PNC FINANCIAL SERVICES GROUP INC
Form 10-Q
August 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 June 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 July 31, 2006, there were 294,455,070 shares of the registrant s common stock ($5 par value) outstanding.

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The PNC Financial Services Group, Inc.

Cross-Reference Index to 2006 Second Quarter Form 10-Q

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CONSOLIDATED FINANCIAL HIGHLIGHTS

THE PNC FINANCIAL SERVICES GROUP, INC.

Dollars in millions, except per share data Unaudited	Three months ended June 30 **2006**	 2005	Six months ended June 30 **2006**	 2005
FINANCIAL PERFORMANCE				
Revenue				
Net interest income, taxable-equivalent basis (a)	**$562**	$541	**$1,125**	$1,053
Noninterest income	**1,230**	929	**2,415**	1,903
Total revenue	**$1,792**	$1,470	**$3,540**	$2,956
Net income	**$381**	$282	**$735**	$636
Per common share				
Diluted earnings	**$1.28**	$.98	**$2.47**	$2.22
Cash dividends declared	**$.55**	$.50	**$1.05**	$1.00
SELECTED RATIOS				
Net interest margin	**2.90%**	3.00%	**2.93%**	3.01%
Noninterest income to total revenue	**69**	63	**68**	65
Efficiency	**64**	71	**66**	69
Return on				
Average common shareholders equity	**17.49%**	14.34%	**17.08%**	16.68%
Average assets	**1.64**	1.29	**1.60**	1.50

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 investment. 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 investments. This adjustment is not permitted under generally accepted accounting principles (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 June 30 **2006**	 2005	Six months ended June 30 **2006**	 2005
Net interest income, GAAP basis	**$556**	$534	**$1,112**	$1,040
Taxable-equivalent adjustment	**6**	7	**13**	13
Net interest income, taxable-equivalent basis	**$562**	$541	**$1,125**	$1,053

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Unaudited	**June 30 2006**	December 31 2005	June 30 2005
BALANCE SHEET DATA (dollars in millions, except per share data)			
Assets	**$94,914**	$91,954	$90,794
Loans, net of unearned income	**50,548**	49,101	49,317
Allowance for loan and lease losses	**611**	596	628
Securities	**21,724**	20,710	20,437
Loans held for sale	**2,165**	2,449	2,275
Deposits	**63,493**	60,275	58,673
Borrowed funds	**15,651**	16,897	18,206
Shareholders equity	**8,827**	8,563	8,243
Common shareholders equity	**8,820**	8,555	8,235
Book value per common share	**29.92**	29.21	28.35
Common shares outstanding (millions)	**295**	293	290
Loans to deposits	**80%**	81%	84%
ASSETS UNDER MANAGEMENT (billions)	**$506**	$494	$456
FUND ASSETS SERVICED (billions)			
Accounting/administration net assets	**$743**	$835	$766
Custody assets	**389**	476	462
CAPITAL RATIOS			
Tier 1 risk-based (a)	**8.8%**	8.3%	8.3%
Total risk-based (a)	**12.4**	12.1	11.9
Leverage (a)	**7.7**	7.2	7.2
Tangible common equity	**5.2**	5.0	5.0
Common shareholders equity to assets	**9.3**	9.3	9.1
ASSET QUALITY RATIOS			
Nonperforming assets to loans, loans held for sale and foreclosed assets	**.44%**	.42%	.32%
Nonperforming loans to loans	**.41**	.39	.27
Net charge-offs (recoveries) to average loans (for the three months ended) (b)	**.24**	.33	(.32)
Allowance for loan and lease losses to loans	**1.21**	1.21	1.27
Allowance for loan and lease losses to nonperforming loans	**294**	314	476

(a) 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.

(b) This ratio for the three months ended June 30, 2005 (net recoveries of $38 million annualized and divided by average loans of $47.1 billion) reflects the impact of a $53 million loan recovery during that quarter. Excluding the impact of this recovery, the ratio of net charge-offs to average loans for the second quarter of 2005 would have been .13%.

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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 13 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, operating businesses engaged in retail banking, corporate and institutional banking, asset management and global fund processing services. We operate directly and through numerous subsidiaries, providing many of our products and services nationally and others in our primary geographic markets in Pennsylvania; New Jersey; the greater Washington, DC area, including Virginia and Maryland; Ohio; Kentucky and Delaware. We also provide certain asset management and 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.

