SAMPLE FILES FROM CREDITSIGHTS

Please note: The following documents are representative samples of the various report types published by CreditSights. This is a file of multiple report samples. When using CreditSights on Alacra, you will select the report (or reports) you wish to access.

Article - see document BofA @ Goldman: "Universal Bank" with U.S. Focus

The CreditSights' team analyzes 40+ industries and 1,200+ companies with comprehensive coverage of 568 companies combining top-down and bottom-up analysis. Each day detailed reports analyzing recent company developments of significance to the markets capturing the timeliness of breaking news but surround this with meaningful interpretation of the events.

BondScore CRE Report – see document Bank of America CRE Report

BondScore CRE Reports are a one-year forward estimate model of default probability. CreditSights uses the BondScore 3.0 model to calculate CREs weekly for publicly traded companies with assets over $250 million. They also convert these scores to implied categorical ratings and spreads for ease of comparison with agency ratings and corporate bond market spreads. The model-derived scores and the ratings and spreads based on them can complement qualitative judgment by rating firms to small to merit ongoing qualitative coverage, by giving frequent updates of a company's status in between qualitative evaluations, and by providing a systematic algorithm for scoring risk that can be used in the context of an integrated analysis as a check and jumping-off point for in depth discussion.

Industry Review – see document U.S. Bank Outlook 2005, Part I: Rising Rates, Falling Banks?

Industry Reviews drill beneath the company-specific events to identify trends with broad impact on credit quality and security pricing for a particular industry. Quarterly Sector Outlooks provide the ability to review comparative industry exposure before the onset of the earnings season with its attendant headline risk.

Special Report – see document Estimating The Impact of Homeland Investment

Special Reports provide a thorough examination of critical market risk variables that extend beyond the confines of any one company or industry. These topics are often both complex and controversial, and require an in-depth understanding to assess their full implications. Recent examples include asbestos litigation, structural subordination, pension liabilities, bank line disclosure practices, vendor financing, and rating agency policies.

Spreadsheet – see document Bank of America Spreadsheet

Spreadsheets address the challenges inherent in time-series analysis of financial data in a dynamic and complex market. They are a tool that facilitates investment decisions by providing convenient access to the financial data necessary to perform company, industry and competitive analysis. Spreadsheets offer high-quality, consistent, historical financial information on a broad range of companies, providing a valuable time-saving resource for fundamental analysis.

Tearsheet – see document Bank of America Tearsheet

Tearsheets are the most in-depth company reports that CreditSights provides. They are designed to capture all aspects of a company's competitive position, placing the financial and operating performance within a context of broader credit trends. Tearsheets go beyond the latest headline event to offer a comprehensive company overview that delivers all the information investors should consider prior to the commitment of capital. Tearsheets meet the need for a detailed analysis by providing a thorough overview that addresses all aspects of a company's operations in a single report.

Weekly Sector Review – see document Finance Sector Review Week End

On six comprehensive industries, Weekly Sector Reviews provide a wrap up of the global news contained within the Worth Watchings for that previous week. In addition, we provide a list of all company articles written the previous week pertaining to that industry sector.

Worth Watchings – see document Bank of America Worth Watching

Worth Watchings consolidate market news flow into a single location. These succinct research comments enhance the news with immediate analysis and enable readers to easily filter for the events most relevant to them. Worth Watchings frequently provide links to longer articles, enabling subscribers to drill into areas of greater interest.

BofA @ Goldman: "Universal Bank" with U.S. Focus
Date Published: 08 Dec 2004, 04:21

- BofA sees plenty of growth in the U.S.
- Opportunistic international expansion possible
- 2005 outlook: better loan growth vs. net interest income headwinds

Bank of America - Debt View and Valuation Metrics				**Key Equity Indicators**	
Total Debt	$86.3 B	@ 12/7/2004		Market Cap.	$185.2 B
Rating Agency	Aa2/A+, S&P has a positive outlook			LTM Revenues	$47.2 B
CreditSights Rating	AA-			Revenue Growth*	23.6%
CreditSights ST Rec.	Marketweight			EPS Growth**	9.6%
				Divd Yield	3.93%
				P/E	12.03x
				P/B	1.90x

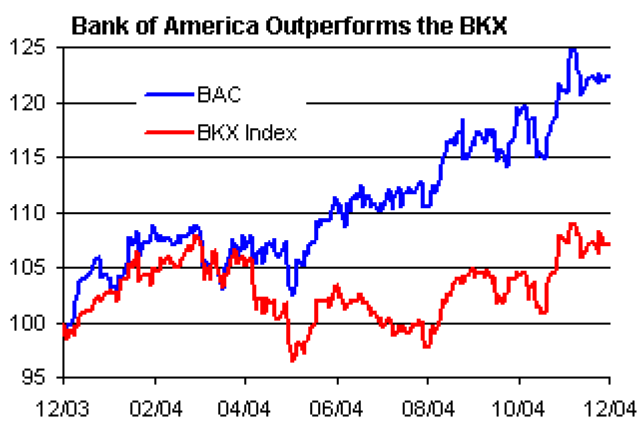
Credit Metrics	**ROAE**	**Efficiency**	**NCO %***	**Leverage**
Actual (3Q04)	15.6%	54.94%	0.57%	5.92%
Forward Trend	Improving	Improving	Stable	Stable

Valuation Benchmarks		**@ 12/7/04**	**6M Avg.**	**FV**	**Rich(-)/ Cheap (+)**
10Y	5.375s of 2014	60 bp	68 bp	61 bp	+1 bp

Source: Company Reports, Bloomberg, CreditSights
* Growth rates are quarter-over-quarter, NCO %= Net Charge-offs as a % of Avg. Loans
** EPS Growth is the Bloomberg consensus estimate of long-term growth

Bank of America presented at the Goldman Sachs Bank CEO Conference and was represented by CEO Kenneth Lewis. The presentation highlighted the company's growth opportunities for 2005. Management also discussed BofA's M&A opportunities both in the U.S. and abroad.

BofA did not spend much time discussing its asset/liability management strategy and positions like most of the other banksi n the conference. But as we noted in our recent report on asset/liability management (see Fifth Third's Asset/Liability Flame Out - Who's Next?), BofA seems to have been lessening its exposure to rising rates with its shorter duration swaps book. This tends to mitigate the banks exposures to convexity risk related to MBS and mortgage loans that are generated by its large origination platform. So we believe BofA's stock and bonds are less at risk to the volatility of the interest rate environment and should not show big charges related to its 4Q04 results to be released in January 2005.



Note: Returns Rebased to 100
Source: Bloomberg, CreditSights

CEO Lewis characterized BofA as a "universal bank" in his comments, and the company is focused on growing its contribution from Global Corporate and Investment Banking (GCIB) and

Wealth & Asset Management (WAM) segments. That said, Lewis said he prefers to invest in these businesses rather than acquire.

CEO Lewis opened with a brief overview of BofA's consumer business, which accounts for approximately 50% of the company's income. CEO Lewis emphasized the broad reach of BofA's footprint, noting that the company had "leading market share in 16 of 20 most populous U.S. states." The strategy here seems clear: higher sales and standardized service throughout the footprint. Only 30% of "stores" are performing at excellent levels, so the goal is to learn what these branches are doing and implement best practices everywhere. Bringing legacy Fleet branches to BofA production provides low hanging fruit for improving profitability.

The company disputed that they are trying to get the U.S. deposit cap lifted. CEO Lewis said he believed BofA's franchise was unmatched and that repealing the deposit cap could give its competitors more room to merge. The company also derives nearly 95% of earnings from the U.S. and appears to want more global diversity of earnings rather than increasing its exposure to the U.S. economy.

Global Expansion Attractive, but No Clear Path
CEO Lewis highlighted BofAs strategic partnership with Mexican bank Banco Santander Serfin as the kind of deal they like and would be interested in "another one like that," possibly in Asia. Later, CEO Lewis commented that BofA would prefer investments looking for "low beta" countries with a strong legal infrastructure. CEO Lewis also commented that he prefers businesses that the company "become dominant" in, not just be "global for the sake of being global." **So, it seems that the company would like to expand beyond the U.S. but at this point has not settled on a clear strategic direction.** Lewis notes that one of BofA's core competencies is in executing M&A. But so far the company has only done deals in the U.S. and appears wary of buying banks abroad.

Middle Market: Signs of Life
The commercial bank performance is "accelerating" and has leads in several business lines, including treasury services, asset-based lending and leasing. This segment is more dependent on economic conditions, which appear to be picking up. **CEO Lewis noted that BofA is "now seeing a faster pick up in middle market" than they have seen in the past year. BofA now expects "higher loan growth in 2005 than in 2004."**

GCIB, Asset Management: Build Not Buy
BofA will continue to invest in the GCIB and Wealth & Asset Management. CEO Lewis said the company's goal was to be the "#1 fixed income platform by 2009." The company also wants to strengthen its presence in equities and add to international operations in Asia and Europe. CEO Lewis noted that the probability of an acquisition of an investment bank "like Merrill Lynch" was "very, very low." He cited the reason for this is that investment banks have changed to a more proprietary trading-based business model and that "cultural fit" would be extremely difficult.

As for Wealth Management, CEO Lewis downplayed his interest in acquiring asset management companies, saying that he has become "less enamored" with buying an asset manager. Though BofA might acquire in this area "at the right price", he said current opportunities in this area were "not compelling or strategic." **However, we wonder if CEO Lewis is just talking down his interest for the sake of a lower price. It seems to us that a meaningful asset management presence takes years to build and with the excess capital generated by BofA the temptation to consolidate assets and/or acquire a strong investment track record could be compelling.**

In the absence of large M&A deals in the pipeline, CEO Lewis emphasized that BofA would maintain its "shareholder friendly" capital strategy of returning cash to shareholders through steadily rising dividends and discretionary share repurchases.

Update on Fleet merger

CEO Lewis also provided an update on the Fleet merger, noting that the company had rebranded former Fleet branches in Boston yesterday and would complete rebranding in Rhode Island, New Hampshire, Maine and the rest of Massachusetts later in December. The general ledger and mortgage systems conversions have been completed and the company is on schedule to deliver the promised cost savings. Net new checking accounts have reached 130,000 and net new savings accounts 119,000, above initial projections.

2005 Outlook

BofA promised more specifics in January but did reveal a few aspects of its 2005 outlook. Deposit growth should slow, as consumers redirect excess cash to equity markets rather than parking balances in deposit accounts. A decline in escrow balances will also impact deposit growth. As a result, BofA predicts slower growth in net interest income for 2005, though not a contraction.

BofA projects a moderately good economy and a moderate rise in rates for 2005. The company expects "customer assets to rise," meaning more robust loan growth in 2005 when compared with 2004.

The mortgage volume levels for 4Q04 are roughly similar to 3Q04 levels, so early 2005 results should be roughly in line with current performance, excluding the negative impact of MSR amortization. The fast pace of growth in both home equity and credit card receivables should continue into 2005.

The company expects to deliver positive earnings momentum from "positive operating leverage." BofA's stated goal is an efficiency ratio below 50%, which CEO Lewis believes the company can deliver through expense discipline above and beyond what was promised in relation to the Fleet merger.

Baylor A. Lancaster
blancaster@creditsights.com

David Hendler
dhendler@creditsights.com

Portfolio: ***Banks*** ***Data last updated:*** ***11-Jan-05***

Risk Report Criteria: ***None***

Company Name	Ticker	Industry	Rating Sector	Q	Last Changed	Current CRE	BondScore Rating	Agency Ratings	Notches Difference	Preferred Rating Sector for I-Spread	CRE for I-Spread	Recovery Rate	Market Spread	I-Spread
						Current Data								
Bank of America Corporation	BAC	Commercial Banks	Bank Holding Companies	30-Jun-04	11-Oct-04	0.00021%	A2	Aa2/A+	-2	Bank Holding Companies	0.00021%	49.13%	61	77

	Trend					Past weeks' BondScore CREs -------->										
	CRE Divergence															
	VAD=(CRE-Mean)/Std Dev															
Rich (-) / Cheap (+)	6M Mean CRE	1Y Mean CRE	6M VAD *	1Y VAD *	Change in CRE	Current	-1 wk	-2 wks	-3 wks	-4 wks	-5 wks	-6 wks	-7 wks	-8 wks	-9 wks	-10 wks
-16	0.00017%	0.00015%	1.15	1.52	0.00000	0.00021%	0.00021%	0.00020%	0.00021%	0.00021%	0.00021%	0.00021%	0.00021%	0.00021%	0.00020%	0.00019%

-11 wks	-12 wks	-13 wks	-14 wks	-15 wks	-16 wks	-17 wks	-18 wks	-19 wks	-20 wks	-21 wks	-22 wks	-23 wks	-24 wks	-25 wks	-26 wks	-27 wks
0.00020%	0.00021%	0.00013%	0.00013%	0.00013%	0.00013%	0.00013%	0.00013%	0.00013%	0.00013%	0.00013%	0.00014%	0.00013%	0.00014%	0.00014%	0.00012%	0.00012%

-28 wks	-29 wks	-30 wks	-31 wks	-32 wks	-33 wks	-34 wks	-35 wks	-36 wks	-37 wks	-38 wks	-39 wks	-40 wks	-41 wks	-42 wks	-43 wks	-44 wks
0.00015%	0.00012%	0.00012%	0.00012%	0.00012%	0.00012%	0.00012%	0.00012%	0.00012%	0.00012%	0.00010%	0.00010%	0.00009%				

-45 wks -46 wks -47 wks -48 wks -49 wks -50 wks -51 wks -52 wks

U.S. Bank Outlook 2005, Part I: Rising Rates, Falling Banks?

Date Published: 09 Jan 2005, 22:39

- Interest Rate Risk Management Remains a Key Theme in 2005
- Commercial Loan Growth Rebounds, but Not Gangbusters
- Capital Markets Performance Drives Fee Trends
- Biggest Banks Stand to Benefit, but also have Highest Headline Risk
- Underperfoming Regionals Could be Takeover Bait, Limits Downside
- We Maintain Our Marketweight on the Bank Sector

Part 1 of our 2005 U.S. bank outlook reviews the macro industry trends influencing the sector. Tomorrow in Part II, we examine the external factors which affect bank spreads, including rating agency trends, technical factors (bond supply), and M&A activity. In Part III we review more specifically our top "picks and pans" in the U.S. banking sector for bonds and stocks. The hyperlinks below allow our readers to navigate the report more quickly whether in its entirety or to focus in on specific macro trends.

Summary Outlook (back to top)

The year 2004 brought solid performance for financial stocks and bonds (KBW Banks +7%, S&P Financials +9%), roughly in-line with the broader market performance (S&P 500 +9%). **The year was characterized as one of continued industry consolidation, persistent worries about interest rate risk, excellent asset quality, and stagnant revenue growth.**

Towards 2H04, interest rate sensitivity and asset-liability management had moved to top-of-mind for many bankers, as the vagaries of the interest rate environment proved tough for even the savviest ALM practitioners to master. Companies which had trouble managing the volatile interest rate climate included **Fifth Third**, **Morgan Stanley**, **Washington Mutual**, and **JPMorgan Chase**.

Looking into 2005, we foresee a good year for the U.S. banking industry. **We think the main trends will be a growing and more solid return of commercial loan growth, a challenging interest rate environment, and positive momentum in high margin investment banking and equity capital markets fees. We view these trends as most beneficial to the largest banks while smaller and less diversified institutions could face greater headwinds. In general, we favor the Big 3 largest banks over the smaller regional banks.**

Overall, we maintain our Marketweight recommendation on the U.S. bank sector as we enter 2005. We base this on the sectors richer relative valuations versus other corporate sectors. Also, many of the negative drivers (interest rate, emerging consumer credit quality), should be mitigated by positive drivers (M&A activity, commercial loan growth, high margin investment banking fees, investment management and brokerage related fees).

Asset-Liability Management Key Risk Factor for 2005

The yield curve entered 2005 near its flattest levels for the year, leading to our view that the asset-liability story could continue to be a headline risk for U.S. banks' performance this year. We would not be surprised to see further asset-liability management losses, as some banks find that their rates scenarios and modeling assumptions have not adequately forecasted for the effects of higher interest rates and/or various yield curve slope shapes. Though higher rates could eventually lead to healthier earnings for banks, the transition to a higher interest rate environment is unlikely to be a smooth one.

We believe institutions with the greatest exposure include mortgage-oriented banks and those with a large proportion of MBS holdings. **The impact from ALM missteps is likely to be felt through compression of the net interest margin or via special charges meant to better position companies' balance sheets for higher rates.**

Commercial Loan Growth—Still Not A Big Factor

In terms of the balance sheet growth, **we expect 2005 to bring the long-awaited upturn in corporate loan growth to the mid-to-high single digit range, based on favorable signs of commercial loan demand toward the end of 2004.** For example, 3Q04 was the first time in 13 quarters that the FDIC reported positive commercial loan growth. **However, we are doubtful a positive trend in corporate lending will be strong enough to be enough to prop up earnings for banks, as corporate loans have become a smaller component of banks' loan portfolios.** Instead, heightened exposure to real estate-related lending has become the driver of most banks' loan growth, which we expect will extend into 2005.

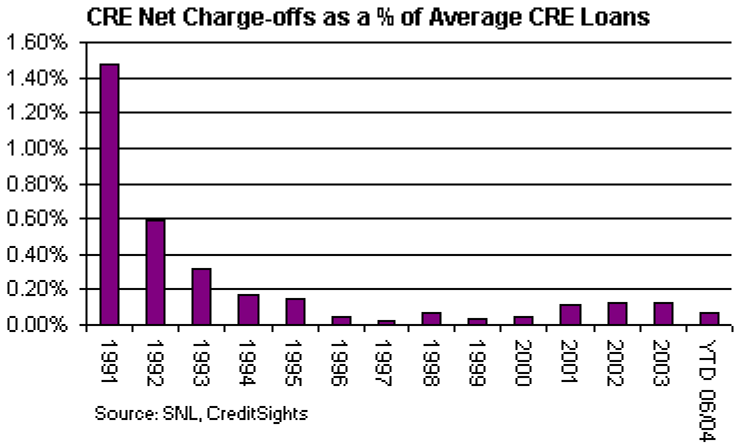
Fee Growth Mix Transitions to High Margin Investment Banking

Fee revenue should pick up momentum in 2005 after a lackluster 2004. However, the growth in deposit-related fees is likely to be weak, as deposit-related fee growth slowed in 2004 and growth in deposit balances could lag in 2005. **So, positive trends in fee growth could be concentrated among banks with larger exposures to capital markets activities.** In the group most positively exposed to higher capital markets conditions, we would include **Citigroup**, **JPMorgan Chase**, **Bank of America**, **Wachovia**, and the processor banks.

Equity underwriting/IPO, and M&A fees should benefit from the late 2004 surge in capital raising activities. Volatility in currencies and commodities should be positive for proprietary trading revenues; more a driver for some brokers but increasingly so for the biggest banks (Citigroup, JP MorganChase, Bank of America). Recent indicators of retail equity trading volumes also show positive momentum. Higher equity market volumes and valuations could lead to higher revenues for the processor banks, which suffered in the lackluster markets of 2004.

Credit Quality Should Turn Gradually For the Worse

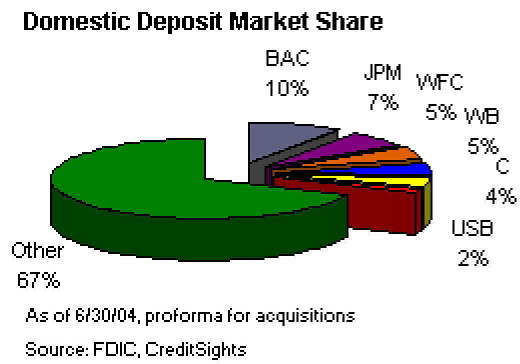
In terms of asset quality, **we expect to see a gradual deterioration in credit quality indicators over the course of the year as we are skeptical that the halcyon days of credit can continue forever. That said, credit quality remains healthy and should weaken only gradually from 2004's strong levels.** In particular, **we believe a deterioration in consumer credit could be on the horizon, as recently originated home equity and consumer loans begin to season. Higher interest rates could pressure carrying costs on commercial real estate (CRE),** leading to higher losses in this notorious sector. However, so far asset quality indicators in CRE remain robust, with charge-offs close to all-time lows reached in 1999.



