

Danielson Associates Inc.

6001 Montrose Road, Suite 405

Rockville, Maryland 20852

(301) 468-4884 phone

(301) 468-0013 fax

February 10, 2006

Dear Banker:

The past fifteen years have seen an extraordinary consolidation in American banking. The five largest banks have increased their share of all bank assets from 16% to 45% and the next five largest added together are less than two-thirds the size of number three – JPMorgan. In all likelihood, in the next five years, the combined assets of these five banks will reach 60% of the nation's banking assets. This process has squeezed most of the mid-sized banks, but it still leaves a sizable market of more than \$5 trillion for everyone else, much of which is moving toward small specialty banks.

The enclosed report written by Arnold G. Danielson takes a look at the rapid growth of a handful of domestic banks as well as the foreign banks that have taken a renewed interest in the U.S. market. It also speculates on the next steps in banking and tries to answer the question – “Where do we go from here?”

Respectfully yours,



David G. Danielson
President



February 10, 2006

National Banking Report – Winter 2006

Consolidation: Where It Goes From Here

By
Arnold G. Danielson
Chairman
Danielson Associates Inc.

As the new millennium began, consolidation in banking had reached a level that left few doubts about the degree of dominance a handful of banks were likely to have in the coming decade. In 2000, the number of American banking organizations with more than just regional aspirations had been reduced to eight banks – Citigroup, Bank of America, Chase Manhattan, J.P. Morgan, Bank One, First Union, Wells Fargo and Fleet – and a single thrift – Washington Mutual.

In terms of market share, in a single decade – from 1990 to 1999 – the share of assets held by the five largest banks had jumped from 16% to 36%. The gain for ten largest was from 25% to 47%. This was after an extended period of diminishing market share by the large banks as their entrenched culture as “money center” banks had not served them well in the 1980s.

This concentration of so much power in so few hands had come only eighteen years after interstate banking was introduced; nine years after the concentration of assets in the hands of the large banks had begun to rise; and one year after the fall of Glass-Steagall. By 2000, it was readily apparent that in a few years, five or six banks were likely to control more than half of the nation’s banking assets.

The nine banking organizations that had moved ahead of all others by 2000 had survived a winnowing process, but they were not equals. Citigroup and Bank of America were much larger than the others and had momentum. Chase Manhattan with the Chemical management in charge had size, but not momentum. Fleet, Wells Fargo and Washington Mutual were the smallest of the group, but in 2000, they were stars in performance and momentum. Not doing as well were J.P. Morgan, Bank One and First Union, and by 2001, Fleet had begun to feel the pain from its purchase of BankBoston through the latter's commitment to Argentina, Silicon Valley investment banking operation and large national corporate lending operation. With consolidation having come so far, and the economy showing signs of weakness as the long stock market boom came to a resounding end, it was not a good time to be falling behind.

J.P. Morgan would not even make it out of 2000, but its name would survive in the new JPMorgan Chase, and by 2001, the gap between the "haves" and "have-nots" among the banking elite was immense. Citigroup, Bank of America, JPMorgan Chase and Wells Fargo had the look of winners while it seemed to be only a matter of time before Bank One, First Union and Fleet followed J.P. Morgan out the door. Washington Mutual was still doing well, but its size and product mix suggested limitations in keeping pace with the others.

By 2006, the sorting out was pretty much over, but the first six years of the new millennium would have its surprises. Bank One and Fleet would be sold, but First Union refused to believe the obituaries being written about it in 2000 and 2001 and stunned industry observers, including this one, by winning Wachovia away from SunTrust in a spirited acquisition battle. This victory did not immediately win over its doubters as the merger at the time was viewed as two laggards making matters worse by combining, but it gave First Union both a new lease on life and a new name. At the high end of the spectrum, Chase Manhattan continued to grow. It acquired J.P. Morgan and Bank One, and changed its name, but its performance did not keep pace with Citigroup, Bank of America and Wells Fargo – or even Wachovia after 2001.

Concentration Impact

The impact on consolidation of just a few large bank mergers since 2000 was immense. Between year-ends 1999 and 2000 the share of all bank assets held by just five banks rose from a little less than 33% to about 36%,

and most of the gain came from the Chase Manhattan-J.P. Morgan merger. Four years later, the five largest banks had increased their share to just under 45% of all bank assets. The gain of the ten largest was from 46% to almost 54%.

