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The Local Impact of Banking's New Realities

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Banking has moved into a highly challenging phase in its continuing evolution from a protected and constrained business toward a competitive free market environment. Margins are sliding; revenue gains have become more difficult; new, unregulated competitors are growing in numbers; and investors seem to have lost interest in bank stocks. If the business headlines were not reporting new Dow highs and a continuing strong economy, banking in 1999 might seem like a rerun of 1990 and even like the forerunner of an economic downturn.

Who knows, the economy may be headed down since good things cannot go on forever, but the challenges banks face today are not economy-driven, but reflect the new realities that are shaping the direction of financial services in the early years of the 21st century. These realities are national in impact, but they will be felt first in the highly-urbanized areas, which is all of New Jersey and most of Pennsylvania.

These new realities are both causal and reactive. Those that are causing change are:

- Financial services being in a period of sustained high growth with most banks poorly positioned to share in this growth.
- The rapid erosion of the competitive barriers that separate the various parts of the financial services industry.
- Technological advances and a freer competitive environment making financial services available with more convenience at lower prices.

These causal realities have created reactions that impact every bank in the country, albeit some more than others. These reactions are:

- The combination of high growth, rapid technological advances and a changing environment creating opportunities for new, nontraditional competitors, rewarding the forward thinking and leaving traditional banks behind.
- The big getting even bigger.
- Existing banks having to adjust to the changing environment, or accept, reduced sale and investment value.

These realities also will contribute to more margin slippage and slowed revenue growth for traditional banks since the high growth attracts aggressive, innovative competition while size and technology improve productivity. In 1998, the largest bank holding companies, collectively, had their net interest income fall below 3% of average assets, and, at the same time, increased net operating income to record levels. Small banks have higher margins than large banks for many reasons, but when banks that represent more than half of the industry can increase profits with net interest income falling below 3% of average assets, pressure on spreads is the result. Adding further to margin pressure is a reduced availability of loans as securitization moves from home mortgages and consumer loans to commercial real estate, which has been the primary source of high margin loans for most local banks.

There also is the likely "internet effect" on margins to be considered, which may be similar to what happened in the late eighties and early nineties when thrifts like Atlantic Financial tried to outgrow their problems with high deposit rates and created earnings problems for everyone else. Many of those planning extensive use of internet banking will offer very high prices for deposits and then apply that funding to commodity loans and securities and count on low overhead to create a profit. Whether the internet delivers profits to those that go this route has yet to be proven, but this practice will be making insured deposits readily available to customers at high rates without geographic constraints, even without the big banks adding their muscle to the process.

With margins sliding, revenues growing slowly, if at all, and the threat of the internet hanging over banking, it is only logical that investors are looking elsewhere for returns, and the negative view of bank stocks has been increased by a

FASB recommendation relative to poolings that could reduce acquisition prices by as much as a third. Meanwhile, the consolidation pressures will be stronger than ever even as the number of active large and mid-sized acquirers diminishes.

This negative investor perception, though, is not being applied to the large banks, albeit some such as First Union are no longer investor favorites. This is because most large banks are viewed as financial services firms whose earnings are not constrained by margins. As a group, the big banks are getting more than half of their revenues from fees, and Mellon is up to 66%.

Despite the threat to “business as usual,” these new realities present an opportunity for alert local banks to move on to bigger and better things. The game, though, is no longer "protecting banking’s turf," but rather how to share in the financial services industry boom – and be among the winners.

The Local Bank Response

Whether the local bank has \$40 million in assets in some small town in Western Pennsylvania or is a \$30 billion-plus regional like Summit, the proper response to these realities is the same. Banks have to lessen their dependence on spread income, and because spread income will never totally go away, improve the productivity in their spread business.

Productivity gains may be easier than diversification, but for most banks, it can be a very difficult cultural adjustment since high productivity requires a less paternalistic approach toward employees, an exiting of products and services that do not make money and, possibly, the reducing of the number of similar, local financial alternatives. As to the latter, one benefit of lower acquisition prices is that in-market equal or near-equal mergers may be easier to accomplish even though they, too, can be negatively impacted by changes in the pooling rules.

As to a lessening of the dependence on spread income, this requires a strong commitment to fee income, which can create problems since not all fee businesses are profitable and/or readily adaptable to banks of all shapes and sizes. Also, the most obvious fee businesses for local banks, asset management and insurance, are different from banking in culture and expertise.