Even if consumer and commercial real estate loans begin to deteriorate in early 2005, it usually takes several quarters for problem credits to surface as non-performing loans. **Bottom line, we think credit quality problems take a backseat for 1H05, though they could be back on our radar screen by 2H05 and into 2006.**

M&A Outlook: Industry Still Ripe For Consolidation

Given what we see as a **potentially challenging revenue environment for the less capital-markets oriented regional banks, we think bank executives could look to mergers or large share repurchases to goose up earnings**. The potential for M&A seems robust in the U.S. market, which remains remarkably unconsolidated when compared to other mature banking markets in Europe and Canada. Though the national deposit cap places barriers on growth for the very largest banks, this is a hurdle to consolidation in very few cases. Only **Bank of America** has reached the 10% market cap which restricts the company from pursuing additional mergers in the U.S. market. **JPMorgan Chase** (7%), **Wells Fargo** (5%), **Wachovia** (5%), and **Citigroup** (4%), all have substantial room to acquire other banks.



Although M&A activity is usually positive for the ratings and credit strength of banks, a large merger is not without execution risk. The implications of a continued M&A boom for bank equity returns are less clear. The target, of course, enjoys the acquisition premium. For the acquirer, the stock can take an initial hit, but can rebound over time if the merger integration is handled smoothly (e.g. Bank of America following the Fleet announcement). Furthermore, hostile banking acquisitions are extremely difficult to pursue, leading smaller franchises to remain independent for longer than they might in other industries.

In the absence of a merger, a potentially easier road to bolster a bank's total return to shareholders appears to be large share repurchases or dividend increases. We think these tactics could prove irresistible for underperforming franchises in 2005, especially given the likelihood that the Bush tax cuts will remain in force for the next several years at a minimum. **Aggressive capital management policies are less bondholder-friendly if done to excess. Depending on the capital level of the bank usually stock buybacks of 5-7% of outstanding equity capital is tolerated by the rating agencies. From an equity perspective, however, buybacks and dividends are positives. So, depending on an investor's orientation, stock buybacks coud have differing affects on capital structure valuation in 2005.**

Below we drill into these macro themes in more detail to more fully form our 2005 U.S. Bank outlook.

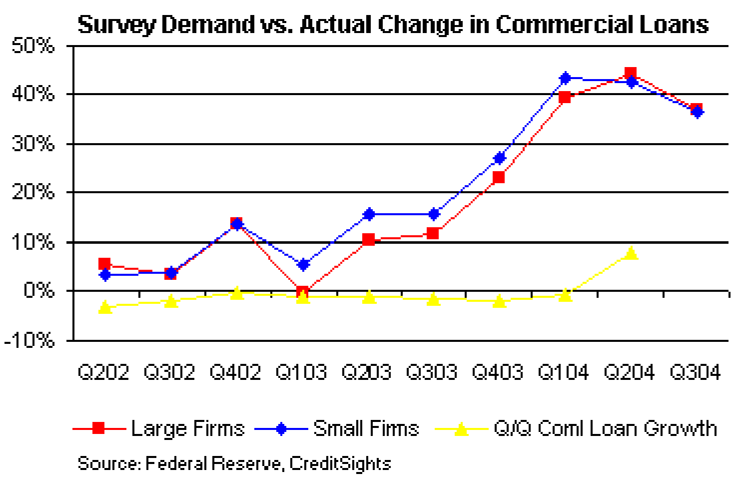
Part I: Bank Fundamental Trends
Commercial Loan Outlook (back to top)

- Commercial loan growth returns in 2005; we forecast growth rates in the mid-to high single digit range
- Key drivers are easing credit standards and pick-up in demand from commercial borrowers
- Development of high yield and securitization markets, better inventory management, and broader access to capital markets by middle market firms keeps commercial growth at lower levels than in past cycles
- Smaller concentrations in C&I lending means a pickup in loan balances is less important driver than in past cycles

We believe commercial loan growth returns in 2005, with our forecast growth rate in the mid-to-high single digit range. We see higher commercial loan growth resulting from a **combination of factors, including a healthy economy, higher M&A activity, and an easing in credit standards.** However, **our forecast rate of commercial loan growth is below prior cyclical peaks.** This is because we think the development of the high yield and securitization markets has moved downstream to more middle market commercial borrowers. Evidence suggests better inventory and working capital management has lessened demand for corporate credit, too.

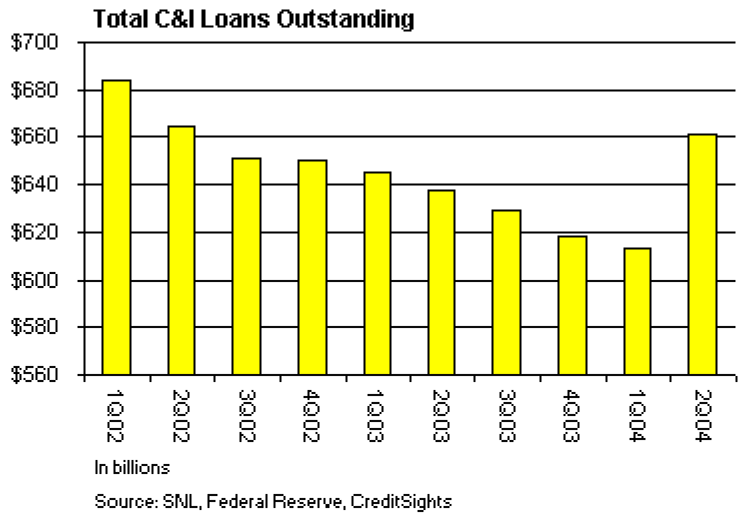
These secular trends should benefit the larger banks with more of a capital markets presence, which derive fees from these high yield/securitization deals at the expense of net interest income. Smaller regionals more dependent on bread-and-butter C&I lending are therefore at a disadvantage. **We also think that even though growth should materialize in C&I lending, it could be a less important earnings drivers since commercial loans have become a smaller component of banks' loan portfolios recently**.

Senior Loan Officers Survey Optimistic
We examined the most recent senior loan officers' survey, which showed the outlook for commercial loans as steadily improving through 2004. **However, a look at the actual trends in commercial loans for the past 8 quarters shows that the senior loan officers' survey has been a more optimistic indicator of commercial loan growth than the actual loan balances.**



For example, improving demand for corporate loans has been cited by the Fed's senior loan officers' survey since July 2003. However, aggregate commercial loan balances did

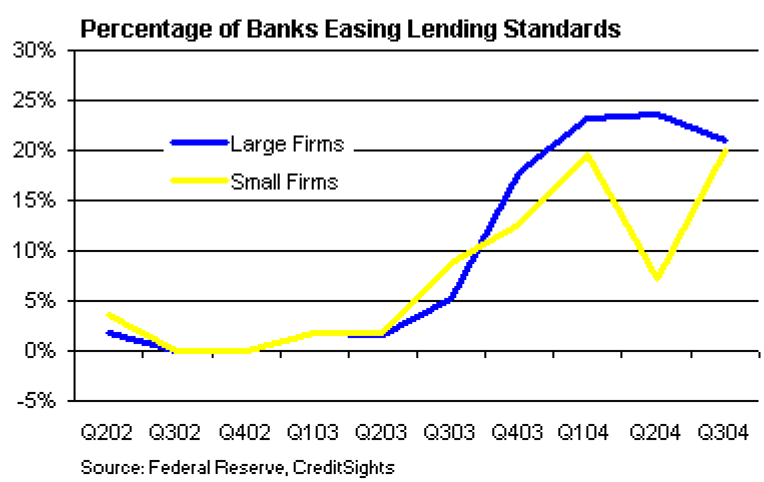
not begin to increase until 2Q04. So, the **survey has been a leading indicator of actual loan growth by nearly 12 months and has been too optimistic in its forecast for strengthening loan demand for the past year.** Several banks, such as **SunTrust** and **Comerica**, have said that they expect lackluster demand for corporate borrowing to continue into 2005. Even, the biggest deposit bank, Bank of America, sees lackluster middle market loan growth and almost no large corporate growth.



Aggregate commercial loan balances finally began to increase after declining for over 3 years with 2Q04 balances of $661 billion, up +8%. **So it appears the optimism of the senior loan officers' survey is at last beginning to filter through to higher loan balances.**

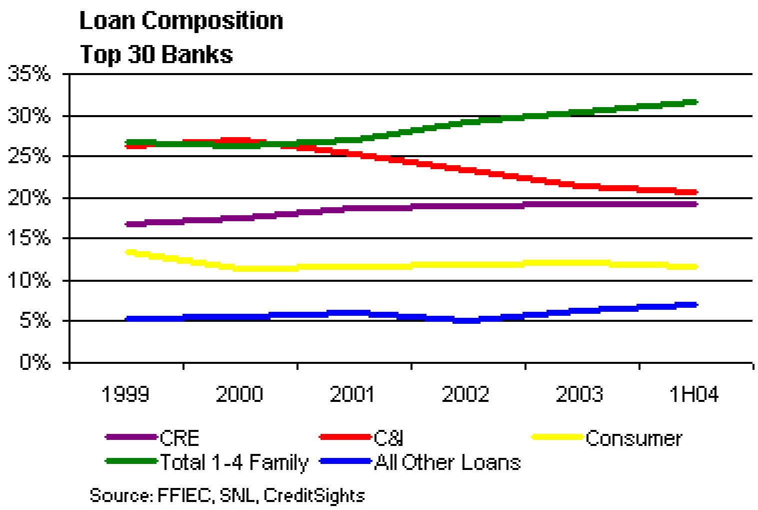
Coincides with Easing Standards

It is notable that the increase in demand for commercial loans coincided with the Senior Loan Officers' report showing that banks had begun to ease credit standards. **So, we suspect that banks have felt pressured to maintain balance sheet growth and replace maturing assets, which has led some of them to turn on the spigot of easy credit.** This easier credit plus an improving economy appears ready to boost corporate loan balances for 2005, although we fear this growth could be at the cost of credit quality metrics down the road.



Commercial Loan Growth Could Lag Prior Recoveries
Though we expect commercial loan growth to kick in, the growth rates may not be as robust as in previous economic cycles. In the 1995-1999 time frame, at the peak of the last corporate borrowing cycle, commercial loans grew by an average of 24% per year. We think a more reasonable growth rate for 2005 could be in the mid-to- high single digit range. **Supporting this view, CEOs of banks with a focus in commercial lending including KeyCorp, National City, and SunTrust have all mentioned the deepening access to the capital markets by middle market firms as a structural change in demand for corporate loans.**

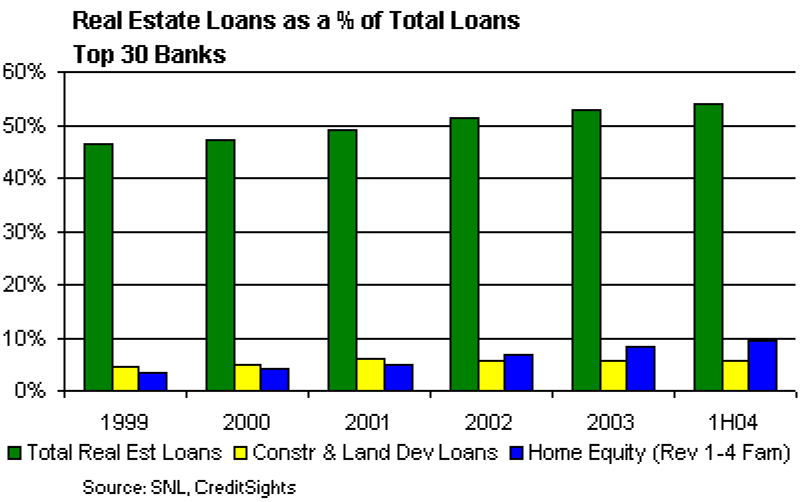
Finally, the importance of corporate lending to large banks has lessened significantly over the past few years. For the Top 30 banks, C&I loans have declined from a high of 27% of their loan portfolio in 2000 to 21% as of 2Q04. So, in 3.5 years C&I loans' contribution to large bank's loan portfolios has declined by 22%. Even if banks were to experience robust growth in their C&I lending for 2005 of 15%+, the contribution of C&I lending to banks' total bank portfolios would remain below their historic highs. **The implication is that even if corporate borrowing does the reappear in 2005, it may not be enough to provide a strong driver to earnings.**



Real Estate Lending Grows: Home Equity Driver (back to top)

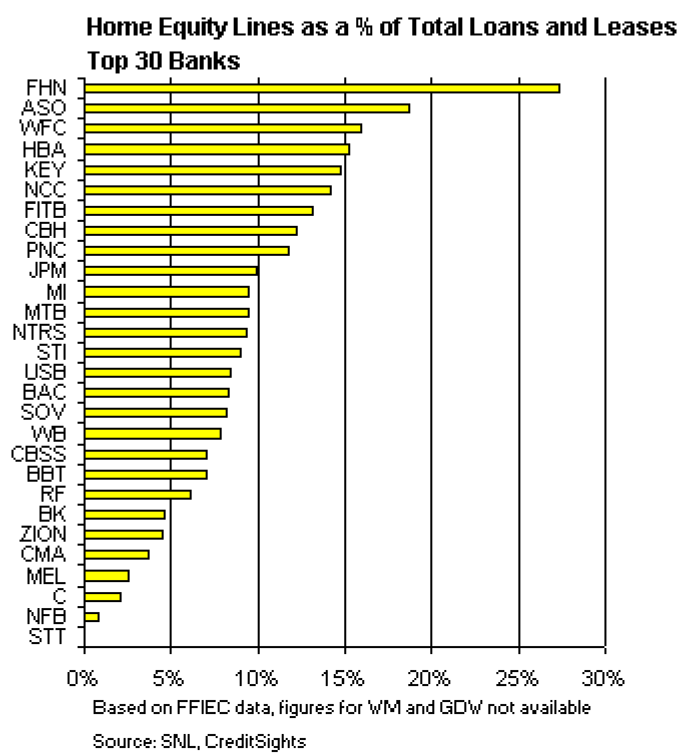
- Home equity loan growth likely to continue
- Low loss rates to rise as portfolios season, but stay manageable
- Hybrid ARMs and other new products are for the most part untested in higher rates
- Regional real estate recessions also a risk factor

The lack of corporate loan demand has led many banks to gorge on real estate-related credit, especially home equity lending. In aggregate, the Top 30 largest banks' exposure to real estate-related assets has increased to 54% of total loans, up from 47% in 1999 (up 7 percentage points, or +15%).



Most of the increase in real-estate related lending can be linked to higher amounts of home equity lines of credit which have increased to nearly 10% of total loans, up from 4% in 1999 (up 6 percentage points, or 159%). The banks for which home equity lending represent the largest portion of their loan portfolios include **First Horizon** (27%), **AmSouth** (19%), **Wells Fargo** (16%), **Huntington** (15%), and **KeyCorp** (15%).

Over the same time this has been partially offset by a decrease in traditional residential mortgage loans held at banks. **Commercial real estate lending, which includes construction and development lending, has increased slightly to 17% of overall loans (up 2% pts, or +13%).**



Home Equity Explosion

We suspect the trend toward higher home equity lending continues into 2005 given favorable supply and demand dynamics. From the supply side, there is a steady supply of banks willing to lend. **Banks utilized a steady stream of new home equity loans to feed balance sheet growth and interest income, and have been attracted by the low loss rates on these loans.**

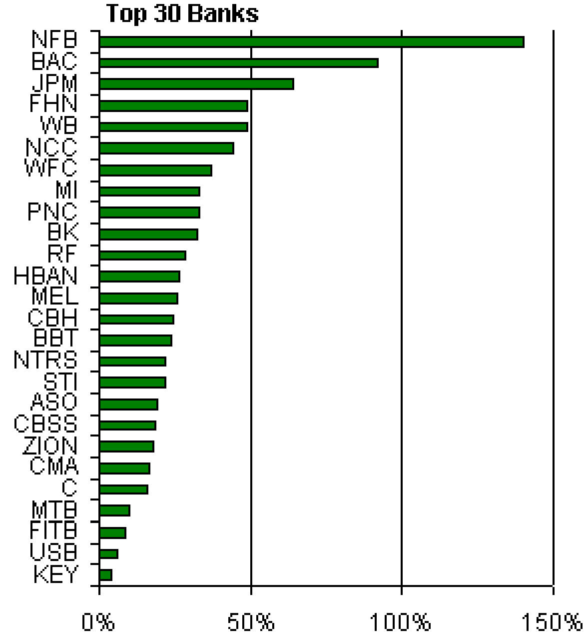
There is also plenty of demand from consumers, for whom the home equity product has moved into favor as they have become savvier in their use of credit. The tax-deductibility of a home equity loan provides an attractive alternative to higher-rate, non-deductible credit card debt. Many banks have begun to issue charge cards linked to home-equity lines of credit, making it even easier for consumers to replace credit card debt with home equity debt. **Rising house prices feed the ability of consumers to increase their home equity borrowing as well.**

Loss Rates Currently Low

For the Top 30 banks, home equity balances increased an average of 33% from the prior year as of 2Q04. The **largest increases in home equity lending were registered** at **North Fork** (+140%), followed by **Bank of America** (+92%), **JPMorgan Chase** (+64%), **First Horizon** (+49%), and **Wachovia** (+49%).

So far, consumers seem to have managed the additional burden of home equity lines and leases as loss rates on these loans remain very low. **From 1991 to 2003, the aggregate loss rate on home equity loans for the Top 30 banks has never been above 27 bp (1991) and was just 16 bp for 2003.**

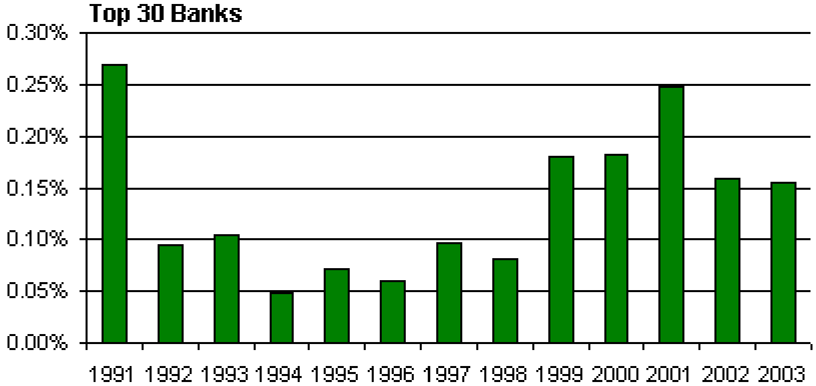
Year-over-Year Change in Home Equity Loans
Top 30 Banks



Based on FFIEC data, some figures not available

Source: SNL, CreditSights

Home Equity Net Charge-Offs as a % of Average Home Equity Loans
Top 30 Banks



Based of FFIEC data, some figures not available

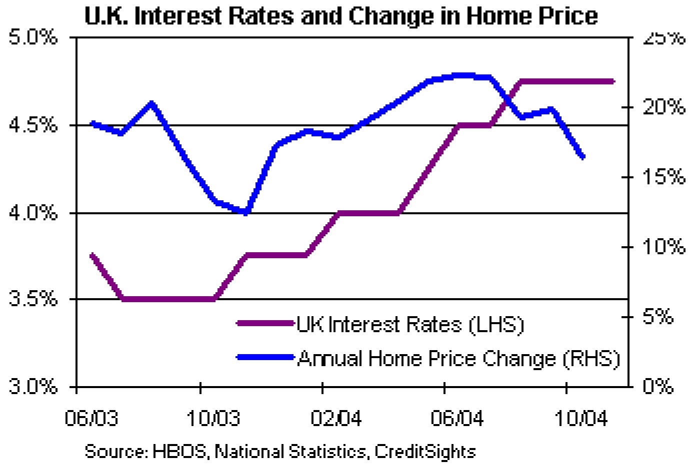
Source: SNL, CreditSights

However, a home equity loan or line of credit is typically in a junior, or subordinated, position to a first mortgage on a house. So, in the case of foreclosure, a bank with a home equity loan is not paid off until after the holder of the first mortgage has been fully satisfied. It is not uncommon for home equity loans to be in the 80-110% loan-to-value range. **So in a real estate recession leading to a general decline in housing prices of 20% or more, many home equity lines would become essentially unsecured.**

U.K. Shows Weaker Home Market as Rates Increase

While there is scant evidence of a slowdown in housing prices so far, rising interest rates often precipitate a weaker housing market. We need only look to the UK to the see the effect of higher rates on housing price appreciation. **The Bank of England began raising rates in late 2003, with rates now 1.25% pts. higher than when the tightening cycle began. It took until July 2004, or an eight month lag for housing price appreciation to slow. A similar timeline for**

the U.S. could lead to a slowdown in U.S. house price appreciation perhaps as early as spring 2005.