Asset Share of the Nation's Largest Banks – 1990 to 2004

<u>Dec. 31,</u>	<u>Share of Bank Assets</u>		<u>Total Bank Assets</u> (in billions)
	<u>Five Largest</u>	<u>Ten Largest</u>	
2004	44.6%	53.6%	\$8,072
2000	36.1	47.2	6,246
1999	32.8	46.2	5,735
1995	22.8	33.1	4,313
1990	16.2	25.4	3,390

Source: SNL Financial, Charlottesville, Virginia and FDIC: Historical Statistics on Banking.

The growth of the top five at the expense of the second tier of large banks was a continuation of the pattern of the very largest banks buying the biggest banks available. In 1998, five of the ten largest banks – Citigroup, BankAmerica, First Chicago/NBD, Wells Fargo and Bankers Trust – were sold. When this big-buying-big merger activity occurred after 2000, the impact was magnified by the increased sizes of both the buyers and sellers. When eight banks leave all others behind, and then in the next five years, three of the eight – J.P. Morgan, Bank One and Fleet – are bought by two of the three biggest banks – Bank of America and Chase Manhattan – a large increase in concentration is guaranteed.

Rise of the Big Five

That five large banks had left all others behind was evident in the numbers, and it was hard-to-believe how far they had come in just 25 years. Citigroup, Chemical and Wells Fargo were big banks by the standards of that time in 1980, but those numbers pale beside what they became in 2005. Citigroup had raised its assets from \$115 billion in 1980 to \$1.5 trillion in 25 years; Chemical, or JPMorgan as is it now called, went from assets of \$41

billion to \$1.2 trillion; and Wells Fargo increased its assets from \$24 billion to \$482 billion. What was truly astounding, though, was just how far the two North Carolina banks, Bank of America and Wachovia, had come.

Largest Banks in the United States – 2005

	Assets				
	<u>2005</u>	<u>1999</u>	<u>1993</u>	<u>1988</u>	<u>1980</u>
	(in billions)				
<u>Big Five</u>					
Citigroup	\$1,494	\$717	\$217	\$208	\$115
Bank of America	1,354	633	158	30	7
JPMorgan	1,199	406	150	67	41
Wachovia	521	253	71	22	3
Wells Fargo	<u>482</u>	<u>218</u>	<u>53</u>	<u>47</u>	<u>24</u>
Subtotal	\$5,050	\$2,227	\$649	\$374	\$190
<u>Second Tier</u>					
U.S. Bancorp	\$209	\$82	\$26	\$24	\$13
SunTrust	180	95	41	29	3
National City	142	87	31	22	5
BB&T	109	43	9	4	1
Fifth Third	<u>105</u>	<u>42</u>	<u>12</u>	<u>6</u>	<u>1</u>
Subtotal	\$745	\$349	\$119	\$85	\$23
Washington Mutual	\$343	\$187	\$16	\$1	-

Source: SNL Financial, Charlottesville, Virginia and American Banker, April 11, 1990 and April 20, 1981.

In 1980 what was then NCNB had assets of just \$7 billion, which was far less than the \$1.3 trillion of 2005. Despite its relatively small size, it was a well-known bank in 1980 because of its nonbank activities that went beyond the borders of North Carolina. No one at the time, though, could have begun to imagine that 25 years later it would be using the Bank of America name and be the country's largest bank when measured by branches or deposits – and one of the three biggest in the world in earnings and market capital.

Wachovia was not nearly as large as Bank of America in 2005, but it also has journeyed a long way since 1980 when its predecessor bank, First Union, had assets of \$3 billion and was just the third largest bank in North Carolina. By 2005, it was the fourth largest American bank with assets in excess of \$500 billion and in the top ten in the world in earnings and market capital.

There were only five other domestic banks – U.S. Bancorp, SunTrust, National City, BB&T and Fifth Third – that had assets of more than \$100 billion in 2005 and were totally committed to traditional banking and related activities. Only U.S. Bancorp was above \$200 billion and just barely so. The growth of these second-tier banks was just as explosive as that of Bank of America and Wachovia. In 1980, U.S. Bancorp had assets of \$13 billion, National City \$5 billion, SunTrust \$3 billion and BB&T and Fifth Third a mere \$1 billion.

