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

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- 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

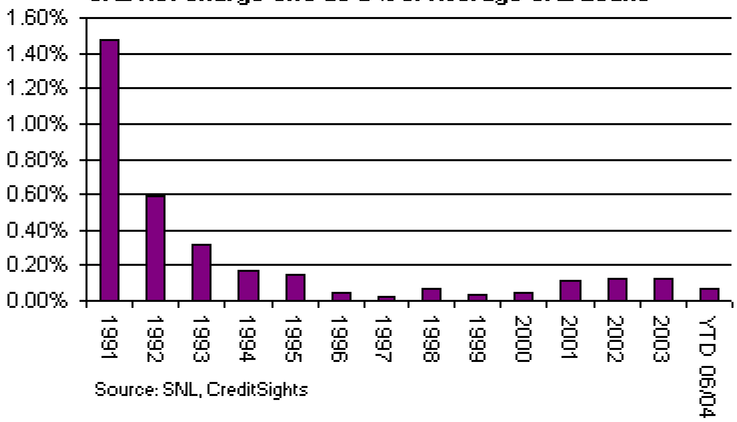
Fee revenue should pick up momentum in 2005 after a lackluster 2004. However, the growth in deposit-related fees is likely to be weak, as deposit-related fee growth slowed in 2004 and growth in deposit balances could lag in 2005. **So, positive trends in fee growth could be concentrated among banks with 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.

CRE Net Charge-offs as a % of Average CRE Loans



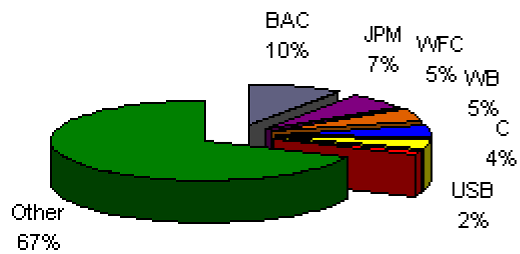
Source: SNL, CreditSights

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.

Domestic Deposit Market Share



As of 6/30/04, proforma for acquisitions

Source: FDIC, CreditSights

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.

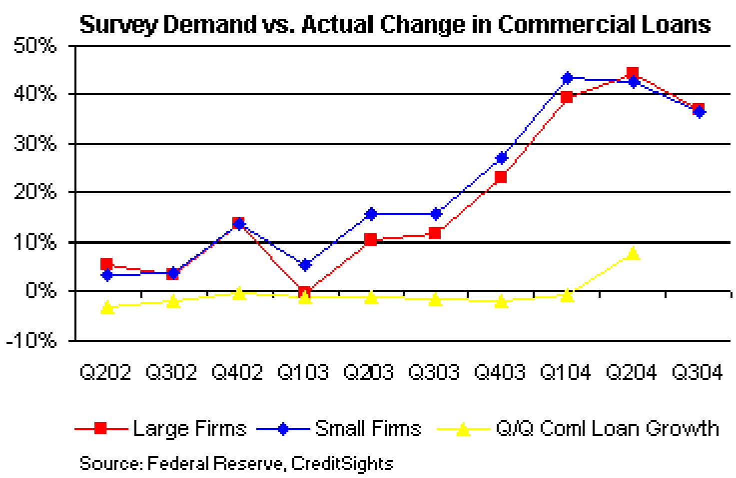
Part I: Bank Fundamental Trends
Commercial Loan Outlook (back to top)

- 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.

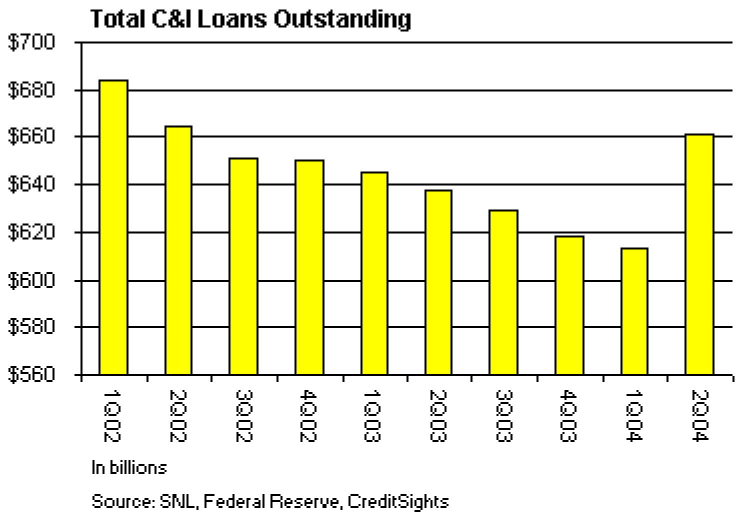
These secular trends should benefit the larger banks with more of a capital markets presence, which derive fees from these high yield/securitization deals at the expense of net interest income. Smaller regionals more dependent on bread-and-butter C&I lending are therefore at a disadvantage. **We also 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

