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“And Then There Were Six”

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The big banking story in recent months was the return of large bank acquisitions. There have been eight acquisitions announced since October 2003 with sale values in excess of \$6 billion compared to just one in the preceding three years. This reduced the number of truly large banks from eight to six; had a big impact on the Southeast banking structure; and has added to the chaos in the Northeast.

The return of the megamerger was inevitable, but the timing, and so many in such a short period of time, was a surprise. A year ago Bank of America and Wachovia were talking about organic growth through branch expansion; J.P. Morgan was still answering questions about the wisdom of having combined Chase Manhattan and J.P. Morgan; and Alabama and Tennessee were almost making believers out of people like me that they would continue to stay out of the national consolidation process. What a difference a year makes.

There are always rumors in the air about the next big bank merger, but as 2003 was winding down, we had not woken up in the morning to read about a really large merger since April 2001 when the First Union agreement to buy Wachovia was announced. Since then, Washington Mutual made public its plans to acquire Dime; Citigroup bought Golden State; and BB&T greatly improved its position in the Washington area with

the acquisition of First Virginia. None of these, though, created much interest outside the market of the acquiree.

In this type of environment, it is easy to understand why bankers, investors and the public, in general, were not only surprised, but in some cases shocked, when Bank of America announced it was paying almost \$50 billion to buy Fleet. This was the nation’s biggest retail bank buying the bank with largest deposit share in the Northeast, and the transaction value was only topped by the NationsBank-BankAmerica and Travelers-Citicorp deals; and that was just the beginning.

Large Bank and Thrift Acquisitions Since 2001

<u>Acquirer/Acquiree</u>	<u>Deal Value</u> (In billions)	<u>Date</u>
Toronto-Dominion/Banknorth	\$ 7.5*	8/04
Wachovia/SouthTrust	14.2	6/04
SunTrust/National Commerce	7.0	5/04
Royal Bank of Scotland/Charter One	10.5	5/04
North Fork/GreenPoint	6.4	2/04
Regions/Union Planters	6.0	1/04
J.P. Morgan/Bank One	58.8	1/04
Bank of America/Fleet	49.3	10/03
First Union/Wachovia	13.6	4/01

*\$3.8 billion for 51% controlling interest.

Source: SNL Financial, Charlottesville, Virginia.

Just three months later in an even bigger surprise, J.P. Morgan announced it was going to purchase Bank One for almost \$60 billion, and it was the new “third largest” deal. In terms of the future, this merger was even more interesting in that when Bank of America bought Fleet it had reached the top of the deposit cap allowed for domestic banks, which put it on the “sidelines” as to further domestic retail bank acquisitions. Not only was J.P. Morgan well below the deposit cap, even after buying Fleet, but the gaps in its retail banking coverage suggested another large bank acquisition was not only possible, but that it is a logical next step.

There have been six bank or thrift acquisitions announced since the J.P. Morgan-Bank One surprise in January with deal values of \$6 billion or more. They were not in the megamerger class, but three of them finally brought Alabama and Tennessee into the national consolidation process. For whatever reasons, the biggest banks in those states had stayed out of the consolidation that had engulfed the rest of the country. They always seemed to be at the top of likely acquisition target lists, but after years of nothing happening, it was easy to give up expecting any large deals in the area. Then in a five-month period, two of the regional leaders, Regions and Union Planters, joined forces and SouthTrust and National Commerce announced that they were being acquired.

The other large 2004 deals – Toronto-Dominion buying controlling interest in Banknorth, Royal Bank of Scotland buying Charter One and North Fork's acquisition of GreenPoint, were not as monumental as the Bank of America-J.P. Morgan transactions and had nothing to do with Alabama and Tennessee. Each, though, could have significant future ramifications. Toronto-Dominion's purchase of controlling interest in Banknorth was a counter-consolidation move in that it added a new player to a region that is far from reaching its final form. The Charter One acquisition took Royal Bank of Scotland beyond the Northeast, making it a candidate to be one of five or six national, or near national, banks, in the United States. There are no national ramifications to the GreenPoint acquisition, but overnight it has created a \$50 billion asset-plus North Fork in the Middle Atlantic area with a strong appetite for acquisition growth.

The major impact of these recent large mergers has been to change the dynamics at the top nationally and overall in the Southeast. A year ago, there were eight domestic banks that were much larger than all others and presumably were candidates for eventually being national, or at least multi-regional, in scope. With the sales of Bank One and Fleet, the eight is now six. In the Southeast, the ten second-tier banks – i.e., deposits between \$10 and \$25 billion – at the start of 2004 are now down to seven, which is a 30% drop in numbers in six months.

