHCs to engage in any other activity that was found to be “financial in nature” or “complementary” to financial services by both the Federal Reserve and the Treasury Department.

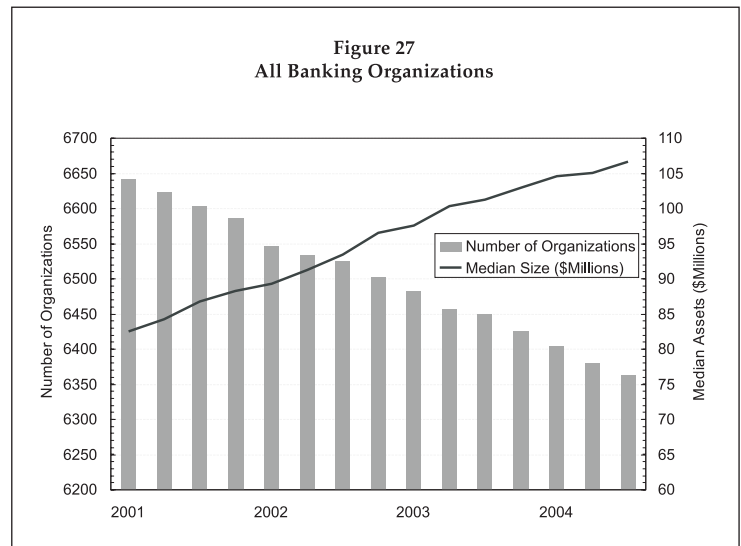
The changes brought about by GLBA promised the most sweeping restructuring of banking and financial services since the early 1930s. What has happened in the banking industry since the enactment of GLBA?

First, a substantial number of banking organizations have converted to FHCs. Figure 27 shows the total number of banking organizations and their median size, while Figure 28 shows the same information for FHCs. While the total number of banking organizations has decreased about 4 percent, the number of FHCs continues to grow.¹³

Moreover, although some small organizations have converted to FHCs, the median FHC is over four times the size of the median banking organization. In fact, nearly all of the top banking organizations in the United States, including nine out of the 10 largest, are now FHCs. As will be shown below, these organizations are taking full advantage of the expanded powers granted by GLBA, but few other organizations are.¹⁴

Figures 29, 30, and 31 show the number and median size of FHCs engaged

Figure 27
All Banking Organizations



in underwriting securities, insurance underwriting, and merchant banking, respectively. Only a small number of firms engage in each activity, and they are among the largest banking organizations in the country.¹⁵ As the data show, the fewest FHCs are engaged in insurance underwriting, and they also have the smallest median size. While few firms currently engage in insurance underwriting, a substantial number of banks, BHCs, and FHCs engage in insurance sales and agency activities (see below). FHCs engaged in securities underwriting are the most numerous. Only very large FHCs engage in merchant banking.

Most firms engaged in one of these activities engage in others as well: eight firms engage in both investment banking and insurance underwriting, 18 firms engage in investment banking and merchant banking, six firms engage in both insurance and merchant banking, and these same six firms engage in all three activities. Twenty-two of the firms currently engaged in investment banking were already underwriting securities

¹² Merchant banking consists of making and holding relatively small investments in primarily nonfinancial firms.

¹³ The total number of organizations includes independent banks, BHCs, and FHCs. The source of these data is the Federal Reserve Board’s National Information Center.

¹⁴ See Appendix B for a summary of the methodology used to calculate the extent of FHCs’ involvement in nontraditional activities.

¹⁵ There are four firms included as FHCs that were not originally BHCs. Two are brokerage firms, and two are insurance companies. As in Figure 27, the median size numbers are in \$ billions. The decline in the number of firms engaging in these activities in recent years can be attributed to mergers among several large organizations.

