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Financial Crisis and the Banking Structure

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It was coincidental, but good timing, to have finished my recent book, Consolidation of Banking: or How Five Banks Bought 50% of America's Biggest Business, in July 2007. This was when the good times ended for financial services firms, and the banking downturn began. In early 2007, the dark clouds were already gathering, but no one really knew at the time that a long anticipated decline in the real estate markets was going to turn into the nation's biggest financial crisis since the early 1990s, if not since the 1970s.

In the book, one of the primary themes is that financial crises are one of the biggest factors that drives consolidation and determines who wins and who loses. Thus, the book's next chapter, if there were to be one, would be about the impact of the current financial crisis. Since this latest downturn is in its early stages, it is too soon to write that chapter, but it may not be too soon to at least try to sort out what is likely to happen.

Unlike the book, which is national in scope, this analysis of the likely impact of the current financial crisis on the banking structure is focused on the Northeast, particularly the densely populated corridor from Norfolk to Boston. However, to put the regional situation in the proper context, it is helpful to understand what the overall impact of the current financial crisis is likely to have on banking in general, and then apply that understanding to

smaller geographic areas. The most significant of these general crisis-driven factors that also will impact regional banking structures are:

- The early sale or restructuring of the weakest links among the large financial services companies;
- A market-driven moratorium on the sale of healthy, large and mid-sized banks;
- Local banks generally outperforming their larger brethren, but showing only minimal, if any, earnings gains; and
- Internal consolidation of retail banking being stalled, possibly by as much as five years.

The last point about retail consolidation being stalled for a number of years is good news for local banks. A year ago, it seemed likely that Bank of America would be spending most of its time on internal expansion and improving its branch coverage and Citicorp would be joining JPMorgan in buying and opening branches across the country. A year later, this is an outdated view.

Today, Bank of America faces the usual large bank financial crisis problems including trying to make investors happy by minimizing losses, and is also busy consolidating a LaSalle acquisition in the Midwest and a Countrywide acquisition across the nation. There is no need to cry for Bank of America as it fills its primary geographic void in the Midwest; becomes the largest mortgage banker in the country; and leaves Citigroup in the dust; but for a couple of years, this large bank that has been a primary threat to local banks, has other things to do.

As for Citicorp, it is more likely to be a seller than a buyer of banking offices, albeit that may be a mixed blessing in the long run as the buyers of its branches will be tougher competitors at the local level. Even in the short run, though, the sale of its New York branch network to a Royal Bank of Scotland or Wachovia, the most likely buyers, would create distractions for those two aggressive, large retail banks.

The first two points – the forced sale or restructuring of the weak links and a market-driven moratorium on the exiting of healthy second-tier banks

– are reruns of the early 1990s financial crisis. Then, large, troubled banks like MNC, C&S/Sovran, Manufacturers Hanover, Security Pacific and Bank of New England were gone or on their way out by 1992 . The big exodus of big banks that had fared better, but had lost the will to go forward, did not occur, though, until 1995 when Chase Manhattan, Shawmut, First Fidelity, Midlantic, First Chicago and First Interstate gave up the fight.

In this present financial crisis, 2008 will see the sale of troubled large financial firms with Countrywide and Bear Stearns being only the first of several, but healthy, second-tier banks that might have been thinking about selling will delay that move. For them, the time to sell is when stock prices are high, asset quality is no longer a concern and the primary buyers are not busy elsewhere. This is not a description of 2008, and probably not of 2009.

Fortunately for local banks in these troubled times, their big problems are only a loss of momentum and guilt by association – i.e., the industry is in trouble, so all banks must be a bad investment. Earnings gains and growth may be hard to come by in 2008, but few local banks outside of California, Florida, Georgia and Michigan are having serious asset quality problems.

So what in particular can banks in the Northeast expect from this economic crisis?

- High on the list are Bank of America and JPMorgan being distracted as they consolidate LaSalle, Countrywide and Bear Stearns, and JPMorgan may add Washington Mutual to the list;
- Citigroup accepting the inevitable and selling its New York branch network to the Royal Bank of Scotland or Wachovia;
- Capital One and Sovereign finding it investor friendly to take a bigger bank's money and run; and
- In time, but not immediately, most of the region's dwindling number of mid-sized banks and thrifts joining the rush to the exit. In the Northeast, there are only five banks and six thrifts left with assets in the \$10 billion to \$50 billion range.

