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Getting Ready for the 21st Century, or
"Stop This World, I Want to Get Off"

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As we move into 1999, there are two new certainties in banking. One is that 1998 has joined 1969 and 1980 as a banking “watershed” year even without the sweeping legislative change that marked each of those earlier years. Another is that 1994 through the first half of 1998 will be viewed as the “good old days of banking” much as thrifts in the eighties looked back on the seventies. As 1998 began, it would have been impossible to imagine the changes in the landscape that would occur, and banks and thrifts of all sizes are going to have to adjust to the results.

The results of 1998 are a good news-bad news story. The good news is that financial services, of which banking is a part, are likely to experience high growth into the foreseeable future. The bad news is that most existing banks and thrifts may be ill-equipped to participate in this financial “boom.”

What so radically changed the banking environment in 1998? The five occurrences that led the way were:

- The Citicorp-Travelers merger – It combined the two most disparate parts of financial services and showed that the regulators will let the large players do what they want even when clearly violating existing laws.
- The OTS’s wide distribution of banking charters – Whether good or bad, is subject to debate, but it makes legislation to

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separate banking and industry a “tilting at windmills.”

- BankAmerica-NationsBank and other megamergers – This has resulted in six banks moving away from the crowd to virtual national status, and they will get even bigger.
- A major margin contraction - This is separating the strong from the weak and favors those banks with a growing stream of noninterest income.
- The emergence of the internet – This suggests banking’s version of the Schwab One-account is just around the corner.

These are just the biggest events and omit what might have been the lead stories in any other year. In addition to the above, in 1998 there was the steady parade of major investment banks being bought by commercial banks; the largest foreign acquisition of an American bank - Deutsche Bank purchasing Bankers Trust; and a major reversal in bank stock prices. Thus, it is little wonder that there also was a record number of bank mergers.

What does all this mean for the future? and – What can individual banks do about it? In looking to the future, banks should move forward with six basic tenets in mind. These are:

- All competitive barriers that separate the various parts of financial services will disappear.
- Financial services will be one of the growth industries of the new millenium.
- The big will get even bigger.
- Technological advances will make financial services available to customers with more convenience at lower prices.
- Rapid growth, changing environment and technology will combine to create opportunities for new entrants, reward forward thinking and leave traditional banks behind.

- Acquisition prices are likely to fall to levels that will induce most banks to remain independent.

This outlook may be scary to some, but the results can be very rewarding. In order for it to be rewarding, though, it must be realized that people do not wake up in the morning thinking – “Oh good, I have to visit my bank today.”

Citicorp and the OTS

In looking to the future, it is helpful to fully understand the impact of the Citicorp-Travelers merger and what the OTS is doing with its thrift charter. Thanks to Citicorp and the OTS, the "genie is out of the bottle" relative to unfettered competition in financial services, and the most likely impact of any moves by Congress to alter the process is to make traditional banks even less competitive than they are now.

The importance of Citicorp-Travelers cannot be understated in that it will have a major impact on the future of every banking organization since what "Citicorp wants Citicorp gets," and this will not change because the name is now Citigroup. This has been shown in the past by:

- Its being allowed in 1981 and 1982 to circumvent interstate banking prohibitions by acquiring large, failing thrifts in such cities as Los Angeles, Washington, Miami and Chicago. This was the primary catalyst for interstate banking going from virtually nonexistent to almost nationwide by 1986.
- The Fed approving the Travelers merger despite admitting it violated existing laws on the assumption that if it was not in compliance in five years that somehow the nation's largest financial firm could be pulled apart.

With this in mind, it is inevitable that Citigroup will be selling insurance and investment products side-by-side with its banking services despite possible protests by competitors, legislators and regulators. The courts may delay the process, but challenges based on Citigroup making financial services available with greater customer convenience and at lower prices will not play well in the courts. The good news is that Citigroup is opening the door for those capable of following.

The OTS's willingness to give banking franchises to State Farm, Allstate Merrill Lynch and the nation's largest casket maker, which are likely to soon be followed by GE Capital, GMAC and Ford, is equally important. This not only reinforces the Citicorp-Travelers' consolidation of financial services, but it is a further step toward breaking down the barriers between finance and industry.