Despite the difficulties and the culture problems in adapting to these new realities, local banks have strong competitive advantages. The major advantage is that they are well-known in their communities and usually have a large market

share that includes the best potential customers for fee products - businessmen and the upper end of the affluence ladder. Another plus is that the big banks will pave the way. When First Union is through "moving people to the mountain," the customers will think banks are where you buy insurance.

If the banks do not use their customer advantages aggressively, though, there will be no shortage of competitors without cultural "hang-ups" ready to serve these customers. Among these will be new entrants that are fully conversant with the most recent technological innovations.

Local Structural Impact

The impact of the banking realities on the make-up of the financial services industry, and which existing banks and thrifts make a successful transition to the next stage of the industry's evolution, will vary by region. In the high density Philadelphia and Pittsburgh areas and in North Jersey, size will count more and technology will have a quicker impact on who succeeds and who does not. In the outlying areas, the race will still go to the swift, but there will be a lot more size and time flexibility.

The large markets, though, have room for small financial institutions in that they, and probably only they, can support specialized financial services firms. Philadelphia, for example, should be able to support several operations that specialize in small business lending and/or asset management.

While it may be easy to recognize the overall patterns of change that are likely to occur in financial services, what is not so clear is the timing of possible radical change and which existing banks are most likely to successfully make the transition. In my opinion, radical change, will be when the present delivery system can no longer deliver good annual revenue and earnings growth.

As to the timing, it is comfortable to think that change comes gradually to banking and that despite all the talk for the last twenty years about the end of bricks and mortar and a "checkless society," neither has happened. What is often conveniently forgotten, though, is that in 1978, there was a healthy and confident thrift industry, and by 1981, that industry was swimming in a "sea of red ink" and well on the road to extinction. Also, past transitions in banking did not have to take into account interindustry alliances like Citicorp-Travelers, the impact of the internet and the securitization of commercial real estate.

In fact, gradualism may no longer be part of the game. The Schwab-One Account and what it has done to the brokerage business should be a wake-up call to bankers. It is possible, and some would say likely, that within five years the traditional bank mix will be unable to deliver meaningful annual earnings gains. Banks may still have busy lobbies, provide substantial local employment and satisfy regulators with strong capitalization, but without good earnings growth, they will have little investor appeal and will not play an expanding role in what is likely to be a “booming” financial services industry.

The existing banks that are most likely to make a successful transition to the emerging banking environment, other than as product specialists, will have three primary characteristics. These are:

- A good franchise – i.e., high market share in a well-defined market;
- A strong commitment to fee businesses; and
- The ability to deliver a high ROE, probably above 14%.

Some indication of those with the best starting positions among regional leaders can be seen in their present market shares, noninterest income as a percent of revenue and ROEs. The market-by-market look at Pennsylvania and New Jersey that follows provides this insight relative to the regions’ large and mid-sized banks, and what happens to them will have a ripple effect on smaller banks.

Philadelphia Area

The biggest market in Pennsylvania and New Jersey, and the one that ties the two states together, is the Philadelphia area. This region includes Southeast Pennsylvania and South Jersey, which have a combined population of about 8.2 million. It also includes many distinct centers, but is dominated by Philadelphia, and what happens in Philadelphia will determine the region's financial services structure.

First Union is the leader in this region that stretches from Harrisburg to the Atlantic Ocean with more deposits than the next three banks combined. It also is one of the country's largest and, up until quite recently, best performing banks with a return on equity above 20%; 47% of its revenues coming from fees; and it is spending tens of millions on brand identification.

Despite holding a strong position in the Philadelphia area, First Union has its problems. Staying competitive involves changes that are not always popular with employees and customers. Also, the banks it acquired locally - CoreStates and First Fidelity - as well as its recent acquisition to the south, Signet - were losing ground rapidly prior to being acquired, which underlies much of First Union's present weaknesses - i.e., it is difficult to get projected cost savings in mergers if revenues are declining. Since its problems are not over, First Union will continue to lose customers for another couple of years, which is a plus for competitors, but it also can give them a false sense of security.

First Union's primary Philadelphia area competitors are PNC and Mellon. They have much smaller shares, but are well-established and not experiencing the merger woes of First Union. They also have high ROEs and are less dependent on spread income, but their smaller overall size makes them likely acquisition candidates. Their sale, though, would not change the competitive mix in the area since it would be substituting one large financial institution for another.

First Union, PNC and Mellon are the leaders, but the Philadelphia area has many significant players besides these three, some of which are leaders in their own sub-areas. This includes eight commercial banks and four thrifts that have regional deposit shares in excess of 1%, which is a substantial percentage in a market of this size.

