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## **Middle Atlantic Banking Report**

### **The Last Domino Falls**

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It has been a long time coming, but the last domino finally fell. With the October announcement that Mercantile will be acquired by PNC for a little over \$6 billion, the last of the local banks that once dominated Maryland, Virginia and the District banking disappeared. Mercantile has joined Maryland National, First National Bank of Maryland, Equitable, Union Trust, Suburban, Sovran, Crestar, Signet, Central Fidelity, Dominion, Riggs, First American and American Security as part of banking nostalgia. It was a nice run for Mercantile and a very nice price when the run ended, but with its sale, the banking world as we once knew it locally is no more.

Technically, there are two remaining mid-size banks – Chevy Chase and Provident – that still call the region home, but they are relative newcomers as major players. In the early 1980's, when all banking was local, Chevy Chase was a small, state-insured savings and loan with more of a future than a past, and Provident was a savings bank with most of its branches in the eastern part of Baltimore. In those days, Chevy Chase and Provident were not in a class with larger competitors such as Maryland National, Riggs and Mercantile. Another financial services newcomer with some size, Capital One, is headquartered in Northern Virginia, but its banking offices are outside the region.

The sale of Mercantile also changes the dynamics of the local bank merger picture. In recent years, it had been one of the region's most active bank buyers. Its acquisitions of James Monroe, Community Bank of Northern Virginia and F&M in Frederick were three of a very small number of sales with deal values in

excess of \$100 million in the area since 2003, and Mercantile paid well. Take it off the list of potential bank acquirers, and there are not many banks left in the region that are able and willing to buy banks with price tags in that range.

### Local Banking Leaders

Just how much the local banking structure has changed in recent years and the impact on bank acquisition potential can be seen in who are the largest banks in Virginia, Maryland and the District. Not only are the Baltimore, Richmond and the Washington banks that dominated the local scene long gone, but no one has stepped up to take their place. Virginia's biggest bank today, TowneBank, is less than eight years old; the largest in Maryland is a converted savings bank that has struggled in recent years; and in the District, the largest bank started as a woman's bank in the 1970s and has assets of only \$300 million.

### Ten Largest Banks Headquartered in Virginia

<u>Name</u>	<u>City</u>	<u>Assets</u>	
		<u>2006*</u>	<u>1999*</u>
		(In millions)	
1. TowneBank	Portsmouth	\$2,096	\$198
2. Union	Bowling Green	2,078	822
3. First Community	Bluefield	2,007	1,087
4. Virginia Commerce	Arlington	1,878	283
5. Virginia Financial	Culpeper	1,594	473
6. Cardinal	McLean	1,549	54
7. FNB	Christiansburg	1,507	519
8. Burke & Herbert	Alexandria	1,495	722
9. Gateway	Virginia Beach	1,125	44
10. National Bankshares	Blacksburg	844	166

\*September 30, 2006 and December 31, 1999.

Source: SNL Financial, Charlottesville, Virginia.

In Virginia, not only is TowneBank the largest bank in the state with just over \$2 billion in assets, but the fourth largest, Virginia Commerce, was opened in 1988. Two others among the ten largest, Cardinal and Gateway, opened only a year before TowneBank. Thus, four of the ten largest banks in the state opened in the last twenty years. Two others, First Community and Gateway, moved their headquarters to Virginia from West Virginia and North Carolina, respectively.

The biggest banks in Maryland, Provident and Sandy Spring, have long histories, and in the case of Provident – with assets over \$6 billion – much more size than the newer banks. Provident, though, with its recent struggles and the pressures that will follow the Mercantile sale – if the biggest Baltimore bank saw the need to sell, why not number two – is a likely sale candidate. Sandy Spring has been an active bank buyer in the last year, but it is not much bigger than TowneBank.

Ten Largest Banks Headquartered in Maryland

	<u>Name</u>	<u>City</u>	<u>Assets</u>	
			<u>2006*</u>	<u>1999*</u>
			(In millions)	
1.	Provident**	Baltimore	\$6,412	\$5,095
2.	Sandy Spring	Olney	2,598	1,583
3.	First Mariner	Baltimore	1,366	616
4.	First United	Oakland	1,321	793
5.	Shore	Easton	934	191
6.	Eagle	Bethesda	727	108
7.	K Capital**	Owings Mill	689	316
8.	Tri-County**	Waldorf	566	223
9.	Fidelity & Trust	Bethesda	384	-
10.	Calvin B. Taylor	Berlin	384	277

\*September 30, 2006 and December 31, 1999.