Future of Financial Services

The story in financial services is not only the convergence of its various segments, but also the collective high growth potential. This is the result of the rapid accumulation of individually-controlled wealth that is flowing from private pensions, particularly 401(k)s; greatly increased personal disposable income; and the large amounts of money to be transferred from one generation to the other. The more funds in private hands, the greater the need for services to handle and invest those funds.

Adding to the high growth are changing methods for delivering insurance as well as securitization. Insurance has been a relatively low-growth business in a period of rapidly increasing insurance needs primarily because of an inefficient delivery system. As more insurance is sold directly or through mediums that can operate with low handling fees - i.e., full-service financial institutions, internet, etc. - the amounts of insurance sold should increase rapidly. Securitization, in much the same way, reduces the cost of loans, and in so doing, increases loan availability. While all of this is good for financial services growth, it is not good news for banks as it is likely to mean better growth for others and lower margins for all.

The Problems of Spread Income

The growth problems of a dependence on spread income can readily be seen in collective bank and thrift numbers; and it is necessary to include both since much of the banking growth in the last decade is the result of purchasing thrifts and shifting their numbers into bank totals. The major problem is that in recent years, net interest income growth has been very low. From 1995 to 1997, the annual increase rose to 5.7%, but through the first nine months of 1998, the annualized increase of 3.3% was typical of the early nineties. This low growth is why banks are losing share in the overall financial services business, and further share losses can be expected.

Depository Institutions Income and Expense Growth

	Annual Increase				Net Oper. Income
	Net Int. Income	Nonint. Income	Revenue	Overhead	
1997-98*	3.3%	16.1%	7.9%	8.9%	6.2%
1995-97	5.7	12.1	7.8	5.8	11.2
1993-95	3.5	4.4	3.8	1.8	7.4

*Nine months 1998 data annualized.

Source: SNL Securities L.P., Charlottesville, Virginia.

Even within banking, the better dynamics of the non-spread business can readily be seen through the growth of noninterest income. While spread income was growing slowly, bank noninterest income went from a 4.4% annual rate of increase between 1993 to 1995 to double-digit gains after 1995 with the annual increase reaching 16.1% in 1998. This was enough to produce overall annual revenue gains in each successive period. Those doing the best with fees are the large and/or specialty banks, and they are enjoying better revenue growth than the 7% to 8% average. Those depending primarily on spread income, which is most community banks, are doing worse.

The negative impact of the minimal spread income increases had been mitigated by growth in revenues being higher than the growth of overhead, but this was not the case in 1998. The large 1998 overhead increase may reflect the natural reaction to "good times" – i.e., expense control suffers when earnings are good –

and the costs of Y2K. Expenses in the preceding two years also were reduced by the "windfall" benefit of the elimination of deposit insurance.

Because of the declining importance of spread income, traditional banking might be viewed as a modern day version of the railroads of the early 1900s. The railroads were once the dominant players in a transportation business that was exploding as travel and shipping needs grew, but the constraints of their iron rails kept them from keeping pace with automobiles, trucks and airplanes. Being tied to traditional delivery systems, hampered by regulatory constraints and the reduced need for deposit-funded loans has created similarities for banks with the railroads of the early 20th century.

To say that banks are in a similar position relative to financial services as railroads once were to transportation is not a "stretch," but where banks differ from the railroads is that at least two of their albatrosses - the dependence on deposits and branches - are not as confining as iron rails. If a bank wants to move into another part of financial services, it can operate without deposits and branches, or at least fewer or different types of branches. The real barriers are management skills, culture and the ultimate albatross, regulatory restrictions.

In fact, other than insurance, most of the financial services that are now outside of traditional banking were once part of banking. Non-deposit funded mortgage lending, consumer finance and commercial finance historically were fringe businesses that took loans banks did not want until securitization switched the competitive advantage away from deposit-based lenders to those that were less encumbered by regulation; and, in so doing, took away much of the deposit-funded lending. Asset management also is a variation of trust services, but with a greater opportunity for customer gain.

Thus, it is not that big a step for banks to follow the flow of the business that was once theirs and avoid the railroad analogy. More often than not, the parts of the financial services industry that are eroding the bank share are bank products sold and/or packaged differently.