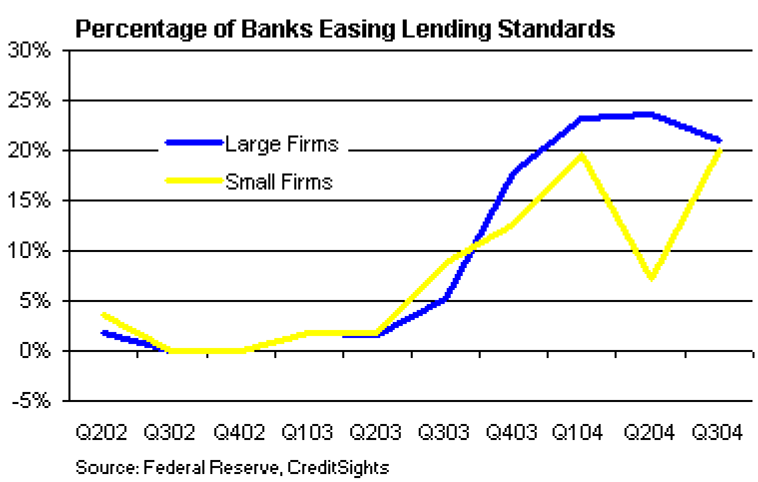
not begin to increase until 2Q04. So, the **survey has been a leading indicator of actual loan growth by nearly 12 months and has been too optimistic in its forecast for strengthening loan demand for the past year.** Several banks, such as **SunTrust** and **Comerica**, have said that they expect lackluster 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.**

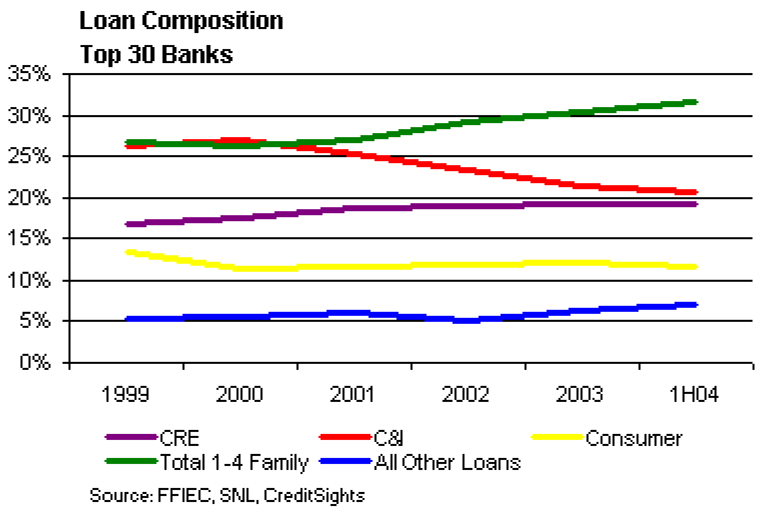
Coincides with Easing Standards

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.**

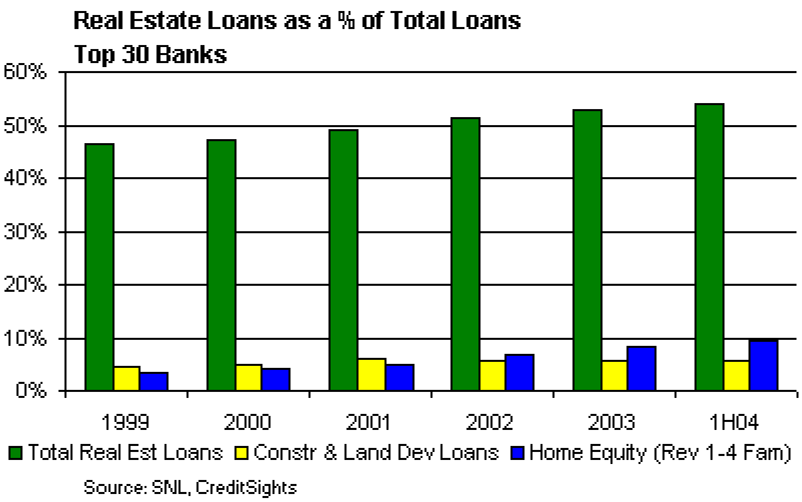
Finally, the importance of corporate lending to large banks has lessened significantly over the past few years. For the Top 30 banks, C&I loans have declined from a high of 27% of their loan portfolio in 2000 to 21% as of 2Q04. So, in 3.5 years C&I loans' contribution to large bank's loan portfolios 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.**



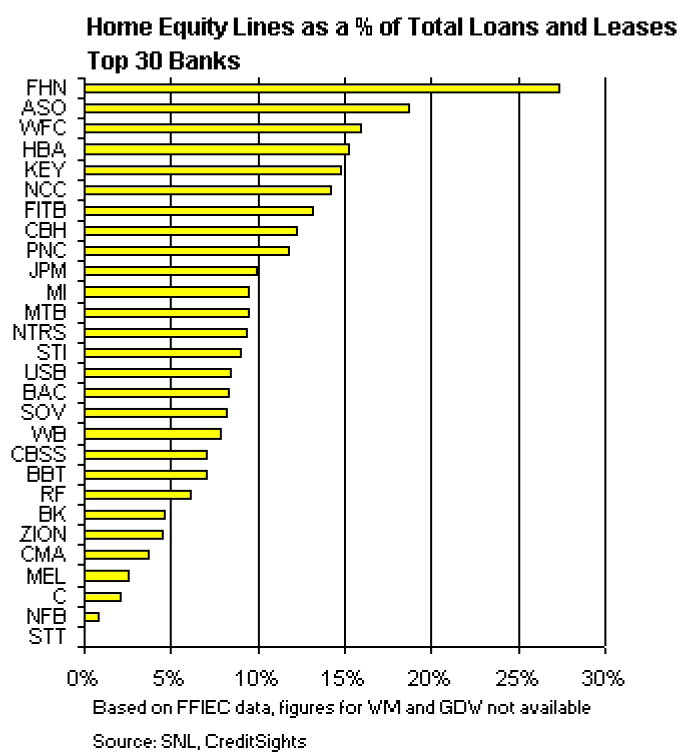
Real Estate Lending Grows: Home Equity Driver (back to top)

