

December 17, 2002

National Banking Report
Winter 2002-03

What Do We Do For An Encore?

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In 2002, banking headlines were dominated by the problems of the big banks, particularly the relationships of Citigroup, J.P. Morgan Chase, PNC and Fleet and their investment banking brethren with Enron, the telecoms, troubled economies in Latin America and the regulators. There was only one really large financial services merger announced, which was a foreign bank buying a finance company, and the media had little interest in what was happening in the rest of the industry. This emphasis on the negatives of the few was not only misleading, but it obscured what may have been one of the best years in American banking history. In fact, it was such a good year that the question most banks should be asking is “What do we do for an encore?”

Before worrying about the future, though, it is hard not to feel good about:

- One of the better year-to-year earnings gains being recorded in 2002, if the big banks are excluded, and that it was done in a down economy; and,
- Whether measured by earnings or market capital, three of the four largest banks in the world are American – Citigroup, Bank of America and Wells Fargo – and two others, Wachovia and Bank One, that were written off by many as “gone,” including this writer, are eighth and ninth, right behind J.P. Morgan Chase. This is a long way from a dozen years earlier when only one American bank was in the top twenty worldwide.

Another big story in 2002 was the gains made by transaction banks. It is encouraging that a banking model exists that can add \$5.5 billion in

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deposits in just the first nine months of 2002, and with an ROE in excess of 19%, which is what Commerce has done; and that Washington Mutual has the confidence to enter a new market with 70 de novo branches; albeit for banks “in their way,” it may not be all that encouraging.

A less positive note was that, collectively, bank stock prices, were still below late 1997 and early 1998 highs and the greatly reduced merger activity and pricing may be the future norm and not an aberration. Within that merger “norm” also is the near disappearance of the “all stock” deal.

While 2002 was a good year for banking that was overshadowed by the media attention focused on the problems of a few, 2003 could be the reverse. Many banks will struggle to match their 2002 performance, but the big banks with 2002 problems should welcome the comparison.

The direction of earnings will be the biggest concern for bankers as they move into a new year, but there are other stories that will be worth following. These include:

- Will bank stock prices, as a group, spend a fifth year below their previous highs?
- Are the low merger activity and pricing levels of 2002 going to continue?
- Can transaction banks can continue their rapid growth in a less friendly banking environment?
- Is it the successes of Bank of America and Wells Fargo or the troubles of Citigroup and J.P. Morgan Chase that will determine the future direction of the big banks?

This report looks at these subjects in the context of both history and common sense with some concern that neither may be good determinants of what happens going forward. What history has taught us about banking, though, is that it is a resilient industry with strong underlying growth, and what has changed over time is not the resiliency and growth, but rather “who plays the game.” Banking is coming off one of its best years ever, but it also must be remembered that:

- Just one of the 30 largest banks in Pennsylvania in 1982 is still around.
- A once strong thrift industry now holds only 4% of the North Carolina's deposits.
- Of the 215 banks in New Jersey in 1970, 21 remain, and they are outnumbered by 34 banks that have opened since 1988.

Change may be healthy in that it allows an industry to grow and prosper, but industry success does not automatically transfer to all of its members. This may be more important to recognize than ever because of a decline in good exit opportunities.

Earnings Trends: Up or Down?

The biggest concern in 2003 for most banks is earnings. Since 1992, bank income has increased every year. In the past, it has been bad economic conditions that have normally interrupted earnings growth, and the industry has to feel good about 2001 and 2002 - i.e., strong earnings growth in a down economy. This "good feeling," though, also has to be tempered by continuing margin declines and a likelihood that 2003 may be a modified, delayed reaction to the normal recession interruption.

To help understand bank earnings trends, the median performance of 115 publicly-traded banks in the Northeast, Southeast and Midwest with assets under \$50 billion that have per share data that goes back to 1994 was analyzed. The "market basket" could have been larger if the sample had gone beyond publicly-traded banks with longevity, but the analysis is more meaningful if it includes continuing, same bank earnings per share and the stock price impact.

If these banks are viewed over time in terms of income and expense as a percent of average assets, some of the highlights are:

- Net interest income has been declining since 1994 as a percent

of average assets, but the real slippage came after 1997 with net interest income from 1997 through 2001 falling from 4.39% to 3.91% of average assets.

