

April 19, 2005

Middle Atlantic Banking Report

Post-Merger Era Consolidation: What to Expect

By:
Arnold G. Danielson
Chairman
Danielson Associates Inc.

It seems like just yesterday we were worrying about technology problems connected with Y2K when the 21st century arrived, and yet here we are five years into the new millennium. These have been quiet years in Middle Atlantic banking with the biggest headline – First Union buying Wachovia – already sounding much like ancient history, albeit as the bank examiners make their rounds some bankers may feel Sarbanes-Oxley is the real “big story.” Although this quiet period produced much less change than in the preceding five year period, there are still big differences today from what existed five years ago.

One way of viewing these differences is through changes in various sub-sectors of Middle Atlantic banking. Change has been most apparent at the top with the merger of First Union and Wachovia and a series of mergers that have made BB&T one of the regional banking leaders, but the impact of these mergers has changed the ballgame from top to bottom. In particular, the acquisitions of BB&T, alone, have almost totally eliminated mid-sized banks in the region – and, with them, some of the most active acquirers of small banks.

In fact, a good case could be made that this area has entered the post-merger stage of bank consolidation. Instead of merger headlines, the major banking stories are branching and extended hours. PNC’s purchase of Riggs seems to hold little interest for anyone beyond the staff of the Washington Post business section, but the entry of Commerce into Northern Virginia and Washington with long hours and Sunday banking and Wachovia’s matching response is another matter.

*Danielson Associates Inc.
6001 Montrose Rd., Suite 405
Rockville, MD 20852
(301)468-4884
www.danielsonassociates.com*

Looking back at the changes in the last five years, the coming of the Commerce revolution is not only a logical next step, but there are not many local banks remaining that are vulnerable to this type of change. With First Virginia and Riggs having “thrown in the towel,” the region need only lose the two mid-sized Baltimore banks, Mercantile and Provident, to create the ultimate barbell structure – a region with no traditional mid-sized banks filling the gap between the very big banks and the local niche banks.

In fact, talking about a barbell structure may soon be as out-of-date as the superregional concept of the 1990s. What replaces the barbell? A likely banking structure going forward is a three-tiered system of large full-service banking organizations, mono-lines and niche boutiques. Somehow, though, Capital One never got the message with a Louisiana acquisition that appears to be as out-of-line with current banking trends as PNC’s Washington “hail Mary.”

Nothing, though, is ever that structurally neat. Commerce and Chevy Chase could fit anyone of those classifications, and BB&T and SunTrust may not be “large full-service banking organizations” that can survive in a world of offices open 70 to 80 hours a week. Only time will tell, but those who have been comforted by recent talk about banking going back to the basics are misreading the trends.

Five Years of *Fait Accompli*

When one looks back at the deposits by type of organization over the last five years in the Middle Atlantic states of Maryland and Virginia plus the District of Columbia, the degree of change is astounding. In mid-1999, the big banks – those with assets of \$50 billion or more – had local deposits of \$77 billion, or little more than twice the \$35 billion of the region’s mid-sized banks. Five years later, they had local deposits of \$135 billion, which was more than four times the \$30 billion of the mid-sized banks. In fact, we are only a big bank acquisition of Mercantile away from changing those numbers to \$146 billion and \$19 billion, or a more than a seven-to-one ratio, and that is just deposits. For almost every bank product except construction and small business loans, the variance between large and mid-sized banks is probably greater.

Middle Atlantic* Deposit Change by
Organization Type, 1999 to 2004

| <u>Sub-sector</u> | <u>Deposits</u> | | <u>Market Share</u> | |
|------------------------|-----------------|--------------|---------------------|-------------|
| | <u>2004</u> | <u>1999</u> | <u>2004</u> | <u>1999</u> |
| | (In millions) | | | |
| Large Banks | \$ 134,572 | \$ 77,456 | 53.7% | 46.6% |
| In-State Regionals | 22,584 | 27,870 | 9.0 | 16.7 |
| Out-of-State Regionals | <u>7,470</u> | <u>7,338</u> | <u>3.0</u> | <u>4.4</u> |
| Subtotal | \$ 164,626 | \$ 112,664 | 65.7% | 67.7% |
| <u>Community Banks</u> | | | | |
| Established | \$ 29,678 | \$ 17,184 | 11.8 | 10.3 |
| New** | <u>2,286</u> | <u>1,855</u> | <u>1.0</u> | <u>1.1</u> |
| Subtotal | \$ 31,964 | \$ 19,039 | 12.8% | 11.4% |
| <u>Thriffs</u> | | | | |
| Stock | \$ 13,550 | \$ 9,294 | 5.4% | 5.6% |
| Mutual | <u>4,936</u> | <u>3,871</u> | <u>2.0</u> | <u>2.3</u> |
| Subtotal | \$ 18,486 | \$ 13,165 | 7.4% | 7.9% |
| Credit Unions | \$ 35,491 | \$ 21,634 | 14.1% | 13.0% |
| Total | \$250,567 | \$166,502 | 100.0% | 100.0% |