- 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

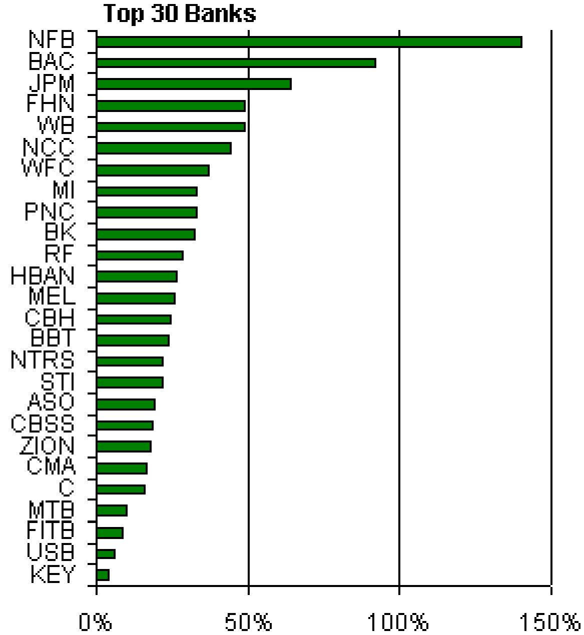
We suspect the trend toward higher home equity lending continues into 2005 given favorable supply and demand dynamics. From the supply side, there is a steady supply of banks willing to lend. **Banks utilized a steady stream of new home equity loans to feed balance sheet growth and interest income, and 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%).

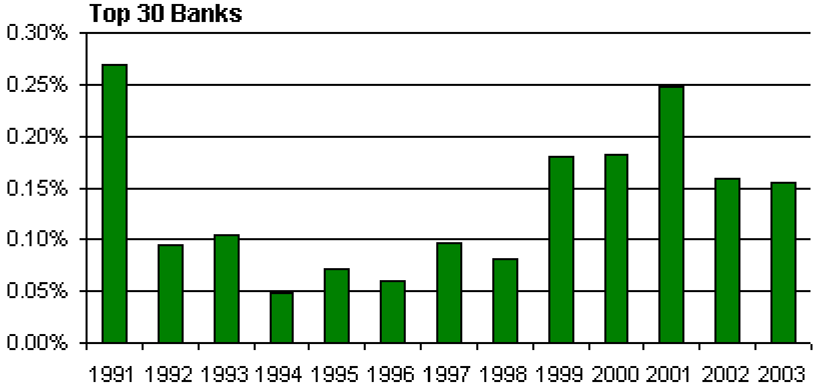
Year-over-Year Change in Home Equity Loans
Top 30 Banks



Based on FFIEC data, some figures not available
Source: SNL, CreditSights

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.**

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



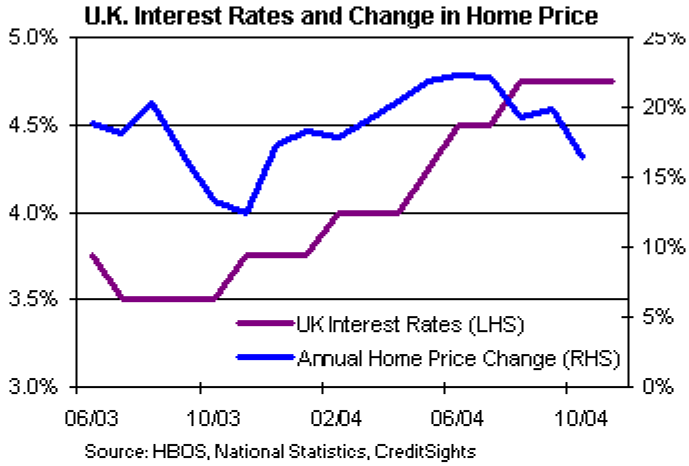
Based of FFIEC data, some figures not available
Source: SNL, CreditSights