Deposit Share
Philadelphia Area*

	Deposits 1998 (In mill.)	<u>Market Share</u> <u>June 30,</u>		Nonint./ Income Revenue**	<u>ROE**</u>
		<u>1998</u>	<u>1996</u>		
<u>Market Leaders</u>					
First Union	\$ 30,544	23.3%	6.3%	47%	20.37%
PNC	13,004	9.9	9.8	49	20.46
Mellon	9,465	7.2	7.7	66	21.08
Subtotal	\$ 53,013	40.4%	23.8%		
<u>Second Tier</u>					
Summit	\$ 7,313	5.6%	3.2%	23%	17.64%
Sovereign	6,246	4.8	1.9	15	15.31
Allied Irish	5,023	3.8	.7	37	8.78
Fulton	3,497	2.7	1.8	18	15.20
Commerce	3,354	2.6	1.9	28	18.00
Subtotal	\$25,433	19.5%	9.5%		
<u>Others</u>					
Hudson United	\$ 2,503	1.9%	-	19%	7.02%
Keystone	1,972	1.5	.9%	26	14.82
Commonwealth	1,560	1.2	1.2	28	6.76
National Penn	1,395	1.1	.8	16	16.23
Beneficial	1,295	1.0	1.0	5	9.42
Susquehanna	1,282	1.0	.7	16	12.02
Hudson City	1,244	1.0	.8	2	10.92
Subtotal	\$11,251	8.7%	5.4%		
Other Banks	\$ 18,806	14.5%	38.9%		
Other Thrifts	13,509	10.3	14.7		
Credit Unions	8,851	6.6	7.7		
Total	\$130,863	100.0%	100.0%		

*Adams, Berks, Bucks, Chester, Cumberland, Dauphin, Delaware, Franklin, Lancaster, Lebanon, Lehigh, Montgomery, Northampton, Perry, Philadelphia and York counties in Pennsylvania. Atlantic, Burlington, Camden, Cumberland, Gloucester, Mercer, Ocean and Salem counties in New Jersey.

**Twelve months ending March 31, 1999 or latest available.

Source: SNL Securities LC, Charlottesville, Virginia.

The largest of the second tier banks - Summit, Sovereign and the Allied Irish
- have steadily narrowed the gap between themselves and the smallest of the "big

three." In 1996, Mellon had 7.7% of the region's deposits, which was considerably more than the above three had combined. Two years later, Summit with a 5.6% deposit share and Sovereign at 4.8% were not far behind Mellon's 7.2%, and, as a result of its acquisition of Dauphin Deposit, the Allied Irish and its Allfirst subsidiary, had almost 4% of the region's deposits. At the low end of the second tier, but well ahead of everyone else, and also with much increased market shares since 1996, are Fulton and Commerce.

The one thing all five of these second tier banks have in common is rapid deposit share increases via acquisition as they, along with First Union, have been the primary consolidating forces in the region. In commitment to fee income, Allfirst is far ahead of the others with noninterest income accounting for 37% of revenues. Commerce and Summit are at 28% and 23%, respectively, in their noninterest income as a percent of revenue. Sovereign and Fulton are typical of smaller banks with noninterest income at less than 20% of revenues. All except Allfirst have ROEs above 15%.

A major differentiating factor between these second tier banks and the big three is their coverage in the submarkets. Although they have relatively small shares in this broad market centering on Philadelphia, Allfirst is the leader in the Harrisburg-York area; Fulton is number one in Lancaster County and second in the Lehigh Valley; and Summit and Commerce are one-two in South Jersey. Sovereign alone is spread throughout the region without a subarea of market leadership.

The remaining four banks – Hudson United, Keystone, National Penn and Susquehanna - and three thrifts - Commonwealth, Beneficial and Hudson City Savings - with deposit shares over 1% are fringe players in the Philadelphia area with the largest share amongst them being Hudson United's 1.9%, much of which comes from its announced purchase of JeffBanks. The banks in this group have been gaining share by acquisition, but except for Keystone, they have only modest commitments to fee income. National Penn stands out in this group with a better than 16% ROE, and Keystone is the only other one of the seven above 14%.