In 2005, Washington Mutual was still a thrift, but it was larger than all of the second-tier banks with assets of \$343 billion, but because of its home mortgage orientation, it was closer in market strength – earnings and market capital – to U.S. Bancorp than to Wells Fargo and Wachovia. Washington Mutual, though, has traveled the furthest by far. In 1980, it was Columbia Federal, a mutual thrift in Wenatchee, Washington with assets of less than \$300 million.

Investor Return

Despite their success in consolidating American banking and gaining tremendous size and stature, the nation's five largest banks have been widely criticized for not having served investors well. Investors might have done better if at some point these banks had been sold instead of being buyers, but this is true of almost any stock firm. If all companies were sold before they became too large to be bought, then many of the nation's businesses, and most certainly banking, would be dominated by foreign companies that are not as investor-oriented as their American counterparts.

In any event, those that invested early in these five big banks did not do badly, particularly with Citigroup, Bank of America and Wells Fargo's predecessor bank, Norwest. A \$100,000 investment in Citigroup at the end of 1985 with reinvested dividends would have grown to \$2.5 million by the end of 2005 – an annual return of 17.4% – and a similar 1995 investment,

when Citigroup was struggling, would be almost \$1 million ten years later for a 25.5% annual gain. A \$100,000 investment in NCNB/NationsBank in 1985 and 1995 would have been \$1.3 million and almost \$500,000 by the end of 2005 for annual returns of 13.7% and 17.1%, respectively. For the Norwest investors, the annual return since 1985 and 1995 on a \$100,000 investment was a very robust 20% in both instances.

Investor Return on the Big Five – 1985 to 2005

	2005 Return on \$100,000 Invested in*			
	1985		1995	
	<u>Amount</u> (in thous.)	<u>Annual</u> <u>Return</u>	<u>Amount</u> (in thous.)	<u>Annual</u> <u>Return</u>
Citigroup	\$2,478	17.4%	\$969	25.5%
Bank of America**	1,306	13.7	484	17.1
JPMorgan***	508	8.5	424	15.5
Wachovia	819	11.1	317	12.7
Wells Fargo****	3,859	20.0	615	19.9

*Investment made at the end of the calendar year.

**Original investment in NCNB.

***Original investment in Chemical.

****Original investment in Norwest.

Source: Various sources.

Investors did not do as well with Chemical's New York roll-up. The Chemical-led consolidation of the four large New York money center banks – Chemical, Manufacturers Hanover, Chase Manhattan and J.P. Morgan – has yet to deliver any real momentum, but it is also unlikely that any of the component parts would have done better on their own or could have found better buyers considering their conditions at the time of sale. For Chemical, now JPMorgan, an investment of \$100,000 at the end of 1985 would have become about \$500,000 at the end of 2005, or an annual return of 8.5%. If the investment had been made in 1995, though, when most of Chemical's merger activity was finished, it would have generated a much better 15.5% annual return; and the dollar value would be almost as much as the same investment ten years earlier.

Wachovia also has not done as well for investors as Citigroup, Wells Fargo and Bank of America, and this was primarily due to its slippage from 1998 to 2001 when its stock fell from about an adjusted \$66 per share to \$24 per share and its dividend was cut in half. Even with this slippage, though, an investment of \$100,000 in Wachovia's predecessor bank, First Union, twenty years ago was worth over \$800,000 at the end of 2005. This was an annual return of 11.1%. A similar investment in 1995 would have been worth about \$300,000, which was a 12.7% annual increase.

This is not bad performance, and it certainly contradicts what is being said by some headline-grabbing New York investment bankers who seem to think the world began in 1998 when bank stocks were at their peak. Bank of America has proved them wrong with its recent Fleet acquisition, and Wells Fargo, Wachovia and JPMorgan are likely to do the same as they move on to bigger and better things.