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.**

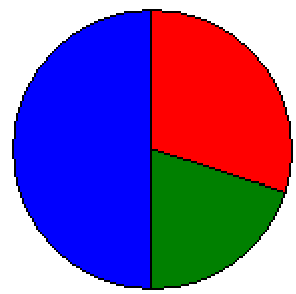
New Products Untested

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.**

Hybrid ARMs % of Mortgage Book



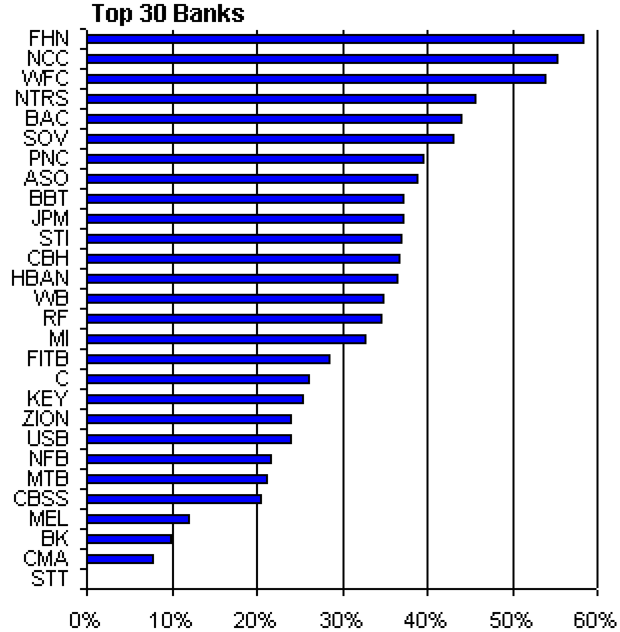
Source: Federal Reserve, CreditSights

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.**

1-4 Family Mortgages as a % of Total Loans
Top 30 Banks



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

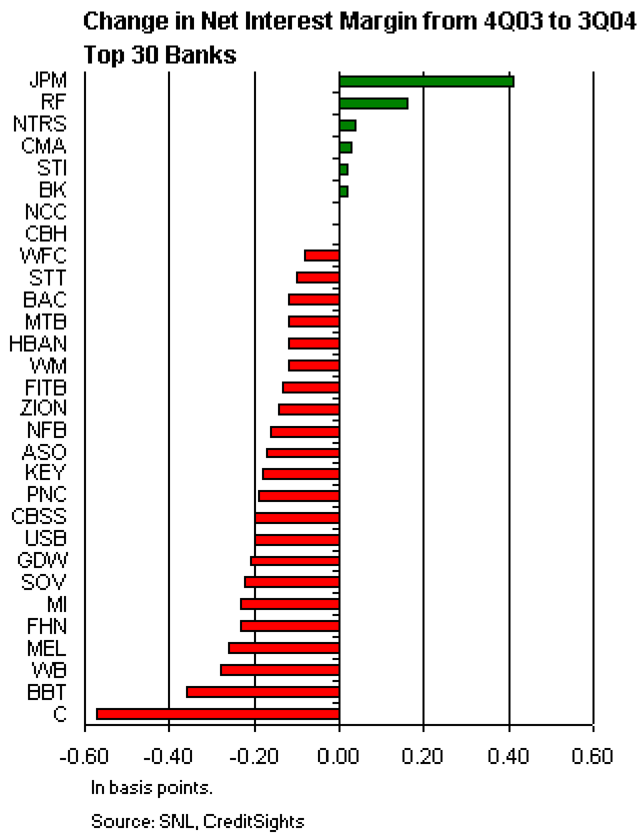
Source: SNL, CreditSights

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.**

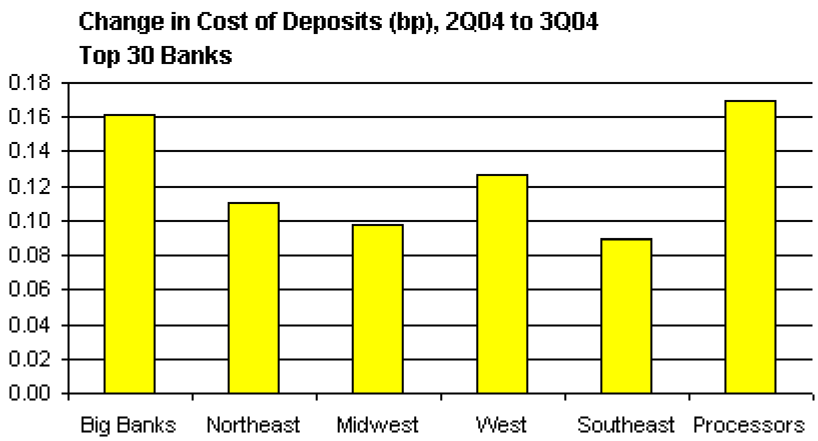


For 2005, net interest margin trends are likely to be a tug-of-war between the positive impact of higher rates and the negative effects of a flatter yield curve. The Fed cycle of higher rates in 2004 came too late for meaningful increases in the net interest margin to filter through most banks' balance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

