M&T Bank

Annual Report Message to Stockholders

Two years ago, this section of First Empire State Corporation's annual report discussed at length, and in generally disapproving terms, the then frenzied pace of consolidation through mergers and acquisitions in the banking industry. The text took a skeptical view of the goings-on and cited a number of studies which had found that bank combinations more often than not fell short of realizing their expected benefits.

There was an admitted irony in the commentary. As the text acknowledged, acquisitions had played an important part in First Empire's growth up to that point. And, it added, "First Empire continues to look for and examine promising opportunities to add earning power through acquisitions."

The identification of such an opportunity led, after careful analysis and patient negotiation, to the conclusion last October of an agreement for a merger between First Empire and ONBANCorp, Inc., a bank holding company based in Syracuse. The merger plan calls for ONBANCorp's banking subsidiaries to be merged into First Empire's Manufacturers and Traders Trust Company (M&T Bank).

This latest and largest in the series of combinations which began just ten years ago with First Empire's acquisition of The East New York Savings Bank will result in a financial services enterprise with total deposits initially of approximately $15 billion and loans of approximately $14 billion. Required regulatory approvals have been granted. Subject to approval by the stockholders of both companies, the merger is expected to be accomplished on or about April 1, 1998.

Our decision to undertake a further major expansion came near the end of another year of double-digit percentage increases in earnings per share and in the dollar total of net income, of continued improvement in key performance indicators, and of further progress in building up the contribution of noninterest income to the bottom line.

Diluted earnings per share amounted to $25.26 in 1997, an increase of 20% over the $21.08 earned in 1996. The 1997 figure is computed according to a newly prescribed accounting rule, and earnings per share for all prior periods have been restated in conformity with the new rule.

Net income last year rose to $176.2 million, 17% above the $151.1 million recorded in 1996. It produced a return of 1.32% on average total assets, compared with 1.21% in 1996. Return on average common stockholders' equity was 18.49%, compared with 17.60%.

The board of directors raised the quarterly cash dividend to 80 cents per share, effective with the distribution for the first quarter of 1997, a 14% increase over the previous rate of 70 cents. Stockholders' equity was $1.0 billion at the year-end, having increased by $124.6 million during the year. Book value per share outstanding rose to $155.86 from $135.45.

Last year's earnings growth reflected a higher average volume of earning assets and substantial year-to-year increases in fee-based revenues from such sources as mortgage banking, trust functions, the marketing of mutual funds and annuities, and deposit services.

Taxable-equivalent net interest income, generated by earning assets that averaged $12.8 billion, was $562.7 million in 1997. That compared with $535.5 million the year before, when earning assets averaged $12.0 billion. Net interest margin, the ratio of taxable-equivalent net interest income to earning assets, narrowed a bit, from 4.45% in 1996 to 4.38% in 1997, crimped by a tightening of the spread between the average yield earned on assets and the average interest rate paid on liabilities.

After two years in each of which the average total of loans on our books increased by more than $1.2 billion, growth slowed somewhat last year but achieved a still-impressive rise of $859 million. The year's average volume was $11.0 billion.

At the year-end, total loans net of unearned discount were $11.5 billion. The allowance for possible credit losses, after provisions aggregating $46 million during the year and net charge-offs amounting to $41.8 million, stood at $274.7 million at December 31, equal to 2.39% of loans outstanding.

Fees and income from other noninterest sources totaled $193.1 million, an increase of 13% over the prior year's $170.2 million. Noninterest expense was held to a 3% increase, rising to $421.8 million from $409.0 million. The year-to-year expense comparison is skewed by the incidence in 1996 of a non-recurring $7-million charge to meet a special assessment by the Federal Deposit Insurance Corporation. With that factor excluded, the year-to-year increase in non-interest expense was 5%.

The rise in non-interest income and moderation in the increase in non-interest expense both contributed to improvement in the company's efficiency ratio - non-interest expense divided by the sum of non-interest income and taxable-equivalent net interest income. The ratio in 1997 was 55.8%; in 1996, even when the special $7-million expense item related to deposit insurance is excluded from the calculation, the ratio was 57.0%.

First Empire's solid 1997 performance sets the stage for the boldest and most ambitious undertaking in its recent history - a merger that will increase the company's size by more than one-third and involve an investment nearly double the amount of the company's stockholders' equity just seven years ago.

