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The New Face of Banking

By:
Arnold G. Danielson
Chairman
Danielson Associates Inc.

An emergence of truly national banks, the resurgence of branch openings and a tenth year of margin declines promises to make 2004 a memorable year in banking and financial services annals. There is nothing new about the big getting bigger, and certainly after nine years of margin declines, diminishing spread revenues have become almost a way of life. What is new is the resurgence of interest in branching, particularly the big banks using branching instead of acquisitions to enter large markets en masse and smaller banks doing so just as deposits return to a slow growth status.

The march toward bigness in banking and financial services has long been covered in these reports and elsewhere, but the most recent large mergers have lifted it to levels that would have seemed inconceivable only a few years ago. The purchases of Fleet by Bank of America and Bank One by J.P. Morgan, means there are three American banks – Citigroup, Bank of America and J.P. Morgan – with assets above, or close to, \$1 trillion. When ranked by the primary index of success, earnings, they are among the nation's and the world's five largest corporations. The largest, Citigroup, in 2003 earned more than Wal-Mart and Microsoft combined.

It seems like only yesterday, albeit it was about twenty years ago, in helping an old friend and mentor, Carter Golembe, prepare a strategic plan for what was then Florida's largest bank, one conclusion was that as soon as 1990, our client would be competing with banks based outside of New

Danielson Associates Inc.
6001 Montrose Road, Suite 405
Rockville, Maryland 20852
(301) 468-4884
www.danielsonassociates.com

York City with assets as high as \$20 billion. With the regional leaders, NationsBank and First Union, having deposits in the \$5 to \$7 billion range at the time, this seemed like an incredible feat. What would have been truly incredible, though, was that these two Charlotte-based institutions eventually would become the second and eighth largest income producing banks in the world; and that we would be talking about at least one of them having assets of as much as \$2 trillion by 2010.

Few also would have guessed just one year ago that the smaller of those two banks, now using the name Wachovia, or any bank, would be announcing the *de novo* entry into a state as large as Texas with 250 new offices. Wachovia is not alone in forsaking, or at least complementing, acquisitions as an entry vehicle with branching, but this is the “new new” thing in banking that brings a complex dynamic into the consolidation process – i.e., moving into markets with multiple “modernistic” branches without eliminating an existing major competitor.

Trillion dollar banks, massive *de novo* entry and margins moving toward 3% of average assets – Is this is the “new face” of banking? If it is, existing banks, big and small, have to deal with it as they plan their futures and consider how to grow and increase investment value. For many, the quick response may be “bring it on,” but this is not a rerun of the move to bigness and margin volatility of the 1990s.

Emergence of Truly National Banks

Events of the last couple of years have not only produced three national banks in Citigroup, Bank of America and J.P. Morgan, but they also have made it almost certain that there will be no more than five or six national, or near-national, banks when the consolidation process runs its course. Wells Fargo is likely to be a fourth, and Wachovia appears on its way to being the fifth. The other contenders are Washington Mutual, U.S. Bancorp and two foreign banks, HSBC and the Royal Bank of Scotland, but they are in danger of falling too far behind unless they become even more aggressive with their acquisitions.

The real story, though, is not that these banks have become so large, but how they are doing it. In trying to survive in a race for national status, the game the big banks are playing is building a dominant position in as many of the five major financial service businesses as possible. These businesses are:

- Delivering a broad array of financial services through stores, or branches.
- Purchasing consumer products by use of a credit or debit card.
- Advising corporations on investment and merger activities.
- Managing personal and corporate assets.
- Originating and servicing home mortgages.

The recent acquisitions of Fleet by Bank of America and Bank One by J.P. Morgan have put the primary consolidation focus on retail banking, but that is only part of the story. What is happening in the other areas is equally important, and a leading position in one area can be transferable to others – i.e., Citigroup and J.P. Morgan using lending to promote their investment banking services.

