

- 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 of 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.

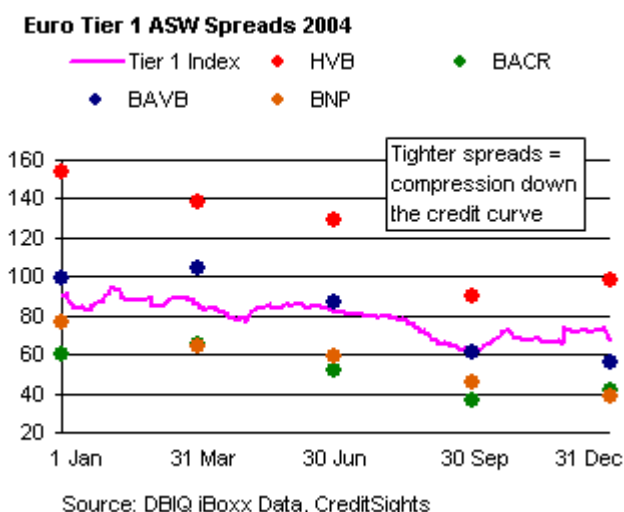
We are not surprised by Moody's action, as we noted in our recent tearsheet for BB&T that "Moody's is likely to review BB&T's rating in the next 6 months, most likely in 1Q05." We also commented that "given Moody's bullish view on U.S. bank ratings, we would not be surprised if BB&T achieved an upgrade." 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 acquisition 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 be 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 executive 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 mergers 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 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 receive 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 achieve 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 Francisco-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.

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