Seasoning Could Lead to Higher Losses

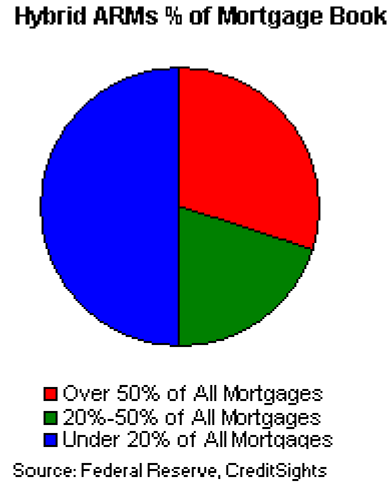
Even in the absence of a large scale decline in housing prices, home equity loss rates are likely to rise. According to FDIC data, the weighted-average age of home equity pools was 16 months as of 2Q04. **The FDIC noted that the peak period for delinquency risk is at 36 months of age, implying that loss rates are likely to go up in the next 12-20 months, as the current vintage of home equity loans age. Continued growth in home equity balances could mask asset quality deterioration for a short period of time, but we expect loss rates to rise eventually.**

The undrawn portion of home equity loans represents a large potential increase in borrowings. As of 2Q04, home equity utilization rates were 49% of available credit according the FDIC data, far less than the 60% utilization rate reached in 1990. **Like corporate borrowers that drew down corporate credit lines in advance of earnings warnings or negative news, we fear at-risk consumers could increase their utilization of home equity lines in advance of defaulting on payments.**

New Products Untested

Finally, a recently published study by the FDIC warns about the growth in new products related to home equity lending. **These products include interest-only loans, renovation loans with borrowing limits based on the value of the house after the project is completed, and loans with limits that automatically adjust upward with the increasing value of the home. Though so far these products have performed well, they remain untested in periods of rising interest rates.** Borrowers on the interest-only products could have difficulty making payments when the introductory period ends. Home values are also more vulnerable to depreciation in higher interest rate environments, which could cause more aggressively underwritten home equity loan products to become unsecured.

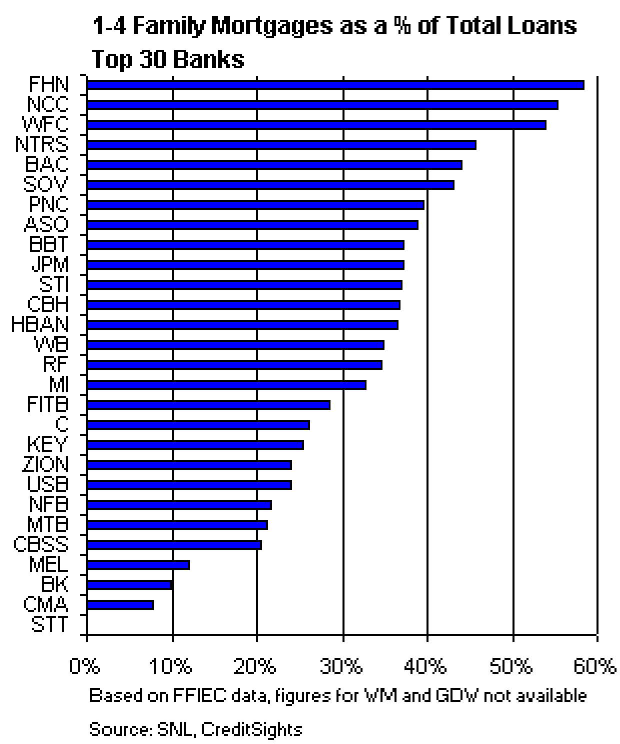
Hybrid ARMs = Hidden Danger?
Another wildcard is the increasing amount of hybrid adjustable–rate mortgages (ARMs) which banks hold on their balance sheets. From the July 2004 Senior Loan Officers' survey, we found that the share of straight ARMs most banks hold is relatively low, with two-thirds of banks responding that traditional ARMs were less than 20% of total mortgages on their books.



Banks have increasingly replaced conventional ARMs with hybrid ARMs, which have become very popular with consumers. These hybrid mortgages represent more than 50% of all mortgages at 30% of the banks surveyed. Hybrids accounted for 20-50% of all mortgages at another 20% of banks. **So, half of banks have over 20% of their mortgages in hybrid ARMs.**

Because many of these ARMs have been originated in the most recent re-fi boom, many of them are not set to re-price for several years. **These hybrid ARM loans could be more vulnerable to default than traditional ARMs in a rising rate environment, as marginal borrowers may not be able to handle the sudden increase in payments on their mortgages once the fixed payment period ends**.

Another possible danger with hybrid ARMs is the potential for their negative impact on banks' net interest margin. About 40% of hybrid ARMs re-price between 3-5 years from now, and an additional 18% of hybrids re-price beyond 5 years. Altogether, this means that close to 60% of hybrid ARMs have the essential characteristics of a fixed-rate mortgage for the next 3 years, although often at a lower spread than the bank would earn from an identical fixed rate mortgage.



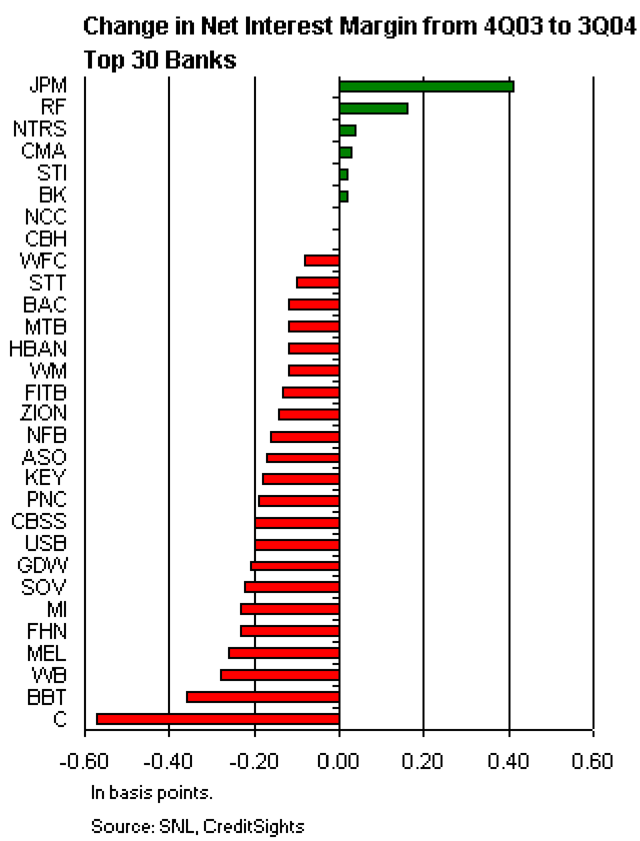
In a period of steadily rising rates, there is no advantage for the customers to refinance these loans, so they are less likely to be prepaid. **Banks' holding these hybrids could experience steady erosion of the net interest spread associated with these loans, unless they match-funded these ARMs as they were originated. Given that we expect interest rates to rise for most of 2005, we could see spread compression at those banks which are relatively more exposed to mortgage lending, as many of these are likely to be ARMs.**

Net Interest Margin: Offsetting Trends (back to top)

- Transition to Higher Rates Not Without Hiccups
- Flatter Curve, Breaking the Carry Trade Habit Could Hurt Margins
- Asset Sensitive Banks Should Enjoy Higher NIM over Time
- Those with High Proportion of Non-interest Bearing Deposits Stand to Benefit

Fed-Inspired Backdrop - Rising Rates
The Fed began its long-awaited interest rate tightening cycle in June 2004, bringing up short term rates significantly (+125 bp) by the end of the year. Though short term rates moved higher, the long end of the curve did not respond in lock-step, causing the yield curve to flatten significantly.

Balance Sheet Positioning - Not As Favorable As Predicted
The flattening of the yield curve led to net interest margin compression for most banks. This was despite their assertions in early 2004 that their balance sheets had become more asset-sensitive. **Only 6 of the Top 30 largest U.S. banks had a higher net interest margin for 3Q04 compared to the last quarter of 2003.** Two of these, **JPMorgan Chase** and **Regions Financial**, benefited by merging with banks that had a higher net interest margin (Bank One and Union Planters, respectively). In the end, the flattening of the yield curve seemed to have a greater impact on banks' net interest margins than even the increase in interest rates. **The difference in actual results as compared to forecasted asset-sensitivity also highlight the vulnerability of interest-rate modeling scenarios to the assumptions embedded in the models, and the limited usefulness of banks' disclosure of their interest rate risk profile.**

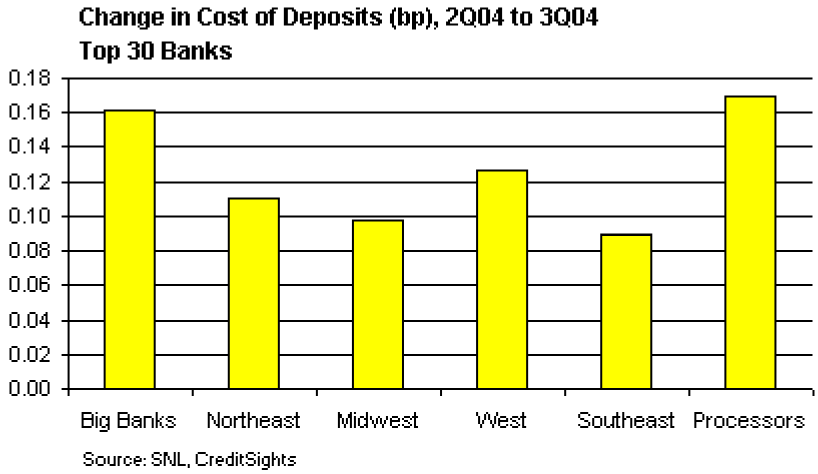


For 2005, net interest margin trends are likely to be a tug-of-war between the positive impact of higher rates and the negative effects of a flatter yield curve. The Fed cycle of higher rates in 2004 came too late for meaningful increases in the net interest margin to filter through most banks' balance sheets. Once started, the pace of future Fed increases was steady and appears likely to continue into 2005.

Ability to Lag Deposits Matters
Given that banks responded to the first two fed rate increases by lagging deposit rate increases behind Fed moves, the outlook for banks' net interest margin going into 2005 could be healthier. **Anecdotal evidence suggests that there has been some divergence in the ability of banks to lag deposit rates depending on the area of the country they are in.** At a recent conference, SunTrust's CEO said banks in the Southeast had been able lag deposit rates significantly, while in the Midwest banks have had to be more aggressive. For instance, **SunTrust** said that it had passed on just 25-30 bp of the 100 bp rise in short term rates to depositors. On

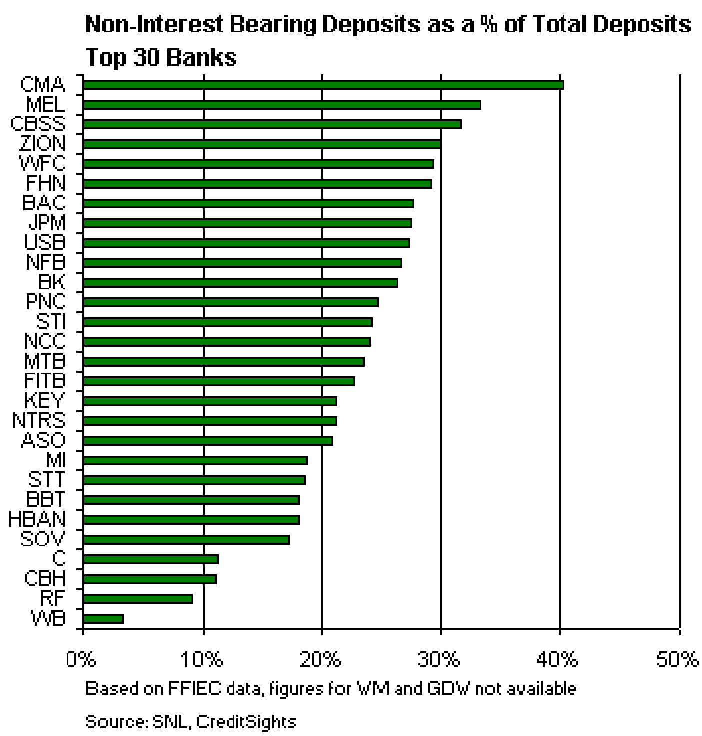
the other hand, one Midwestern bank, **National City** has touted its strategy to "aggressively" increase deposit rates in line with Fed increases in order to attract and retain customers. Meanwhile, **Huntington Bancshares** blamed higher deposit rates for its inability to increase its margin.

We looked at the change in cost of deposits from 2Q04 to 3Q04 to see if this was true. One quarter's change is certainly not enough to draw a trendline, but the evidence did show that the Southeast banks cost of deposits did increase less than Midwest banks as a group, though not by much. The big banks and processor banks has the highest jump in cost of deposits, reflecting their greater reliance on wholesale funding.



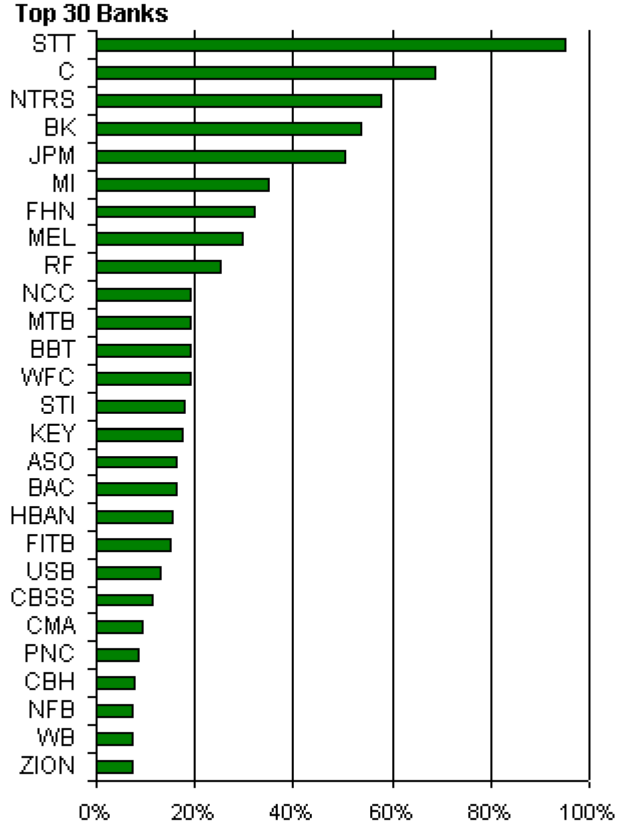
Non-Interest Bearing Deposits Have More Value As Rates Move Up

The benefit of non-interest bearing deposits also increases in a higher rate environment. So we expect those banks with a high percentage of non-interest bearing deposits could benefit from a higher net interest margin in 2005. **Comerica** (40%), **Mellon** (33%), **Compass** (32%), **Zions** (30%), **Wells Fargo** (29%), **First Horizon** (29%), **Bank of America** (28%), **JPMorgan Chase** (27%), and **U.S. Bancorp** (27%) each had over 25% of their total deposits in non-interest bearing deposits at 2Q04. A good chunk of the non-interest bearing deposits at Wells Fargo, First Horizon, and JPMorgan Chase are related to escrow balances as part of their mortgage operations. At the other banks, however, the value of low cost deposits could benefit their net interest margin for 2005.



On the other side of the coin, banks with a higher percentage of foreign deposits and jumbo CDs for their deposit base could have more trouble benefiting from higher interest rates. Predictably, many of the large banks and the processor banks dominate the list of banks reliant on non-core funding, including **State Street**, **Citigroup**, **Northern Trust, Bank of New York**, and **JPMorgan Chase**. Some regional banks which appear surprisingly high on the list include **Marshall & Ilsley**, **First Horizon**, **Regions**, and **National City**.

Jumbo Time and Foreign Deposits as a % of Total Deposits
Top 30 Banks



Based on FFIEC data, figures for WM, GDW, and SOV not available

Source: SNL, CreditSights

Flatter Curve Usually Hurts

The counterbalance to the argument of an improving net interest margin from higher rates is the shape of yield curve. A significant further flattening of the curve could put a damper on the benefits of higher rates. At the beginning of 2004, the 2Y/10Y spread was 234 bp, but had dropped to 114 bp by end of December 2004.

We took a look back at past periods of Fed rate increases to see how much flatter the curve might get. From Dec. 1993 to February 1995, the Fed raised rates by 3.00% pts. to 6.00%. During that time, the 2Y/10Y spread narrowed from 159 bp to 30 bp (-129 bp). In 1999-2000, when the Fed raised rates by 150 bp over 11 months, the yield curve became inverted. In that period, the 2Y/10Y spread fell from 20 bp to -48 bp (-68 bp). So, it would not be surprising if the 2Y/10Y flattened additionally in 2005. We expect the 2Y/10Y yield curve slope to continue to flatten through 100 bp and possibly test the lows of the 1993-1995 time period when inflation was low.

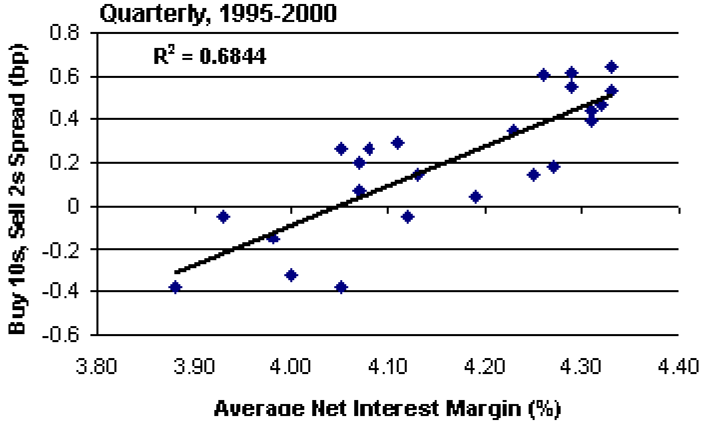
Some banks have already begun to blame the flattening of the yield curve for additional margin pressure expected in 2005. For example, in **SunTrust**'s 3Q04 conference call, the company said that it expected its 2005 net interest margin to be "flattish" compared with 2004, as a result of the company's forecast of flatter curve. Other banks that have complained include **U.S. Bancorp**, and **Fifth Third** which took a large charge in December and revised down their EPS guidance.