Margin Slippage

One of the causes of slowed growth in spread income has been declining margins. Bank margins historically have been cyclical, and reflected interest rate change. If interest rates went up, margins and profits followed. If interest rates went down, margins and profits also declined. This, though, was in an era when noninterest-bearing checking and moderately interest rate-sensitive deposits were the major part of bank funding and securitization had not put deflationary margin pressures on loans of all types.

Since 1993, collectively, bank net interest income as a percent of average assets has fallen every year but one, and that exception was a one basis point gain in 1995. The decline was gradual, though, from 1993 through 1997 – i.e., 21 basis points in four years. In the first nine months of 1998, bank net interest income was down 11 basis points.

There are many reasons for this margin decline, including the increased competition for deposits and leveraging, but a major factor has been the impact of securitization on commercial real estate lending. In the eighties, securitization contributed to the decline in home mortgage profitability, and throughout the nineties, the pressure of securitization on consumer lending pricing has increased, particularly in credit cards. It was not until recently that one of the pillars of interest rate sensitivity, commercial real estate lending felt the impact.

In 1990, securitized commercial real estate loans were so few that they did not "round up" to 1% of the total, but by 1996, they were 8% of all commercial real estate loans. Since then there has been an "explosion," and by the mid-1998, securitized commercial real estate loans were 15% of the total.

This has had a triple negative effect on bank margins in that it has reduced the amount of commercial real estate loans available for portfolio lending, raised interest rate risk and lowered yields. To securitize these loans, lenders are now offering fixed rates, which raises interest rate risk, and since their return is from fees on the sale of the loans, they are willing to accept lower yields. From a growth perspective, commercial real estate loans grew over 9% per annum from 1996 through 1998, but banks and thrifts, which hold more than half, had only a 5.3% annual rate of increase.

Impact of Securitization

	<u>Percent of Total</u>			<u>Annual Increase</u>	
	<u>1998*</u>	<u>1996</u>	<u>1990</u>	<u>1996-98*</u>	<u>1994-96</u>
<u>Home Mortgage Loans</u>	-	-	-	<u>7.7%</u>	<u>5.9%</u>
Securitized Pools	53%	52%	46%	10.4%	8.2%
Banks and thrifts	31	32	28	4.6	5.3
All others	16	16	26	5.4	.1
<u>Consumer Loans</u>	-	-	-	<u>4.6%</u>	<u>10.6%</u>
Banks and thrifts	43%	47%	53%	(.1)	6.7%
Securitized Pools	28	22	10	18.9	34.1
Credit unions/Finance Cos.	24	25	30	5.1	8.0
<u>Commercial Real Estate</u>	-	-	-	<u>9.6%</u>	<u>6.9%</u>
Banks and thrifts	52%	57%	59%	5.3%	4.7%
Securitized Pools	15	8	-	57.6	75.1
Insurance Cos.	19	21	28	1.2	(1.5)

*June 30, 1998 annualized.

Source: Federal Reserve Bulletins.

The 15% of commercial real estate loans securitized is a long way from the 53% of home mortgages and 28% of consumer loans, but it hurts in a special way since this is one of the last major lending areas available to small and mid-sized banks, and the one with the best yields. This leaves only small business lending free from the downward margin pressures of securitization, and even it may not be immune.

The Emergence of National Banks

It also was this changing financial services environment and not ego or greed that was the primary cause of 1998's megamergers. The motivation is to avoid being footnotes in history like the New York Central, the Pennsylvania Railroad and the other iron horses of the past, and reinvent themselves as viable players in an even bigger business. Some large banks will succeed and others may not do well, but no matter what happens, the end result will be even larger financial institutions since the only buyers for those that slip are other big firms.