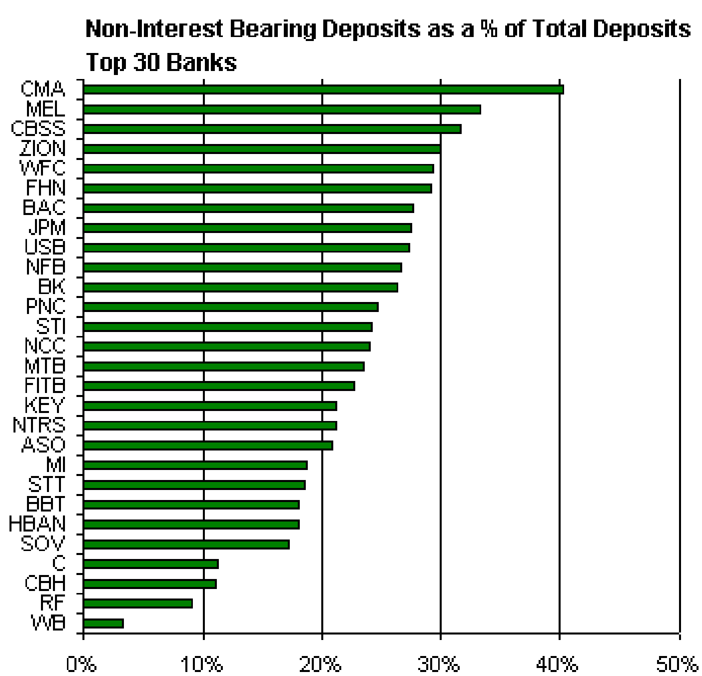
We looked at the change in cost of deposits from 2Q04 to 3Q04 to see if this was true. One quarter's change is certainly not enough to draw a trendline, but the evidence did show that the Southeast banks cost of deposits did increase less than Midwest banks as a group, though not by much. The big banks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



Source: SNL, CreditSights

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.

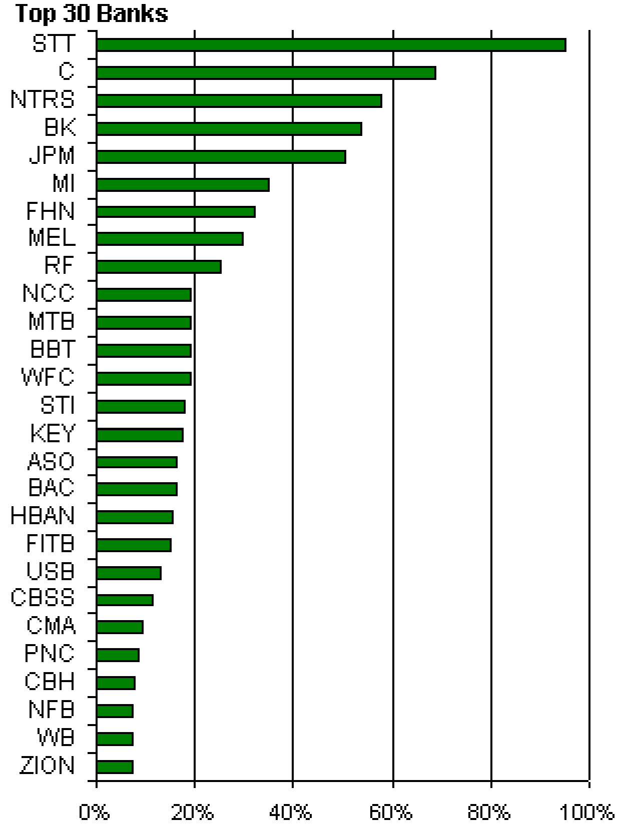


Based on FFIEC data, figures for WM and GDW not available

Source: SNL, CreditSights

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.

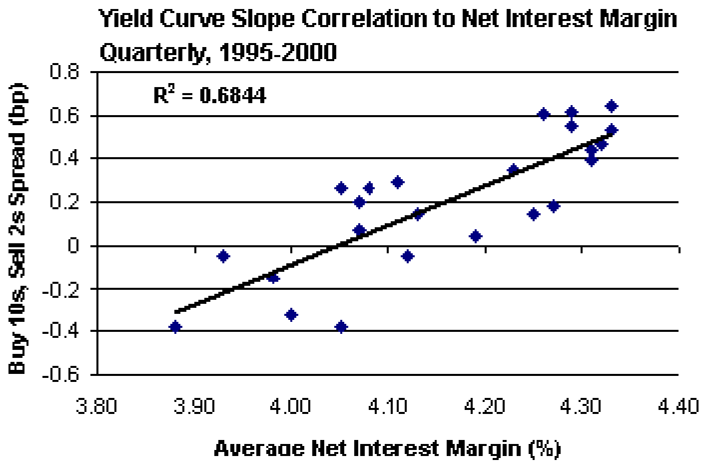
We took a look back at past periods of Fed rate increases to see how much flatter the curve might get. From Dec. 1993 to February 1995, the Fed raised rates by 3.00% pts. to 6.00%. During that time, the 2Y/10Y spread narrowed from 159 bp to 30 bp (-129 bp). In 1999-2000, when the Fed raised rates by 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.**



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%

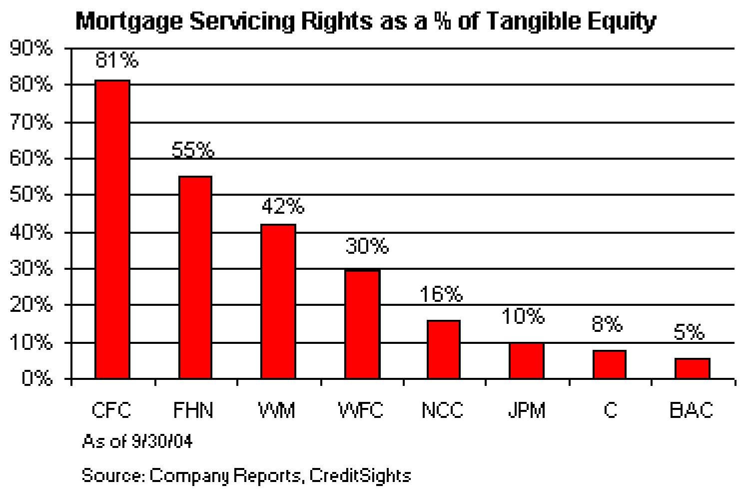
Source: FFIEC, CreditSights

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.