\*\*Converted from thrift charters.

Source: SNL Financial, Charlottesville, Virginia.

After Provident and Sandy Spring comes an interesting assortment of banks rounding out Maryland's top ten. First Mariner is another bank that began operating in the latter half of the 1990s. Eagle made it up to sixth place among the Maryland banks in just eight years, and Fidelity & Trust moved into the top ten in its third full year of operation. Three others – Provident, K Capitol and Tri-County – are converted thrifts. Two of the remaining three, Shore and Calvin B. Taylor, are on the Eastern Shore, and the other, First United, is in Western Maryland.

The District contributes little to the local banking structure with only five banks, but it is not without its “new blood.” WashingtonFirst and Bank of Georgetown are less than three years old, and City First opened in 1998.

Chevy Chase, the only area thrift with assets in excess of \$2 billion, is the biggest local banking organization with branches in Maryland, Virginia and the District. It is a potent local alternative to the large banks, but, unlike Mercantile, it is not an acquirer of smaller banks and thrifts.

This is a different banking world from the days when Sovran, MNC, Crestar, First National Bank of Maryland and a few others were truly local; could respond quickly to the needs of small business; and were buying every bank available. Mercantile was the last of a kind, and what exists now is what is frequently referred to as the “bar bell” structure – large banks with national aspirations surrounding a myriad of small, local banks, generally serving different customer bases, with few mid-size banks in-between.

### Regional Banking Structure

The bar bell structure can readily be seen in a deposit market share table for the entire region and the primary urban complexes within it – Washington, Baltimore, Richmond and Hampton Roads. The dominance of the large banks is hardly a new story, but the arrival of PNC with its recent purchase of Riggs and Mercantile ups the number of banks in the area with assets of more than \$100 billion from five to six. These six – Bank of America, Wachovia, SunTrust, BB&T, PNC and Citigroup – have about 56% of the region's deposits. This is up from 42% in 2002, but most of the increase came through acquisitions by PNC and BB&T's 2003 purchase of First Virginia. On a fully-pooled basis, the big banks are only marginally ahead of their 2002 deposit share. Thrifts, other than Chevy Chase, are bit players with 4% of area deposits. Credit unions have a more substantial 11%, but if measured by deposit share, it is a declining 11%.

Maryland, Virginia and D.C. Deposit Share, Fully-Pooled

	June 30,					
	Deposits	Market Share				Actual
	<u>2006</u> (In mill.)	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2002</u>	<u>2002</u>
<u>Large Banks</u>						
Wachovia	\$39,149	14.2%	14.3%	13.8%	13.3%	13.3%
Bank of America	37,346	13.5	14.0	13.8	12.7	12.7
SunTrust	26,480	9.6	9.4	9.3	10.5	9.8
BB&T	26,308	9.5	9.2	9.8	10.8	6.4
PNC	15,907	5.8	6.0	6.6	7.1	-
Citigroup	<u>9,914</u>	<u>3.6</u>	<u>3.6</u>	<u>3.7</u>	<u>1.3</u>	<u>1.3</u>
Subtotal	\$155,087	56.2%	56.5%	57.0%	55.7%	43.5%
<u>Out-of-State Regionals</u>						
M&T	\$7,929	2.9%	3.2%	3.2%	4.2%	-
Fulton	2,392	.9	.9	.8	.8	.2%
United	2,137	.8	.8	.9	1.0	.8
Susquehanna	<u>1,759</u>	<u>.6</u>	<u>.6</u>	<u>.6</u>	<u>.6</u>	<u>.6</u>
Subtotal	\$14,217	5.2%	5.5%	5.5%	6.6%	1.6%
<u>Leading Locals</u>						
Chevy Chase	\$10,662	3.9%	3.9%	3.7%	3.8%	3.8%
Provident	4,128	1.5	1.6	1.6	2.1	1.7
Sandy Spring	2,014	.7	.8	.8	.8	.7
TowneBank	1,620	.6	.5	.4	.4	.3
Union	<u>1,619</u>	<u>.6</u>	<u>.6</u>	<u>.6</u>	<u>.5</u>	<u>.4</u>
Subtotal	\$26,331	7.3%	7.4%	7.1%	7.6%	6.9%
Other banks	\$44,620	16.2%	15.3%	14.5%	14.1%	31.5%
Other thrifts*	11,561	4.2	4.1	4.2	4.3	4.8
Credit unions**	<u>30,584</u>	<u>10.9</u>	<u>11.2</u>	<u>11.7</u>	<u>11.7</u>	<u>11.7</u>
Total	\$276,112	100.0%	100.0%	100.0%	100.0%	100.0%

