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**National Banking Report – Summer 2003**

**In a Rowboat Without Oars**

By:  
Arnold G. Danielson  
Chairman  
Danielson Associates Inc.

The summer of 2003 has been a quiet one for banking. There have been no big mergers; no interest rate changes; and no consensus on where banking and the economy are headed. The government and Wall Street cheerleaders see a strong economic recovery beginning, but just when you are ready to believe them, a dip in the consumer confidence index or an increase in jobless claims brings a note of caution. What we do know, though, is that banking has held up well in a difficult economic scenario.

Where does banking go from here? That is a question we all would like to know the answer to, and at this time, to say there is considerable uncertainty is a gross understatement. In fact, the situation may be akin to being “in a rowboat without oars” and hoping the current takes one to a pleasant landing. A major reason the industry’s future is hard to forecast is that the most important industry trends point in different directions.

The trends that are the most concerning are:

- Margins have been going down for nine years, and it does not seem to make much difference what interest rates do, and
- A branching boom is underway while transaction volume is diminishing, overcapacity is high and the cost of operating a branch is increasing.

*Danielson Associates Inc.  
6001 Montrose Rd., Suite 405  
Rockville, Maryland 20852  
(301) 468-4884*

The downward drift in margins has taken almost a full percentage point out of net interest income as a percent of average assets since 1994, and there are no signs of a reversal in the foreseeable future. The Fed has given no indication it will increase interest rates anytime soon, which puts downward pressure on loan yields even as the competition for deposits is starting to put upward pressure on deposit rates.

Margins get most of the negative attention, but a bigger banking problem may be the timing of the increased interest in *de novo* branching. Recently, one is more likely to read in the American Banker about the branching plans of banks, big and small, than about acquisitions. It is understandable that as the strong deposit flow of the past three years comes to an end that bank directors and management will look to new offices to maintain their deposit growth, but as deposit growth returns to the lower levels of the nineties, chances for new branches meeting expected deposit goals are greatly reduced. This is complicated by the costs of the need to be open on Saturdays, and probably on Sundays, to be truly competitive. No matter what happens to Commerce, its “long hours concept” will not go away.

Margin declines and too many branches are problems, but there are other trends that make the future look more promising. These are:

- Financial services is a growth industry, and
- Despite margin and cost pressures, publicly-traded banks have increased EPS at high annual rates since the mid-nineties.

The last ten years have been good ones for banking. In the mid and late nineties, a strong national economy lifted virtually everything with it, and even the flow of money out of deposits into stocks did not keep banks from enjoying the benefits of those years. Then, as the economy moved into an extended malaise after the crash of the stock market in 2000, banks have benefited from the steep drop in interest rates that coincided with a flow of funds back to deposits that could be priced at low levels not seen in decades. This has allowed banks to continue to show good growth and produce good stock price gains.

In the “how easy we forget” category, it also is interesting to note that in 2000, most banks and bank investors were lamenting how much their stock prices had fallen since their 1998 highs. Today, banks look to 2000 as the natural starting point rather than 1998, and revel in just how well their stocks have done compared to other industries. This is a rerun on the 1987-1990 experience when in the nineties banks did not compare their stock prices to what they were in 1987.

While the good and bad trends are easy to see, albeit it is not easy to foresee their end results, there are two other bank trends that are “mixed blessings.” These are:

- Merger activity continues to be slow, and, in some areas, almost nonexistent, with few indications of a recovery, and
- A segmenting, rather than consolidation, of banking at the small bank end of the industry’s “bar bell” structure.

The much reduced merger activity, despite what investment bankers would like to think, is the norm and not an aberration, and while it lessens the pressure for individual banks to sell, it is also makes a profitable exit more difficult. There is a strong demand for bank franchises in the “hot” markets, but there are fewer buyers every year, and for most banks the sale value of their franchise is based primarily on someone wanting their branch network – a “want” that will exist only as long as the method of delivering bank services does not change.