Yield Curve Slope vs. Net Interest Margin

We tested the sensitivity of the net interest margin to yield curve shapes by running a regression comparing the difference in the 2Y/10Y slope of the yield curve to margins. Our sample included quarterly net interest margin data from the FDIC for the 15 year period from 1989-2004. We compared this to the average quarterly spread between the 2Y/10Y treasury curve to see what happened in periods of a flatter or steeper curves. We used a 2-quarter lagged net interest margin to properly capture the gradual nature by which bank balance sheets adjust to higher rates.

We found that there seemed to be stronger correlation between the yield curve and the net interest margin in periods of rising rates. This seems to be the kind of period we are in now. For instance, in the period of 1995-2000, banks' net interest margins were 68% correlated (R^2 = 0.6844) to the slope of the curve. For the 1989-1995, period, this correlation decreased to 11% (R^2 = 0.1117). By the 2000-2004 period, the correlation dropped to 0% (R^2 = 0.0022). **So, in a rising rate environment, it appears that banks' net interest margins are more explained by the slope of the yield curve.**

Yield Curve Slope Correlation to Net Interest Margin
Quarterly, 1995-2000



Net interest margin is lagged 2 quarters

Source: FDIC, Bloomberg, CreditSights

The data could also indicate that, over time, banks net interest margins have become less dependent on the steepness of the yield curve over time. So, banks may have become more proactive in protecting their net interest margin regardless of the shape of the yield curve. **We think this highlights the importance of asset-liability management as a core competency of banks.** This ability to manage and respond to various interest rate climates is one that has not been fully recognized and rewarded by the market.

ALM Risk Not Well Disclosed By Banks

In several recent articles, we have reviewed the interest rate risk disclosures given by banks and tried to identify those with elevated exposures to interest rate risks (see: **Fifth Third's Asset/Liability Flame Out - Who's Next?**, **U.S. Banks Capital Structure: Asset/Liability Remains a Puzzle**). **As we note in our reports, the frequency and robustness of interest rate risk disclosure varies widely among banks. Almost none of the interest rate modeling scenarios forecasted by these banks impacts net interest income +/-5% on an annualized basis.** However, what we saw in the case of Fifth Third was that investment securities losses, swap termination charges, and FHLB prepayment fees can have a much larger impact on earnings than predicted by the company's disclosures.

Inadequate or Mis-Constructed ALM Strategies Could Drive M&A

We would argue that these charges are part-and-parcel of the interest rate risk management function. In essence, these charges represent management's decision to take a one-time hit to earnings, rather than experience a slow bleed of the net interest margin as a result of higher rates. If severe enough, some regional banks which experience asset-liability missteps could be forced into the arms of suitors.

Use of Derivatives Also Has an Impact

Banks employ a wide range of interest rate derivatives to manage their sensitivity to rates and volatile mortgage servicing right (MSR) assets. Disclosure on hedging practices is limited and it can be difficult to untangle the underlying core hedging activities from more aggressive interest rate or yield curve bets. That said, we examined how much of banks' net interest income is derived from derivatives to get a sense of the relative importance of derivatives to each bank's overall net interest income stream.

Spread Income From Derivatives Rank (% of 9M04 NI)	Company	9M04 (000s)	%FY03 Net Income	%9M04 Net Income
1	Comerica	$223,490	56%	41%
2	KeyCorp	$114,317	20%	15%
3	Wells Fargo	$782,000	27%	15%
4	U.S. Bancorp	$421,153	15%	14%
5	Mellon	$73,855	14%	12%
6	Wachovia	$446,000	20%	12%
7	PNC	$60,747	13%	7%
8	AmSouth	$28,826	6%	6%
9	JPMorgan	$330,000	33%	6%
10	BB&T	$330,000	7%	6%
11	Huntington	$18,254	15%	5%
12	Regions Financial	$21,852	7%	4%
13	Citigroup	$215,000	4%	1%
14	Fifth Third	$15,524	3%	1%
15	State Street	$11,444	0%	1%
16	National City	$7,028	-2%	0%
17	Bank of America	$29,944	14%	0%
18	Bank of New York	$660	0%	0%
19	Northern Trust	($6,658)	-1%	-2%
20	SunTrust	($35,955)	-4%	-3%

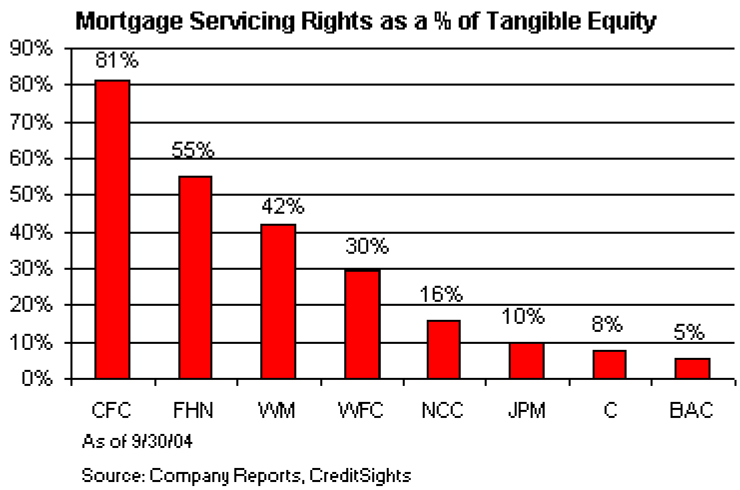
Source: FFIEC, CreditSights

Of these, the banks who get the highest percentage of their net income from derivatives are **Comerica**, **KeyCorp**, **Wells Fargo**, **U.S. Bancorp**, **Mellon**, and **Wachovia**. At the top Comerica got over 40% of net income from derivatives in the first 9M04. The other three banks derived over 14%-15% of 9M04 earnings from derivatives. These amounts are above our level of concern, which begins to kick in around 10% of earnings. Somewhat more positively, most banks have seen a decline in their overall dependence on derivatives swaps income as compared to year-end 2003 levels.

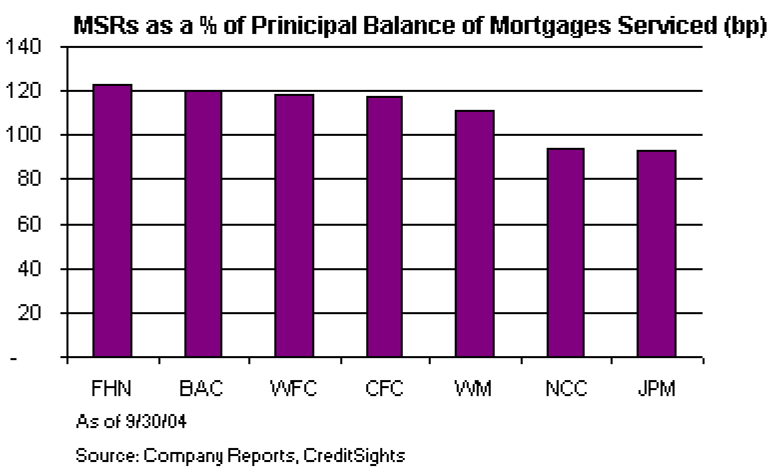
MSR Hedging Also Tricky

We note that mortgage servicing rights (MSRs) can be a volatile and tricky asset to hedge. The largest mortgage industry players tout the value of having MSR asset, which in a rising rate environment is believed to act as a "natural hedge" to offset declines in mortgage originations. However, as we have seen with Washington Mutual and First Horizon, the valuation of MSRs rarely moves in perfect tandem with mortgage originations, which can lead to volatile earnings results. Proper hedging can mitigate some of the volatility associated with the MSR, but rarely fully offsets swings in MSR value.

The chart below shows that mortgage servicing assets account for over 50% of tangible equity for both **Countrywide** and **First Horizon**. **Washington Mutual** and **Wells Fargo** are the next largest, with 41% and 30% ratios of the MSR asset to tangible equity.



We also compared the valuation of the MSR asset to the principal value of mortgages serviced. By this calculation, **First Horizon** and **Bank of America** have the highest MSR values while **JPMorgan Chase** and **National City** are the most conservative. **Countrywide** and **Washington Mutual** are in the middle. For **Bank of America** we are less concerned, as the MSR asset represents a small portion of the bank's total capital.



So, we are cautious on mortgage-concentrated banks going into 2005, especially those which have larger MSR assets relative to capital. In this group we would include Washington Mutual, First Horizon, and Wells Fargo.

Investment Portfolio Losses Likely to Widen

We have identified banks with larger percentages of mortgage-backed securities as potentially vulnerable to rising rates as well. This is because rising interest rates typically lead to higher unrealized losses in banks' investment portfolios. We ranked the largest banks by assets and found that **Commerce**, **Mellon**, **Fifth Third**, **AmSouth**, **Bank of New York**, **U.S. Bancorp**, and **Wachovia** all had over 15% of their total assets invested in mortgage-backed securities.

Mortgage Backed Securities, 3Q04		
	% of Total Securities	% of Total Assets
Commerce	92%	**54%**
Mellon	79%	**28%**
Fifth Third	74%	**23%**
AmSouth	94%	**23%**
Bank of New York	84%	**20%**
U.S. Bancorp	93%	**19%**
Wachovia	71%	**16%**
Bank of America	87%	**13%**
PNC	56%	**12%**
Marshall & Ilsley	74%	**11%**
SunTrust	56%	**11%**
State Street	25%	**9%**
Regions	58%	**8%**
Key	92%	**8%**
Comerica	93%	**7%**
Wells Fargo	76%	**6%**
National City	74%	**5%**
Huntington	39%	**5%**
JPMorgan Chase	54%	**4%**
Countrywide	75%	**4%**
BB&T	18%	**3%**
Citigroup	11%	**2%**
Northern Trust	0%	**0%**

Source: FFIEC, Federal Reserve, Company Reports

Most all banks have increased the absolute level of exposure to mortgage-backed securities (MBS) in the past few years in order to generate net interest income. MBS are among the trickiest assets to manage in terms of interest rate and prepayment risk.

Unrealized investment portfolio losses do not flow through net income, but rather get deducted from shareholder's equity, via changes in other comprehensive income (OCI). **As rates move higher, the value of fixed rate paying securities falls. So, losses in the OCI account can show which banks are likely to experience the most pressure on their net interest margins in the next 12 months**.

Changes in OCI can Portend Earnings Trouble

So, we believe the change in OCI can be a valuable indicator of which banks are vulnerable to higher interest rates. In the past, markets have generally been slow to react to changes in the valuation of banks' available-for-sale portfolios, believing the swings in valuation to be largely temporary. The concern is that at some point, temporary impairments transition to permanently underwater losses as interest rates move higher. **The dilemma for bank ALM managers is when and how to realize losses without causing a knee-jerk sell-off in the stock or provoking a reaction from regulators or the rating agencies.**

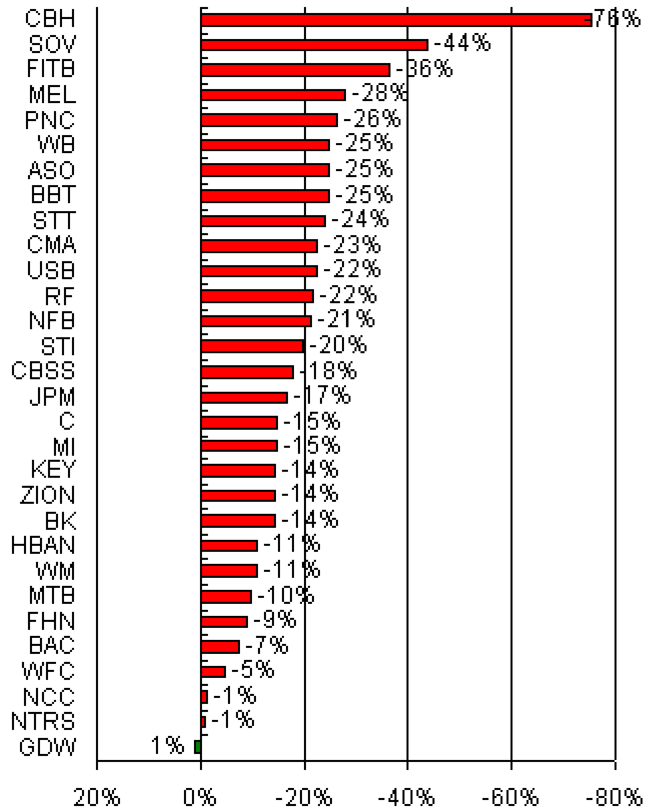
So, we looked at the change in other comprehensive income relative to net income to get a picture of which banks had the most exposure to higher interest rates. We looked at the quarterly change in accumulated other comprehensive loss from 1Q04 to 2Q04, which was a period of rising rates. Then, to measure the relative importance of the change for each company, we compared this to the company's annualized net income.

We found that in general the regional banks had more sensitivity to this metric compared to the bigger banks. Banks with relatively high changes in accumulated OCI relative to net income from 1Q04 to 2Q04 included **Commerce Bancorp**, **Sovereign**, **Fifth Third**, **Mellon**, **PNC Financial**, **Wachovia**, and **AmSouth**.

Due to Fifth Third's balance sheet restructuring announced in 4Q04, we would expect its sensitivity to higher rates to be somewhat lessened going forward. The other banks could remain vulnerable to higher rates.

Those with the lowest sensitivity included **Golden West**, **Northern Trust**, **National City**, **Wells Fargo**, and **Bank of America**. This shows that although the big banks might show large swings in the accumulated OCI account, the significance of this metric relative to the overall earnings power of the largest banks is less important.

Change in AOCI (1Q-2Q04) as a % of Annualized Net Income
Top 30 Banks

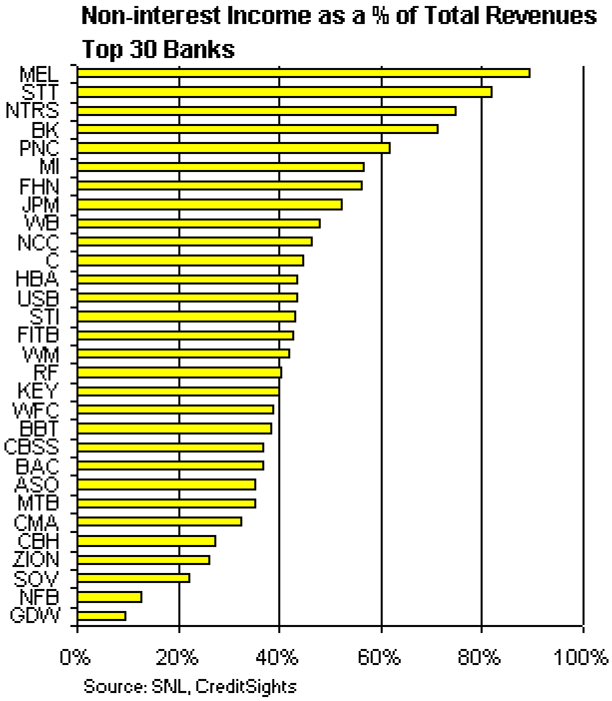


Source: SNL, CreditSights

Can Core Businesses Fill in the Revenues Gap?

Still the overriding question is whether other businesses will pick up the earnings burden as the yield curve carry trade abates. We have written extensively that we do not think it will be an easy transition for many of these banks since their core businesses of lending and fee generating capability is limited.

The processor banks can also be viewed as a relative safe haven from some of the ALM management troubles, as they derive a larger percentage of their net income from non-interest sources than the regional banks, lessening the impact of net interest margin pressure.



Credit Quality Lift Over (back to top)

- Asset quality has likely peaked, but no major deterioration expected in 2005
- Earnings lift from low/no provisioning ending
- Provisions should rise in tandem with loan growth and portfolio seasoning

Credit quality has, for the most part, continued to improve in 2004. That said, **we think the positive leverage from improving credit quality is all but played out.** Our view is that asset quality trends for banks should weaken somewhat going into 2005. **Though there has been no widespread evidence as yet of a sustained weakening in credit quality, the stellar credit metrics posted in 2004 seem destined to erode. In fact, many banks have themselves stated that they do not think that asset quality levels are sustainable.**

We may have already seen the "canaries in the coal mine", as **SunTrust** and **Commerce Bancorp**, banks which are known for strong credit quality, both reported a modest uptick in net charge-offs for 3Q04. In line with our belief that asset quality could begin to deteriorate somewhat in 2005, we believe that the positive support to earnings provided by reserve releases is also on its last legs. **So, we think banks such as Citigroup, JPMorgan, and KeyCorp will have to break the habit of covering up earnings shortfalls with under-provisioning which was present in 2004.**

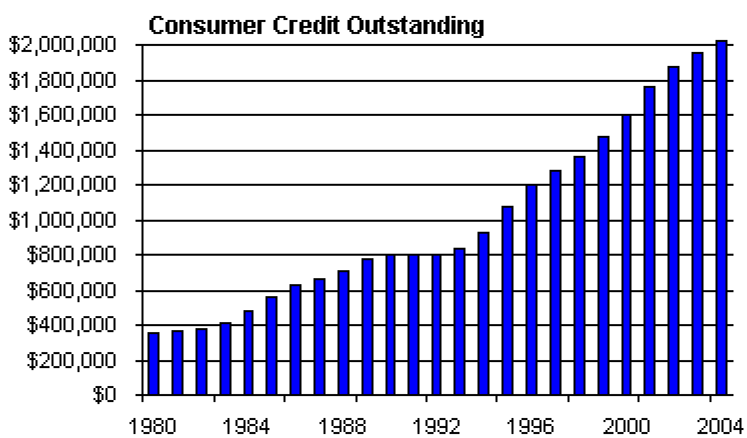
Company Name	9M04 Underprovisioning EPS Impact	9M04 Core EPS	Underprovisioning Impact as % of Core EPS
Citigroup	0.32	2.98	11%
JPMorgan Chase	0.12	1.99	6%
KeyCorp	0.09	1.77	5%
SunTrust	0.17	3.99	4%
Fifth Third	0.08	2.14	4%
Bank of America	0.05	2.45	2%
U.S. Bancorp	0.04	1.65	2%
Wachovia	0.06	3.03	2%
PNC	0.05	2.94	2%
Wells Fargo	0.04	2.97	1%
Comerica	0.04	3.20	1%
Regions	0.02	1.69	1%

Source: SNL, CreditSights

We also forecast provisions to increase as a consequence of higher loan growth, as banks provide for new loan balances. In summary, we see 2005 as a transition year from steadily improving credit quality to one with some deterioration. That said, we sense it could it be 2H05 at the earliest before asset quality problems return as a headline issue.

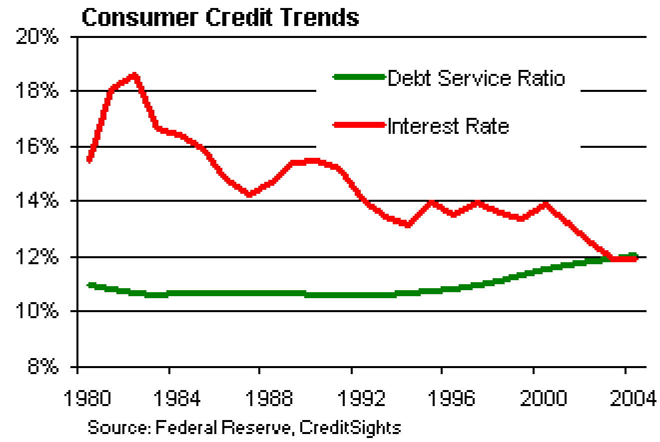
Credit Card Outlook

The consumer borrowing binge so far has not slowed down, as total consumer credit reached all-time highs. Total consumer debt reached over $2.0 trillion as of August 2004.