Figure 28
Financial Holding Companies

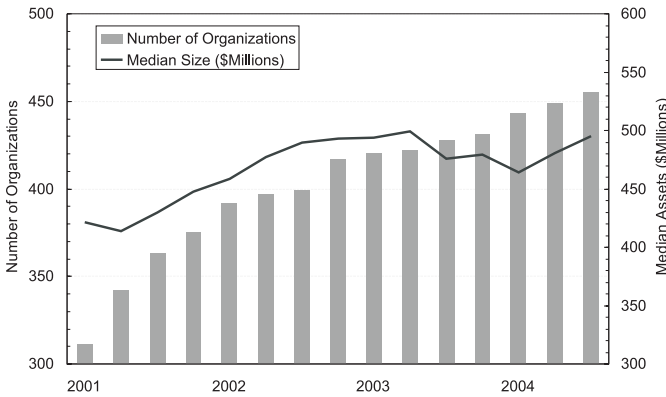


Figure 29
FHCs Engaged in Underwriting Securities

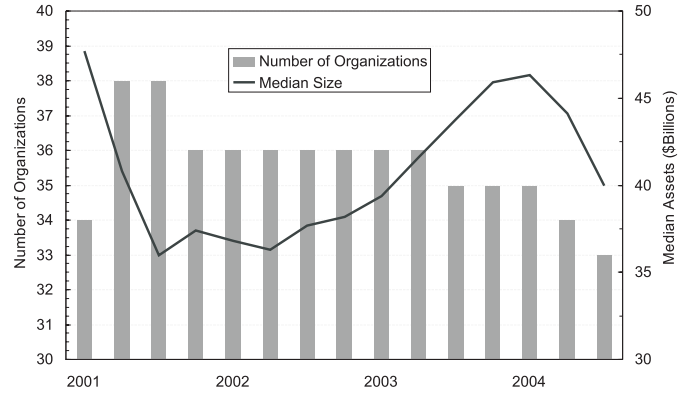


Figure 30
FHCs Engaged in Underwriting Insurance

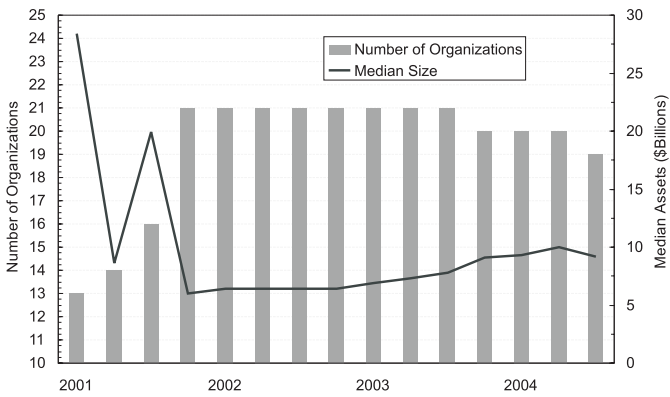
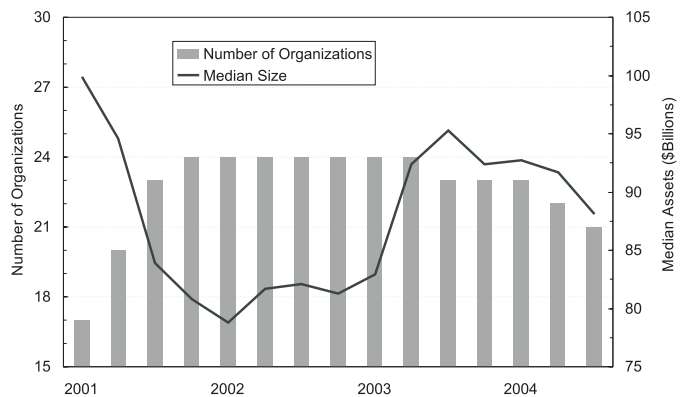


Figure 31
FHCs Engaged in Merchant Banking



through Section 20 subsidiaries prior to the enactment of GLBA.¹⁶

While only a small number of organizations actually engage in these new activities, as shown by the median sizes of these firms, they are generally quite large. As shown in Figure 32, the organizations engaging in nontraditional activities represent a substantial portion of total banking assets.¹⁷ FHCs that engage in securities underwriting represented just over 60 percent of all commercial banking assets as of September 2004. The asset

share of those FHCs engaged in insurance underwriting was 46 percent, while the share of firms engaged in merchant banking was 57 percent.

