



# BANKING BRIEF

## FOR PENNSYLVANIA, NEW JERSEY, AND DELAWARE

### SPECIAL REPORT: COMMERCIAL BANKS IN 2005

#### Large Banking Organizations

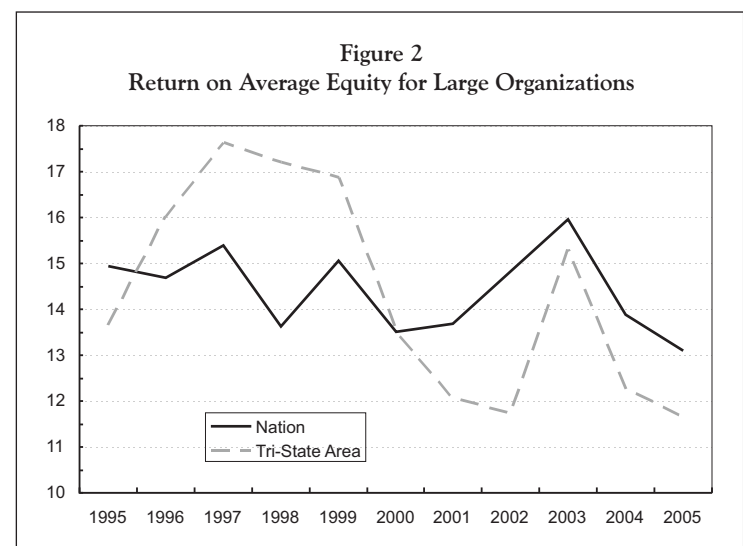
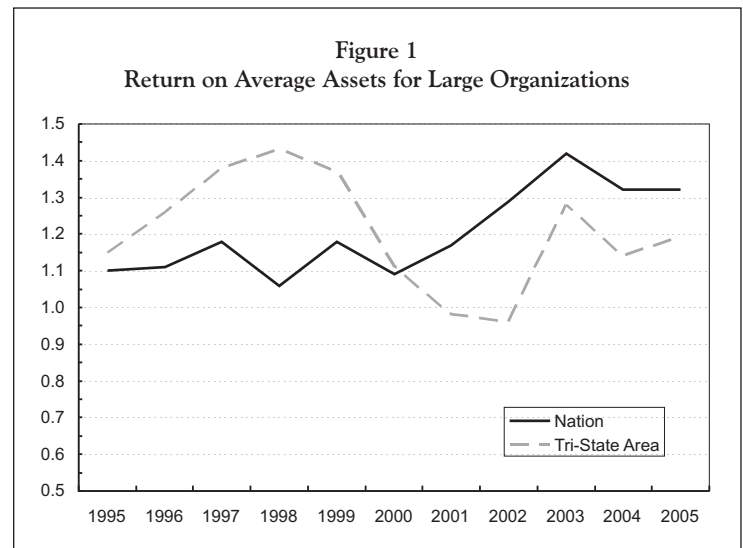
Large banking organizations reported mixed results in 2005.<sup>1</sup> Profitability, as measured by return on average assets (ROA), increased for tri-state area banks but was flat nationally (Figure 1).<sup>2</sup> Return on average equity (ROE) decreased for the second year in a row at both tri-state area banks and banks nationally (Figure 2). Actual net income increased for both groups of banks, but it was outpaced by growth in equity and assets at banks nationally. Net income increased for tri-state area banks by 15.0 percent in 2005, while the increase for the nation was 9.4 percent.

Overall, loans outstanding grew 8.7 percent for banks in the tri-state area, while the corresponding number for banks in the nation as a whole was 8.2 percent (Figure 3). Both real estate loans and commercial loans grew at double-digit rates for tri-state area banks in 2005. Real estate loans increased 12.5 percent; commercial loans increased 15.9 percent.<sup>3</sup> The corresponding figures for banks nationally were 15.2 percent for real estate loans and 13.0 percent for commercial loans. Consumer loans at tri-state area banks also increased but at the lesser rate of 6.0 percent; consumer loans at banks in the nation as a whole actually decreased slightly, by 0.3 percent. One

<sup>1</sup> Large banking organizations are determined annually as those firms that are at least as large as the 100<sup>th</sup> largest bank holding company in the nation at the previous year-end (here 2004), 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 the Appendix for a description of the methodology used in grouping these banks.

<sup>2</sup> Data used in Figures 1 to 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.

<sup>3</sup> Real estate loans were 50.2 percent of total loans for large organizations in the tri-state area, C&I loans were 16.8 percent of total loans, and consumer loans were 18.6 percent. For the nation as a whole, real estate loans were 50.8 percent of total loans, C&I loans were 16.7 percent, and consumer loans were 17.9 percent.



possible reason for the slower growth of consumer loans is that banks appear to be securitizing more of them, thus removing them from their books. This was especially true of automobile and education loans. On the other hand, banks securitized a smaller percentage of their real estate loans.

Loan and asset quality improved in 2005. The ratio of nonperforming loans to total loans decreased for the third year in a row at both tri-state area banks and in the nation as a whole, as did the ratio of nonperforming assets to total assets (Figures 4 and 5).<sup>4</sup> The ratio of net charge-offs to average assets increased at tri-state area banks in 2005; nationally, this ratio continued to decrease (Figure 6). The national rate is still slightly higher than that for banks in the tri-state area. In part, the increase in the net charge-off ratio at tri-state area banks is due to one large firm charging off credit card loans and other consumer loans in anticipation of a merger with a large credit card lender, but other institutions increased their charge-offs of credit card loans as well.

A substantial portion of credit card charge-offs in 2005 were in the fourth quarter, and this is likely due to changes in bankruptcy law. On April 20, 2005, Congress enacted and President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.<sup>5</sup> This law is intended to make it more difficult for individuals to discharge their debts in bankruptcy court, but there was a perception that the law would make it increasingly difficult to file for bankruptcy at all. The law didn't go into effect until November, and some institutions reported large increases in personal bankruptcies in the preceding months.<sup>6</sup> These bankruptcy filings made it necessary to charge off credit card loans.

The loan-loss coverage ratio decreased slightly at both tri-state area banks and banks nationally last year, but it is still well above the levels it was at earlier in the decade and nearly as high as it was in the late 1990s (Figure 7).<sup>7</sup> The ratio of noninterest income to average assets increased only slightly for both the tri-state area and the nation (Figure 8).<sup>8</sup> The ratio of noninterest expense to average assets increased slightly at banks in the tri-state area and decreased slightly at banks nationally (Figure 9).<sup>9</sup>

<sup>4</sup> Nonperforming loans are defined as loans 90 days or more past due plus nonaccruing loans. Nonperforming assets are defined as nonperforming loans plus other real estate owned.