Foreign Banks

Another phenomenon of the early 2000s has been the resurgence of foreign bank influence in the United States. Other than the London-based HSBC, which is the largest bank outside of the United States and in the same size category as Citigroup and Bank of America, these foreign banks are not threatening the dominance of the big five of American banking, but they are becoming the new second tier as the present second tier of domestic banks dwindles in numbers. Not since the late 1970s and early 1980s has there been such significant foreign bank acquisition activity in the country, and the foreign banks look to have more staying power this time around. All that is left from the first incursion is HSBC, Bank of Tokyo, which has become Mitsubishi UFJ, in California and ABN AMRO and Bank of Montreal in the Midwest. The British banks that made such a big splash in California during those years are long gone.

Between 2000 and 2004, nine American banks and thrifts were bought by foreign banks with deal values in excess of \$1 billion. The combined deal value of these acquisitions was about \$27 billion. Go back one day to December 31, 1999, and add in HSBC's purchase of Republic of New York that closed on that day, and the number of big foreign bank purchases rises to ten and the combined deal value to \$35 billion. This does not include the

2002 purchase by HSBC of Household Finance for \$14.9 billion that is not technically a bank despite being a big-time lender nationwide.

The large foreign buyers besides HSBC were BNP Paribas of France with four large American bank acquisitions, Royal Bank of Scotland with three and Toronto Dominion Bank with two. These are substantial banks with a lot of market clout. Royal Bank of Scotland was the fourth largest non-American bank and ninth largest in the world in 2005 measured by market capital, and BNP Paribas was seventh in market value and sixth in earnings among just foreign banks. Toronto Dominion was not quite in a class with the others, but with 2005 assets of \$316 billion and market capital of \$38 billion, it was a large bank with closer geographic proximity than the European banks.

Large Foreign Banks' Positions in the United States

<u>Banks</u>	<u>Market Value*</u>	Net <u>Income**</u> (In billions)	American <u>Assets***</u>	<u>Country</u>
1. HSBC	\$191	\$14.3	\$396	United Kingdom
2. Mitsubishi UFJ	135	7.5	56	Japan
3. UBS	118	7.4	18	Switzerland
4. Royal Bank of Scotland	91	8.7	152	United Kingdom
5. Banco Santander	84	6.2	9	Spain
6. ING Groep	76	7.9	51	Netherlands
7. BNP Paribas	74	6.9	55	France
8. Barclays	69	6.4	271	United Kingdom

*January 18, 2005.

**Latest available.

***September 30, 2005.

Source: SNL Financial, Charlottesville, Virginia and Bloomberg.com.

HSBC with American assets as of September 30, 2005 of \$396 billion, a large branch network in the New York and finance offices across the country, has the potential with the acquisition of a second-tier American bank to turn a “big five” into a “big six”. It is rumored to be a potential

acquirer whenever a large regional bank is thought to be selling, but it has stayed on the sidelines since its 2001 Household acquisition.

Royal Bank of Scotland has been the most aggressive of the foreign banks in the early 2000s with its \$10.5 billion purchase in 2004 of Charter One – a \$41 billion thrift with 571 branches focused on Ohio, Michigan and western New York. With just \$152 billion in American bank assets in 2005, however, Royal Bank of Scotland has a long way to go to move beyond the second tier of domestic banks.

In terms of large bank and thrift acquisitions in the United States since 2000, the Paris-based BNP Paribas has been the most active buyer, but its purchases have been smaller than those of HSBC and Royal Bank of Scotland, and all of its acquisitions have been in the western part of the United States. In 2005, its American assets were just \$56 billion.

Barclays, a British bank ranked sixth in market value among banks outside the United States, had assets of \$271 billion in its American banking subsidiaries in 2005, and a slightly smaller Deutsche Bank had \$360 billion in American banking assets, but this overstates their true banking positions on this side of the ocean. Neither has retail banking offices in United States and most of these banking assets represent investment banking and asset management activities.

Banco Santander, the Madrid-based bank that was the fifth largest bank outside the United States based on market capital is potentially a large player in the domestic market. It bought a 20% share of Sovereign, a thrift with deposits of a little over \$60 billion in the Northeast. It has the right of first refusal if Sovereign chooses to sell, and its 2004 purchase of the largest British mortgage bank, Abbey National, suggests Banco Santander is not afraid of large acquisitions outside of Spanish-speaking countries.