In trying to assess GLBA's impact, two questions arise: (1) how important are these activities to the organizations; i.e., how much of their business do these activities represent; and (2) have banks become important within the markets for these activities? To answer the first question, the only consistent data available on this subject are revenue data from

the bank and BHC call reports. There are no corresponding data for costs, so it is not possible to assess the impact of these activities on profitability.

Figure 33 shows the percentage of total revenue derived from investment banking activities for all organizations, FHCs, the 10 largest banking organizations, and the firms identified as engaging in securities underwriting. The data shown are for all securities activities, which includes underwriting, brokerage, and investment advisory commissions.¹⁸

¹⁶ A Section 20 subsidiary of a BHC underwrites and deals in certain securities. These types of investments have been permissible since 1987 and consist primarily of bonds. The activities of these firms were limited. For instance, until 1998, they could not share management with any of the BHCs' affiliated banks. Also, the BHCs' total revenue from any single Section 20 sub was limited to 5 percent of its total revenue, with an absolute limit of 25 percent for all of these subsidiaries. There were also additional firewalls to ensure that all securities transactions were separate from the activities of the BHCs' subsidiary banks. The securities affiliates of FHCs are not subject to these restrictions.

¹⁷ Total banking assets are calculated as the sum of assets of independent banks and consolidated assets of BHCs/FHCs.

The firms that engage in underwriting derived over 10 percent of their revenue from these activities in September 2004. Although the percentage of revenue from investment banking dipped in 2004 for all categories, the data in Figure 33 show that since 2001 this percentage has generally been trending up.

The absolute numbers for revenue show a more dramatic rise. The total revenue from investment banking of all banking organizations increased 272 percent from 2001 to 2004, to \$36 billion. For FHCs, total revenue from investment banking in September 2004 was \$35 billion, an increase of 277 percent from 2001. Over the same period, the firms engaged in underwriting had a 268 percent increase in investment banking revenue, to \$33 billion, while the 10 largest organizations showed a 235 percent increase, to \$24 billion.

While investment banking may be becoming more important to FHCs, how important are FHCs to investment banking? There is some evidence that banks are having an impact. Investment banking can be broken down into four main segments: securities underwriting, money management, financial advice (including mergers and acquisitions), and broker/dealer activities.¹⁹ As mentioned above, banks and BHCs had the power to act as a broker/dealer and offer investment advice prior to GLBA, so those activities will not be examined.

Among the top securities underwriters in the United States in 2003, two FHCs ranked in the top five firms. One of those (Citigroup) was the product of a merger between a bank holding company and an insurance company/investment bank. Among the top 20 worldwide money managers in 2003, there were five FHCs, including three in the top 10. Moreover,

there is anecdotal evidence that FHCs are gaining market share in investment banking by targeting small-market and middle-market clients.²⁰

With regard to insurance, BHCs have been able to engage in some underwriting activities for many years: reinsuring credit life, accident, and health insurance.²¹ Some states permitted state-chartered banks to underwrite certain types of insurance, such as title insurance. GLBA allowed FHCs to engage in underwriting any type of insurance. Data on the types of insurance FHCs underwrite are not available, but there is anecdotal evidence that banking organizations prefer to engage in commercial property insurance and other types of commercial insurance.

As mentioned above, banks with operations in small towns were able to act as insurance agents and brokers. A substantial number of firms do engage in insurance sales. As of September 30, 2004, over 1300 banking organizations derived revenue from insurance sales and agency activities. This number has increased steadily from the 950 that had such revenue in the first quarter of 2001.

FHCs that engage in insurance underwriting appear to derive significant revenues from that activity (Figure 34). In this case, revenue from insurance includes commissions from agency activities. Figure 35 shows revenue percentage from insurance underwriting only.²² For three categories, this exceeds or nearly exceeds 5 percent of revenue. The trend for these revenues is also going up; that is, insurance is becoming more important both to FHCs and non-FHCs.

One reason insurance represents a high portion of revenue for those organizations that underwrite is that GLBA works two ways. Not only can bank-

ing organizations enter the insurance industry, but insurance companies can also enter the banking industry. In fact, several insurance companies, including two of the largest (MetLife and John Hancock), have entered the banking industry as FHCs. A third large FHC is the result of a merger between a large banking organization and a large insurance company (Citigroup).²³ While this is evidence that GLBA is working as intended (i.e., the differences between various sectors of the financial services industry are disappearing), including these institutions may exaggerate the banking sector's presence in the insurance industry. Figure 36 provides an alternative view, with Citigroup, John Hancock, and MetLife removed from the data.