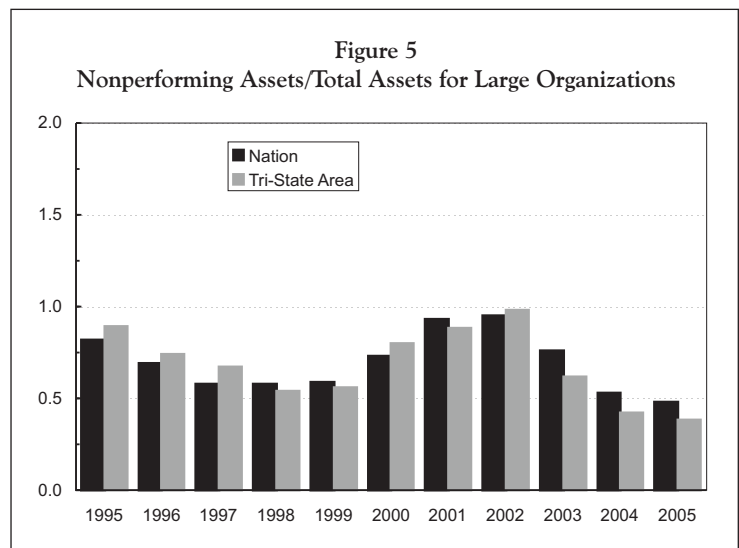
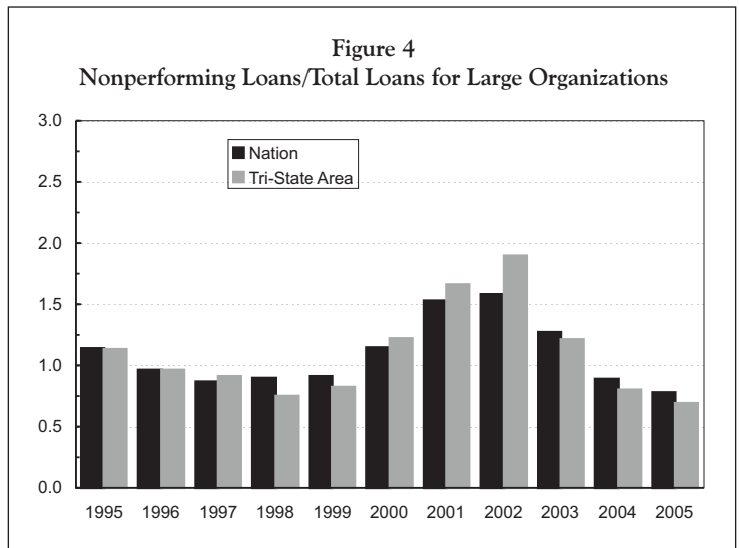
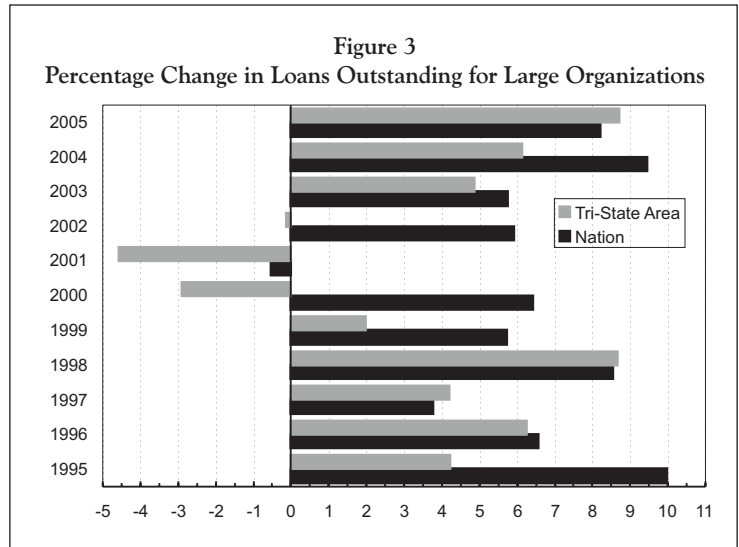
<sup>5</sup> See *Banking Legislation and Policy*, Federal Reserve Bank of Philadelphia, First Quarter 2005, [www.philadelphiafed.org/files/blp/blpq105.pdf](http://www.philadelphiafed.org/files/blp/blpq105.pdf) for a summary of this law.

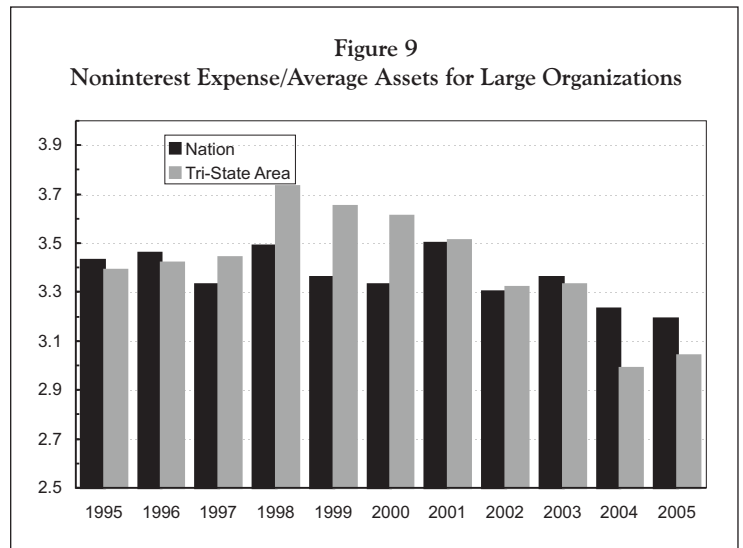
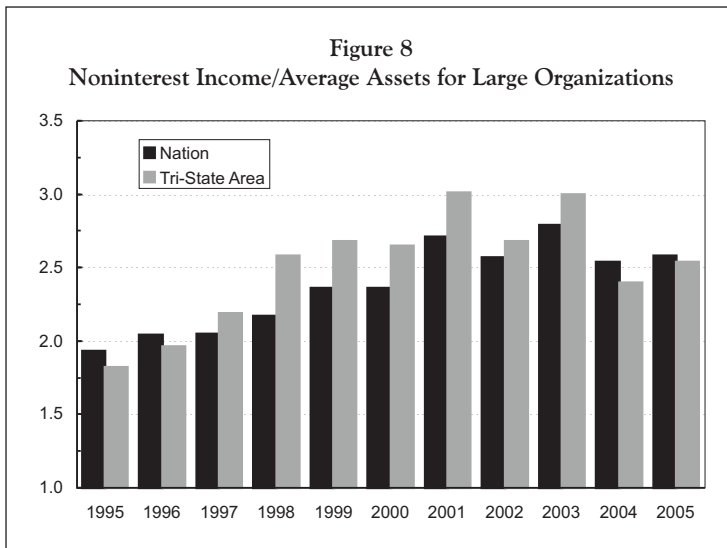
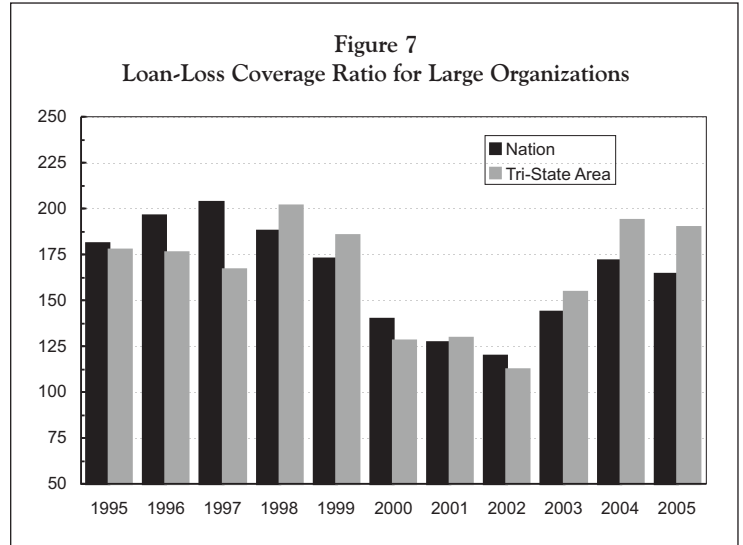
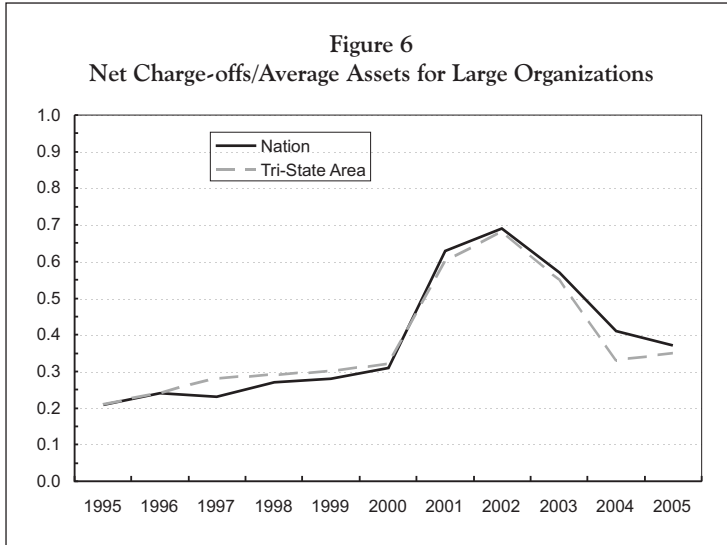
<sup>6</sup> See *FDIC Quarterly Banking Profile*, Fourth Quarter 2005, [www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP](http://www2.fdic.gov/qbp/qbpSelect.asp?menuItem=QBP)