- This margin slippage dropped net operating income as a percent of average assets from 2.09% in 1997 to 1.84% in 2001.
- The first six months of 2002 reversed the slide, but net interest income increased only nine basis points despite a steep drop in rates paid on deposits and a six basis point decline in the third quarter wiped out much of that gain.
- Net operating income followed the same pattern as margins, but also benefited from a big increase between 2000 and 2001 in non-interest income as a percent of average assets that carried into 2002. This was primarily increased fees from an expanded deposit base as money flowed out of the stock market into bank deposits and the boom in refinancing home mortgages as interest rates hit forty year lows.
- Improved cost control and recent gains in contributions to reserves have not had much impact on earnings. Costs fell sharply when deposit insurance was eliminated, but overhead declines as a percent of averages assets since 1997 have been small and, despite some decline in asset quality, contributions to the loan loss reserve as a percent of average assets in 2001 and 2002 were only a couple of basis points above the medians from 1996 through 2000.
- When measured by ROE, bank earnings peaked in 1997 at 13.20%, then fell erratically through 2001 when the median ROE was 12.55%. This slippage also was reversed in 2002 with a median ROE of 13.15% through the first nine months.

Commercial Bank Financial Performance*

Percent of Average Assets			
Net Int.	Nonint.	Oper.	Net Oper.

	<u>Income</u>	<u>Income</u>	<u>Expense</u>	<u>Income**</u>
2002***	3.94%	1.01%	3.04%	1.97%
2001	3.91	.99	3.08	1.84
2000	4.01	.90	3.03	1.92
1999	4.05	.87	3.09	1.96
1998	4.14	.87	3.10	2.02
1997	4.39	.86	3.16	2.09
1996	4.41	.81	3.17	2.10
1995	4.43	.83	3.27	2.05
1994	4.44	.78	3.39	2.02

	<u>Percent of Avg. Assets</u>	<u>Return</u>	<u>Earnings</u>
	<u>Contr. to</u>	<u>on Avg.</u>	<u>Per Share</u>
	<u>Reserve</u>	<u>Equity</u>	
2002***	.20%	13.15%	\$1.73
2001	.19	12.55	1.59
2000	.17	12.99	1.47
1999	.16	13.13	1.40
1998	.17	12.81	1.30
1997	.18	13.20	1.18
1996	.17	12.94	1.08
1995	.14	12.84	.98
1994	.14	12.58	.89

*Medians for 115 publicly-traded banks in the Midwest, Northeast and Southeast with assets under \$50 billion and per share data from 1994.

**Does not add to net operating income since these are medians.

***Nine months annualized.

Source: SNL Financial, Charlottesville, Virginia.

- When bank earnings are translated into EPS, there have been good median increases every year since 1994 with 2001 and 2002 being two of the best years with deposit-driven volume and the 2002 margin increase being the primary reasons.

Where these numbers differ from the past is that historically any margin gain from a sharp drop in prime during recessions was “wiped out” by larger contributions to reserves and fewer fees, which did not happen this time. This was good news for banks, but it created a “tough act” to follow, and 2003 could be the biggest year-to-year earnings challenge for banks in a decade. The last time banking faced a similar “tough year to follow,” was in 1995 when the elimination of deposit insurance came to the rescue.

In 2003, there will be a contraction in margins as long-term forces come back into play, which already had begun in the second half of 2002, and it may be exacerbated in earnings impact by a decline in fees. Home mortgage refinancing is likely to suffer the double whammy of those that want to refinance having already done so and a modest rise in rates. DDA fees should maintain past levels, but will not show the gains of 2001 and 2002 as the deposit inflow from the stock market appears to have run its course.

The difficult earnings environment in 2003, though, is more a matter of comparisons rather than being “truly difficult.” This may be hard to explain to investors, but the annual increase in earnings, and particularly EPS, from 2000 through 2003 should be better than what it was from 1998 through 2000.

A bigger earnings concern than 2003 may be what happens in 2004 and the reaction to it. If the recent trend in margin slippage reemerges with insufficient offsets from noninterest income and volume gains, which is a likely scenario, then 2004 may not be much better than 2003 and, in that case, the 1999 and 2000 negativity relative to the growth potential of traditional banking is likely to resurface and could do so at a heightened level.

Stock Price Impact

Little, if any, earnings growth in 2003 and doubts about 2004 cannot help bank stock prices, and it would be surprising not to see a fifth, and even a sixth, year of collective bank stock prices being below late 1997 and early 1998 highs (see Table 1). This is not pleasant to think about, but the problem is not recent bank performance, but rather the unrealistic levels bank stocks reached in 1998.