In millions.
Source: Federal Reserve, CreditSights

We tracked the consumer debt service ratio from 1980 through year-to-date 2004. The consumer debt service ratio reached all-time highs of 13.3% in February 2003. Since that time the ratio has persistently stayed above 13%, well above its long-term average of 11.8%. **This relatively high debt service ratio is even more troubling when viewed in the context of the long-term trend of declining interest rates.** Interest rates for personal loans peaked in 1982 at 18.7% and have declined ever since. By 2004, personal loan rates had dipped to 11.9%. **So, even though rates have been decreasing, the consumer's debt burden has been rising.**



Credit Card Trends
Trends in Spread to Loss

Company	Current	1 Month Prior	3 Months Prior	1-Yr Prior	Rolling Bp Change 1M	1Qtr	1Yr
Capital One	2.13	2.33	2.35	1.72	(20)	(22)	42
American Express	2.05	2.07	1.94	1.65	(2)	11	40
Citigroup	1.69	1.32	1.29	1.13	38	40	56
MBNA	1.57	1.54	1.46	1.49	3	11	8
Bank of America	1.46	1.49	1.55	1.28	(3)	(9)	17
Bank One	1.12	1.27	1.21	0.97	(14)	(9)	15
JPMorgan Chase	1.02	1.12	1.08	1.01	(11)	(6)	1
Discover	0.88	0.97	0.89	0.73	(9)	(0)	15
Household	0.75	0.80	1.18	1.12	(5)	(43)	(37)
Fleet	0.56	0.60	0.55	0.70	(3)	1	(14)
Metris	0.30	0.32	0.30	0.18	(2)	0	12
Average	**1.23**	**1.26**	**1.25**	**1.09**	**(3)**	**(2)**	**14**

Source: Company Reports, Bloomberg

That said, credit spreads as indicated by the credit card master trust data above shows that credit card quality remains strong. The spread over loss rates remains near all-time highs. This has been a consequence of improving credit quality rather than higher rates. The fear is that credit losses could begin to escalate rapidly, as subprime or barely prime consumers are unable to meet higher monthly payments as higher rates take hold.

Indeed, there is growing evidence that consumers with high balances are struggling to repay credit card debt. It seems the card companies have become more aggressive in raising rates, even when consumers continue to make minimum payments. As rates move higher from the lows reached in early 2004, we think the debt service ratio is likely to creep higher. At some point, it seems inevitable that a higher consumer debt burden will translate in higher delinquencies and loss rates for unsecured consumer lending, including credit cards.

Non-Interest Income: Positive Momentum Depends on Capital Markets (back to top)

- Positive fee momentum depends on capital markets trends

- Larger banks with more capital markets presence should benefit
- M&A, IPOs, F/X, and Commodities on track for Strong Performance
- Credit and debit card fees continue to rise

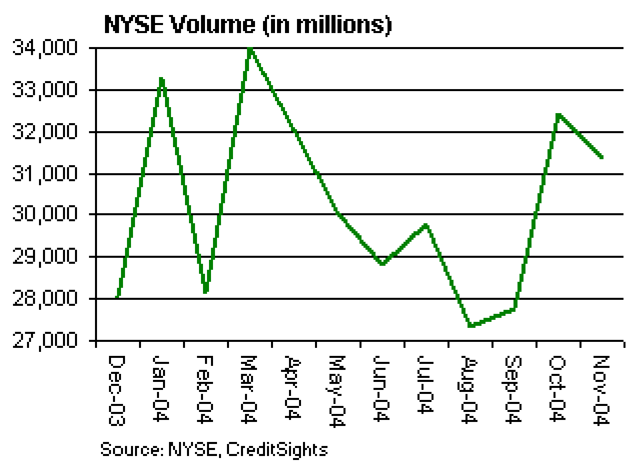
Deposit-related fees continue to be the single largest source of non-interest income for banks. As of 3Q04, service charges on deposits were nearly 26% of total non-interest income, the highest quarterly contribution in 2+ years. The growth in these fees has been steady, and tends to be related to growth in total deposits. However, after double digits increases in 1999-2000, growth in deposit charges slowed to single-digit growth in 2004. We believe that this indicates the inability on the part of banks' to significantly increase deposit fees beyond their current levels as a result of competitive pressures.

As a result, we think positive momentum for non-interest income is more tied to improving high margin capital markets going into 2005. Positive capital markets trends should provide a lift to fee income at the bigger banks which are active in investment banking. Healthy equity markets also provide a lift to equity trading-related volumes and revenues and even trust income, as a result of higher asset valuations.

Highest Exposure to Capital Markets Fees

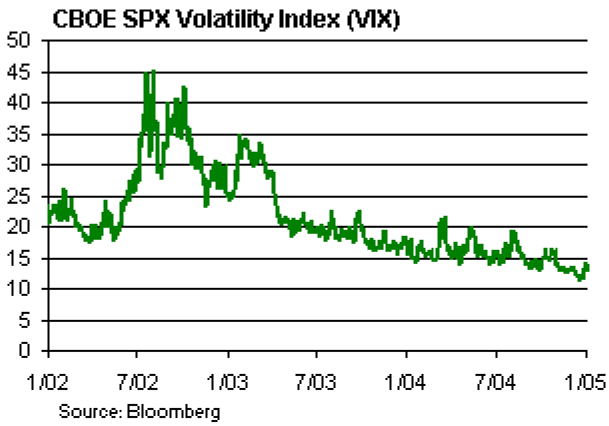
Among the big banks, **JPMorgan Chase** and **Citigroup** have the most upside from improving markets, while **Wells Fargo** and **U.S. Bancorp** are less dependent on capital markets businesses. For most regional banks, trading fees are a relatively small component of non-interest income. That said, some regional banks are move leveraged to positive trading momentum than others. Among these we would single out **Wachovia**, **SunTrust**, and **PNC** as having larger components of market-sensitive revenues compared with most regional banks.

For the first half of the year, equity markets went nowhere, reaching their 2004 lows in the dog days of August. Following the U.S. Presidential election, equity markets finally showed signs of life with the S&P index reaching its highs for the year in December. Also encouraging was the trend in trading volume, which began to ramp up following seasonal lows reached in August 2004. Looking ahead to 2005, the first quarter of the year typically brings healthy equity market activity, as retail investors reallocate their portfolios and make annual IRA contributions in the beginning of the year.



Volatility Still Low

However, the lack of equity market volatility could impede upward progress for trading revenues, as there is typically positive correlation between market volatility and customer demand for hedging products. The trend of the volatility index, VIX, has been on a steady decline since the beginning of 2004, falling 27% for the year. In late December, the VIX hit a low of 11.4 compared to 2002-2003 period when the VIX frequently ranged between 20-40.



Fixed Income Could Slow

The outlook for fixed income trading seems to be less robust. The much-predicted slowdown in 2004 due to rising rates did not materialize, but seems to have been only postponed rather than avoided. The specter of rising rates could make banks and other institutions less active buyers of fixed income investments. **So, banks with a concentration in sales of traditional fixed income products could be vulnerable to a slowdown in activity. This list could include the regional banks such as SunTrust, PNC, and Wachovia who are more developed on the fixed income side compared to their equity activities.**

Investment Banks have Offsetting Factors

However, large investment banks with a wide array of fixed income products could prove to be more resilient in a higher interest rate environment. Investment banks with a traditional strength in fixed income have broadened their franchise to include other products such as ABS, CMBS, credit derivatives, or investment banking should be less affected by a drought in traditional fixed income sales. **Lehman Bothers** is an example of an institution we expect to be less affected by higher interest rates than in past interest rate cycles. Among the banks, **Citigroup** and **JPMorgan Chase** have much less overall exposure relative to earnings than the brokers.

F/X, Commodities Hot

On the other hand, foreign exchange (F/X) rates and commodities prices have moved strongly, fueling demand for related products. Oil and gold both reached multi-year highs in 2004. The F/X market has been characterized by the steady decline in the U.S. dollar against major foreign currencies, including the Euro, Yen, British pound, and Canadian dollar. Institutional broker-dealers, such as **Goldman Sachs** and **Morgan Stanley,** and big banks including **Citigroup and JPMorgan Chase**, and to a lesser extent **Bank of America** should have the highest positive leverage to a rally in F/X and commodity trading.

M&A, IPOs Gaining Strength

While not yet a return to the go-go days of the late 1990s, 2004 saw a slow build of momentum in M&A and IPO activity. The performance of IPOs measured from 1998 to 2005 by the BIPO index has shown a positive trend since the lows reached in dot-com bust of 2001-02.

An analysis of the deal pipeline also demonstrated improvement from the 2003 lows. We think the positive trend could spill over into 2005, as improving equity markets make the marginal M&A deal or IPO more likely to get to market. Here again, the usual suspects such as **Citigroup**, **Morgan Stanley**, **Goldman Sachs**, **Merrill Lynch**, **JPMorgan Chase**, and **Lehman Brothers** stand to benefit the most from hotter M&A markets.

U.S. IPO Pipeline

	1998	1999	2000	2001	2002	2003	2004
Announced	458	675	708	129	230	233	432
Priced	438	572	444	101	170	151	314
Upcoming	-	-	-	-	-	-	3

M&A Volume ($ in millions)

	2000	2001	2002	2003	2004
Global	2,948,782	1,588,711	1,130,294	1,224,213	2,010,938
U.S.	1,751,192	853,713	528,524	631,842	1,017,979

2000 M&A volume annualized based on 6/00-12/00

Source: Bloomberg

Credit Card Issuers: Fees Continue to Grow

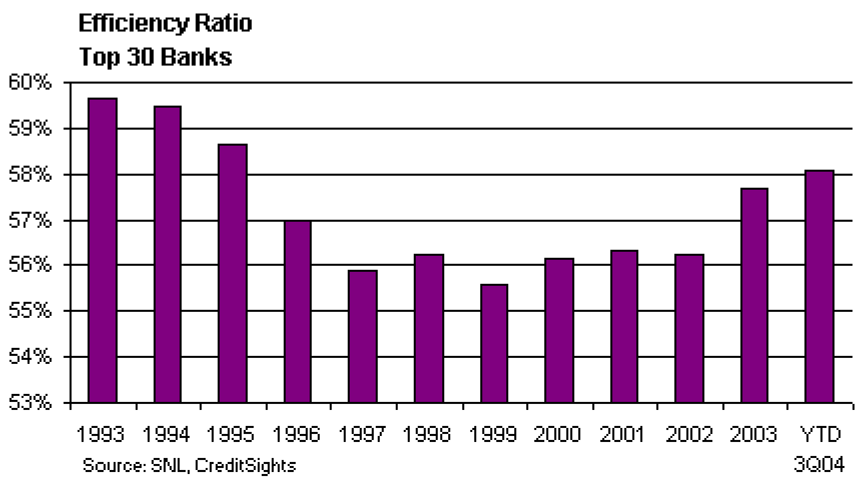
We also note that large credit card issuers have hiked fees and interest rates for a number of consumers. Fees which have increased in the past 2-3 years include late fees, telephone payment fees, and other fees. While the preponderance of credit card fees is positive from non-interest income standpoint, we think the aggressive application of some fees could invite regulatory scrutiny (see below: Expense Trends).

Overall, we think the outlook for non-interest income for 2005 is healthy. The comparisons from a lackluster 2004 should be relatively easy, assuming positive contribution from the high margin investment banking and capital markets fees, as higher equity markets support both asset valuations and capital-raising activities. F/X and commodities trading are likely to remain strong given the high volatility in these markets of late. **Fixed income could be weaker, although we are not expecting a precipitous drop, as structured products soften the blow from declines in plain-vanilla fixed income products.**

Expense Trends: Moving Higher **(back to top)**

- Non-interest expenses remain stubbornly high, especially in compliance, legal, marketing
- Gains in efficiency ratio elusive, dependent on revenue growth
- Big banks should have advantage on expenses, but also higher "headline" risk

Our review of non-interest expenses for the largest banks indicates that long-term efficiency gains have been elusive as the benefits from non-interest revenues wained in the past few years. We examined the aggregate efficiency ratios for the the Top 30 banks over the past decade. After bottoming out in 1999 at 55.5%, the efficiency ratio for large banks has been deteriorating ever since. By the 3Q04, the average efficiency ratio had crept back to over 58%, mostly as capital markets, brokerage, other market related revenues dried up.



Escalating Compliance Costs
One area in which banks are facing higher non-interest expenses is in relation to compliance costs. Escalating audit expenses and the introduction of Sarbanes-Oxley has greatly increased compliance expenses for banks, which were already among the most highly regulated companies.

Regulatory Penalty Box
Banking regulators also seemed to have taken a more activist role recently, and many financial institutions have been under placed under regulatory oversight or forced to beef up compliance procedures recently. Banks which have faced regulatory scrutiny within the past few years include **PNC**, **Fifth Third**, **Huntington**, and **Capital One**. Banks subject to pending investigations or heightened regulatory supervision include **AmSouth**, **Bank of New York**, **Huntington**, and **SunTrust**. Below, we review the status of the currently pending investigations.

AmSouth is currently under a Cease and Desist order from the Federal Reserve related to deficiencies in its compliance function related to the company's suspicious activities reporting. The company has agreed to improve training and compliance functions. Until the company is in "substantial compliance" with the requirements of the Cease and Desist order, the Fed has restricted AmSouth's expansion activities. The company has been forced to halt its *de novo* branching plans for the time being.

Bank of New York is in negotiations with U.S. prosecutors to avoid a possible criminal indictment on charges of failing to report possible money laundering in one of its branches. The bank failed to report suspicious activities in the bank's relationship with a Long Island, NY based medical equipment leasing firm, which caught the attention of the U.S. Attorney for the Eastern District of

New York. Bank of New York is also the subject of a regulatory investigation focused on its Pershing LLC clearing division. According to the company, the focus of the investigation is related to possible market-timing trades cleared by Pershing for Mutuals.com.

Huntington announced in November 2004 that it had entered a formal supervisory agreement with its primary regulators, the Federal Reserve and the OCC. The agreement requires Huntington to submit a comprehensive plan regarding financial reporting controls and policies, and corporate governance practices. The company is also subject to an ongoing SEC investigation regarding its accounting for auto leases. As a result of the investigations, Huntington has extended the timing of its planned merger with Unizan by one year to January 2006.

SunTrust is subject to an informal SEC inquiry related to its loan loss allowance affair. The company has been in trouble in the past with the SEC for its overly conservative reserving practices. SunTrust may also receive an "adverse attestation" from its auditors related to the company's compliance with the Sarbanes-Oxley Act. The Act requires the company's Auditors to attest to the effectiveness of SunTrust's internal control structure.

Legal, Headline Risk Lingers

The efficiency ratio includes all non-interest expenses, and so encompasses legal settlement charges. Banks including **Citigroup** and **JPMorgan Chase** have taken big bath multi-billion dollar charges for legal and settlement costs related to WorldCom, Enron, and other high profile corporate blow-ups. While the settlement charges taken in 2004 were meant to cover reasonable estimates of legal costs, we note that the banks did not take reserves for pending matters such as Parmalat. **Banks including Bank of America and Citigroup have potential legal exposure to Parmalat, which could lead to additional charges**.

Credit Card Tactics Could Come Under Regulatory Review

We also are concerned with aggressive tactics by large credit card issuers which have begun to hike fees and interest rates for a number of consumers, even before they have missed a payment. Anecdotal evidence suggests low rates are quickly ratcheted up for consumers who have as little as one late payment on a credit card or on another bill.

Gift card issuance, which is the fastest growing sector of cards behind debit, also seems to be attracting more scrutiny. Many bank-issued gift cards have hidden fees, such as non-usage fees which sap the value of the cards if they are not utilized within a specified time frame (usually 6 months).

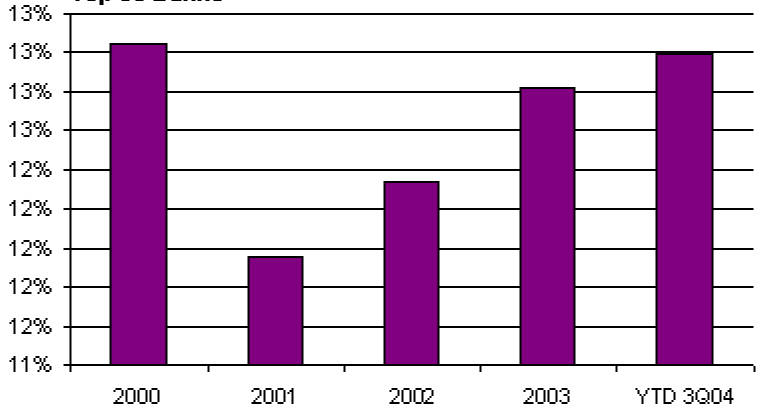
While high credit and gift card fees are positive for short run profitability, we are concerned that aggressive fee tactics could eventually invite regulatory or legislative scrutiny. Time and again, we have seen that fees which seem too aggressive can arouse the ire of consumers, lawyers, and even politicians. Practices which are deemed unfair to consumers or are not adequately disclosed can be ripe for investigation, such as in the Spitzer investigation of the asset management and insurance industries. Even if the fees are not found to be illegal, the bad publicity from these types of hidden charges can run the risk of alienating customers.

Marketing, Tech Expenses Stay High

Finally, discretionary expenses such as marketing and technology costs could remain elevated in 2005, continuing an upward trend which has been in place since 2001.

Fixed costs, which include occupancy and equipment costs, climbed to around 13% of total non-interest expenses for 2004. Banks that have postponed technology projects may now have to spend to modernize outdated systems and processes. Also, mergers can prompt managers to contemplate technology overhauls and systems conversions, as the bank outgrows its former operating platform.

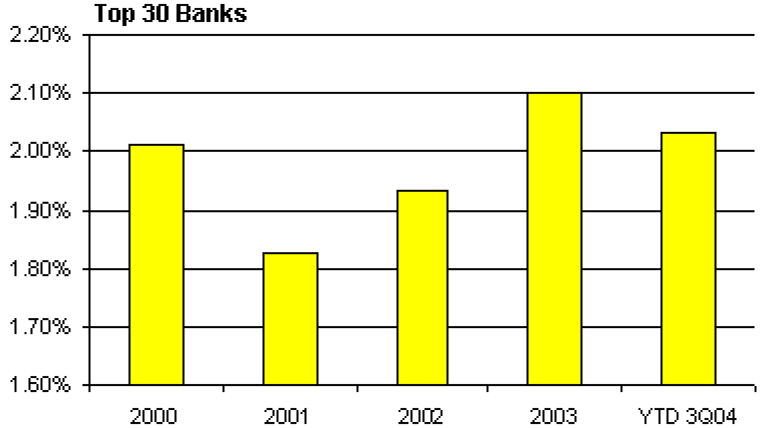
Occupancy and Equipment Costs as a % of Total Expenses Top 30 Banks



Source: SNL, CreditSights

Marketing expenses could stay elevated as well. One driver of marketing costs is the large number of banks which have large-scale merger integrations in 2005. These typically call for re-branding campaigns as the surviving bank brand is introduced to customers in the target's footprint. Banks which plan to migrate to one brand as the result of mergers include JPMorgan Chase in former Bank One territory, Regions' integration with Union Planters, North Fork/GreenPoint, and Wachovia/SouthTrust. Marketing campaigns can also help to attract new customers to new branches, many of which have been built in the past 2 years.

Marketing Costs as a % of Total Expenses Top 30 Banks



Source: SNL, CreditSights

In all, we think the trend toward higher non-interest expenses is firmly intact. Efficiency ratios could benefit if revenue growth rebounds in 2005, but we think the positive operating leverage banks achieved from cost-cutting in the mid-1990s has been largely exhausted. **So, the only way to cut costs further seems to be through continued industry consolidation, which we believe will be a long term secular trend for the banking sector.**

Conclusion (back to top)

- Interest Rate Risk Management Remains a Key Theme in 2005
- Commercial Loan Growth Rebounds, but Not Gangbusters
- Capital Markets Performance Drives Fee Trends
- Biggest Banks Stand to Benefit, but also have Highest Headline Risk

- Underperfoming Regionals Could be Takeover Bait, Limits Downside

So, what are they key take-aways from our review of bank fundamentals? Commercial loan growth should finally become a net positive after three years+ of acting as a drag on banks' loan portfolios. Consumer loan growth should remain strong, although we think the more aggressive players are sowing the seeds for some type of future asset quality deterioration.