On February 15, 2006, we announced that BlackRock and Merrill Lynch had entered into a definitive agreement pursuant to which Merrill Lynch will contribute its investment management business to BlackRock in exchange for newly issued BlackRock common and preferred stock. Upon the closing of this transaction, which we expect to occur around September 30, 2006, BlackRock s assets under management would increase to approximately $1 trillion and Merrill Lynch would own 65 million equity shares, or approximately 49%, of the combined company. At the closing of the transaction, we expect to continue to own approximately 44 million shares of BlackRock common stock, representing an ownership interest of approximately 34%. In addition, upon closing, the carrying value of our investment in BlackRock would

increase, based on the price of BlackRock stock at the time of announcement of this transaction and other factors, resulting in our recognizing an after-tax gain we currently estimate to be approximately $1.6 billion. This gain would significantly enhance our capital position and our tangible common equity ratio.

This transaction must be approved by BlackRock shareholders and is subject to obtaining appropriate regulatory and other approvals. We currently control more than 80% of the voting interest in BlackRock and will vote our interest in support of the transaction.

Additional information on this transaction is included in Note 2 Acquisitions in the Notes To Consolidated Financial Statements in this Report. To the extent that statements we make in this Report about our expectations for future results include results from BlackRock, those expectations do not give any effect to the impact to PNC from the change to the equity method of accounting for PNC s interest in BlackRock that would take place when BlackRock and Merrill Lynch close 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 2,400 had been eliminated as of June 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 the second half of 2005 and $9 million recognized during the first six months of 2006. We expect that the remaining charges of approximately $11 million will be incurred later in 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. Initiatives are progressing according to plan.

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We realized a net pretax financial benefit from the One PNC program of approximately $120 million in the first six months of 2006, including $60 million in the second quarter. We expect to capture approximately $265 million in cumulative value by the end of 2006 as originally planned.

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,
- 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

	Three months ended		Six months ended	
In millions, except per share data	**June 30 2006**	June 30 2005	**June 30 2006**	June 30 2005
Net income	**$381**	$282	**$735**	$636
Diluted earnings per share	**$1.28**	$.98	**$2.47**	$2.22
Return on				
Average common shareholders equity	**17.49%**	14.34%	**17.08%**	16.68%
Average assets	**1.64%**	1.29%	**1.60%**	1.50%

Results for the first six months of 2005 reflected the impact of the reversal of deferred tax liabilities that benefited earnings by $45 million, or $.16 per diluted share, in the first quarter of 2005 related to our transfer of ownership in BlackRock from PNC Bank, National Association (PNC Bank, N.A.) to PNC Bancorp, Inc. that occurred in January 2005.

Our second quarter 2006 performance included the following accomplishments:

- Net income for the second quarter increased 35% compared with the second quarter of 2005, substantially due to a 32% increase in total noninterest income.
- Solid growth in revenue and well-managed expenses propelled strong improvement in operating leverage compared with the prior year second quarter.
- Average loans for the second quarter of 2006 increased $2.8 billion, or 6%, compared with the second quarter of 2005, primarily as a result of increased residential mortgage, commercial and commercial real estate loans, in part due to our expansion into the greater Washington, DC area. In addition, average loans for the second quarter of 2005 included $2.0 billion related to the Market Street Funding commercial paper conduit that was deconsolidated in October 2005.
- Average deposits for the second quarter increased $6.0 billion, or 11%, compared with the same quarter in the prior year, primarily as the result of an increase in Eurodollar deposits, retail certificates of deposit, money market deposits, and demand and other noninterest-bearing deposits, in part due to our expansion into the greater Washington, DC area.

- Asset quality remained very strong, with the ratio of nonperforming assets to loans, loans held for sale and foreclosed assets at .44%. The ratio of net charge-offs to average loans was .24% for the quarter.
- We increased the common stock dividend 10%, to 55 cents per share, and repurchased approximately 1.8 million of our common shares during the second quarter of 2006.

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Balance Sheet Highlights

Total assets were $94.9 billion at June 30, 2006. Total average assets were $92.8 billion for the first six months of 2006 compared with $85.5 billion for the first six months of 2005. This increase was primarily attributable to a $6.8 billion increase in interest-earning assets. An increase of $3.9 billion in average loans was the primary factor for the increase in average interest-earning assets. In addition, average total securities increased $3.3 billion in the first half of 2006 compared with the prior year period.