The early 2000 interest in American banking by foreign banks also was symptomatic of the rising globalization of the industry. In Europe, Canada and Japan, the limited size of the home market prompted banks to look to new markets for expansion. In the United States, Citigroup needed no prompting to do so, but as Bank of America and JPMorgan reach regulatory limits on their domestic expansion, they, too, will face pressure to expand into other countries as well as trying keeping pace with Citigroup.

Where Do We Go From Here

If the last 25 years taught us anything about the direction of banking, it was that big banks keep getting bigger and the overall number of banks continues to diminish. This should come as no surprise as artificial barriers limited bank expansion until the 1980s. When constraints were removed, it was only natural that banking would evolve toward the structure of most industries – a handful of dominant firms surrounded by specialists supplying services that are uneconomical for industry leaders to provide.

What is different about the direction of banking in 2006 from five or ten years ago is that banking in the United States is nearer the end point in the consolidation process. It is fairly obvious now who the end players are, and the likes of Bank of America and Citigroup do not need additional bank acquisitions to remain leaders in perpetuity. All they need to do is execute well with what they have and stay ahead of the technology curve. This does not mean the big banks are through acquiring, but their future acquisitions will be more internally-driven and not a merely a race to survive.

The large American banks, though, are like large stock organizations everywhere in that they need to keep growing to satisfy investors, and this means continuing to increase earnings at meaningful rates. For big banks to do this requires some combination of selling more of the same to the same customers, expanding the geographic base, broadening the product base and cutting costs – and the last, cutting costs, can only carry earnings upward for a limited time without revenues also increasing from some combination of the first three.

What banking will look like ten or twenty years from now, though, will reflect more than just the results of today's banking leaders running their businesses well as their relative positions, and those of their foreign competitors, could be dramatically different. The key determinants of the future structure are likely to be demographics, technology, changes in the way bank products and services are delivered, globalization and economic recessions. These determinants are not mutually exclusive – changes in the delivery system will be driven by demographics and technology, for example – but each has its own set of dynamics.

Demographics

Demographics have long played a major role in banking change and will continue to do so with an aging population leading the way. The major impact on banking of an aging population in the past was that it reduced the thrift customer base as the thrifts were not as effective as banks in replacing older customers. In the future, aging customers will do what has long been predicted, but has yet failed to occur, which is dramatically reduce the need for banking services delivered through branches.

In time the number of customers that heavily use branches for banking only will be sharply reduced. On one end, the upper age limit of those that are truly internet savvy will rise, reaching 45 to 50 by 2015 and 55 to 60 by 2025. At the other end of the spectrum, will be an expanding senior base that has its social security and retirement accounts deposited directly into a bank, which eliminates one of the biggest reasons for going into a bank branch – depositing or cashing a paycheck.

This does not mean the end of bank branches, but it suggests that they will be used differently. A decline in usage for traditional banking services will increase the importance of having the branch sell other products such as insurance, annuities and mutual funds. This should favor the branches of large banks over those of small banks, but this is not an area where a trillion dollar bank necessarily has much of an advantage over a regional bank with assets of \$50 billion.

Changing demographics also will further speed the specialization, which may favor some small banks. As the mass market moves away from branch usage, banks that specialize in small business lending, recent immigrants and other niches may find themselves in greater demand. The words “recent immigrants” are used rather than “ethnic group” because most ethnic groups, once they move past recent immigrant status, prefer the same conveniences of the mass market as everyone else.

These changing demographics also would seem to favor a Citigroup model that focuses on remote access, lending and non-traditional banking activities over a branch-laden Bank of America. The Citigroup advantage, though, could go the other way if Bank America and others with a similar approach, which is just about everybody else, succeed in making the branch

a major distribution point for selling products other than those directly related to banking.

Technology

Technology is one of the two most unpredictable determinants of the future banking structure – economic cataclysms being the other – but only in the details. Banking is primarily a business of moving numbers from one place to another, and, as a result, is much more susceptible to technological change than almost any other large industry. Moving numbers around does not need two pairs of human hands interacting.

The technology for substantial continued change in how banking will be done is already out there, and all that is holding it back from being even more of a force is consumer fears. Much of the fear factor is well-founded because of concern over identity theft, but it should be only a matter of time before technology solves this problem as well.