The impact at the top can best be seen by looking at the four types of large financial services companies in the country – national players, large regional banks, international banks and specialty banks. This also will provide some indication of what might be coming next.

National Players

Prior to these recent mergers, there were eight banks in the country that were much larger than any others that could be further subdivided into three subgroups. Citigroup, Bank of America and J.P. Morgan were, and are, by far the largest, although a year ago, Citigroup could have been considered in a class by itself. Wells Fargo, Wachovia and Bank One had moved away from the other banks in the eight largest, and were only an equal, or near-equal, merger away from joining the “big three.” Fleet and U.S. Bancorp were a step down from the “middle three,” but they were still far bigger than any other bank in the country.

National Players

	<u>Market Capital</u>	<u>Net Income*</u>	<u>Revenue</u>	<u>Assets</u>	<u>Branches</u>
		(In billions)			
Citigroup	\$236	\$20.6	\$87.6	\$1,397	817
Bank of America	178	14.3	50.6	1,037	5,790
J.P. Morgan	136	12.1	53.1	1,117	2,483
Wells Fargo	98	6.8	29.1	420	3,094
Wachovia	73	5.9	24.6	471	3,358
U.S. Bancorp	55	4.3	12.2	190	2,315

Note: Data is as of August 18, 2004 for market capital and June 30, 2004 for everything else in this and subsequent tables.

*Adjusted to eliminate unusual charges.

Source: SNL Financial, Charlottesville, Virginia.

With their acquisitions of Fleet and Bank One, Bank of America and J.P. Morgan became much closer in size to Citigroup, and we now have a real “big three” whose size suggests that the race for industry leadership nationally is pretty well over. When measured by earnings adjusted for unusual charges, they also are three of the five largest corporations of any type in the world.

With Bank One gone, Wells Fargo and Wachovia, now sit alone in a second tier below the “big three,” but they are high up among truly elite financial services companies. On a worldwide basis, only HSBC, and the “big three” have more market capital than Wells Fargo, and Wachovia ranks 7th among banks worldwide. It is tempting to suggest they need another large acquisition to keep pace with the “big three,” but with more capital and earnings than American Express, Morgan Stanley, Merrill Lynch and all but a couple of financial services firms outside of the United States, there is no pressing need for more large acquisitions.

It would be out of character, though, if Wells Fargo and Wachovia did not make that next big merger. They will do so, but they can pick their time as they will be “buyers of choice” for a wide range of potential sellers.

In this “and then there were six” scenario, U.S. Bancorp is the “odd man out.” Without Fleet, it stands alone in a size category between Wells Fargo and Wachovia and the largest regional banks. It is tempting to place it among the large regional banks, but in the most important measures of market power, earnings and market capital, U.S. Bancorp is much closer to Wachovia than the largest of the regional banks.

What can we expect next out of these big banks?

- Bank of America, J.P. Morgan and Wachovia will be busy digesting their recent acquisitions for quite some time, and Bank of America is now “out of the ballgame” for further domestic retail banking acquisition because of being close to the cap on allowable domestic deposits. J.P. Morgan should be the first to make another move as its combination with Bank One virtually “begs” for a fill-in acquisition east of the Bank One branch network. This will probably occur in 2005 or 2006.
- Citigroup is unlikely to stay quiet long, and it could reverse its historic aversion to large commercial bank acquisitions, but it is more likely to be the first American bank to make a major bank acquisition in Europe. Its purchase of a small Texas bank does not qualify as a change in pattern, but it does create a “maybe.”

- Wells Fargo claims it is not interested in a major bank acquisition at today's prices, but that is a familiar refrain. What makes Well Fargo different than others, though, is that it has a two or three year window in which it may not have much competition if one of the largest regional banks decides it wants to sell.

Large Regional Banks

Up until this year, it had been the acquisition of large regional banks by even bigger banks that had been the primary building blocks for the consolidation at the top with the original Wachovia and Mellon following the many others that in the late 1990s chose to sell rather than buy. With none of them having disappeared since the First Union-Wachovia deal in 2001, and Fifth Third, SunTrust, National City, BB&T, Regions and PNC having made substantial acquisitions in the past two years, it would appear, though, that this group not only has staying power, but that they also are far from through acquiring.