While it appears that FHCs are becoming more involved in investment banking and insurance, that is not the case for merchant banking. As noted above, merchant banking consists of making equity investments in nonfinancial companies. BHCs and banks have always been permitted to make some investments in nonbanking companies as part of their trading accounts and through small business investment companies (SBICs), but these holdings are generally for short periods. Merchant banking is a highly specialized field involving significant risk to the investors, because many of the firms they invest in do not have a track record and are not traded on any of the stock exchanges. Thus, as shown in Figure 31, only a small number of very large banking organizations engage in merchant banking.

Figure 37 shows the equity investments in nonfinancial firms of FHCs that engage in merchant banking.²⁴ Both their total investments and those made

¹⁸ Investment advice and discount brokerage were legal activities for BHCs before the enactment of GLBA. Also, the figures presented in Figure 30 include income from venture capital. Only a few firms engage in this activity, and it does not make up a significant portion of their revenue.

¹⁹ The data in this section are from *Standard & Poor's Industry Survey on Investment Services*, June 2004.

²⁰ See www.hoovers.com/company-information/--HICID__1308--/free-ind-factsheet.xhtml.

²¹ Credit insurance is insurance that guarantees the lender will be paid in the event the borrower cannot pay because of death, accident, or illness. Reinsurance is essentially insuring the insurer. Thus, an insurance company would underwrite the policies sold to borrowers, and the BHC would underwrite a policy for the insurance company.

²² The data on insurance underwriting revenue are available from the first quarter of 2003.

²³ On January 31, 2005, Citigroup announced that it was selling most of its insurance business to MetLife.

²⁴ Source: Federal Reserve FRY-20 reports. These data have been collected only since the third quarter of 2001.