Who stays and who goes in the Philadelphia area will be greatly influenced by "insider" confidence, financial performance and investor pressures. PNC, Mellon and Summit are particularly vulnerable to the investor pressures, and because of their size, if they sell, it could bring a large outsider such as Bank of America, Bank One, Fleet or National City into the market. As Sovereign moves toward \$30 billion it faces similar investor pressures, but despite a major balance

sheet transformation, it may be too thrift-like to attract any large bank acquirers. Thus, it is likely to be around awhile acquiring thrifts throughout the Northeast and, perhaps, becoming the Washington Mutual of the East. It is unlikely that many of the stock organizations with more than 1% shares will be around for the duration, but their disappearance will be gradual.

North Jersey

The other very large market in a combined Pennsylvania-New Jersey is North Jersey with 1998 deposits in excess of \$100 billion. Despite being part of the New York City media market, North Jersey has a banking structure with a very "un-New York" flavor. The banking leaders are the locally-based Summit and First Union with its North Carolina heritage. The area's largest New York City bank is Bank of New York, and it is eighth in deposit size with a declining 3% share.

Even without New York acquirers, though, North Jersey will see more structural change. Summit is too small to maintain its leadership position in the emerging financial services environment; too big to avoid direct competition with the truly large; and far too attractive not to receive an offer it cannot rationally refuse - and what Summit does may determine future leadership in North Jersey. Meanwhile, number two in the region, First Union, is going through a period of stress that could end up with it experiencing a marriage of convenience. Of the second tier banks, only Fleet is a national player with staying power.

The second tier of North Jersey banks is a very mixed bag. At the top are Fleet and another large bank, PNC, that have high ROEs and major commitments to fee income - i.e., each has almost 50% of its revenues coming from fees - and are losing deposit share, albeit much of it may be by choice. The others in the second tier - Hudson City, Valley National and Sovereign - have been gaining deposit share, mostly by acquisition, but are traditional in revenue generation with noninterest income accounting for 15% or less of total revenues.

Deposit Share
North Jersey*

	Deposits <u>1998</u> (In mill.)	<u>Market Share</u> <u>June 30,</u>		Nonint./ Income Revenue**	<u>ROE**</u>
		<u>1998</u>	<u>1996</u>		
<u>Market Leaders</u>					
Summit	\$ 14,882	14.6%	13.6%	23%	17.64%
First Union	<u>11,156</u>	<u>11.0</u>	<u>10.8</u>	48	17.26
Subtotal	\$ <u>26,038</u>	<u>25.6%</u>	<u>24.4%</u>		
<u>Second Tier</u>					
PNC	\$ 7,282	7.2%	7.4%	47%	21.76%
Fleet	6,801	6.7	8.4	47	18.06
Hudson City	5,409	5.3	4.4	2	10.92
Valley National	4,886	4.8	4.0	15	18.36
Sovereign	<u>4,789</u>	<u>4.7</u>	<u>2.4</u>	15	14.64
Subtotal	\$ <u>29,167</u>	<u>28.7%</u>	<u>26.6%</u>		
<u>Other Large</u>					
Bank of New York	\$ 3,021	3.0%	3.3%	56%	24.15%
Dime	2,421	2.4	2.0	46	17.33
Trust Co.-N.J.	2,355	2.3	2.1	18	13.20
Chase Manhattan	2,233	2.2	2.3	54	18.37
Ocwen	2,018	2.0	1.5	57	(3.76)
Investors	1,949	1.9	1.8	1	19.44
Hudson United	1,781	1.8	1.5	19	7.02
Provident	1,757	1.7	1.5	15	9.18
United National	1,392	1.4	.8	24	6.75
First Sentinel	1,240	1.2	-	6	6.52
Columbia Savings	1,185	1.2	1.0	10	11.69
Independence	<u>1,006</u>	<u>1.0</u>	<u>-</u>	6	4.87
Subtotal	\$ <u>22,358</u>	<u>22.1%</u>	<u>17.8%</u>		
Other Thrifts	\$ 11,550	11.3%	15.7%		
Other Banks	8,684	8.5	11.7		
Credit Unions	<u>4,064</u>	<u>3.8</u>	<u>3.8</u>		
Total	\$ <u>101,861</u>	<u>100.0%</u>	<u>100.0%</u>		

*Bergen, Essex, Hudson, Hunterdon, Middlesex, Monmouth, Morris, Passaic, Somerset, Sussex, Union and Warren counties.

**Twelve months ending March 31, 1999 or latest available data.

Source: SNL Securities LC, Charlottesville, Virginia.

The similarities end there, though, with Valley National being a locally-based commercial bank with a very high ROE; Sovereign is a large, acquisitive

thrift based in Pennsylvania; and Hudson City is a local mutual thrift about to convert to a mutual holding company form of stock company.

