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**Internet, Investors and Legislation Add Up to Uncertainty**

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As the transitional year between the old and new millennium, 1999 was eerily quiet for Middle Atlantic banks. Earnings held up, but the gains were not spectacular. The local merger market died with only two deals with transaction values in excess of \$600 million, and one was a bank with strong international ties, Republic, being acquired by a large British bank, HSBC. The preceding two years had eleven such transactions. In fact, it was so quiet deal-wise, that it could be argued that the biggest banking story locally was the collapse of bank stocks while the broader market indices rose to record levels.

All may have been quiet on the homefront, but the evolution of banking was not standing still. A major reform hurdle was eliminated with the passage of financial modernization legislation that finally buried the Glass Steagall Act and made it possible for all financial services to be sold in concert. The internet moved front and center and signs of weakness in some large banks emerged, which may be "early warnings" of casualties in the next round of the battle for industry supremacy that could include some new and interesting players such as AOL/Time Warner, Microsoft, Yahoo and Amazon.com.

What does all this mean going forward? In two earlier reports, "Financial Modernization: A Blueprint for Local Banks" and "Getting Ready for the 21st Century," I discussed the direction of banking in the new millennium, but these reports were national in scope. In this report, the focus is on the Middle Atlantic states and the impact of financial modernization and other trends on the region's financial services industry. This includes the internet, which is the "wild card" of the future, and it is a volatile, capricious "wild card."

In looking to the future of financial services in the Middle Atlantic, a good starting point is the realities of change in the industry. These are:

- Financial services have become a high growth business, but traditional banking is not part of the high growth;
- All barriers between the common ownership and delivery of the various financial services have been eliminated;
- The combination of high growth, unfettered competition and the impact of the new technologies, particularly the internet, will provide greater convenience and lower prices for most financial services customers;
- The high stock prices of 1998 have gone with no likelihood they will be back anytime soon; and
- The inevitable tendency for the big to get bigger.

What these sources of change mean is subject to various interpretations, but two of the them – high growth and the trend toward greater convenience at lower prices – are alien concepts to many bankers. Bankers talk about high growth, but the focus is still on gathering deposits – a source of funding that has a 2% growth rate – and producing loans – a use of money that for depository institutions is increasing at a rate of 4% to 5% annually. As to having greater convenience at lower prices, this suggests that the six-year slide in margins is more than a cyclical movement and that the future may introduce competition that other industries, but not banking, are very familiar with – giving away services and products to build market share.

The impact of these changes will not treat all financial services companies equally, but those that ignore change or downplay its coming, better be serving a small town far removed from the big city media coverage. If not, they may not be around to enjoy the second half of the next decade, which is as true of PNC and First Union as it is of local banks.

## Financial Modernization Legislation

The basic realities of change and the impact of financial modernization legislation are national in impact, but every market has its own unique elements. In the Middle Atlantic, the uniqueness is minimized because it is home to so many of the large players that will shape the future of the industry, and it may not be wrong to say that relative to future financial services evolution – as goes the Middle Atlantic, so goes the nation.

While it is a source of pride for a region to be home to most of the largest financial services companies, it also means that the impact of the next stage of consolidation and convergence will be felt sooner rather than later. Although not an intended result of the legislation, it has firmly established New York as the financial center of the nation and the world because of its being the location of choice for U.S. headquarters of large foreign financial services firms and being home to most of the largest nonbank financial services firms – i.e., American Express, Merrill Lynch, Morgan Stanley, Prudential, AIG, etc.

The impact of the financial modernization legislation, however, goes far beyond reestablishing New York as the sun around which the rest of the financial services world orbits. For local banks this may be a nuisance – i.e., change will come sooner – but it is secondary to the trends that it sets in motion that will change the way local banking is done.

How will financial modernization legislation impact local banks? The major competitive effects will be:

- A local bank may soon be considered “out of it,” if it cannot supply its customers with a full range of insurance products, mutual funds and retirement products on a competitive and convenient basis.
- Business clients and the profitable individual customers will demand these services be available by remote access, and presumably on the internet.
- The competition will come as much from the local Merrill Lynch, Smith Barney or Paine Webber office as it does from big banks, albeit many of these will be owned by large banks a la Smith Barney and Citigroup.

