PNC FINANCIAL SERVICES GROUP INC
Form 10-Q
November 09, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _______ to _______

Commission file number 001-09718

The PNC Financial Services Group, Inc.

(Exact name of registrant as specified in its charter)

Pennsylvania	**25-1435979**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

One PNC Plaza, 249 Fifth Avenue, Pittsburgh, Pennsylvania 15222-2707

(Address of principal executive offices)

(Zip Code)

(412) 762-2000

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. Check one:

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

As of October 31, 2006, there were 293,812,255 shares of the registrant s common stock ($5 par value) outstanding.

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CONSOLIDATED FINANCIAL HIGHLIGHTS

THE PNC FINANCIAL SERVICES GROUP, INC.

Dollars in millions, except per share data Unaudited	Three months ended September 30 **2006**	 2005	Nine months ended September 30 **2006**	 2005
FINANCIAL PERFORMANCE				
Revenue				
Net interest income, taxable-equivalent basis (a)	**$574**	$566	**$1,699**	$1,619
Noninterest income (b)	**2,943**	1,116	**5,358**	3,019
Total revenue (b)	**$3,517**	$1,682	**$7,057**	$4,638
Net income (c)	**$1,484**	$334	**$2,219**	$970
Per common share				
Diluted earnings (c)	**$5.01**	$1.14	**$7.46**	$3.35
Cash dividends declared	**$.55**	$.50	**$1.60**	$1.50
SELECTED RATIOS				
Net interest margin	**2.89%**	2.96%	**2.92%**	2.99%
Noninterest income to total revenue (d)	**84**	67	**76**	65
Efficiency (e)	**34**	69	**50**	69
Return on				
Average common shareholders equity	**65.94%**	16.13%	**33.87%**	16.49%
Average assets	**6.17**	1.45	**3.17**	1.48

See page 33 for a glossary of certain terms used in this Report.

Certain prior period amounts included in these Consolidated Financial Highlights have been reclassified to conform with the current period presentation.

(a) The interest income earned on certain earning assets is completely or partially exempt from federal income tax. As such, these tax-exempt instruments typically yield lower returns than a taxable asset. To provide more meaningful comparisons of yields and margins for all earning assets, we also provide revenue on a taxable-equivalent basis by increasing the interest income earned on tax-exempt assets to make it fully equivalent to interest income on other taxable assets. This adjustment is not permitted under GAAP in the Consolidated Income Statement.

The following is a reconciliation of net interest income as reported in the Consolidated Income Statement to net interest income on a taxable-equivalent basis (in millions):

	Three months ended September 30 **2006**	 2005	Nine months ended September 30 **2006**	 2005
Net interest income, GAAP basis	**$567**	$559	**$1,679**	$1,599
Taxable-equivalent adjustment	**7**	7	**20**	20
Net interest income, taxable-equivalent basis	**$574**	$566	**$1,699**	$1,619

(b) Noninterest income for the three months and nine months ended September 30, 2006 included the pre-tax impact of the net gain on the BlackRock/MLIM transaction of $2.1 billion. This category also included the impact of pre-tax charges from third quarter 2006 balance sheet repositioning activities totaling $244 million. Further information is included in the Executive Summary portion of the Financial Review section of this Report.

(c) Net income and earnings per share for the three months and nine months ended September 30, 2006 included the after-tax impact of the items referred to in note (b) above, in addition to the after-tax impact of integration costs related to the BlackRock/MLIM transaction. These integration costs totaled $72 million and $91 million on a pre-tax basis for the three months and nine months ended September 30, 2006, respectively, or $31 million and $39 million on an after-tax basis, net of related minority interest.

(d) Calculated as noninterest income divided by the sum of net interest income (GAAP basis) and noninterest income. See note (b) above regarding certain items impacting noninterest income for both 2006 periods.

(e) Calculated as noninterest expense divided by the sum of net interest income (GAAP basis) and noninterest income. See notes (b) and (c) above regarding certain items impacting noninterest income and expense for both 2006 periods.