On the day the merger with ONBANCorp takes effect, First Empire's deposits will increase by approximately $4 billion and its loans by about $3 billion. ONBANCorp's 59 banking offices in New York State and its 19 in northeastern Pennsylvania will become units of M&T Bank. Starting on the day of the merger, First Empire's financial results will include those generated by the former ONBANCorp.

The combined institution will have a strong presence in the key markets of upstate New York, the Hudson Valley, and the New York City metropolitan area. The facilities and business coming from ONBANCorp's savings bank subsidiary, Franklin First Savings Bank, based in Wilkes-Barre, Pennsylvania, will give M&T Bank its first taste of interstate banking.

Merger-related expenditures will eat up a portion of the economic benefits of the combination in the first year. With those one-time outlays behind us, revenue growth and cost reductions are projected to enhance cash earnings progressively as we tap the business potential of a larger market, eliminate duplications and realize economies of scale in technology-intensive servicing functions.

On the basis of the ONBANCorp shares outstanding when the merger agreement was signed, the $411 per share price of First Empire stock on that day, and the agreed exchange ratio of .161 share of First Empire or $69.50 in cash for each ONBANCorp share, the transaction has a price tag in the vicinity of $870-$875 million.

ONBANCorp stockholders will elect to receive First Empire stock or cash for their shares, subject to the merger agreement's provision that not fewer than 60% nor more than 70% of the ONBANCorp shares outstanding are to be exchanged for stock. Allocation and proration will be applied if necessary to keep the stock component within that range.

Paying for the ONBANCorp stock with a combination of First Empire stock and cash was chosen as the method most beneficial to the present stockholders of First Empire and to those ONBANCorp stockholders who choose to become First Empire stockholders by exchanging their shares for stock.

An all-cash-for-stock exchange would have been unacceptable to many ONBANCorp stockholders because of the tax consequences. Financing the transaction entirely by issuing stock would have saddled the post-merger First Empire with the cost of having capital in excess of our foreseeable needs. The blended stock-and-cash method, with its limits on the proportion to be represented by each, provides balance between the two components. The build-up of equity through the issuance of shares will be sufficient for the combined company's capital ratios comfortably to meet the regulatory standards for classification as a well-capitalized bank, while cash earnings per share will be substantially greater than in an all-stock exchange.

As a stock-and-cash transaction, the merger with ONBANCorp will be treated for accounting purposes as a "purchase." This has important consequences for the company's ability to form and pursue strategies after the merger. For example, the company will be able to continue repurchasing its own stock. That and other activities are much more closely restricted for companies in mergers or acquisitions that qualify for "pooling of interests" accounting treatment because of being financed entirely with stock.

The most significant difference between the "purchase" and "pooling" methods of accounting for a business combination is in their treatment of the premium over fair value which one combining partner pays for the net assets of the other. In our merger, ONBANCorp's stated net assets, or stockholders' equity, at December 31, 1997 were approximately $335 million. Thus the merger price, in the $870- to $875-million range, represents a premium of some $540 million, which suggests in present-value terms the "break point" that future economic benefits derived from the merger are projected to exceed.

In conformity with generally accepted accounting principles (GAAP) in a "purchase" transaction, the premium, plus or minus any write-downs or write-ups involved in booking ONBANCorp's assets and liabilities at fair value, will be identified on First Empire's balance sheet as goodwill and will have to be amortized through charges to earnings over a period of years.

Under GAAP rules the "pooling" treatment of a merger or acquisition, by contrast, ignores the premium paid in the transaction and simply combines the assets and liabilities of the combining companies at their stated values. What is identified as goodwill in a "purchase" combination is buried in the asset total under the "pooling" method and is not subject to amortization.

Obviously, earnings reported on the traditional GAAP basis are not comparable between a company which has done a "pooling" combination and a company which has done one under "purchase" accounting. The only true comparison between two such companies is on the basis of cash earnings. These are computed by adding back to traditional, GAAP-basis earnings the charges taken for amortization of goodwill and for amortization of the intangible asset which GAAP rules create when core deposits are assumed in a "purchase" merger or acquisition. Neither charge involves any outlay of cash. The add-backs are adjusted for any tax effects applicable to the charges.

