In 2001 large and small banks had a difficult year, relative to recent years, primarily because of the deterioration of the national and regional economies. There were a higher number of bad loans in 2001 than in the mid-to-late 1990s, and, at some institutions, profitability was adversely affected. Most banks were able to charge off the bad loans using reserves built up throughout the previous decade. Thus, while nonperforming loans and assets are substantially higher than they have been for most of the last decade, adequate reserves exist to keep the problems under control.

Large Banking Organizations

Large banking organizations had mixed results in 2001.1 Nationally, return on average assets increased from 1.09 percent to 1.17 percent (Figure 1).2 Return on average equity was 13.68 percent, essentially unchanged from 2000 (Figure 2). For banks operating in the tri-state area, these profitability measures continued to fall. Return on average assets dropped below 1.0 percent for the first time since 1992. Return on average equity fell from 13.51 percent to 12.06 percent, its lowest level in a decade. Net chargeoffs as a percent of average assets nearly doubled both nationally and locally (Figure 3). These ratios are still below the levels of the last recession, and there is reason to believe that the long-term health of banks has not been affected. Loan-loss coverage ratios did not change appreciably from 2000, either nationally or locally (Figure 4).3 This suggests that banks’ provisioning for loan losses has kept pace with the deterioration of their loan portfolios. But this increased provisioning did have a negative impact on earnings. The ratios of nonperforming loans to total loans and nonperforming assets to total assets increased both locally and nationally, but both are well below the levels experienced during the slow recovery from the 1990-91 recession (Figures 5 and 6).4 Thus, it would appear that banks are recognizing losses more quickly, at the cost of reported income. This strategy appears viable as long as the

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1 Large banking organizations are determined annually as those firms that are at least as large as the 100th largest bank holding company in the nation at the beginning of that year, ranked by total assets. 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 located in the region. It should be noted that the year-to-year ratios presented are based on different samples, so the inclusion or exclusion of an organization can affect the numbers. See Appendix A for a description of the methodology used in grouping these banks.

2 All data used in Figures 1-26 are from Federal Financial Institutions Examination Council (FFIEC) Call Reports. All ratios are weighted averages of all banks within the sample. That is, the numerator and denominator are summed across banks, with the resulting aggregates divided.

3 Loan-loss coverage ratio is the ratio of loan-loss reserves to nonperforming loans. Nonperforming loans are defined as loans past due 90 days or more plus nonaccruing loans.

4 Nonperforming assets are defined as nonperforming loans plus other real estate owned.
nonperforming loans do not continue to pile up. Despite increased chargeoffs and provisions for loan losses, large banks in the nation and the tri-state area were able to increase their ratio of equity capital to assets (Figure 7).

Another reason for the decrease in profitability at large banking organizations that operate in the tri-state area is falling net interest margins (Figure 8). While interest margins actually increased from 3.10 percent to 3.21 percent nationally, banks operating in the tri-state area experienced a substantial decrease, from 3.23 percent to 2.67 percent. The reason for the disparity in interest margins becomes clear when comparing the loan-to-deposit ratios for the respective samples (Figure 9). The national sample experienced a decrease of about two percentage points in loans-to-deposits, but the ratio for banks that operate in the tri-state area fell by nearly nine percentage points, to its lowest level since 1994. It should be noted that both of these numbers were affected by the change in sample from 2000 to 2001. Using the 2001 sample for both years, net interest margin would have decreased from 2.93 percent to 2.67 percent, while loans-to-deposits would have decreased from 89.7 to 85.2 percent.

For the second consecutive year, the amount of loans outstanding decreased

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5 Net interest margin is defined as the ratio of net interest income to average earning assets. Average earning assets are the sum of interest-earning balances, net loans, securities, and fed funds sold and securities purchased under agreements to resell.
substantially at large banks that operate in the tri-state area (Figure 10). Loans outstanding also fell nationally, but only about 0.5 percent. This was primarily due to a large drop-off in commercial loans. The loan portfolios of the largest banks in the country have a much heavier concentration of commercial and industrial (C&I) loans than other banks. This is the result of both reduced demand and a tightening of lending standards.

The four Senior Loan Officer Opinion Surveys conducted by the Federal Reserve Board in 2001 cite both a tightening of standards and decreasing demand for C&I loans and commercial real estate loans, and a less pronounced tightening of standards and weakening demand for consumer loans. In contrast, lending standards for residential real estate loans remained unchanged, while demand for these loans increased. Deposits increased in 2001, both locally and nationally (Figure 11).