The biggest Northeast banking story in these troubled times, barring a Merrill Lynch sale, is likely to be Citigroup realizing that it waited too long

to expand its retail business, and finding the \$5 billion to \$7 billion it might net from a sale of its New York banking network is a necessary ingredient to replenish a diminishing capital base. This also would give Citigroup the flexibility of Merrill Lynch, Morgan Stanley and other investment banks that are not directly regulated by the Fed in being able to accept capital from the sovereign funds with minimal political and regulatory concern.

The impact of a Citigroup's branch network sale could be of more competitive significance because of the buyer rather than the seller. A purchase of this size would only be doable and make sense to a bank the size of Bank of America, JPMorgan, Royal Bank of Scotland and/or Wachovia, and the first two would be options only if Citigroup is in danger of failing and no other options existed – and other options do exist. For Royal Bank of Scotland, these offices would fill the gap between its major areas of strength – New England, Pennsylvania and Upstate New York. If Wachovia was the buyer, it would overnight become the nation's fourth trillion dollar bank and would intensify its coverage.

The “wild cards” in Northeast banking relative to forced sales because of bad times that also could have major structural impacts are Sovereign and Capital One. After a good “run,” Sovereign has been going nowhere fast, lost money in 2007 and is 20% owned by one of Europe's largest banks, Banco Santander. Capital One is holding on well in a difficult environment, but its emphasis on credit cards may cause problems that could cause a sale, and its North Fork subsidiary has the fourth largest branch network in the New York City area. Their potential buyers include the usual suspects – Royal Bank of Scotland and Wachovia – but could also include Toronto-Dominion, PNC and Banco Santander.

New York City

Since so much of the present banking crisis is focused on the largest commercial and investment banks, the biggest impact of the downturn will be in New York City and its immediate environs. Much of the negative impact will come from out-of-work bankers and crippled investment banks, but it also will have a major impact on traditional banking in the area.

It was an earlier financial crisis that allowed Chemical to take over Manufacturers Hanover and Chase Manhattan and gave it the size to then acquire J.P. Morgan and the Bank of New York branches. In so doing, it

turned a less than 10% share of the area's deposits into about 40%, some of which is corporate funds from outside the area. Chemical, or JPMorgan Chase as it is now called, is certainly dominant locally, but its primary local competition comes from four of the world's largest banks – HSBC, Bank of America, Citigroup and Wachovia (not in the table below, but number six if the table went that far) as well as Capital One's North Fork affiliate.

New York City Area*

<u>Bank</u>	<u>Deposits</u> <u>2007</u> (in bill.)	<u>Market Share</u>		
		<u>2007</u>	<u>2000</u>	<u>1995</u>
1. JPMorgan Chase	\$216.8	40.3%	30.4%	18.0%
2. Citigroup	57.4	10.7	16.0	13.2
3. HSBC	44.8	8.3	7.2	-
4. Capital One	34.6	6.4	-	-
5. Bank of America	33.3	6.2	2.7**	-
Largest five at time	<u>-</u>	<u>-</u>	<u>9.6</u>	<u>24.1</u>
Subtotal	\$386.9	71.9%	65.9%	55.3%
Other large banks***	\$29.2	5.4%	8.8%	2.7%
Local and regional banks	63.4	11.8	8.6	16.4
Thrifts	<u>58.5</u>	<u>10.9</u>	<u>16.7</u>	<u>25.6</u>
Total****	\$538.0	100.0%	100.0%	100.0%

*New York City, Long Island, Rockland and Westchester County.

**Fleet.

***Assets over \$100 billion in 2007 in this and subsequent tables.

****Excludes single office foreign banks.

Source: SNL Financial, Charlottesville, Virginia and FDIC.gov.

Substituting Royal Bank of Scotland and Wachovia for Citigroup and North Fork in New York may not alter the large/small bank relationship, but it changes the Northeast banking power structure. It would be the replacing of two large banks, Citigroup and Capital One, which have minimal interest in retail bank expansion with two of the most expansion-oriented big banks, Royal Bank of Scotland and Wachovia.

Upper Middle Atlantic

The biggest impact of structural changes in New York City outside the state's borders would be in an Upper Middle Atlantic area that includes Upstate New York, New Jersey and Pennsylvania. The primary impact, of course, would be in New Jersey.

