WASPS AND 1Q BANK RESULTS

by Steve Brown

We love the summer because the weather is warm and it kicks off the backyard barbeque season. While cooking up steaks, chicken and vegetables is fun in warmer weather, grill masters should be wary of unwanted guests - particularly wasps. After all, no one wants to be stung by a wasp. Following the 1Q industry financial results that were released late last week, we find many bankers feeling they too have been stung.

In general, the data showed bankers are struggling to deal with deteriorating asset quality (loans 90 days or more past due and those in nonaccrual status jumped 24% during the quarter), which drove higher loss provisions (400% higher than 4Q) and the lowest ROA in 17Ys (fell to 0.59%). All of this deterioration led to an increase in charge-offs in most sectors, with the largest jump in residential real estate, construction and development loans. All-in-all, it was a stinging 1st quarter for most banks.

One of the most disconcerting things we found during our analysis came in the form of reserve coverage. Despite pushing the ratio of loan loss reserves to loans from 1.30% to 1.52%, higher noncurrent loans continued to strain banks. As a result, banks held 89 cents in reserve for every $1 of noncurrent loans. That level is the lowest in 15Ys (the last time if fell to this level was during the 1Q of 1993) and regulatory worries have soared.

Banks flagged put on the FDIC "problem list" increased to 1.1% of total institutions, a higher number, but still relatively low by historical standards. Recall that back in the early 1990's, almost 10% of all banks were on that list.

On the funding side of things, domestic deposits grew 2.3% during the 1Q and 75% of that growth came from interest bearing checking/savings accounts. Meanwhile, FHLB borrowings soared 39%, as banks leaned on wholesale channels to support assets. As of the end of the 1Q, FHLB borrowings funded 6.3% of assets, up from 5.1% as of the end of the prior quarter.

Community banks in particular felt additional pain, as the amount of noncurrent real estate construction and development loans soared a whopping 47% during the quarter. Weaker loans, bigger losses and slower growth swarmed community banks, leading to the lowest NIM in 20Ys (dropped to 3.70% for banks under $1B in assets).

Delving even deeper into the results, we examined 7,828 institutions identified as community banks. This group had an average cost of funds of 2.88%, efficiency ratio of 73.20%, ROA of 0.77% and ROE of 6.45%. This group also held loan loss reserves to total loans at the end of 1Q of 1.25%. Finally, loans past due 90 days or more and those in nonaccrual (as a percentage of total loans) for this group jumped to 1.61% for all real estate loans, 3.77% for construction and development, 1.35% for commercial/industrial and 1.47% for all loans.

While tactics vary as to the best way to combat an infestation of this magnitude, we suggest community banks consider the following action steps: Stress test your loan portfolio to be sure you have a good handle on exposures; validate your ALLL calculation to ensure it is adequate given ongoing market deterioration; recognize problem loans early and move quickly to address them; be sure to commit plenty of resources to problem credits; consider cutting dividends to preserve capital (about 50% of publicly traded banks have already announced or paid lower dividends in the 1Q); and reassess the impact of slower loan growth on performance.

Whether your bank has been stung yet or not by the economic downturn, being prepared and reacting quickly to any potential allergic reactions are critical to ongoing success.

BANK NEWS

Wachovia

CEO Ken Thompson was forced to resign over the weekend, as the bank posted its first quarterly loss since 2001 and lost half of its market value over the past year. Subprime losses, the ill-timed Golden West Financial acquisition and a series of other disappointments were cited as the reasons.

WAMU

The country's biggest S&L said Kerry Killinger would step down as chairman, after the company lost 80% of its market value in the past year.

Closed

First Integrity Bank ($53mm, MN) was closed by the OCC late Friday for unsafe and unsound practices. The bank is the 4th to be shut down this year. As 14% of their loans went noncurrent, the 88 year-old bank could not raise enough capital to cover the losses and allowances.

M&A

Central Valley ($495mm, CA) will acquire Service 1st Bancorp ($241mm, CA) for approximately $23.6mm, or a little over 1.3x book value.

M&A

Emclaire Financial ($320mm, PA) will purchase 83 year-old Elk County Savings ($10.4mm, PA) for an unknown price.

LIBOR

Defying critics, the British Bankers' Association ("BBA") kept the calculation of LIBOR as is, despite some questions over its accuracy. While contributing lenders may have underestimated their borrowing costs, the BBA has found no material wrongdoing, but has agreed to increase oversight.

Mortgages

The top 5 mortgage originators in the 1Q were Countrywide ($73B), Wells Fargo ($66B), JPMorgan ($54B), Bank of America ($39B) and Citigroup ($34B). Overall, total origination was down 22% from the 1Q of 2007, but up 3% from the 4Q of 2007.