<sup>7</sup> Loan-loss coverage ratio is defined as the ratio of loan-loss reserves to nonperforming loans.

<sup>8</sup> 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.

<sup>9</sup> 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.





Similarly, although net interest margins increased only slightly at banks in the tri-state area, they decreased at banks nationally (Figure 10). This may be due to a flattening of the yield curve. The yield curve describes the relationship between the time to maturity of a financial instrument and its annual yield. For the previous several years, longer-term yields were much higher than shorter-term yields. However, that spread started decreasing in mid-2004, and by year-end 2005 it was essentially zero. Banks' interest income comes mainly from longer-term assets (mortgages and debt securities), while their interest expense comes from shorter-term liabilities (deposits). Thus, with the rates on these essentially equal, margins dropped.

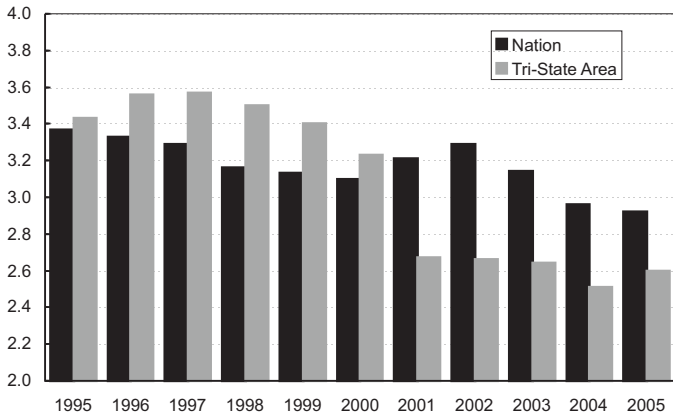
Deposit growth was much slower than loan growth (compare Figure 11 with Figure 3). Although loans increased 8.7 percent at tri-state area banks and 8.2 percent nationally in 2005, the corresponding changes in deposits were 4.8 percent and 7.2 percent. The unbal-

anced growth of loans and deposits has left these banks somewhat less liquid, evidenced by the increase in the loan-to-deposit ratio at both tri-state area banks and banks in the nation as a whole (Figure 12). Loan-to-deposit ratios remain well below their levels at the peak of the last cycle in the late 1990s.

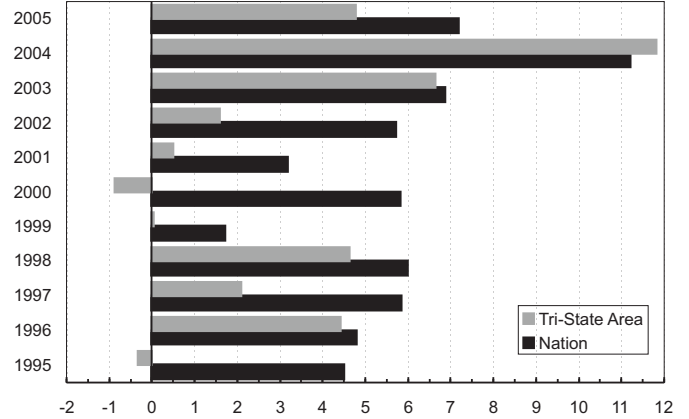
Large organizations continue to be strongly capitalized; equity-to-asset ratios were nearly unchanged between 2004 and 2005 (Figure 13).

In summary, while some measures of profitability decreased in 2005, net income growth continued to be strong. Loans, particularly real estate and business loans, experienced substantial growth in 2005, as did noninterest income, while nonperforming loans dropped. At the same time, both loan-loss reserves and loan-loss coverage decreased, suggesting that banks continue to believe in the overall health of their loan portfolios.