The segmenting of banking below the national level is positive in that it allows small banks to exist in niches that big banks do not want or are not good at, but at the same time, it makes the all purpose small bank more of anachronism. This is reflected in most new banks being either business or mortgage banks, and the Commerces and Chevy Chases of the world having taken transaction banking to new levels.

This report looks at each of these trends as to their impact and where they are likely to go, and, whenever possible, supports these views with numbers. The numbers, of course, reflect the past, and in a rapidly changing banking environment the past may not reflect the future.

### The Margin Decline

The major concern of bankers today is margins and how low they can go. From 1994 through 2003, margins have fallen every year but one, and using a broad sample of publicly-traded banks in the eastern half of the country with assets under \$50 billion, the decline in net interest income as a percent of average assets was over 80 basis points – i.e., from 4.44% to 3.62% of average assets. Most of this decline has occurred since 1997.

Commercial Bank Financial Performance\*

	Percent of Average Assets			
	<u>Net Int.</u> <u>Income</u>	<u>Nonint.</u> <u>Income</u>	<u>Oper.</u> <u>Expense</u>	<u>Net Oper.</u> <u>Income**</u>
<u>2003</u>				
2nd Qtr.	3.62%	1.16%	3.11%	1.74%
1st Qtr.	3.69	1.06	3.08	1.81
2002	3.92%	1.04%	3.02%	1.95%
2001	3.86	.98	3.08	1.86
2000	3.94	.88	3.03	1.92
1999	4.04	.85	3.08	1.96
1998	4.12	.86	3.09	2.01
1997	4.37	.86	3.16	2.09
1996	4.38	.80	3.13	2.10
1995	4.39	.82	3.26	2.05
1994	4.44	.77	3.36	2.02

\*Medians for 113 publicly-traded banks east of the Mississippi River with assets under \$50 billion.

\*\*Medians will not necessarily add across.

Source: SNL Financial, Charlottesville, Virginia.

In 2002, the steep drop in interest rates combined with the flow of deposits out of the equities market reversed the margin decline as banks were able to drop rates paid on deposits faster than loan yields fell. Even in that favorable environment the increase in net interest income as a percent of average assets was only six basis points, or about 14% of the decline in the preceding seven years.

Margins began declining again in the second half of 2002, and the pace of decline accelerated in 2003. Net interest income as a percent of average assets for this bank sample was 3.62% in 2003's second quarter, which was 30 basis points below 2002. The amount of decline in the first half of 2003 suggests that 2002 was an aberration in a pattern of declining margins that is about to move into its tenth year.

Will margins go even lower? The nearterm answer is that they will if banks are forced to be more competitive in pursuing deposits than they were over the last couple of years and average loan yields continue to slide, even if only modestly. This is almost certain if the prime rate is not increased, and unfortunately, this appears to be the scenario for at least the next few months.

What makes the downward margin pattern an even bigger concern is noninterest income and operating expense.

- After being almost flat in the late nineties, noninterest income for these banks, moved up sharply in 2001 and 2002 – i.e., from .88% to 1.04% of average assets, and the rise continued in early 2003, reaching 1.16% of average assets. These gains were largely driven by mortgage-related fees, a source of earnings increase that is over and will compound the negative impact of margin slippage.
- Overhead fell sharply as a percent of average assets in the early years of margin decline, primarily as a result of eliminating deposit insurance. Since 1999 there has been little change as a percent of average assets, and overhead could be banking's "next new problem."

### The Branching Boom

Why might overhead be banking's "next new problem?" If margins keep sliding and overhead remains constant, then there is a margin/cost relationship problem, but it is more than that.

Two areas of industry consensus at the local level are that there are too many banks chasing too few loans and too many banking offices. The

“too many banks chasing too few loans” is a more acute problem in a down economy than in a strong economy, and at least the number of banks is decreasing – i.e., the number of banks and thrifts has been reduced by about a third over the past decade. Fewer banks, though, has not meant fewer banking offices, and after a modest reduction in the early nineties, there has been an increase in branches nationwide every year since 1995. This is why banking, unlike most other industries, has not been able to produce strong productivity gains, and this situation is likely to worsen.

