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Banking: After the Recession

by
Arnold G. Danielson
Chairman,
Danielson Capital, LLC

Banking discussions today are frequently dominated by stock prices, toxic assets, loss potential, predicting when things will get better and the impact of federal programs. This is understandable considering the harsh economic problems the industry is encountering, but it may be time to pay more attention to what the industry is going to look like when the storm clouds lift. This may not be anytime soon, but for most banks, their future success will be determined by their post-recession performance rather than by what they are doing in the midst of these troubled times.

In looking to the post-recession era, there are four important structural and competitive determinants that will go a long way toward determining the strength of the banking industry and individual bank success. Unfortunately, much of this is being ignored or misread in an era when the media is filled with misleading commentary of a much reduced financial service industry, nationalization of large banks and what to do with toxic assets. These key determinants are:

- The size of the banking industry when the recession is over.
- The market status of the large banks.
- The role of foreign banks.
- Who fills local banking needs.

There are many other things that will impact post-recession banking – some old, some new. The recession, for example, has not removed the continued evolution and popularity of remote access banking and the huge cost differentials among different types of financial firms.

Banking: Bigger or Smaller in the Future

It has been stated frequently in recent months that banking and/or the overall financial services industry will come out of the recession in a much reduced form. To some, this may have only meant that financial services will never again be 35% of the total market capitalization of publicly-traded firms, while others may be thinking more about the disappearance of large investment banks rather than commercial banking. No matter what the rationale, though, post-recession banking will be as large and important as ever and market capitalization will recover.

Banks will always suffer in a recession and have slower loan growth because of fewer credit-worthy borrowers, but the industry remains central to all aspects of the economy – and in these troubled times, the commercial banks continue to increase their overall share of the financial services sector. Investors may not have liked Bank of America buying Countrywide and Merrill Lynch, but this is done – and the largest independent mortgage bank and one of the largest securities firm no longer exist as competition to the large banks. Add to that, JPMorgan buying Bear Stearns and Lehman Brothers' demise, and we have a post-recession financial services industry that is more under the control of commercial banks than ever.

In addition, the only remaining large investment banks, Goldman Sachs and Morgan Stanley, are now part of the Federal Reserve System and technically closer to traditional banks than in the past. "Close," though, is as far as the proximity goes.

Acquisitions of non-banks aside, the recession has not yet stopped the steady growth of traditional banking. Commercial bank assets have grown by almost half since the end of 2004 and had a 10.2% gain in 2008 – which was by most accounts a bad year for banking. The earnings in 2008 may not have been what bankers would have liked, but the banking industry is not getting smaller.

Bank Asset Growth

<u>Year-end</u>	<u>Assets</u>			<u>Annual Increase</u>
	<u>Banks</u>	<u>Thrifts</u>	<u>Total</u>	
		(In billions)		
2008	\$12,313	\$1,534	\$13,847	6.2%
2007	11,176	1,863	13,039	9.9
2006	10,091	1,770	11,860	8.9
2005	9,040	1,837	10,887	7.7
2004	8,413	1,692	10,105	11.1

Source: FDIC bank data and statistics.

Year-to-year asset growth of commercial banks has continued to be strong, even if adjusting for thrift acquisitions, such as JPMorgan taking over Washington Mutual, and several thrift conversions. The amount of thrift assets at the end of 2008 were smaller than at the end of 2004, but when combined with commercial bank assets, the total asset gain from the end of 2004 to the end of 2008 was 37% – and the increase in 2008 alone was 6.2%. Not bad for a recession year.

Market Status of Large Banks

In a still rapidly growing post-recession banking industry, at least in the short-term, the clout of the large banks will be diminished somewhat, not because they are weaker, but because there are fewer of them. Unlike in past economic downturns when market leaders faltered, this time there are no rising regional banks ready to replace them. In the 1990s, waiting in the wings as large New York City, Chicago and California banks faltered were the likes of NationsBank, First Union, Norwest, Fleet and Bank One.

In 2009, with Wachovia gone and Citigroup moved into a downsizing mode, there are just three large banks that are national, or near national, in scope – JPMorgan, Bank of America and Wells Fargo – and no other bank in the country even comes close to their size. The smallest of the three, Wells Fargo, has about the same amount of assets as all other domestic retail banks with assets over \$100 billion – PNC, U.S. Bancorp, SunTrust, Capital One, Regions, BB&T and Fifth Third – combined. Needless to say, there is no

ready replacement for Wachovia and, if needed, there will be no replacement for Citigroup.