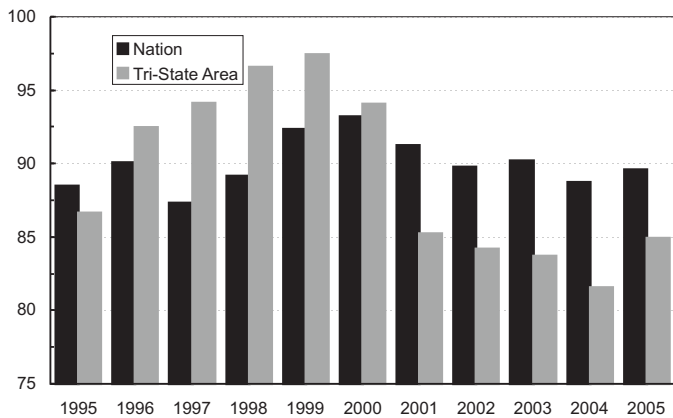
**Figure 10**  
Net Interest Margins for Large Organizations



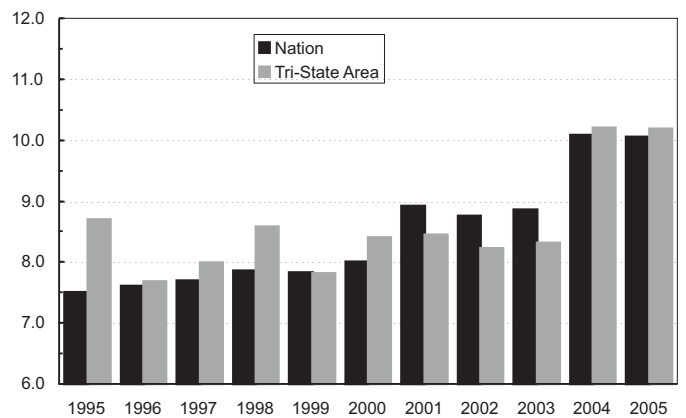
**Figure 11**  
Percentage Change in Deposits for Large Organizations



**Figure 12**  
Loans/Deposits for Large Organizations



**Figure 13**  
Equity/Assets for Large Organizations



Community banks were at least as profitable as the larger banks, but they also reported mixed results in 2005. ROA at both tri-state area banks and banks in the nation increased slightly (Figure 14). ROE at banks nationally also increased slightly, but at banks in the tri-state area it decreased somewhat (Figure 15). Actual net income increased for both sets of banks, by 10.4 percent for banks in the tri-state area and by 10.8 percent for banks nationally.

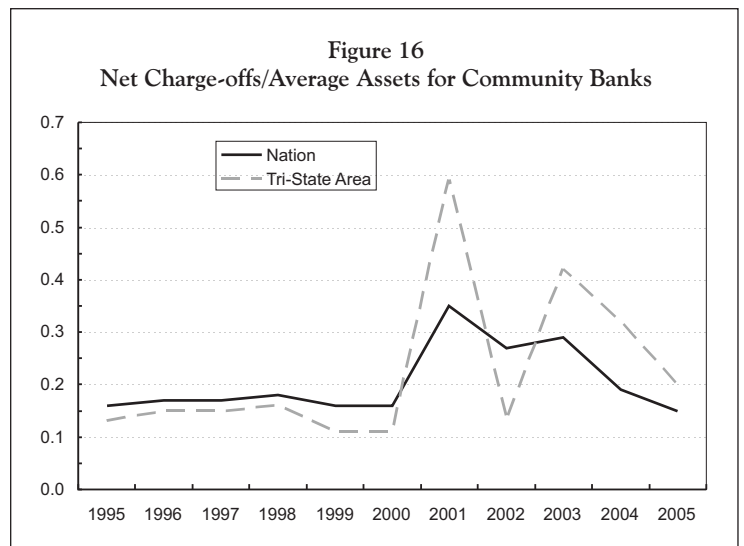
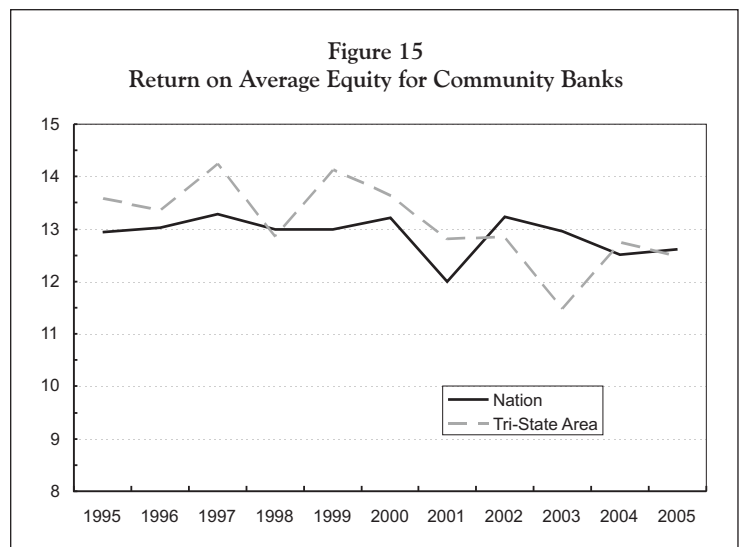
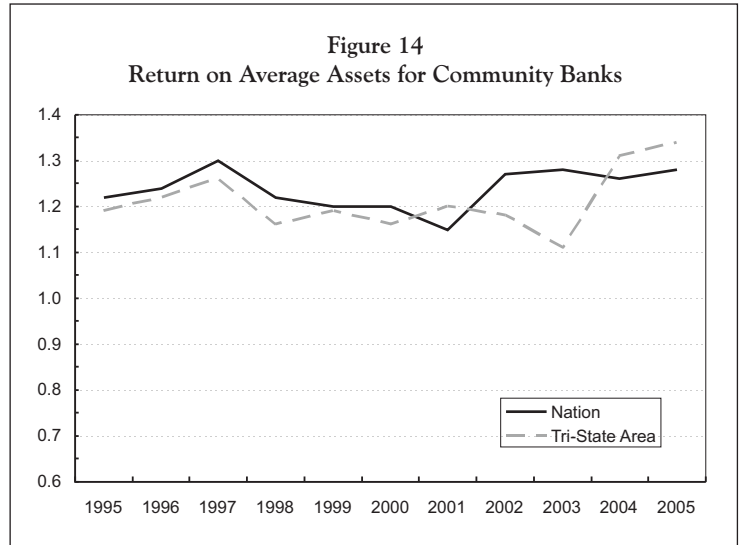
The main reason for the increased profitability of community banks was a substantial decrease in net charge-offs. The ratio of net charge-offs to average assets fell dramatically at tri-state area banks (Figure 16). There was also a decrease at banks in the nation as a whole, but it was not as large. Much of the difference in charge-off rates between community banks and the larger banks can be explained by credit card charge-offs. As mentioned above, one large organization charged off a large number of credit card and other consumer loans in anticipation of a merger, and other organizations charged off credit card loans because of bankruptcy filings. Community banks have basically abandoned the credit card business, so these problems don't affect them.

