Banking Brief

For Pennsylvania, New Jersey, and Delaware

Third Quarter Highlights

(1) Profitability continued to improve in the third quarter at both large banking organizations and community banks.

(2) Year over year, assets of large organizations grew at 4.5 percent, similar to the previous quarter. At community banks in the nation and the tri-state, growth in assets stabilized at around 2 percent and 3 percent, respectively.

(3) Year-over-year loan growth was mixed:

- Loans at large organizations grew at 0.55 percent, mainly driven by C&I lending.
- Loan growth continued to contract at community banks in the nation.
- Loan growth declined to nearly zero at community banks in the tri-state region.

(4) Loan quality continued to improve for both large and small banks from a year ago:

- Ratios for both nonperforming loans and nonperforming assets continued to decline.
- The loan loss coverage ratio increased.
- The loan loss provision to operating income ratio declined.
- The total amount of nonperforming loans, net charge-offs, and loan loss provisions declined.

Research Department Federal Reserve Bank of Philadelphia
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Summary Table of Bank Structure and Conditions – Third Quarter 2011

Community Banking Organizations

	Tri-State			*Nation*		
	$ Bill	**% Change From**		**$ Bill**	**% Change From**	
	11Q3	**11Q2**	**10Q3**	**11Q3**	**11Q2**	**10Q3**
Total Assets	100.2	3.02	5.47	1,880.5	2.10	8.21
Total Loans	66.1	4.38	0.13	1,180.3	0.63	-2.38
C&I	9.0	8.75	2.25	177.9	-0.35	0.39
Real Estate	52.1	0.54	-0.92	884.5	-0.42	-3.01
Consumer	2.5	2.29	-5.26	52.3	-1.84	-6.53
Total Deposits	83.6	9.77	4.10	1,556.2	5.14	2.56
Ratios (in %)	**11Q3**	**11Q2**	**10Q3**	**11Q3**	**11Q2**	**10Q3**
Net Income/Avg Assets (ROA)	0.58	0.48	0.23	0.45	0.36	0.04
Net Interest Inc/Avg Assets (NIM)	3.33	3.33	3.33	3.46	3.45	3.41
Noninterest Inc/Avg Assets	1.15	1.20	1.20	0.92	0.92	0.90
Noninterest Exp/Avg Assets	3.14	3.17	3.37	3.10	3.10	3.10
Loans/Deposits	79.11	80.12	82.25	75.84	76.68	79.68
Equity/Assets	10.29	10.16	9.99	10.72	10.55	10.30
Nonperforming Loans/Total Loans	3.00	3.08	3.16	3.41	3.55	3.81

Large Banking Organizations

	Tri-State			*Nation*		
	$ Bill	**% Change From**		**$ Bill**	**% Change From**	
	11Q3	**11Q2**	**10Q3**	**11Q3**	**11Q2**	**10Q3**
Total Assets	632.4	10.65	5.62	9,854.0	7.02	4.52
Total Loans	326.8	6.05	3.63	4,758.7	1.15	0.55
C&I	67.2	18.25	11.59	973.2	18.08	11.93
Real Estate	182.1	2.28	-1.91	2,520.7	-1.21	-4.24
Consumer	44.1	3.21	7.33	692.2	-3.46	-4.53
Total Deposits	474.9	16.67	9.75	7,067.0	10.91	9.53
Ratios (in %)	**11Q3**	**11Q2**	**10Q3**	**11Q3**	**11Q2**	**10Q3**
Net Income/Avg Assets (ROA)	0.83	0.83	0.65	0.81	0.72	0.55
Net Interest Inc/Avg Assets (NIM)	2.94	2.99	3.14	2.71	2.78	2.89
Noninterest Inc/Avg Assets	1.74	1.76	1.87	1.91	1.88	1.92
Noninterest Exp/Avg Assets	3.03	2.98	2.97	2.98	2.97	2.86
Loans/Deposits	68.80	70.46	72.87	67.34	68.90	73.35
Equity/Assets	11.88	11.99	12.07	11.01	11.02	11.10
Nonperforming Loans/Total Loans	4.70	4.80	5.56	4.69	4.85	5.79

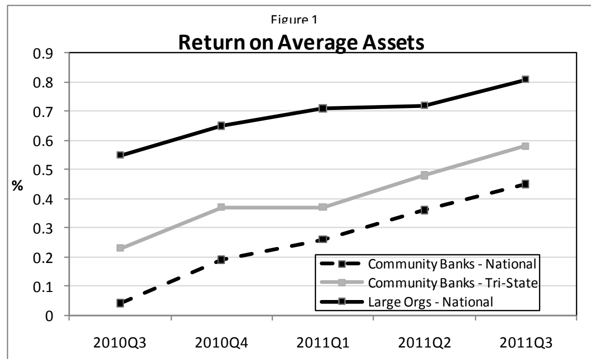
A banking organization is an independent bank or all the banks within a highest-level bank holding company; however, banks less than five years old and special purpose banks such as credit card banks are excluded. The large banking organization sample is based on banking organizations whose total assets were at least as large as those of the 100th largest banking organization in the United States as of December 31, 2010. The community banking organization sample is based on the remaining banking organizations. Tri-state large banking organizations are the balance-sheet or income statement items of large banking organizations that have deposits in the region weighted by the percentage 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 — 185 for the tri-state area and 5,536 for the nation; (2) large banking organizations — 25 for the tri-state area and 99 for the nation. Ratios are aggregates; that is, the numerators and denominators are summed across all banks in the group, and then divided. Data are adjusted for mergers. Quarterly percentage changes are compound annualized rates.