The concerns about branching going forward are:

- The checks and balances of closures following big bank mergers offsetting the franchise expansion of small, and often new, banks is over. Big banks while still buying branch networks, are doing so in smaller doses and have ended the closings related to the merger explosion of the late nineties and are, themselves, doing more *de novo* branching. Washington Mutual planning for seventy new branches in Chicago and Bank of America announcing its intent to open 10 to 15 offices in large markets it does not serve are just the tip of the iceberg.
- The tendency of small banks to open branches when they have the least chance of success is about to be played out again. When deposit growth slows, a typical response of bank management and boards, particularly the latter, is to open branches in new markets to keep the deposit inflow going. This is a “zero sum” game for the industry and an increase in expenses without compensating revenues. Unlike in other industries, when a bank opens a new office, old ones are seldom closed.
- Also, if a new branch is intended to be more than a loan production office that takes deposits, then to be competitive in urban markets, it has to be open on Saturday, stay open on weekdays until at least 6:00 p.m., and it may not be long before Sundays are added to the mix. This means at least two sets of tellers, which is likely to drive the deposit “break-even” to the \$30 to \$40 million range.

The cost-related case against branching is easy to make, but it is a “catch-22” in that banks cannot remain truly competitive if they are not continuously upgrading their branch delivery system. Large banks and transaction specialists are building big, expensive offices in expectation of selling a full range of financial services through offices that are not built around a row of teller stations. They also are focusing on convenience and an ambience that makes it easier to sell such services. Commerce and others have proven that customers like convenience; like nice offices; and tend to associate success with appearance.

Unfortunately, while bank branches are getting bigger and staying open longer hours, the intent of selling more products and services through these offices may be more “hope” than reality. The financial store of the future may well sell a broad range of services that includes insurance and investment products, but they are not yet doing this profitably, and it is unlikely they will be doing so in the near future.

This sudden interest in branching is like a rerun of a comment once made about the overbuilding of hotels in Atlanta in the seventies. A study had come out that suggested the city could use two more hotels, and, as a result, a dozen companies decided to build those two hotels.

### Financial Services As a Growth Industry

Bankers should be concerned about margins and the negative impact of too many branches being built at an increasing cost, but an even more important trend for banks is the overall growth of financial services. Good management can handle margin and cost pressures, but it may add up to little in the way of increased value if the growth of the banking industry is not good. Banking is different things to different banks, but by far the best outcome is for all parts of the industry to show good growth fundamentals – i.e., deposits, loans, asset management, etc.

From a traditional deposit and loan perspective, the numbers have been encouraging in recent years even when the economy has performed badly. Since the end of 1999, deposits have increased at a rate of almost 8% per annum; one-to-four family mortgage debt grew 12.6% annually; year-to-year growth of commercial mortgages was 8.5%; and consumer debt

increased 6.8% annually. The only real negative was an economy-reduced 1.1% annual gain in non-mortgage commercial loans.

### Key Financial Products

	<u>December 31,</u>			<u>Annual Change</u>	
	<u>2002</u>	<u>1999</u>	<u>1994</u>	<u>1999-</u> <u>2002</u>	<u>1994-</u> <u>2002</u>
	(In millions)				
<u>Deposits*</u>					
Savings	\$2,779	\$1,741	\$1,150	16.8%	11.7%
Retail CDs	894	956	818	(2.3)	1.1
Jumbo CDs	792	746	363	2.0	10.2
Checkable	<u>603</u>	<u>618</u>	<u>788</u>	<u>(.8)</u>	<u>3.4</u>
Total	\$5,068	\$4,061	\$3,119	7.7%	6.3%
<u>Debt</u>					
Res. Mortgage**	\$6,460	\$4,787	\$3,424	12.6%	8.3%
Consumer**	1,726	1,416	965	6.8	7.5
Comm. & Ind.***	1,506	1,460	984	1.1	5.5
Comm. Mortgage**	1,402	1,058	681	8.5	9.4

\*Banks and thrifts.