Despite protestations that technology is the great leveler, it favors the established big banks over the traditional small banks, and, as a result, would appear to favor increased concentration of banking in the hands of a few, but it is not that simple. Part of technology's leveling aspect, though, is that it provides an opportunity for outsiders with special skills to move quickly and take business from the existing firms. This outsider can come in the form of a foreign bank, a technology powerhouse like Microsoft or a newcomer with a better "mousetrap." This is what makes technology such a "wild card," and it is likely that banking will experience its own "Google" sometime over the next decade.

Changes in Delivery System

Changes in the delivery system are part of the natural evolution of banking, and it was, and will be, heavily impacted by alterations in customer mix and knowledge as well as by technology, but it also will make its own unique contributions. The move toward longer hours, that was pioneered by Commerce in the late 1990s and has subsequently spread across much of the Northeast, is a prime example of this.

Technological innovation, though, will be at the forefront of change in the delivery system. It already has given us the ATM, securitization of loans and the ability for the customer to move money around by using the internet. Being able to move money from one account to another and pay virtually all bills by remote access is out there for everyone to use, albeit its usage is still in its infancy.

This is where demographics come in with a little help from retirement accounts. Most people born after 1965 are internet-savvy and cannot begin to imagine going to a branch to do what they can do at the touch of fingertip. At the same time, those senior citizens that have social security checks or payments from a retirement account show-up on an internet display of his or her bank account will increasingly realize what comes in that way also can go out the same way.

In Europe, branch traffic is far less than in the United States because of greater use of direct payment, not because Europeans are more internet savvy, but because the largest recipients of checks – utilities, credit card companies and lenders – demand it. The greater degree of competition in the United States may preclude a credit card company telling a customer that the monthly payment must come automatically from a banking account, but it is only a matter of time before this becomes the norm in the United States on an either voluntary or involuntary basis.

While check usage in the United States has been declining at a very slow rate, longer banking hours, including Sundays, is not going to wait ten to twenty years to become standard operating procedure. Long hours are consistent with normal retailing patterns, and it was a change just waiting to happen. Customers may be slow to make use of the long hours, but, they will factor these hours into their choice of banks – and there will be no going back. As early morning to early evening hours plus Saturday and Sunday banking becomes more available, customers will increasingly view it as the norm and an entitlement. Banks interested in retail banking will have to either go along or lose business.

Long hours coinciding with reduced branch usage is a potential killer for small, general-purpose banks and a big competitive advantage for large banks. The benefits of scale economies have been slow to come to much of banking, but they play a significant role in this scenario. The cost of keeping a branch open more than seventy hours a week requires a branch

with a large customer base that measured in deposits could be upward of \$50 million in all but the most rural markets. This raises the survival barrier beyond what many banks can afford at a time when branch usage for traditional banking activities is falling.

Globalization

Not a lot of attention is paid to the possible impact of globalization on the domestic banking structure, but it will have a big effect on who wins and who loses among large banks and the expansion interests of foreign banks, particularly European, in the American market. In the United States, it is not until banks reach the size of Citigroup, Bank of America and JPMorgan that the urge and long-term need to go beyond their home country's borders takes hold. In smaller countries, which is just about everybody else, the lead bank(s) typically already have such high in-market coverage that it has to go beyond its home market if it hopes to show growth satisfactory to investors and avoid being dwarfed by banks in other countries.

World GDP by Country or Group – 2004 to 2050

	Percent of Total		
	<u>2050</u>	<u>2025</u>	<u>2004</u>
China	28%	15%	4%
United States	26	27	28
India	17	5	2
European Union	15	25	34
Japan	4	7	12
Other	<u>10</u>	<u>21</u>	<u>20</u>
Total	100%	100%	100%

Source: Business Week, August 22, 2005, p. 58.

In Europe and Japan this is a particularly acute problem in that the projections of Gross Domestic Product (“GDP”) by country suggest by 2025 their combined share of global GDP will have fallen from 46% to 32% – or a one-third share decline. To maintain acceptable investor growth and some parity with American banks, they have to either get a much larger share of their home market, which is virtually impossible because of already large market shares, or expand into other countries. The most obvious expansion

targets are China whose GDP is expected to grow from 4% to 15% during this same period – and to 28% by 2050 – and the United States which is expected to retain close to its present 28% share of world GDP.