In spite of the drop in lending, fee income rose both locally and nationally (Figure 12). Noninterest income as a percent of average assets increased from 2.36 percent to 2.71 percent for banks in the national sample and from 2.65 percent to 3.01 percent at large banks operating in the tri-state area. These are historic highs for this ratio. A possible explanation for the increase in fee income is the 1999

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enactment of the Gramm-Leach-Bliley Act, which allowed banks and bank holding companies to offer a wide variety of products and services that were previously prohibited. The parent companies of nearly every institution in the large bank sample have converted from bank holding companies to financial holding companies, the vehicle for offering many of these additional services.

Many banks announced cost-cutting plans in 2001, but the results appear mixed. Nationally, noninterest expense as a percent of average assets increased, from 3.33 percent to 3.50 percent (Figure 13). The expense ratio for banks operating in the tri-state area decreased 0.1 percentage point, continuing a trend that began in 1999. This is most likely because, in 1998, many banking organizations in the local sample made large acquisitions, and since then have been attempting to integrate the operations of the acquired firms into their own. This is a process that requires several years.

In summary, it appears that 2001 was a year of internal consolidation for large banking organizations. The recession caused a large increase in bad loans, but the banks were aggressive in writing these loans off. There was also a drop in net interest margins at tri-state area banks. At the same time, the banks increased their capital and reserves, engaged in more fee-generating activities, and adopted more conservative lending standards. Thus, while profits fell, the overall health of these banks was largely unaffected. They remain well capitalized and well reserved. Attempts at cost-cutting were less successful. If, as recent data indicate, the recession is in fact over, it appears that unlike the last recession a decade ago, there will be little lingering effect on the health of large banking organizations.
Community banks experienced some of the same problems as the large organizations in 2001, but not to the same degree. Also, they reacted in a very different manner. Return on average assets was relatively stable at community banks in 2001, with the ratio for banks in the national sample falling from 1.20 percent to 1.15 percent and the ratio in the local sample increasing from 1.16 percent to 1.20 percent (Figure 14) both nationally and locally. Return on average equity fell (Figure 15). Net interest margins were nearly stable (Figure 16).

As with the large organizations, the major drag on profitability for community banks was nonperforming loans, which led to a large increase in net chargeoffs as a percent of average assets (Figure 17) and an increase in loan-loss provisions. After six years of stability, the ratio of net chargeoffs to average assets for community banks in the national sample more than doubled, from 0.16 percent to 0.35 percent, while the ratio for banks in the tri-state area increased nearly sixfold, from 0.11 percent to 0.59 percent. These increases were concentrated not in commercial and industrial loans, however, but in consumer installment loans.

The reaction of small banks to these problems was in some ways similar to the reaction of the large organizations and in some ways quite different. One of the similarities is that the increase in chargeoffs was a result of the smaller banks’ desire to prevent the accumulation of problem loans. In this, they have been as successful as the larger banks. The ratio of nonperforming loans to total loans increased both nationally and locally but in both cases remained at relatively low levels (Figure 18). This is also true for the ratio of nonperforming assets to total assets (Figure 19).

As shown by the drop in the loan-loss coverage ratios, smaller banks are charging off bad loans more rapidly than they are adding to their reserves for loan losses (Figure 20). This is probably because the reserves at community banks were very high at year-end 2000, and, in spite of the decrease, still are. Smaller banks, both locally and nationally, continue to maintain high levels of capitalization. While reserves dropped, the level of equity to assets increased nationally from 9.18 percent to 9.69 percent and locally from 8.74 percent to 9.29 percent (Figure 21).

Another problem for smaller banks in 2001 was an increase in overhead. The ratio of noninterest expense to average assets in the national sample increased from 3.10 percent to 3.52 percent, and in the tri-state area sample the ratio increased from 3.00 percent to 3.43 percent (Figure 22). The community banks also sought to increase their fee income (Figure 23). This is an unusual development in that smaller banks have historically kept their fees low. In 2001, the ratio of noninterest income to average assets at community banks increased substantially both nationally and locally. For banks in the tri-state area, this figure nearly doubled, from 1.10 percent to 2.09 percent; nationally the ratio increased about 60 percent, from 1.01 percent to 1.61 percent. Some of this increase is due to the smaller banks’ offering a wider variety of fee-based products, such as mutual funds and insurance, but there is some anecdotal evidence that the banks are increasing conventional fees such as service charges. This may be a risk for the smaller banks, whose historic selling point to customers has been personal service and low fees. It should be noted that the noninterest income ratios at the smaller banks are still quite a bit lower than at the large organizations.