Upper Middle Atlantic, Excluding New York City*

<u>Bank</u>	<u>Deposits</u> <u>2007</u> (in bill.)	<u>Market Share</u>		
		<u>2007</u>	<u>2000</u>	<u>1995</u>
1. Wachovia	\$59.8	10.5%	9.8%	-
2. PNC	55.8	9.8	9.5	6.4%
3. Bank of America	44.1	7.7	4.8**	-
4. Toronto-Dominion	37.6	6.6	-	-
5. Royal Bank of Scotland	34.5	6.1	5.4***	5.5***
Largest five at time	<u>-</u>	<u>-</u>	<u>11.7</u>	<u>22.5</u>
Subtotal	\$231.8	40.7%	35.8%	28.9%
Other large banks	\$59.0	10.3%	18.1%	9.5%
Local and regional banks	166.1	29.1	28.3	40.5
Thrifts	<u>114.0</u>	<u>19.9</u>	<u>17.8</u>	<u>21.1</u>
Total	\$570.9	100.0%	100.0%	100.0%

*New Jersey, Pennsylvania and Upstate New York.

**Fleet.

***Mellon.

Source: SNL Financial, Charlottesville, Virginia and FDIC.gov.

A New York acquisition by the Royal Bank of Scotland that is fifth in the Upper Middle Atlantic region, but with limited branches in New Jersey, would create a strong incentive to build on its minimal New Jersey coverage. It could readily do this by acquiring a struggling Sovereign or even Valley National, one of the few quality, mid-sized banks remaining.

For Wachovia, already the region's leader, any buying it does in New York will have little impact on the Upper Middle Atlantic other than keeping

it busy consolidating rather than expanding. Such an acquisition, though, would provide more parity with Bank of America and JPMorgan.

The Upper Middle Atlantic's large banks also are far from being an overwhelming force and unlikely to be so anytime soon. In 2007, they held a little over 50% of deposits, down from 2000. Some of this lesser degree of concentration comes from the large number of small towns and far more mid-sized banks and thrifts – M&T, Sovereign, Valley National, Fulton, Valley, Susquehanna and Hudson City – than elsewhere in the Northeast.

The purchase of Sovereign by Royal Bank of Scotland or Toronto-Dominion would raise the big bank share. That would be partially offset, though, by the slowed momentum of the large banks as they are distracted by the consolidation of acquisitions and other concerns.

Philadelphia Metropolitan Area

<u>Bank</u>	Deposits <u>2007</u> (in bill.)	<u>Market Share</u>		
		<u>2007</u>	<u>2000</u>	<u>1995</u>
1. Wachovia	\$24.8	21.0%	23.9%	-
2. Toronto-Dominion	16.0	13.6	5.8*	-
3. Royal Bank of Scotland	14.1	11.9	11.2**	12.5%**
4. PNC	10.3	8.7	13.2	7.4
5. Sovereign	10.3	8.7	-	-
Largest five at time	<u>-</u>	<u>-</u>	<u>4.6</u>	<u>33.5</u>
Subtotal	\$75.5	62.9%	58.7%	53.4%
Other large banks	\$7.8	6.6%	.3%	1.6%
Local and regional banks	19.9	16.9	18.6	24.3
Thrifts	<u>14.8</u>	<u>12.6</u>	<u>22.4</u>	<u>20.7</u>
Total	\$118.0	100.0%	100.0%	100.0%

*Commerce.

**Mellon.

Source: SNL Financial, Charlottesville, Virginia and FDIC.gov.

A 50% deposit share regionwide for big banks, however, understates the level of concentration in the individual population complexes. This is evident in the region's largest metropolitan area, Philadelphia. In 2007, the large banks held about 58% of the area's deposits – and adding Sovereign to the mix would lift the share to about 68%.

This is quite a change from the past. In 1995, no banks from outside Pennsylvania and New Jersey had a presence in the Philadelphia area. In 2000, Wachovia was the only outside bank present.

Lower Middle Atlantic Area

In the Lower Middle Atlantic region – Maryland, Virginia and the District of Columbia – the large banks already have 60% to 65% of the deposits regionwide. In 2007, they had about 62% of the region's deposit, up from 52% in 2000 and 47.5% in 1995.

Lower Middle Atlantic*

<u>Name</u>	<u>Deposits</u> <u>2007</u> (in bill.)	<u>Market Share</u>		
		<u>2007</u>	<u>2000</u>	<u>1995</u>
1. Wachovia	\$41.2	16.7%	10.1%	6.5%
2. Bank of America	37.5	15.2	14.0	16.0
3. BB&T	27.0	11.0	4.0	-
4. SunTrust	26.1	10.6	12.1	-
5. PNC	15.4	6.3	-	-
Largest five at time	<u>-</u>	<u>-</u>	<u>5.1</u>	<u>19.8</u>
Subtotal	\$147.2	59.8%	45.3%	42.3%
Other large banks	\$5.6	2.2%	7.1%	5.2%
Local and regional banks	71.1	28.8	37.4	36.1
Thriffs	<u>22.8</u>	<u>9.2</u>	<u>10.2</u>	<u>16.4</u>
Total	\$246.7	100.0%	100.0%	100.0%

*Maryland , Virginia and the District of Columbia.