In quarter three 2011, a consolidation of banking charters within Citigroup brought a credit card lending division onto the balance sheet of Citibank, one of the large banking organizations. We report pro-forma numbers for Citibank that adjust for this accounting change. Therefore the numbers for large banks for previous quarters may differ from those reported in previous *Banking Brief* reports.

Any questions or comments should be directed to Neeraj Goyal at (215) 574-3874 or by e-mail at neeraj.goyal@phil.frb.org. Detailed documentation on the methodology used in constructing this document, prior issues, and the current issue of *Banking Brief* are available on our website at www.philadelphiafed.org/research-and-data/publications/banking-brief. To subscribe to this publication, please go to www.philadelphiafed.org/philscriber/user/dsp_content.cfm.

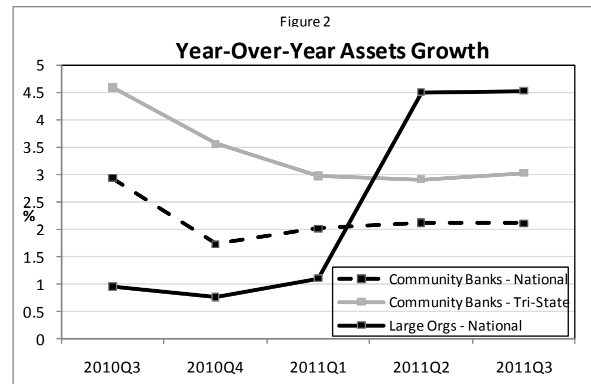
Return on Average Assets

In the third quarter of 2011, return on average assets (ROAA) continued to increase across the banking industry from previous quarters (Figure 1).[1] Profitability at the nation's largest banking organizations improved from the previous year by 26 basis points, to 0.81 percent.[2] Large organizations have continued to outperform community banks over the past five quarters.[3] In the nation, community banks saw a 41-basis-point rise in ROAA over the year, to 0.45 percent. Similarly, community banks in the tri-state region of Pennsylvania, New Jersey, and Delaware saw a 35-basis-point rise in profitability to 0.58 percent.



Asset Growth

Assets at large organizations nationwide continued to grow in the third quarter of 2011, as year-over-year asset growth rose to 4.52 percent (Figure 2). This was stronger than the asset growth observed at community banks both in the nation and in the tri-state area. For the past three quarters, asset growth has stagnated at around 3 percent at tri-state community banks and around 2 percent at community banks in the nation. The accelerated growth of assets at large organizations appears to be driven by expansion in domestic commercial and industrial (C&I) lending, as described in subsequent sections.



Loan Growth

Large organizations continued to see a different trend in loan growth relative to community banks in the third quarter of 2011 (Figure 3). Large organizations' lending activities expanded, albeit slowly, by 0.55 percent from a year ago. Moreover, the growth came after four quarters of negative or zero loan growth at large organizations and appears to be driven by expansion in domestic C&I loans (see Figure 12 below). In the nation, community banks saw their total outstanding loans shrink by 2.38 percent from the third quarter of 2010, and community banks in the tri-state region saw their year-over-year total outstanding loans increase a mere 0.13 percent. Over the past year, loan growth at tri-state community banks exceeded that at both community banks and large banking organizations in the nation. However, the rate of loan growth at tri-state community banks has been decreasing.

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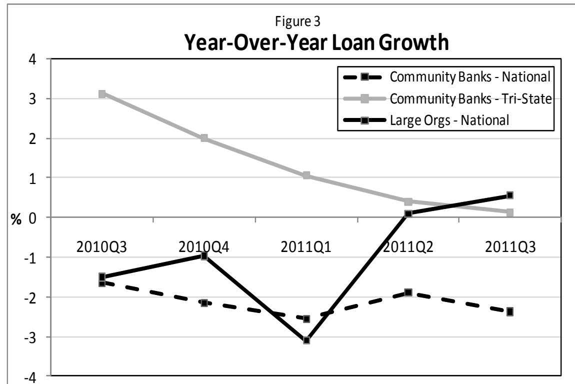
[1] Return on average assets is the ratio of net income to the average of beginning-of-year and year-end balances of total assets. It measures the profitability of a firm.

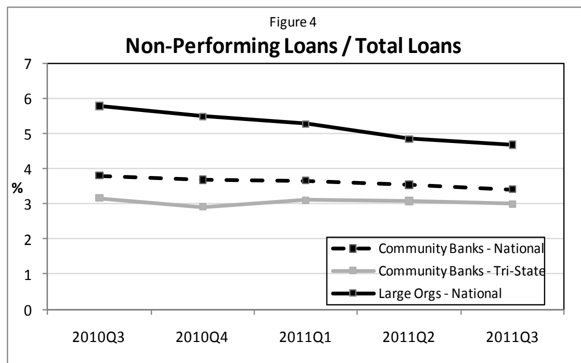
[2] Large banking organizations are defined as the top 100 banking organizations by total assets.

[3] Community banks are defined as all banking organizations with total asset values lower than those of the top 100 banking organizations.