It also may not be enough just having these services available. They may need to be available in settings that suggests knowledge and sophistication. The real competition will be Merrill Lynch et al, not the local credit union, and the office of the future is more likely to have a stock “ticker board” and a couple of sofas than a row of teller stations.

A much overlooked side-effect of this legislation is that it is moving check-cashing out of the mainstream of financial services. This will increasingly be a subsidy service used by the least profitable customers who may be intimidated by the office of the future. There will be negative social consequences that favor less regulated competitors over a bank, but there also will be many local banks that do not accept deposit services as a declining business and continue to cater to this generally unprofitable end of the business.

Entrepreneurship being what it is, though, there will be deposit service specialists that do very well and increase revenues and earnings as others reduce their emphasis. It could be argued that Commerce and Chevy Chase are doing this with spectacular results. To make this work, though, requires size and the commitment these two institutions have made.

This new legislation also is going to force local banks to make difficult decisions relative to customer orientation. Most local banks have commitments to serving entire communities, which may not be consistent with conducting a profitable business in the future, albeit in small towns, this may still work. For most new banks, though, this is not a problem since without past baggage, they typically target business and affluent customers. For traditional thrifts, it is a losing game since their historic customer is an integral part of the Wal-Marting of America’s financial services.

### Internet

The internet is the “wild card” in financial services. That it will play a major role in the marketing and handling of financial services goes without saying, but - How pervasive will that role be? and - Who will benefit most from it? These are the “unknowns.”

The internet may be in its early stages of development, but it already has much of the world “hooked” on its use whether it is to buy almost anything, trade stocks, send messages, play games, check stock prices and sports scores or just “kill time.” It has become a way of life, and its usage rises with income and

education levels - i.e., the most profitable bank customers - and it is a necessary tool in the financial departments of virtually every business. When the internet can provide these affluent and business customers convenience and/or value in the usage of financial services, it will be used.

There is little question that the internet will at least do the following:

- Reduce the number of meaningful transactions done in branches even if it does not reduce the number of branches – i.e., bank branches become a check cashing service for the less affluent.
- Give customers access to the highest deposit rates and the lowest commodity loans rates, and further reduce bank margins.
- Enhance the viability of “one-stop” shopping.
- Reduce distance as a constraint on buying or selling financial services.

Even if one assumes no more than this, it is likely that in the future:

- Deposit rates will be higher and commodity yields will be lower than they would have been without the internet.
- Personal and corporate money management accounts that include direct deposit, lines of credit, bill payment, mutual fund contributions and transfers, stock trading and insurance purchasing, among others, will become commonplace with the internet being the primary access vehicle.

- The less affluent will look to the “banking Wal-Marts” for their money management accounts.
- The affluent and corporations will key on the investment function as a major determinant of which cash management account they use.

It is uncertain whether large numbers of cash management customers will insist on a local physical presence. Amazon.com’s success vis-à-vis Barnes & Noble suggests that a physical presence is not important to everyone, albeit books are not money.

With the internet, the hard question relative to financial services is – Who will benefit most? Nonbank aggregators like Amazon.com, Microsoft and Yahoo want to be in the business, and traditional banking stalwarts such as Citigroup, Bank of America, Fleet, Wells Fargo and Merrill Lynch are not going to give the business away. The aggregators have internet skill advantages, and if they stay away from insured deposits – a factor of diminishing importance - they will have few regulatory constraints. The big banks and Merrill Lynch have the financial services knowledge offices to back up an online presence. Citigroup is not noted for its bank branch network, but its Smith Barney offices should serve its cash management account needs quite well.

Predicting who will be the winners in this battle, other than Citigroup, is difficult, and the road to be traveled is full of “pot holes.” One problem is the inevitable price wars that will hurt industry profits, at least temporarily. Another is that strategic alliances between the various major players, which are already well underway, will intensify and could even lead to mergers that remove the restrictions between banking and commerce.

### Stock Prices

The potential impact of the internet also may be having an effect on bank stock prices, which clearly have seen better days. The major negative relative to bank values, though, is rising interest rates and the uncertainty over just how high rates are going, but there is increasing discussion in the press over what financial services “model” will work the best in the future – and the internet is certainly a part of all non-traditional models. Since investors in banks include many institutional traders, recent stock patterns also indicate where sophisticated investors are placing their bets.