Figure 32
Percentage of Total Banking Assets as of 9/30/2004

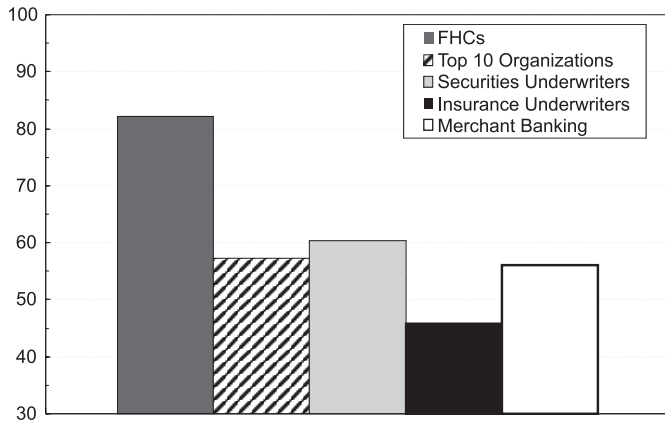


Figure 33
Investment Banking Revenue as a Percentage of Total Revenue

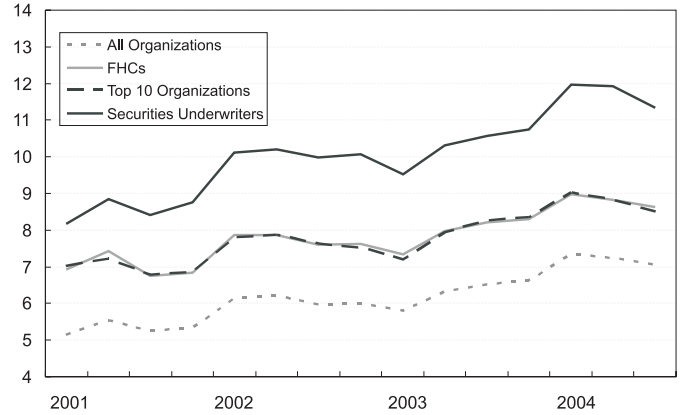


Figure 34
Insurance Fees as a Percentage of Total Revenue

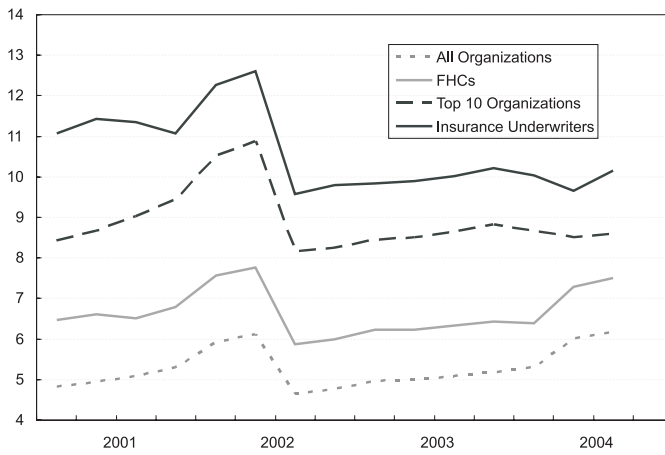


Figure 35
Insurance Underwriting Fees as a Percentage of Total Revenue

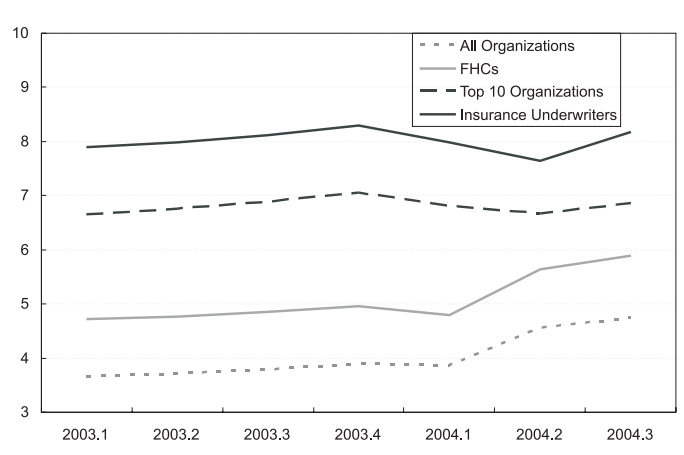


Figure 36
Insurance Underwriting Fees as a Percentage of Total Revenue Excluding Citigroup, MetLife, and John Hancock

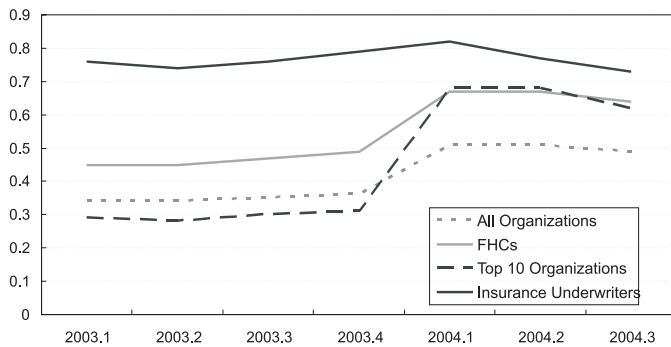


Figure 37
Equity Investments in Nonfinancial Firms

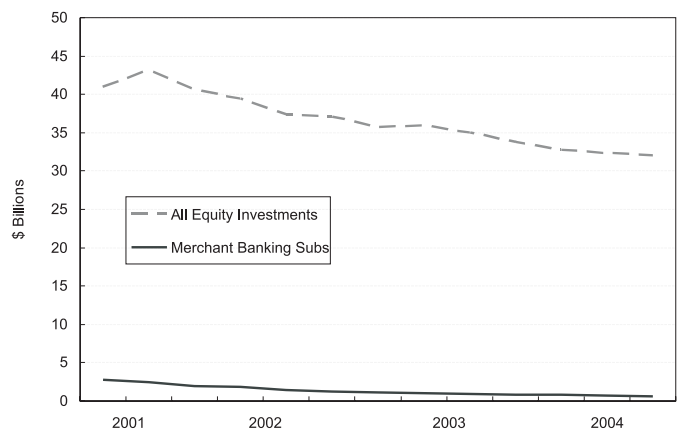


Figure 38
Federal Home Loan Bank Advances as a
Percentage of Total Bank Liabilities