Nonperforming Loans to Total Loans

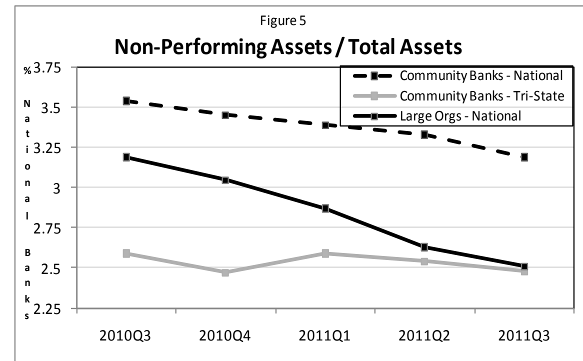
Nonperforming loan ratios continued to decrease across all bank types (Figure 4). Large organizations saw a decline of 110 basis points, from 5.79 percent in the third quarter of 2010 to 4.69 percent this past quarter; they also saw the NPL ratio drop by 16 basis points over the past quarter. Similarly, community banks in the nation saw a steady decline of 40 basis points over the past year, from 3.81 percent to 3.41 percent. Tri-state area community banks saw a 16-basis-point decline, to 3 percent, over the past year.



Nonperforming Assets to Total Assets

In the third quarter of 2011, all banks saw an improvement in the nonperforming assets ratio from a year ago (Figure 5).[4] The ratio dropped to 2.51 percent for large organizations nationwide, an improvement of 68 basis points from the third quarter of 2010. Community banks nationwide saw the next largest improvement of 35 basis points from 3.54 percent to 3.19 percent over the year, and community banks in the tri-state region saw the most modest improvement, 9 basis points, to 2.48 percent over the same period.

Large organizations have a lower nonperforming assets (NPA) ratio than community banks in the nation, reversing the ranking reflected in NPL ratios (see Figure 4). This is due to the inclusion of nonperforming other real estate owned (OREO) in the NPA calculation. At community banks, nonperforming OREO increased 2.81 percent nationally and 15.16 percent locally from a year ago. At large organizations, on the other hand, nonperforming OREO dropped by 10.41 percent, further driving down the NPA ratio, along with the decrease in the NPL ratio.



Quarterly Net Charge-Offs to Average Loans

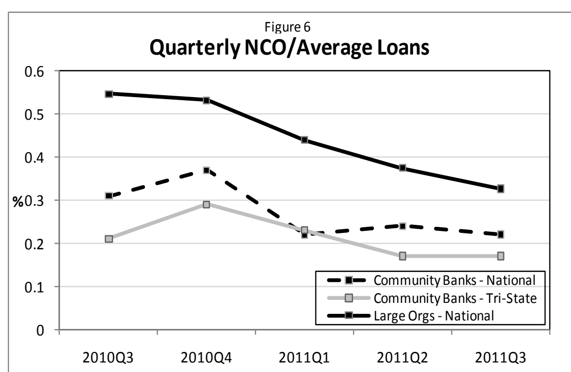
Compared with the third quarter of 2010, the net charge-offs ratio dropped at all types of banking institutions (Figure 6).[5] Large banks experienced a 22-basis-point decline (from 0.55

[4] Nonperforming assets comprise nonperforming loans and other real estate owned (OREO). Other real estate owned includes properties owned or controlled by a bank or its subsidiaries, even if the bank has yet to receive title to the property. This also includes foreclosed real estate, direct and indirect investments in real estate ventures, and properties originally acquired for expansion but no longer intended to be used for that purpose. The nonperforming assets to total assets ratio compares foreclosed properties and the proportion of loans that are at risk of default to total assets.

[5] The net charge-offs ratio is the percentage of average loans that incurred a loss over total loans and leases.

percent a year ago to 0.33 percent in the third quarter of 2011). Community banks in the nation saw a 9-basis-point decline to 0.22 percent, and local community banks saw a 4-basis-point decline, to 0.17 percent, over the same period.

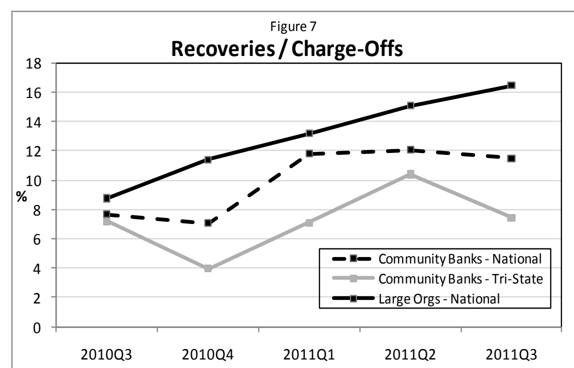
The net charge-offs ratio has steadily declined at large banking organizations since the fourth quarter of 2010. In comparison, community banks have had more variation in this ratio, and although the charge-off ratio has declined since last year, it seems to have stabilized in recent quarters.



Recoveries to Charge-offs

The recovery ratio, the ratio of recoveries to charge-offs, improved for all types of banking organizations over the past year (Figure 7). Large organizations nationwide saw a 7.69-percentage-point improvement in the ratio, to 16.46 percent, in the third quarter of 2011. However, tri-state community banks saw a modest increase of 27 basis points in the ratio, to 7.44 percent in the third quarter of 2011. Nationally, community banks saw a 3.83-percentage-point increase, to 11.49 percent, from a year ago.

Over the previous quarter, the recovery ratio declined for community banks. This decline was most pronounced at tri-state community banks, where growth in charge-offs outpaced the increase in recoveries, causing the ratio to fall by 2.95 percentage points, to 7.44 percent, in the third quarter of 2011. Nationwide, community banks saw a smaller decline of 59 basis points, to 11.49 percent. Large organizations were the only type of institutions to see an increase; recovery ratios at large banking organizations rose to 16.46 percent over the past quarter, an improvement of 1.36 percentage points.