*Maryland, Virginia and the District of Columbia in this and subsequent tables.

** Opened since 1990.

Source: SNL Financial, Charlottesville, Virginia.

It has not been downhill for all bank types over the last five years in the region. Established community banks, even with some of them being acquired, had a regional deposit increase from \$17 billion to close to \$30 billion. This translated into a significant market share gain from 10.3% of all deposits to almost 12%. Credit unions, even excluding the large national ones based in the area, increased their market share from 13% to 14.1%.

The big deposit increase of the large banks also had some noteworthy shifts between banks, with Wachovia, Bank of America and BB&T making big gains. Wachovia more than doubled its deposit base with the merging of First Union and the old Wachovia, and internally-generated deposit growth. Bank of America, after several years of struggling locally, increased deposits from \$21 billion to more than \$33 billion without any acquisitions. BB&T outdid them both, jumping from \$5 billion to almost \$24 billion through a series of acquisitions of which First Virginia, F&M National and FCNB were the most prominent.

Large Banks* - Middle Atlantic Deposits 1999 and 2004

| <u>Bank</u> | <u>Deposits</u> | | <u>Market Share</u> | |
|-----------------|-----------------|--------------|---------------------|-------------|
| | <u>2004</u> | <u>1999</u> | <u>2004</u> | <u>1999</u> |
| | (In millions) | | | |
| Wachovia | \$ 33,584 | \$ 15,593 | 13.4% | 9.4% |
| Bank of America | 33,582 | 20,714 | 13.4 | 12.4 |
| BB&T | 23,730 | 4,994 | 9.5 | 3.0 |
| SunTrust | 22,484 | 18,602 | 9.0 | 11.2 |
| Citigroup | 8,956 | 1,678 | 3.6 | 1.0 |
| M&T | 7,635 | - | 3.0 | - |
| PNC | 4,374 | - | 1.7 | - |
| Sovereign | 227 | - | .1 | - |
| old Wachovia | - | 8,467 | - | 5.1 |
| Allied Irish | - | <u>7,408</u> | - | <u>4.5</u> |
| Total | \$ 134,572 | \$ 77,456 | 53.7% | 46.6% |

*Assets over \$50 billion

Source: SNL Financial, Charlottesville, Virginia.

Suntrust and M&T did not keep pace with the three leaders in the region. SunTrust had a modest deposit gain over the last five years, but this translated into a more than two percentage points deposit share loss, from 11.2% to 9%. M&T had about the same deposit base in 2004 that Allfirst, which it acquired during this period, had in 1999, but this also was a deposit share loss from 4.5% to 3% of area deposits. Some of this, though, may have been main office deposit transfers from Baltimore to Buffalo.

Citigroup and PNC, after the latter completes the Riggs acquisition, are the large banks with fringe positions, although Citigroup is moving away from the fringe with a deposit increase from \$1.7 billion to almost \$9 billion between 1999 and 2004. It is unlikely much of the increase is in true retail banking, but it certainly makes Citigroup a more meaningful player. As for PNC, it is doing no better in Pennsylvania in terms of losing deposit share than SunTrust is in this region, and, thus, it seems improbable that it will have much luck with the rapidly diminishing Riggs franchise.

The Disappearing Local Mid-Sized Bank

The big share decline of the local mid-sized banks resulted from five of the seven banks in the region with assets over \$1 billion in 1999 being sold. First Virginia, Riggs, F&M National, F&M Bancorp and FCNB are all gone. All that remains are Mercantile and Provident, both Baltimore banks.