\*\*All lenders.

\*\*\*Banks and finance companies.

Source: Federal Reserve Bulletin, August 1995 and 2003.

The more meaningful numbers, though, are those going back to the beginning of the last upward swing in economic activity, which measures growth over a more complete cycle. The upswing started before 1994, but for banking purposes, 1994 is a good starting point as it is the first normal year after the difficult times of the early nineties.

From a deposit perspective, the full cycle only reduces the annual increase from 7.7% to 6.3%, but it greatly changes the deposit growth by type. In the last three years, almost all of the deposit growth has been in savings deposits, particularly MMDAs. In the five years prior to 1999, deposit growth was driven by jumbo CDs as well as savings accounts, which reflects the need to buy deposits on the growth side of the business cycle. In

terms of growth, long and short-term, checking accounts and retail CDs are non-factors.

On the loan side, the full business cycle evens out the growth of the major types of loans. Residential mortgage debt falls back to its historic 8% to 9% rate of increase, and commercial mortgages and consumer debt have annual increases in that general vicinity. Non-mortgage commercial loans increased at a lower 5.5% annual rate over the full period, but prior to the economic downturn, this type of loan was increasing at a rate of better than 8% annually.

Thus, over a full business cycle, annual loan growth, which is still the most important determinant of banking success, is in the 8% to 9% range, but the mix varies on the up and down side of the business cycle. The major cyclical variants are more deposit cost pressures on the upside, and the lack of growth of commercial loans on the downside.

As banks diversify and customers move more into an investor mode, loans and deposits no longer are the whole story for banks, and to get a more complete picture of the industry's underlying fundamentals, it is helpful to use a different set of numbers that focus on domestic financial wealth. This adds equities, money market funds ("MMFs") and household equity to the mix as well as a large miscellaneous category, little of which the Federal Reserve bothers to define.

### Domestic Financial Wealth

	December 31,			Annual Change	
	2002	1999	1994	1999-	1994-
	(In millions)			2002	2002
<u>Stock Related</u>					
Corp. equities	\$11,840	\$19,546	\$ 6,238	(18.2)%	8.3%
Pension fund res.	8,014	9,065	4,872	(4.2)	6.4
Mutual funds	3,639	4,538	1,477	(7.6)	11.9
Personal trust	841	1,130	699	(10.3)	2.3
Subtotal	\$24,334	\$34,279	\$13,286	(12.1)%	7.9%

### Deposits

Retail time*	\$ 3,402	\$ 2,672	\$ 2,183	8.4%	5.7%
MMF	2,224	1,579	603	12.1	17.7
Checkable	1,649	1,485	1,242	3.5	3.6
Jumbo time	1,175	936	411	7.9	14.0
Foreign	<u>934</u>	<u>704</u>	<u>325</u>	<u>9.9</u>	<u>14.1</u>
Subtotal	\$ 9,384	\$ 7,376	\$4,764	8.4%	8.8%
Household equity	\$ 5,024	\$ 4,510	\$3,416	3.7%	4.9%
Miscellaneous	<u>17,442</u>	<u>13,916</u>	<u>8,321</u>	<u>7.8</u>	<u>9.7%</u>
Total	\$56,184	\$60,081	\$29,787	(2.3)%	8.3%

\*Includes retail CDs, MMDA and savings account.

Source: Federal Reserve Bulletin, August 1995 and 2003.

The negative impact of stocks since early 2000 on domestic wealth is something everyone is painfully aware of, but securities growth in value is almost 8% per annum over the full business cycle defined to start in 1994. This does not lessen the “hurt” of having corporate equities, pension fund reserves, mutual funds and personal trusts experience a loss of value of about \$10 trillion in just three years, but this was less than half of the \$21 trillion they gained in the preceding five years.