Residential Real Estate Loans

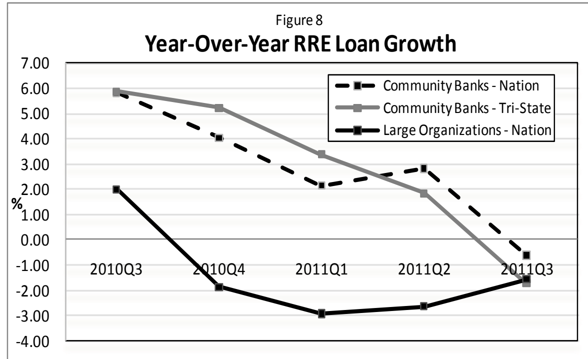
Year-Over-Year Residential Real Estate Loan Growth

Year over year, residential real estate (RRE) lending contracted at all types of banking organizations in the third quarter of 2011. RRE loans at large organizations in the nation declined 1.58 percent from a year ago, marking the fourth consecutive quarter of decrease (Figure 8). The main drivers appear to be contractions in home equity lines of credit and second mortgages. [6] RRE loans comprised roughly 35 percent of all loans at large organizations in the third quarter of 2011.

RRE loan growth has been decelerating at community banks, which saw the first decline in more than a year. Loan growth at community banks in the nation dropped from 5.8 percent a year ago to -0.63 percent in the third quarter of 2011. Similarly, community banks in the tri-

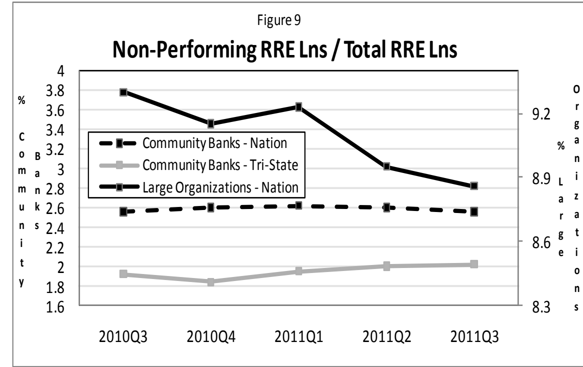
[6] Here, home equity line of credit refers to the revolving open-end loans as defined in call reports. Similarly, second mortgage refers to junior lien closed-end loans secured by one- to four-family residential properties as in call reports.

state region saw their RRE loan portfolios shrink by 1.74 percent from the third quarter of 2010, when they recorded year-over-year growth of 5.85 percent.



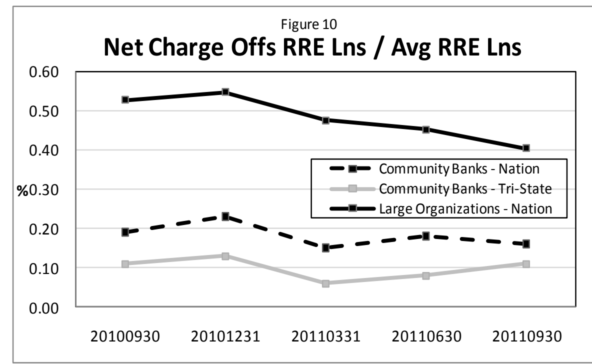
Nonperforming Residential Real Estate Loans/Total Residential Real Estate Loans

Along with the decline in RRE lending, RRE loan quality continued to improve from the third quarter of 2010 (Figure 9). The ratio of nonperforming RRE loans to total RRE loans declined 44 basis points for large organizations, from 9.3 percent in the third quarter of 2010 to 8.86 percent in the third quarter of 2011. Over the third quarter of 2011 these institutions saw a 9-basis-point decline, from 8.95 percent to 8.86 percent. Despite the improvement, nonperforming RRE loan ratios at large banks remained at a higher level than those at community banks, which saw little change in the RRE NPL ratio over the year. In the third quarter of 2011, RRE NPL ratios at community banks in the nation and tri-state community banks were 2.56 percent and 2.02 percent, respectively.



Residential Real Estate Loan Net Charge-Offs/Average Real Estate Loans

Consistent with the improvement in the RRE NPL ratio, the RRE net charge-offs ratio at large banks fell 13 basis points over the past year, settling at 0.4 percent in the third quarter of 2011 (Figure 10). The change in this measure for community banks nationally and locally was more subtle. The ratio fell 3 basis points over the year, to 0.16 percent, for community banks nationally in the third quarter of 2011. This ratio at tri-state community banks stayed at 0.11 percent over the past year. Overall, the downward trend in the net charge-offs ratio is more evident for large organizations than for community banks.