The acceleration in bank consolidation began in the recession of the early 1990s, and by 2000, the five largest banks in the country had doubled their share of bank assets from 16% to 33% in just ten years. When Bank One and Fleet were acquired in the early 2000s and J.P. Morgan opted to join the conglomeration of New York City banks assembled by Chemical, the share of bank assets held by the five largest by 2005 was almost 44%.

Large Bank Share of Bank and Assets – 1990 to 2008

<u>Dec. 31</u>	<u>Share of Bank Assets</u>		<u>Assets</u>
	<u>Five Largest</u>	<u>Next Five</u>	(in billions)
	<u>Commercial Banks</u>		
2008	52.6%	8.0%	\$12,050
2007	49.8	7.6	11,176
2006	46.5	8.2	10,092
2005	43.7	8.8	9,040
2000	33.2	13.7	6,246
1995	23.1	10.8	4,313
1990	16.2	9.3	3,390
Five largest	52.6%		
Next five	8.0		
Foreign	7.5		
Other \$50 bill.	7.4		
\$10 to \$50 bill.	3.8		
Non-bank	<u>2.9</u>		
Total	82.2%		

Source: SNL Financial, Charlottesville, Virginia and FDIC, Historical Statistics on Banking, Washington, D.C.

Despite the problems of the large banks since 2005, the five biggest banks had lifted their share of bank deposits to almost 53% by the end of 2008. With Wachovia gone, this was really a “big four” with over 50%.

The share of the next five largest banks slipped from about 14% in 2000 to just 8% in 2008 as acquisitions by the very largest took their toll, and for all banks with assets over \$100 billion, other than the top five – including specialty firms such as Bank of New York Mellon, State Street and American Express – the share was about 15%. Banks with \$10 billion to \$50 billion assets, a rapidly disappearing group, were only 4% of all bank assets. Foreign banks and nonbanks had a little over 10% of the total.

This leaves about 18% of the nation's bank assets to local banks with assets under \$10 billion. This is a small and declining share of the industry, but it translates into assets of \$2.3 trillion and a deposit share in excess of 25%. Relatively small or not, this segment is a big industry in its own right that is not going away any time soon – and more on this later.

What seems to be getting lost in the media chatter is how just three banks – JPMorgan, Bank of America and Wells Fargo – have become so much larger than everyone else except Citigroup, which is a case onto itself. When writing my book, Consolidation of Banking, two years ago, I had envisioned a banking sector dominated by five large domestic banks and at least two significant foreign players. The most likely foreign banks at that time were HSBC and Royal Bank of Scotland. Today, that thinking is in shambles.

Helped by the economic downturn – JPMorgan, Bank of America and Wells Fargo – have grown much faster than could have been imagined two years ago. JPMorgan moved into Florida and the West Coast when it bought Washington Mutual. Bank of America's purchase of LaSalle Bank filled its major gap in Midwest coverage. It then became the co-leader, along with Wells Fargo, in originating and servicing mortgage loans when it acquired Countrywide, and also became one of the two largest security brokerages with the purchase of Merrill Lynch. It also bought a lot of headaches and possible investor dilution, but that does not change its greater size and reach when the economy improves. As to Wells Fargo, it more than doubled its size with the purchase of Wachovia and became a major force on the East Coast. If these three banks were too big to fail prior to the current recession, they are certainly now much too big to fail.