There is little question that right now, institutional investors favor the diversified banking organizations and like the thrifts the least. It is uncertain, though, whether this is a “bet” on different model types, the ability to use the internet or an assumption that diversified banks with the majority of their revenues coming from fees are less subject to interest rate risk. The “right model” and reduced vulnerability to interest rate risk, though, could be one and the same.

Whatever the reasons, investors have voted yes on Citicorp-Travelers; like Bank of New York’s emphasis on financial services processing and specialty trust businesses; and enthusiastically have endorsed Mellon moving faster than others into asset management. While typical Middle Atlantic bank stocks are selling at 10 to 11 times earnings and 30% to 50% off their highs, Citigroup is selling at, or near, its high, and Bank of New York and Mellon are in the 10% to 20% decline range. Median price times earnings and book of these favored firms are a healthy 19.1 and 407%, respectively. Specialty banks elsewhere in the country such as State Street and Northern Trust are doing equally well.

The stock performance of these diversified banks contrasts sharply with the other large banks with major stakes in the region. Bank of America, Chase, First Union, Fleet and J.P. Morgan have a median price of 10.1 times earnings and 177% of book – albeit Chase is doing better than the others with a price of about 13 times earnings and 300% of book. The large players most tied to branch networks, Bank of America and First Union, have seen their stock prices decline by almost half since the glory days of late 1997 and early 1998.

It could be argued that J.P. Morgan is no longer a bank, and with a profile more like an investment bank, its stock price should not suffer with banks. The problem is that mono-line investment, finance and insurance companies do little, if any, better with investors than the commercial banks. The investor interest in nonbank financial firms is in asset management companies and diversified players like American Express and Marsh & McLennan.

## Middle Atlantic Bank and Thrift Stock Performance

	<u>Stock Price*</u>	<u>Price Times Earnings</u>	<u>Percent of Book</u>	<u>Change From High</u>
<u>Large</u>				
Bank of America	\$ 45.19	10.1X	171%	(48.6)%
Chase	82.63	13.2	301	(7.1)
First Union	30.00	9.0	177	(54.3)
Fleet	27.63	9.5	173	(35.4)
J.P. Morgan	112.63	<u>10.8</u>	<u>195</u>	<u>(24.3)</u>
Median		10.1X	177%	(35.4)%
<u>Diversified</u>				
Bank of New York	\$ 36.81	22.4X	529%	(17.9)%
Citigroup	54.00	19.1	407	-
Mellon	31.44	<u>17.0</u>	<u>392</u>	<u>(21.2)</u>
Median		19.1X	407%	(17.9)%
<u>Regionals</u>				
First Virginia	\$ 34.75	11.6X	166%	(41.0)%
Keystone	17.50	9.2	155	(58.3)
M&T	400.00	12.2	172	(30.5)
Mercantile	26.38	11.7	186	(34.1)
North Fork	15.75	9.7	327	(42.4)
PNC	42.13	10.2	219	(35.1)
Summit	26.88	10.6	166	(49.7)
Valley National	23.75	<u>13.7</u>	<u>256</u>	<u>(29.8)</u>
Median		11.1X	179%	(38.1)%
<u>Thrifts</u>				
Astoria	\$ 26.31	6.0X	119%	(57.9)%
Greenpoint	18.19	7.4	85	(57.3)
Independence Comm.	11.50	13.4	94	(36.8)
Roslyn	17.75	12.8	199	(41.8)
Sovereign	7.19	<u>7.1</u>	<u>90</u>	<u>(67.6)</u>
Median		7.4X	94%	(57.3)%

\*February 11, 2000.

Source: SNL Securities LC, Charlottesville, Virginia.

Almost all of the Middle Atlantic regionals have been “tarred by the same brush” as their larger, less diversified brethren. The largest of the regionals have median stock prices of 11 times earnings and 179% of book; all are at least 29% off past highs; and the median decline is about 38%. Only Valley National is trading above 13 times earnings.

For thrifts, the past year has been a disaster with the median price for the largest, publicly-traded thrifts in the Middle Atlantic states being 7.4 times earnings and 94% of book. The declines from previous highs range from 40% to 70%. Sovereign leads the way at 68%, which partially reflect its acquisition of the Fleet branches in New England, but judging by what others have done, it would probably be down 50% even if it had not bought these branches.