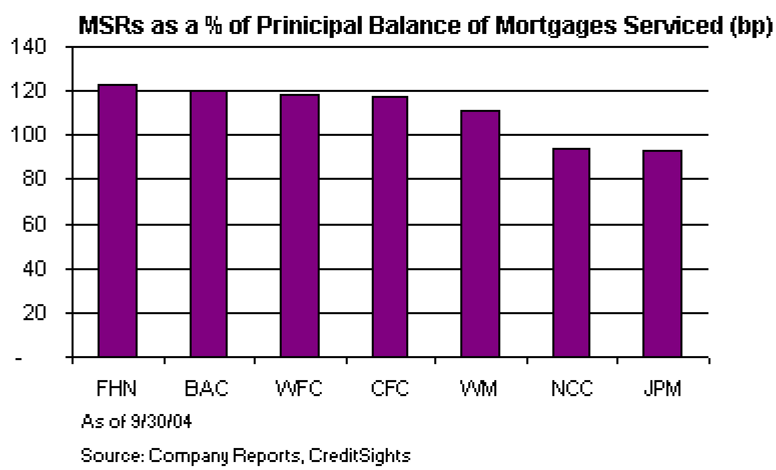
MSR Hedging Also Tricky

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.

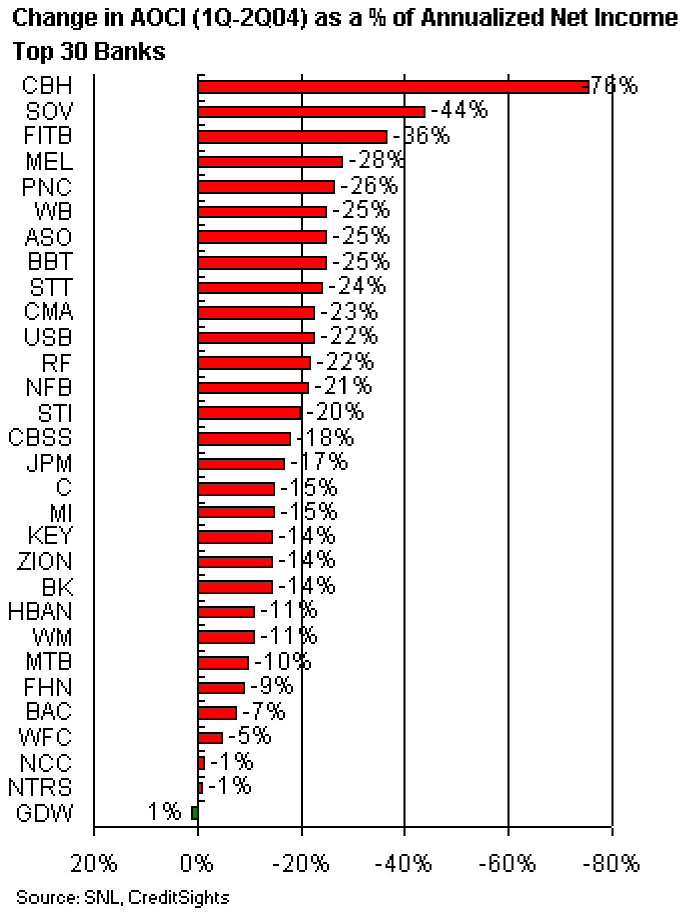
Unrealized investment portfolio losses do not flow through net income, but rather get deducted from shareholder's equity, via changes in other comprehensive income (OCI). **As rates move higher, the value of fixed rate paying securities falls. So, losses in the OCI account can show which banks are likely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



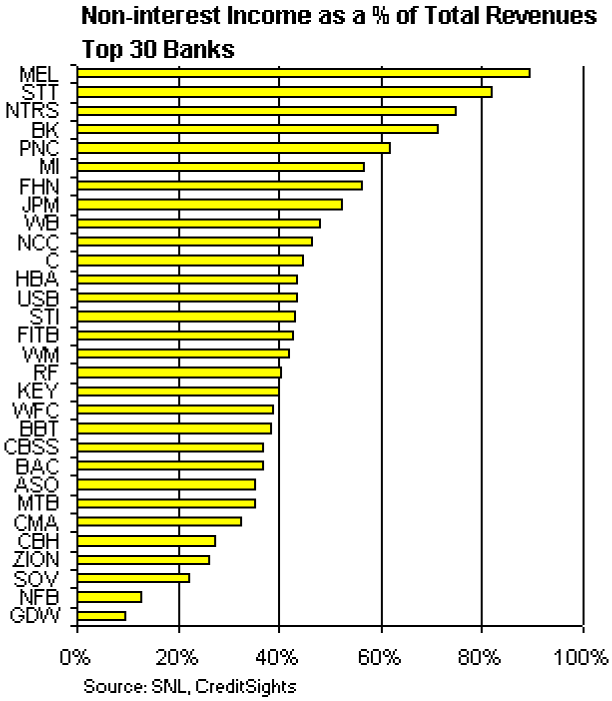
Due to Fifth Third's balance sheet restructuring announced in 4Q04, we would expect its sensitivity to higher rates to be somewhat lessened going forward. The other banks could remain vulnerable to higher rates.