For validity in comparisons, and also because cash earnings have greater economic significance, First Empire post-merger will regularly report net income, earnings per share, and the ratios derived from net income on both the traditional and the cash basis. Cash-basis reporting will be particularly significant for First Empire stockholders because of the predominance in the banking industry in recent years of mergers and acquisitions done under the "pooling" method of accounting. That method, the use of which is much more closely restricted in other industrialized countries than in the United States, has become controversial in this country. There are proposals in accounting and regulatory circles to restrict or even eliminate its use. Meanwhile, it complicates comparisons among companies both domestically and internationally and has led to increased emphasis on cash earnings by investors and analysts.

After the merger takes place, Robert J. Bennett, who has been chairman, president and chief executive officer of ONBANCorp since 1989, will be elected chairman of the board of First Empire State Corporation. The undersigned will continue as president and chief executive officer of First Empire and as chairman of the board and chief executive officer of M&T Bank. Mr. Bennett will be elected a vice chairman of M&T Bank. He and four other current members of ONBANCorp's board of directors will be elected directors of First Empire and M&T Bank.

Raymond D. Stevens, Jr., who has been a director of First Empire State Corporation since 1970 and of M&T Bank since 1963, is retiring from the board of directors of the company and from that of the bank, effective at the company's 1998 annual meeting of stockholders. Mr. Stevens, for many years a leading Buffalo industrialist as chairman of Pratt & Lambert, Inc., brought to the direction of First Empire and the bank the calm judgment and practical insights born of his business experience, along with a keen understanding of a financial institution's community role, reflecting his own involvement over many years in civic causes in Buffalo. He served on the executive, compensation, trust and investment, and nominating committees of First Empire and M&T Bank. His stalwart dedication and valued contributions to the First Empire family will be remembered with respect and affection.

In those communities to which the merger will bring First Empire as a business presence for the first time, the tradition of community involvement and support that we have established in our existing locations will be maintained. We are mindful of the degree to which a bank's success is affected by the economic, civic and social well-being of the people and enterprises it serves.

In joining forces with the leading bank in the Syracuse area, First Empire is not only extending its market reach. It also is binding its future more closely than ever to New York State, and therefore deepening its resolve to work for needed further improvement in the conditions which impair the state's ability to attract or retain businesses, jobs and people.

This is a subject that has been discussed repeatedly in the company's annual report and at our annual meeting of stockholders. It has taken on added clarity with the appearance last year of two reports from respected and disinterested sources.

One, a study by Regional Financial Associates (RFA), an economic consulting group, ranked the 50 states on a weighted composite of the factors considered to be most important in the cost of operating a business - namely, unit labor costs, energy costs and the burden of state and local taxes.

New York State was fifth-highest in over-all cost, with an index score of 113.1 against 100 as the national average. Only Hawaii, Connecticut, Massachusetts and New Jersey had higher indices, ranging from 114.7 to 113.3.

New York also was high on the list for each of the cost components:

- Sixth-highest in unit labor costs, with an index of 105.1 (national average = 100). Connecticut, with 109.1, was highest
- Higher than all but nine states in energy costs, with an index of 140. Only two of the most populous ten states had higher index numbers - New Jersey with 148.7 and California with 141.7
- Far above the field in state and local taxes with an index of 132.9. Only Hawaii, at 126.3, was even close

The high cost of being a high-cost state can be seen in stunted economic growth. New York's gross state product, the broadest measure of economic activity, grew at an average annual rate of only 1.5% during the years 1991-1996. That rate ranked 42nd among the 50 states. The all-states average rate was 2.6%.

In a seeming contradiction of the "high costs equal slow growth" equation, two of the four states with over-all cost indices higher than New York’s experienced significantly better economic growth. Massachusetts had an average annual growth rate of 2.5%; New Jersey had a 1.9% rate. Those states had higher unit labor and energy costs than New York but sharply lower state and local taxes, testifying to the importance of the tax burden as an element in a state’s economic environment.

That importance is no longer ignored in the setting of tax and other economy-related policies in New York State. After a long history of official indifference, and even antagonism, toward business, worth-while steps have been taken in the last few years to improve the climate for enterprise in the state. Corporate and personal income tax rates have been reduced, and the punitive levy on employers to fund workers compensation has been eased. There definitely has been a change for the better.

But much more movement in the new direction is needed if New York is once again to be an effective player in the competition to attract new businesses and jobs, or even retain existing ones. Other states are cutting taxes too. The National Governors Association reports that 25 states have reduced personal income taxes in the current fiscal year. Twelve states have reduced corporate income taxes. The war among the states, with companies and jobs as the prize for the victors, goes on.