These banks, though, includes a) the best options for J.P. Morgan to fill the gap between the Chase and Bank One franchises; b) the merger that could take Wells Fargo much closer to the "big three"; and c) the partners that would keep U.S. Bancorp from falling back into this group. Only KeyCorp answers none of the needs.

Large Regional Banks

	<u>Market Capital</u>	<u>Net Income</u>	<u>Revenue</u>	<u>Assets</u>	<u>Branches</u>
		(In billions)			
Fifth Third	\$ 28	\$ 1.8	\$ 6.0	\$ 100	1,051
SunTrust	25	1.8	7.1	152	1,745
National City	25	2.5	8.7	135	1,232
BB&T	22	1.5	5.4	97	1,420
PNC	16	1.3	5.7	79	823
Regions	15	.8	4.6	82	1,422
KeyCorp	13	1.0	4.3	86	902

Source: SNL Financial, Charlottesville, Virginia.

There is also a possibility of a merger between two of the seven to create a bank that could move to the next level. If this were to happen, it almost would certainly include one or more of the Ohio banks, and this includes KeyCorp.

International Banks

There is a lot of talk about foreign banks increasing their share of American banking and the broader financial services market, and HSBC and Royal Bank of Scotland are the names most frequently mentioned. They are the biggest foreign banks when measured by market capital, and probably earnings as well, and they have been the most active in United States. They are helped if they choose to acquire further in this country by a cheap dollar and a common language.

HSBC is particularly interesting since its market capital is about the same as that of Bank of America, and its American revenues and assets are far larger than those of U.S. Bancorp. Much of this comes from HSBC's recent Household Finance purchase, but that is still financial services and makes HSBC national in scope. It has been a reluctant buyer of banks in this country, but we could wake up one morning and read about it buying American Express, Washington Mutual, MBNA or U.S. Bancorp, and then the "big three" would be a "big four."

Royal Bank of Scotland has been anything but a reluctant buyer, and although it may need a breather after the Charter One purchase, it is not through. With Charter One taking it into the Midwest, it will be bidding on banks with \$1 to \$30 billion assets in the Northeast and Midwest, and it is more willing to buy thrifts than the other large players.

International Banks

	<u>Market Capital</u>	<u>Net Income</u>	<u>Revenue</u>	<u>Assets</u>	<u>Branches</u>
	(In billions)				
			<u>U.S. Only</u>		
HSBC	\$166	\$3.1	\$16.8	\$272	430
Royal Bank of Scotland	88	1.3	4.8	121	1,575
ABN AMRO	35	.3	3.9	136	406

Source: SNL Financial, Charlottesville, Virginia.

The recently announced purchase of controlling interest in Banknorth by Toronto-Dominion raises the profile of the Canadian banks, but their size and role is similar to that of the large domestic regionals. The market capital, revenues and earnings are in the SunTrust-National City range, and they are not threats to be significant players beyond a region in the United States. Toronto-Dominion's acquisition of Banknorth adds an interesting player to the mix in the Northeast; Bank of Montreal could use its LaSalle Bank base in Illinois to expand in the Midwest; with the right acquisition, Royal Bank of Canada might be able to strengthen its faltering fringe role in the Southeast; but they do not have the size or resources to go further.

Beyond HSBC, Royal Bank of Scotland and the Canadian banks, the foreign banks are probably more hype than action. ABN AMRO has a good American franchise, and BNP Paribas has been acquiring in the western part of the country. They may continue to expand, but not in a manner that significantly changes regional dynamics.

Specialty Banks

In banking's consolidation at the top, the largest of the specialty banks also play a part. Citigroup and J.P. Morgan owe some of their preeminence

to investment banking and other “nonbank” activities; Wells Fargo is one of the nation’s two largest mortgage bankers; and as was mentioned above, HSBC is more than just another regional franchise with its Household Finance subsidiary. The still independent, large specialty banks, though, look more like sellers than buyers.

Specialty Banks

	<u>Market Capital</u>	<u>Net Income</u>	<u>Revenue</u>	<u>Assets</u>	<u>Branches</u>
	(In billions)				
American Express	\$63	\$ 3.3	\$27.5	\$ 179	-
Morgan Stanley	54	4.9	26.4	730	-
Merrill Lynch	46	4.7	22.8	548	-
Goldman Sachs	43	5.0	23.3	468	-
Washington Mutual	33	3.1	11.3	279	1,662
MBNA	32	2.4	10.4	61	-
Bank of New York	22	1.5	6.2	98	341
Golden West	16	1.2	2.7	93	271
State Street	15	1.1	5.1	94	2

Source: SNL Financial, Charlottesville, Virginia.