In-State Regionals* - Middle Atlantic Deposits 1999 and 2004

| <u>Bank</u> | <u>Deposits</u> | | <u>Market Share</u> | |
|--------------------|-----------------|--------------|---------------------|-------------|
| | <u>2005</u> | <u>2000</u> | <u>2005</u> | <u>2000</u> |
| | (In millions) | | | |
| Mercantile | \$ 11,212 | \$ 5,809 | 4.5% | 3.5% |
| Provident | 3,904 | 3,563 | 1.6 | 2.1 |
| Sandy Spring | 1,690 | 996 | .7 | .6 |
| Union Bancshares | 1,278 | 638 | .5 | .4 |
| Virginia Financial | 1,198 | 374 | .5 | .2 |
| FNB | 1,133 | 398 | .4 | .2 |
| Burke & Herbert | 1,095 | 625 | .4 | .4 |
| TowneBank | 1,074 | 80 | .4 | .1 |
| First Virginia | - | 7,524 | - | 4.5 |
| Riggs | - | 3,504 | - | 2.1 |
| F&M National | - | 2,180 | - | 1.3 |
| F&M Bancorp | - | 1,143 | - | .7 |
| FCNB | - | <u>1,036</u> | - | <u>.6</u> |
| Total | \$ 22,584 | \$ 27,870 | 9.0% | 16.7% |

*Deposits over \$1 billion.

Source: SNL Financial, Charlottesville, Virginia.

There are six Middle Atlantic banks that have raised their deposits above \$1 billion since 1999, but they look far more like community banks than the regional banks they replaced. Sandy Spring is the biggest of these, and the only other ones in urban markets are TowneBank in the Hampton Roads area and Burke & Herbert of Alexandria. The former is only in its sixth full year of operation, and the latter is the oldest bank in Virginia – having opening in 1858 – and it is the epitome of a community bank despite its increased size.

The Disappearing Out-of-State Regionals

There have been several bank acquisitions in the region by out-of-state regionals since interstate banking arrived, and mostly by three banks – United, Susquehanna and Fulton. They have almost 2% of the region’s deposits between them, but none has as much as a 1% share individually. The Charleston, West Virginia based United also may be shedding the “out-of-state” connotation as it recently announced a dual headquarters approach with corporate offices in Washington and Charleston.

Out-of-State Regionals - Middle Atlantic Deposits 1999 and 2004

| <u>Bank</u> | <u>Deposits</u> | | <u>Market Share</u> | |
|-------------|-----------------|--------------|---------------------|-------------|
| | <u>2004</u> | <u>1999</u> | <u>2004</u> | <u>1999</u> |
| | (In millions) | | | |
| United | \$ 2,081 | \$ 1,114 | .8% | .7% |
| Susquehanna | 1,501 | 1,146 | .6 | .7 |
| Fulton | 1,047 | 410 | .4 | .2 |
| One Valley | - | 1,156 | - | .7 |
| Other | <u>2,841</u> | <u>3,512</u> | <u>1.2</u> | <u>2.1</u> |
| Total | \$ 7,470 | \$ 7,338 | 3.0% | 4.4% |

Source: SNL Financial, Charlottesville, Virginia.

The out-of-state regionals also are subject to being acquired by larger banks, and the one with the largest share in 1999, One Valley, was bought by BB&T. Keystone and National Commerce were others acquired by large banks, and they certainly will not be the last.

Community Banks

Community banks, both old and new, accounted for a little under 13% of the regional deposits in 2004, and a little over 15% if the six banks with deposits in the \$1 to \$2 billion range are added. This is a relatively small share, but they are the most resilient of the local competitors with almost a 70% deposit gain in the last five years. Their resilience, though, owes a lot to location and the regenerative powers of new banks, many of which do not fit the normal community bank definition.

Most of the community banks are in outlying regions that are not high priorities of the big banks, and, as a result, are still serving a very important purpose within the banking community. The majority of these banks are in southwestern and south central Virginia.

New banks, as a group, are included as community banks because of their size, but for the most part, this is misleading nomenclature. Most new banks are, in reality, business banks with little consumer walk-in business. Others are local mortgage banks. As such, they are not in the path of the big banks and have little to worry about from extended lobby hours. They can survive on weekday banking only, and, in fact, the customers they lose might benefit the bottom line.