The major difference in behavior between the smaller and larger banks is that the smaller banks appear to be actively seeking loan business. While loan-to-deposit ratios decreased at large banks they remained unchanged at community banks in the nation and the tri-state area (Figure 24). It should be noted that these levels are still below those of the larger organizations, but smaller banks also had strong loan and deposit growth (Figures 25 and 26). The continued increase in lending at smaller banks can be explained in several ways. First, the smaller banks’ major lending area is real estate rather than commercial lending—in particular mortgages—

![Figure 14: Return on Average Assets for Community Banks](image-url)
which have been largely unaffected by the recession.\footnote{See \textit{Banking Brief Special Report: Commercial Banks in 1997}, August 1998, for a breakdown of the loan portfolios of large and small banks. This breakdown can be summarized as follows: for large banks (total assets>$10 \text{ billion}), real estate loans represented 36.2 percent of all loans; commercial and industrial loans represented 33.6 percent; consumer installment loans 9.9 percent; and credit cards 3.4 percent. For other banks, these numbers were real estate, 61.0 percent; C&I, 17.4 percent; consumer installment, 13.1 percent; and credit cards, 0.8 percent.} Second, smaller banks likely have not tightened their lending standards to the extent that larger banks have. In addition, there is some evidence that larger banks are making fewer syndicated loans, and there is less merger-related lending. Neither of these types of loans accounts for a significant portion of the small banks’ loan portfolios.

In summary, the community banks experienced the same problems as the large organizations, basically a rise in bad loans. Additionally, the smaller banks also saw a substantial increase in their overhead expenses. The smaller banks were already well-reserved and capitalized, and they have aggressively written down nonperforming loans. Unlike the larger banks, smaller banks appear to have been actively seeking out new loan business. Finally, they have also increased their fee income.
Residential Real Estate

The residential real estate industry is one of the largest in the nation, with approximately $4.5 trillion of outstanding balances as of year-end 2000.8 Real estate lending is the most substantial portion of overall bank lending. As of year-end 2001, real estate loans made up 46.3 percent of all bank lending nationally and 41.1 percent of loans at banks headquartered in the tri-state area (Figure 27).9 Real estate lending can be broken down into several different categories: construction, residential, commercial, and farmland. Of these, residential real estate makes up the bulk of all real estate loans (Figure 28).

Residential real estate loans can further be broken down into loans on one-to-four family properties (hereafter referred to as mortgages, with no differentiation between first and junior liens), revolving loans (referred to as home equity loans), and loans on multifamily properties. As shown in Figure 28, mortgages represent by far the largest portion of these loans, representing 45.0 percent of real estate loans nationally and 53.9 percent of real estate loans at banks headquartered in the tri-state area.

In the early recession of the 1990s, real estate lending played a significant role in the financial problems of the banking industry, primarily because real estate values dropped in many areas.10 It should be noted that this was primarily a problem with commercial real estate lending and loans on multifamily properties. This drop in real estate prices had several effects. First, real estate lending slowed substantially in some areas, thus depriving those banks of their single largest lending market. Second, some banks found themselves with inadequate reserves to cover chargeoffs of real estate loans and therefore carried nonperforming real estate loans on their books for longer than they normally would. Although bank real estate lending has increased since then, nonperforming real estate loans have not been much of a problem so far in this recession. There are many indications that this will continue to be the case, but we can’t be sure if these types of problems have been avoided until the economy fully recovers.

The good news is that nonperforming loans among various categories of residential real estate have remained relatively low (Figures 29, 30, 31). Nonperforming mortgages as a percent of total mortgages increased nationally from 0.80 percent to 0.95 percent in 2001 and from 0.60 to 0.66 percent at banks in the tri-state area. Nonperforming home equity loans as a percent of total home equity loans increased slightly for the nation in 2001, from 0.35 to 0.39 percent, and actually decreased slightly for banks in the tri-state area. Nonperforming loans on multifamily properties remained extremely low both nationally and locally. All of these are well below their 1992 levels, following the last recession. Moreover, they are well below the figures for all loans (see Figures 6 and 19).