The impact of higher rates is a key variable, leading to divergent trends in the net interest margin. Those who have we have identified as being vulnerable to interest rate moves could feel the most pressure, while banks who have been more conservative or are less dependent on net interest income could fare better.

Non-interest income has potential for positive contribution relative to 2004. Equity valuations have steadied. Capital markets activity, as measured by IPO pipelines and M&A activity have rebounded. Trading activity in currencies and commodities should benefit from ongoing volatility. Expense trends are elevated, reflecting increased regulatory burden, compliance costs, branch expansion, marketing, and technology budgets.

The primary beneficiaries of the 2005 trends appears to be the very largest banks, such as Citigroup, JPMorgan Chase, Bank of America, and Wachovia. In general, larger banks' net income is less dependent on net interest income and more fee-based. They also tend to have more robust ALM capabilities to manage their interest rate sensitivity position. So, shifts in the yield curve could have less of an impact on their earnings.

Larger banks should also have the advantage in terms of non-interest income and expenses. The large capital markets participants benefit the most from higher margin market and investment banking activity. On the expense side, larger banks have a greater revenue base over which to spread higher fixed costs.

We think, too, that the processor banks (Bank of New York, Northern Trust, Mellon, and State Street) could be due for a reprieve from poor market conditions which prevailed in 2004. Many of the processor banks struggled to cut costs as revenues stagnated in 2004. Going into 2005, both State Street plans to cut costs further in 1Q05. With a generally improving economy, higher equity valuations, and a slimmer cost bases, these banks could find favorable comps to 2004 results fairly easy to achieve.

Those banks which we would avoid are the smaller and mid-size regionals, especially those names which we have singled out as having above-average interest rate risk profile. Banks which we have highlighted for heightened risk from interest rate sensitivity include **Commerce**, **Mellon**, and **Sovereign**. Some Midwestern banks which have weaker fundamentals than peers could remain under pressure, including **Huntington**, **Comerica**, and **KeyCorp**. Mortgage-oriented banks such as **Washington Mutual** and **First Horizon**c ould also face a tough 2005.

That said, the underperformers could be appealing targets for larger regional players looking to extend their geographies, product lines, or deepen their local penetration. If these executives of these banks confront a period of underperformance, the temptation to sell out could prove irresistible. So, although we think performance of the aforementioned banks could be pressured in 2005, positive returns as a result of being bought out remains a possibility.

David Hendler
dhendler@creditsights.com

Baylor A. Lancaster
blancaster@creditsights.com

Craig Guttenplan
cguttenplan@creditsights.com

CreditSights

Estimating The Impact Of The Homeland Investment Act

Date Published: 14 Sep 2004, 23:18

- Legislation before Congress would introduce a one-year reduction from 35% to 5.25% in the tax on repatriated earnings from offshore subsidiaries. Passage of the bill before the election is not likely and it is generally considered to have an approximately 50% chance of passing afterwards.
- Industry has lobbied strongly for the bill and should it succeed US corporations would have a strong incentive to repatriate. To the degree that earnings are not held in cash this could necessitate bond issuance in order to monetize profits. Speculation of this has sparked fear of technical pressure on US corporate bond spreads.
- Although the bill would certainly increase repatriation and issuance, we believe its impact on the bond market is highly uncertain and easily overstated. When the potential for companies to continue to hold earnings offshore to facilitate strategic investment, the possibility of non-dollar issuance, the likelihood of borrowing being focused at the short end, and the current dearth of investment grade issuance are taken into account the likely impact of this legislation is more muted than it appears at first glance.

Introduction

There has recently been speculation that a legislative change currently going through the congressional process could result in a surge in corporate bond issuance. On June 17, 2004, the U.S. House of Representatives passed international tax reform legislation known as the *American Jobs Creation Act of 2004* H.R. 4520 (the JOBS Act) by a vote of 251-178. The Senate approved its version of the legislation, called the *Jumpstart Our Business Strength (JOBS) Act* S.1637 on May 11. **Both bills include a provision that would provide a one-year window that would reduce taxes payable on earnings repatriated from foreign subsidiaries to US corporations. The provision is referred to as the *Homeland Investment Act of 2003* H.R. 767 (HIA) in the House version of the bill and the *Invest in the USA Act of 2003* S. 596 in the Senate legislation**. The bills are now in conference to resolve the differences between the two versions but these negotiations will focus on issues other than the tax window on repatriated earnings. It is not generally expected that a final version of the bill will pass prior to the election, and indeed several commentators put the probability that the legislation passes after the election at less than 50%. **If it is successful however, the significant drop in the tax on repatriated earnings (from up to 35% to 5.25%) would create a notable incentive for US companies to increase the dividends paid from offshore subsidiaries in 2005. To the degree that an offshore subsidiary has a high level of retained earnings but is not flush with cash, the dividend could be financed by borrowings** and this is what is giving rise to the expectation of increased bond issuance and technical pressure on corporate spreads.

Background To The Legislation

A primary motivation behind the JOBS Act is to enact new legislation that will replace the *Foreign Sales Corporation* (FSC) law. Under this law, the US had been providing certain tax breaks for manufactured exports but the European Union challenged this in the World Trade Organization as an export subsidy and had it ruled as illegal in 2000. A subsequent law called the *Extraterritorial*

STATEMENT OF ADMINISTRATION POLICY
H.R. 4520 – American Jobs Creation Act of 2004

The Administration supports foreign sales corporation /extraterritorial income (FSC/ETI)legislation that reforms the tax code, removes the underlying reason for the tariffs that have been imposed on American exports by the European Union (EU), and further advances the competitiveness of American manufacturers and other job creators.

Source: Office Of Management and Budget

Income Exclusion Act (ETI) was likewise declared illegal by the WTO in 2002. The WTO has authorized the EU to impose import sanctions on up to $4 billion worth of US imports a year commencing on January 1, 2004 if the US failed to comply with the ruling and remove the incentives provided under FSC-ETI. However many beneficiaries and members of Congress did not expect the EU to make good on its threat to retaliate and consequently the legislation was not repealed. **After waiting for the US to act, the EU began imposing tariffs on March 1 worth 5% of the authorized level. The sanctions have increased the price of the US exports on which they have been applied, directly harming competitiveness in many sensitive industries.** The EU has indicated that it will end the sanctions if the US acts expeditiously to repeal FSC-ETI. Alternatively, further delays in the repeal process will result in an increase at the rate of 1% a month (as at August 1, the retaliatory tariff reached 10% and increases will continue to a maximum of 17%). Hence repealing the legislation has a high priority.

With regard to the HIA, its inclusion is part of a broader effort to ensure that the necessary reform of the tax code takes place in such a way that fosters US growth and job creation. Proponents argue that the 35% tax rate on repatriated income is a form of double taxation and has created an incentive for US corporations to accumulate profits in offshore subsidiaries when such capital could otherwise be made available for domestic investment, further stimulating US growth. The counter argument that temporary tax moratoriums can work to undermine the fairness and transparency of the tax code has been overwhelmed by political sensitivity to the recalcitrant US employment market in an election year. The additional tax revenue that would be generated by a widespread "one-off" repatriation in 2005 is also appealing given current budgetary pressures. The HIA has received widespread industry support, particularly from sectors that have sizeable profits in offshore operations such as technology and pharmaceuticals.

Details Of The Homeland Investment Act/ Invest In The USA Act

Select Corproate Supporters Of The JOBS Act

Alcatel	Hewlett-Packard
Altria	IBM
Apple	Intel
AT&T	JP Morgan Chase
Bayer	McDonalds
Boise Cascade	MeadWestvaco
Caterpillar	Microsoft
Cicso	Morgan Stanley
Citigroup	Nike
Coca-Cola	Oracle
DaimlerChrysler	Pfizer
Exxon	Proctor & Gamble
Ford	Qualcomm
General Electric	Schering-Plough
General Motors	Sun Microsystems
Georgia-Pacific	Verizon
Goodyear	Wal-Mart

Source: House Ways and Means Committee

With final bill yet to be passed the exact nature of the HIA is not certain but, given the details available from the pending legislation, we believe that it will take the following form. For the tax year that applies 120 days after the legislation becomes effective, tax paying US corporations can elect to be taxed at a rate of 5.25% on excess qualified distributions from controlled foreign corporations (offshore subsidiaries) that are described in a domestic reinvestment plan. The excess qualified distribution amount is the excess of any dividends received by the taxpayer over a base amount. The base amount refers to five prior years worth of dividends ending on or before December 2002 and is calculated by excluding the two years during the period in which the highest and lowest payments were made, and averaging the payments made during the remaining three years. The reinvestment plan requires the investment of the dividend in the US, for such purposes as "being a source for the funding of worker hiring and training; infrastructure; research and development; capital investments; or the financial stabilization of the corporation for the purposes of job retention or creation." This requirement has been interpreted broadly enough to suggest that the funds could be used for such purposes as debt repayment or dividend payments.

Likely Response To The Legislation

As we noted earlier, passage of the legislation is by no means certain but, given the substantial offshore profits of many US multinationals, the degree of industry lobbying for the legislation that has taken place, and the motivation provided by the limited period for which the tax advantage will be available, the wide assumption has been that if the HIA becomes law then the amount of repatriation will be significant. **According to estimates from the Joint Committee on Taxation, the legislation has the potential to pump as much as $135 billion dollars into the U.S. economy. Other estimates have been even more generous ranging to $300 billion or more.** Further, because offshore subsidiaries may not have cash balances available sufficient to fund the possible dividend payment to the US parent corporation it has been forecast that a rash of borrowing will take place in order to monetize the retained earnings and facilitate the dividend payments. Such forecasts have translated into concern that the passage of the HIA would result in substantial technical pressure on corporate bond spreads. **Although the HIA would certainly increase repatriation and create an incentive for corporate bond issuance, there are several reasons why we believe fears of meaningful spread pressure are overstated.**

US Corporations Are Waiting For Clarity But Appear Set To At Least Partially Capitalize On The Tax Break

"..it's very likely we will use at least some of the foreign cash we have to move to the U.S. for purposes of debt reduction, and evaluate, based on what the provision says exactly, what other uses we might make of funds."

Dan Kostenbauder, VP of Transaction Taxes
Hewlett-Packard

Source: www.sfgate.com

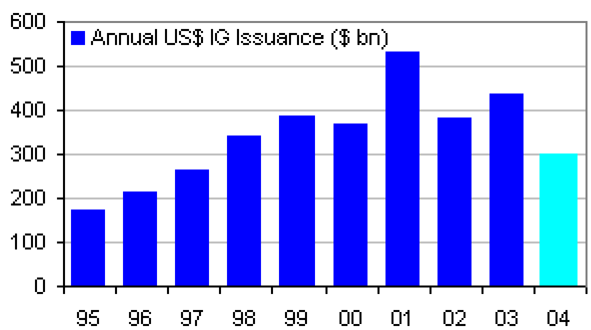
Firstly, there is the question of the competing influence of tax strategy and operational strategy. If US corporations consider the bulk of their retained profits in offshore operations to be, to borrow the terminology of proponents of the legislation, "trapped", then they can capitalize on the opportunity to repatriate them at a substantially lower tax rate without undue concern that they will be forgoing attractive investment opportunities in offshore markets. To the extent that industry lobbying for the HIA has been aggressive it is fair to assume this approach will be adopted to some degree (though we are hard pressed to recall a time when industry lobbying was anything but aggressive on the subject of lower corporate tax rates). Clearly Congress is expecting this to be the result of enacting the legislation. However, **the repatriation of profits requires companies to forego tax deferral and embrace tax payment, even if it is at a lower tax rate, and willingly incurring this expense implies that US corporations consider there to be more attractive investment opportunities in the US than in the countries where those retained earnings are currently held.** Macro trends such as globalization, foreign outsourcing and the long-term trend to expand into developing markets, particularly in high growth regions such as Asia, run contrary to the belief that the best operational strategy is to concentrate investment in the US. Clearly it is possible to influence strategic investment decisions with tax policy but the degree of success achieved by such policies is often dependent on their fit with broader investment trends. One can cite the increase in dividend payments that has occurred since the 2003 US tax changes that lowered the taxation of dividends as evidence of the power of taxation policy to influence corporate strategy. However, the change also coincided with greater demand for increased dividends given the lackluster price performance of the equity market since it peaked in 2003 and the shift that this caused in investor priorities. As a contrast, the tax changes made in the same year to enhance capital investment have been less effective as uncertainty about the sustainability of demand continues to act as a drag on the capex cycle. With regard to the HIA, the considerations to be taken into account when assessing this are very industry-specific and difficult to forecast given the complex nature of international finance but we would highlight that the potential amount of repatriation can be easily overestimated by simply focusing on the aggregate level of retained offshore earnings.

Then on the question of the likely amount of debt issuance that could result from the legislation, **where a company does decide to the increase the dividend payment to the US parent and such a payment goes beyond available cash balances and requires borrowing, the question that arises is which is the optimal currency for issuance.** Although financial engineering enables the relatively easy mitigation of exchange rate risk, given that the debt issuance would likely occur at the level of the foreign subsidiary and not the US parent, it may be considered optimal to issue in foreign currencies rather than dollars. **There is also the question of target maturities. Issuance done for the purpose of capturing a one-year reduced tax window on retrospective earnings would seem to be better matched by short-term debt** than bonds with maturities of five-years or greater. If the legislation passed and we consequently saw a jump in euro-denominated three-year floaters, this is not likely to exert much pressure on dollar corporate spreads or, given the depth of the short-term market in Europe and the appeal of high quality spread product in the industrial sector, would we expect a sustained negative effect on euro-denominated corporate spreads. Making accurate forecasts with regard to these considerations is not possible but once again our conclusion is that it is easy to oversimplify the implications of the legislation and so overstate the likely amount of issuance or spread pressure.

Would More Issuance Be A Problem?

Our final comment on the question of the likely amount of technical pressure on spreads that could result from this legislation is that estimates should be considered in the context of broader issuance trends. Currently the US investment grade market is on track to deliver our forecast $300 billion of investment grade issuance, which is a 30% drop on last's year $436 billion total. Net issuance has dropped even more substantially and has been running at a negative level in the US for the last five months driven by factors such as higher interest rates, constrained capex investment, a sluggish rebound in M&A markets, flush cash balances from 2002-2003 borrowing programs, and increased cash flow during the 2003 economic rebound. Certainly there are increasing demands on cash flow (such as the increased demand for dividends) and in 2005 we are likely to see higher levels of both capex and M&A activity and consequently, more bond issuance than has been the case this year. But **given the prevailing technical squeeze and the likelihood it will continue into year-end 2004, we do not believe that the increase in dollar issuance that can reasonably be expected from this legislative change will become a key factor in medium term spread direction**. Another reason for this conclusion is that many of the companies that are candidates to issue to effect repatriation are highly rated and from industries that such as technology and pharmaceuticals that traditionally have made little draw on the corporate bond markets. From the perspective of portfolio exposure, this should ensure that investors have the capacity and the desire to absorb any new deals from these companies and spread pressure is more likely to be related to the usual new issue concession that a sustained trend set in place by technical deterioration.

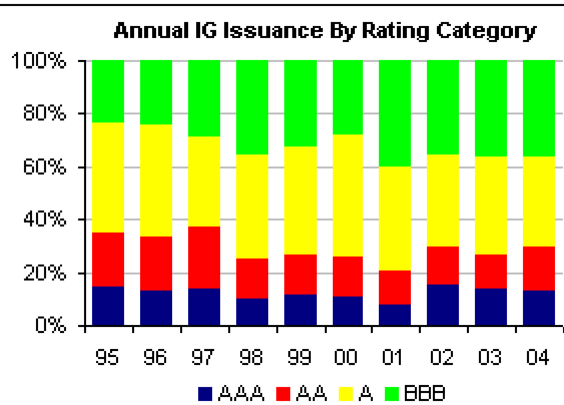
2004 Has Seen A 30% YOY Drop In IG Issuance So Increased Volume Would Not Unduly Weaken Technicals



Note: CreditSights Forecast for 2004 total

Source: CreditSights

Issuance Trends Have Favored Lower Rating Categories, So An Increase In Highly Rated Borrowers Is Welcome



Source: CreditSights

Related Links

Details of the Jumpstart Our Business Strength (JOBS) Act

Details of the Homeland Investment Act of 2003

Comparison of House and Senate versions of the legislation

List of Companies that support the legislation

Louise Purtle
lpurtle@creditsights.com

Bank of America Spreadsheet
Date Published: 08 Dec 2004, 14:40

Click on the excel file below for the full spreadsheet.