Average total loans were $49.5 billion for the first six months of 2006 and $45.6 billion in the first six months of 2005. This increase was driven by continued improvements in market loan demand and targeted sales efforts across our banking businesses, as well as our expansion into the greater Washington, DC area that began in May 2005. The increase in average total loans reflected growth in residential mortgages of approximately $2.0 billion, commercial loans of approximately $1.4 billion, and commercial real estate loans of approximately $.8 billion. In addition, average loans for the first half of 2005 included $2.1 billion related to Market Street Funding (Market Street) which was deconsolidated in October 2005. Loans represented 64% of average interest-earning assets for the first six months of 2006 and 65% for the first six months of 2005.

Average securities totaled $21.2 billion for the first six months of 2006 and $17.9 billion for the first six months of 2005. Of this increase, $3.0 billion was attributable to increases in mortgage-backed, asset-backed, and other debt securities. The higher average securities balances reflected our desire to continue investing through the interest rate cycle and the Riggs acquisition. Securities comprised 28% of average interest-earning assets for the first half of 2006 and 26% for the first half of 2005.

Average total deposits were $61.8 billion for the first six months of 2006, an increase of $6.8 billion over the first six months of 2005. The increase in average total deposits was primarily driven by the impact of higher certificates of deposit, money market account and noninterest-bearing deposit balances, and by higher Eurodollar deposits. Similar to its impact on average loans and securities described above, our expansion into the greater Washington, DC area also contributed to the increase in average total deposits. Average total deposits represented 67% of average total assets for the first half of 2006 and 64% for the first half of 2005. Average transaction deposits were $41.0 billion for the first six months of 2006 compared with $37.8 billion for the first six months of 2005.

Average borrowed funds were $15.4 billion for the first six months of 2006 and $15.7 billion for the first six months of 2005. This decrease was primarily due to a significant decline in commercial paper due to the deconsolidation of Market Street in October 2005, partially offset by net increases in bank notes and senior debt, subordinated debt and federal funds purchased.

Shareholders equity totaled $8.8 billion at June 30, 2006, compared with $8.6 billion at December 31, 2005. See the Consolidated Balance Sheet Review section of this Financial Review for additional information.

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Business Segment Highlights

	Three months ended		Six months ended	
	June 30	June 30	**June 30**	June 30
In millions	**2006**	2005	**2006**	2005
Total segment earnings	**$390**	$383	**$783**	$712

Total business segment earnings for the second quarter and first half of 2005 included the benefit of a $53 million loan recovery included in the Corporate & Institutional Banking business segment. A summary of results for both the first half and second quarter of 2006 comparisons with the prior year periods follows. Further analysis of business segment results for the six-month periods is found on pages 15 through 23.

We provide a reconciliation of total business segment earnings to total PNC consolidated net income as reported on a GAAP basis in Note 13 Segment Reporting in the Notes To Consolidated Financial Statements in this Report and in the Results of Businesses - Summary table on page 15.

Retail Banking

Retail Banking s earnings were $375 million for the first six months of 2006 compared with $311 million for the same period in 2005. Compared with the prior year, revenues increased 12% and noninterest expenses increased 5%, resulting in a 21% earnings improvement. The increase in earnings was driven by higher taxable-equivalent net interest income fueled by continued customer and balance sheet growth along with improved fee income from customers and a sustained focus on expense management.

Earnings from Retail Banking totaled $185 million in the second quarter of 2006 compared with $162 million in the second quarter of 2005. Revenue increased 10% compared with the second quarter of 2005, while noninterest expense increased only 4%, driving a 14% increase in earnings.

Corporate & Institutional Banking

Earnings from Corporate & Institutional Banking for the first six months of 2006 totaled $221 million compared with $254 million for the first six months of 2005. This decline was primarily attributable to a $53 million loan recovery recognized in the second quarter of 2005 compared with a $29 million provision for credit losses in the first half of 2006. In addition to the $81 million swing in the provision for credit losses, total revenue increased $91 million and noninterest expenses grew by $59 million for the first six months of 2006 compared with the comparable 2005 period.

Corporate & Institutional Banking earned $116 million in the second quarter of 2006 compared with $144 million in the second quarter of 2005. The earnings decrease compared with the prior year quarter was largely the result of an increase in the provision for credit losses, primarily due to a $53 million loan recovery referred to above that benefited the prior year quarter. Revenue increased $61 million in the second quarter of 2005, driven by an increase in noninterest income, while noninterest expense