



## Financial Condition of the U.S. Banking Institutions – First Quarter 2010

June 4, 2010

It would appear that based on financial results for first quarter of 2010 the U.S. banking system is starting to recover from its recent lows. Earnings for the industry were \$18.0 billion, up from the fourth quarter 2009 total of \$5.6 billion, and capital increased \$15.1 billion. However, asset quality continued to deteriorate but at a slower rate. Implementation of the new FASB 166 and 167 accounting rules has affected some of the reported data, particularly the aggregate figures on assets, capital, and loan loss reserves<sup>1</sup>.

The FDIC reported that the improvement in earnings for the first quarter of 2010 were due to lower provisions for loan losses and reduced expenses for goodwill impairment. Net interest margins increased significantly from 3.53% in the fourth quarter 2009 to 3.83% in the first quarter of 2010 due to the changes in FASB 166 and 167 which affected mainly the large credit card banks.

### First Quarter 2010 Reporting of the Eight Largest<sup>2</sup> U.S. Commercial Banks Data in Millions \$

Bank Name	City	ST	Total Assets (in millions)	% Chg From: D09	Net Loans March 2010 (in millions)	% Chg	Net Income	% Chg From: D09	ROA March 2010
JPMORGAN CHASE BANK	COLUMBUS	OH	1,674,523	2.9	567,058	1.3	2,734	45.5	0.67
BANK OF AMERICA, NAT'L	CHARLOTTE	NC	1,496,322	2.1	741,621	-1.9	1,501	554.1	0.38
CITIBANK, N.A.	LAS VEGAS	NV	1,171,094	0.8	509,722	4.6	2,192	-518.3	0.74
U.S. BANK NAT'L ASSC.	CINCINNATI	OH	277,509	0.4	185,902	-2.5	625	4.4	0.90
PNC BANK, NAT'L ASSC.	PITTSBURGH	PA	254,518	-2.2	160,018	-0.1	557	-51.3	0.86
HSBC BANK USA, NAT'L	MCLEAN	VA	183,562	9.8	76,156	-5.1	530	754.1	1.18
BANK OF NY MELLON	NEW YORK	NY	162,064	-1.4	22,907	-12.0	425	42.1	1.03
SUNTRUST BANK	ATLANTA	GA	160,993	-2.0	117,527	-0.8	-186	-27.5	-0.46

<sup>1</sup> FASB 166 & 167 add clarification and transparency to an institution's balance sheet by requiring institutions to bring many special purpose entities and other off balance sheet entities back on the balance sheet. "These changes were proposed and considered to improve existing standards and to address concerns about companies who were stretching the use of off-balance sheet entities to the detriment of investors. The new standards eliminate existing exceptions, strengthen the standards relating to securitizations and special-purpose entities, and enhance disclosure requirements. They'll provide better transparency for investors about a company's activities and risks in these areas." - Robert Hertz, chairman of the FASB

<sup>2</sup> Note: LACE generally shows the information for the 10 largest commercial banks but information for Wells Fargo and FIA Card Services have been affected by a merger and acquisition.

The eight largest commercial banks accounted for approximately 46% of the industry's earnings; HSBC of McLean, VA, and Bank of New York, NYC, had the highest ROA's of 1.18% and 1.03% respectively and SunTrust Bank had the lowest of -0.46%.

Increases in assets were due to the new accounting rules and the purchase of \$54.4 billion in treasury securities, up 53.0% from the fourth quarter of 2009. Bank loans also showed an increase but this was also due to accounting rule changes affecting credit card loans. Commercial and industrial loans fell 2.7%, construction and development loans declined 7.3% and residential mortgage loans declined 1.5%. Bank liabilities were somewhat affected by the new FASB rules as banks brought securitized loans back on to their balance sheets. Their short term secured borrowing accompanied them, raising the bank's liabilities. Total deposits at banks fell by \$28.6 billion while non-deposit liabilities increased by \$263 billion.

Asset quality continued to deteriorate although at a slower rate. Nonperforming loans were up 4.4% to \$17.4 billion from year-end 2009. Nonperforming assets increased 7.2%, or \$12.9 billion. The FDIC reported that inclusion of securitized credit card loans on the banks consolidated balance sheets, due to the new accounting rules, caused credit card nonperforming assets to rise by 51.9% to \$7.6 billion. On the positive side, the FDIC reported that nonperforming assets fell for commercial and industrial (C&I) loans by 12.2%, or \$5.1 billion, and construction and development loans fell by 2.5% or \$1.8 billion.