From a banking perspective, these numbers suggest that like loans, asset management has an underlying growth momentum in the 8% area. This may not be the double-digit growth that most would like, but 8% is not bad.

If there is a negative for banks in these expanded numbers, it is the rapid growth of money market funds. This competitor for bank deposits has increased at a rate of 17.7% annually over the full cycle, and since 1999, money market funds have grown at a rate of 12.1% off a much larger base. This is the non-bank competition for funding that puts the most upward pressure on the cost of funds for banks.

Another interesting number in this wealth mix is household equity. A less than 4% annual increase since 1999 indicates that homeowners, as a group, have chosen to increase the size of their mortgage rather than enjoy the net worth benefit of the higher valuation of their homes.

## Bank EPS Goes Up Despite the Negatives

Another positive trend during these nine years of margin decline is that the same banks that were discussed earlier as having severe margin slippage also have doubled their collective EPS during that same period, which is an annual increase of about 8%; and the strong EPS gains have continued into 2003. In any one year, some of this gain can be attributed to one-time events like a decrease in contributions to the loan loss reserve or securities gains, but over the long haul, it is primarily loan growth and capital management offsetting the reduced margins.

### Commercial Bank EPS Performance\*

<u>2003**</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1998</u>	<u>1996</u>	<u>1994</u>
\$1.70	\$1.61	\$1.50	\$1.33	\$1.19	\$1.01	\$.82

\*Medians for 113 publicly-traded banks east of the Mississippi River with assets under \$50 billion.

\*\*Six months annualized.

Source: SNL Financial, Charlottesville, Virginia.

Can banks continue to grow and manage their way through margin slippage and increase EPS enough to satisfy shareholders? No one can be sure of the answer to this question, but the likely answer is – as a group “yes,” but there may be more laggards than in the past. The banks most likely to lag are those with poor margin/cost relationships. The future also will favor the large over the small if they are competing for the same business with operating expense being the primary reason.

## Bank Mergers and Consolidation

The reduction in bank merger activity has been widely documented, but the focus on numbers of deals rather than the size of the transaction has obscured the impact on consolidation and, possibly, the role of mergers in shaping the banking industry structure in the future. From 1997 through 2000, the average annual number of bank sales with deal volumes of more than \$250 million was almost 16 in the eastern half of the country, and the average cumulative deal value per year was \$73.4 billion. Since the start of 2002, there have been only four deals of that size in the states east of the

Mississippi River, and only one of those, BB&T buying First Virginia, had a transaction value in excess of \$1 billion.

The over \$250 million deal value recently has become primarily a thrift event. While there were only four banks sales in eastern United States with transaction values over \$250 million, there were ten such thrift transactions of that size. Even among thrifts, though, only one transaction, New York Community acquiring Roslyn, had a transaction value in excess of \$1 billion.

The reason most often given for the slowdown in bank transactions of all sizes is the gap between what sellers want and buyers are willing to pay, and there is some applicability of this reasoning to large acquisitions as well as small ones. There are no big acquirers going around, as First Union and others did in the late nineties, making offers “too good to be refused” for banks of substantial size, but most banks that can justify a price in excess of \$250 million know their real value and realize that future increases in sale value are tied to their earnings gains.

Large Bank and Thrift Sales, Eastern United States\*

	<u>Commercial Banks</u>		<u>Thrifts</u>	
	<u>No. of Deals</u>	<u>Deal Value</u> (In mill.)	<u>No. of Deals</u>	<u>Deal Value</u> (In mill.)
2003**	3	\$ 4,509	6	\$3,551
2002	1	293	4	1,795
2001	6	18,371	3	6,286
2000	13	55,246	-	-
1999	15	39,293	5	4,440
1998	20	145,635	11	7,501
1997	14	53,514	16	8,651
1996	4	3,101	6	4,695
1995	14	44,664	7	3,048
1994	7	5,066	4	1,525
1993	11	10,029	3	1,058
1992	5	3,588	-	-
1991	9	11,760	-	-
1990	-	-	1	301

1989	7	5,123	-	-
1988	4	1,613	1	440
1987	4	4,382	1	265

\*Sale value in excess of \$250 million and acquire based east of the Mississippi River.