\*Excludes Capital One, Countrywide and E\*Trade.

\*\*Excludes Navy and Pentagon Federal.

Source: SNL Financial, Charlottesville, Virginia.

Over the last four years, the deposit shares of the top two, Wachovia and Bank of America, increased while the fully-pooled deposit shares of SunTrust and BB&T have slipped, opening some room between the upper echelons of the region's "big four" and the other two. Wachovia and Bank of America had a combined 27.7% deposit share in June 2006 – up from 26% in 2002, and BB&T and SunTrust were down from 21.3% in 2002 to 19.1% in 2006. This may not sound like much of a change, but expressed as a differential, it is a widening from 4.7% to 8.6%, or almost a doubling.

There are still mid-size banks with modest deposit shares. One of these, Commerce, is causing quite a stir in the Washington area, but they are mostly based outside the region. Among them, only M&T has more than a 1% share, and its 2.9% share was a big drop-off from the 4.2% it inherited from AllFirst. Collectively, Fulton, United and Susquehanna had a combined 2.3% deposit share, which was about where they were four years earlier on a fully-pooled basis.

Chevy Chase and Provident are the only locally-based banks with more than 1% of the region's deposits, and all of this is in the Baltimore-Washington corridor. Chevy Chase with over \$10 billion in local deposits has an almost 4% deposit share, marginally up from where it was in 2002. Provident has not done nearly as well with its 1.5% share down sharply from a fully-pooled 2.1% in 2002 – and even below the 1.7% that year excluding later acquisitions.

The best regional momentum has been with the "other banks," which is the small bank part of the bar bell. This is primarily new banks in urban areas and long-established small banks located in western and southwestern Virginia and on the Eastern Shore. For now, the "other bank" numbers also include Commerce, a new entrant from New Jersey that opened 12 offices in northern Virginia and the District in the last couple of years with spectacular results.

The Commerce numbers speak for themselves, but there is no telling just how much of its deposits come from municipalities and how much from individuals. Where it comes from aside, as of mid-2005, Commerce had two offices with \$6.6 million deposits. A year later, it had eight offices and \$474 million deposits, or \$59 million per office, albeit three offices accounted for almost \$400 million of the total. In the last six months of 2006, it opened four more.

## The CD Impact on Deposit Shares

It should be noted that in some cases, the individual bank annual deposit share changes in 2006 went counter to the longer term trends. Much of this had to do with the rise in interest rates that shifted the deposit growth to CDs and the differing approaches of banks to selling CDs. The big banks have less interest in CDs than small banks as they can finance loan growth with borrowed funds. There are variances among small banks as well.

Bank of America is the most obvious case of a low CD focus. About 25% of its deposits nationwide are CDs, but while most banks in 2006 were increasing CDs on a year-to-year basis by more than 25%, Bank of America had a 4% decline. With growth in other deposits consistent with the market, it lost deposit share when measured as total deposits in most markets across the country. In Maryland, Virginia and the District, where its share fell from 14% to 13.5%, Bank of America's difference from other banks in pursuing CDs suggests that in deposits other than CDs, it may not have lost share.

Bank of America's lack of interest in CDs may be more than just a preference for borrowed funds. Choosing to avoid the most expensive type of deposits and losing deposit share has the advantage of taking Bank of America further below the national deposit cap of 10%. Based on 2006 numbers, it can now buy a \$100 billion deposit bank and still be under the 10% national limitation.

Among other local leaders, Wachovia and PNC were the only other banks to have 2006 CD increases of less than 20% while SunTrust, Chevy Chase and Provident were the most aggressive in chasing high cost funds. Wachovia, system-wide, had about a 14% gain in CDs and PNC an increase of 12%. During the same period, SunTrust, Chevy Chase and Provident were up more than 35%. This is not the total reason for the deposit share change, but it goes a long way toward explaining why Bank of America lost share so dramatically and why SunTrust gained share over the last two years after losing so much in prior years.