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Unaudited	**September 30 2006**	December 31 2005	September 30 2005
BALANCE SHEET DATA (dollars in millions, except per share data)			
Assets	**$98,436**	$91,954	$93,241
Loans, net of unearned income	**48,900**	49,101	50,510
Allowance for loan and lease losses	**566**	596	634
Securities	**19,512**	20,710	20,658
Loans held for sale	**4,317**	2,449	2,377
Investment in BlackRock (a)	**3,836**		
Deposits	**64,572**	60,275	60,214
Borrowed funds	**14,695**	16,897	18,374
Shareholders equity	**10,758**	8,563	8,317
Common shareholders equity	**10,751**	8,555	8,309
Book value per common share	**36.60**	29.21	28.54
Common shares outstanding (millions)	**294**	293	291
Loans to deposits	**76%**	81%	84%
ASSETS ADMINISTERED (billions)			
Managed (b)	**$52**	$494	$469
Nondiscretionary	**89**	84	85
FUND ASSETS SERVICED (billions)			
Accounting/administration net assets	**$774**	$835	$793
Custody assets	**399**	476	475
CAPITAL RATIOS			
Tier 1 risk-based (c)(d)	**10.4%**	8.3%	8.4%
Total risk-based (c)(d)	**13.6**	12.1	12.5
Leverage (c)(d)	**9.4**	7.2	7.1
Tangible common equity	**7.5**	5.0	4.9
Common shareholders equity to assets	**10.9**	9.3	8.9
ASSET QUALITY RATIOS			
Nonperforming assets to loans, loans held for sale and foreclosed assets	**.36%**	.42%	.29%
Nonperforming loans to loans	**.34**	.39	.25
Net charge-offs to average loans (for the three months ended)	**.37**	.33	.12
Allowance for loan and lease losses to loans	**1.16**	1.21	1.26
Allowance for loan and lease losses to nonperforming loans	**339**	314	499

(a) See BlackRock/MLIM Transaction in the Executive Summary portion of the Financial Review section of this Report for additional information.

(b) Assets under management at September 30, 2006 do not include BlackRock s assets under management as we deconsolidated BlackRock effective September 29, 2006. Excluding the impact of BlackRock, our assets under management (consisting of Retail Banking assets under management) totaled $49 billion at December 31, 2005 and $50 billion at September 30, 2005.

(c) The regulatory minimums are 4.0% for Tier 1, 8.0% for Total, and 3.0% for Leverage ratios. The well-capitalized levels are 6.0% for Tier 1, 10.0% for Total, and 5.0% for Leverage ratios.

(d) The ratios for September 30, 2006 reflect the impact of the deconsolidation of BlackRock effective September 29, 2006.

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Financial Review

The PNC Financial Services Group, Inc.

This Financial Review should be read together with our unaudited Consolidated Financial Statements and unaudited Statistical Information included elsewhere in this Report and with Items 6, 7, 8 and 9A of our 2005 Annual Report on Form 10-K (2005 Form 10-K). We have reclassified certain prior period amounts to conform with the current period presentation. For information regarding certain business and regulatory risks, see the Risk Factors and Risk Management sections in this Financial Review and Items 1A and 7 of our 2005 Form 10-K. Also, see the Cautionary Statement Regarding Forward-Looking Information and Critical Accounting Policies And Judgments sections in this Financial Review for certain other factors that could cause actual results or future events to differ, perhaps materially, from those anticipated in the forward-looking statements included in this Report or from historical performance. See Note 14 Segment Reporting in the Notes To Consolidated Financial Statements included in Part I, Item 1 of this Report for a reconciliation of total business segment earnings to total PNC consolidated net income as reported on a generally accepted accounting principles (GAAP) basis.

Executive Summary

The PNC Financial Services Group, Inc.

PNC is one of the largest diversified financial services companies in the United States based on assets, operating businesses engaged in retail banking, corporate and institutional banking, asset management and global fund processing services. We provide many of our products and services nationally and others in our primary geographic markets located in Pennsylvania; New Jersey; the greater Washington, DC area, including Maryland and Virginia; Ohio; Kentucky; and Delaware. We also provide certain global fund processing services internationally.

Key Strategic Goals

Our strategy to enhance shareholder value centers on achieving revenue growth in our various businesses underpinned by prudent management of risk, capital and expenses. In each of our business segments, the primary drivers of growth are the acquisition, expansion and retention of customer relationships. We strive to achieve such growth in our customer base by providing convenient banking options, leading technological systems and a broad range of asset management products and services. We also intend to grow through appropriate and targeted acquisitions and, in certain businesses, by expanding into new geographical markets.

In recent years, we have managed our interest rate risk to achieve a moderate risk profile with limited exposure to earnings volatility resulting from interest rate fluctuations. Our actions have created a balance sheet characterized by strong asset quality and significant flexibility to take advantage, where appropriate, of changing interest rates and to adjust to changing market conditions.