The largest specialty banks when measured by market capital include two credit card firms, American Express and MBNA; three investment banks – Morgan Stanley, Merrill Lynch and Goldman Sachs; two mortgage Banks, Washington Mutual and Golden West; and two banks that earn most of their money as processors rather than lenders, Bank of New York and State Street. Like the other specialty banks, the last two represent potential diversification for the largest domestic banks and access to the American market for foreign banks.

The specialty banks are probably the “wish list” for Citigroup and HSBC right now, and when Bank of America and J.P. Morgan have their recent acquisitions fully-integrated, they can be added to the buyer list. Citigroup and J.P. Morgan already may be too big in credit cards to buy American Express or MBNA, but one or the other of these credit card companies being part of Bank of America or HSBC within the next three years is a logical progression in the consolidation process. The most likely

to sell within that timeframe are Washington Mutual and Bank of New York with Citigroup, HSBC and Royal Bank of Scotland being the logical “short list” of buyers.

Southeast Impact

While the consolidation at the top features a diminishing, but still significant number of players, the recent mergers have had a much more substantial impact on a region – the Southeast. In just six months, three of the Southeast’s 15 largest banks have disappeared into a larger bank based in the area. Going back another year raises the total to four.

In the process, the level of concentration that is common in most states is becoming regional. Using the latest available deposit share data for June 30, 2003, the share of the four largest banks in the Southeast – Wachovia, Bank of America, SunTrust and BB&T – rose from 43.2% to 49.2% as a result of 2003 and 2004 acquisitions. Wachovia and Bank of America alone had a little over one-third of the deposits.

Equally as important as the increased share of the very large banks is the decline in the number of mid-sized banks, which has spread the barbell structure beyond states into a region. As of mid-2003, Southeast banks, other than the “big four,” with regional deposits in excess of \$10 billion held about 18% of the area deposits. After the recent acquisitions, their combined share fell to 12.5%.

Merger Impact on Southeast* Banking Structure

	Pro Forma Deposits <u>2003</u> (In billions)	Deposit Share		No. of <u>Branches</u>
		Pro Forma <u>2003</u>	Reported <u>2003</u>	
<u>National Leaders</u>				
Wachovia	\$167.1	17.6%	14.5%	2,438
Bank of America	148.0	15.6	15.6	1,856
SunTrust	90.6	9.5	7.8	1,745
BB&T	<u>61.5</u>	<u>6.5%</u>	<u>5.3%</u>	<u>1,432</u>
Subtotal	\$467.2	49.2%	43.2%	7,471
<u>Second Tier</u>				
SouthTrust**	-	-	3.0%	-
Regions	\$ 32.5	3.4%	2.1	736
Amsouth	23.8	2.5	2.5	513
National Commerce**	-	-	1.7	-
Synovus	16.0	1.7	1.6	292
First Horizon	15.2	1.6	1.6	181
Union Planters**	-	-	1.3	-
Washington Mutual	10.8	1.1	1.1	216
First Citizens	10.7	1.1	1.1	384
First Virginia**	-	-	1.0	-
Mercantile	<u>10.5</u>	<u>1.1</u>	<u>.9</u>	<u>234</u>
Subtotal	\$119.5	12.5%	17.9%	2,556
Total	\$586.7	61.7%	61.1%	10,027

*Alabama, Florida, Georgia, Maryland, North Carolina, South Carolina, Tennessee, Virginia, West Virginia and the District of Columbia.

**Since acquired.

Source: SNL Financial, Charlottesville, Virginia.

It is unlikely that the multiple sales of mid-sized Southeast banks will see a sequel. There are fewer sale candidates left, and those that were most likely to sell – National Commerce, Union Planters and First Virginia – are gone. Only SouthTrust was not widely rumored to be selling. Also, if one of the remaining Alabama-Tennessee banking leaders were sold, unlike the 2004 mergers, the buyer should come from outside the area and would not increase the market position of the regional “big four.” The most likely buyers are Fifth Third, Wells Fargo and J.P. Morgan.

Northeast Impact

In an expanded Northeast, it may not be that difficult to see where things are headed in terms of banking structure, but when it gets there is another story. Recent mergers made Bank of America and J.P. Morgan larger; took Royal Bank of Scotland into the Midwest; gave Banknorth access to “deeper pockets;” and eliminated one of the largest remaining thrifts – GreenPoint. What it did not do within the traditional Northeast is increase the market share of any of the pre-2003 leaders. This suggests there are several more large mergers coming.