Credit Cards

Nowhere has the growing financial strength of the same few banks been more obvious than in the concentration of consumer purchasing by use of credit and debit cards. What just a year ago was a “big three” with Citigroup, Bank One and MBNA each having about \$70 billion in credit card receivables has become a “big two” of Citigroup and J.P. Morgan with receivables of approximately \$125 billion each. This was the result of Citigroup buying Sears credit card portfolio and the combining of the J.P. Morgan and Bank One portfolios. An independent, at least for the time being, MBNA, is still a strong number three, but coming up fast in sixth place is Bank of America as it puts together the Bank of America and Fleet credit card portfolios (see Table 2).

This also is not the end of credit card consolidation, and the next steps will come sooner rather than later. It is no coincidence that the two biggest bank advertisers in national media in 2003, Citigroup and Bank One, were one-two in the credit card business last year, and in credit cards, more than any other financial services, advertising is vital.

Another big step toward further credit card consolidation was the recent approval of America Express issuing Mastercard and Visa cards. This makes American Express a more compatible merger partner for a large bank, although it might be “pushing the envelope” a little far if any of the “big three” were to acquire it. This may also apply to their buying MBNA or even the smaller portfolios of Morgan Stanley’s Discover card and Capital One that rank fourth and seventh in credit card activity.

If not the “big three” – Which financial services firms are the likely buyers for an MBNA, American Express or Capital One? Wells Fargo and Wachovia are candidates, but this is an area that may facilitate another banking trend, globalization, as HSBC and the Royal Bank of Scotland are possible buyers. HSBC showed a renewed interest in American financial services when it bought Household Finance a couple of years ago, and, coincidentally, this made it number eight in credit card receivables. Royal Bank of Scotland went beyond its retail bank and thrift acquisitions with its recent purchase of the small credit card portfolio of People’s Mutual in Connecticut.

Investment Banking

What has been happening in credit cards through acquisition has occurred in investment banking through mergers and internal expansion, and some might add - the willful use of commercial lending power. The positions of the once “big three” of investment banking – Goldman Sachs, Morgan Stanley and Merrill Lynch – have been diminished by the rise of Citigroup and J.P. Morgan to pre-eminence in investment banking.

Bank of America is playing catch up, this area, but its plan to build a 51 story building on 42nd Street in New York signals its intent. It is a good bet that within five years Bank of America will be an integral part of the investment banking elite.

Goldman Sachs, Morgan Stanley and Merrill Lynch are not going away nor are they likely to be acquired. The latter, though, historically has been more focused on asset management and is increasing its emphasis in that area. Goldman Sachs and Morgan Stanley will continue to be major players in investment banking with an international scope; but, perhaps, not as important as the large banks.

Asset Management

Asset management always has been a major part of the financial services business; grew rapidly during the booming late nineties; had a modest setback after the stock market crash in 2000; but is a business with a tremendous future. This particular financial service also has several subsectors – i.e., trust, pension funds, mutual funds, brokerage firms and personal financial advisory.

Big banks have long dominated the trust portion, but in the last ten years they have become major players in two segments that are growing rapidly and have direct personal contact, the sale of securities and personal financial advisory. Merrill Lynch is the leader in both of these areas, but the large banks are its major competition. In retail securities brokerage, Citigroup and Wachovia rank second and third. In assets managed for private clients with accounts in excess of \$1 million, Citigroup is second and J.P. Morgan, Bank of America and Wachovia rank fifth, sixth and seventh (see Table 3). It is likely each will move up a position in the next couple of years.

Mortgage Banking

Mortgage banking is showing the same trend towards large bank dominance as credit cards, investment banking and asset management, but here, it is large banks other than Citigroup, Bank of America and J.P. Morgan taking the lead. Washington Mutual and Wells Fargo rank one-two in both home mortgage originations and servicing, and each has originating and servicing volume that is substantially more than what it was five years earlier (see Table 4).

Citigroup, Bank of America and J.P. Morgan also are players in mortgage banking, but they have much smaller roles. J.P. Morgan and Bank

of America, though, rank among the top five in servicing, and they, plus Citigroup, are among the top eight in mortgage originations.