With Bank of New York and Chase Manhattan being among the next tier of North Jersey banks, it might seem logical for them to improve their status by acquisition, but they seem more likely to exit than to expand. Bank of New York is more interested in processing businesses than retail banking, and just recently, Chase Manhattan sold its Upstate New York branches.

The other North Jersey banking organizations with more than 1% deposit shares, with one exception, are either thrifts or commercial banks that are not aggressive acquirers. The exception is Hudson United, and it can be expected to increase its share in this very fluid market.

The eventual structure of North Jersey banking, though, may take on more of a New York flavor than branches and deposit shares suggest. This region is particularly susceptible to electronic banking and will be high on the target list of marketers from Citigroup and other large financial services companies. Thus, looking ahead five to ten years, it is easy to envision a North Jersey with names like Citigroup, Chase Manhattan, Bank of America and Fleet being preeminent with PNC, Summit and maybe even First Union, becoming "remembrances of things past" like Fidelity Union, MidLantic, First National State, Chemical, NatWest and so many others.

Pittsburgh Area

The third large urban complex in the two states, the Pittsburgh area, was one of the first major markets to assume the banking structure of the future - i.e., three or four large financial institutions competing with a myriad of small firms with little in-between. Mellon and PNC have long been dominant in this market, and National City assumed the position that Integra built by acquiring EquiBank and Union National. These three banks held 63% of the deposits in mid-1998, and it is likely that they have a much larger share of the transaction deposits and commercial lending.

Deposit Share Pittsburgh Area*

Market Share

Nonint./

	Deposits 1998 (In mill.)	June 30, <u>1998</u> <u>1996</u>		Income Revenue**	ROE**
<u>Market Leaders</u>					
Mellon	\$11,850	26.1%	26.7%	66%	22.73%
PNC	8,814	19.4	23.0	47	21.76
National City	<u>8,031</u>	<u>17.7</u>	<u>17.3</u>	42	20.77
Subtotal	\$28,695	63.2%	67.0%		
<u>Second Tier</u>					
Dollar	\$ 1,504	3.3%	3.2%	18%	11.82%
First Commonwealth	1,144	2.5	.9	17	13.27
Sky	959	2.1	-	35	23.03
Parkvale	<u>952</u>	<u>2.1</u>	<u>1.8</u>	8	14.78
Subtotal	\$ 4,559	10.0%	5.9%		
<u>Other Large</u>					
USBANCORP	\$ 606	1.3%	1.3%	27%	14.29%
BT Financial	592	1.3	1.2	15	10.70
GA Financial	475	1.0	.9	12	6.40
First Bell	474	1.0	.9	2	10.88
S&T	<u>454</u>	<u>1.0</u>	<u>.4</u>	15	15.74
Subtotal	\$ 2,601	5.6%	4.7%		
Other Banks	\$ 4,732	10.5%	10.0%		
Other Thrifts	2,384	5.3	7.6		
Credit Unions	<u>2,471</u>	<u>5.4</u>	<u>4.8</u>		
Total	\$45,442	100.0%	100.0%		

*Allegheny, Armstrong, Beaver, Butler, Fayette, Greene, Washington and Westmoreland counties.

**Twelve months ending March 31, 1999 or latest available data.

Source: SNL Securities LC, Charlottesville, Virginia.

The Pittsburgh "big three" also combine the market structure of the future with a futuristic revenue mix and financial performance. They have returns on equity in excess of 20% and more than 40% of revenue coming from noninterest income. Mellon, in particular, has moved away from spread income with 66% of its revenues being noninterest income.

To talk of a second tier in the Pittsburgh area is a "stretch," but two banks - First Commonwealth and Sky - and two thrifts - Dollar and Parkvale - are larger than everyone else, albeit, collectively, they have only 10% of the region's deposits. Sky is an \$8 billion Ohio bank with the commitment to fee income and high ROE of the large banks. First Commonwealth, Dollar and Parkvale get less than 20% of their revenues from fees - and Parkvale less than 10%. Parkvale, though, is a high performer when measured by ROE.

Going forward, names may change, but there should be little change in the industry structure in the Pittsburgh area. A possible exception to this would be a merger of two of the three major players, which would be consistent with the growing trend toward in-market consolidation. Such a merger would result in a large divestiture of loans and deposits, but the buyer of those loans and deposits would be a distant third to what would then be a very dominant "big two."