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.

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.**

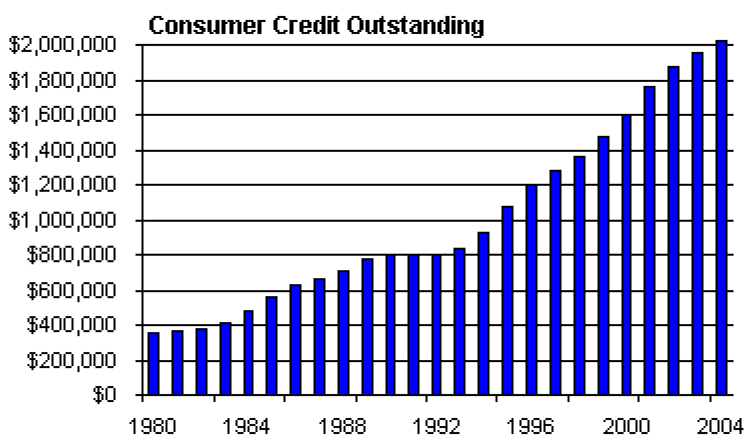
Company Name	9M04 Underprovisioning EPS Impact	9M04 Core EPS	Underprovisioning Impact as % of Core EPS
Citigroup	0.32	2.98	11%
JPMorgan Chase	0.12	1.99	6%
KeyCorp	0.09	1.77	5%
SunTrust	0.17	3.99	4%
Fifth Third	0.08	2.14	4%
Bank of America	0.05	2.45	2%
U.S. Bancorp	0.04	1.65	2%
Wachovia	0.06	3.03	2%
PNC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

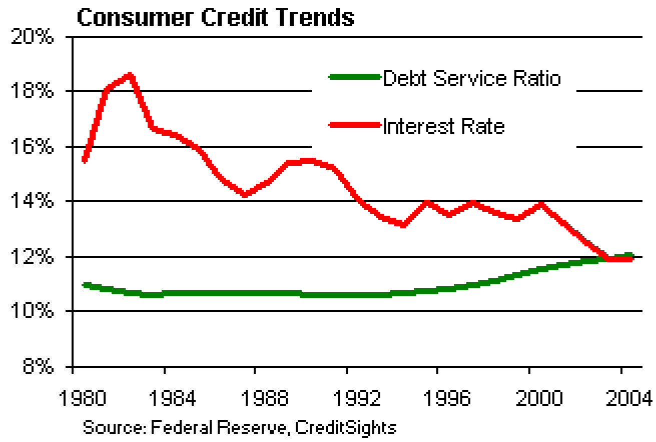
The consumer borrowing binge so far has not slowed down, as total consumer credit reached all-time highs. Total consumer debt reached over $2.0 trillion as of August 2004.



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

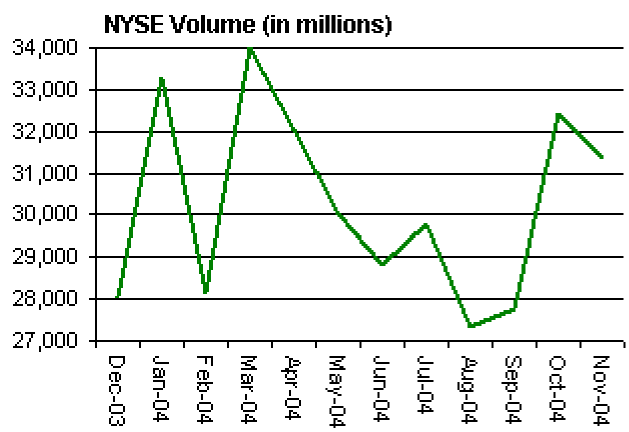
Deposit-related fees continue to be the single largest source of non-interest income for banks. As of 3Q04, service charges on deposits were nearly 26% of total non-interest income, the highest quarterly contribution in 2+ years. The growth in these fees has been steady, and tends to be related to growth 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.

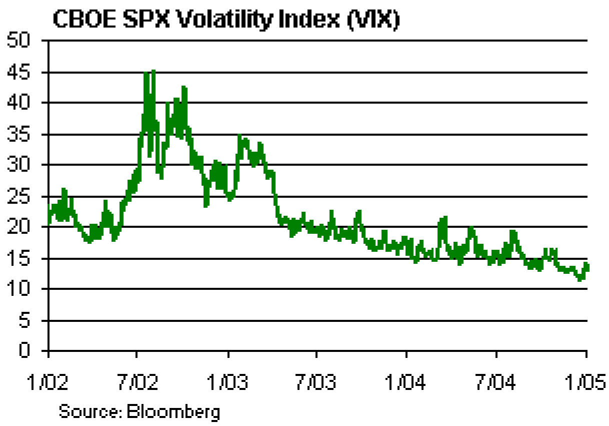
For the first half of the year, equity markets went nowhere, reaching their 2004 lows in the dog days of August. Following the U.S. Presidential election, equity markets finally showed signs of life with the S&P index reaching its highs for the year in December. Also encouraging was the trend in trading 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.