There is also a big difference in CD dependence. SunTrust, BB&T and M&T among the large banks and Provident among local banks had CDs accounting for more than 40% deposits in mid-2006 while Bank of America, Wachovia, PNC and Chevy Chase were in the 20% to 30% range.

The renewed emphasis on CDs also explains why the bank cost of funds is rising so rapidly. Most banks had an absolute fall-off in combined other deposits, which is primarily non-interest-bearing demand and money market demand accounts. SunTrust, Bank of America, M&T, Chevy Chase, Provident and Sandy Spring were all down by 3% or more.

None of these numbers apply to Commerce. In mid-2006, only 13% of its deposits were CDs, and it had about a 25% increase in deposits other than CDs between 2005 and 2006. It had a similar percentage gain in CDs.

### Market Variations

As consolidation moves forward, grouping the Maryland, Virginia and District banking structure has become more meaningful each year, but it also misses some important distinctions. There are large variations within the region's major population clusters – the Washington, Baltimore, Richmond and Hampton Roads areas – and in outlying areas like Southwest Virginia and the Eastern Shore, the impact of the big banks is much less.

In the region's four major population clusters, the strong positions of Bank of America and Wachovia are evident. In mid-2006, Wachovia had the largest deposit share in three of the regions and Bank of America in the other. Where Bank of America was not number one, it was second. The only one of these markets in which these two large banks were not running one-two was Baltimore, where the Mercantile franchise being taken over by PNC was a distant second to Bank of America.

In the strictly Virginia urban clusters, Richmond and Hampton Roads, the “dominance of two” can be extended to a big four as SunTrust and BB&T run three-four behind Wachovia and Bank of America. They are the only banks with double-digit deposit market shares. In Richmond, there are no other banks with market share even close to the four big banks.

This is not the case in Hampton Roads where TowneBank has turned the big four into a big five with an 8% deposit share. If the present trends continue, TowneBank could rise as high as number two in a few years. As mentioned earlier, it is already the biggest bank based in Virginia.

Deposit Share Leaders by Region, 2006\*

	<u>Deposits</u> (In bill.)	<u>Deposit</u> <u>Share</u>		<u>Deposits</u> (In bill.)	<u>Deposit</u> <u>Share</u>
<u>Washington</u>			<u>Baltimore</u>		
1. Wachovia	\$18.2	15.9%	1. Bank of America	\$10.5	22.5%
2. Bank of America	13.9	12.1	2. PNC	5.6	12.0
3. SunTrust	13.6	11.9	3. M&T	4.6	9.8
4. Citigroup	9.8	8.6	4. Wachovia	3.6	7.7
5. Chevy Chase	9.5	8.3	5. Provident	2.6	5.5
6. BB&T	8.7	7.6	6. BB&T	2.2	4.7
7. PNC	5.3	4.6	7. SunTrust	1.6	3.3
8. United	2.1	1.8	8. Susquehanna	.9	1.9
9. Sandy Spring	1.6	1.4	9. First Mariner	.8	1.8
10. M&T	1.6	1.4	10. Eastern Savings	.8	1.6
 <u>Richmond</u>			 <u>Hampton Roads</u>		
1. Wachovia	\$6.1	24.9%	1. Wachovia	\$3.6	17.9%
2. Bank of America	6.0	23.4	2. Bank of America	2.4	11.8
3. SunTrust	4.3	16.8	3. SunTrust	2.4	11.7
4. BB&T	3.1	12.2	4. BB&T	2.2	10.6
5. Franklin	.6	2.3	5. TowneBank	1.6	8.0
6. Central Virginia	.3	1.1	6. Fulton	.6	3.0

\*June 30, 2006.

Source: SNL Financial, Charlottesville, Virginia.

The very large Washington banking market, with its size and growth, is far more competitive than most as outsiders seemingly cannot resist the lure of these twin attractions and Chevy Chase will not go away. Wachovia, Bank of America and SunTrust have the three largest shares, but BB&T is joined by Chevy Chase, Citigroup and PNC in a very potent second tier with deposit shares between 4% and 9% as of June 30, 2006.