\*\*Through August 31, 2003.

Source: SNL Financial, Charlottesville, Virginia.

Other reasons for the slowdown in merger activity involving banks of substantial size are:

- Big banks are more frequently using *de novo* branches to expand as they prefer “stores” that fit their marketing design.
- Most banks that could justify a sale value of more than \$250 million, and were open to a sale, took advantage of the high prices of the late nineties and did not gamble on what merger pricing would be after the elimination of “pooling” accounting.
- Reduction in the number of banks that are able and willing to make an acquisition of this size.
- Banks are coming off a couple of very good years resulting from an unusual deposit inflow that was easily downpriced to offset margin pressures temporarily and feel little need to sell absent offers “too good to be refused.”

Will this paucity of significant acquisitions change in the future? Arguing against change is the reduced interest of large banks in buying “old” branches and fewer buyers than in the past. Conversely, there may be widespread disappointment in earnings results coming from margin and cost pressures that will make many banks question their future prospects. If this happens, though, it will affect buyers as well as sellers, and, as a result, it could increase merger activity, but have a negative effect on pricing.

While overall merger activity remains slow, there are likely to be a couple large bank mergers in the next few months as some of the serial acquirers need “action.” Bank of America, Wells Fargo, Bank One, Wachovia and the Royal Bank of Scotland are the most likely buyers, and mid-sized banks in Michigan, Ohio and Pennsylvania are the most logical targets.

Fleet also could be in the mix, and, although it is widely rumored as a seller, it also could be a buyer of a significant bank in Pennsylvania or Ohio. The recently announced Progress Financial acquisition is a step in that direction, albeit an acquisition of that small size is likely to have been a local market decision rather than a signaling of Fleet’s overall corporate direction.

## Bank Specialization

Another trend that is a “mixed blessing” is a tendency for new banks to specialize rather than follow the traditional community bank approach of trying to fill all the financial needs of its customers. The growth of the transaction-oriented bank led by Commerce receives a lot of attention, but an equally important step in specialization is the greater emphasis the new banks place on commercial lending than their predecessors, as well as the growing importance of the new “business banks.”

### New and Old Bank Loan Orientation\*

<u>State</u>	<u>Percent of Loans</u>				<u>Number of Banks</u>	
	<u>Commercial</u>		<u>Retail</u>		<u>New</u>	<u>Old</u>
	<u>New</u>	<u>Old</u>	<u>New</u>	<u>Old</u>		
New York	83%	55%	17%	45%	31	75
Massachusetts	81	51	19	49	11	21
New Jersey	74	53	26	47	43	22
North Carolina	72	58	28	42	37	28
Maryland	71	56	29	44	14	33
Virginia	66	52	34	48	50	67
Pennsylvania	65	54	35	46	30	118

\*Banks opened before and after 1985, and excludes banks with over \$5 billion in assets, foreign banks, nonbanks and trust banks.

Source: SNL Financial, Charlottesville, Virginia.

If local banks are divided into those opened before and after 1985 in seven large East Coast states, the greater commercial loan emphasis can be readily seen. The older banks in each state have a commercial/retail split that is generally in the 55/45 vicinity. For the banks opened since 1985, in five states they have an average commercial loan content over 70%, and in two, New York and Massachusetts, it is over 80%. Only in Virginia and Pennsylvania do the new banks not have at least 70% of their loans being classified as commercial, and for each, the percentage is 65% or higher. It also is likely that many loans classified as home mortgages are business loans with the home being used as collateral, and that this is more often the case for new banks than it is for their longer-established brethren.