Outlying Western Pennsylvania

The rest of Western Pennsylvania is a very fragmented market that is decentralizing rather than consolidating as National City, Mellon and PNC reduce their coverage. National City and PNC are the only ones with double-digit deposit shares, but if present trends continue, this will not be the case by mid-2000. It is likely that additional branch sales by the large banks and some consolidation among others will create new leaders as the new millennium begins.

The largest of the others in terms of deposit share in outlying Western Pennsylvania are Northwest and First Commonwealth, but Sky, F.N.B., S&T, BT and USBANCORP also are substantial players. FirstMerit, a \$9 billion Ohio bank, has a token presence.

Deposit Share
Outlying Western Pennsylvania*

	Deposits 1998 (In mill.)	Market Share June 30,		Nonint./ Income Revenue**	ROE**
		1998	1996		
<u>Market Leaders</u>					
National City	\$ 1,940	12.1%	15.2%	42%	20.77%
PNC	1,782	11.1	14.8	47	21.76
Northwest	1,562	9.7	7.0	7	8.59
First Commonwealth	<u>1,374</u>	<u>8.5</u>	<u>8.0</u>	17	13.27
Subtotal	\$ 6,658	41.4%	45.0%		
<u>Second Tier</u>					
FNB	\$ 1,034	6.4%	6.2%	12%	6.36%
S&T	905	5.6	5.3	15	15.74
BT Financial	841	5.2	4.4	15	10.70
Sky	741	4.6	-	35	23.03
Mellon	710	4.4	4.3	66	22.73
USBANCORP	<u>660</u>	<u>4.1</u>	<u>3.5</u>	27	14.29
Subtotal	\$ 4,891	30.3%	23.7%		
<u>Other Large</u>					
CNB	\$ 450	2.8%	1.4%	15%	8.92%
FirstMerit	280	1.7	-	26	13.91
Penn Laurel	<u>254</u>	<u>1.6</u>	<u>.6</u>	12	10.69
Subtotal	\$ 984	6.1%	2.0%		
Other Banks	\$ 1,738	10.9%	17.6%		
Other Thrifts	830	5.2	5.9		
Credit Unions	<u>980</u>	<u>6.1</u>	<u>5.8</u>		
Total	\$16,081	100.0%	100.0%		

*Cambria, Cameron, Clarion, Clearfield, Crawford, Elk, Erie, Forest, Indiana, Jefferson, Lawrence, McKean, Mercer, Potter, Somerset, Venango and Warren counties.

**Twelve months ending March 31, 1999 or latest available data.

Source: SNL Securities LC, Charlottesville, Virginia.

Those most likely to replace PNC and National City as the financial services leaders in this region should come from among First Commonwealth, S&T, BT,

Sky and USBANCORP with the combination of two or more of them being a major determinant. F.N.B. is also a possibility, but it seems more committed to growth in Florida than in Western Pennsylvania, and it could at some point, sell its Pennsylvania business and become a totally Florida bank. Northwest as a mutual holding company may not be a likely regional leader, but it also is not going away.

Most of the locally-based banks in outlying Western Pennsylvania are extremely traditional in their dependency on spread banking and modest ROEs. USBANCORP is a bit of an exception on both counts with noninterest income accounting for 27% of revenues and a 14.29% ROE, and S&T has an ROE of almost 16%.

Northeastern Pennsylvania

Northeastern Pennsylvania is a world unto itself. It is as urban as the major metropolitan areas with Scranton and Wilkes-Barre at its core, but the distance from New York and Philadelphia has kept it from enjoying the growth of a Lehigh Valley or Central Jersey. This, though, may change with improved road connections and the continuing out-migration from New York City.

The region's banking structure is similar to that of the Philadelphia area since a couple of major acquisitions have left a large bank, in this case PNC, with almost as much of the banking business as the next three largest - Mellon, First Union and M&T - combined. Unlike in a big market like Philadelphia, this disparity raises questions, however, as to the willingness to stay of large banks with less than 10% of the local business.

This market also has numerous small banks with significant shares in a small geographic area, the majority of which have low ROEs and only minimal commitments to fee income. This suggests a need for further consolidation to remove overcapacity, and this has been slow to occur because of a lack of interest in the area by Pennsylvania's regional banks and the failure of a natural kinship with North Jersey to develop because of the deterrence of state lines to local bank mergers.