Branching “More Than One-at-a-Time”

The sudden resurgence of interest in opening bank branches is often interpreted as a “return to the basics” and recognition of the benefits of retail banking, but that is an oversimplification and possibly a misleading concept. For many small banks, branching is either “business as usual” or a misguided reaction to the slowdown in deposit inflow after two years of strong deposit growth – i.e., we need deposits, let’s open a branch. For the large banks, it may be a combination of “squeezing others out” and becoming better positioned to sell a wide range of financial services that goes well-beyond the traditional bank services.

The impact of the mass approach to a resurgence in branch banking can be measured readily in the actions of some early practitioners in a favorable deposit-gathering environment, particularly Commerce, but it is only the “tip of the iceberg.” It is the plans of others in a less favorable deposit-gathering climate that tells an even more ominous story.

Commerce has been the “poster child” on the benefits of *de novo* branching. Since June 30, 2000, it has opened 115 branches that just three years later had combined deposits of \$5.6 billion, and the 33 branches opened between June 30, 2000 and 2001 had average deposits of \$71.5 million per branch in mid-2003. Key to this growth has been extended hours, including being open on Sundays.

Not as widely publicized, but, perhaps more indicative of the future, are moves of large banks like Washington Mutual. In the Phoenix area, it opened its first branch in the early 2001, and as of June 30, 2003, it had opened 39 branches, which gave it the fourth largest branch network in Maricopa County. By June 30, 2003, these branches held deposits of \$566 million. The 14 opened in early 2001, had average deposits per office of \$32.1 million. Washington Mutual is now moving into Chicago with 80 *de novo* branches.

The activities of Commerce and Washington Mutual are dwarfed by the recent announcement by Wachovia to enter Texas with 250 *de novo* branches over the next five years. If done, this would make Wachovia the

fourth largest bank in Texas in number of branches behind whom else but Bank of America, J.P. Morgan and Wells Fargo.

New Face of Banking

What does all this mean? Only time will tell, but what is happening now is different from the after-effects of the megamergers of the mid- and late 1990s. The major differences are that as a result of these recent large mergers, we now have:

- Three banking organizations – Citigroup, Bank of America and J.P. Morgan - that are truly national in retail banking.
- Two of the three enhance their national image as national retail banking leaders by ranking one-two in credit cards, which is a good conduit for brand identification, and the other is in the top five.
- Each is a significant player, if not a leader, in other major financial services businesses such as asset management, investment banking and/or mortgage originations.

National coverage with leadership positions facilitates two trends in financial services that were already of growing importance:

- The ability to promote brand and image recognition in and on national media.
- Enter new, large markets through *de novo* branching rather than acquisitions.

In addition, their size allows them to acquire the best of the few remaining large regional banks with minimal financial deterrents. One of them, however, Bank of America, is prohibited from doing so by the national cap on deposit share.

Although their leaders will deny it, this puts pressures on the few remaining large regionals – Wells Fargo, Wachovia and U.S. Bancorp – to do what it takes to also become more truly national. For Wells Fargo, this

would not take much. At the other end of the spectrum, U.S. Bancorp may already have fallen too far behind.

Washington Mutual can claim to be national because of its mortgage banking operation and having branches on both coasts. It, though, may be too oriented toward the most cyclical of the financial services subareas, mortgage banking, to be considered in the same category as banking's "big three," or even Wells Fargo.

As for the local banks, a quick response to this latest round of large mergers may be "bring it on," but that also may be an irrational response. In New England, much has been written about banks playing the "local" card in response to the disappearance of the last big New England bank, Fleet. This is good short-run marketing, but consumers are not likely to be any more concerned that Bank of America is based in North Carolina than they are that Citizens is headquartered in Scotland, Stop & Shop is based in Amsterdam or Wal-Mart in Arkansas.

If Bank of America offers a wider range of services at lower prices with a nationally known brand name, then it is going to do very well, and in time, it is likely to have a much larger market share in New England than it inherits from Fleet. Also, the willingness of big banks to enter markets *de novo*; the availability of such attractive franchises as Banknorth and Sovereign; and the already strong position of the world's fifth largest bank, Royal Bank of Scotland suggest that Bank of America will not be the only national brand competing in that market.