However, the net charge-off ratios have risen in each category except multifamily loans (Figures 32, 33 and 34). The ratio of net mortgage chargeoffs to average

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8 See the Fannie Mae web site at www.fanniemae.com.
9 The data in Figures 27-34 are for commercial banks only. Commercial banks represent only a portion of all real estate lending. In this section, the banks are broken down into those headquartered in the tri-state area and all banks in the nation. Unless otherwise noted, all commercial banking data are from FFIEC Call Reports.
10 See the Office of Federal Housing Enterprise Oversight (OFHEO) historical Housing Price Index at www.ofheo.gov/house.
vestors, including many of the same lenders. This approach has several advantages for the lenders. First, it allows small banks and other firms to diversify geographically. A small lender holding a portfolio of mortgages on local properties is more sensitive to the state of the local economy, but now that lender can purchase securitized mortgages from around the country. A second advantage is that banks and other lenders can specialize in originating loans while the task of funding loans can be spread more widely. This has contributed to the expansion in real estate lending in general.

Perhaps the most important advantage is that replacing loans with securities on their books permits banks to solve an asset-liability mismatch whereby long-term assets are funded by short-term liabilities. Much of the thrift industry’s problems in the 1980s can be traced to the funding of 15- and 30-year mortgages with 12- to 30-month certificates of deposit. As long as interest rates are stable, this does not create a problem. However, when interest rates rise, as they did in the late 1970s and early 1980s, the assets (mortgages), whose rate of return is fixed by the interest rate at the time the loan was made, are funded by a series of liabilities (CDs) whose cost rises with each successive rollover. For banks, the problem is magnified, as their primary source of funds is demand deposits.

Fannie and Freddie had a large increase in purchases of loans last year (Figure 35), but there are indications that they may not be able to sustain this level of purchases. First, a number of analysts have expressed concern about the amount of debt they are...
carrying. Figure 36 shows the combined debt-to-equity ratios of both firms. In 2001, they expanded their borrowing by a substantial amount. The short-term debt is not much of a concern as that is how loan purchases are financed, i.e., funds raised from short-term borrowing are used to purchase mortgages from primary lenders; these loans are then securitized and sold, and the proceeds from the sale are used to pay off the short-term debt. However, the combined long-term debt-to-equity of these firms now stands at over 2,350 percent.

This represents an increase of more than 26 percent over 2000. This increase in long-term debt was in part due to Fannie Mae’s attempt to create a benchmark security to replace 30-year Treasury bonds, but Freddie Mac shows an increase in long-term debt-to-equity similar to Fannie’s. Moreover, the equity-to-assets ratios of each of these firms has been steadily decreasing (Figure 37) and now stands at well under 3 percent for both.

The regulator for Fannie and Freddie, the Office of Federal Housing Enterprise Oversight (OFHEO), has enacted several regulations to establish more stringent prudential controls. Most significantly, OFHEO recently enacted regulations to replace their current capital standards with a risk-based system. This regulation also includes regulatory sanctions for failing to meet capital standards. Additionally, OFHEO has been encouraging Fannie and Freddie to retain more of their earnings.

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11 Data on Fannie Mae and Freddie Mac were obtained from historical data published on their respective web sites: for Fannie Mae, www.fanniemae.com; for Freddie Mac, www.freddiemac.com.

Legal Developments

Only Pennsylvania enacted significant banking legislation in 2001. On June 25, then-Governor Ridge signed Act No. 55 into law. The bill actually has two parts, the Consumer Equity Protection Act (CEPA), and the Mortgage Bankers and Brokers Act (MBBA). CEPA is an anti-predatory lending bill, but its main purpose is to clarify that the state, not any municipality, has sole authority over financial institutions. CEPA overturns a Philadelphia ordinance that established prohibitions on certain lending practices and imposed criminal penalties for violations of the ordinance. CEPA does not contain criminal sanctions, but it addressed many of the same issues as Philadelphia’s law.

