THE EVOLUTION OF THE BANKING INDUSTRY

by Steve Brown

Former Federal Reserve Chairman Alan Greenspan proved that he lacks a "partial" sense of irony. He went to the Hill yesterday and called for tighter regulation of financial companies, said he was "shocked" at the breakdown in US credit markets and said he was "partially" wrong to resist regulation of some securities. With that statement goes the last vestiges of his "sage" moniker and shifts many of our views of what we believed during the golden years of banking.

Our shift in thought hit home yesterday as we listen to the Treasury and the FDIC. We now get the picture that the government will continue to exert their influence by heavily "suggesting" banks take the liquidity guarantee, as well as the capital. We can't really argue with them, as Q3 earnings from banks are doing little to assuage our confidence that these government programs will go underutilized.

Similar to Wachovia's admission, many banks and credit unions are struggling mightily. We know this because as we test our loan valuation tool (in beta) we arrive at the conclusion that if banks marked their loans to market just in accordance with cash flows (let alone market prices), losses would exceed their entire capital level. While most of the market derides the mark-to-market concept now that it has created the "death vortex," we remain supporters of the methodology from a theoretical standpoint and have come to realize that it can be one way to manage risk in a dynamic environment. For all its flaws, banking will get better at observable inputs and risk will be apparent sooner in the credit cycle. Had we had the methodology back at the end of 2005, banks would have seen the capital effect of widening credit spreads on mortgages and construction loans and likely stopped lending into those sectors. While that wouldn't have stopped the carnage, it would likely have made it less severe. We reported the changes back then, but we didn't have the methodology to parse wider market spreads into a specific dollar price action (taking into account optionality and liquidity of a particular instrument). Throughout this down credit cycle, we have learned some valuable lessons on credit performance.

What lies ahead are most likely several quarters of old fashioned realized losses and increases in allowances. We will see record levels of bank loan charge-offs and we don't hold out hope that lending activity for the industry will accelerate anytime soon. Implied in our piece yesterday on Wachovia - if things are that bad there, we worry about what is happening at Citibank, Bank of America and JP Morgan. Regional banks, such as 5th 3rd, showed that loan default rates are now past levels seen in 1990 and 3x greater than the last brief recession in 2001. For large and regional banks, 4% non-performing assets is becoming the norm. The net result - this current round of government assistance may just be a down payment on more capital to come.

The other realization we had as we travel around the country is that a good 50% of community banks are in fine shape. While asset problems are increasing, it is happening slowly enough that issues remain within credit stressed parameters. Different from the large and regional banks, for most credit stress testing, community banks generally have the liquidity and capital to handle things if they get 2 to 3 times worse.

The end realization is that save for about 300 community banks that could fail or be forced to merge; the smaller bank model may dominate for some time to come. Over the next year, the business platform of the mega bank will be called into question. If community banks can adopt all that is good from the larger banks (marketing, sales culture, technology, etc.), while keeping the traditional service and community focus that has been a hallmark, community banking will be unstoppable well into the next decade. Maybe we are looking through rose colored binoculars or maybe this week's paradigm shift is for the better.

BANK NEWS

Mega TARP M&A #1

PNC Financial ($136B, PA) will buy National City ($151B, OH) for about $5.2B. As part of the transaction, PNC will issue $7.7B of preferred stock under the TARP program to pull off the transaction and strengthen its capital ratios. The acquisition makes PNC the 5th largest US bank by deposits, 4th in total branches

Unfreezing

GECC, the largest issuer of commercial paper, said it would use the Federal Reserve's new short-term funding facility when it starts next week.

SunTrust

Amidst climbing loan defaults, 3Q profits dropped 42.2% from the 2Q and 25.5% from last year. Loan loss provisions rose 12.4%, net chargeoffs jumped 21.5% and nonaccruals increased 25.3% from the 2Q.

Mortgage Plan?

The FDIC and Treasury began work yesterday on a $40B home loan guarantee program that will provide banks partial government backing for modifying loans and avoiding foreclosures. Perhaps coincidentally, a report emerged yesterday reporting foreclosure filings up 71% in the 3Q from a year earlier and 3% up from the 2Q. Month-to-month filing rates dropped 12% in Sept. although largely as a result of changes in state laws prolonging foreclosure procedures.

Bankruptcy

Nearly 750k US families have filed for bankruptcy this year with over 88K last month.