Bank of America.xls

Bank of America Corp.
BAC
Aa2/A+
Banks

SUMMARY DATA

(mil $, Except per share data)	**LTM 9/30/2004**	**12/31/2003**	**12/31/2002**
INCOME STATEMENT SUMMARY			
Net interest income	26,633	21,464	20,923
Noninterest income	18,682	16,422	13,571
Net revenues	47,476	38,827	35,124
Noninterest expense	(24,887)	(20,127)	(18,436)
Preprovision income	22,589	18,700	16,688
Provision for loan losses	(2,646)	(2,839)	(3,697)
Pretax income	19,943	15,861	12,991
Net income	13,614	10,810	9,249
Net income available to common	13,603	10,816	9,244
EPS fully diluted	$7.38	$7.13	$5.91
BALANCE SHEET SUMMARY			
Liquid assets	283,015	216,681	174,970
Net loans	502,916	365,300	336,397
Total assets	1,088,996	736,445	660,951
Total deposits	591,258	414,113	386,458
Purchased funds	300,515	177,919	145,666
Stable funding (core deposits)	541,994	383,562	356,679
Preferred stock	271	54	58
Common equity	97,740	47,926	50,261
Total shareholder's equity	98,011	47,980	50,319
ASSET QUALITY			
Total loans and leases ($ mil)	511,639	371,463	342,755
Reserve for loans and leases ($mil)	(8,723)	(6,579)	(6,358)
Non-performing assets ($ mil)	2,836	3,021	5,262
Other real estate owned (OREO $ mil)	133	148	225
Reserves % of gross loans	1.7%	1.8%	1.9%
Net charge-offs % of average loans	0.6%	0.9%	1.1%
Non-performing assets % of total loans and OREO	0.6%	0.8%	1.5%
Non-performing assets % of total assets	0.3%	0.4%	0.8%
Y/Y Loan growth	37.1%	8.4%	4.1%

(mil $, Except per share data)	LTM 9/30/2004	12/31/2003	12/31/2002
LOAN MIX			
Commercial - domestic	122,211	96,644	105,053
Commercial - foreign	18,976	15,293	19,912
Commercial real estate - domestic	30,255	19,043	19,910
Commercial real estate - foreign	464	324	295
Commercial lease financing	19,991	NA	NA
Residential mortgage	179,673	140,513	108,197
Home equity lines	46,497	23,859	23,236
Direct/indirect consumer	38,378	33,415	31,068
Consumer finance	4,207	5,589	8,384
Credit card	47,554	34,814	24,729
Foreign consumer	3,433	1,969	1,971
Total loans	511,639	371,463	342,755
PROFITABILITY METRICS			
Return on assets	1.4%	1.4%	1.4%
Return on common equity	15.6%	22.0%	19.4%
Net interest margin	3.3%	3.4%	3.8%
Efficiency (overhead) ratio	54.9%	52.2%	52.6%
CAPITAL ADEQUACY			
Tier 1 capital ($ mil)	62,981	44,050	43,012
Tier 1 capital ratio	8.1%	7.9%	8.2%
Total capital ratio	11.7%	11.9%	12.4%
Leverage ratio	5.9%	5.7%	6.3%
LIQUIDITY			
Total loans % of total deposits	86.5%	89.7%	88.7%
Liquid assets % of total assets	26.0%	29.4%	26.5%
Purchased funds ratio	39.4%	35.7%	24.8%

Notes:

Liquid assets include cash and cash equivalent, fed funds sold and securities resale agreements, time deposits placed and other short-term investments, trading account assets and derivative assets

Purchased funds include Fed funds purchased and securities repurchase agreements, foreign interest-bearing deposits , other borrowing funds, trading liabilities, commercial paper and other short term borrowings and acceptance outstanding

Stable funding (core deposits) includes domestic interest bearing deposits, noninterest bearing deposits and noninterest bearing deposit non US

Common equity excludes preferred stock

Other real estate owned (OREO $ mil) includes foreclosed properties included in non-performing assets

LTM return on assets, LTM return on common equity, LTM net interest margin and LTM efficiency (overhead) ratio are 3rd quarter 2004 ratios only

Y/Y Loan growth represents year to year growth of total loans

Consumer finance includes consumer finance and consumer lease financing

Purchased funds ratio is the net non core fund dependence ratio for the lead bank. Source: FDIC, Uniform Bank Performance Report

Bank of America Tearsheet

Date Published: 01 Dec 2004, 18:36

BANK OF AMERICA CORPORATION (Aa2/A+; S&P has a positive outlook)

BANK OF AMERICA, N.A. (Aa1/AA-; S&P has a positive outlook)

CREDIT TRENDS

Bank of America - Debt View and Valuation Metrics			Key Equity Indicators	
Total Debt	$86.5 B	@ 12/1/2004	Market Cap.	$185.7 B
Rating Agency	Aa2/A+, S&P has a positive outlook		LTM Revenues	$47.2 B
CreditSights Rating	AA-		Revenue Growth*	23.6%
			EPS Growth**	9.7%
			Divd Yield	3.91%
			P/E	12.07x
			P/B	1.91x
Credit Metrics				
	ROAE	**Efficiency**	**NCO %***	**Leverage**
Actual (3Q04)	15.6%	54.94%	0.57%	5.92%
Forward Trend	Improving	Improving	Stable	Stable

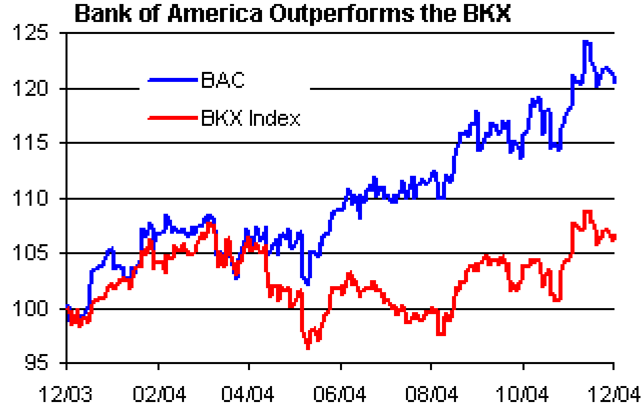
Source: Company Reports, Bloomberg, CreditSights

* Growth rates are quarter-over-quarter, NCO %= Net Charge-offs as a % of Avg. Loans

** EPS Growth is the Bloomberg consensus estimate of long-term growth

Following the addition of FleetBoston, Bank of America ranks as the "King of Core Deposits" in the U.S., with approximately 10% national deposit market share. The company also enjoys one of the most geographically diverse branch networks, with locations throughout the Northeast, California, Midwest, and the South. Looking into 2005, we think the major challenge for Bank of America lies in driving core revenue growth and bottom line earnings from the efficient utilization of this leading national deposit franchise. We consider BofA a core holding for fixed income investors, as it enjoys healthy profitability, an exceptional deposit franchise, good asset quality, and what we view as a strong core competency in asset-liability management.

Bank of America Outperforms the BKX



Note: Returns Rebased to 100

Source: Bloomberg, CreditSights

We have said that our belief is that core deposit growth is really "code words" for asset/liability management (ALM), and we feel the bank has been a savvy practitioner of ALM given the vagaries of interest rates in 2004. That said, the company's 3Q04 results perhaps showed a chink in the ALM armor, as BofA's mortgage hedging gains were not enough to offset the MSR impairment.

5-Year Highlights	2003	2002	2001	2000	1999
Net Income	10,810	9,249	6,792	7,517	7,882
Return on Assets	1.41%	1.40%	1.05%	1.12%	1.28%
Net Interest Margin	3.36%	3.75%	3.68%	3.22%	3.47%
Efficiency Ratio	52.2%	52.6%	55.5%	54.4%	55.3%
Tier 1 Capital Ratio	7.85%	8.22%	8.30%	7.50%	7.35%
Net Charge-offs/Loans	0.87%	1.10%	1.60%	0.61%	0.55%
Total Equity	47,980	50,319	48,520	47,628	44,432
Total Assets	736,445	660,951	621,764	642,191	632,574

Note: ($ in millions) Source: Company Reports

Going into 2005, we think BofA's growth drivers will be predominantly derived from the consumer business, as the company is focused on ramping up its cross-sell results. Cross-selling would include credit cards, debit cards, home equity and home mortgages as the primary product sets. The full realization of cost savings from the FleetBoston integration and cross-selling to the New England customer base should also contribute to revenue growth. More economically dependent segments include commercial banking, which has not yet seen sustained loan growth, and BofA's investment banking unit, materializes, to which the company is making additional investments. Given a favorable economic backdrop, these could provide incremental support to the bottom line.

Rating Agency Dynamics

Overall, we see Bank of America as a solid double-A at the bank level and an AA- at the holding company. The key issue for the company continues to be positive earnings momentum given the lack of strong corporate loan demand. We suspect that expense saves and fee growth will be the key drivers in 4Q04 while loan growth appears to be a 2005 story. The integration of the Fleet franchise appears to be going smoothly.

Our ratings are one notch below those of Moody's, which has a Aa2 rating at the holding company. S&P, on the other hand, is one notch lower than us at A+. S&P has a positive outlook on Bank of America, which is assigned in October 2003 after the announcement of the Fleet acquisition. S&P stated that it could raise its rating for BoA if the company "can keep asset quality under control and successfully integrate Fleet." The S&P analyst also cited lingering "headline risk" (for instance, regarding the company's relationship with Parmalat) as a possible roadblock to an upgrade. Finally, S&P has cited pressure on BofA's tangible capital ratios as a concern. So, the timing of an upgrade could extend well into 2005, but we continue to believe the agency will recognize and reward the company's solid performance with a "low AA" rating.

Key Themes

Integration Update: Accelerating The Schedule

The company noted that cost savings from the Fleet merger were approximately $309 million, or about $0.05 for 3Q04. This compares to cost saving of about $206 million the previous quarter. So since the merger was completed, the company has realized cost savings of $515 million. BofA expects to realize total cost savings of $875 million for the current year and $1.8 billion for 2005.

With regards to re-branding, BofA remains on target, with over 620 branches completed to date. A total of 87,000 net new customer savings accounts were opened in the legacy Fleet franchise, up from only 42,000 the previous quarter and in the Northeast, 81,000 new consumer savings accounts were opened. Perhaps most importantly, "Cross-footprint" transaction volume has continued to increase. BofA noted that in the final week of September, its customers completed 25,000 cross-footprint transactions, of which 60% were done by legacy BofA customers at former Fleet branches.

Loan Growth: Still Missing for 3Q04

During its 3Q04 conference call, CFO Okun mentioned that loan growth was good in middle market as it was up 1% linked and 4% annualized. On the other hand, large corporate lending was basically quiet with no real signs of positive change. Within middle market, it sounds to us more like specialty and commercial real estate lending than classic middle market lending. CFO Okun noted that it has been releasing loan loss reserves in commercial and global corporate due to the anemic loan environment where new loans are hard to come by and old ones are paying down without increases on renewal.

Consumer Banking Drivers

In a review of its consumer banking effort, BofA stressed its mission to deliver a set of identical products and services to customers throughout the footprint. The company trains its salespeople to deliver a consistent message, or script, suggesting additional products to customers which fit a certain profile. In this way, BofA hopes to anticipate customer needs through data mining of its customer database. BofA's goal is to deliver a similar, positive experience for its customers whether they are in Boston or San Francisco.

In order to achieve growth, BofA is, like many other banks, focused on the core retail deposit account. The company feels this is the strongest product from which it can cross-sell other products such as home equity and credit cards. BofA is already the clear market leader, and estimates that it has a 14%+ market share of national deposits (when excluding branches of over $500 million in deposits). The company expects to end 2004 with $415 billion in total customer deposits, compared to $284 billion at year-end 2003 (+47%). Excluding Fleet, legacy BofA would be at approximately $323 billion (+14%). BofA serves 33 million households in 29 states and expects to add 2.2 million net new checking accounts in 2004.

BofA benefits from having a broad array of products with which to sell to its customers. BofA ranks as the 5th largest credit card issuer in the country and has been growing its receivables at a rapid clip. The return on managed assets for this business was 2.94% for 3Q04, second only to Citigroup. In terms of home equity, it is the 2^{nd} largest lender in the country and hopes to overtake market leader JPMorgan Chase in 2005. BofA expects to generate about $56 billion in home equity production for 2004 (+47%). BofA will use best practices from Fleet, which had a well-honed home equity effort, across its footprint.

First Mortgage Still a Challenge

The only area of weakness which BofA acknowledged was its first mortgage effort. The company pledged to reduce the volatility of income in this business by improving servicing efficiency and delivering steadier origination volume by increasing the branch contribution rather than relying on wholesale volume. The company is committed to being in the mortgage business, as it says that the only other product which matches the retail deposit for a deepening the customer relationship is a mortgage.

In addition to its cross-sell efforts, BofA is continuing to grow organically by adding new branches. The company believes that no other organization can match its national presence and calculates that 76% of the U.S. population lives in its footprint.

Recent Results

Quarterly Earnings Trends	3Q04	2Q04	1Q04	4Q03	3Q03
Net Interest Income	7,665	7,581	5,801	5,586	5,304
Securities Gains	732	795	495	139	233
Mortgage Income	-250	299	209	292	666
Other Non-Interest Income	5,145	5,141	3,508	4,043	3,773
Total Non-Interest Income	4,895	6,235	4,212	4,474	4,672
Total Revenue	12,560	13,816	10,013	10,060	9,976
Operating Expenses	6,994	7,201	5,417	5,282	5,070
Loan Loss Provisions	650	789	624	583	651
Pre-Tax Income	5,648	5,826	3,972	3,903	4,255
Net Income	3,764	3,849	2,681	2,726	2,922

Note: ($ in millions) Source: Company Reports

Bank of America reported 3Q04 EPS of $0.91, a penny ahead of the Street consensus. Reported earnings declined to $3.7 billion, down $85 million (-2%) on a linked quarter basis. However, when adjusted for reserve releases ($235 million or $0.04) and other adjustments to noninterest income and expenses ($104 million or $0.02), we believe that the company missed by a nickel.

Reported revenues declined to $12.5 billion, down $461 million (-3%) on a linked quarter basis. Adjusting for above-trend items, core revenues were flattish at $12.2 billion. Net interest income was flattish at $7.6 billion (up $85 million) and the net interest margin came in at 3.28% (down 1 bp). Interest income benefited from a higher level of investments coupled with solid consumer loan growth, which more than offset the negative impact of lower trading related net interest income. Bank of America's return on assets was 1.35% (down 5 bp), and its return on equity was 15.56% (down 107 bp). For more on BofA's 3Q04 results, see: **BofA: 3Q Core Misses – Merger Ahead, Core Behind**.

Business Segments

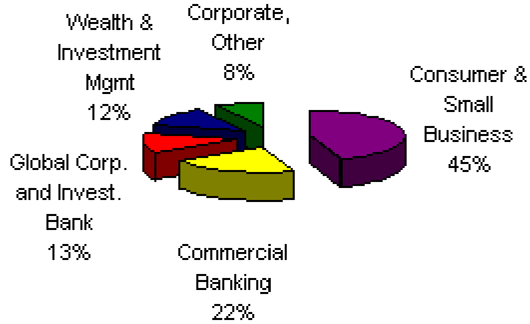
As part of the Fleet integration process, BofA reorganized its segment breakout. Specifically, the former Consumer and Commercial Banking segment has been split into a) Consumer and Small Business Banking and b) Commercial Banking. The other two operating segments are Wealth and Investment Management and Global Corporate and Investment Banking (GCIB).

The **Consumer and Small Business** segment contains the retail bank and remains the driver of results for the bank, delivering 56% of revenues and 67% of net income, before consolidation eliminations. This segment also includes total managed credit card receivables of $45.0 billion.

For 3Q04, the **Consumer and Small Business** segment delivered revenues of about $7 billion, and net income of $1.6 billion. Results in the segment were negatively impacted by a loss in mortgage banking income ($250 million), due to lower origination volume and a write down of mortgage servicing writes, as well a higher level of provisioning associated with credit card growth and the return of securitizations to the balance sheet. Mortgage banking results included production income of $70 million and servicing income of -$320 million. These negative items were partially offset by excellent account and deposit growth, strong fee generation, and loan growth in home equity and credit cards. The unit produced return on equity of 17% with an efficiency ratio of 50%

The **Commercial Banking** segment, which includes Middle Market Banking, Commercial Real Estate Banking, Leasing, Dealer Financial Services (auto, RV, and marine vehicle financing), registered revenues of $1.8 billion and net income of $824 million. The unit benefited from a release of provisions as credit quality continued to improve, and strength in middle market lending. On a sequential basis, average outstanding loans increased by about $1 billion. The unit delivered return on equity of 14% and an efficiency ratio of 34%.

Bank of America 3Q04 Net Income Breakout



Source: Company Reports, CreditSights

The **Global Corporate and Investment Banking (GCIB)** segment caters to large U.S. and global corporate customers. Bank of America has solid market positions in loan syndications and debt underwriting, but has lower market share in equity underwriting and M&A. For 3Q04, **GCIB** revenues totaled $2 billion and net income reached $475 million. Sequentially results benefited from benefited from lower litigation expense. Investors will remember that last quarters results included a $300 million charge to settle Enron litigation. On a normalized, apples to apples basis, results the overall slowdown in market activity and decreased volatility. Investment banking income fell 21% and trading related revenues fell 41%. GCIB's return on equity was 17% and its efficiency ratio came in at 73%.

The **Wealth and Investment Management** segment is currently the smallest contributor to the bottom line, but appears to be an area of strategic focus for the firm. This segment includes Private Banking, Columbia Management Group, Banc of America Investments, and Premier Banking. BofA has $430 billion of asset under management, consisting largely of mutual funds, and client assets of $142 billion in client brokerage accounts (including Quick & Reilly). For 3Q04, **Wealth and Investment Management** recorded revenues of $1.5 billion and net income of $469 million. Results in this business segment benefit from growth in loans and deposits as well as the absence of a conforming accounting adjustment that was made in 2Q04. The positive trends were partially offset by the decline in the overall markets, lower brokerage volume and the absence of tax preparation fees. The segment's return on equity was 21% and its efficiency ratio was 54%.

Corporate Other includes the Latin American operations, Equity Investments (private equity), and Other, which is primarily responsible for corporate ALM management. Latin America includes Brazil, Argentina, and Chile, but excludes Mexico. Most of these assets were picked up in the Fleet deal. For 3Q04, **Corporate Other** had net income of $314 million, aided by gains on sale of securities ($614 million) and a negative loan loss provision ($114 million).

Asset Quality

Credit quality remained healthy as commercial and large corporate credits showed improvement while consumer held steady. On a combined basis, net charge-offs fell to $719, down $110 million (-13%) from 2Q04, and exceeded provisions by $69 million. Net charge-offs as a percentage of loans improved to 0.57% (down 10 bp). Nonperforming assets dropped to $2.8 billion, down $343 million (-11%), reflecting 0.55% of total loans and leases. The bank's reserve to loan ratio came in at 1.70% and its reserve coverage of nonperforming loans was a comfortable 343%. During the conference call, the company noted that the consumer loan loss reserve would likely rise in-sync with loan growth.

Capital Strategy

BofA repurchased 40 million shares during 3Q04, which more than offset new issuance of 26 million shares related to stock option and incentive plans. Overall capital ratios were mixed during the quarter. BofA's Tier 1 capital ratio declined to 8.08% (down 12 bp), the total capital ratio fell to 11.70% (down 27 bp), however its average equity to average asset ratio improved to 8.68% (up

26 bp) sequentially. The leverage ratio rose to 5.92% (up 9 bp). Goodwill is high at 46% of total equity at 3Q04, mostly as a consequence of the Fleet deal.

Interest Rate Posture—Mildly Liability Sensitive

BofA measures interest rate risk by quantifying the estimated effect of rate movements on net interest income. At 3Q04, a +100 bp gradual shift in interest rates was predicted to decrease net interest income by 1.6%, reflecting a shift to being mildly liability sensitive (at 2Q04, the same shift would have increased net interest income by 0.4%). At 3Q04, the company estimated that a -100 bp shift in interest rates would increase net interest income by 0.9% (v. lowering it by 0.7% at 2Q04).

David A. Hendler
dhendler@creditsights.com

Baylor A. Lancaster
blancaster@creditsights.com

Rob Haines
rhaines@creditsights.com

Finance Sector Review: Week Ended January 7
Date Published: 07 Jan 2005, 09:11

- A wrap up of the news worth watching in the finance sector in the latest week.
- Includes comments on ABN AMRO, AIG, Bank of Nova Scotia, BB&T Group, Bear Stearns, CIT Group, Citigroup, European Banks, Fifth Third, Goldman Sachs & Morgan Stanley, Insurance Sector, JPMorgan Chase, Lehman Brothers, Marsh & McLennan, Marshall & Ilsley, Merrill Lynch, Morgan Stanley, Société Générale, Sovereign Bancorp, U.S. Bancorp, Washington Mutual, and Wells Fargo.
- We have published new spreadsheets on Huntington Bancshares, and Regions Financial.
- We have published a new tearsheet on Caterpillar Financial.

For a list of all financial sector articles published, please click here.

The following articles were published in the latest week.
ACE Asbestos Review: Well Within Expectations
European Banks 2005 Outlook: The Year of The Crab?
CIT: Going To School or Getting Schooled?
GE Capital: One-on-One With Imagination
2005 Property and Casualty Outlook – Proceed with Caution

- **ABN AMRO** (Aa3/AA-/AA-) shares rose 4% on the back of speculation about a possible takeover by **Royal Bank of Scotland** (Aa2/AA-/AA). We suspect there is little substance to the rumour, which appears to have been started by an idea floated in a research report. **While we would be surprised to see anything happen, the rationale is actually more compelling than some of the possible combinations mentioned in recent speculation about European bank M&A.** ABN has, from RBS's point of view, a large and attractive U.S. franchise that could be merged with RBS's own operations in the USA, and it is also relatively cheap compared with most major European banks, as well as with potential U.S. targets, at around 9x estimated 2005 earnings. ABN also removed a class of "poison pill" preference shares in 2004 that protected it against hostile takeover. **Whether RBS would be interested in ABN's other businesses (e.g. Netherlands, Brazil) is more questionable, and ABN's market capitalisation of around €35 billion would make it a large acquisition - perhaps prohibitively so - even for RBS.** Under IFRS, any deal would have to be structured as an acquisition, with mergers achieved by "pooling of assets" no longer permitted.