The Leading Banks

	<u>Revenues*</u>	<u>Net Income*</u>	<u>Market Capital**</u>	<u>Nonint. Income/ Revenues *</u>	<u>Branches*</u>
(In billions)					
<u>Banking Big Six</u>					
Citigroup	\$47.3***	\$ 8.8	\$117	61%***	497
BankAmerica	26.8	4.6	106	39	4,282
Chase Manhattan	17.3	3.5	61	51	661
Bank One	16.9	3.8	61	45	3,100
Wells Fargo	15.1	2.8	65	43	2,849
First Union	13.3	2.6	61	43	2,546
<u>Other</u>					
J.P. Morgan	\$ 6.7	\$ 1.1	\$ 19	78%	4
Fleet	6.6	1.5	26	42	1,166
U.S. Bancorp	5.2	1.3	26	40	999
National City	4.7	1.0	24	42	1,417
PNC	4.7	1.1	16	46	764
SunTrust	4.5	1.1	25	36	1,070
Mellon	4.3	.8	18	65	441
KeyCorp	4.2	1.0	15	33	961
BankBoston	4.1	.8	11	39	438

*September 30, 1998 or twelve months ending September 31, 1998.

**January 5, 1999.

***Estimated.

Source: SNL Securities L.P., Charlottesville, Virginia.

Already six banks - Citigroup, BankAmerica, Chase Manhattan, Bank One, Wells Fargo and First Union - have left all others behind. When measured by revenues, the smallest of the six, First Union, is about twice the size of the nation's seventh and eighth largest banks, J.P. Morgan and Fleet. In terms of market capital, First Union is \$16 billion ahead of Fleet and Morgan combined.

This is not to suggest that the "big six" cannot become a "big seven" or "big eight." Certainly one or two amongst Fleet, U.S. Bancorp and National City will act boldly in 1999 and acquire a PNC, Mellon, Summit or Keycorp or align themselves with nonbanks such as Fidelity or American Express. They also,

though, could be acquired by one of the "big six" and more consolidation between the present "big six" is inevitable. The BankAmerica-NationsBank merger is a model for a future merger between First Union and Wells Fargo, or one of those two with Bank One.

Size also has become a major competitive advantage, and articles and studies that suggest otherwise are either misinformed, outdated or presenting a biased view for a target audience. The advantages of size can be seen readily in financial results during good times for banks of all sizes, 1994 through the first half of 1998. This advantage is particularly noticeable when the large bank holding companies are contrasted with those with assets of less than \$2 billion.

Bank Holding Company Performance by Size

	1998*		Change 1994-98*	
	Over \$50 Billion	\$100 Million to \$2 Billion	Over \$50 Billion	\$100 Million to \$2 Billion
	<u>Percent of Avg. Assets</u>			
Net interest income	3.05%	4.20%	(.26)	(.03)
Net oper. expense**	<u>.64</u>	<u>2.22</u>	<u>(.68)</u>	<u>(.19)</u>
Net oper. income	2.41%	1.98%	.42	.16
Return on avg. equity	17.92%	13.29%	2.03	.55
Nonint. income/Revenue	48%	19%	9	3
Capital/Assets	7.00%	9.43%	(.12)	.60

*June 30, 1998 or six months annualized.

**Operating income less noninterest income.

Source: SNL Securities L.P., Charlottesville, Virginia.

The favorable variance for large banks is apparent in every measurement of financial performance, but the keys are their net overhead that was .64% of average assets in the first half of 1998 and noninterest income that was 48% of revenues. This differs greatly from bank holding companies with assets below \$2 billion that had net operating expense in excess of 2.20% of average assets and noninterest income in the teens as a percent of revenue.

The large bank holding companies' lower costs create major competitive advantages, one of the most important of which is producing superior returns on relatively low margins. The big banks can lend for less while paying more for money and still earn better than their smaller brethren. In 1998, bank holding companies under \$2 billion had net interest income in excess of 4% of average assets, which meant margins a full percentage point higher than the big banks. Despite this, the small bank holding companies had net operating income that was 30 to 40 basis points lower. The end result was a collective big bank holding company return on equity of almost 18% compared to about 13% for their smaller brethren.

More concerning for community banks than the 1998 comparisons are the trends since 1994. During this period, the large bank holding companies reduced net operating expense by more than half compared to a 19 basis points reduction for the small banks. This resulted in a 42 basis points large bank increase in net operating income, which was more than twice that of the smaller banks. This contributed to about a two percentage point increase for large banks in return on equity compared to a half a percentage point gain for the under \$2 billion banks. Contributing to this shift in favor of the large banks was a 3 to 1 advantage in percentage point gains in noninterest income as a percent of revenue.