New banks, though, in terms of market share, are not a growing part of the industry, and, collectively, they do not take business from big banks. Their market share has been very consistent over recent years, and the new ones that open tend to replace the ones that were sold from the previous new bank cycle. Most new banks have opened when bank stock prices were at or near a peak – 1987-88, 1997-00 and 2004 – which is also when most “older” new banks are sold.

Thriffs – A *de Minimis* Factor

Thriffs, which were once major players in the Baltimore-to-Norfolk corridor, have become almost nonexistent in the Middle Atlantic area. The mutual savings association share of regional deposits slipped to 2% in 2004, and the 5.4% stock thrift deposit share is misleading. Take out Chevy Chase and the stock thrift share drops to 1.9%, down from 2.4% five years earlier.

Chevy Chase is technically a thrift and a significant factor in the region’s largest market, Washington, but it operates more like a transaction

bank than a thrift. With its size and saturation coverage in the Washington area, Chevy Chase is in the path of Commerce, the big banks and long hours, but it has unique pluses that make it less vulnerable than a traditional mid-sized bank in that it cannot be easily “out-convenienced.” It has the most branches and ATMs in the Washington area, and its centralized, private ownership allows it to do what is necessary to compete without the constant quarter-to-quarter scrutiny by stock analysts.

Credit Unions

The banking group other than the large banks that has made big gains in the last five years in the Middle Atlantic region is the credit unions. Even excluding the large military credit unions that operate nationwide, they still held 14.1% of the deposits in 2004, which was up from 13% five years ago. Their mix of tax breaks, mutuality and in-workplace convenience is a big plus, particularly in a market with such a large concentration of government employees. Deposit shares, though, overstate their overall banking stature, and the major credit union impact on other banking organizations is to put upward pressure on deposit pricing and, as a result, on margins. In many ways, they are filling a void that has been left behind by the disappearance of a large thrift presence.

Where Does Banking Go From Here?

Where does banking go from here? Unless there is a sudden change in an evolution of the banking business that has been going on for decades, what is likely to happen in the next few years is that:

- Long hours will become the norm. Commerce is coming with its extended hours and Sunday banking. Wachovia is matching all but the Sunday hours, and that will come sooner rather than later. Bank of America has little choice but to follow, and even if the results are disappointing, there will be no return to nine-to-three banking, or even nine-to-five. This will increase operating costs for the retail banking offices that will need two teams of tellers and deposits of at least \$50 million.
- Remote access banking continues its relentless forward march with some powerful out-of-area players taking part– i.e., ING and HSBC on the retail side and Wells Fargo on the corporate side.

- Extended hours, particularly on the weekends, and larger, more customer-friendly offices will finally make in-branch sale of other financial services – life insurance, annuities, mutual funds, etc. – a meaningful source of bank earnings.
- The competitive impact of all of the above may make SunTrust, BB&T and M&T rethink their future and will push most of the remaining in-state and out-of-state regionals into selling.

What will the banking structure look like in 2010? The “easy call” is that Bank of America and Wachovia should be running one-two, most likely with Bank of America at the top. Number three, though, could be a new entrant as BB&T may be sold by that time. JPMorgan is the most likely buyer, but it could just as easily be Wells Fargo. SunTrust may still be part of a big four in 2010 as its Atlanta loyalties makes it more resistant to a sale than BB&T with its short tenure in Winston-Salem, but SunTrust, in all likelihood, will continue to lose ground to the bigger banks.

Largest Banks in Middle Atlantic - 2010 Estimated

| | <u>Bank</u> | <u>Deposits</u> | | <u>Rank</u> <u>2004</u> |
|-----|--------------------------------|------------------|-------------|----------------------------|
| | | <u>2010 est.</u> | <u>2004</u> | |
| | | (In billions) | | |
| 1. | Bank of America | \$43.0 | \$33.6 | 1 |
| 2. | Wachovia | 43.0 | 32.4 | 3 |
| 3. | JPMorgan <u>or</u> Wells Fargo | 35.0 | - | - |
| 4. | SunTrust | 23.0 | 21.0 | 4 |
| 5. | Royal Bank-Scot. | 15.0 | 10.6 | - |
| 6. | Citigroup | 15.0 | 9.0 | 6 |
| 7. | Chevy Chase | 15.0 | 8.8 | 7 |
| 8. | M&T | 10.0 | 7.6 | 8 |
| 9. | United | 3.0 | 2.1 | - |
| 10. | Sandy Spring | 3.0 | 1.7 | - |

Source: SNL Financial, Charlottesville, Virginia and Danielson Associates estimates.

