
The Chase Manhattan Corporation Competitive Outlook Post Mergers and Associated Corporate Restructuring in the “New Era” of World Banking

Charles M. Becker, TCU

Edward M. McNertney, TCU

Abstract

This paper examines the financial position of the Chase Manhattan Corporation as it prepares to enter a “new era” of increasingly stringent worldwide competition for banking services. The study is based primarily on accounting data analysis from appropriate corporate documents. These included audited annual reports as well as SEC Form 10K’s.

Introduction

The authors of this paper decided to undertake an investigation of one of America’s premier wholesale banks, Chase Manhattan Corporation, in an effort to ascertain its current and recent financial status and performance relative to its ability to compete into the future. One disclaimer that should be clearly understood from the beginning of this exercise follows: the authors make no claim, either explicit or implicit that the “new era” competitive position of The Chase Manhattan Corporation can be analyzed in terms of a simple model such as a Von Neumann-Morganstern two person zero sum game model.¹ It would be convenient indeed if things were so simple that one could treat the situation as a case of Chase against the world or some world proxy. Unfortunately Chase competes already on an international scale against a host of foreign as well as domestic rivals who in addition compete directly against one another for dominance within the New York Clearinghouse regional area.² This being the case it was decided to attack the issue at hand by conducting an analysis of Chase Manhattan Corporation as a stand-alone entity. This analysis was undertaken primarily from the perspective of financial accounting utilizing appropriate recent annual reports and SEC Form 10k filings. Economic theory enters the discussion in places but is de-emphasized due to its inherently tentative nature.

Our interest in this topic dates back to a series of papers published in the 1980’s on various aspects of banking. In 1983 C.M. Backer and the late K.A.N. Luther published The Recently Evolving International Exposure of Major Texas Banks in the Journal of the Southwestern Society of Economists. This was followed in 1985 in the same journal by the paper Selected Texas Banks: Some Risks of Foreign Exposure authored by C.M. Becker, K.A.N. Luther, and J. Tollett. Our focus then shifted from international banking to issues of earnings quality with the 1989 publication of Appraising the Earnings of Selected New York City Banks co-authored by C.M. Becker and C.R. Waits. This article appeared in Public Administration Economics and Finance a NAEFA sponsored publication. A short form of the The Manufacturers Hanover/Chemical Bank Merger: A Contrarians Perspective by C.M. Becker and Allyn Needham was published in 1992 in the Southwestern Journal of Economic Abstracts. The complete version appeared later, by permission, in Integration Financiera y TLC: Retos y Perspectivas. A 1997 paper by C.M. Becker, E.M. McNertney and A. Needham titled The Chase Manhattan Corporation/Chemical Banking Corporation:

A Skeptical Overview appeared in July 1998 in the Southwestern Journal of Economics. The present paper, while related to the entire series of aforementioned work is particularly closely tied in as an extension of our merger related research.

The remainder of this paper shall address the financial position of the Chase Manhattan Corporation and offer some conclusions about the analysis. All this shall be undertaken against a background of unknowable political, legal, and merger/restructuring uncertainty. In this latter regard the authors must caution that in an environment of historically elevated share prices and pooling of interests accounting NO RESTRUCTURING POSSIBILITY CAN BE RULED OUT WITH ABSOLUTE CERTAINTY.³

The Financial Position of the Chase Manhattan Corporation

In this section our procedure shall be to break the analysis down into three categories. These follow:

Category I: Balance Sheet Issues

Category II: Income Statement/Cash Flow Issues

Category III: Other Issues

Balance Sheet Issues: As a point of departure the readers attention is directed to

Table I:

Table I:
Consolidated Balance Sheet
Of The Chase Manhattan Corporation (Based
On December 31, 1995 - 1997 Data)

	1995	1996	1997
Asset Categories:			
Cash	7.7%	6.8%	5.1%
Securities:			
Trading	17.1%	17.8%	19.8%
Investment	13.7%	14.4%	14.4%
Loans 48.2%	45.1%	45.1%	
Total Assets	100.0%	100.0%	100.0%
Liability Categories:			
Deposits	56.4%	53.8%	53.0%
Long Term Debt	4.2%	3.8%	3.7%
Total Liabilities	93.1%	93.6%	93.9%
<u>Total Liabilities & Equity</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Source: Annual Reports and SEC Form 10Ks

Table I has been expressed in percentage terms rather than in dollar amounts for ease of understanding. This procedure was suggested, if not dictated, by the fact that Chase Manhattan Corporation at December 31, 1997 sported total assets slightly in excess of \$365,000,000,000. At this size it boasts the critical mass and probable associated economies of scale to compete in the international marketplace "ceteris paribus."