This second tier creates some fluidity in Washington area banking as there are questions about the future of all four banks in the group. BB&T has openly talked about being involved in a large merger. Citigroup's share is misleading in that it has few offices in the area, and there are even some

that think it may abandon branch banking. Chevy Chase is unique in that it has more branches and ATMs in the area than any of the larger banks and with the sale of Mercantile, it is the only bank with assets under \$100 billion that can provide a buyer with instant parity with the other leaders.

PNC is a Washington area wild card that may have overreached. It entered the market by acquiring the faltering Riggs franchise in 2005 and is augmenting that with Mercantile's Washington area branches. Combined, this gives it an almost 5% Washington area deposit share, but this is only good enough for seventh place; and what it bought has been losing share for years. PNC may be able to turn this acquired franchise around, but it has lost deposit share in much of Pennsylvania and New Jersey in recent years.

In Baltimore, the situation is much more favorable for PNC as the Mercantile franchise in that market was a good one and second only to Bank of America in deposit share, but there will likely be the usual post-merger slippage. With a 12% share and more than a two percentage point lead over number three, M&T, PNC has room to slide and still remain the primary rival to Bank of America.

The second tier in Baltimore includes Wachovia, BB&T, SunTrust and Provident. With Mercantile gone, Provident, inherits the status as the leading local, but it does so with far less size and little momentum.

### Branch Growth

Another story that has been building nationally, and dramatically impacting local banking, is the surge in new offices. The branching boom that started in the 1960s and ran through the 1980s seemed to have run its course in the 1990s. The general feeling a few years back was that the nation was over-branched, and, with the advent of remote access banking, it was anticipated that the number of branches would decline. In 2001 and 2002, branch growth slowed, but since that time, there has been a rapid acceleration in the annual net increase in banking offices.

In 2004, for the first time since the 1980s, the net number of banking offices in the country went up more than 2%. Then in 2005, the 2.3% gain of the previous year was eclipsed by a 2.5% increase, and 2006 upped the ante to 2.9%.

National – Branch Growth\*

<u>June 30,</u>	<u>Total Branches</u>	<u>Annual Change</u>	<u>Percent Change</u>
2006	94,741	2,695	2.9%
2005	92,046	2,261	2.5
2004	89,785	1,995	2.3
2003	87,790	1,212	1.2
2002	86,578	509	.6
2001	86,069	577	.7
2000	85,492	1,180	1.4
1999	84,312	998	1.2
1998	83,314	1,205	1.5
1997	82,109	734	.9
1996	81,375	400	.5
1995	80,999	(305)	(.4)

\*Banks and thrifts.

Source: FDIC.

Considering long-term trends in branch usage, this increase made little sense, and one of the major reasons for the gain was based on a questionable rationale. Specifically, the rapid decline in rates paid on deposits as interest rates fell sharply from 2001 through 2003 created a feeling among many that the best banking strategy was “back to the basics,” another way of saying open branches and gather deposits. This worked well as long as deposit growth was strong, but ironically, by the time most branches based on this rationale opened, the rate structure had moved in the other direction and the growth of the key deposit types that fueled this momentum was over.

A more rational reason for the rapid branch growth, but not any better in terms of the long-term health of the industry, was a shift in the expansion strategies of large banks relative to new markets. In the last few years, they have moved away from entering new markets by acquisition in favor of *de novo* branching, presumably assuming that they would be survivors as others dropped out.

The disappearing deposit growth does not augur well for recently opened branches, which can be readily seen in industry statistics. Savings accounts, including MMDAs, were the basis of the rapid growth of cheap deposits in the earlier years of the new millennium. They rose from \$1.9 trillion in 2000 to \$3.5 trillion in 2004, or almost a 22% per annum gain in the first two years of that period and a 12.5% annual gain in the second two. Since 2004, the annual increase has been less than 2%. The other source of cheap funding, non-interest-bearing checking accounts, continued their long-term decline during this entire period.