The key questions relative to bank stock prices and the impact on financial services in Middle Atlantic states are – What can we expect in the future? and – What impact could this have on industry trends? Predicting stock prices is a guessing game, but the direction of bank stocks will influence the future make-up of the industry.

Where are banks stocks headed? The safe answer is – Who knows? - but the combination of the large banks missing analyst estimates, the reduction in acquisition prices accompanying the elimination of pooling accounting, the likelihood of more interest rate increases in 2000 and that sometime in the next three years there will be a major correction in the stock market, does not bode well for bank stocks in the near future. It also is likely that when the climate for financial services stocks improves, which it should considering the industry’s growth potential and the large amounts of money looking for a home, investors will distinguish between financial firms tied to traditional banking and those that have developed a profitable, high growth profile.

What this means to the industry structure is that by 2005, the financial services business could be made up of “haves” and “have nots,” and that there will be tremendous shareholder pressure on the stock “have nots” to exit even if there are no lucrative sale opportunities. What will separate the “haves” from the “have nots” is ROE, spread income dependence and earnings growth.

Can a financial services company survive and reward investors with one and not the other – i.e., a good ROE with an emphasis on spread income or high growth with a low ROE? The real winners will be those that have both, but a sustainable ROE at 15% or better with low growth – which is, in effect, a “cash cow” - could

make investors happy via high dividends. Growth without double-digit ROEs, albeit quite consistent with the present investor love of non-earning internet stocks, is a more “iffy” proposition.

While a two or three year “down period” in bank stocks is not a favorable outlook for investors or those on the firing line relative to unhappy investors, this may be a “cloud” with a “silver lining.” If investors are not going to like bank stocks anyhow, it is a good time to spend the money to move into faster growing financial service businesses.

### What Does All This Mean?

With so much happening from many different sources, it is increasingly difficult for bankers in the Middle Atlantic states and elsewhere to integrate the information being received and confidently draw a blueprint for the future. We are in an “information glut” era where knowing how to use the information, and not just reading about it, is vital.

In trying to make sense out of all this information and plan for the future, it might be wise to focus on a three-part scenario that includes:

- Two years, 2000 and 2001, of incremental change that will not greatly alter the way financial services are sold or the structure of the industry doing the selling, but that will see some headline-generating mergers that will make it look like things are moving faster than they are.
- Three years, 2002 to 2005, when the battle for supremacy at the top includes many more players than can possibly survive and may bring with it price wars that create a Darwinian sorting out of the strong from the weak.
- A post 2005 era when the winners are pretty much in place and stability returns to an industry with high growth and good profit potential.

While this may sound like a revolutionary scenario, it is no more than a textbook description of a newly-created industry – i.e., a natural evolution from an artificially separated industry structure to a normal “one business” structure at an

accelerated pace with a new form of delivery, the internet, playing a major role. The debate is likely to be more about the pace than the steps, and there will be those that argue the pace described above is too slow.

The immediate concern is the next two years, and, although they may be difficult years, the problems are likely to be more cyclical and economy-driven than a reaction to the more extreme elements of change. The common wisdom is that the economy will remain strong, but that the Fed is likely to raise interest rates, and the latter is not good news for already beleaguered bank stocks. Bank stocks also may be hurt by more year-to-year earnings disappointments at large banks as they have trouble maintaining the high earnings and revenue growth of recent years, if only because for many, the growth was higher than the overall industry fundamentals. The elimination of “pooling” accounting also will force some significant mergers even while bank stock prices act as merger deterrents – i.e., few acquirers are in a position to meet seller expectations.

The Middle Atlantic states may see only modest structural change in the next couple of years, but there will be some big mergers nationally, if not locally, partially driven by the need to beat the elimination of “pooling;” and some of them could have a major impact on Middle Atlantic banking. Possible large mergers over the next couple of years involving banks are:

- The acquisitions of Bank One and First Union with Bank of America and Wells Fargo the most likely buyers, but these two beleaguered giants also could be the ingredients for the next big inter-industry merger with AIG, American Express or a European insurance company such as AXA, Allianz or Fortis.
- Fleet making a major nonbank move with a mutual fund or insurance company with Fidelity and John Hancock being among the most likely partners.
- Midwest consolidations involving some combinations of Firststar, KeyCorp, National City, U.S. Bancorp and PNC with an outside possibility being that Wells Fargo or Bank of America could acquire one of them.
- An insurance company diversifying by merging equally with, or acquiring, PNC, Mellon or Summit.