Source: NYSE, CreditSights

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.

Source: Bloomberg

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

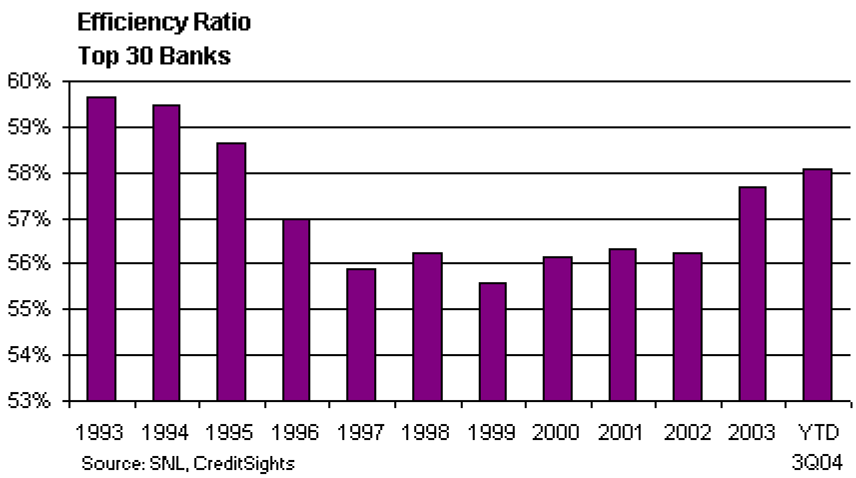
We also note that large credit card issuers have hiked fees and interest rates for a number of consumers. Fees which have increased in the past 2-3 years include late fees, telephone payment fees, and other fees. While the preponderance of credit card fees is positive from non-interest income standpoint, 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.

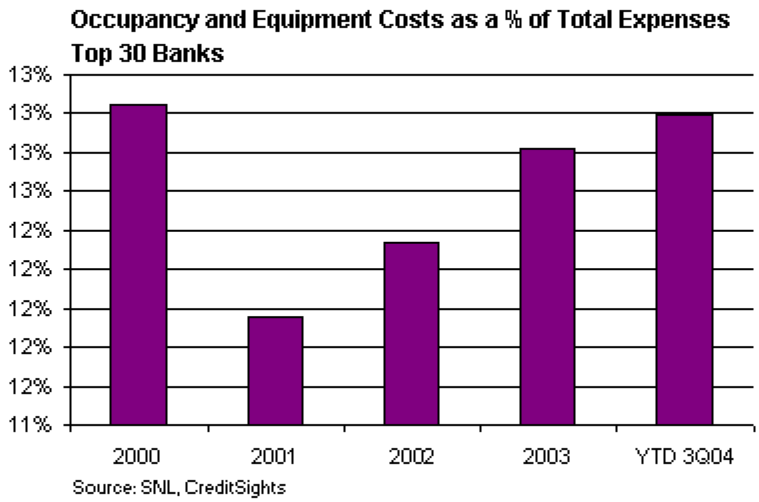
Gift card issuance, which is the fastest growing sector of cards behind debit, also seems to be attracting more scrutiny. Many bank-issued gift cards have hidden fees, such as non-usage fees which sap the value of the cards if they are not utilized within a specified time frame (usually 6 months).

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.

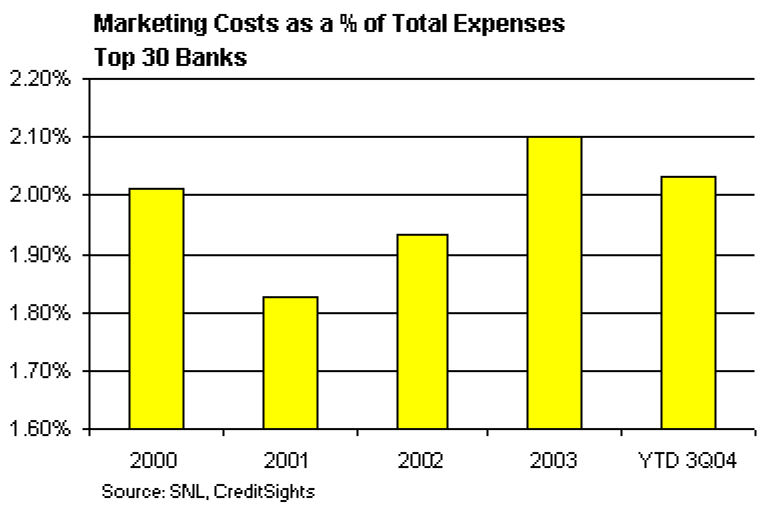
Marketing, Tech Expenses Stay High

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.



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.



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.

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