- **AIG** (Aaa/AAA, Moody's has a negative outlook) announced that it would increase its quarterly cash dividend to $0.125 per share (+67%), up from $0.075 per share. In a press release AIG Chairman Hank Greenberg said that the increase reflects the company's strong financial position. Despite the size of the increase the company still sports a rather modest annualized dividend yield of only 0.7%. By comparison the S&P 500 Index has a yield of approximately 1.7%. **We view AIG's decision to return additional capital to shareholders as yet another signal of slowing growth prospects for the property & casualty industry**. In our opinion, underwriting profitability is likely to deteriorate over the course of the coming year as the insurance industry market cycle continues to shift into a market-softening phase (see **2005 Property and Casualty Outlook – Proceed with Caution**).

- **Bank of Nova Scotia** (Aa3/AA-) announced that it may buy back up to 50 million of its shares over the next year, beginning on Thursday, January 6th. Comparably, Scotiabank bought 12.9 million shares in 2004, at an average price of C$36.93 ($30.24) for a total of C$475 million ($389 million). Bank of Nova Scotia posted healthy quarterly earnings in its 4Q04 and full year 2004 results. The bank, which has a strategy to grow its presence in Latin

America, has so far avoided the problems in expanding abroad encountered by some its peer banks, most notably Royal Bank of Canada.

- **BB&T Corp.** (A1▲/A) has been placed on review for a possible ratings upgrade by Moody's. BB&T had been on positive outlook from Moody's since January of 2003. BB&T currently has an issuer rating of A1 and subordinated debt rating of A2 at the holding company level, and a long term deposit rating of Aa3, financial strength rating of B, and subordinated debt rating of A1 at the bank level. During its review, Moody's will focus on BB&T's continued profitability, especially its ability to produce organic growth, in light of the company's diminished appetite for acquisitions. The review will also take into account the liquidity management policies of the holding company. The review should be completed within three months.

  We are not surprised by Moody's action, as we noted in our recent tearsheet for BB&T that "Moody's is likely to review BB&T's rating in the next 6 months, most likely in 1Q05." We also commented that "given Moody's bullish view on U.S. bank ratings, we would not be surprised if BB&T achieved an upgrade." Our CreditSights rating agrees with Moody's current rating of A1, and we would consider an upgrade to low double-A to be aggressive given BB&T's Southeast regional concentration and high exposure to commercial real estate.

- **Bear Stearns** (A1/A) received approval from its board of directors to purchase up to $1 billion of its common stock. The new authorization supercedes the company's previous repurchase plan, under which the brokerage bought back approximately $623 million of its stock.

- **CIT Group** (A2/A)'s Chairman Al Gamper retired on December 31, capping a 17 year career leading the specialty lender. CEO Jeff Peek has assumed the role of chairman going forward. Gamper ceded his CEO title to Peek back in July. The company recruited Peek from **Credit Suisse** (Aa3/A) in September 2003 as President/COO, allowing the Wall Street veteran (Peek spent 18 years at **Merrill Lynch**, Aa3/A+) about a year to learn the business before assuming the top job. CIT has delivered strong results of late with respectable asset growth and expanding net finance margins while the aircraft portfolio has finally showed some signs of improvement (see: **CIT: 3Q Ahead – Peek Performance**).

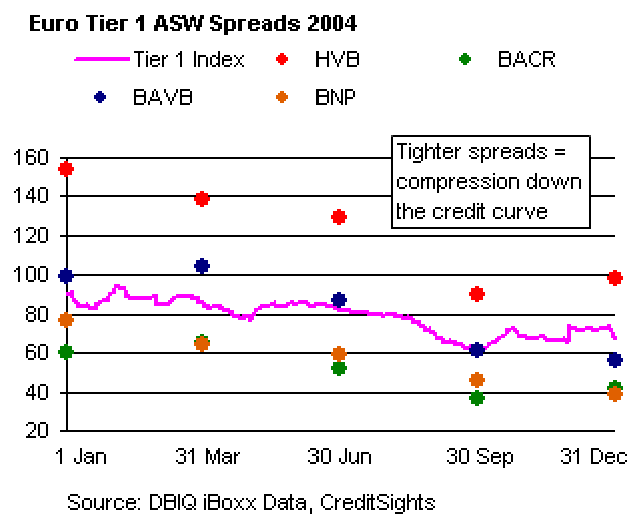
- **Citigroup** (Aa1/AA-) named Richard Stanley as its chief executive officer in its Chinese unit, replacing Catherine Weir. Weir was made CEO in June, replacing Stanley who became head of global corporate investment banking in southeast Asia. Now, Weir will replace Stanley as head of southeast Asia global corporate investment banking, effectively returning both employees to the positions they held in June.

- **European Banks**: A quiet end to a quiet year, which is another way of saying you didn't miss much in the European bank sector if you were away during the Christmas and New Year holiday period. There were several small-scale deals as banks tidied up their balance sheets at the year-end: **Credit Suisse Group** (Aa3/A/AA-) sold its 19.9% stake in U.S. private equity firm Warburg Pincus, acknowledging that it has now built up its own private equity business – the transaction will not have a significant financial impact; **Deutsche Bank** (Aa3/AA-/AA-) acquired asset manager Wilhelm von Finck for an undisclosed sum, but with around €1 billion assets under management, this is a small transaction; and **Banco Comercial Portugues** (A1/A-/A+) received approval from the Portuguese insurance regulator and competition authority for its sale of non-life insurance business to **Caixa Geral** (Aa3/A+/AA-). Newspaper reports suggested that BCP will seek permission to record the gain in its 2004 accounts. The bank also sold a consumer finance unit to **Crédit Agricole's** (Aa2/AA-/AA) subsidiary, Sofinco, for €65 million, representing a gain of €52 million.

  The most interesting story, however, came from reports in the Korean press that HSBC Holdings (Aa2/A+/AA) and Standard Chartered Bank (A2/A/A+) are vying for control of Korea First Bank (KFB). Both are said to have offered around KRW3.5 billion (US$3.3

billion) for KFB, but controlling shareholder, U.S. investment company Newbridge Capital, has yet to choose between the two offers. KFB ran into trouble in the 1997/98 Korean banking crisis and was nationalised in 1998 after huge losses before being sold to Newbridge, which owns 49% (the government still owns 51%) and has managerial control. It has been transformed from a leading corporate bank to a predominantly consumer lender, but it is the smallest of the main Korean commercial banks with a market share of around 3%. **Standard Chartered has missed out on recent acquisition opportunities in Asia to bigger competitors, and might well do so again as HSBC seems determined to fill a gap in its Asian franchise.**

- **European Banks: The problem we face this year in compiling an outlook for European banks is not so much the credit story, which is relatively straightforward, but the prospects for relative value in the credit market.** We see two alternatives: a) stick with the banks that have demonstrated resilient performance across different economic backdrops – these tend to be higher rated, retail-focused or broadly diversified banks trading at tight levels, or b) seek out higher yielding names, on the view that credit spreads will be stable and therefore risks low. **Our preference is for alternative a)**, not because we are predicting spreads will necessarily weaken, but for two reasons: i) from this starting position, the downside risks are stacked higher than the upside; and ii) the steady compression of spreads in 2004 means that the extra spread available on weaker credits is, in any case, small in absolute terms, undervaluing the incremental credit risk.

  This conservative view colours our recommendations for the year ahead. **We split these into three aspects: geographic, capital structure and bank specific.** Of these, the country view is less meaningful than the others, as the strength of banks within an individual system can vary widely. However, the majority of European banks are still predominantly domestic institutions, and many are geared to the underlying economies in which they operate. **[more...]**

- **Fifth Third** (Aa2/AA-, on CreditWatch negative at S&P) completed its acquistion on First National Bankshares of Florida on January 1. The bank will be merged into Fifth Third's Florida affiliate and will have approximately 100 full service locations, $5 billion in deposits, and $7 billion in assets primarily in Boca Raton, Sarasota, Fort Myers, Orlando, Naples, and Tampa Bay. The Florida affiliate will be lead by former First National president Kevin Hale.

- **Goldman Sachs & Morgan Stanley** (Aa3/A+) issued a combined $6 billion of debt on Wednesday, January 5th, with each firm issuing in two separate parts. Goldman's first offering was $2.25 billion of 5.125% debt, due on January 15, 2015. The issue was priced at 99.628 or 90 bp over comparable treasuries, which is 22 bp cheap according to our fair value calculation. The second offering was $500 million of floating rate debt, paying LIBOR +50 bp and maturing on January 12, 2015. Morgan Stanley's first offering was $2.75 billion of extendable floating rate debt, maturing on February 3, 2006 and paying monthly LIBOR -1 bp. The second offering was $500 million of extendable floating rate debt, maturing on

February 3, 2006 and paying the US Federal Funds Effective Rate +10bp.

Also on January 5th, **National City** (A1/A) sold $275 million worth of bonds with a 4.9% coupon, due on January 15, 2015. The issue was priced at 99.726 or 67 bp over comparable treasuries, which is 3 bp rich according to our fair value. **GE Capital Corp.** (Aaa/AAA) also issued debt, a $500 million 3.875% annual coupon offering, maturing on December 15, 2008.

- **Insurance Sector**: Insured losses related to the tsunami that struck Southern Asia appear to be minimal. Despite the massive devastation and loss of life, industry losses will likely be modest relative to the economic damage caused since much of the regions property was uninsured. According to the Insurance Information Institute in New York, estimated insured losses will likely be less than $5 billion.

- **Insurance Sector**: President Bush unveiled plans to amend laws governing class action and medical malpractice lawsuits in Collinsville, Illinois. The American Tort Reform Association has identified Collinsville as a "judicial hellhole." In our opinion, tort reform should a top priority for the new Congress. According to Tillinghast-Towers Perrin, at current levels, U.S. tort costs amount to a 5% tax on wages. In 2002, tort costs increased by 13.3% or almost 4x GDP growth of 3.6%. As of year-end 2002, U.S. tort costs accounted for more than 2% of GDP. Many industry prognosticators remain pessimistic regarding material tort reform since the Republican majority does not have the seats to prevent Democratic filibusters from upholding the tort system. We would contend that a number of moderate Democrats might be more willing to compromise, particularly in light of the experience of former Senate Minority leader Tom Daschle, who lost due partly to his perceived closeness with the plaintiff's bar (see **2005 Property and Casualty Outlook – Proceed with Caution**).

- **JPMorgan Chase**'s (Aa3/A+) chief executitve officer William Harrison gave an interview on CNBC, where he rebuffed the idea of more significant M&A activity from the U.S.'s second largest bank. Specifically, Harrison responded to the issue of a merger with the U.K.'s Barclays as well as a potential takeover of a brokerage company, by saying that the bank would not be interested in doing any megers for two to three years. JPMorgan Chase lacks a significant retail brokerage division that its bigger brother Citigroup has in Smith Barney. Harrison also commented that he was pleased with the progress the bank was making in achieving its $3 billion cost savings it anticipated when it purchased Chicago-based Bank One. According to Harrison, the bank's trading revenue slump was due to a minimal presence in the more active markets, like commodities, energy, and mortgages, as well as the defection of some of the staff to hedge funds.

- **Lehman Brothers** (A1/A, S&P has a pos. outlook) issued $1 billion of notes due January 27, 2010. The non-callable issue carries a 4.25% coupon and was priced at 99.576 or 64 bp over comparable treasuries.

- **Marsh & McLennan** (Baa2▼/BBB▼) managing director Robert Stearns plead guilty to criminal charges stemming from New York Attorney General Eliot Spitzer's investigation into price fixing in the insurance industry. Stearns is the sixth insurance executive to plead guilty to criminal charges related to Spitzer's investigations. In a press release Marsh reiterated that it is committed to cooperating with the investigations.

- **Marshall & Ilsley**'s (A1/A) financial technology division, Metavante Corp., announced the acquisition of Prime Associates for undisclosed terms. Headquartered in Clark, NJ, Prime Associates provides about 140 companies with data services and software to help them comply with anti-money laundering regulations, specifically the Bank Secrecy Act, U.S. Patriot Act, and the Office of Foreign Asset Control, among others. The deal is scheduled to close in February 2004 when Prime Associates will become an independently run unit of

Metavante. Metavante acquired six companies in the past year for over $1 billion dollars and accounted for 14% of M&I's earnings in 3Q04.

- **Merrill Lynch** (Aa3/A+) announced that Scott Kisting will join John Qua as the co-head of its Global Bank Group. Kisting had been a consultant to the securities firm since 2002 and has been in the banking industry for 33 years. Kisting will focus on small business lending and consumer banking services.

- **Morgan Stanley** (Aa3/A+; S&P has a positive outlook) was in the news as a New York hedge fund publicly called for a breakup of the firm. The Chairman of Copper Arch Capital, Scott Sipprelle, called for Morgan Stanley to sell its retail broker, Discover card, and asset management operations. Sipprelle, who was an employee of Morgan Stanley until 1998, made his comments in a letter to CEO Purcell which was publicly released.

  We speculated that Morgan Stanley might consider exiting the retail brokerage, Discover, or both back in 2003, and have reiterated this possibility in 2004 (see: **Morgan Stanley: At a Cross-Roads?**).

- **Société Générale** (Aa2/AA-/AA-) was raised from Aa3 to Aa2 by Moody's in a move that was well signposted, having been under review for upgrade since August 2004. Moody's highlighted two main features of SocGen's recent performance: its improved risk management and its better operating efficiency (evidenced by a declining cost/income ratio). Moody's continues to be the most bullish of the rating agencies on European banks, and, unlike S&P and Fitch, now rates SocGen at the same level as rival **BNP Paribas** (Aa2/AA/AA). It already trades virtually in line with BNP, so we do not expect any material reaction from credit spreads. **We moved SocGen from Marketweight to Overweight in our 2005 outlook summary for European banks** (see **European Banks 2005 Outlook: The Year of The Crab?**).

- **Sovereign Bancorp** (Baa3/BBB-) announced that it will record a non-cash, non-operating impairment charge of approximately $21 million after-tax, or $0.06 per diluted share, related to its holdings of $260 million predominantly preferred fixed rate securities. The securities were issued by Fannie Mae (FNMA) and Freddie Mac (FHLMC) and were rated AA- by S&P and Aa3 by Moody's. The Philadelphia-based bank holding company held the preferred stock in its available-for-sale portfolio so the unrealized losses will be recorded as part of its other comprehensive income. Chief executive officer Jay Sidhu remarked that Sovereign was still "comfortable with meeting or beating the analyst mean estimate of $1.86 in implied cash earnings and $1.66 in operating earnings" for full year 2004.

- **U.S. Bancorp**: We recently called Moody's to to discuss their pending review of U.S. Bancorp (Aa3/A+; Moody's has on Review for Upgrade). Moody's placed U.S. Bancorp on Review for Upgrade on August 16, 2004 and had previously stated that it expected to complete its review of U.S. Bancorp by the end of 2004.

  Given the delay in Moody's taking action, we wondered if U.S. Bancorp's recent announcement of an increase in its dividend (+25%), a new share repurchase program (150 million shares), and lowering of its target equity ratios (6% from 6.25%) had put a Moody's upgrade on ice. In speaking with the Moody's analyst, however, she said the delay in taking action was purely logistical, given the holiday season at the end of the year.

  So, we asked if the company's recent announcement would be a factor in whether to upgrade U.S. Bancorp. Moody's said that while capital ratios were a factor in its committee deliberations, the major focus is the earnings power of the company. The analyst noted that U.S. Bancorp's decision to return capital to shareholders was not surprising given that a similar situation was faced by many banks, as they have struggled to generate sustained loan growth. Moody's also said that the agency did not impose a specific target for tangible equity ratios, and that the new targets would not necessarily stand in the way of an upgrade. In all, Moody's seemed relatively sanguine regarding U.S. Bancorp's recent update to its capital policies.

Based on our conversation, we sense an upgrade by Moody's is still on track. However, we feel an upgrade to Aa2 would be aggressive. Our view is that U.S. Bancorp is a strong regional franchise with additional revenue diversity provided by national fee businesses, and is similar to Wachovia (Aa3/A; S&P has on positive outlook). However, we do not consider U.S. Bancorp of the same credit strength as a larger, more diverse institutions such as Bank of America, which U.S. Bancorp's rating would be equivalent to if it were to recieve a Moody's upgrade.

Our current rating for U.S. Bancorp is at A+, in line with its S&P ratings. In its most recent report, S&P cited U.S. Bancorp's high degree of revenue diversity and high level of core profitability as key rating factors, while citing the bank's expanded repurchase strategy as a weakness. We agree with S&P's more conservative view of U.S. Bancorp's capital strategy. We think the company's moves consistently signal a willingness to pursue shareholder friendly policies, which provide a thinner capital cushion to bondholders. The large dividend increase and buyback program could also signal the company's belief that loan growth could remain elusive in 2005.

We also have concerns over the company's interest rate sensitivity. We have highlighted U.S. Bancorp as one of the banks with above average interest rate risk sensitivity in several articles, and ALM continues to remain a concern of ours going into the new year. At a recent CEO conference, U.S. Bancorp CEO Grundhofer said that the company was willing to give up some its net interest margin for earnings growth. U.S. Bancorp claimed it has the second highest net interest margin among its peers, so it can afford to give up on the net interest margin to achive higher absolute earnings. To us, this could be a case of the famous "lose money on every sale, but make it up on volume" slogan. It appears rather than take its lumps in one charge as Fifth Third decided to do, U.S. Bancorp has chosen to bleed in the deterioration of the margin over time. (see: **U.S. Bancorp @ Goldman: More NIM Pressure Expected**).

- **Washington Mutual** (A3/A-) announced the resignation of Deanna Oppenheimer, the head of its retail banking division. Oppenheimer will leave the bank on March 1 to pursue other endeavors after spending twenty years at the Seattle-based thrift. Separately, WaMu announced that it will begin to issue MasterCard International debit cards worldwide instead of Visa cards. The bank is planning to convert to MasterCard's network by the end of 2005 and begin issuing MasterCard branded cards in early 2006. WaMu's customers currently have 1.5 million PIN-only cards in addition to its 9 million signature debit cards and spent more than $21 billion in 2004.

- **Wells Fargo** (Aa1/AA-) has said that it expects about $65 million in costs from its purchase of $29 billion in mutual fund assets from Strong Financial Corp. According to the San Fransisco-based bank, $20 million will be recorded in 4Q04 and the remaining $45 million will be accounted for in 2005. The purchase was made in May 2004 for an undisclosed amount after Strong paid an $80 million penalty and agreed to cut fees by $35 million over five years subsequent to New York Attorney General Eliot Spitzer's allegations of improper fund trading. Wells Fargo acquired approximately 775,000 accounts from Strong and will combine the assets with its own family of funds in 2Q05. Many of Strong's mutual fund managers have joined Wells Capital Management, the bank's asset management unit.

- **Wells Fargo** (Aa1/AA-) announced the sale of its FAS Holdings and First Allied Securities to Advanced Equities Financial Corp. Terms were not disclosed and the transaction is expected to close in 1Q05. First Allied is a full service retail brokerage with 92 team members and 465 contracted representatives domestically. It will be operated as a separate entity within Advanced Equities, who already own Round Hill Securities, another independent broker-dealer.

CreditSights Staff

Worth Watchings

Worth Watching - Bank of America: Chairman Gifford Retiring

Date Published: 15 Dec 2004, 01:20
Bank of America (Aa2/A+, S&P has a positive outlook) announced the retirement of Chad Gifford, chairman and director of the U.S.'s third largest bank, effective January 31, 2005. Kenneth Lewis, president and chief executive officer of Bank of America, was named his successor by the board of directors. Gifford had been with the company since 1966 and was named chairman and chief executive officer of Bank of Boston Corporation and the First National Bank of Boston in 1995. He was named president and chief operating officer of FleetBoston Financial in 1999, following the merger of BankBoston and Fleet Financial Group, and became chief executive officer of FleetBoston Financial on December 31, 2001 and chairman on December 31, 2002.