Commercial Bank Stock Performance*

	<u>Price/ Earnings</u>	<u>Price/ Book</u>	<u>Book Per Share</u>	<u>Dividend Yield</u>
2002**	13.2X	157%	\$14.14	2.87%
2001***	13.3	151	12.88	3.12
2000	11.7	133	12.22	3.69
1999	13.0	177	10.81	2.91
1998	17.5	210	10.58	2.11
1997	18.4	223	9.80	1.83
1996	13.1	159	8.62	2.51
1995	12.5	141	8.23	2.67
1994	10.8	131	7.21	2.68

*Same banks as preceding table.

**September 30, 2002 or nine months ended September 30, 2002 annualized.

***Year-end except for dividends.

Source: SNL Financial, Charlottesville, Virginia.

Since 1998, median bank stock prices generally have been in the vicinity of 13 times earnings, which is above what they were in most years prior to 1997. The problem is that at year-end 1997, the median bank stock price was 18.4 times earnings, and at mid-year 1998, it went above 19 times earnings. These unrealistic values were part of the overall stock market “bubble,” and these multiples are unlikely to be reached again.

Without strong EPS gains there also may be little progress toward closing the gap on 1998 stock prices unless the median PE multiple goes

significantly above 13 times earnings. This is possible, but it is not what would be expected in a year of earnings stagnation with expectations of further margin declines.

While stock prices and earnings comparisons may not be all that is desired, the capital value of banks will rise whether earnings do or not. Book value per share has doubled since 1994, and it goes up every year, and even flat earnings are likely to push the median capital per share for the banks in the analysis from \$14.14 as of September 30, 2002 to about \$15 by the end of 2003. This suggests that the median dividend yield that had fallen below 3% could easily return to the 3.69% of year-end 2000, or higher. These kinds of yields can make bank stocks as popular in the future investment environment as the capital appreciation potential that was partly driven by acquisition premiums had made them throughout much of the eighties and nineties.

Merger Activity

Acquisition premiums are still a factor in bank stock prices, but the reduced merger activity has greatly reduced its relevance. Since the peak acquisition year of 1998, bank and thrift sales with deal values in excess of \$10 million have fallen from 321 to 103 through the first eleven months of 2002. Pricing also slipped with the median prices in 2000, 2001 and 2002 being in the 18 to 19 times earnings range and around two times book, well below the 23 times earnings and 170% of book of 1998. There was a slight rise in pricing in the 2002's third quarter, but this was an aberration as the ten deals in October and November had a median price of less than 18 times earnings.

This level of acquisition activity and pricing also should be the norm going forward. Merger activity and high prices from 1997 through 1999 were fueled by high buyer stock prices; recognition that the elimination of "pooling" accounting in 2001 would make it harder for buyers to pay high multiples of book; and, in many markets, seller concern over a diminishing number of buyers. Thus, the real aberrations were the activity levels and values of 1997 through 1999, not what has happened since then.

Bank and Thrift Acquisition Summary*

	<u>No. of Deals</u>	<u>Price</u>		<u>Currency Used</u>		
		<u>Times Earnings</u>	<u>Percent Of Book</u>	<u>Cash</u>	<u>Mixed</u>	<u>Stock</u>
<u>2002</u>						
Oct.–Nov.	10	17.7X	204%	2	5	3
3rd qtr.	41	21.3	208	14	21	6
1st half	52	18.5	192	25	20	7
2001	141	18.3	195	60	47	34
2000	149	18.4	195	44	29	76
1999	211	21.7	228	63	21	127
1998	321	22.9	269	65	17	239
1997	294	20.5	223	56	35	203
1996	252	17.2	185	76	46	130
1995	236	16.1	179	66	44	126
1994	265	14.3	178	77	39	149
1993	229	14.9	180	60	29	140
1992	140	13.0	151	40	18	82
1991	86	13.7	144	20	24	42
1990	56	14.3	147	21	15	20

*Excludes mergers of equals and transactions under \$10 million in deal value.

Source: SNL Financial, Charlottesville, Virginia.

Recent merger activity also has focused heavily on two types of sellers – stock thrifts and de novo banks. Thrift stock prices peak when interest rates are low, and many stock thrifts, particularly in the Northeast, have chosen to sell rather than face the inevitable decline in value when interest rates return to more normal levels. For new banks, a major reason for their existence is to produce good investor returns, and uncertainties relative to future market values and a possible diminishing of buyer interest often makes selling sooner, rather than later, a rational decision.