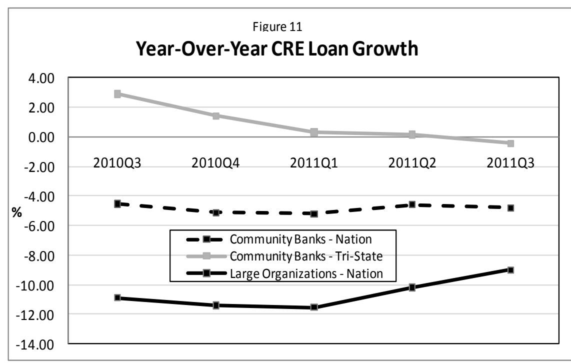


Commercial Real Estate Loans

Year-Over-Year Commercial Real Estate Loan Growth

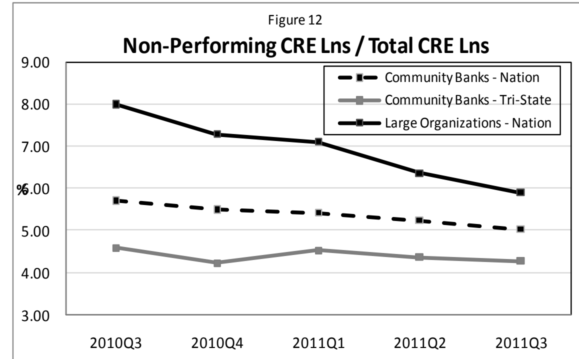
Year-over-year, commercial real estate (CRE) lending declined at all types of banking organizations in the third quarter of 2011[7] (see Figure 11). Large organizations saw the growth of CRE lending shrink by 9.02 percent from a year ago, a much larger drop than the declines at community banks.

Community banks in the tri-state region saw negative loan growth for the first time in the third quarter of 2011 as year-over-year CRE lending shrunk 0.43 percent. Nationally, community banks did not see much change and continued to have negative CRE loan growth (-4.81 percent).



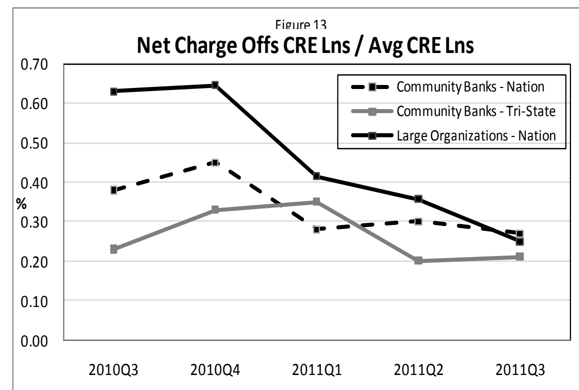
Nonperforming Commercial Real Estate Loans/Total Commercial Real Estate Loans

CRE NPL ratios continued to fall at all types of banking organizations in the third quarter of 2011 (Figure 12). For large organizations, this ratio dropped by 210 basis points, from 8 percent in the third quarter of 2010 to 5.9 percent in the third quarter of 2011. Similarly, community banks in the nation saw a 69-basis-point decline, from 5.71 percent a year ago to 5.02 percent in the third quarter of 2011. Finally, tri-state community banks had a relatively modest improvement of 31 basis points in their CRE NPL ratios, but the measure's current level (4.27 percent) is the lowest among all three types of organizations.



Commercial Real Estate Loan Net Charge-Offs/Average Commercial Real Estate Loans

The CRE net charge-offs ratio continued to decline over the year across the banking industry, suggesting improvement in CRE loan quality (Figure 13). The drop was most noticeable for large banking organizations, where this measure fell 38 basis points over the year to 0.25 percent. For community banks, the change over the year was more modest. Nationwide, community banks observed an 11-basis-point decline in the ratio to 0.27 percent, while tri-state area banks did not experience a significant improvement.



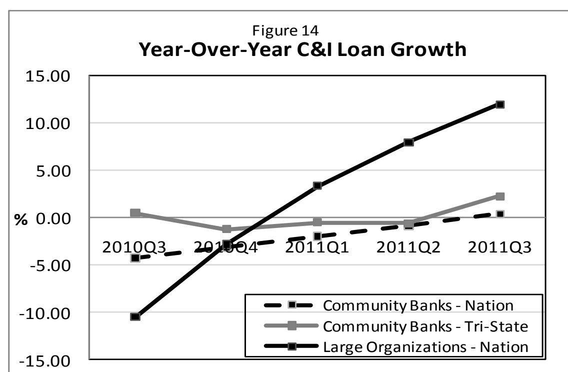
[7] CRE loans comprised about 16.5 percent of all loans made by large organizations in the past quarter.

Commercial & Industrial Loans

Year-Over-Year Commercial & Industrial Loan Growth

Commercial and industrial (C&I) lending at large organizations continued its rally in the third quarter of 2011, growing 11.93 percent from a year ago (Figure 14). This is the highest year-over-year growth in C&I lending at large banks in the previous five quarters. In the third quarter of 2011, C&I loans comprised slightly over 20 percent of all loans made by large organizations.

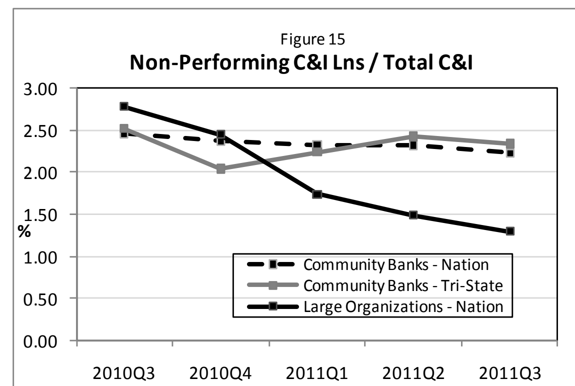
Community banks had their first quarter of positive C&I loan growth since a year ago. The magnitude of the growth, however, appears to be marginal compared with that at large organizations.