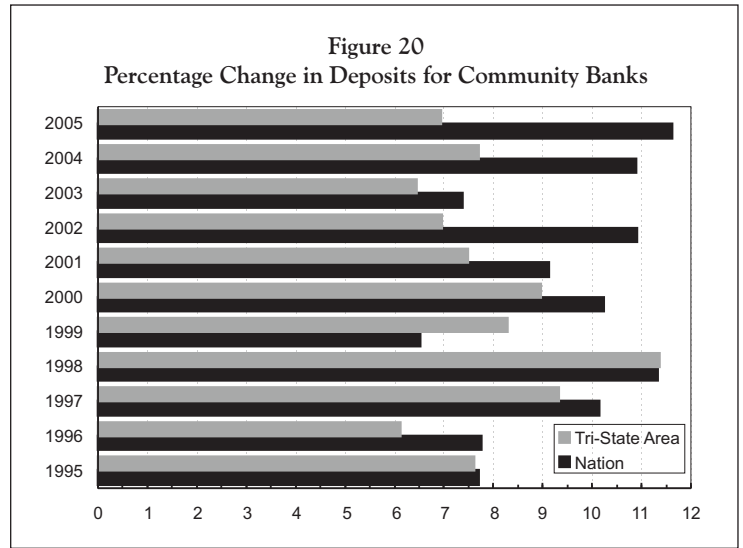
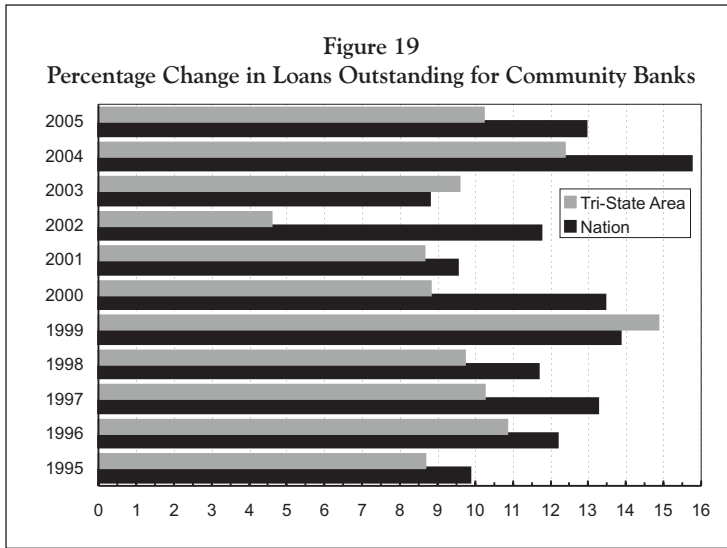
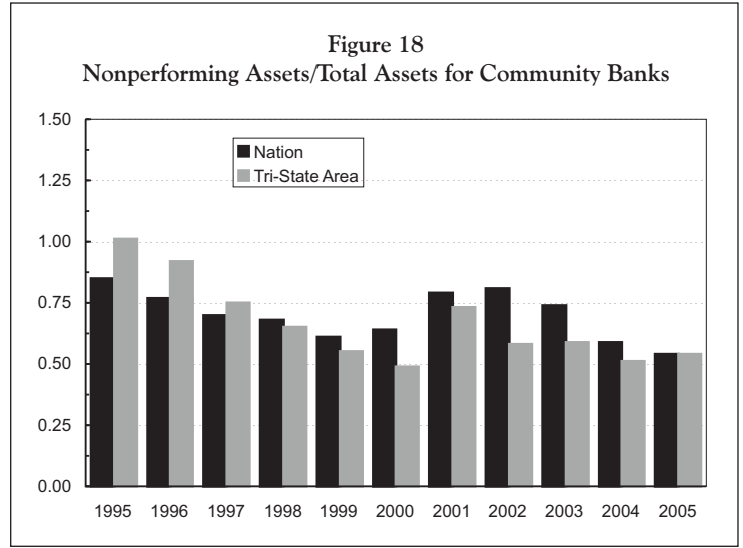
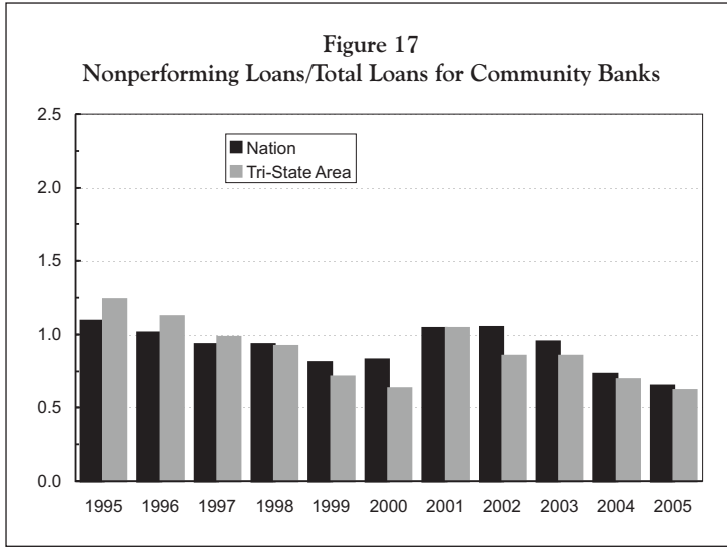
These decreases in net charge-offs were accomplished despite the fact that nonperforming loans didn't decrease substantially. The gross amount of nonperforming loans was nearly unchanged from 2004 at banks in the tri-state area, and it declined 5.0 percent at banks nationally. This is shown in the ratio of nonperforming loans to total loans (Figure 17). Also, the ratio of nonperforming assets to total assets remained the same (Figure 18).

Loan growth at community banks continued to outpace that of the large organizations. Loans outstanding increased 10.2 percent at community banks in the tri-state area and by nearly 13 percent at community banks nationally (Figure 19). At banks in the tri-state area, real estate loans grew 11.7 percent in 2005, commercial loans grew 20.1 percent, and consumer loans actually decreased 5.6 percent.<sup>10</sup> The corresponding numbers for banks nationally are an increase of 15.2 percent for real estate loans, an increase of 20.4 percent for commercial loans, and a drop of 1.7 percent for consumer loans. However, deposits at community banks are also growing faster than those of the larger banks (Figure 20).

Net interest margins also rose slightly last year (Figure 21). In the tri-state area, the net interest margin increased from 3.50 to 3.55 percent, while in the nation it increased from 3.79 to 3.82 percent. Community banks both locally and nationally were somewhat successful at controlling their overhead last year. The ratio of noninterest expense to average assets increased only slightly at tri-state area banks; for banks in the nation as a whole it was nearly flat (Figure 22).

<sup>10</sup> Real estate loans were 76.4 percent of total loans for community banks in the tri-state area, C&I loans were 11.7 percent, and consumer loans were 5.6 percent. For the nation as a whole, real estate loans were 72.0 percent of total loans, commercial loans were 10.0 percent, and consumer loans were 7.1 percent.