In 2002, big banking mergers also have been almost nonexistent. Only three announced deals had values above \$600 million – Citigroup's offer to buy Golden State; Banknorth's purchase of American Financial; and

the Allied Irish sale of Allfirst to M&T. The first two acquirees were thrifts, and the Allfirst sale followed a \$700 million securities trading loss.

Another change in the acquisition environment since 1998 has been the reduced role of the “all stock” transaction. Among deals with values in excess of \$10 million, “all stock” transactions have fallen from 239 in 1998 to just 16 through the first eleven months of 2002, or 16% of all such transactions. In a “purchase” environment, buyers can pay more in cash, and the difference between “all cash” and “all stock” transactions can be as much as the capital gains that would be paid on a cash deal.

Acquisitions will continue to play an important role in reducing industry overcapacity, maximizing investment value and providing an exit when future prospects are not all that is desired, but there is no bringing 1998 back. The 100 to 150 deals annually since 1999 with values of \$10 million or more a year also is not an insignificant number. Presumably all that want to sell can sell, and the only real losers are investors that want unrealistic capital gains and investment bankers who hoped the “bubble” of 1997 through 1999 would last forever.

Pricing also can be above 20 times normalized earnings if a seller fills an important need for one or more capable buyers. Sellers should realize, though, that the 18 to 19 times annual earnings medians since 1999 are higher than the median sale prices in all years prior to 1997.

Big Get Bigger

The big getting bigger sounds like a broken record as it has been a prime ingredient of banking change for more than two decades, but it is still a major determinant of the industry’s future. With eight banks and a thrift now holding more than half of all domestic banking assets, what they do has an inordinate impact on everyone else. This was evident in 2002 when article after article began with some version of “banks in trouble,” and then went on to talk primarily about Citigroup, J.P. Morgan, Fleet, PNC and the big investment banking houses – Merrill Lynch, Morgan Stanley, CSFB and Goldman Sachs. It was as if they were the industry.

Even among the large, though, the negative news of impending doom is misleading. J.P. Morgan Chase has real problems, and 2002 was not a good year for Citigroup, Fleet or PNC, but that was only part of the story.

Compared to foreign banks, the American banks were a beacon of light. A decade ago, there was not a single American bank ranked among the twenty largest globally. Today, eight of the world's fifteen largest banks in market capitalization are American, and this includes three of the top four.

A highlight for the large domestic banks in 2002 was the recovery of Wachovia and Bank One, two banks that some had written off as merger targets that would be absorbed by larger, healthier banks. Today, they are eighth and ninth in market capital worldwide and on track to record 2002 earnings in the \$3.5 to \$4 billion range to go with strong regional retail leadership (see Tables 2 and 3). They also are now buyers rather than sellers.

Another 2002 highlight was the much increased statures of Bank of America and Wells Fargo. Bank of America is the world's second largest bank when measured by revenue and net income, and it is third in market capital. Wells Fargo is number four in market value and earnings. With few problems, these two banks are well-positioned to continue to grow both internally and through acquisition.

As for Citigroup, it is hard to shed tears relative to its travails. It is the world's biggest financial institution, and when measured by assets and capital it is the largest company of any type. It may have to absorb losses from its legal and Latin American problems, but it would take only about a month for Citigroup to earn back as much as \$3 billion of losses. Its size, though, makes it an inviting target for politicians and ambitious attorney generals, but the old slogan, "what is good for General Motors is good for the country," may have more applicability to Citigroup today than it ever had to General Motors.

World's Largest Banks*

<u>Banks</u>	<u>Market Value**</u>	<u>Revenue</u>	<u>Net Oper. Income</u>	<u>Net Income</u>	<u>Home Country</u>
	(In billions)				
1. Citigroup	\$195	\$71.0	\$31.9	\$17.1	U.S.
2. HSBC	109	26.2	11.1	6.6	U.K.
3. Bank of America	104	34.3	16.1	8.8	U.S.
4. Wells Fargo	78	24.0	10.5	5.3	U.S.
5. Royal Bank of Scotland	69	25.4	10.7	4.2	U.K.
6. UBS	60	25.5	5.0	3.7	Switzerland
7. J.P. Morgan	49	28.4	8.8	2.7	U.S.
8. Wachovia	48	17.5	6.5	3.6	U.S.
9. Bank One	45	16.7	7.1	3.3	U.S.
10. Barclays	45	17.8	8.4	3.8	U.K.
11. U.S. Bancorp	41	12.3	6.4	3.3	U.S.
12. HBOS	39	11.5	5.8	3.1	U.K.
13. ING Group	37	22.3	7.5	4.2	Netherlands
14. Washington Mutual	34	12.8	6.5	3.9	U.S.
15. BNP Paribas	34	17.4	6.5	4.0	France
16. Mitsubishi Tokyo	33	13.4	2.1	(1.6)	Japan
17. Fifth Third	33	4.6	2.4	1.6	U.S.
18. Grupo Santander	32	14.3	5.9	2.3	Spain
19. Banco Bilbao	32	12.4	5.9	2.2	Spain
20. Deutsche Bank	31	28.2	6.6	.7	Germany
21. National Australia	28	12.9	8.9	2.4	Australia
22. Credit Suisse	27	21.8	4.0	(.3)	Switzerland
23. Fleet	27	11.7	5.4	1.2	U.S.
24. Royal Bank of Canada	25	10.1	3.6	1.9	Canada
25. ABN Amro	25	15.7	5.4	2.0	Netherlands