Nonperforming C&I Loans/Total C&I Loans

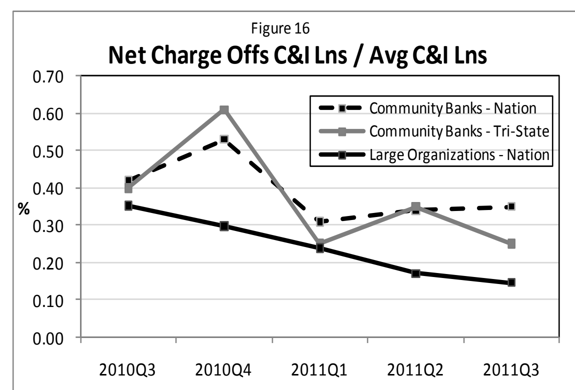
The C&I NPL ratio continued to decline at all three types of banking organizations in the third quarter (Figure 15). Large banks saw a 20-basis-point decline over the quarter to 1.29 percent, which was part of a larger decline of 151 basis points over the year. This decline was driven by a sharp drop in nonaccrual loans made to non-U.S. institutions and was first observed in the first quarter of 2011. Since then, nonaccrual loans to non-U.S. institutions have consistently declined. Nonaccrual domestic loans have also contributed to the decline in the C&I NPL ratio over the past five quarters.

However, no similar improvement occurred in community banks. Both nationally and in the tri-state area, community banks saw modest changes over the year and had higher C&I NPL ratios than large organizations.



C&I Loan Net Charge-Offs/Average C&I Loans

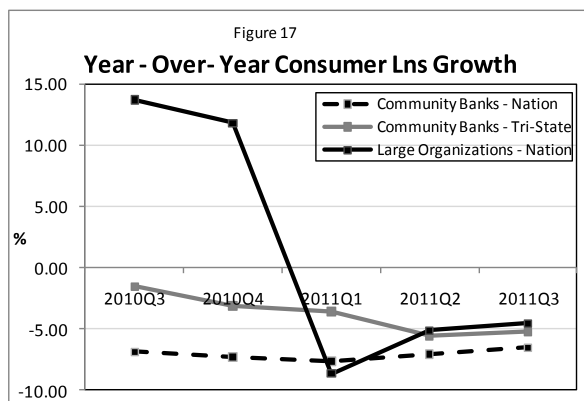
All types of banking organizations observed a decline in their C&I net charge-offs ratios over the year (Figure 16). Large organizations saw a 20-basis-point decline over the past year, to 0.15 percent in the third quarter of 2011. Tri-state community banks saw a 15-basis-point decline, to 0.25 percent, over the past year. Nationally, community banks have seen a 7-basis-point decline since the third quarter of 2010.



Consumer Loans

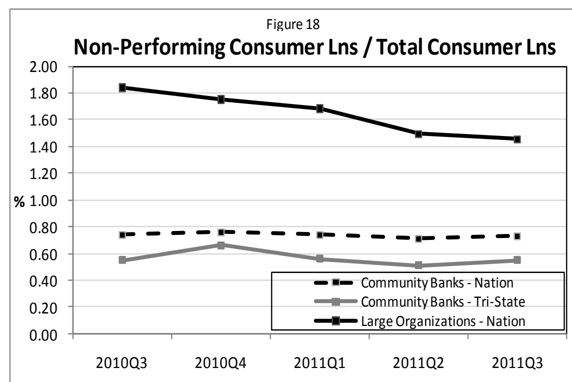
Year-Over-Year Consumer Loan Growth

Year-over-year growth in consumer loans was negative for all banking organizations in the third quarter of 2011 (Figure 17). [8] Large organizations saw a year-over-year decline of 4.54 percent in consumer lending.[9] Community banks saw continued contraction in consumer lending, with community banks in the nation faring worse than tri-state community banks.



Nonperforming Consumer Loans/Total Consumer Loans

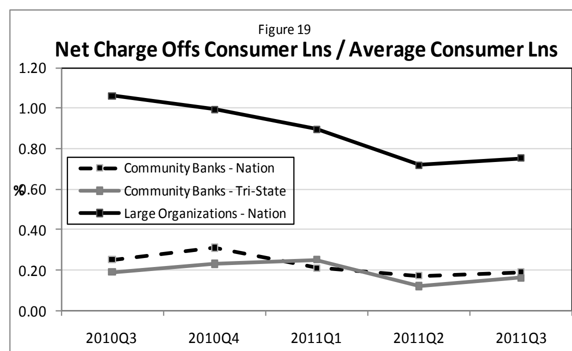
Large organizations saw a 38-basis-point decline in the nonperforming consumer loan ratio from the third quarter of 2010, to 1.46 percent, but this measure was largely unchanged for community banks in the nation and tri-state area (Figure 18). It is worth noting, however, that large organizations continued to have higher nonperforming loan ratios than community banks.



Consumer Loan Net Charge-offs/Average Consumer Loans

Large organizations saw a decline of 31 basis points to 0.75 percent in the NCO ratio for consumer loans in the third quarter (Figure 19). Community banks in the nation and the tri-state area did not observe such a change over the year, and the NCO ratio for both stayed near 0.20 percent.

It is worth noting that large organizations saw both charge-offs and recoveries increase for all types of consumer loans. However, the rise in charge-offs significantly outpaced the rise in recoveries.



[8] In the third quarter of 2011, a consolidation of banking charters within Citigroup brought a credit card lending division onto the balance sheet of Citibank, one of the large banking organizations. We report pro forma numbers for Citibank that adjust for this accounting change. Therefore, the numbers for large banks for previous quarters may differ from those reported in previous *Banking Brief* reports.