Also, it is difficult to look at the Northeast without including Ohio because of the large bank overlap – J.P. Morgan-Bank One, Royal Bank of Scotland-Charter One, KeyCorp’s coverage reflecting a long ago equal merger between an Albany and Ohio bank and Cleveland’s National City being number two in western Pennsylvania. All of this tends to tie Ohio banking closer to the Northeast than the rest of the Midwest.

As things now stand, the situation in the Northeast is essentially as follows:

- The nation’s three largest banks – Bank of America, J.P. Morgan and Citigroup – have the biggest deposit shares, but only Bank of America is close to its final form.
- J.P. Morgan is almost certain to make an acquisition that closes the gap between Bank One’s Ohio base and its New York franchise, but who – PNC, Sovereign, M&T?

Merger Impact on Northeast* Banking Structure

	Pro Forma Deposits <u>2003</u> (In billions)	Deposit Share		No. of <u>Branches</u>
		Pro Forma <u>2003</u>	Reported <u>2003</u>	
<u>National Leaders</u>				
J.P. Morgan Chase	\$162.8	10.8%	9.5%	725
Bank of America	135.5	9.0	.7	1,553
Fleet**	-	-	8.2	-
Citigroup	123.4	8.2	8.2	280
Royal Bank of Scotland	71.4	4.7	3.5	1,281
Wachovia	57.7	3.8	3.8	827
Bank One**	-	-	<u>1.3</u>	-
Subtotal	\$550.8	36.5%	35.2%	4,666
<u>Second Tier</u>				
National City	\$ 45.8	3.0%	2.3%	633
PNC	44.4	2.9	2.8	731
HSBC	40.0	2.6	2.6	412
Bank of New York	37.3	2.5	2.5	359
KeyCorp	35.4	2.4	2.3	502
Sovereign	33.9	2.2	1.8	666
North Fork	30.5	2.0	1.0	342
Fifth Third	25.4	1.7	1.7	372
M&T	22.7	1.5	1.5	542
Banknorth	<u>20.6</u>	<u>1.4</u>	<u>1.2</u>	<u>426</u>
Subtotal	\$336.0	22.2%	19.7%	4,985
Total	\$886.8	58.7%	54.9%	9,651

*Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island and Vermont.

**Since acquired.

Source: SNL Financial, Charlottesville, Virginia.

- Citigroup is a logical candidate to use its size to move its retail franchise beyond metropolitan New York, but this has been the case for 25 years, and it has not done so other than to expand in California and Texas.
- Royal Bank of Scotland, HSBC and Wachovia are among the world's largest banks and have the wherewithal to move beyond their present second-tier Northeast status, although HSBC, like Citigroup, does not seem to attach much importance to this.
- Toronto-Dominion adds a new dimension to the picture, and may be introducing a new entry method for foreign banks – i.e., limited cash outlay and maximizing local control with 51% ownership. It is not in a position to move beyond second-tier status, but its staying power is exceptional as Canadian banks do not get bought.
- The number of strong sub-regional leaders in the Northeast may have been increased, rather than decreased, by one with the North Fork-GreenPoint merger. What North Fork did was move up and take its place alongside PNC, Bank of New York, Sovereign and M&T in the locally-based section of the second tier. Also Commerce is growing its way into this status.
- KeyCorp's present or future role is beyond easy definition.

Needless to say, the Northeast is a long way from the neat hegemony that characterizes the banking structure in the Southeast; and, although not shown in this report, the Southwest and Far West as well. The region's only certainty is that Bank of America and J.P. Morgan will be among the big four or five when that hegemony arrives, and that the latter will make another big acquisition to improve its regional coverage. A near certainty is that Royal Bank of Scotland will keep acquiring in an effort to be part of that big four or five.

Citigroup and HSBC as two of the biggest banks in the world would seem like logical candidates to expand their Northeast coverage, but they have a “lot of irons in the fire” and may be more interested in China than New Jersey. They also could decide to sell their branch networks in New York without doing any real damage to their international stature.

Thus, it is likely that the Northeast banking structure will spend at least another five years evolving to something close to its final form and, in doing so, will continue to provide interesting headlines for the rest of us. This also should create action at the next level down as the second-tier players continue to enhance their franchises by acquisition – i.e., North Fork buying GreenPoint and Toronto-Dominion increasing Banknorth’s ability to move south and west. Others, particularly Commerce will continue to rapidly expand their branch networks.