*Latest 2002 numbers annualized.

**December 3, 2002.

Source: Various.

Even Fleet, which may be second only to J.P. Morgan Chase in big bank problems, is not without its “silver linings.” It has by far the largest banking franchise in the Northeast (see Table 4), and while its falling stock price has reduced its market value to about 60% of what it was a couple of years ago - and moved it out of the top fifteen globally - it still has a net operating income that is not far behind Wachovia and Bank One. If the economy has no major negative surprises, then by 2004, if not 2003, the Fleet story should be a rerun of Wachovia and Bank One with earnings a slightly lower \$3 to \$3.5 billion and a market value that puts it back in the top fifteen.

It is hard to find “silver linings” for J.P. Morgan Chase with its “unknowns” being so big. Still, when consolidation began for real in 1980, the three biggest American banks were Citicorp, Bank of America and Chase Manhattan; in 1986, Bank of America looked like a “goner” and five years later the future did not look very promising for Citicorp; but today, the three biggest banks in the world in revenues are Citigroup, Bank of America and J.P. Morgan Chase. Thus, history suggests that J.P. Morgan Chase will return to its former preeminence, but this is not the best of times to be playing “catch up.”

Europe’s two largest banks when measured by market capital, HSBC and The Royal Bank of Scotland, also are major, growing players in the United States. HSBC is number six in Northeast deposit share and buying Household gives it a national presence. Royal Bank of Scotland’s Citizens affiliate ranks fifth in the Northeast, and it is likely to buy its way up at least a couple of positions. Most continental European and Japanese banks have such substantial problems at home that they should continue to lose ground to American banks into the foreseeable future with ABN AMRO, which is fifth in the Midwest, a likely exception.

Also prominent among the big players is a large thrift, Washington Mutual, which is by far the biggest originator and servicer of mortgages. It has 2002 earnings running in excess of Wachovia and Bank One and seems determined to be a national leader in transaction banking as it moves east from California into Florida, New York and now Illinois.

While the large banks will get even bigger, mergers between them should be limited. Their growth in traditional banking will continue, but it is likely to be done internally or by reaching into a second tier for banks like National City, Comerica, KeyCorp or PNC. Fleet's sale also could occur because of its franchise value, and if life does not get better for J.P. Morgan Chase soon, it may need a partner like Bank of America or HSBC to broaden its retail coverage.

Converging Industries

The conflict of interest between commercial and investment banking and the losses in developing nations also might seem to argue for a return to the "basics" for the big banks. This makes for good rhetoric in a down economy, but it will not happen except in isolated cases.

The large banks cannot maintain their growth or global preeminence on traditional banking alone. Wells Fargo and Washington Mutual may be able to compensate with mortgage banking and insurance sales, and Bank One has a "big three" credit card operation to go with its Midwest retail leadership. Citigroup, J.P. Morgan Chase, Bank of America, Wachovia and Fleet, though, need some combination of investment banking and foreign operations to pay-off if they hope to maintain, or regain, strong earnings momentum.

Also arguing against deconsolidation by the large banks is HSBC's recently announced \$14.2 billion acquisition of Household. Despite the problems of Citigroup, Wachovia and others with subprime lending buys, the "need" to do many things is still there for the large banks.

The Household acquisition also heralds the end of an independent consumer finance industry. When the nineties began, the largest non-captive consumer finance companies were Household, Associates First, TransAmerica, CIT, Beneficial and Heller. HSBC buying Household, and indirectly the Beneficial franchise; Citigroup acquiring Associates First; the Dutch-owned AEGON buying TransAmerica; and GE Capital having bought Heller, leaves CIT as the only big independent, and as a recent IPO spin-off from the troubled Tyco, its independence may be short-lived.