Growth of Interest Bearing Account Types – National

	<u>Savings and MMDA</u>	<u>Retail CDs</u>	<u>Jumbo CDs</u> (in billions)	<u>Money Market Funds</u>	<u>Repurchase Agreements</u>
2006*	\$3,613	\$1,104	\$1,403	\$2,017	\$565
2005	3,622	976	1,354	1,843	564
2004	3,520	817	1,071	1,774	493
2003	3,169	810	885	1,900	495
2002	2,779	893	816	2,140	473
2001	2,309	973	794	2,181	379
2000	1,876	1,044	830	1,714	366
<u>Growth Rate</u>					
2004 – 2006*	1.6%	19.8%	23.1%	8.0%	11.2%
2002 – 2004	12.5	(4.3)	14.6	(9.0)	2.0
2000 – 2002	21.7	(7.5)	(0.9)	11.7	13.7

\*August 2006 for savings and MMDA, retail CDs and money market funds.  
April 2006 for jumbo CDs and repurchase agreements.

Source: Federal Reserve Bulletins.

To make up the difference in loan funding, banks turned to CDs, the most expensive deposit type. CDs had a modest decline in absolute totals from 2000 to 2004, and then exploded to a more than 20% annual gain in the last two years. This was the cause of the recent surge in the cost of funds,

and it undercut the profitability of all branches, particularly recently opened ones that did not have large amounts of “lazy” money going into 2005.

Washington Area Branch Growth by Bank

	<u>2006 Branches</u>	<u>Net New Offices*</u>			<u>Deposits Per Branch** (In mill.)</u>
		<u>2006</u>	<u>2005</u>	<u>2004</u>	
Chevy Chase	208	14	18	10	\$39.1
Bank of America	180	(2)	6	-	68.0
SunTrust	176	5	-	2	61.1
BB&T	160	1	(1)	(21)	62.9
PNC	140	3	2	(2)	52.5
Wachovia	122	(6)	4	(5)	71.5
Provident	64	3	1	2	20.0
M&T	56	-	(3)	(2)	37.3
United	33	-	(3)	(3)	62.7
Sandy Spring	32	2	(1)	1	56.9
Citigroup	27	-	3	-	115.1
Virginia Commerce	19	1	5	-	75.4
Cardinal	16	3	3	3	60.7
Burke & Herbert	16	-	1	-	72.2
First Horizon	13	1	12	-	10.1
Maryland B&T	12	1	-	-	22.9
Fulton	11	1	-	1	49.5
Eagle	9	1	1	1	69.3
Tri-County	9	-	1	-	43.2
Commerce	8	6	2	-	59.3
IBW	8	-	-	(2)	34.7
Presidential	<u>8</u>	<u>-</u>	<u>-</u>	<u>-</u>	52.0
Subtotal	1,327	34	51	(15)	
All others	<u>163</u>	<u>20</u>	<u>14</u>	<u>8</u>	
Total	1,490	54	65	(7)	

\*Fully pooled.

\*\*Excludes offices with deposits over \$1 billion.

Source: FDIC.

These deposit trends hurt bank profitability nationwide, but the dual problem of rising deposit cost and excessive branching was most acute in high growth urban areas. Washington, Richmond and the Hampton Roads were among these, and branching in the Washington area in the last couple of years was an extreme case.

The number of banking offices in the Washington area exploded after 2004. Instead of the 2% to 3% gain nationwide, the increase between June 2004 and June 2005 was 5%, or a net gain of 65 offices, and in the following year it was almost a 4% increase, or 54 new branches. This came after many years of modest changes in branch numbers and an actual decline in 2004 when BB&T was consolidating its First Virginia acquisition.

The major culprits were recent entrants – Commerce, PNC and First Horizon – expanding their modest coverage; Chevy Chase meeting the challenge; and new banks expanding their franchises. The recent entrants opened 26 offices in the last two years, and Chevy Chase alone opened 32. The largest new banks – Virginia Commerce, Cardinal and Eagle – opened 14 offices, and banks with fewer than eight offices in the Washington area, which are primarily new banks, added 34 new offices.

It is unlikely this pace will continue. First Horizon, in particular, has to be rethinking its strategy with 13 offices with average deposits of just \$10.1 million, but Commerce is far from through, and with four branches opened in the second half of 2006 and at least 11 more offices to open in 2007. The growth of branches connected with small bank franchises also will continue. PNC, on the other hand, should be through branching as it consolidates the Riggs, Mercantile and James Monroe offices. It now has 20 more offices in the Washington area than Wachovia, the market leader in deposit share.