Bank expansion into China will not directly impact banking structure in the United States, but the rush in the last couple of years to invest in the leading Chinese banks is an indication of which banks are most attuned to global expansion. Among the large banks, Bank of America has been the most aggressive investing \$3 billion in the China Construction Bank, and HSBC and the Royal Bank of Scotland were not too far behind with investments of \$1.8 and \$1.6 billion, respectively, in other Chinese banks. Others, including Citigroup, are scrambling to catch-up.

It is not surprising to see HSBC and the Royal Bank of Scotland joining Bank of America in investing in China, but it also is pertinent that these are the two foreign banks with the largest market shares in the United States. Thus, while Bank of America, Citigroup and presumably JPMorgan spread their wings globally, HSBC and Royal Bank of Scotland will do so as well with the American market an obvious part of their plans.

Global spread will not be limited to these five banks as such national leaders as Banco Santander in Spain, BNP Paribas in France and Deutsche Bank in Germany and leading banks in small countries like ABN AMRO and ING in the Netherlands and UBS and Credit Suisse in Switzerland also need to move far beyond their home country to avoid being marginalized. The Swiss and Dutch banks have long been aware of this and are among the most aggressive in their global spread, but they, like other leading European banks in bigger countries, either start so far behind or, in some cases have special interests such as the asset management of the Swiss banks that may lessen their interest in full-service banking in the United States.

Thus, globalization should impact the domestic banking structure in at least two ways. It will add to the size of the largest banks, and presumably it will increase their overall market clout vis-a-vis everyone else. Also, at least two foreign banks, HSBC and Royal Bank of Scotland, are likely to at least be at the top of the domestic second tier and possibly even rise to the level of a Wachovia and Wells Fargo and turn a domestic big five into a big six or seven.

Severe Economic Recessions

History has also shown that nothing changes the banking structure like bad times, and one does not have to go back to the Great Depression to see this phenomenon. A turbulent 1970s with huge budget deficits, oil shocks and inflation sent interest rates soaring, and it brought a thrift industry to its knees. In the 1980s, another round of excessive deficits combined with a speculative building boom ended in the most serious banking crisis since the 1930s and resulted in more than 2,000 bank and thrift failures in a six-year period. The first crisis took out an industry, and the second eliminated most of the banking leaders in those states that were hit hardest.

When the dust cleared in the early 1990s recession, the banks in Ohio, North Carolina and Minnesota that were relatively untouched by economic problems from 1989 to 1992 had a clear path to national prominence while banks in New England, the Middle Atlantic states, California and Florida either disappeared or were badly crippled. Bank of New England, Shawmut, Chase Manhattan, First Fidelity, Manufacturers Hanover, MNC, MidLantic, C&S/Sovran, First Interstate, Security Pacific and Southeast Banking were among the prominent victims.

It is unlikely that the country has experienced its last severe economic recession, and when the next one comes, it is inevitable that some banks will fare better than others, which will result in further consolidation. Even the mild downturn following the dot-com implosion and the resulting 2000 stock crash played a role in changing the bank structure. Without these negative economic events, Bank One and Fleet might still be part of the nation's banking elite.

Because of the immense size of both the five largest domestic banks and the second-tier banks, any recession-driven problems of these banking leaders that force a sale, even if only because of investor pressure, the size of the sellers will dictate that the buyers be the best-performing of the biggest banks. This is how five banking leaders can be reduced to just four, and the diminishing handful of second-tier banks further reduced.

What Does All This Mean?

Although many would like to deny the obvious and believe banking is still in the 1980s, there are some numbers and trends that are hard to ignore. Among the most prominent of these are:

- The five largest banks almost tripling their share of bank assets from 16% in 1990 to 45% in 2004.
- The spread between the top five and second five widening so that the big five are, collectively, almost seven times as large as the second five, and Citigroup and Bank of America are nearly twice as large, as the second five combined.
- Since interstate banking began, every one of the ten largest banks in such diverse states Massachusetts, New Jersey, Virginia and Florida has been sold, and in Pennsylvania, only PNC remains from its top thirty banks at the time.
- London-based HSBC already having more American banking assets than all but the domestic big five, and this should be true of the Royal Bank of Scotland in the not too distant future.
- The trend toward branches being open from 8:00 a.m. to 8:00 p.m. as well as on Saturday and Sunday eventually making it uneconomical for a branch to have deposits of less than \$50 million.