A second issue raised by Table I concerns the question of whether or not Chase is in a position to aggressively pursue new customers and the growth that such customer accounts might entail. Leaving aside, for the moment, the question of account profitability (personal bankruptcies in mid 1998 are running at a projected annualized rate of 1,900,000 filings - clearly a concern for retail lenders like Chase) an examination of the bank's loan

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to deposit ratio was undertaken. This ratio (which registered 85.5% in 1995, 83.8% in 1996, and 85.1% in 1997) has obviously registered characteristics of stability over the past three fiscal years. However, this stability has occurred at a very high and arguably aggressive level when viewed in the context of historic standards.⁴ A ratio of seventy percent loans to deposits has been recognized by financial analysts since the 1920's as the absolute prudent maximum lending exposure by institutions of size and Chase on December 31, 1997 was 21.6% exposed beyond this benchmark.⁵ How much additional lending activity can be expected against this background is problematical. Much will depend on the state of the world economy already threatened by events in Asia and the risk tolerance level of Chase's senior management. In order to throw some added light on this issue we examined the degree of leverage present figuring that high leverage might discourage aggressive lending behavior. Long term debt, as is typical for commercial banks, imposes no limitation in and of itself. It held at or around the 4% level of total assets during the three year survey period.⁶ The ratio of equity to deposits was also reviewed. It stood at 12.2% in 1995, 11.9% in 1996, and 11.5% in 1997. These figures are in the high end of the neutral category (a figure of less than 5% has historically been viewed as too aggressive while a figure of more than 15% has historically been viewed as too conservative). Thus, our preliminary conclusion on this issue is that while leverage does not really enter into the picture in a material way Chase Manhattan Corporation finds itself fully extended, to say the least, in terms of loan commitments as of December 31, 1997.

Still another balance sheet related issue which carries implications for future lending as well as institutional solvency concerns the matter of net long term asset exposure. This exposure is clarified in Table II which follows:

Table II
Net Long Term Asset Exposure of The Chase Manhattan Corporation
(based on December 31, 1997 data-figures expressed in millions of dollars)

Long Term Assets (LTA):	
Securities Maturing in 10 years or longer ⁷	\$31,606
Residential Mortgage Loans	\$40,155
Real Estate Loans ⁸	\$ 4,747
Bank Premises and Equipment	\$ 3,780
TOTAL LTA	\$80,288
Long Term Liabilities & Equity (LTL&E):	
Deposits ⁹	\$13,354
Long Term Debt ¹⁰	\$ 6,020
Equity ¹¹	\$21,742
TOTAL LTL&E	\$41,116
Net Long Term Assets (LTA-[LTL&E])	\$39,172

Source: Derived from 1994/1997 Annual Reports and 10K's

Table II would seem to contribute a fairly conservative and realistic statement of long term asset exposure since it assumes that all loans carried in every other category by Chase are short term in character. This assumption is probably too extreme with the result that some understatement of long term asset exposure is built into the analysis.

Now, as to the significance of Table II, it is clear that no lender of other peoples

money can remain in business indefinitely by borrowing short term and lending long term. The net long term asset exposure of \$39,172, which constitutes 180.2% of consolidated equity for Chase, in effect places a fairly significant bet on the continuance of an upsweeping yield curve with its inherent favorable spreads between long and short term interest rates.¹² Should market forces prove adverse in the future and should the yield curve become flat or, in a worst case scenario, inverted Chase would find itself exposed to fairly significant losses and might in consequence have to reevaluate its lending policies in a manner consistent with credit contraction. Given Chase's size and stature within the banking community, the negative multiplier effects on the overall United States economy can only be guessed. Given that this potential threat is clearly understood by government regulators it would seem doubtful that Chase would be allowed to pursue expansion in anything other than a very cautious and conservative manner from this point in time forward, the balance sheet position being what it is at the close of the 1997 fiscal year.¹³ In fairness to Chase it should be noted that noninterest or fee revenue, amounting to \$8,625,000,000 during the 1997 fiscal year, constitutes 39.6 percent of interest income and thus clearly provides diversity in overall sources of revenue. Thus, it may be that, inverted yield curve or not, Chase is protected to a material extent from bond market happenings in terms of whatever earnings effect may ensue.