Transaction Banking

Then there is transaction banking that long has been the “bread and butter” of local banks and that is still their primary profit generator, but transaction banking has taken on a new meaning now that it has been made a specialty with a “fast food” recipe. Commerce gets the most attention, and deservedly so, but it is not the only bank with an aggressive approach to transaction banking that hurts local competition. TCF has had success in Chicago with an almost exclusively grocery store model; Washington Mutual has moved eastward with its Occasio branches; Chevy Chase has combined almost 1,000 ATMs with its retail expertise in the Washington area; and Bank of America has been experimenting with Bank of America Express.

A common reaction of traditional banks to this threat is that it is a fad or their customers want more service than transaction specialists offer. This is short-sighted, and the threat to local banks from this source is big. It is hard to explain away the following and its impact on competition.

- Commerce, after increasing deposits by \$2.5 billion in 2001, added \$5.5 billion in just the first nine months of 2002 with a formula of long hours – 8:00 a.m. to 8:00 p.m. weekdays and open Saturdays and Sundays – common branch appearance and the lowest deposit prices in town. It is doing this with an ROE in excess of 19%.
- Chevy Chase’s success in Washington has contributed to a more than 10% deposit share decline for the leading local banks.
- TCF has not had the deposit growth of the other two, but its model has produced DDA fees equal to 1.90% of average assets and a 25% ROE through 2002’s first nine months.

What makes this threat even bigger than the home market successes of the above is that transaction banks are moving from market-to-market via branching rather than acquisitions and usually have such high operating costs that local banks cannot rationally emulate them. Like McDonalds, Nordstrom and Wal-Mart, they want their own store designs and, thus, usually build from “scratch” rather than acquire. On the cost side, the customized branches and long hours, which for Commerce means three teams of tellers, is something few local banks can afford to copy.

Most of the transaction specialists have thrift origins – Washington Mutual, TCF and Chevy Chase – or are relatively new banks – Commerce opened its doors in the mid-seventies. This suggests that when there is “less to lose,” there is a greater willingness to try something new.

The downside of the transaction bank model is that it may be merely a transitional phase in banking’s evolution as greater use of remote access could eventually render this model obsolete. In the meantime, though, the success of the few will encourage others, including more of the large than just Washington Mutual. A large bank buying Commerce and taking it nationwide is more than just a possibility.

Conclusion

Thus, as banking moves into 2003, it can anticipate:

- Commercial bank year-to-year earnings may be up marginally in 2003, but the gain is likely to come from the big banks – i.e., Fleet, Citigroup and J.P. Morgan Chase – coming off bad years.
- Far more banks than usual, and most thrifts, could report negative year-to-year earnings comparisons, but this will allow the banks with the most promising futures to look even better.
- Bank stocks will spend their fifth straight year below their 1998 highs, but investors in banks stocks in recent years will still be happy considering the alternatives.
- Transaction banks should continue to rack up the big numbers with Commerce continuing to set the pace and possibly moving its “game” to New England.
- Merger activity, but not pricing, will increase in response to earnings concerns, particularly among thrifts, but “increase” means the high end of the 100 to 150 per year range for deals of \$10 million or more of the last three years, not a return to the busy days of 1997 to 1999.

It is unlikely that 2003 will see any really earth-shattering mergers, but there will be more in the \$500 million to \$5 billion asset range than the three recorded in 2002 with Royal Bank of Scotland/Citizens, BB&T and Wells Fargo continuing to be the primary buyers. It is possible, though, that Bank One and/or Wachovia will join them with at least one big acquisition. The most likely acquisition possibilities for each are:

- Royal Bank of Scotland/Citizens – GreenPoint, New York Community, North Fork and Webster.
- BB&T – FirstMerit, Provident (Maryland and Ohio) and Sky.
- Wells Fargo – Comerica, Huntington and PNC.
- Wachovia and Bank One – National Commerce, Union Planters and PNC.

The possibility of Commerce “cashing in its chips” while it is “hot,” also cannot be discounted. This could mean a Bank of America or Royal Bank of Scotland putting their “deep pockets” behind the most successful of the transaction bank models.

As to “what do we do for an encore?” The answer to that question is a big one, and it should be approached from both a long and short-term perspective.