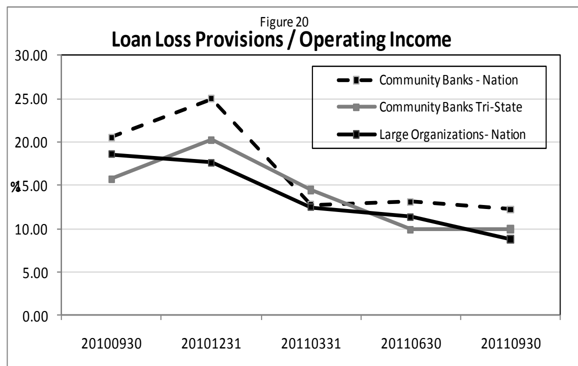
[9] The significant drop in loan growth in the first quarter of 2011 is mainly due to the pro forma adjustment on Citibank's consolidation of the credit card division, which experienced a significant increase in credit card loans in the first quarter of 2010, driving down the year-over-year growth number for the first quarter of 2011.

Loan Loss Provisions

Loan Loss Provision/Operating Income

The ratio of loan loss provisions to operating income was lower for all banks compared with the third quarter of 2010 (Figure 20). The drop was the largest for community banks in the nation, which saw a decline of 8.31 percentage points over the year, to 12.21 percent in the third quarter. Large organizations nationwide saw the next largest drop of 9.83 percentage points, to 8.75 percent in the third quarter of 2011, and tri-state community banks had a 5.79-percentage-point decline, to 9.92 percent, over the same period.

The decline in this ratio was mainly driven by a reduction in the loan loss provision amount set by all types of firms in the banking industry.[10] Along with the improving loan quality (see Figure 4) and the decreasing net charge-offs (see Figure 6), banks are provisioning less, suggesting that banks anticipate continuing improvement in loan quality.



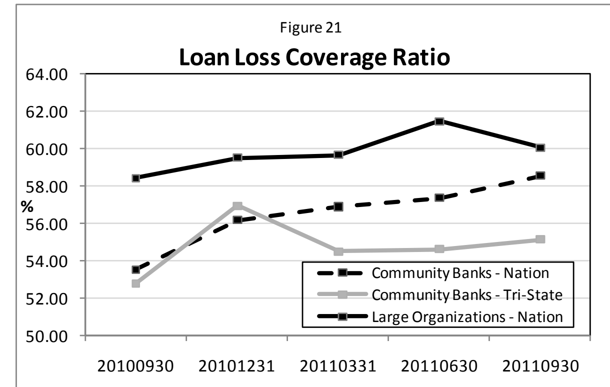
Loan Loss Coverage Ratio

Despite reduced provisioning, the loan loss coverage ratio has steadily increased since the third quarter of 2010 for large organizations and community banks in the nation and rose marginally at tri-state community banks (Figure 21).[11]

[10] The denominator for this ratio, operating income, stayed largely unchanged for community banks but rose for large organizations in the past quarter.

[11] The loan loss coverage ratio is the ratio of allowance for loan and lease losses to nonperforming loans.

NPL and allowance for loan and lease losses both dropped at all types of banks. For large organizations, the decline in NPL outpaced the decrease in the allowance for loan and lease losses, resulting in a 1.62-percentage-point rise from the previous year.



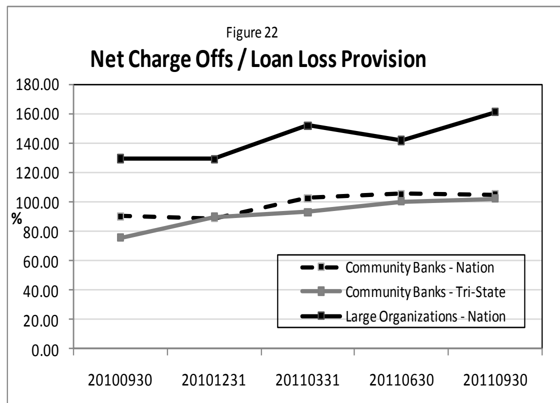
Net Charge-offs/Loan Loss Provision

The net charge-offs to loan loss provision ratio saw a significant increase for large organizations over the year, rising from 129.41 percent in the third quarter of 2010 to 160.88 percent in the third quarter of 2011 (Figure 22). For large organizations, both net charge-offs and loan loss provisions have been declining, but the trend in this ratio was largely driven by declining loan loss provisions over the past four quarters.

The decline in total charge-offs is consistent with improving loan quality at large organizations (see Figure 4). The drop in loan provisioning, therefore, might reflect expectations of continuing improvement in loan quality at large banks (see Figure 4). It is worth noting that total net charge-offs have been consistently higher than loan loss provisions at large organizations, implying shrinking loan loss reserves. However, the rising reserve/NPL coverage ratio (Figure 21) at large banks suggests that, given the improving loan quality, (see Figures 4 and 6) banks might not be too concerned about the lower level of reserves.

The pattern has been different at community banks. Specifically, a 14.49-percentage-point rise, to 104.6 percent, for community banks in

the nation, and a 26.76-percentage-point increase, to 102.33 percent, for tri-state banks over the year indicate that total charge-offs and provisioning have largely been balanced. This implies that the amount of loan loss reserves for these institutions has stabilized in recent quarters.