The second of the two reports cited indicates that the battle has not been going well for New York State. The firm of Dun & Bradstreet early last year did a count of business relocation's between 1991 and 1995. It tabulated more than 56,000 interstate moves, involving some one million jobs, and ranked the 50 states as to their net gain or loss of companies and jobs. New York suffered the most, losing 3,561 companies and 83,469 jobs to other states.

The D&B study also traced where the departing companies and jobs went. Of the net departures from New York State, 47% of the companies and 44% of the jobs moved to either New Jersey or Connecticut. Significantly, in the RFA compilation both those states were from 2% to 6% higher than New York in unit labor and energy costs but 21% to 22% lower than New York in state and local tax burden.

Other states making sizable gains at New York’s expense included Ohio, Massachusetts, Florida, North Carolina and Virginia. New York was a net winner against only five states in terms of companies and just eleven in terms of jobs.

Presumably most of the companies that left New York State went through some process of comparing relative advantages and disadvantages in making their stay-or-go decisions. A research team at M&T Bank undertook a simulation of such a comparison as a way of putting reasonably specific numbers on the cost considerations a New York company considering relocation would face.

To that end, the team did hypothetical recasts of First Empire State Corporation’s 1996 operating expenses as if the company had been located and doing its principal business in five alternative states - Ohio, Tennessee, Virginia, Florida, North Carolina. The five were selected because of their success in attracting companies away from New York and because their over-all business costs, as measured in the RFA study, were at or below the national average.

In this "what if" exercise, Cincinnati, Memphis, Richmond, Jacksonville and Greensboro-Winston Salem were designated as the supposed locations of the company’s headquarters. In each hypothetical version all facilities and operations of First Empire and its subsidiaries except those located outside New York State were assumed to be located in the alternative state under consideration.

The major business expense categories that vary among states - state and local taxes, wages and benefits, workers compensation and unemployment insurance premiums, utilities and miscellaneous costs such as transportation - were estimated for each of the comparison states as they would have applied to First Empire’s 1996 operations if located there.

Compared with First Empire’s actual expenditures in those categories, the estimates for the five states showed savings in total expense ranging from $17.8 million, or 10%, in Tennessee to $2.5 million, or 1%, in Florida. In between were North Carolina with estimated savings of $16.9 million or 9%, Ohio with $12.5 million or 7%, and Virginia with $5.9 million or 3%.

New York’s disadvantage was most apparent in the area of state and local taxes, especially state and municipal income, property and sales taxes. The research team’s estimates are that the aggregate of those levies would have been $9.1 million less in North Carolina, between $7.8 million and $2.3 million less in Tennessee, Ohio and Virginia, and $3.6 million more in Florida.

The stand-out differentials were in local taxes on real property. The estimated savings from being located in the five comparison states averaged 42% and varied from a high of 57% to a "low" of 27%. For businesses generally, property taxes are the main component of state and local taxes. A study by the Federal Reserve Bank of Chicago found that they make up 43% of the state and local total.

Personnel costs are far and away the largest expense item for most businesses. Our researchers found that wage and benefit costs in upstate New York, where most of First Empire’s employees are located, were reasonably competitive with those in the alternative states. Weak economic growth and a painful restructuring away from high-paying manufacturing jobs have helped moderate upstate labor costs. Our team's estimates of personnel costs in the comparison states placed the reductions from the company's actual costs in a range of $7.5 million or 5% (Tennessee)to $1.9 million or 1% (Virginia).

A surprising finding was that employee health benefit costs in all the comparison states except North Carolina were estimated to be higher than those actually incurred by First Empire. Workers compensation and unemployment insurance costs combined, however, were calculated to be lower in the comparison states by margins of between 58% and 11%.

While recent legislative actions have helped reduce workers compensation and unemployment insurance expenses for employers in New York State, other states also are aggressively cutting payroll-related costs in an effort to maintain their competitive advantage. It's still a catch-up game for New York, and more will have to be done to hold what ground has been gained in the area of payroll-related costs.

The estimated percentage reductions in electricity costs were dramatic across the board - from 41% to 55%. Power prices are a major handicap to New York State in attracting or retaining industrial enterprises, which characteristically are large users of electricity. Some lowering of rates is scheduled for the near future under agreements reached between utility companies and the New York State Public Service Commission, but this category of business cost will continue to be a problem for the state.

The research by our team obviously was an academic exercise so far as any consequent action by First Empire State Corporation is concerned. A banking enterprise with 178 branches (to be 256 after the merger) doesn't pick up and leave. The exercise should be useful, however, as documentation in detail of some of the disadvantages attached to doing business in New York State.