In the short-term – i.e., 2003 - the comparison that will count will be with the competition, not the previous year, and it is in “difficult” years that market gains are often made. It is at these times that the weaker banks tend to pull back or sell while the courageous and strong take advantage of the situation. Decision-makers, though, should be realistic as to whether their bank is among the strong or the weak, or even if strong whether it is in a “peak” situation, and then “play the hand that has been dealt” to the optimum benefit of competitive status and/or investment value.

The long-term is trickier in that while financial services have grown faster than any large, mature industry other than health care, this growth has been accompanied by continual change. Bank of America, Citigroup and J.P. Morgan Chase have stayed at the top and adjusted to change through

“deep pockets” and acquisitions, but local leaders constantly have been changing through merger, failure or irrelevancy.

It is not just a coincidence that only one of the 30 largest banks in Pennsylvania from twenty years ago is left, and that one, PNC, is not exactly enjoying the present; that thrifts hold just 4% of the North Carolina deposits; and that there are far more banks in New Jersey that were not around twenty years ago than that were. Thus, when “playing the hand that has been dealt,” in the words of Kenny Rogers’ song “The Gambler,” bank decision-makers have to “know when to hold ‘em, know when to fold ‘em, know when to walk away and know when to run.”

Table 1**Bank Stock Value Change**

		<u>Price</u>		<u>Change</u>	<u>Dividend</u>
	<u>Stock</u>	<u>Times</u>	<u>Percent</u>	<u>Since</u>	<u>Yield</u>
	<u>Price*</u>	<u>Est. 2003</u>	<u>of Book</u>	<u>Pre-1999 High</u>	
		<u>Earnings</u>			
<u>Large Banks</u>					
Citigroup	\$37.85	11.3X	241%	3.7%	1.90%
Bank of America	69.30	11.2	216	(21.2)	3.69
J.P. Morgan Chase	24.61	10.1	116	(52.1)	5.53
Wells Fargo	45.89	12.6	260	5.6	2.44
Wachovia	34.95	11.5	149	(46.8)	2.98
Bank One	38.64	12.5	206	(40.4)	2.17
Fleet	26.03	10.3	164	(42.2)	5.38
U.S. Bancorp	21.37	10.7	234	(31.1)	3.65
National City	27.56	10.6	207	(28.9)	4.43
SunTrust	57.55	<u>11.6</u>	<u>185</u>	<u>(34.2)</u>	<u>2.99</u>
Median		11.3X	206%	(32.6)%	3.32%
<u>Largest Thrifts</u>					
Washington Mutual	\$36.08	8.3X	167%	6.3%	3.10%
Sovereign	13.82	9.8	133	(37.7)	.72
GreenPoint	42.00	7.5	197	(1.5)	2.38
Astoria Financial	26.10	<u>8.6</u>	<u>149</u>	<u>(16.5)</u>	<u>3.07</u>
Median		8.4X	158%	(9.0)%	2.73%
<u>Small and Mid-Sized Banks**</u>					
Midwest (42)	-	13.1X***	152%	(25.3)%	2.74%
Northeast (52)	-	13.9***	165	(13.4)	3.03
Southeast (21)	-	14.1***	161	(10.6)	2.97

*December 1, 2002.

**Medians for banks with assets under \$50 billion and the number of banks in parentheses.

***Times trailing twelve months EPS.

Source: SNL Financial, Charlottesville, Virginia.

Table 2**Deposit Share in Southeast***

	Deposits 2002 (In millions)	Market Share			
		June 30,			
		2002	2001	2000	1996
<u>Market leaders</u>					
Bank of America	\$121,416	13.7%	13.8%	13.7%	10.3%
Wachovia	117,331	13.2	13.1	8.5	9.3
SunTrust	67,550	7.6	7.0	6.7	4.7
BB&T	45,898	5.2	5.1	3.7	2.1
Subtotal	\$352,195	39.7%	39.0%	32.6%	26.4%
<u>Other large</u>					
SouthTrust	\$26,610	3.0%	2.9%	2.9%	2.3%
AmSouth	23,859	2.7	2.6	2.9	1.8
Regions	19,786	2.2	2.2	2.3	1.8
National Commerce	14,878	1.7	1.6	.6	.4
Synovus	12,886	1.4	1.3	1.2	1.0
Union Planters	12,743	1.4	1.3	1.5	1.0
First Tennessee	12,170	1.4	1.3	1.4	1.2
First Citizens	10,102	1.1	1.0	1.0	.9
First Virginia	8,962	1.0	.9	.9	1.0
M&T	8,119	.9	.1	-	-
Subtotal	\$150,115	16.8%	15.2%	14.7%	11.4%
Other banks	\$255,367	28.9%	29.8%	36.6%	43.7%
Other thrifts	48,527	5.5	7.0	7.4	9.7
Credit unions	80,197	9.1**	9.0	8.7	8.8
Total	\$886,401	100.0%	100.0%	100.0%	100.0%

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

**Estimated in this and following tables.

Source: SNL Financial, Charlottesville, Virginia.