Largest Domestic Banks - 2008

	<u>Assets</u>			<u>Net Income**</u>	<u>Equity</u>
	<u>2009*</u>	<u>2000</u>	<u>1990</u>		
			(in billions)		
<u>Big Four</u>					
Bank of America	\$2,321	\$642	\$ 7	\$7.0	\$240
JPMorgan	2,079	715	41	5.4	170
Citigroup	1,823	902	115	(21.3)	146
Wells Fargo	<u>1,285</u>	<u>272</u>	<u>24</u>	<u>3.8</u>	<u>107</u>
Subtotal	\$7,508	\$2,531	\$187	\$(5.1)	\$663
<u>Ex-Investment Banks</u>					
Goldman Sachs	\$925	\$284	-	\$2.6	\$64
Morgan Stanley	<u>626</u>	<u>421</u>	<u>-</u>	<u>.0</u>	<u>49</u>
Subtotal	\$1,551	\$705	-	\$2.6	\$115
<u>Second Tier</u>					
PNC	\$286	\$ 70	\$ 6	\$1.1	\$29
U.S. Bancorp	264	77	13	2.5	28
Bank of New York	203	77	8	1.0	28
SunTrust	179	104	3	(.3)	22
Capital One	177	19	-	(.7)	27
BB&T	143	59	1	1.4	16
Regions	142	44	2	(5.9)	17
State Street	142	69	3	1.8	14
American Express	121	154	-	2.1	16
Fifth Third	<u>119</u>	<u>46</u>	<u>1</u>	<u>(2.4)</u>	<u>12</u>
Subtotal	\$1,776	\$719	-	\$.6	\$209
- Retail only	1,310	419	\$26	(4.3)	151

Note: Traditional second tier retail banking organizations are boxed.

*March 31, 2009.

**Trailing twelve months as of March 31, 2009.

Source: SNL Financial, Charlottesville, Virginia and American Banker, April 20, 1982.

The future of Citigroup is still an open question, but its impact on traditional banking will be minimal going forward. Two years ago, it had the options of adding to its 1,077 branches, most of which were in the metropolitan New York area, or selling its branch network. Now, Citigroup cannot make meaningful acquisitions and is very reliant on federally-insured funding from its branch network.

Some among the second tier – PNC, U.S. Bancorp, SunTrust, Capital One, BB&T, Regions and Fifth Third – will benefit from the narrowing of the group at the top to just three national retail banks and the problems of the foreign banks, but some is not all. Regions and Fifth Third are struggling, and JPMorgan needs coverage in the Southeast that makes SunTrust, BB&T and Regions tempting targets.

Initially, there was some thought when Goldman Sachs and Morgan Stanley became part of the Federal Reserve System by becoming bank holding companies that they might start buying bank franchises to gain access to cheaper federally-insured funding. This was probably never a real possibility because of cultural differences, and nothing they have done since suggests they are going in this direction.

The Role of Foreign Banks

While three American banks moved to domestic preeminence, the possibility of foreign banks becoming major players in United States has receded, and probably for good. HSBC, which is now the biggest bank in the world from virtually any perspective, is a major player in the United States, primarily because of its Household Finance offices. This, however, placed it in the center of the subprime mortgage disaster, and it recently announced it was closing all of its American finance company offices. The Royal Bank of Scotland, whose Citizens affiliate is one of the five largest banks in the Northeast measured by branches and deposits, was essentially taken over by the British government because of massive losses, and it recently sold 65 banking offices in Indiana.

Looking north, Toronto-Dominion with its purchases of BankNorth and Commerce is second in number of branches and third in the United States in assets among foreign banks, but it is a relatively small bank in the global picture. The other Canadian banks, Royal Bank of Canada and Bank

of Montreal, had year-end 2008 United States assets between them of just \$79 billion.

Foreign Banks in the United States

<u>Banks</u>	<u>U.S. Offices*</u>	<u>U.S. Assets*</u> (in billions)	<u>Market Capital**</u>	<u>Country</u>
<u>Retail Banking</u>				
Royal Bank-Scotland	1,397	\$160	\$26	United Kingdom
Toronto-Dominion	1,040	123	33	Canada
Banco Santander	748	77	69	Spain
BNP Paribas	733	80	54	France
Banco Bilbao	662	68	38	Spain
HSBC	485	184	115	United Kingdom
Royal Bank of Canada	442	31	47	Canada
Mitsubishi UFJ	344	75	56	Japan
Bank of Montreal	301	68	17	Canada
Deutsch Bank	5	52	27	Germany
ING Groep	1	79	16	Netherlands

For comparison purposes market capital in billions for:

JPMorgan	\$117
Wells Fargo	77
Bank of America	54
Citigroup	16

*December 31, 2008.

**April 20, 2009.

Source: SNL Financial, Charlottesville, Virginia and Bloomberg.com.

The one European bank that still talks publicly about its American ambitions is Spain's Banco Santander. It took advantage of the tough times to buy the 76% of the shares it did not already own in a struggling Sovereign Bank that had 77 offices in northeastern United States. It is one of the few large European banks that had not had a subprime mortgage loan concern, but one has to wonder how well it fares in a faltering Spanish economy.