Deposit Share Northeastern Pennsylvania*

	<u>Market Share</u>	Nonint./
Deposits	June 30,	Income

	<u>1998</u> (In mill.)	<u>1998</u>	<u>1996</u>	<u>Revenue**</u>	<u>ROE**</u>
<u>Market Leader</u>					
PNC	\$ 2,571	21.8%	23.6%	47%	21.76%
<u>Second Tier</u>					
Mellon	\$ 987	8.4%	8.3%	66%	22.73%
First Union	893	7.6	4.5	48	17.26
M&T	<u>769</u>	<u>6.5</u>	<u>-</u>	28	13.73
Subtotal	\$ 2,649	22.5%	12.8%		
<u>Others</u>					
First Liberty	\$ 499	4.2%	-	8%	7.06%
Summit	478	4.1	5.0%	23	17.64
Penseco	369	3.1	2.9	30	9.10
First National Community	360	3.1	2.5	8	15.17
Comm Bancorp	339	2.9	2.7	11	11.62
Pioneer American	294	2.5	2.5	15	10.92
Lake Ariel	272	2.3	2.1	33	9.82
East Stroudsburg	235	2.0	1.8	14	9.39
Norwood	226	1.9	1.8	12	12.38
Fidelity	224	1.9	1.7	14	11.16
Citizens Savings	<u>219</u>	<u>1.9</u>	<u>1.8</u>	8	9.33
Subtotal	\$ 3,515	29.9%	24.8%		
Other Banks	\$ 1,948	16.4%	30.6%		
Other Thrifts	511	4.3	3.3		
Credit Unions	<u>612</u>	<u>5.1</u>	<u>4.9</u>		
Total	\$11,806	100.0%	100.0%		

*Carbon, Lackawanna, Luzerne, Monroe, Pike, Susquehanna, Wayne and Wyoming counties.

**Twelve months ending March 31, 1999 or latest available data.

Source: SNL Securities LC, Charlottesville, Virginia.

That is the past, however, and Northeastern Pennsylvania is likely to be a major center of merger activity over the next few years. Among Mellon, First Union, M&T and Summit, at least one, and probably two, will exit with those that remain and Sovereign being the likely buyers. At the lower end, investor pressures will force the sale of many small banks that cannot achieve returns on equity above 14% and push noninterest income above 30% of revenues. The most immediate merger activity is likely to be local consolidations that can raise ROEs through cost savings.

Outlying Central Pennsylvania

Among the smaller regions, outlying Central Pennsylvania is more akin to outlying Western Pennsylvania than Northeastern Pennsylvania with its lack of an urban core. Like its western counterpart, banking is fragmented with only one bank, Keystone, having more than a 7% deposit share, and much of the banking is still done by single community, or at least single county, banks.

Consolidation also will be much slower in outlying Central Pennsylvania than elsewhere since most of the small banks are in fairly protected markets, have acceptable returns on equity and, theoretically, are in good positions to be the local purveyor of financial services that are not traditional banking products - i.e. insurance and asset management. This somewhat lessens the competitive threat from the changing environment, and, in so doing, reduces the perceived need to change or sell; albeit it is doubtful many of these small banks will use their “good” positions to go much beyond traditional banking.

Thus, much of the structural change in this region is likely to result from the gradual reduction of coverage in the region by the large banks. This would be accelerated if the regionals that have major stakes in the area - Keystone, Susquehanna, Sovereign, Fulton and First Commonwealth - were acquired by large banks. It is inevitable that there will be some of this, but these regionals have more staying power than most banks of their size, if only because banks large enough to buy them are not enamored with having a physical presence in this part of the state.

Deposit Share
Outlying Central Pennsylvania*

	Deposits 1998 (In mill.)	<u>Market Share</u> <u>June 30,</u>		Nonint./ Income Revenue**	<u>ROE**</u>
		<u>1998</u>	<u>1996</u>		
<u>Market Leader</u>					
Keystone	\$ 2,396	19.7%	20.2%	27%	12.65%
<u>Other Large</u>					
Omega	\$ 842	6.9%	7.2%	17%	11.39%
Susquehanna	574	4.7	3.6	17	12.02
Mellon	562	4.6	5.1	66	22.73
Sovereign	533	4.4	-	15	14.64
Fulton	511	4.2	3.4	18	15.20
Citizens & Northern	486	4.0	3.6	11	13.29
PNC	444	3.7	4.2	47	21.76
First Union	415	3.4	-	48	17.26
First Commonwealth	382	3.1	3.1	17	13.27
Sun	298	2.5	1.7	12	13.19
Juniata Valley	271	2.2	1.3	7	9.04
Main Street	<u>251</u>	<u>2.1</u>	<u>-</u>	16	11.43
Subtotal	\$ 5,569	45.8%	33.2%		
Other Banks	\$ 3,075	25.3%	37.0%		
Other Thrifts	603	5.0	5.6		
Credit Unions	<u>515</u>	<u>4.2</u>	<u>4.0</u>		
Total	\$12,158	100.0%	100.0%		

*Bedford, Blair, Bradford, Centre, Clinton, Columbia, Fulton, Huntingdon, Juniata, Lycoming, Mifflin, Montour, Northumberland, Schuylkill, Snyder, Sullivan, Tioga and Union counties.

