BANKING BRIEF

FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

Fourth Quarter 2005

Profitability remained stable for community banks and large banking organizations both locally and nationally during the last quarter of 2005. Net interest margins and overhead costs didn't change substantially, nor did the ratio of fee income to average assets. One potential problem was a rise in the ratio of nonperforming loans to total loans.

At large banks both nationally and locally, business loans grew more than 10 percent. Banks have been easing lending standards for businesses. Most large banks reported that demand for business loans was either moderately stronger or about the same during the quarter.[1] Consumer loans outstanding dropped substantially, but this was primarily because of an increase in securitizations rather than a drop in demand.

At community banks, real estate loans continued to have strong growth. While some large banks are tightening their real estate lending standards, there is little evidence of this at community banks. Most banks reported that demand for real estate loans was either unchanged or slightly weaker, but many respondents believe that both the commercial and residential real estate markets will weaken in the near future.

A Brief Look at Overhead

How banks manage their noninterest expenses (overhead) can have a major effect on profitability. At year-end 2004 overhead accounted for nearly 66 percent of all expenses.[2] This was somewhat higher than the historical figure of 60.3 percent, so managing overhead is becoming more important.

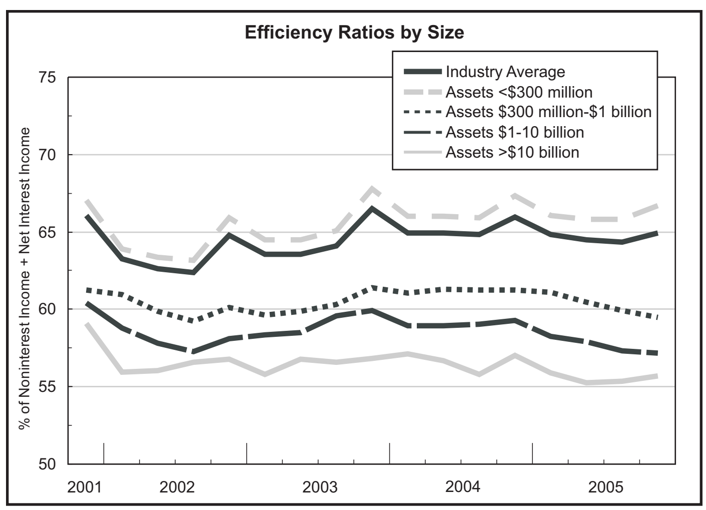
Overhead expense is generally defined as any costs not directly attributable to deposits or investments. It includes salaries and employee benefits; spending on premises and equipment (net of rental income and excluding mortgage payments); data processing; advertising and marketing; directors' fees; the cost of printing, stationery, and office supplies; postage; legal fees, including the cost of settling any litigation; FDIC deposit insurance assessments; additions to and subtractions from goodwill; and amortization.

On average, the makeup of overhead has remained fairly stable. Employee expenses represented 54.9 percent of overhead in the third quarter of 2005, up from 53.7 percent at year-end 2001.[3] Spending on premises and equipment was stable during that time, at around 13.5 percent. The next largest component of overhead was data processing, representing 4.5 percent of all overhead in September 2005, up from 4.0 percent in 2001. None of the other categories represented more than 1.5 percent of total overhead spending in either 2001 or 2005. Advertising expenses rose slightly, while spending on office supplies and postage fell slightly; all other categories of spending were nearly unchanged.

Banks use an efficiency ratio, the ratio of overhead to total operating revenue, to measure how well they control overhead. The lower the ratio, the better a bank is at controlling overhead. However, some categories of expenses included in overhead are actually investments in new products and services or in more efficient ways of delivering existing products and services.

For example, a bank that spends heavily on replacing and integrating its computer systems will have higher data processing expenses, but over time this investment will actually cut overhead. This can also be true of marketing. Therefore, one should be careful about interpreting efficiency ratios at one point in time. With that in mind, the chart below shows the efficiency ratios of banks in various size categories over time. In general, the larger the bank, the more efficient it tends to be.