Table 3**Deposit Share in Midwest***

	Deposits 2002 (In millions)	Market Share			
		June 30,			
		2002	2001	2000	1996
<u>Market leaders</u>					
Bank One	\$90,395	8.3%	8.6%	8.6%	4.0%
U.S. Bancorp	61,144	5.6	6.2	4.9	1.6
Fifth Third	47,807	4.4	4.2	2.4	1.6
National City	45,580	4.2	4.3	4.1	2.9
ABN AMRO	43,928	4.0	4.2	3.9	2.1
Wells Fargo	35,022	3.2	3.1	2.5	2.2
Subtotal	\$323,876	29.7%	30.6%	26.4%	14.4%
<u>Other large</u>					
KeyCorp	\$23,292	2.2%	2.2%	2.4%	2.0%
Comerica	20,895	1.9	2.1	1.8	2.0
Charter One	18,720	1.7	1.3	1.2	.9
Bank of Montreal	18,334	1.7	1.5	1.6	1.5
Marshall & Ilsley	15,439	1.4	1.4	1.5	1.2
Huntington	15,090	1.4	1.2	1.4	1.2
Bank of America	13,089	1.2	1.2	1.4	.6
Associated	9,047	.8	.8	.9	.4
Provident	9,033	.8	.8	.7	.5
Subtotal	\$142,939	13.1%	12.5%	12.9%	10.3%
Other banks	\$435,759	40.1%	40.3%	44.2%	55.7%
Other thrifts	95,617	8.8	8.3	8.5	13.4
Credit unions	89,957	8.3	8.3	8.0	6.2
Total	\$1,088,148	100.0%	100.0%	100.0%	100.0%

*Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Ohio and Wisconsin.

Source: SNL Financial, Charlottesville, Virginia.

Table 4**Deposit Share in Northeast***

	Deposits <u>2002</u> (In millions)	Market Share			
		June 30,			
		<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1996</u>
<u>Market leaders</u>					
Fleet	\$110,352	10.3%	10.9%	9.6%	7.8%
J.P. Morgan Chase	72,429	6.8	6.6	5.8	6.2
Wachovia	52,287	4.9	5.1	6.4	2.8
Citigroup	44,288	4.1	3.4	3.0	2.8
Royal Bank-Scotland	41,361	3.9	2.4	2.2	1.4
HSBC	37,606	3.5	3.7	3.6	1.7
PNC	<u>37,443</u>	<u>3.5</u>	<u>3.8</u>	<u>4.0</u>	<u>4.3</u>
Subtotal	\$395,766	37.0%	35.9%	34.6%	27.0%
<u>Other large</u>					
Bank of New York	\$29,457	2.8%	2.7%	3.0%	2.7%
Sovereign	24,685	2.3	2.3	2.0	.6
M&T	23,833	2.2	1.9	1.6	1.2
State Street	18,702	1.8	1.2	1.2	.9
Banknorth	17,003	1.6	1.3	1.3	.4
Mellon	13,879	1.3	2.4	2.7	2.2
Commerce	12,470	1.2	.8	.7	.3
North Fork	12,294	1.2	1.0	.9	.4
Washington Mutual	<u>12,263</u>	<u>1.2</u>	<u>-</u>	<u>-</u>	<u>-</u>
Subtotal	\$164,586	15.6%	15.7%	13.6%	8.7%
Other banks	\$232,477	21.7%	25.2%	26.4%	32.2%
Other thrifts	201,352	18.9	18.7	19.2	24.6
Credit unions	<u>74,842</u>	<u>6.8</u>	<u>6.6</u>	<u>6.4</u>	<u>6.5</u>
Total	\$1,069,023	100.0%	100.0%	100.0%	100.0%

*New England, New Jersey, New York and Pennsylvania and excludes nonbanks with bank charters, single office foreign banks and J.P. Morgan Chase and Citigroup main offices to create a better "local" comparison.

Source: SNL Financial, Charlottesville, Virginia.