Source: SNL Financial, Charlottesville, Virginia and FDIC.gov.

The high regional shares for the large banks reflects four of them – Bank of America, Wachovia, BB&T and SunTrust – being present in all major markets and that these Lower Middle Atlantic states are in the post-consolidation stage with an almost complete bar bell structure in place – i.e., large banks and small banks with little in-between. There is only one local bank or thrift with assets over \$10 billion, Chevy Chase, and just one more with assets between \$5 billion and \$10 billion, Provident. As a result, the region is two mergers away from the complete disappearance of local mid-sized banks.

Bank of America and Wachovia, which have about one-third of the region's deposits, are locked in as the 'big two' since they are too big to be bought and in no danger of losing ground to other large banks. Despite the multi-billion dollar plus write-offs, the economic downturn is more of an opportunity than a growth-threatening problem for them. Pushing much beyond their existing market shares, though, is unlikely as they are already leaders in all of the region's major population centers.

This is not to suggest that there will be no changes among the Lower Middle Atlantic's market leaders. Rumors of the possible sale of BB&T, SunTrust and/or PNC will continue, and one of them will probably be sold in the next five years – despite not having the write-off problems of the very large banks. Such a sale, though, will not occur until economic conditions return to normal, and it will be a market extension merger by a JPMorgan, Wells Fargo or the Royal Bank of Scotland.

This is a good news/bad news story for local banks. The good news is that this economic crisis, unlike the one in the early 1990s, is not having a devastating negative impact on banks in the region, big or small. The bad news is that there will be no big bank mergers creating unique opportunities from the normal post-merger run-off. Mercantile's purchase by PNC was the end-of-the-line for this type of run-off growth.

With the big banks having over 60% of the Lower Middle Atlantic region's deposits, there is minimal difference in the degree of concentration between the region and its major submarkets, and thus, there is little need for separate tables. Bank of America, Wachovia, BB&T and SunTrust are the leaders in the Washington, Richmond and Hampton Roads area with Bank of America and Wachovia usually in the top two positions. Only Baltimore

varies from this pattern with PNC and M&T in the second and third spots behind Bank of America and ahead of Wachovia, BB&T and SunTrust.

New England

The banking structure in New England has been constantly changing over the last 20 years, but unlike the Lower Middle Atlantic region, there is more change to come; and some of it is driven by the present financial crisis. New England has moved a long way from the early 1990s when the locally-based Fleet, BankBoston, Shawmut and Baybanks were the banking leaders, but a post-consolidation structure as described above is not yet here. The structural certainties going forward in New England are that the two banking leaders, Bank of America and Royal Bank of Scotland, will hold on to their positions, and unlike in the rest of the country, the thrifts are not going away.

New England

<u>Bank Name</u>	<u>Deposits</u> <u>2007</u> (in bill.)	<u>Market Share</u>		
		<u>2007</u>	<u>2000</u>	<u>1995</u>
1. Bank of America	\$59.5	19.8%	29.1%*	11.1%*
2. Royal Bank of Scotland	44.0	14.6	9.7	4.6
3. Toronto-Dominion	20.8	6.9	-	-
4. Sovereign	17.5	5.8	2.6	-
5. People's United	15.2	5.1	3.4	2.5
Largest five at time	<u>-</u>	<u>-</u>	<u>8.1</u>	<u>26.6</u>
Subtotal	\$157.0	52.2%	52.9%	44.8%
Other large banks	\$12.5	4.2%	4.1%	2.9%
Thrifts	84.2	28.0	29.7	36.0
Local and regional banks	<u>47.1</u>	<u>15.6</u>	<u>13.3</u>	<u>16.3</u>
Total	\$300.8	100.0%	100.0%	100.0%

*Fleet.

Source: SNL Financial, Charlottesville, Virginia and FDIC.gov.

Below the top two in New England, though, there are questions about the staying power of the leading banks. Toronto-Dominion is a large bank,

but not quite world class, and the record of Canadian and most foreign banks – the Royal Bank of Scotland being a major exception – has not been good in American retail banking. Taking over a franchise like Commerce that is unique, to say the least, is a challenge and mixing it with a large bank culture suggests problems. Sovereign having lost \$1.3 billion last year is likely to sell once it has its problems behind it. People’s United has a lot of capital to leverage in a low-growth market, and, like Webster, which is number six in the region, is bucking the trend of disappearing mid-sized banks.