Foreign banks not only have their own problems, but they also are not big enough to buy any of the largest American banks. The largest foreign banks by market value are HSBC, Banco Santander, Mitsubishi UFJ and

BNP Paribas with values between \$50 billion and \$115 billion. JPMorgan had a greater market value than any of them in mid-April, and Bank of America and Wells Fargo, even though selling at large historic discounts, have market values in that same range. Citigroup's market value is less than \$20 billion, but it is unlikely anyone wants to buy its problems.

The Local Bank Role

From the perspective of the local banks, a term used here to cover all banks with assets under \$10 billion, the pace of the consolidation at the top and fewness and weakness of so many second tier banks has to look like an opportunity. Not only are there just three national retail banks and arguable futures for at least half of the other banks with assets over \$50 billion, but along the East Coast there are only six commercial banks remaining with assets between \$10 billion and \$50 billion.

Having just 18% of all bank assets held by banks with assets under \$10 billion may seem like a small share, but it represents \$2.3 trillion in assets with a competitive mix that looks extremely favorable. JPMorgan, Bank of America and Wells Fargo have greatly increased their market status, but they are just three banks and they will have to pick and choose what is most important to them in terms of geography and product. Thus, they will leave gaps in their services and geography for smaller banks with a declining amount of mid-sized players able to respond.

Despite the sharp drop in earnings in 2008, the local banks are holding up quite well in this down economy, particularly in asset quality and capital. Banks on East Coast from South Carolina to Maine with assets under \$10 billion and open at least eight years, had aggregate income almost halved in 2008 from \$3.7 billion to \$1.9 billion, but on the plus side the median NPAs stayed below 1% of average assets and equity was still healthy at 9.52% of assets.

In 2008, asset growth also was positive for local banks, albeit down sharply from the year before; loan growth was up sharply; and deposit growth exploded. These numbers are quite different from the local bank results, particularly along the East Coast, in the real estate-driven recession of the early 1990s.

Local Bank Recession Performance*

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>Annual Increase in</u>	
	(In billions)			<u>2008</u>	<u>2007</u>
Assets	\$433.0	\$422.5	\$383.6	2.5%	10.1%
Loans	293.5	260.9	236.8	12.5	10.2
Deposits	373.7	306.5	287.4	21.9	6.6
Equity	46.2	45.5	38.8	1.5	17.3
	(In millions)				
Net Income	\$1,866	\$3,776	\$4,011	(50.6)%	(5.9)%
		<u>Medians</u>			
Return on Equity	6.69%	9.00%	10.41%	-	-
Net Int. Income/Avg. Assets	3.46	3.60	3.78	-	-
Equity/Assets	9.52	9.94	9.65	-	-
NPA/Assets	.95	.50	.34	-	-

*Includes 602 East Coast banks from South Carolina to Maine open prior to 2000 with assets under \$10 billion and excluding hard-hit geographic areas like Florida, Georgia and the Rust Belt to avoid major negative distortions.

Source: SNL Financial, Charlottesville, Virginia.

There are market reasons for the continued good loan growth and the substantial increase in deposits – some good, some bad – but they are not the numbers of a fading business. A closer look at the loan growth would show that the major growth driver was home equity lines of credit being accessed by consumers pulling equity out of their homes to make ends meet. On a more positive note, much of the deposit inflow has been coming directly out of the big banks, particularly Wachovia, whose troubles in 2008 resulted in a large deposit outflow.

It is likely 2009 will bring further increases in NPAs as a percent of assets and little, if any, gains in earnings, but the most negative possible outcome will be nothing like the early 1990s when, collectively, NPAs soared to 5% and 6% of assets in entire states, and in 1991, when the entire banking system reported a loss. In 2008, even the big banks did not have a combined loss position except in the fourth quarter.