There is another aspect to this general discussion which requires some mention. This in the matter of asset quality which for a commercial banking entity translates itself down into an examination of loan account quality.¹⁴ Raw accounting data and ratios while useful give an incomplete picture of the financial situation. We thus now turn to Table III:

Table III
Loan Account Quality of the Chase Manhattan Corporation
(based on December 31, 1997 data - figures expressed in millions of dollars)

Nonperforming Assets ¹⁵	\$ 1,018
Past Due 90 Days and Over Credit Card Receivables	\$ 633
Total Nonperforming Assets	\$ 1,651
Asian Exposure (IMF Involvement):	
Korea	\$ 5,400
Indonesia	\$ 2,600
Thailand	\$ 2,100
Malaysia	\$ 1,100
Philippines	\$ 1,100
Totals ¹⁶	\$12,300
Risk Assets	\$13,951
Risk Assets/Loan Loss Reserves & Equity	53.6%

Source: 1997 Annual Report and 10K of The Chase Manhattan Corporation

Table III constitutes an indicator of the overall asset quality and risk exposure of Chase. It states a basic non-performing assets figure by adding past due credit card receivables to nonperforming assets (which make no allowance for credit card losses and related items). It then addresses, on a very conservative basis, the Asian Contagion by totaling only those assets in International Monetary Fund (IMF) involved countries. It next adds these in to derive a so called "risk asset" total of \$13,951,000,000. This total is finally divided by loan loss reserves plus owners equity (which includes \$550,000,000 of preferred stock) to derive an indicator of risk asset coverage. Even using these conservative

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assumptions writeoffs of nonperforming assets and assets exposed directly in Asia would eliminate the entire \$3,624,000,000 loan loss reserve (which constitutes a paltry 2.15% of total loans outstanding) as well as reducing owners equity by 45.8%.

Table III makes no allowance for the possibility of the Asian Contagion spreading further and signs indicating this possibility clearly exist in Japan. When one considers that Japan is an export driven nation, that Korea is its largest trading partner, and that the Bank of Japan has publicly stated that the Japanese commercial banking system has \$1,000,000,000,000 in nonperforming loans (a sum so vast as to require not only the entire net worth of the Japanese commercial banking system were it to assume default status but the entire net worth of the World Bank and the IMF as well) it can certainly be argued that the threat to Chase is not immaterial and irrelevant.¹⁷ And even this ignores already present signs of fallout in both Latin America and the Soviet Union. Thus, while the asset quality issue remains moot for the present it raises longer term questions concerning Chase's ability to expand.

Finally, Table III as constituted makes no allowance for the risks associated with trading and market making in capital market assets (bonds and debt paper). To have included this, given the inherent uncertainties associated with such undertakings, would have been impossible since no statistical measure exists which could offer precise cardinal or even reliable ordinal measurement. Yet this is an important risk area and has rightly assumed a central place on the agendas of regulatory authorities. As such its omission constitutes a significant argument in favor of the proposition that Table III may actually understate risk. To put the case another way Chase's trading asset account of \$72,393,000,000 stands at 332.9 percent of stated stockholder equity including preferred stock. Given this almost 3.33 to 1 ratio it follows that trading losses of 10 percent would wipe out one full third of consolidated owner equity of Chase. Given recent cases (such as Barings Bank) such a scenario cannot be dismissed out of hand.

Income Statement/Cash Flow Issues: In this subsection we shall consider the issue of earnings growth. When viewed superficially (employing the end of the 1990 fiscal year as a base since this must be viewed as the last year of Chase's independent operation prior to two major mergers)¹⁸ the results appear to be impressive with earnings rising from \$2.16 per share in 1990 to \$8.03 per share in 1997, a gain of 271.8% over a period of only seven fiscal years. As it stands this appears to be an indicator of forward earnings momentum for future earnings reporting periods. But all is not so simple once the merger element is addressed and examined.