The large banks' increase in share of banking assets from 16% to 45% between 1990 and 2004 is of particular interest because it is unlikely such a pronounced trend will end overnight. Bank of America may be done with buying traditional banks, but JPMorgan, Wachovia, Wells Fargo and maybe even Citigroup are far from through, and their collective 45% share going to 55% or even 60% is possible. If HSBC and Royal Bank of Scotland are factored in, then the 60% is almost inevitable. In submarkets the shares will be much higher. Acquisitions also will not be the only way these big banks grow.

A 60% share of bank assets, though, still leaves a lot for others, and it does not include thrift or the credit unions assets that combined are about

one-fifth of bank assets. Thus, even if the big banks had 60% of all bank assets, in 2006 this would still leave close to \$5 trillion in bank assets alone growing at a rate of as much as 8% per annum for everyone else and another two billion in thrift and credit union assets. This is a lot of banking or bank-related business for others.

The problem for most banks will not only be big bank competition, but who shares the other 40% of bank assets not held by the big banks. If banking follows the patterns of most other industries, then most of what the large banks do not have will go to specialists that focus on areas in which big banks are either not effective or not willing to participate fully. This could include niches in sub-prime lending, high cost deposits and serving local small business and commercial real estate markets.

Some regional chains should continue on with the size to play the big bank game, particularly in high growth markets that can provide the growth investors expect. If these banks choose to sell, it will be investors or a severe economic downturn and not big bank competition that force the sale.

A difference between the post-2000 period and the 1990s in big bank acquisitions was that the impetus for the sale of second-tier banks since 2000 usually came from the seller and its investment banker, not the buyer, and this is likely the way it will be going forward. If a SunTrust, National City, BB&T or Fifth Third is sold, it will decide when it is time to sell, and hope there are multiple buyers, which there should be, but the pricing might not be what they had once expected.

Stock and sale prices for big and small banks, in this scenario, should reflect performance and not acquisition prospects. This could be in the best interest of the industry and individual banks – value being determined by returns on invested capital instead of acquisition premiums.

CONSULTING & FINANCIAL ADVISORY SERVICES FOR COMMUNITY BANKS

MERGER ANNOUNCEMENTS

STRATEGIC PLANNING



CAPITAL PLANS



M&A ADVISORY



FAIRNESS OPINIONS



BRANCH STUDIES



BOARD RETREATS



STOCK VALUATIONS



FEASIBILITY STUDIES



NEW BANK START UP



ASSET MANAGEMENT



November
2005

Maryland Permanent Owings Mills, Maryland

has agreed to merge with



Northwest Bancorp Warren, Pennsylvania

Deal value was \$14.8 million.

Danielson Associates acted as financial advisor
and prepared the fairness opinion for
Maryland Permanent.



July
2005

Columbia Bancorp Columbia, Maryland

has merged with

[FULTON FINANCIAL
CORPORATION](#)

Fulton Financial Corp. Lancaster, Pennsylvania

Deal value was \$311 million.

Danielson Associates acted as financial
advisor and prepared the fairness opinion for
Columbia Bancorp.



April
2005

Legacy Bank, N.A. La Jolla, California

has merged with



Landmark National Bank Solana Beach, California

Deal value was \$11.1 million.

Danielson Associates
prepared the fairness opinion for
Legacy Bank.



January
2005

SVB Financial Services, Inc. Somerville, New Jersey

has merged with

[FULTON FINANCIAL
CORPORATION](#)

Fulton Financial Corp. Lancaster, Pennsylvania

Deal value was \$90 million.

Danielson Associates acted as financial advisor
and prepared the fairness opinion for
SVB Financial Services, Inc.



DANIELSON
ASSOCIATES

ARNOLD G. DANIELSON
CHAIRMAN

DAVID G. DANIELSON
PRESIDENT

JONATHAN D. HOLTAWAY
PRINCIPAL

6001 MONTROSE ROAD, SUITE 405 • ROCKVILLE, MARYLAND 20852 • (301) 468-4884

WWW.DANIELSONASSOCIATES.COM