It is not hard to envision that five years from now at least two of the four banks ranked third through sixth in New England will be gone, and the buyers will have to come from the ranks of the very large because of their size. The Royal Bank of Scotland could expand its New England coverage, but the buyers are more likely to come from New England fringe players like JPMorgan and Wachovia.

This is good news for the local banks and thrifts. Not only would they be helped by the distractions Bank of America and Royal Bank of Scotland face in consolidating their acquisitions, but they would also benefit from the natural post-merger run-off at a mid-sized bank when bought by a big bank.

In the immediate Boston area, the post-crisis banking scene would be subject to less change than in all of New England since Bank of America and Royal Bank of Scotland have almost half of the deposits compared to one-third in the broader market, and there are no large local banks to be sold. The only one with a large deposit share is Eastern Bank, a mutual.

A sale of Sovereign, though, could create some interesting dynamics. If Royal Bank of Scotland were the buyer in an effort to gain market share in New Jersey and Pennsylvania, it might have to sell its Boston area branches. It would be a second divestiture of the same offices, and perhaps a chance for Toronto-Dominion to move into a stronger number three position if it can successfully handle the Commerce acquisition. Otherwise, number three in the Boston area is likely to be JPMorgan or a foreign bank.

Summary

At the close of my book when speculating on what the structure of banking might look like ten or even twenty years from now, I suggested that “the expansion of remote access banking will accelerate the pace of change

within the framework of natural evolution. There will be fewer bank branches, and a lot fewer that have a positive impact on a bank's earnings. There will be much greater use of remote means to access accounts and transfer funds. Much the same could have been said looking back ten years from 2007, but the game has changed, and those most capable of using remote access banking to the fullest are no longer busy trying to acquire to survive.”*

This is still a good assessment looking out ten or twenty years, but whenever there is a financial crisis, consolidation continues, but in a very different way. The largest of the banks continue to increase their share of banking assets that is already close to 50% nationally, but they do it by taking over troubled institutions and not through internal expansion. Thus, large banks may no longer be busy trying to acquire to survive, but they are still acquiring. No matter what the reason for the acquiring, it will still have the same effect of switching the acquiring large bank's short term priorities away from using its size, brand recognition and remote access capabilities for internal expansion and toward consolidating the financial institutions they have recently acquired.

There also should be no doubts that this present financial crisis will have some big winners and big losers. JPMorgan, Bank of America, Wells Fargo and probably Wachovia, despite their write-offs, will come out of this bigger and stronger. Citigroup, Washington Mutual and Merrill Lynch may come off better than Bear Stearns and Countrywide, but they will either be acquired or diminished in size.

There also will be winners and losers among the local banks with the winners far outnumbering the losers, and unlike for the large banks, the winning should start a lot earlier. For small banks that have a high degree of deposit rate flexibility and little in the way of asset quality concerns, the steep decline in interest rates should produce earnings gains in the second half of 2008 that accelerate in 2009. For those with less favorable loan-to-deposit rate matches, the earning gains will still be there, just a little slower in coming.

*Consolidation of Banking: or How Five Banks Bought 50% of America's Biggest Business, Arnold G. Danielson, Danielson Capital, Vienna, Virginia, 2007.

The real winners among local banks, though, will be those that do not repeat the mistakes of the low interest rate environment of the early 2000s. The recent and drastically reduced rates will not stay down forever, and a weakening dollar and inflation may force rate increases in the foreseeable future that go far beyond what occurred in 2005 and 2006. Smart banks will recognize the dynamics beyond these changing interest rates and economic cycles and spend as much time looking at the impact on profits of overhead as they do at margins in producing the all important spread between the two that ultimately determines profitability. With the big banks moving toward 60% to 70% of the banking business and remote access banking expanding the way it is, margins are never going back to where they once were.

A rational approach to the future should also recognize that although 2009 might be a good year for most local banks, this does not mean that the economy will have returned to normal or that 2010 is the start of another growth surge driving the economy to new heights as it did in the late 1990s and from 2002 to 2006. A weak dollar, rising deficits, inflationary pressures and wary legislators and regulators will almost certainly create an uncertain economic environment for years to come that produces slower growth than most would like. Slower growth in the economy, though, does not have to mean slower earnings growth for banks if they are able to raise returns on equity to the 12% to 15% range that represents good performance.