The importance of recently opened banks being primarily business banks is exaggerated by the disappearance through acquisition of so many of the older banks with more traditional product mixes. In New Jersey and North Carolina, there are more local banks opened since 1985 than before, and Virginia is getting close. If only large urban areas were included, the more new than old would be the rule rather than the exception.

The “mixed blessing” of this specialization and segmenting is that the low end of commercial lending appears to be a niche that local banks can serve without being faced with ruinous competition with large banks and other financial services companies, but there are still many local banks trying to be true full-service operations. This may work fine in outlying markets, but it is a questionable strategy in urban areas.

### Conclusion

What do these trends and numbers mean? They may mean different things to different people, but it is hard to avoid three logical conclusions. These are that:

- Financial services is a growth business, but that traditional banking built around spread income is still at the low end of the growth spectrum.
- The primary reason for this is that a continuous shrinkage in margins translates directly into lost revenues.
- There is a lack of productivity gains in a business that is experiencing little, if any, revenue growth from its basic deposit and lending business.

If this sounds familiar, it is because it is the thinking of 2000 and early 2001 before a steep decline in interest rates gave some margin relief and sent refi-based fee income soaring. If there is anything new, it is the renewed interest in “bricks and mortar” in an industry that has not had significant reductions in overhead as percent of assets for years.

Also indicative of the move back to the scenario of 2000 is the change in tone of bank analysts that for most of the last two years were critical of the nonbank activities of the likes of J.P. Morgan, Fleet and others while praising the more traditional large banks like BB&T and SunTrust as well as applauding Fleet's "return to the basics." In the first half of 2003, BB&T and Suntrust were among a very small group of big banks with flat or declining earnings, and Fleet may be falling out of favor because of the poor growth dynamics of banking's "basics."

The bottomline is that while financial services is a good place to be, and a wonderful place to have invested in recent years, traditional spread banking is not a growth business. Thus, for most banks, their thinking should go back to where it was in 2000 and 2001, which is how to offset the poor dynamics of spread banking and not "tilt at windmills" by trying to extend the unusual deposit bonanza that made 2002 and, for some, early 2003 the best of times.

If spread banking will not work on a "business as usual" basis, the options for good earnings growth are rather limited with the primary ones being:

- Increase revenues at above-market rates by taking business from others.
- Increase overhead at a much slower rate than revenues.
- Add substantial new fee income without commensurate increases in overhead.
- Specialize in areas in which others do not have an advantage.
- Be big enough in a small market to be the best combination of cost and convenience.

Throughout most of the nineties and at least through 2001, local banks were able to grow by taking business from others in most markets because of big bank mergers with accompanying branch closures that had customers looking for better service and greater stability. Unfortunately, those days are

over, and the mega-mergers of the future will be more like the Royal Bank of Scotland purchase of the Mellon branches and the First Union-Wachovia merger that saw little customer disaffection rather than the earlier First Union purchases of anyone; the Fleet consolidation in New England; and Nationsbank's acquisitions of Sovran and MNC that had large customer run-offs.

Taking business from others will be a combination of price and convenience. To win on price requires a cost advantage that widens the overhead-margin spread. Winning on convenience means spending more on delivery systems without narrowing the overhead-margin relationship. Either way favors the large over the small as costs are a big factor. If the market is large enough, the large can be a locally-based bank, but "large enough" means the likes of metropolitan Boston, New York, Philadelphia and Washington.

For most local banks, success in the future will depend on some combination of profitable non-bank fee income, specialization away from a competitive disadvantage or being an efficient "big fish in a small pond." In urban markets, local business and mortgage banks can make this work if they do not get too big. In outlying markets, the key is not only a high market share, but also a delivery system and cost structure that deters outsiders.

Thus, while the present uncertainty for banks can be characterized, as it was earlier, as being "in a rowboat without oars," all rowboats are not necessarily equal. The chances of a successful ending are far better for sturdy rowboats in a moving current than for leaky ones in still waters.