Thus, while small and mid-sized banks can rationalize that people are not enamored by large banks and that with every megamerger there is an outflow of customers, the large banks make more money, do it on narrower margins and are widening the profit advantage. It is also almost axiomatic that those that make the most money come out ahead in "crunch time."

Just becoming part of a banking elite, though, would not be of much value to the large banks if they were not using their size to become full-service players in financial services. Their core business is the slow growing spread banking, and if they do not diversify, they will have trouble keeping up with the largest "nonbanks" - AIG, GE Capital and Morgan Stanley.

This risk is not being ignored. Four of the five largest home mortgage originators and servicers are BankAmerica, Wells Fargo, Chase Manhattan and Fleet. In credit cards, four of the six largest are Bank One, Citigroup, Chase Manhattan and BankAmerica. Investment banking is headed the same way, and it is only a matter of time before this large bank dominance is expanded into mutual funds and insurance sales.

Changes in Delivery and New Competition

With the industry barriers falling, the large getting larger, the demand for financial services growing and technology making rapid advances, it is inevitable that new forms of delivery will emerge and that the mix of players will change. Customers want price and service, and the ultimate service is not having to get into one's car and go to a bank branch.

The internet is all the "rage" right now, but it is just another step along the path of easier, albeit less personal, banking service. The credit card was the first big step in that direction, the ATM was a second and telephone banking a third. These steps were introduced and initially dominated by banks, but few mid-sized or community banks now have a meaningful credit card business, the bank monopoly on ATMs is rapidly eroding and telephone banking is an interim step toward computer/internet banking.

For those that want to deny changes in the delivery of financial services, the cliches are there to be used – i.e., one stop banking has been tried and did not work; the branch has been pronounced dead for 25 years, and every year there are more branches; and a limited amount of customers, mostly the young, are truly comfortable with electronic banking. There are merits to these arguments, but Sears buying Dean Witter and a thrift and trying to sell financial services through a then fading retail franchise is not the same as Citicorp joining with Travelers and Smith Barney in the age of internet; and more bank branches every year is the result of decisions that may be correct on an individual bank basis, but, collectively, are the equivalent of “lemmings moving toward the cliffs.” As to the young, they will get older.

Sale Value Impact

The growth of other forms of delivery and the lessened dependence on deposits to fund loans suggests that the sale value of branches and deposit bases will diminish. This is inevitable, and the real questions are - How soon? and - By how much? It is difficult to predict the timing, but the downward trend is underway in many places, and by choice or just by waiting too long, most banks and thrifts will miss the chance to sell at a good price and be forced to adjust to the changing environment.

This may not be a great scenario for investors, but it is not all bad. It was not until 1984 that banks stopped being just banks and also became vehicles for

large capital gains. What we may be looking at now is a return of the pre-1984 era in terms of investor interest - i.e., dividends count more than growth - but the basis for delivering those dividends will be quite different.

Community Bank Reaction

How does a community bank react to this changing landscape? There is no one answer since each community bank is dealing with a different set of factors, but, in general, the reaction should be a balancing of some combination of cost reductions, more fee income and greater specialization, but realizing that there are contradictions among the three. The major difference between country and urban community banks will be a lesser need for specialization by the former.

The need for cost reductions may sound like an old refrain, but it is taking on some new meanings. In the future, local banks will be competing even more on price, and service will mean greater convenience, not smiling tellers. Since branches will continue to be a part of the community bank game, even as they play a reduced role in the overall dispensing of financial services, in order to meet future expense reduction needs, it will be necessary to push more volume through fewer branches. From a strategy perspective, this will make in-market mergers more important.

The need for more fee products is a shift from the low growth portion of financial services to higher growth areas. Insurance and asset management are the primary fee businesses for community bank expansion with the latter having by far the better growth potential. It is unlikely many community banks will be relevant in five years if they are not generating at least 30% of their revenues from fees, but getting there will not be easy.

The need for more specialization while broadening the product line into fee businesses is not as contradictory as it sounds. Specialization should come at the customer end with local financial institutions focusing on customers whose needs go beyond the Wal-Marting of America and sell them more services - i.e., loans, deposits, insurance and asset management. This customer generally will be the businessman, professional and others on the higher end, but not the very top, of the affluence spectrum. BankAmerica, First Union and Citigroup will be the financial service providers for the people who do their shopping at Wal-Mart and Nieman Marcus.