One reason for this is that larger banks have much lower employee expenses. Banks in the smallest category spent 36.2 percent of their operating revenue on salaries and benefits in 2005, while those in the largest category spent 24.8 percent. Larger banks also had substantial cost advantages in areas like premises and equipment and data processing. Smaller banks had a cost advantage in goodwill, amortization, and advertising and marketing.



[1] Senior Loan Officer Opinion Survey, www.federalreserve.gov/boarddocs/SnLoanSurvey/.

[2] Source: FDIC Historical Statistics on Banking, www2.fdic.gov/hsob/hsobRpt.asp (January 18, 2006).

[3] Data presented here are from call reports. Prior to 2001 noninterest expense wasn't broken down in the detail presented here.

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Fourth Quarter 2005

Community Banking Organizations

	Tri-State			*Nation*		
	$Bill	% change from		$Bill	% change from	
	05Q4	05Q3	04Q4	05Q4	05Q3	04Q4
Total Assets	88.3	5.07	6.39	1656.8	10.09	10.22
Total Loans	57.6	8.98	10.31	1109.8	10.66	12.61
Business	8.1	5.45	8.2	173.8	8.95	8.97
Real Estate	45	11.17	11.74	807.7	11.04	14.32
Consumer	2.7	-8.26	-2.07	69.4	-3.47	1.92
Total Deposits	68.8	5.82	6.62	1315.2	11.53	10.84
Ratios (in %)	**05Q4**	**05Q3**	**04Q4**	**05Q4**	**05Q3**	**04Q4**
Net Income/ Avg Assets (ROA)	1.18	1.16	1.11	1.23	1.23	1.20
Net Interest Inc/ Avg Assets (NIM)	3.44	3.40	3.36	3.77	3.77	3.72
Noninterest Inc/ Avg Assets	1.18	1.15	1.16	0.98	0.99	1.05
Noninterest Exp/ Avg Assets	2.93	2.91	2.92	2.90	2.92	2.98
Loans/Deposits	83.67	83.06	80.87	84.38	84.55	83.06
Equity/Assets	10.08	10.08	9.89	9.71	9.71	9.79
Nonperforming Loans/ Total Loans	0.59	0.57	0.62	0.66	0.64	0.73

Large Banking Organizations

	Tri-State			*Nation*		
	$Bill	% change from		$Bill	% change from	
	05Q4	05Q3	04Q4	05Q4	05Q3	04Q4
Total Assets	2187.2	2.40	7.72	6777	5.45	6.94
Total Loans	1188.4	6.42	10.84	3847.5	8.14	9.36
Business	241.3	20.33	10.75	795.1	12.77	11.57
Real Estate	704.9	6.68	13.95	2085.5	8.69	13.65
Consumer*	90.5	-33.17	-7.39	504.1	-0.58	0.87
Total Deposits	1459.9	4.53	4.95	4484.7	11.18	7.75
Ratios (in %)	**05Q4**	**05Q3**	**04Q4**	**05Q4**	**05Q3**	**04Q4**
Net Income/ Avg Assets (ROA)	1.38	1.40	1.35	1.22	1.21	1.16
Net Interest Inc/ Avg Assets (NIM)	2.68	2.73	2.77	2.71	2.73	2.73
Noninterest Inc/ Avg Assets	1.93	1.98	1.97	2.20	2.20	2.08
Noninterest Exp/ Avg Assets	2.57	2.63	2.78	2.93	2.98	2.97
Loans/Deposits	81.41	81.04	77.08	85.79	86.39	84.53
Equity/Assets	9.82	9.82	9.91	9.46	9.46	9.50
Nonperforming Loans/ Total Loans	0.46	0.45	0.61	0.72	0.65	0.82

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, 2004. 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 he region. The numbers of banking organizations in the categories are as follows: (1) community banking organizations—185 for the tri-state area and 5816 for the nation; (2) large banking organizations—18 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.
*The reported drop in consumer loans is largely due to increased securitizations at several large banks. Consumer loans + securitizations at large tri-state area organizations decreased by 3.01 percent in the fourth quarter.

Any questions or comments should be directed to Jim DiSalvo at (215) 574-3820 or jim.disalvo@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 website at www.philadelphiafed.org/econ/bb/index.html. To subscribe to this publication, please go to www.philadelphiafed.org/econ/respubs/index.html.