New England will feel the major impact of the Bank of America acquisition of Fleet, but the story applies to other markets. This type of change is coming to Pennsylvania and New Jersey and at a slower pace to the Midwest. In the Middle Atlantic states south of Pennsylvania and in the Southeast, the big banks are pretty much in place and just waiting to see what is next for BB&T and SunTrust. This scenario also depicts the Far West with the major "wild card" being whether Washington Mutual can stay in the race.

This suggests that there is a "new face" for banking and the broader financial services industry, but there also are two sides to the immense size and earnings of these national or near national banks. Citigroup and Bank of America ranking as two of the four biggest corporations in the world in

earnings says a lot about just how big and profitable the financial services business is today, and it is good news not only for them, but for the small banks that fill the gaps in their coverage. Margins are a problem, and will continue to be so, but there is still a lot of money being made in financial services, and it is not all going to just five or six firms.

Table 1

Deposit Leaders, Domestic Only*

	<u>Domestic Deposits*</u> (In billions)	<u>Domestic Loans</u>	<u>No. of Branches</u>
1. Bank of America	\$501	\$485	5,883
2. J.P. Morgan Chase	341	344	2,468
3. Wells Fargo	246	291	3,073
4. Wachovia	196	172	2,612
5. Citigroup	173	292	816
6. Washington Mutual	144	164	1,284
7. U.S. Bancorp	113	123	2,352
8. SunTrust	74	88	1,240
9. National City	61	101	1,213
10. BB&T	58	61	1,466
11. Royal Bank of Scotland	55	41	870
12. Merrill Lynch	54	31	2
13. Regions	52	55	1,450
14. Fifth Third	51	53	968
15. KeyCorp	47	60	917

*September 30, 2003 and updated for recent mergers.

Source: SNL Financial, Charlottesville, Virginia.

Table 2

Credit Card Leaders

	Credit Card <u>Receivables*</u> (In billions)
1. Citigroup	\$131
2. J.P. Morgan	125
3. MBNA	81
4. American Express	55
5. Morgan Stanley	49
6. Bank of America	48
7. Capital One	43
8. HSBC	30

*June 30, 2003 and updated for recent mergers.

Source: J.P. Morgan presentation based on Nilson Reports.

Table 3

Asset Management Leaders

Wealth Management*

	<u>Private Client Assets</u> (In bill.)	<u>Median Accounts</u> (In mill.)	<u>No. of Offices</u>
1. Merrill Lynch	\$630	\$2.0	610
2. Citigroup	497	2.8	551
3. Fidelity	295	1.5	91
4. UBS	191	N/A	367
5. J.P. Morgan	190	25.0	113
6. Bank of America	168	N/A	172
7. Wachovia	160	N/A	486
8. Charles Schwab	130	N/A	360

Retail Securities Brokerage**

	<u>Net Revenue</u> (In billions)	<u>Client Assets</u>
1. Merrill Lynch	\$8.8	\$1,142
2. Citigroup	5.7	897
3. Wachovia	4.2	537
4. Morgan Stanley	4.0	517
5. UBS	4.0	470

*Individual clients with accounts of \$1 million or more as of June 30, 2003 and updated for recent mergers.

**December 30, 2002 and updated for recent mergers.

Source: Barrons, September 15, 2003 and Wachovia presentation.

Table 4

Mortgage Banking Leaders*

	<u>Volume</u> (In billions)	<u>Market Share</u>
<u>Originations</u>		
1. Wells Fargo	\$333	12.1%
2. Washington Mutual	312	11.4
3. Countrywide Financial	252	9.2
4. J.P. Morgan	172	6.3
5. GMAC	124	4.6
6. ABN AMRO	118	4.3
7. Bank of America	88	3.2
8. Citigroup	81	3.0
9. National City	79	2.9
10. First Tennessee	34	1.3
<u>Servicing</u>		
1. Washington Mutual	\$723	11.5%
2. Wells Fargo	570	9.1
3. J.P. Morgan	467	6.7
4. Countrywide Financial	452	7.2
5. Bank of America	265	4.2
6. GMAC	261	4.1
7. ABN AMRO	184	2.9
8. National City	123	2.0
9. Citigroup	120	1.1
10. SunTrust	57	.9

*December 31, 2002 and updated for recent mergers.

Source: National Mortgage News.