CEPA applies to any loan of $100,000 or less secured by a one-to-four family property. It prohibits the following: (1) negative amortization schedules (except to upper income borrowers); (2) balloon payments that come due less than 10 years after the loan was made; (3) call provisions that permit lenders to accelerate payments at their sole discretion, except in cases of default, due-on-sale provisions, fraud, or where the borrower’s actions adversely affect the lender’s security interest; (4) increases in the interest rate as a result of the borrower’s default; (5) advance payments using loan proceeds; (6) lending without regard to the borrower’s ability to repay (a borrower is presumed to have the ability to repay if the monthly payment is less than 50 percent of his gross income at the time the loan is made); and (7) lenders disbursing loan funds directly to home improvement contractors. CEPA also requires lenders to provide borrowers written notice stating that the loan is a mortgage, that the borrower could lose his home for failure to repay, that the borrower is under no obligation to accept the loan and could benefit from shopping for better terms from other lenders, and that the borrower should consider credit counseling before accepting a loan. There is also a prohibition on the refinancing of low-interest loans from government agencies or nonprofit corporations within the first 10 years of the term of the loan without the written consent of the borrower.

Finally, CEPA requires that in order to offer single premium insurance at the time a loan is made, the lender must provide the borrower with a written notice indicating that the insurance is not required and may be canceled at any time. If it is legal to offer a comparable insurance product paid via monthly premiums, the lender must make this option available to the borrower.

These second part of Act No. 55, the MBBA, requires mortgage bankers and brokers and loan correspondents involved in at least three residential mortgages in a single year to be licensed by the state banking department and bonded for at least $100,000. However, the law provides an exception for banks, thrifts, credit unions, attorneys, real estate brokers, builders, government or quasi-government agencies such as Fannie Mae, consumer discount companies, and nonprofit companies making less than 12 mortgages per year. The law does not apply to commercial mortgages, only residential loans.

Neither Delaware nor New Jersey enacted any banking legislation last year.

Mergers and Acquisitions

In spite of the sluggish economy and falling financial markets, there were a significant number of mergers and acquisitions among institutions with greater than $1 billion in assets that have operations in the tri-state area in 2001. Three relatively large mergers were completed last year: the merger of First Union Corporation (Charlotte, North Carolina) and Wachovia Corporation (Winston/Salem, North Carolina), the acquisition of Summit Bancorp, Inc. (Princeton, New Jersey) by FleetBoston Financial Corporation (Boston, Massachusetts), and the acquisition by Citizens Financial Services Group, Inc. (Providence, Rhode Island, a subsidiary of Royal Bank of Scotland, Edinburgh, Scotland, United Kingdom) of nearly all of the Pennsylvania, New Jersey, and Delaware branches of Mellon Financial Corporation (Pittsburgh, Pennsylvania).


There were also a number of intrastate mergers involving Pennsylvania banking organizations. Fulton Financial Corporation (Lancaster) acquired Drovers Bancshares Corporation (York). National Penn Bancshares, Inc. (Boyertown) acquired Community Independent Bank, Inc. (Bernville). Three Rivers Bancorp, Inc.
(Monroeville) bought Pennsylvania Capital Bank (Pittsburgh). Also, prior to its acquisition by F.N.B. Corporation (see above), Promistar Financial Corporation (Johnstown) acquired FNH Corporation (Irwin). One merger that was announced in 2001 but completed in 2002 was the acquisition of Main Street Bancorp, Inc. (Reading) by Sovereign Bancorp, Inc. (Wyomissing).

There were no notable intrastate mergers or acquisitions in Delaware or New Jersey in 2001.

**Appendix: Methodology for Selecting Bank Categories**

This publication splits banks into two categories: large banking organizations and community banks. It further splits 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 100th largest bank holding company in the nation at the beginning of that year, ranked by total assets. Thus the banks in the 2001 sample are selected based on their year-end 2000 total assets, updated for mergers that occurred in 2001. 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 located in the region. Community banks in the tri-state area are either headquartered here or are subsidiaries of bank holding companies headquartered here.

Moving averages, such as average assets and growth rates, are calculated by averaging the numbers of all banks within a particular year’s sample over a two-year period. Thus, there were 22 banking organizations in the 2001 sample of large banks. The ROA of these organizations was calculated as follows. The numerator is the sum of the 2001 net incomes of these organizations, and the denominator is the sum of these organizations’ year-end 2001 and 2000 total assets. For 2000, the data consisted of a sample of 17 organizations; the numerator was their combined net income, and the denominator was their average assets.
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.

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