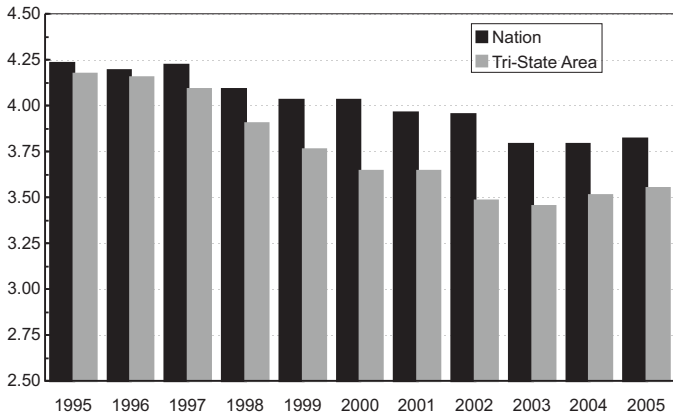
Fee income yielded mixed results for community banks. At tri-state area banks, the ratio of noninterest income to average assets rose only slightly, while it decreased by over 10 basis points nationally (Figure 23). Capital ratios also moved in different directions. The ratio of equity to assets increased at tri-state area banks; it was nearly flat at banks nationally (Figure 24).

The loan-loss coverage ratio decreased at tri-state area community banks and increased at those in the nation (Figure 25). It should be noted that the loan-loss coverage ratio at tri-state area banks is still substantially greater than that at banks nationally, and all community banks are better reserved than the large organizations. Given their falling charge-offs and nonperforming loans, as well as their high capital ratios, they may be able to reduce loan-loss provisions more, thus increasing their profits.

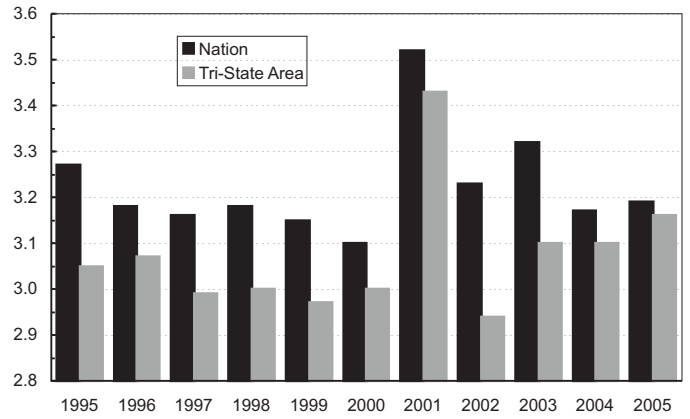
This could be important because loan-to-deposit ratios are very high now, so further loan growth may be hampered (Figure 26). Banks normally don't lend out all of their deposits, keeping some funds in either cash or short-term investments as a liquidity reserve. Because this reserve is necessary, especially at smaller banks that can't easily tap the markets for quick cash, high loan-to-deposit ratios make it difficult for them to make more loans.

In summary, community banks continued to perform strongly in 2005. Profits, capital, loan growth, and deposit growth remained strong, while charge-offs and nonperforming loans continued to drop. The only minor problems are that expenses at some institutions are beginning to creep up, and liquidity concerns may slow further increases in loans.

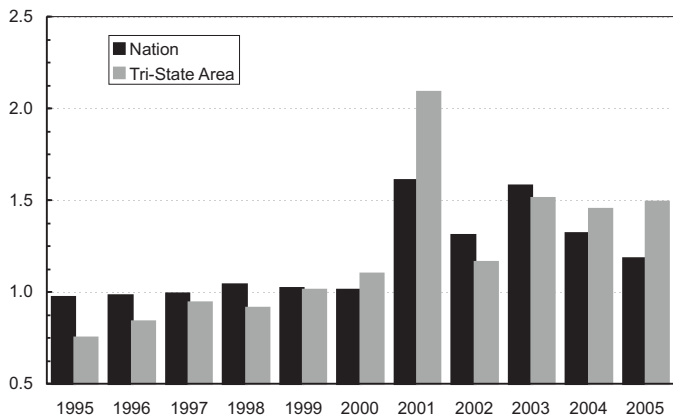
**Figure 21**  
Net Interest Margins for Community Banks



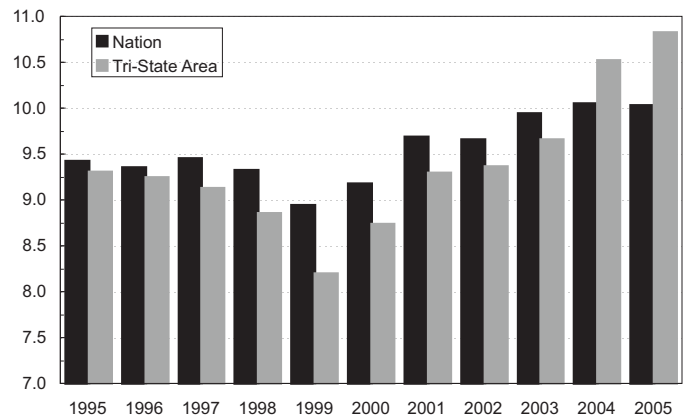
**Figure 22**  
Noninterest Expense/Average Assets for Community Banks



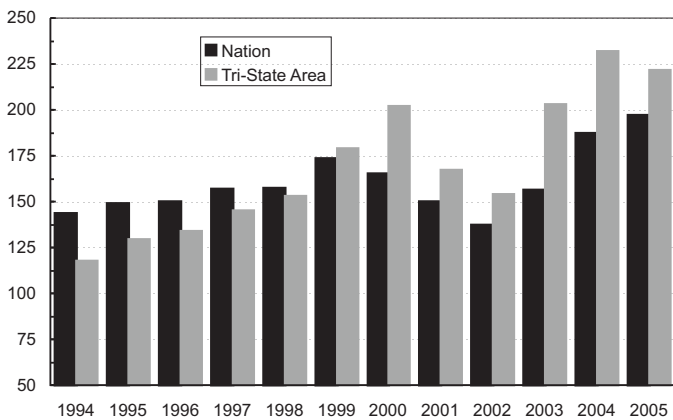
**Figure 23**  
Noninterest Income/Average Assets for Community Banks



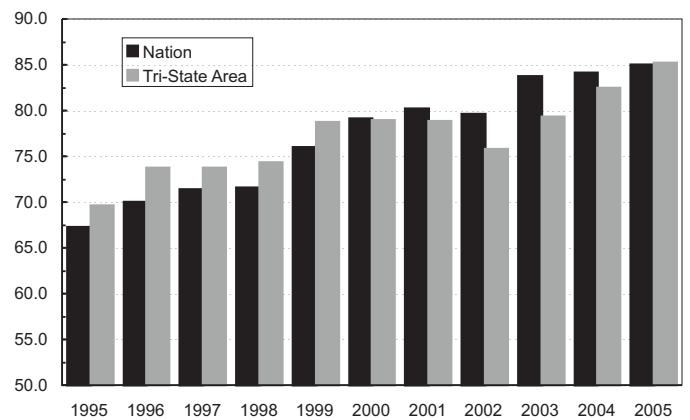
**Figure 24**  
Equity/Assets for Community Banks



**Figure 25**  
Loan-Loss Coverage Ratio for Community Banks



**Figure 26**  
Loans/Deposits for Community Banks



In each of 15 consecutive meetings the Federal Open Market Committee voted to raise the federal funds rate by 25 basis points. In June 2004, it stood at just 1 percent; by March 2006 it had risen to 4.75 percent. This is the largest and longest episode of monetary tightening in the U.S. since 1994, when the fed funds rate increased 300 basis points over the course of a year (see Figure 27). What has been the effect of this round of monetary tightening on bank lending? Is it somehow different from the previous round of tightening?