BlackRock/MLIM Transaction

As previously reported, in February 2006, BlackRock, Inc. (BlackRock), then a majority-owned subsidiary of PNC, and Merrill Lynch entered into a definitive agreement pursuant to which Merrill Lynch agreed to contribute its investment management business (MLIM) to BlackRock in exchange for 65 million shares of newly issued BlackRock common and preferred stock. This transaction closed on September 29, 2006. BlackRock accounted for the MLIM transaction under the purchase method of accounting. The value of the 65 million shares issued to Merrill Lynch was allocated among the MLIM assets acquired, including intangibles, and the MLIM liabilities assumed to the extent of their fair market value, with any excess purchase price being allocated to goodwill. Immediately following the closing, PNC continued to own approximately 44 million shares of BlackRock common stock, representing an ownership interest of approximately 34% of the combined company after the closing (as compared with 69% immediately prior to the closing). Although PNC s share ownership percentage

declined, BlackRock s equity increased due to the increase in total net assets recorded by BlackRock as a result of the MLIM transaction.

Upon the closing of the BlackRock/MLIM transaction, the carrying value of our investment in BlackRock increased by approximately $3.1 billion to $3.8 billion, primarily reflecting PNC s portion of the increase in BlackRock s equity resulting from the value of shares issued in that transaction. Based on BlackRock s closing market price of $149 per common share on September 29, 2006, the market value of PNC s investment in BlackRock was approximately $6.6 billion at that date. As such, an additional $2.8 billion of value is not recognized in PNC s investment

account.

We also recorded a liability at September 30, 2006 for deferred taxes of approximately $.9 billion, related to the excess of the book value over the tax basis of our investment in BlackRock, and a liability of approximately $.6 billion related to our obligation to provide shares of BlackRock common stock to help fund BlackRock long-term incentive plan (LTIP) programs. The LTIP liability will be adjusted quarterly based on changes in BlackRock s common stock price and the number of remaining committed shares.

The overall balance sheet impact was an increase to our shareholders equity of approximately $1.6 billion. The increase to equity was comprised of an after-tax gain of approximately $1.3 billion, net of the expense associated with the LTIP liability and the deferred taxes, and an after-tax increase to capital surplus of approximately $.3 billion. The recognition of the gain is consistent with our existing accounting policy for the sale or issuance by subsidiaries of their stock to third parties. The gain represents the difference between our basis in BlackRock stock prior to the BlackRock/MLIM transaction and the new book value per share and resulting increase in value of our investment realized from the transaction. The direct increase to capital surplus rather than inclusion in the gain resulted from the accounting treatment required due to existing BlackRock repurchase commitments or programs.

For the three months and nine months ended September 30, 2006, our Consolidated Income Statement included our former 69% ownership interest in BlackRock s net income through the closing date. However, our Consolidated Balance Sheet as of September 30, 2006 reflects the deconsolidation of BlackRock s balance sheet amounts and recognizes our 34% ownership interest in BlackRock as an investment to be accounted for under the equity method. On a prospective basis, this accounting will result in a reduction in certain revenue and noninterest expense categories on PNC s Consolidated Income Statement as the net pretax earnings impact of our net investment in BlackRock will be reported on a separate line item within noninterest income.

Additional information on the BlackRock/MLIM transaction is included in Current Reports on Form 8-K (Form 8-K) dated February 15, 2006 and September 29, 2006 filed by PNC and BlackRock.

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Mercantile Bankshares Acquisition

As previously reported, on October 8, 2006 we entered into a definitive agreement with Mercantile Bankshares Corporation (Mercantile) for PNC to acquire Mercantile for 52.5 million shares of PNC common stock and $2.13 billion in cash. Based on PNC s common stock price on October 6, 2006, the consideration represents $6.0 billion in stock and cash or $47.24 per Mercantile share.

Mercantile is a $17 billion asset banking company that provides banking and investment and wealth management services through 240 offices in Maryland, Virginia, the District of Columbia, Delaware and Southeastern Pennsylvania. This transaction will enable us to significantly expand our presence in the mid-Atlantic region, particularly within the attractive Baltimore and Washington, DC markets.

The transaction is subject to customary closing conditions, including regulatory approval and the approval of Mercantile s shareholders, and is expected to close during the first quarter of 2007. We refer you to our Form 8-K dated October 8, 2006 for additional information on this transaction.

The One PNC Initiative

As further described in our 2005 Form 10-K, the One PNC initiative began in January 2005 and is an ongoing, company-wide initiative with goals of moving closer to the customer, improving our overall efficiency and targeting resources to more value-added activities. PNC expects to realize $400 million of total annual pretax earnings benefit by mid-2007 from this initiative.