For at least the next couple of years, though, in the Middle Atlantic, Bank of America, Citigroup, Chase, First Union, PNC, Mellon and Fleet will still be the dominant players. First Union might have a new name, but that will only continue its market share erosion. Mid-sized banks like Summit, Mercantile, Fulton, Commerce, Valley National and BB&T will do most of the acquiring. For local banks, there will be a lot of talk about equal mergers, but it will be mostly talk.

The real change will be less obvious, but not lacking for media coverage, and that is the continual “roll-out” of remote access banking via the internet. The large banks will lead the way, but most local banks will provide their better customers with some form of internet banking. The role of the outsiders like Merrill Lynch, Charles Schwab and others in internet banking will grow.

What happens after the next couple of years is hard to predict in terms of players since we have not yet had the “shake out” among the major internet participants. It is only a matter of time before some large players lose big time with the inevitable negative results on stock prices, but this also is just a normal part of the consolidation process. Since it is large banks and the major internet firms like AOL Time Warner, Yahoo and Amazon.com that are most at risk, the local carnage should be no more than what the large players bring through their price wars.

After all the shouting, there will emerge a stable financial services industry with a handful of big firms at the top and many local financial service specialists filling voids in the coverage of the very large. Some of these local specialists will be new firms with new thinking, but there also will be as many as 800 of the present 1,162 Middle Atlantic banking organizations still on the scene. Some will be there because they are mutual or highly-capitalized stock organizations that have nowhere to go and can make money on capital alone. Banking is not like other businesses in that when the customer no longer needs a particular bank’s services, sale or failure are the only options.

Among the local specialists, there will be existing banks that find their niche and build a modern financial services business around the trust that they have built over the years. This will be more readily done in outlying parts of the region, but there will be numerous success stories in the urban areas as well.

The ingredients for local bank success will be leadership in traditional bank products least vulnerable to remote access – small business lending and local commercial real estate; the ready availability of other financial services desired by

existing customers – i.e., a wide range of insurance products, annuities, mutual funds and various other forms of asset management, but probably not brokerage services; and the ability to make the internet work to its advantage. In fee areas, the big players will do the marketing for the local financial services firms – i.e., when Citigroup is through, potential customers will believe they always bought their insurance from banks - and the key may not be the ability to aggressively sell these new products, but rather having them readily available with recognizable brand names at competitive rates.

While it may be unnerving to see change coming that can threaten one's business, bankers in the Middle Atlantic states can take solace in that the changes that are coming also are likely to bolster the local economy, which has to be good for business, in general, and the financial services, in particular, in the long-run. Being home to so many of the national and global financial services leaders and being a leader in technological development can only mean good things for the Middle Atlantic region, and a positive side-effect will be a continuing aggregating of large amounts of personal wealth. Change always brings disruptions, but it also creates opportunities for those that know how to make it work to their advantage.

## New York Banking Leaders

	Deposits 1999* (In mill.)	Market Share <u>June 30,</u>		Nonint. Inc./ Revenues**	ROE**
		1999	1998		
1. Chase	\$97,933	22.3%	21.6%	60%	23.70%
2. Citigroup	44,307	10.1	9.5	64	17.92
3. HSBC	34,795	7.9	4.8	25	23.01
4. Bank of New York	22,938	5.2	5.2	59	34.00
5. Fleet	17,636	4.0	4.2	51	13.81
6. Deutsche Bank	16,538	3.8	-	-	-
7. M&T	13,953	3.2	3.1	27	15.30
8. Greenpoint***	11,792	2.7	2.5	41	11.03
9. Dime United	11,350	2.6	2.5	43	16.46
10. Astoria	9,655	2.2	1.4	10	17.31
11. North Fork	9,103	2.1	1.4	12	28.02
12. KeyCorp	8,551	1.9	2.0	41	17.68
13. ABN AMRO	8,517	1.9	1.8	37	10.92
14. First Union	8,108	1.8	1.9	47	20.23
15. J.P. Morgan	7,935	1.8	1.5	82	17.68
16. Charter One***	5,487	1.3	.6	22	13.11
17. Emigrant***	5,425	1.2	1.2	9	10.58
18. Apple Bank***	5,085	1.2	1.0	13	15.25
19. Roslyn Savings***	4,257	1.0	.5	10	.89
20. Independence Community***	3,556	.8	.8	8	5.72

\*June 30, 1999.