To begin with both mergers appear to have been dilutive. In this regard Table IV is provided for clarification:

Table IV begins with a computation of normal earning power for both MHC and CHL. These figures were derived by taking the annual earnings per share figures for each banking entity over a seventeen year period, summing them and then computing a simple mean average of the results. The period selected purposely went back to include the deep recession year of 1974 as well as the writeoff years of 1987 and 1989 (during the former MHC reported a loss of \$27.04 per share while CHL reported a loss of \$16.68 per share - during the latter MHC reported a loss of \$11.49 per share while CHL reported a loss of \$8.29 per share). Since 1989 was a writeoff year and since writeoffs continued to impact 1990 results we were in effect precluded from making the usual comparisons between the year before merger with the year of pooling. Thus, we decided to use what we term normal earning power as a basis of comparison. The inclusion of the bad banking years mentioned

above biases earnings growth in a positive direction, if anything, by materially lowering the base figure for both MHC and CHL.

Table IV
The Earnings Impact of Two Mergers on The Chase Manhattan Corporation

The December 31, 1991 Merger (MHC into CHL) ¹⁹ :	
Normal Earning Power (1974-1990):	
MHC	\$3.70
CHL	<u>\$3.16</u>
Total Combined	\$6.86
Pooled Earnings (1991)	\$.11
Apparent Dilution	96.5%
The March 31, 1996 Merger (CHL into CMB):	
Adjusted Earnings (1995)	\$6.66
Pooled Earnings (1996)	\$4.94
Apparent Dilution	25.8%

Sources: Annual Reports, SEC Forms 10K, Value Line
Investment Survey.

Regarding the March 31, 1996 merger of CHL (which by that time included MHC) into CMB, we calculated 1995 net income for both merger partners and then divided it by combined shares of CHL and CMB assuming implicitly that they had operated as a combined entity in 1995. This procedure would give an earnings prior to pooling number consistent with results that would normally be expected by applying the pooling of interests method.

In both parts of Table IV there is significant apparent dilution.²⁰ But this is not all. If one were to examine Table V a much better sense of earnings growth will emerge:

Table V
The Adjusted Earnings of The Chase Manhattan Corporation 1974 Versus 1990
1974 Earnings of CMB by Component as Reported (adjusted for stock splits):

CHL	\$ 2.88
CMB	\$ 2.84
MHC	<u>\$ 4.28</u>
Total Combined	\$10.00
1974 Combined Earnings (adjusted for pooling)	\$ 5.28
1997 CMB Earnings	\$ 8.03
Apparent Earnings Percentage Gain (1997 vs. 1974)	52.1%
1997 CMB Earnings	
(deflated by CPI using 1982 - 1984 base)	\$ 2.47
Adjusted Earnings Percentage Gain	(53.2%)

Sources: Annual Reports, SEC Form 10K, Value Line Investment Survey.

Table V begins with a straight-forward statement of reported earnings per share for the three entities that are assumed to comprise the present Chase Manhattan Bank.²¹ These are then combined to achieve a \$10.00 total combined earnings per share figure. An adjustment is then made to reflect the impact of pooling lowering the total combined figure

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from \$10.00 to \$5.28. When this figure is compared against 1997 earnings of \$8.03 an apparent earnings percentage gain of 52.1% is achieved for the combined entity over 24 years. However, this is merely an apparent gain for when a consumer price index adjustment is made the result emerges as \$2.47 or a 53.2% adjusted earnings loss achieved over this same period. We are troubled by this result given its rather obvious secular implications not only for Chase but perhaps for world banking and credit expansion/contraction. Still, if one looks on the positive side of things, the final numbers are not negative ones but show a flow of positive earnings.

Other Issues: A further accounting issue to be addressed with Chase concerns its off-balance sheet lending exposure. In Table VI we detail this issue:

Table VI reveals an off-balance sheet credit exposure totaling \$289.3 billion as of December 31, 1997. As the table demonstrated this total has been growing at a steady pace. The total constitutes 13.33X consolidated net worth or book value and 79.2% of consolidated total assets. While Chase correctly points out that this total represents only potential as opposed to current ongoing commitments and thus represents maximum potential risk in cases of contemplates non-performance the total is still a staggering sum. When one looks to the future and contemplates the possibilities for growth and expansion of Chase's lending posture one must consider these things and the fact that were these commitments all called for by customers (a totally absurd assumption except in the case of a worldwide financial panic) Chase would be dealing with a loan/deposit ratio of 236.4%!!