The biggest change among those banks below the big four could be the entry of the Royal Bank of Scotland. It is the world’s fifth largest bank when measured by market capital, and its success in Pennsylvania since it

bought the Mellon branches will prompt it to move south. Mercantile is the logical target, but Provident is a possibility. This could give Royal Bank of Scotland a regional share similar to that of Citigroup and Chevy Chase.

Where are PNC and Commerce? They may be long gone by 2010. PNC is “tilting at windmills” with its Riggs acquisition, and that plus its regulatory problems of a couple of years ago and substantial share loss in Pennsylvania will create pressure for a sale. Buyers, though, are limited. JPMorgan and Royal Bank of Scotland are the logical ones, but PNC could be the acquisition that brings the country’s sixth largest bank, U.S. Bancorp, east. Commerce will find the Washington area tougher than it expected, and the difficulties of running a larger, more complex bank could convince its ownership to take the money and run while Commerce is still small enough to have multiple sale options.

To get a better feel for why this is a likely structure to emerge in the Middle Atlantic region, it may be helpful to take a look at the national bank scene. Today just five banks hold about 45% of the banking assets, and the smallest, Wells Fargo, is more than twice as large as the next largest, U.S. Bancorp. All five are among the seven largest banks in the world. Thus, they are too big to be bought and far from through expanding.

It is not much of a “stretch” to suggest that Citigroup, JPMorgan and Bank of America will have more than \$2 trillion in assets in 2010, and that Wachovia and Wells Fargo will reach the \$1 trillion mark. At these sizes, they will be putting branches in most large markets that they do not already have covered, and it is unlikely that any other banking organizations will come close to matching their size or coverage domestically.

Royal Bank of Scotland and HSBC are the foreign banks with the deep pockets and good starting positions to challenge the “big five,” but the magnitude of the task is such that they can do little more than close the gap over the next five years. Royal Bank of Scotland’s focus is on the northeast quadrant of the United States, which could include Maryland, and HSBC is primarily interested in specialty businesses. It bought Household Finance and is now pursuing credit card portfolios. HSBC is big enough to buy MBNA, Capital One or the Discover card – or all of Morgan Stanley.

Largest Banks in the Nation, 2010

| <u>Bank</u> | <u>Assets</u> | | <u>Rank</u> |
|---------------------------|------------------|-------------|-------------|
| | <u>2010 est.</u> | <u>2004</u> | <u>2004</u> |
| | (In billions) | | |
| 1. Citigroup | \$2,500 | \$1,484 | 1 |
| 2. JPMorgan | 2,010 | 1,157 | 2 |
| 3. Bank of America | 2,000 | 1,110 | 3 |
| 4. Wachovia | 1,000 | 493 | 4 |
| 5. Wells Fargo | 900 | 428 | 5 |
| Subtotal | \$8,400 | \$4,672 | |
| 6. U.S. Bancorp | \$400 | \$195 | 6 |
| 7. Royal Bank of Scotland | 350 | 134 | 10 |
| 8. National City | 300 | 139 | 9 |
| 9. SunTrust | 250 | 159 | 7 |
| 10. HSBC | 240 | 155 | 8 |
| Total | \$9,940 | \$5,554 | |

Source: SNL Financial, Charlottesville, Virginia and Danielson Associates estimates.

There is no stopping the big banks in their pursuit of dominance and size, but there are some interesting numbers worth noting. The five largest banks held 47% of the nation's commercial and industrial loan balances in excess of \$1 million in 2004, and the next five held another 18%, for a total of 65%. For loans with balances under \$1 million, these ten banks held just 28% of the loans. This leaves 72% for all others, and this is the focus of a lot of local banking boutiques.

It has been a long journey since interstate banking came to the region just 20 years ago, and the changes in the next five years, albeit substantial, will not be nearly as dramatic as what happened in the previous 20 years, or in Virginia, in the preceding ten years. Of the ten largest Virginia banks from 20 years ago when interstate banking began, none remain, and most of them have disappeared since 1997. In Maryland, only Mercantile remains from the 1980s leader, and in the District of Columbia, all past leaders are gone. What a difference a generation can make.