Since selling out may not be an option for community banks, there will be a growing interest in mergers of equals since they reduce local overcapacity, create more market clout for selling fee services and spread overhead over a larger base; and a new exit strategy is likely to emerge for highly capitalized banks and thrifts that have trouble reaching double-digit ROEs. This will be to sell, or give away, their banking business and put their capital to better use through nonregulated financial holding companies.

Conclusion

Changes in the post-millennium delivery of financial services, the move toward bigness and narrowing margins will impact existing financial institutions in varying ways, but they all will be affected. If major adjustments are not made, irrelevancy and declining investment value may be the result.

The six largest banks and the one or two that may join them at the top will get the most headlines and appear to know what has to be done as they have led the way into fee businesses. They will continue to expand, and the “big six” may become a “big seven or eight,” before shrinking to four or five and sharing the industry leadership with AIG, GE Capital and some yet-to-be seen financial services equivalent of Amazon.com.

The large regionals are already few in number, and they will be further diminished. Some of the bigger ones like Fleet, U.S.Bancorp and National City may merge their way into the lower echelons of the national elite. Others like Wachovia and SunTrust, may benefit from the investor interest in specialists serving high growth market – i.e., the Sunbelt. For almost everyone else, it is probably - “getting out while the getting is good.”

For community banks in urban areas, the future is specializing away from the commodity products that will be dominated by the big players. The most logical specialty is small businesses, which is where most recently opened banks have positioned themselves. There also may be room for commercial real estate specialists in large urban areas. In addition, there will be the financial services of the future, but much of this is likely to be dominated by new entrants.

In the outlying regions, community banks will have more staying power. This will come from a combination of a lack of sale opportunities and less direct competition from the big banks. More staying power, though, does not mean a continuing of historic growth trends.

Thrifts are almost non-existent in urban markets and most outlying areas outside of New England, New York and California, and those that remain will look increasingly like commercial banks. The bank's primary advantage over thrifts of cheap deposits is being eroded, albeit the banks still have the better customer base. Becoming more like a bank, though, is occurring as the term "community bank" is becoming as outdated as "savings and loans" since the services needed to survive and prosper go beyond traditional banking fare.

Credit unions, which experienced rapid gains in deposits in the late eighties and early nineties as displaced thrift customers sought alternatives to banks, also may diminish in collective size, but will continue to play an important role. They are the logical providers of financial services to customers deemed unprofitable by others.

Insurance agencies and brokerage houses will be losers as fees are driven down by cheaper methods of delivering their services. The reduced fees, though, will enhance the growth of the products they sell.

The main battleground for progressive financial institutions of all sizes will be asset management. Investing a growing surplus of disposable income has driven the stock market to new heights and made mutual funds the high growth financial product of the nineties, and the next wave of megamergers is likely to have the largest financial services companies buying mutual fund companies. This, though, is an area that will provide profitable "niches" for a wide variety of players and is a "must" for community financial institutions if they want to stay relevant.

Mergers and acquisitions will continue to play a role in the transformation of financial services, but the emphasis is moving toward lines of business and away from branch networks. The large financial services companies already are focusing on lines of business and reducing their branch coverage. This is having a negative effect on bank sale prices and should slow the acquisition pace. For local banks, acquisition activity is likely to shift to in-market consolidations, which may be helped by a future trend toward abandoning bank charters and putting existing capital to better use – i.e., some banks, and particularly thrifts, will sell existing banking activities to move into other endeavors.

The future will be challenging in an unprotected environment, but banks, big and small, start with a major competitive plus - access to the best customers. The

big banks are using this customer “card,” plus capital, to overwhelm the nonbanks at the upper end of the spectrum. Whether, local banks can do the same at the other end depends on how well they adjust to the needs of the 21st century.

If banks can free themselves from doing business as usual, then they can continue to be major providers of financial services. If they cannot, then they will join savings and loans as fond memories to be enjoyed each Christmas as Jimmy Stewart takes us back to Bedford Falls.