Finally there are risk factors associated with derivatives, trading activities, and of course lawsuits. These may become important in the future but for the present all we can do is recognize their potential in the factor mix since they are inherently unpredictable and on the whole non-quantifiable. This concludes our discussion of Chase.

Table VI
Off-Balance Sheet Lending-related Exposure of the Chase
Manhattan Corporation as of December 31, 1995-1997
(figures in billions of \$)

	1995	1996	1997
Credit Card Lines	N.A.	\$54.2	\$ 75.7
Other Commitments to			
Extend Credit	\$95.6	\$94.3	\$123.6
Standby Letters of Credit			
and Guarantees	\$24.7	\$30.8	\$ 33.2
Other Letters of Credit	\$ 5.9	\$ 5.6	\$ 4.7
Customers Securities Lent	\$27.1	\$38.7	\$ 52.1

Source: 1996 - 1997 Annual Reports and SEC Form 10K

Summary Comments/Conclusions

This study has had as its purpose the determination of the financial position of Chase Manhattan Corporation for the dynamic new era of world banking competition which appears to lie ahead. To this end the authors scrutinized corporate publications, especially annual reports and SEC mandated 10K documents. The paper reaches a number of specific conclusions relative to The Chase Manhattan Corporation's financial position on the eve of this new era.

I. Balance Sheet Related Conclusions.

- A. Historically high loan/deposit ratio of 85.1% for fiscal 1997.
- B. Leverage not excessive by historical standards.
- C. Significant long term asset exposure (\$39,172,000,000).
- D. Significant asset quality and risk exposure (Risk Assets/Loan Loss Reserves & Equity = 53.6%).

II. Income Statement/Cash Flow Related Conclusions

- A. Earnings growth not demonstrated in the past (1974 - 1997 price level adjusted net earnings decline of 53.2%).
- B. Merger history of present Chase organization indicates heavy presence of earnings dilution.

III. Other Issues Related Conclusions

- A. Off-balance sheet credit exposure is 79.2% of total assets.
- B. Unknown exposure in derivatives, trading accounts and lawsuits

Given these specifics, it seems to the authors unimaginable that The Chase Manhattan Corporation can move aggressively in the "new era" to expand its franchise. Corporate caution and consolidation of mergers seems the more appropriate strategy given these things and the world and United States banking conditions alluded to in this paper.

Appendix A

A Historical Look at the Financial Position of Chase

Regarding balance sheet issues, there has been no material change in the consolidated balance sheet of Chase in terms of the various percentage allocations during the 1990s. During the entire period Chase has had a loan/deposit ratio in excess of 80 percent which could be argued to reflect excessively aggressive lending practices by historical standards. The capital to deposit ratio of Chase has remained throughout the period in a moderate/neutral range. Net long term asset exposure has also been a decade long feature of Chase. Again, no material changes are noted over this time period. Asset quality has varied from year to year largely as a result of foreign lending difficulties. No clear trend has been established. The "quality of earnings" was hurt by both the CHL and MHC mergers and has remained questionable throughout the period. Some improvement has been registered as CHL and MHC have been consolidated in the late 1990s.

The trend in off-balance sheet lending exposure throughout the 1990s has been decidedly upward. In recent years there has been particular growth in customers securities lent. This could be argued to reflect the escalating upward trend in U.S. stock prices.

END NOTES

1. For more on this alternative approach see the Theory of Games and Economic Behavior by John von Neuman and Oscar Morganstern (Princeton University Press, 1944).

2. As recently as the early 1970's the New York Clearinghouse encompassed at least ten major competitors. In addition to Chase the list used to include Citicorp, Franklin National Bank (now defunct), Chemical New York Corporation and Manufacturers Hanover

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Corporation (both subsequently absorbed by Chase), the Irving Trust company (merged in 1988 into the Bank of New York, which still is on the scene), J.P. Morgan and Company Incorporated (which together with the underwriting house Morgan Stanley, Dean Witter, Discover and Company traces its origins to J.P. Morgan the elder), Bankers Trust New York Corporation, and U.S. Trust (a specialty service provider).