The idea that monetary policy influences economic activity by affecting the behavior of banks is sometimes referred to as the *bank lending channel*. According to this explanation, banks are limited in their ability to increase lending by using their liquidity—the cash and other assets easily sold for cash that they can make available to borrowers. Their ability to do so is further constrained in times of rising interest rates because the cost of obtaining loanable funds by increasing deposits rises as investors shift their savings toward instruments (such as jumbo CDs) that pay higher returns.<sup>11</sup>

One piece of evidence that supports this theory is the tendency during periods of rising interest rates for bank lending to increase more rapidly among banks that are more liquid at the beginning of the year than those that are less liquid. Figures 28 and 29 illustrate the patterns for small and large banks, respectively, during the monetary tightening of 1994-95 and 2004-05.<sup>12</sup> For the earlier period, the evidence seems stronger, especially among small banks, which we might expect to have more difficulty raising funds quickly through means other than deposit taking. But the pattern is clearly reversed for small banks during the most recent episode of monetary tightening—the banks with less liquid balance sheets appear to be increasing their lending the most. For large banks, the evidence is mixed, but less so in 2004-05 than during the 1990s' episode.

Has the bank lending channel of monetary policy broken down as these figures might suggest? The answer is probably no. While the significance of this particular channel of monetary policy is probably not very large, more careful analysis suggests that it remains about as important today as it was in the 1990s. What has changed is the way some banks—large and small—manage their balance sheets. For example, today many banks originate mortgages for residential properties and quickly sell those loans on secondary markets. Other banks regularly sell *asset-backed securities*, debt whose principal and interest payments are derived from the loan payments of some of the banks' customers. Both techniques permit banks to engage in more lending

<sup>11</sup> For a more detailed discussion of the theory, and some statistical tests of the theory, see the article by Anil Kashyap and Jeremy Stein.

<sup>12</sup> Following Kashyap and Stein, we measure liquidity as the ratio of the sum of a bank's holdings of securities, sales of federal funds, and repurchase agreements, divided by total assets. To ensure that the results are representative, we exclude banks with very large changes in loans (increases or decreases exceeding 50 percent in a year) or extreme values of liquidity (less than 5 percent or greater than 75 percent).

Figure 27  
Effective Federal Funds Rate

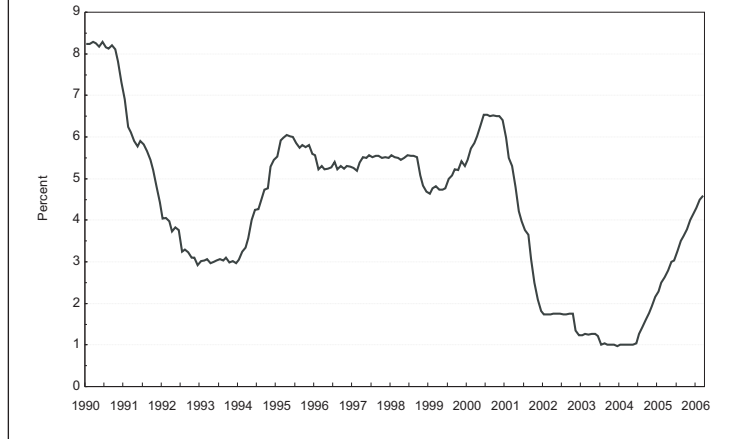


Figure 28  
Small Bank Loan Growth Rates by Liquidity Ranking

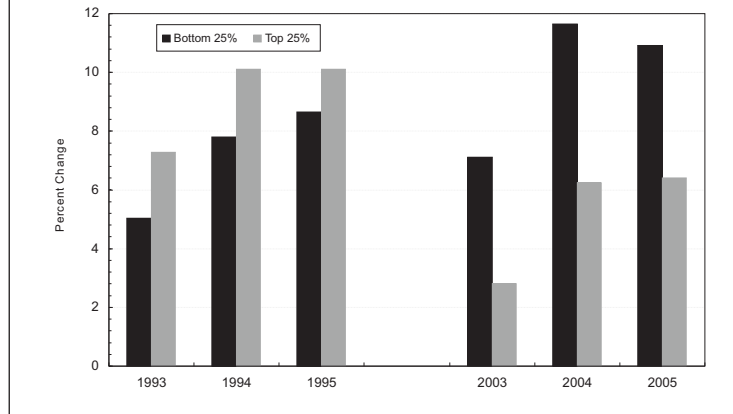
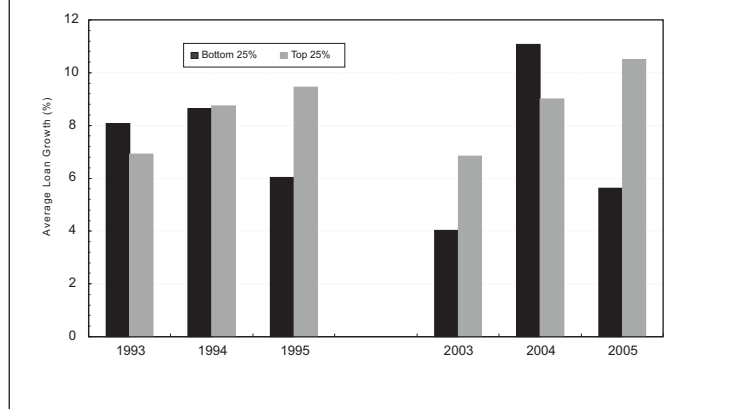


Figure 29  
Large Bank Loan Growth Rates by Liquidity Ranking





and to better respond to changes in demand for loans, for a given amount of liquid assets on hand.

The significance of these innovations complicates a simple analysis of lending behavior that looks across many banks at any particular point in time. While figures 28 and 29 attempt to identify the effect of differences in liquidity across banks at a point in time, our intuition may be confounded by differences in the strategies of banks. This may explain why banks that appear less liquid are quite successful in making more loans than some of their competitors.

Suppose instead that we investigate how a given bank's lending depends on its own liquidity over time and then average those affects across all banks. By focusing first on the individual bank, we are taking into account its strategy for managing its balance sheet.<sup>13</sup> Using this approach, the effects of bank liquidity appear to be stable, albeit relatively small.

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<sup>13</sup> In technical parlance, we are estimating a fixed-effect regression rather than a pure cross-section regression, which is analogous to what we observe in figures 28 and 29. For details, contact the author.