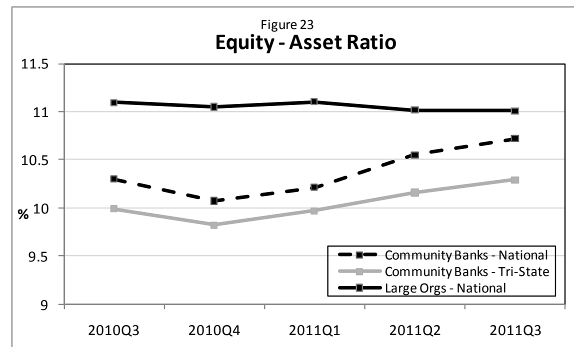


Capital

Leverage Ratio

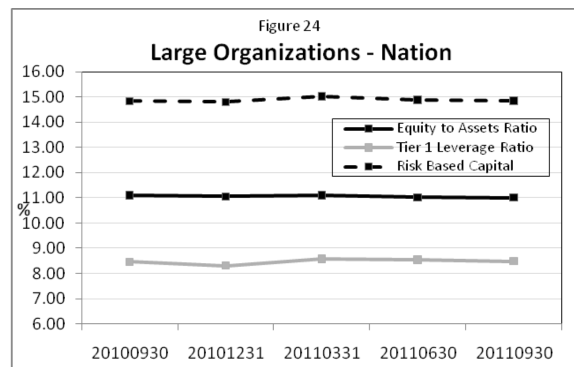
Over the year, large organizations' leverage ratio barely moved, staying at 11.01 percent in the third quarter of 2011 (Figure 23). In contrast, community banks nationwide saw equity capital accounting for a larger portion of their assets than a year ago, as the leverage ratio increased 42 basis points over the year, to 10.72 percent in the third quarter of 2011. Similarly, community banks in the tri-state region were able to raise their leverage ratio to 10.29 percent, an increase of 30 basis points from a year ago. However, the leverage ratios at large banks appear to be consistently above those at community banks throughout the year.

Over the past quarter, leverage ratios at national and local community banks both improved too.



Regulatory Capital

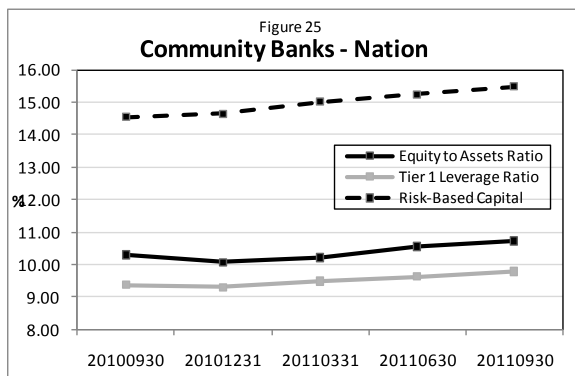
Large organizations did not have a significant year-over-year change. Their equity to assets, Tier 1 leverage, and risk-based capital ratios were 11.01 percent, 8.49 percent, and 14.84 percent, respectively (Figure 24).[12] [13]



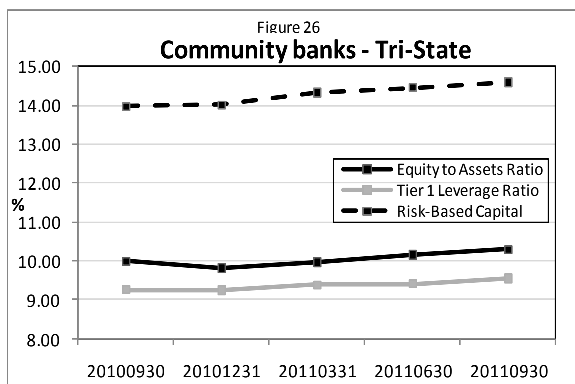
Community banks nationwide have had a 42-basis-point improvement in their equity to assets ratio, to 10.72 percent, since the third quarter of 2010 (Figure 25). The Tier 1 leverage ratio had a similar 41-basis-point improvement to 9.78 percent, and the risk-based capital ratio saw the largest change of 109 basis points, to 15.49 percent, over the past year.

[12] The Tier 1 leverage ratio is the ratio of Tier 1 capital to average total assets where Tier 1 capital is the sum of common equity, preferred noncumulative stock, and minority interests in consolidated subsidiaries. Also, note that preferred stock does not confer any voting rights and pays a fixed dividend.

[13] Risk-weighted assets: The default risk borne by each asset is assigned a risk weight. The total risk-weighted assets are the sum of these assets, as weighed by their respective risks.



The equity to assets ratio improved 30 basis points, to 10.29 percent for community banks in the tri-state area from the third quarter of 2010 (Figure 26). The Tier 1 leverage ratio increased 29 basis points, to 9.55 percent, and the risk-based capital ratio increased 62 basis points, to 14.59 percent, over the same time period. Overall, tri-state community banks appear to have experienced stronger improvement in capital ratios than large organizations.



Funding Sources

Total deposits at all types of banking institutions continued to increase over the past five quarters. At large organizations, total deposits and demand deposits grew 9.53 percent and 62.12 percent, respectively, in the third quarter of 2011. Transaction accounts grew 50.77 percent year-over-year at large organizations from the third quarter of 2010. Correspondingly, deposits at branches and offices of foreign-owned banks operating in the U.S. fell by 25 percent, or $291 billion, to roughly $879 billion. In part, this shift is likely the result of a "flight to quality" by large depositors, who view U.S. banks as a less risky place to hold their funds.

Total deposits at community banks in the tri-state area grew by 4.09 percent and demand deposits grew by 6.74 percent. Since the third quarter of 2010, community banks in the nation have seen year-over-year growth of 2.56 percent in their total deposits and 14.82 percent in their demand deposits.