What makes this branching boom so concerning for the industry is not only overcapacity, but also the rising operating costs of bank branches. In the 1990s, a common benchmark for the cost of operating a typical branch was around \$450,000 annually. If it was assumed that operating expense of about 1.50% of deposits would create a profitable office, then the minimum average size needed was \$30 million deposits.

Branch Operating Expenses – Changing Realities

Annual Branch Operating <u>Expense</u> (in thous.)	Operating Expense/ <u>Deposits</u>	<u>Deposits</u> (in mill.)
Current Reality		
\$750	1.00%	\$75
750	1.50	50
750	3.00	25
750	5.00	15
Just Five Years Ago		
\$450	0.60%	\$75
450	0.90	50
450	1.80	25
450	3.00	15

Source: Danielson Capital estimates.

Today, the average cost is more like \$750,000, and using the same 1.50% of operating costs to deposits, the necessary deposit size per office is more like \$50 million, which may be low for some of the more attractive markets in the Washington area. Many small banks are well below that in average branch size as are Provident and First Horizon. Commerce and Chevy Chase also are below \$50 million deposits per branch, although they can be expected to get back to that level, and above, when they finish their ambitious branching programs.

Concern about bank profitability may seem a little misplaced when the FDIC comes out with its usual year-end report announcing double-digit gains, or close to it, for bank assets and earnings, but this is a bit misleading and few bankers are feeling good about the way things went in 2006. A look behind these total industry numbers will show why.

Through the first nine months of 2006, bank assets and earnings grew at annualized rates of 10.7% and 13.1%, respectively, but most banks did not come close to this growth. With five banks – Citigroup, Bank of America, JPMorgan Chase, Wachovia and Wells Fargo – having 46% of all bank assets, they greatly influence the bank totals. Collectively, these five banks raised their assets in the first nine months of 2006 by almost 15% and earnings by 21% on an annualized basis. This did not leave a lot of growth for everyone else, and the difference is not just that they are big, but that 2006 was a better year for banks that were more oriented toward fee income – particularly investment banking fees – than normal spread income.

### Bank Asset and Earnings Gain by Size

	<u>Annualized Gain*</u>	
	<u>Assets</u>	<u>Earnings</u>
All banks	10.7%	13.1%
Big five	14.7	20.9
Other over \$1 billion	8.9	8.6
\$100 million to \$1 billion	4.3	2.6
Under \$100 million	(4.7)	1.1

\*First nine months of 2006 annualized.

Source: FDIC.

The FDIC category breakdowns are limited, but the earnings growth deteriorates with declining size, which is consistent with “the smaller the bank, the greater the dependence on spread banking.” Thus, banks, other than the big five, with assets over \$1 billion had an annualized 8.6% gain in earnings through the first nine months on 2006 annualized; the \$100 million to \$1 billion asset group had a disappointing 2.6% gain; and the banks with less than \$100 million assets had only a collective 1.1% earnings increase.

### So What Does This Mean Going Forward

In 2007, margin pressures will persist – the median decline in net interest income as a percent of average assets for banks in the area was about 20 basis points in 2006 – and with an increasing overhead burden, it should be more of the same for all but the largest banks, as long as asset quality

holds. The big five should once more run ahead of other banks in earnings – and certainly asset – gains, but it is unlikely they can match the 21% annualized first nine months of 2006, or even get into double-digits. It is hard to show large year-to-year increases coming off one of the best years ever for investment banking fees, a major ingredient in their 2006 increase.

Merger pricing and activity will miss Mercantile, but the lack of mid-size acquirers in Maryland, Virginia and the District is somewhat muted by the existence of a dwindling few in surrounding states. North Carolina is in the same situation structurally as Maryland and Virginia, but United in West Virginia and Fulton and some other mid-size banks in Pennsylvania are still actively acquiring. In 2007, the biggest deterrent to small bank sales will be the gap between the pricing expectations of sellers and the willingness of buyers to pay those prices rather than the lack of acquirers. This could be the last year, however, that this can be said.

As to the bar bell structure, it will not change much in the next couple of years. The names may change at the big bank end, heralding the arrival of a JPMorgan Chase, Wells Fargo or Royal Bank of Scotland, but this will not greatly change the local competitive situation. At the small bank end of the bar bell, for at least another year, the opening of banks should match, if not exceed, the disappearance of banks through mergers.