Equity capital increased 1.0% or \$15.1 billion for the first quarter and would have been higher if not for a \$22 billion conversion of equity into reserves due to the new accounting rules. The FDIC reported that the resulting increase in reserves, "the first time in 16 quarters", caused the coverage ratio (reserves to nonperforming loans and leases) to increase from 58.3% to 64.2%. However, although this is a positive development for the industry, the ratio is still far below LACE's acceptable standard of 80%.

### **Economic Outlook:**

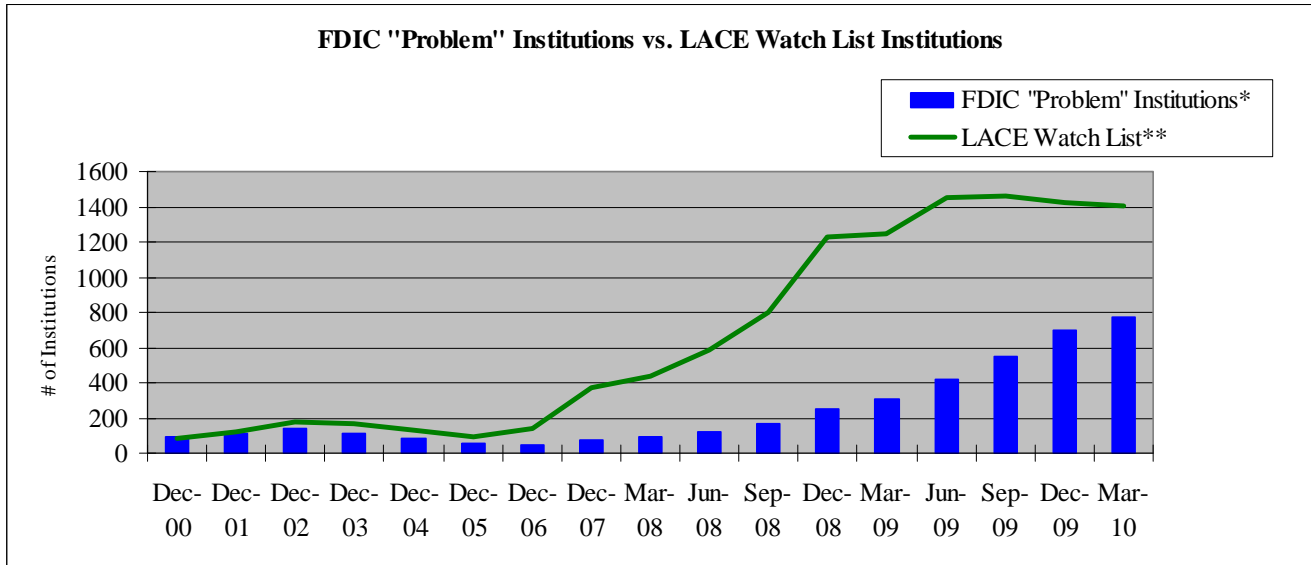
Revised GDP growth for the first quarter 2010 of 3% was driven in most part by consumer spending. Economic and financial problems in Europe could slow the U.S. growth rate, mainly through the low value of the Euro, but economic growth in Asia and other parts of the world are likely to offset lower exports to Europe. There appears to be slight overall improvement in economic activity in most sectors of the economy, with the exception of the housing industry and we would expect GDP growth for the second quarter to be around 3%.

### **Outlook for the U.S. Banking System:**

The banking industry is showing signs of improvement but until nonperforming assets start to decline and loan growth increases it will not have hit bottom nor is it in the process of turning around. Timing wise, this might not occur for another six months. LACE will not be involved in downgrades of the large banks deemed too big to fail because of a change in the Government's position on this issue. All banks deemed to big to fail are currently rated based solely on their financial condition. LACE expects serious problems to occur with the European banks and a few others that could affect the financial condition of the larger U.S. banks. LACE, in approximately 30 days, will send out an Institutions of Concern letter to our foreign clients and others upon request. For the next quarter LACE expects an improvement in bank earnings, the rate of increase in nonperforming loans to decrease and

further improvement in bank capital and resources. All banks deemed to big to fail are currently rated based solely on their financial condition.

It appears that the number of problem banks in the industry is leveling off. The LACE Watchlist for March 2010 contains 1,406 banks with D and E ratings controlling \$1.12 trillion compared with 1,419 banks controlling \$954.8 billion in fourth quarter of 2009<sup>3</sup>. However, the rate of bank failures in the first half of 2010 is accelerating. We predicted that 34 banks would fail in the first quarter of 2010 when actually 41 failed and we expect 50 banks to fail in the second quarter of 2010. It appears that approximately 180 banks could fail for 2010.



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<sup>3</sup> A revision was made to December 2009 data where a very large bank was dropped from the watchlist lowering the amount of assets controlled by D & E rated banks.