\*\*December 31, 1999 and twelve months ending December 31, 1999 and removes unusual quarters relative to ROE.

\*\*\*Thriffs.

Source: SNL Securities LC, Charlottesville, Virginia.

Pennsylvania and New Jersey Banking Leaders

	Deposits <u>1999*</u> (In mill.)	<u>Market Share</u>		Nonint. Inc./ <u>Revenues**</u>	<u>ROE**</u>
		<u>June 30,</u>			
		<u>1999</u>	<u>1998</u>		
1. First Union	\$41,707	12.6%	14.2%	47%	20.23%
2. PNC	37,004	11.2	10.7	51	21.54
3. Summit	22,892	6.9	6.9	23	16.17
4. Mellon	22,562	6.8	7.4	68	22.56
5. Sovereign	12,173	3.7	2.9	17	15.50
6. National City	9,757	3.0	3.2	42	22.56
7. Hudson City***	7,228	2.2	2.1	2	9.03
8. Valley National	5,065	1.5	1.4	15	18.35
9. Dime United	4,840	1.5	.6	43	16.46
10. Commerce	4,496	1.4	1.2	31	19.31
11. Keystone	4,405	1.3	1.4	29	6.21
12. Allfirst	4,299	1.3	1.6	36	8.39
13. Fulton	4,000	1.2	1.2	18	15.79
14. Bank of New York	3,100	.9	.9	59	34.00
15. First Commonwealth	2,979	.9	.7	15	11.63
16. Trust Co. of N.J.	2,621	.8	.7	15	15.72
17. Northwest Savings***	2,417	.7	.6	8	9.14
18. Chase	2,364	.7	.7	60	23.70
19. Investor***	2,192	.7	.6	80	18.65
20. Provident***	2,077	.6	.6	15	8.37

\*June 30, 1999.

\*\*December 31, 1999 and twelve months ending December 31, 1999 and removes unusual quarters relative to ROE.

\*\*\*Thriffs.

Source: SNL Securities LC, Charlottesville, Virginia.

Southern Middle Atlantic\* Banking Leaders

	Deposits <u>1999*</u> (In mill.)	<u>Market Share</u>		Nonint. Inc./ <u>Revenues**</u>	<u>ROE**</u>
		<u>June 30,</u>			
		<u>1999</u>	<u>1998</u>		
1. Bank of America	\$20,714	10.6%	11.4%	44%	16.91%
2. SunTrust	18,602	9.5	-	36	16.20
3. First Union	16,640	8.5	8.8	47	20.23
4. BB&T	10,662	5.4	3.4	33	19.16
5. Wachovia	8,468	4.3	4.5	39	18.62
6. First Virginia	7,524	3.8	3.8	21	14.64
7. Allfirst	7,408	3.8	3.5	36	8.39
8. Mercantile	6,030	3.1	3.0	25	16.23
9. Chevy Chase***	5,339	2.7	2.5	64	33.07
10. Wilmington Trust	4,624	2.4	2.3	44	20.18
11. Provident	3,563	1.8	1.5	29	14.61
12. Riggs	3,517	1.8	1.8	35	9.14
13. United	3,293	1.7	1.5	18	13.89
14. F&M National	2,180	1.1	1.2	25	13.65
15. PNC	1,872	1.0	.9	51	21.54
16. City Holding	1,855	.9	.5	39	(.23)
17. E*Trade***	1,737	.9	-	-	(5.19)
18. Bank One	1,644	.8	1.5	46	17.01
19. Wesbanco	1,644	.8	.8	19	9.36
20. Citigroup	1,558	.8	1.1	64	17.92

\*June 30, 1999.

\*\*December 31, 1999 and twelve months ending December 31, 1999 and removes unusual quarters relative to ROE.

\*\*\*Thriffs.

Source: SNL Securities LC, Charlottesville, Virginia.