What This Suggests

When all of this is considered, it is not hard to draw some rather likely conclusions as to what banking is going to look like in 2011 and 2012 when the economy has recovered. For starters:

- JPMorgan, Bank of America and Wells Fargo will emerge larger and stronger than before with domestic competitors like Wachovia and Citigroup gone or diminished and major foreign banks in retreat.
- Some among the diminishing group of second tier banks will either be forced into mergers with the most vulnerable being Regions, Huntington and Fifth Third based on earnings performance or, in the case of SunTrust and/or BB&T, getting an offer too good to refuse from a JPMorgan that needs better coverage in the Southeast.
- Goldman Sachs and Morgan Stanley, despite their new bank holding company status, will stick with their roots and remain non-factors in retail banking.
- The fewness and immense size of the surviving large banks will leave a lot of room for local banks and financial product boutiques.
- The rules of the game will not change much for local banks in their ability to compete head-on with large banks in metropolitan markets for consumer business and being without direct competition from the “big three” in outlying markets. For most small banks, real estate will continue to dominate its lending and determine the degree of profitability.

It is a positive outlook for Bank of America, JPMorgan and Wells Fargo, competitively, and for local banks, generally, but there remains the problem of getting from here to there. For the very large banks, it will be primarily a problem of investor dilution as their appetites may have outrun their capital. For local banks, particularly those in metropolitan areas, it will be how to enjoy the potential the future is likely to bring with overhead and margins that translate into meaningful earnings. This is particularly true of recently opened banks that because of their very newness have an above-average cost of funds and overhead absorption problems.

LEADING FINANCIAL ADVISORS

 <p>Dec. 2008</p> <p>Old Forge Bank Old Forge, Pennsylvania has agreed to merge with</p>  <p>Penseco Financial Services Corporation Deal Value was \$58.0 million. Danielson acted as financial advisor and prepared the fairness opinion for Old Forge Bank.</p>	<p>CHEVY CHASE BANK Sept. 2008</p> <p>Chevy Chase Bank Bethesda, Maryland has sold the deposits of 7 branches to</p>  <p>Provident Bankshares Baltimore, Maryland</p> <p>Danielson acted as financial advisor for Chevy Chase Bank.</p>	 <p>June 2008</p> <p>HNB Bancorp, Inc. Halifax, Pennsylvania has merged with</p>  <p>First Perry Bancorp, Inc. Marysville, Pennsylvania</p> <p>Danielson prepared the fairness opinion for HNB Bancorp, Inc.</p>
 <p>Dec. 2007</p> <p>CCFNB Bancorp, Inc. Bloomsburg, Pennsylvania has merged with</p>  <p>Columbia Financial Corp. Bloomsburg, Pennsylvania</p> <p>Danielson acted as financial advisor and prepared the fairness opinion for CCFNB Bancorp, Inc.</p>	 <p>Jan. 2007</p> <p>Penn Laurel Financial Corp. Curwensville, Pennsylvania has merged with</p>  <p>Northwest Bancorp Warren, Pennsylvania</p> <p>Deal value was \$32.7 million. Danielson acted as financial advisor and prepared the fairness opinion for Penn Laurel Financial Corp.</p>	 <p>Oct. 2006</p> <p>Potomac Bank of Virginia Fairfax, Virginia has merged with</p>  <p>Sandy Spring Bancorp, Inc. Olney, Maryland</p> <p>Deal value was \$64.7 million. Danielson acted as financial advisor and prepared the fairness opinion for Potomac Bank of Virginia.</p>
 <p>April 2006</p> <p>Centra Financial Holdings Morgantown, West Virginia</p> <p>has acquired</p> <p>Smithfield State Bank Smithfield, Pennsylvania</p> <p>Deal value was \$28.8 million. Danielson acted as financial advisor to Centra Financial Holdings.</p>	 <p>July 2005</p> <p>Columbia Bancorp Columbia, Maryland has merged with</p> <p>FULTON FINANCIAL CORPORATION</p> <p>Fulton Financial Corp. Lancaster, Pennsylvania</p> <p>Deal value was \$310.7 million. Danielson acted as financial advisor and prepared the fairness opinion for Columbia Bancorp.</p>	 <p>Jan. 2005</p> <p>SVB Financial Services, Inc. Somerville, New Jersey has merged with</p> <p>FULTON FINANCIAL CORPORATION</p> <p>Fulton Financial Corp. Lancaster, Pennsylvania</p> <p>Deal value was \$89.6 million. Danielson acted as financial advisor and prepared the fairness opinion for SVB Financial Services, Inc.</p>

WWW.DANIELSONCAPITAL.COM

(703) 564-9120

ARNOLD G. DANIELSON
CHAIRMAN

DAVID G. DANIELSON
PRESIDENT

G. LAWRENCE WARREN
MANAGING DIRECTOR