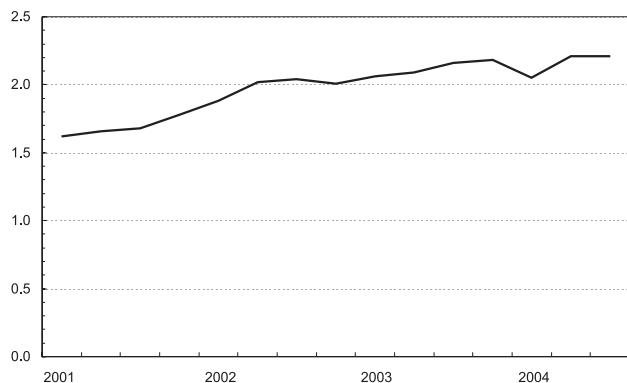
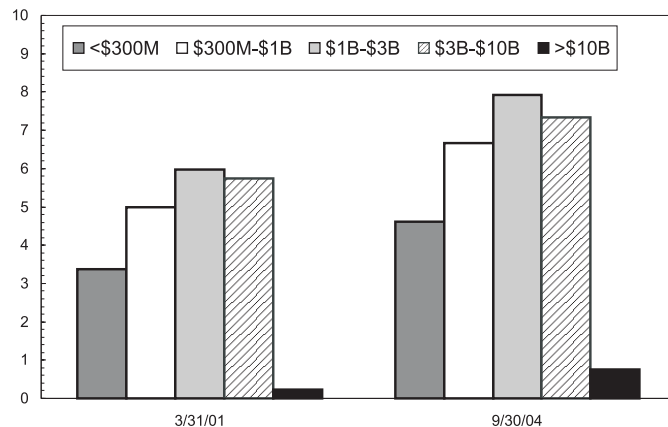


Figure 39
Federal Home Loan Bank Advances
Percentage of Total Bank Liabilities - By Size



specifically through merchant banking subsidiaries are shown. As presented, these investments are relatively small and shrinking. They also comprise a negligible percentage of assets. The investments made through merchant banking subsidiaries were even smaller (less than \$1 billion total) and comprised less than one-ten-thousandth of a percent of total assets. The small percentages may be representative of the small and specialized nature of the merchant banking industry. Also, it is entirely possible that the shrinking amount of equity investments is the result of an overall decline in the market for private equity and venture capital since 2000.

There have been several other non-banking activities either proposed or permitted for FHCs. One that has been approved is the collection and processing of nonfinancial consumer data. Banks have always collected data from their customers in connection with loan tracking.²⁵ The new activity permitted by GLBA allows banks to collect such data as shopping patterns through their credit and debit cards. There is also substantial anecdotal evidence that some banks have begun marketing financial software, but there are currently no data available to quantify that. One kind of business that

has been proposed several times by the Treasury Department is real estate brokerage. Thus far, Congress, responding to concerns of the real estate industry, has prevented that activity from being approved.

The activities summarized above are nearly all performed by large organizations looking for new revenue streams from diversification. Smaller banks, however, were not interested in diversifying, but instead were seeking new sources of funding to make traditional loans. For example, at the time of the passage of GLBA, many small banks had begun using advances from Federal Home Loan Banks (FHLBs) in lieu of deposits.²⁶ Their ability to do this was limited by the need to pass the qualified thrift lender (QTL) test in order to get these advances at the most favorable terms.²⁷ The GLBA eliminated this requirement for banks with assets under \$500 million. This provision was particularly important to agricultural banks, which are generally very small but otherwise cannot pass the QTL test. Thus, one other effect of GLBA to examine is if it has helped the smaller banks gain access to FHLB funds.

Figure 38 shows FHLB advances as a percentage of total liabilities of all banks.²⁸ As shown, the overall ratio of

FHLB advances to liabilities increased from 1.62 percent in the first quarter of 2001 to 2.21 percent in the third quarter of 2004. Overall FHLB advances to commercial banks increased from \$92.0 billion to \$161.9 billion. This represents an increase of over 76 percent, so it would appear at first glance that this GLBA provision is accomplishing what it was intended to do.