**Twelve months ending March 31, 1999 or latest available data.

Source: SNL Securities LC, Charlottesville, Virginia.

Even for most of the larger, local banks in this area, selling nontraditional bank products is more of a future possibility rather than an inevitability. None of the leading banks based in the region have 20% or more of their revenues coming from noninterest income, and most are not even close.

Conclusion

The region-by-region look at the present state of banking in New Jersey and Pennsylvania shows that a) there are tremendous regional variations, b) most of the local banks are still overwhelmingly dependent on spread banking, and c) there is still an abundance of traditional participants in the diminishing part of a growth industry. What these regional overviews do not show is the impact of out-of-area competition and the likely impact of a changing delivery system.

Even without that, though, there should be enough in this report to prompt bankers to ask the hard and relevant questions that are vital to the success of their organizations. Some of these questions bankers are reluctant to ask, but if not asked, their banks are likely to be among those that will not successfully make it through the next stage of the evolution of banking, and with disastrous results for investors. For starters, all banks should ask themselves the following:

- Could the delivery of financial services change so radically in the next few years that many, if not all, local, traditional banks become essentially obsolete?
- Did the value of my institution reach a peak in 1998 that will never again be attained?
- Are we capable of reinventing ourselves sufficiently to play a significant role in the future delivery of financial services?

The first concern - the possibility that the delivery of financial services may change so that many existing banks are rendered obsolete - is a key to everything else. A recent Business Week cover asked if "You're Merrill Lynch when Schwab.com comes along. You're Barnes & Noble when Amazon.com hits big.....What would you do?" Take the names out, and what is being asked is - If you are essentially a "middle man" and the need for the "middle man" is greatly diminished, - What do you do?

The internet is a threat to traditional banking as it would be to any industry that is essentially transferring information at a cost, but it is only part of a change

that will revolutionize the industry. Other elements include brand recognition, product bundling, lower costs, more convenience and better service. While local bankers like to point to better service as their strong point, they are only partially right. One of the services customers most value is being able to accomplish what they want without leaving home or office.

The internet threat also has to be put in its proper perspective in that it is not a threat to banking as an industry, but rather to individual banks. What the internet is likely to do relative to financial services is make deposits available nationally at standard prices and give the large banks the ability to use their cost and brand advantages in markets in which they do not have branches. In other words, it will be used primarily by banks against banks.

As to whether 1998 was a high watermark in bank valuations depends on how well banks adapt to a changing environment, which includes an evolving delivery system. Within five years, a branch network dominated by teller stations and focusing on deposits and check cashing may well be viewed as an altruistic undertaking with little investment value. Conversely, if a financial institution is providing services a customer needs and is willing to pay for, it is likely to attract the investor interest that goes along with being a relevant player in a high growth industry.

Unfortunately for banks, providing services that customers need and are willing to pay for in a day and age when there will be competitors that view market share as more important than profits, will be a challenge that may require reinventing themselves. This is no easy task in a ballgame that changes so fast that yesterday's product of the future is today's albatross from the past - i.e., supermarket banking, proprietary PC banking and fully-automated branches.

It is not a stretch to think that the delivery of financial services could change so radically in the next few years that many local banks could become obsolete, and, if this happens, it will have a negative effect on investment value that will have bankers trying to explain away a stock price decline since 1998. The "flip-side" is that as some banks become obsolete, others will adjust. If there has been one consistent pattern in the continual evolution of the financial services industry, it is that the banks, as a group, always come out ahead because they have the resources and market capital to buy the outside competition if they cannot beat it.

Thus, for banks to "reinvent themselves sufficiently to play a significant role in the future delivery of financial services" - may be challenging, but most of the

financial services institutions that are relevant and have a continuing investment value in the 21st century are likely to have bank origins. Whether your bank is one of them depends on the willingness and determination to do what it takes to adjust to the new realities.