## *Mergers and Acquisitions*

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Merger activity continued to grow in 2005, both nationally and locally. There were several transactions involving large banking organizations, and the number of transactions involving smaller banking organizations increased as well. The notable interstate transactions included the merger of Bank of America Corporation (Charlotte, NC) and MBNA Corporation (Wilmington, DE); and PNC Financial Services Corporation (Pittsburgh, PA) merging with Riggs National Corporation (Washington, DC). Also, Fulton Financial Corporation (Lancaster, PA) acquired First Washington Financial Corp (Windsor, NJ) and SVB Financial Services, Inc. (Somerville, NJ); and Commerce Bancorp, Inc. (Cherry Hill, NJ) acquired Palm Beach County Bank (West Palm Beach, FL). Two large interstate mergers have occurred already in 2006: Fulton Financial Corporation (Lancaster, PA) merged with Columbia Bancorp, Inc. (Columbia, MD); and TD Banknorth, Inc. (Portland, ME) acquired Hudson United Bancorp, Inc. (Mahwah, NJ). TD Banknorth is a subsidiary of Toronto-Dominion Bank in Toronto, Canada.

Several deals were announced in 2005 but have not yet been completed: Sovereign Bancorp, Inc. (Wyomissing, PA) is merging with Independence Community Bank Corp. (New York, NY); Susquehanna Bancshares, Inc. (Lititz, PA) is acquiring Minotola National Bank (Vineland, NJ), and Citizens and Northern Corporation (Wellsboro, PA) is merging with Canisteo Valley Corporation (Canisteo, NY).

Among the notable transactions in Pennsylvania: Sovereign Bancorp, Inc. (Philadelphia) merged with Waypoint Financial Corporation (Harrisburg); F.N.B. Corporation (Hermitage) acquired NSD

Looking first at small banks, an increase in the liquidity ratio of one percentage point in the beginning of the year is associated with a 21-basis-point increase in the volume of bank lending. Is the effect any larger during periods of monetary tightening? The answer is yes, but only slightly so. For small banks, during a period of rising rates, such as we experienced in 2004-05, a one-percentage-point increase in the liquidity ratio is associated with only a 26-basis-point increase in bank lending. Among large banks, the effect of a one-percentage-point increase in liquidity is associated with a 39-basis-point increase in bank lending. During a period of monetary tightening, the effect is slightly larger, about 47 basis points.

In conclusion, a bank's liquidity is certainly one among many important factors that explain the subsequent growth rate in its lending. During periods of rising interest rates, the effects of bank liquidity on subsequent rates of loan growth are indeed larger, for both small and large banks, but not dramatically so. There does appear to be evidence of a bank lending channel, although the effect is relatively small, and it can only be observed after taking into account differences in banks' strategies for managing their balance sheets.

Bancorp, Inc. (Pittsburgh) and North East Bancorp, Inc. (North East); KNBT Bancorp, Inc. (Bethlehem) merged with Northeast Pennsylvania Financial Corporation. (Hazleton); Willow Grove Bank (Wayne) merged with First Financial Bank (Downingtown); Community Banks, Inc. (Harrisburg) merged with PennRock Financial Services Corporation (Blue Bell); Beneficial Mutual Savings Bank (Philadelphia) merged with Northwood Savings Bank (Philadelphia); and ESB Financial Corporation (Ellwood City) merged with PHSB Financial Corporation (Beaver Falls).

There are also several pending intrastate mergers and acquisitions in Pennsylvania. National Penn Bancshares, Inc. (Boyertown) is acquiring Nittany Bank (State College); Orrstown Financial Services, Inc. (Shippensburg) is acquiring The First National Bank of Newport (Newport); and Tower Bancorp, Inc. (Greencastle) is merging with FNB Financial Corporation (McConnellsburg).

There were a number of intrastate mergers in New Jersey in 2005. Valley National Bancorp (Wayne) merged with Shrewsbury Bancorp, Inc. (Shrewsbury) and acquired NorCrown Bank (Livingston); Central Jersey Bancorp (Long Branch) acquired Allaire Community Bank (Wall Township); Interchange Financial Services Corporation (Saddle Brook) acquired Franklin Bank (Nutley); and Greater Community Bancorp, Inc. (Totowa) acquired Rock Community Bank (Little Falls) and Bergen Commercial Bank (Paramus). One intrastate merger has been completed in 2006: Sun Bancorp, Inc. (Vineland) acquired Advantage Bank (Branchburg).

There was only one significant piece of legislation enacted by Third District states in 2005: New Jersey's Identity Theft Prevention Act. The law permits consumers to place security freezes on their credit reports to prevent unauthorized persons from obtaining credit or loans in the consumers' names. A consumer can request a security freeze by contacting any credit reporting agency (CRA), and within five business days of receiving the request, the CRA must comply.

CRA's must develop procedures for accepting requests for temporary lifts, with the goal of processing them within 15 minutes of their receipt. A CRA may permanently remove a security freeze from a consumer's file if the consumer requests it or if the CRA determines that the freeze was placed on the account due to a material misrepresentation of fact by the consumer. In the latter case, a CRA must alert the consumer that the freeze will be removed at least five days prior to the removal's taking effect.

Credit freezes do not apply in situations where a consumer has an existing account with a creditor and a copy of the consumer's credit report is requested by the creditor, one of its agents, or affiliates for

purposes of reviewing the consumer's account or investigating fraud. In addition, the freeze does not apply to law enforcement agencies, child support enforcement agencies, credit monitoring services to which the consumer subscribes, and to entities attempting to provide a copy of the consumer's credit report to the consumer at the consumer's request.

The law also includes two other identity theft prevention measures. First, New Jersey businesses that maintain records of their customers' personal identifying information must alert customers if their security has been breached and unauthorized persons may have gained access to a consumer's information. Next, businesses must take precautions with consumers' Social Security numbers, including not displaying more than three consecutive digits of a person's number, not printing the number on materials that are mailed to the consumer, and not requiring the Social Security number to be used to access the company's website, unless a PIN or password is also required.

## Reference

Kashyap, Anil K., and Jeremy C. Stein. "What Do a Million Observations on Banks Say About the Transmission of Monetary Policy?" *American Economic Review*, 90, 3 (June 2000), pp. 407-28.

### Appendix — 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 100<sup>th</sup> largest bank holding company in the nation at the beginning of that year, ranked by total

assets. Thus the banks in the 2005 sample are selected based on their year-end 2004 total assets, updated for mergers that occurred in 2005. 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. Any questions or comments should be directed to Jim DiSalvo at (215) 574-3820 or [jim.disalvo@phil.frb.org](mailto: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](http://www.philadelphiafed.org/econ/bb/index.html). To subscribe to this publication, please go to [www.philadelphiafed.org/econ/respubs/index.html](http://www.philadelphiafed.org/econ/respubs/index.html).



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