However, as shown in Figure 39, the group of banks with the highest ratio of FHLB advances to liabilities are mid-size banks. Smaller banks (less than \$300 million in assets) show a slight increase, from about 3.5 percent to about 4.6 percent, while the largest banks receive a negligible percentage of their funding through FHLB advances. Moreover, the percentage increases for the different groups of banks from 2001 to 2004 are those with assets less than \$300 million, 35 percent; assets between \$300 million and \$1 billion, 72 percent; assets between \$1 and \$3 billion, 45 percent; assets between \$3 and \$10 billion, 37 percent; and assets greater than \$10 billion, 334 percent. Thus, the intended beneficiaries of GLBA's relaxation of FHLB rules, the smallest banks, have increased their borrowing the least.

That said, there is little evidence that

²⁵ In some cases, such as home mortgages, they were required by law to collect these data.

²⁶ FHLB advances are essentially low-interest, collateralized loans from Federal Home Loan Banks to commercial banks or thrifts. They can be short term (i.e., under one year) or long-term (up to 30 years) in duration. The collateral offered by bank borrowers is generally either mortgages or business loans.

²⁷ The QTL test required that in order to be eligible for FHLB advances an institution had to have at least 60 percent of its assets in traditional thrift products. That is, they had to be in mortgages or other real estate loans.

²⁸ The data in Figures 38 and 39 are for commercial banks only. The size categories are for the size of the individual banks, not the entire organization. The reason for this is that FHLB advances are made at the bank level, not to the parent company.

small banks are not able to obtain as many FHLB advances as they need. Smaller banks have smaller loan-to-deposit and loan-to-asset ratios than larger banks, but that has always been the case. Additionally, there have not been any legal moves made to further increase the availability of FHLB advances, either by individual banks using the courts or by the small banks' industry group.

Legal Developments

The only substantial piece of legislation enacted in the tri-state area in 2004 was an anti-predatory lending bill in New Jersey. The law prohibits mortgage lenders from financing any credit life, credit disability, credit unemployment, or credit property insurance, or any other life or health insurance, or any payments for debt cancellation or suspension agreements. However, debt cancellation or suspension fees that are calculated and paid on a monthly basis will not be

In summary, the passage of GLBA has not substantially affected the activities of the vast majority of banking organizations. The few organizations that are taking advantage of GLBA, however, are among the largest organizations in the country and service a substantial portion of the industry's total customer base. Additionally, the firms that engage in the newly permitted activities derive a

significant and growing portion of their revenue from investment banking, and they are becoming significant players in that market. Thus, while the number of firms engaging in these activities is small, the effect on the overall industry has been significant.

considered to be financed by the lender. Creditors also may not recommend or encourage default on an existing loan or debt prior to the closing of a home loan that refinances all or any portion of that existing loan or debt.

Creditors may only charge late payment fees that do not exceed 5 percent of the amount of the payment past due. Late payment fees may be applied only once for a single late payment, and a fee may be assessed only after a payment is

past due for more than 15 days. Creditors must alert borrowers that a late payment fee has been assessed no more than 45 days after the payment was due. Further, home loans may not include provisions that permit a creditor to accelerate the indebtedness, except when the acceleration is in good faith because the borrower failed to comply with terms of the loan. Finally, creditors may not charge a fee for informing a consumer of the balance due to pay off a home loan.

Mergers and Acquisitions

Merger activity increased substantially in 2004, both nationally and locally. There were several transactions involving large banking organizations, and the number of transactions involving smaller banking organizations increased as well. This increase applied to both interstate and in-state mergers. Notable interstate transactions included two of the largest mergers in history: the merger of J.P. Morgan Chase & Company, Inc. (New York, NY) and Banc One Corporation (Chicago, IL), and the merger of Bank of America Corporation (Charlotte, NC) and FleetBoston Financial Group, Inc. (Boston, MA). Prior to its merger with Bank of America, Fleet had acquired Progress Financial Corporation (Blue Bell, PA).