3. As this paper is being written it is known that the Financial Accounting Standards Board (FASB) has the pooling method under review with a decision expected by late 1998 or early 1999.

4. In 1929 the all commercial bank loan/deposit ratio stood at the then historically high level of 80%.

5. This is not to imply that Chase is necessarily at grave financial risk at the 85.1% level of loans/deposits. In 1984 Manufacturers Hanover Corporation, today a component of Chase achieved a record of sorts with a loan/deposit ratio of 131.7% and still survived, perhaps by grace of its December 1991 merger with Chemical Banking Corporation which itself was merged into Chase in March 1996.

6. While capital notes typically constitute a figure of less than 10% of assets for commercial banks the size of this figure should not be viewed as indicative of overall financial leverage. One must remember that the ratio of total debt to equity for all commercial banks has for decades averaged a figure in excess of 10 to 1.

7. This figure is based on amortized cost which does not differ materially from its related fair market value figure of \$31,876.

8. Construction loans, while real estate related, are considered short term and are thus excluded from this calculation.

9. This figure was derived by computing Chemical Banking Corporations December 31, 1994 percentage of total deposits maturing over 5 years and applying the same percentage to its subsequent merger partner Chase Manhattan Corporation (which does not release this type of detailed breakdown). The December 1994 figure thus obtained (\$12,019) was then divided by 90% a rounded off figure obtained by taking long term debt and equity in December 1994 as a percentage of long term debt and equity in December 1997. While crude we believe that this figure is useful and indicative of long term deposit exposure for the combined banking entity.

10. Debt is classified as long term if it is due to mature in over 5 years from the balance sheet date of December 31, 1997.

11. Equity here includes preferred stock.

12. Historically such an upsweeping yield curve has constituted the norm but there have been times (most recently in the late 1970's and early 1980's) when change occurred and a downsweeping or inverted yield curve emerged.

13. This having been said it is worth reflecting on the fact that Chase is positioned by the inherent composition of its balance sheet to enjoy a certain amount of interest rate generated relief even during a period of tight money and inverted yield curves. This follows from the fact that, unlike regional banks, Chase is both asset and liability side interest rate sensitive

and in addition enjoys significant international diversification which usually can be expected to protect in all except worldwide financial cataclysms.

14. Commercial banks seldom get into serious financial difficulty as a result of cash disappearing, securities fraud, or markdowns (though this is not entirely unknown) or fixed asset account problems. The history of bank failures points clearly in the great majority of instances over hundreds of years at the loan account. For additional perspective on this point see A History of Interest Rates by Sidney Homer (Rutgers University Press, 1963).

15. Management states on page 31 of its 1997 annual report that it expects this figure to rise in 1998.

16. If this list was expanded to include Hong Kong, Singapore, China, Taiwan, and India \$7,200,000,000 would be added to the totals for Asian exposure.

17. As a further point to be considered Barrons has published estimates indicating that Chinese monetary authorities have estimated that as of the Spring of 1998 the Chinese commercial banking system, taken as an aggregate, sports a ratio of nonperforming loans to total loans outstanding of 20%, a sum estimated to be 4X the size of systemwide equity.

18. We refer here specifically to the December 31, 1991 merger with Manufacturers Hanover Corporation with Chemical Banking Corporation which subsequently merged with the Chase Manhattan Corporation on March 31, 1996. Since both these mergers were undertaken for stock using the pooling of interest method their effect on net income in the merger years and subsequently cannot be ignored.

19. These are New York Stock exchange ticker symbols which are routinely provided by Standard and Poor Stock Guide (MHC = Manufacturers Hanover, CHL = Chemical Bank, and CMB = Chase).

20. The calculation of dilution is a complex process and as exact calculation would require data which is properly regarded as confidential by the banking entities involved. Thus, we term our dilution percentage as apparent (translation: ballpark) dilution.

21. Excluded from this and subsequent calculations is Texas Commerce Bank which was acquired by Chemical Banking Corporation in a separate transaction. Had Texas Commerce been included the final results would have looked materially worse for Chase since Texas Commerce would have raised the 1974 total combined figures.