PNC plans to achieve approximately $300 million of cost savings through a combination of workforce reduction and other efficiencies. Of the approximately 3,000 positions to be eliminated, approximately 2,700 had been eliminated as of September 30, 2006. We estimate that these changes will result in employee severance and other implementation costs of approximately $74 million, including $54 million recognized during full year 2005 and $9 million recognized during the first nine months of 2006. We expect that the remaining charges of approximately $11 million will be incurred in the remainder of 2006 and early 2007. In addition, PNC intends to achieve at least $100 million in net revenue growth through the implementation of various pricing and business growth enhancements driven by the One PNC initiative. The initiative is progressing according to plan.

We realized a net pretax financial benefit from the One PNC program of approximately $185 million in the first nine months of 2006, including $65 million in the third quarter. We achieved an annualized run rate benefit of $260 million in the third quarter of 2006.

Key Factors Affecting Financial Performance

Our financial performance is substantially affected by several external factors outside of our control, including:

- General economic conditions,
- Loan demand and utilization of credit commitments,
- Movement of customer deposits from lower to higher rate accounts or to off-balance sheet accounts,
- The level of interest rates, and the shape of the interest rate yield curve,
- The performance of the capital markets, and
- Customer demand for other products and services.

In addition to changes in general economic conditions, including the direction, timing and magnitude of movement in interest rates and the performance of the capital markets, our

success in the remainder of 2006 will depend, among other things, upon:

- Further success in the acquisition, growth and retention of customers,
- Successful execution of the One PNC initiative,
- Revenue growth,
- A sustained focus on expense management and improved efficiency,
- Maintaining strong overall asset quality, and
- Prudent risk and capital management.

Summary Financial Results

In millions, except per share data	Three months ended **Sept. 30 2006**	Sept. 30 2005	Nine months ended **Sept. 30 2006**	Sept. 30 2005
Net income	**$1,484**	$334	**$2,219**	$970
Diluted earnings per share	**$5.01**	$1.14	**$7.46**	$3.35
Return on				
Average common shareholders equity	**65.94%**	16.13%	**33.87%**	16.49%
Average assets	**6.17%**	1.45%	**3.17%**	1.48%

Results for the third quarter and first nine months of 2006 included the impact of the following items:

- The gain on the third quarter BlackRock/MLIM transaction totaling $1.3 billion after-tax, or $4.36 per diluted share;
- Securities portfolio rebalancing charges recognized in the third quarter totaling $127 million after-tax, or $.43 per diluted share;
- The third quarter mortgage loan portfolio repositioning loss of $31 million after-tax, or $.10 per diluted share; and
- Our share of the after-tax impact of BlackRock/MLIM integration costs, which totaled $31 million, or $.10 per diluted share, for the third quarter of 2006 and $39 million, or $.13 per diluted share, for the first nine months of 2006.

In addition to the closing of the BlackRock/MLIM transaction and our balance sheet repositioning activities, our third quarter 2006 performance included the following accomplishments:

- Average loans of $50.3 billion for the third quarter of 2006 increased $888 million, or 2 percent, compared with $49.5 billion for the third quarter 2005, primarily as a result of increased commercial, commercial real estate and residential mortgage loans. Average loans increased $3.0 billion, or 6 percent, compared with the prior year third quarter excluding the $2.1 billion of average loans in the prior year period related to Market Street Funding, PNC s commercial paper conduit that was deconsolidated in October 2005.

- Average deposits for the third quarter increased $5.0 billion, or 8 percent, compared with the same quarter in the prior year, primarily as a result of an increase in money market deposits, retail certificates of deposit, Eurodollar deposits and noninterest-bearing deposits.

- Asset quality remained very strong, with the ratio of nonperforming assets to loans, loans held for sale and foreclosed assets declining to .36% from .42% at December 31, 2005.

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BALANCE SHEET HIGHLIGHTS

Total assets were $98.4 billion at September 30, 2006. Total average assets were $93.7 billion for the first nine months of 2006 compared with $87.4 billion for the first nine months of 2005. This increase was primarily attributable to a $5.5 billion increase in average interest-earning assets. An increase of $2.9 billion in average loans was the primary factor for the increase in average interest-earning assets. In addition, average total securities increased $2.6 billion in the first nine months of 2006 compared with the prior year period.

Our deconsolidation of BlackRock effective September 29, 2006 and recognition of our in