Other notable interstate mergers involving banking organizations with a presence in the tri-state area include the acquisition of United National Bancorp, Inc. (Bridgewater, NJ) by PNC Financial Services Group, Inc. (Pittsburgh, PA), North Fork Financial Corporation (Matituck, NY) acquired Trust Company of New Jersey (Jersey City, NJ), Community

Bank System, Inc., (DeWitt, NY) acquired First Heritage Bank (Wilkes-Barre, PA), and Provident Bank (Montebello, NY) merged with Towne Center Bank (Lodi, NJ). Sovereign Bancorp, Inc. (Wyomissing, PA) acquired two banking organizations in Massachusetts: First Essex Bank (Lawrence) and Seacoast Financial Services Corporation (New Bedford). Citizens Financial Group, Inc. (Providence, RI) also made two acquisitions in 2004, buying Roxborough-Manayunk Bank (Philadelphia, PA) and merging with Charter One Financial Corporation (Cleveland, OH).²⁹ Finally, Fulton Financial Corporation (Lancaster, PA) merged with Resource Bancshares Corporation (Virginia Beach, VA) and First Washington Financial Corporation. (Windsor, NJ).

Among the notable transactions in Pennsylvania: Harleysville National Corporation (Harleysville) acquired Millennium Bank (Malvern), First Commonwealth Financial Corporation (Indiana) merged with GA Financial Corporation (Pittsburgh), Susquehanna Bancshares,

Inc. (Lititz) merged with Patriot Bancorp, Inc. (Pottstown), National Penn Bancshares, Inc. (Boyertown) merged with Peoples First, Inc. (Oxford), Leesport Financial Corporation (Wyomissing) merged with Madison Bancshares Group, Ltd. (Blue Bell), Omega Financial Corporation (State College) merged with Sun Bancorp of Pennsylvania, Inc. (Lewisburg), F.N.B. Corporation (Hermitage) acquired Slippery Rock Financial Corporation (Slippery Rock), Northwest Bancorp, MHC (Warren) acquired First Carnegie Deposit Bank (Carnegie), and Sterling Financial Corporation (Lancaster) acquired Pennsylvania State Banking Company (Camp Hill).

There were three notable in-state transactions in New Jersey. Lakeland Bancorp, Inc. (Oak Ridge) merged with Newton Financial Corporation (Newton), Sun Bancorp, Inc. (Vineland) merged with Community Bancorp of New Jersey, Inc. (Freehold), and Provident Financial Services Corporation (Jersey City) acquired First Sentinel Bancorp, Inc. (Woodbridge).

²⁹ Citizens Financial Group, Inc., is a subsidiary of Royal Bank of Scotland, Edinburgh, Scotland, United Kingdom.

Appendix A — Methodology for Selecting Bank Categories

This publication divides banks into two categories: large banking organizations and community banks. It further divides 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 one-hundredth largest bank holding company in the nation at the beginning of that year, ranked by total assets. Thus the banks in the 2004 sample are selected based on their year-end 2003 total assets, updated for mergers that occurred in 2004. 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 are 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. Detailed documentation on the methodology used in constructing this document is available on our web site at www.philadelphiafed.org. To subscribe to this publication, please go to www.philadelphiafed.org/forms/orderform.htm and scroll down to Economic Research Publications.

Appendix B — Methodology For Data on FHC Activities

The data on FHCs engaged in nontraditional activities are from the Federal Reserve's FRY-9CS reports. These were provisional supplements to the normal FRY-9 BHC call reports, but data were collected only during the years 2000 and 2001. Thus, organizations that are counted as being involved in a particular activity like underwriting securities were those that did so on December 31, 2001. Other FHCs likely have subsequently

entered the business, but there is no solid information to identify which firms have entered which line of business. This methodology also implies that the only way an FHC can be counted as leaving a particular line of business is by merging with another FHC.

Financial data are from the bank call reports and FRY-9C BHC consolidated reports. The data are either the bank call report (in the case of an independent

bank) or the BHC consolidated data (for BHCs and FHCs). To avoid double-counting in the case of multibank holding companies, only one observation for a BHC was used for each period. Also, most of the call report data used below have been available only since March 2001. For the sake of consistency, this is the starting date for all data presented unless otherwise noted.



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