Without diminishing the importance and value of the improvements which have been made in the state's climate for business, the exercise also sends a clear signal that strong additional action is needed, especially in the areas of tax reduction and lower electrical power costs, if the march of companies and jobs across the state's borders is to be halted and an influx of both new and established businesses is to be encouraged. In broader, national terms the banking industry, against the background of a healthy economy and quiescent inflation, is riding a wave of good earnings, capital strength and the favorable regard of investors. This state of general well-being supports and helps explain the concern of members of Congress and others that banks with large loan exposures in Southeast Asia not get special treatment as part of U.S. government-assisted programs to aid the countries of that region.

Legislators considering U.S. financial participation in the rescue programs arranged by the International Monetary Fund for Korea, Thailand and Indonesia have asked for assurances that private creditors - including some of the largest and most powerful U.S., European and Japanese banks - will not be bailed out of losses on their loans to borrowers in the troubled Southeast Asian countries. Government officials urging Congressional support of the rescue programs have stated their opposition to bailouts but stopped short of guaranteeing they won't happen. Treasury Secretary Robert E. Rubin told the Senate Foreign Relations Committee in February: "... a byproduct of programs designed to restore stability and growth may be that some creditors will be protected from the full consequences of their actions."

Insistence that lenders should accept the risks as well as the rewards of their credit decisions reflects more than just a mean-spirited "serves them right" mentality. It is based more importantly on a judgment that an excessive and ill-considered pouring of credit into the emerging economies of Southeast Asia was a major factor causing the financial and economic crisis that now besets that region. It reflects also concern about the "moral hazard" which Federal Reserve Chairman Alan Greenspan has said "arises when someone can reap the rewards from their actions when events go well but does not suffer the full consequences when they go badly. Such a reward structure, obviously, could encourage excessive risk-taking."

Discussion of what is being called "the Asia problem" has tended to focus on why it wasn't foreseen and what could have been done to head it off. Those questions miss an important point: some of the people in the best position to foresee the problem were in fact helping to cause it. Bankers whose job it was to recognize the vulnerabilities inherent in unseasoned, effervescent economies concentrated instead on pushing easy money at already overextended borrowers. The excesses that brought down the brightest stars of the new Asia were excesses of credit.

American banks are not alone in blame for this, but their share is large. South Korean debt owed to U.S. banks totaled $15 billion last September 30, having more than doubled in the preceding four years after holding in the $6-to-$6.5-billion range the four years before that.

The proposed United States share in new financing of the IMF which would be used for aid to the Asian trouble centers is $18 billion. This country's influence on the workings of the agency has on balance been constructive, and maintaining a leadership position among the member countries probably justifies paying the assessment. The U.S. ought to distance itself, however, from the inclusion in IMF rescue plans of any provisions which would exempt creditors from the consequences of their injudicious lending.

Among the banks that have led the American financing frenzy in Southeast Asia, after all, are faces familiar from crisis-threatening credit sprees of the past - LDCs in the '70s, real estate and LBOs in the '80s, Mexico in the '90s. Letting them escape the pain due them for their overreaching in Asia not only would ensure reruns of the same script in other venues. It also would engender in the American public a revulsion that would spill over onto the banking industry as a whole.

In the countries now paying for their credit binges with IMF-imposed austerity, high prices and scarce goods, recession and unemployment, the natural tendency is to blame the bust and the hardship of its aftermath on those who fueled the boom. Seeing them keep their upfront fees while avoiding any share in the downside could nourish already-embedded seeds of anti-American feeling.

Chairman Greenspan appeared before a Senate committee in support of a U.S. contribution to the IMF. A news account of his testimony indicated that he found a positive element among all the negatives in the Asian troubles, seeing as a beneficial side-effect of those difficulties a recognition of shortcomings in the economic systems evolving in Asian countries and a movement there and elsewhere toward arrangements closer to Western free-market style.

That is indeed a shred of good news amid the ruins. A collateral benefit could come if there were to be a demonstration of that ancient verity of banking: reckless lending brings its own reckoning. That dogma has been suppressed too often in recent years in deference to spook-talk about "systemic risk." If it isn’t allowed to apply in the unwinding of the Asian crisis, a valuable lesson will go unlearned, the same mistakes will be repeated, and the only questions to ask will be the when and the where of the next crisis.