THE STATE OF BANKING

by Steve Brown

We have reviewed more than a thousand bank financials and now have a pretty good basis to draw some conclusions from 4Q numbers. We will state right up front that the data isn't pretty. While bank performance now harkens back to the 80's, the rate of change in some key metrics (such as loan losses) are darkly tracking the 1930's. However, the future of banking is coming into clarity and there is some good news on the horizon. Let's start with a rough outline using a representative sample of banks between $300mm and $3B in asset size from across the country.

ROE for 4Q was negative and came in at -7.15%, while ROA came in at -0.79%. As we have pointed out, assets and earnings were positively-correlated, further dispelling the myth that asset growth is important. In general, the larger the asset size of the institution, the lower the performance. Risk-based capital increased slightly to 12.81%, however this increase was primarily driven by TARP capital (for some) and asset downsizing (for many) at larger banks. Banks below $1B saw a decrease in capital as earnings continued to erode.

NIM dropped 14bp from 3Q to 3.72%. Liability costs were reduced by 13bp to 2.71%, but it was really a drop in loan yields (30bp) to 6.17% that had the largest impact on NIM for 4Q. Due to the drop in operating income, the efficiency ratio at banks increased above 70% (a 5% increase). One interesting point with regard to operations is that larger banks have done a better job at shedding under performing branches. As such, their fixed asset expense, as a percent of interest earning assets, has improved. This is not the same for banks under $1B, as branch and fixed asset sales have been very light.

Total assets grew at an 8% annualized rate for 4Q as balances in both loans and securities increased. Loan mix remained unchanged, with a slight increase in CRE concentrations and the 2nd consecutive qtr. of construction balance decreases. Non-performing loans as a percent of total loans grew at an even faster pace than it did from 2Q to 3Q and ended up at 2.80%. Despite an almost 25% increase in non-performing assets, allowance for loan losses increased 12bp to 1.61% (for a growth rate of only 9%). This is of great concern, as not only are a higher percentage of non-performing loans being written off, but less reserves are being held on a relative basis. Non-performing loans as a percent of total reserves are now in excess of 1.7x, up from 1.5x from 3Q. Finally, the modified Texas Ratio (including 30+ days past due loans), now stands at 38% for this cohort, the highest it has been since the early 80's.

The loudest alarm bells in banking remain in asset quality. Not only has been deteriorating, but it has done so at an increasing rate. If CRE and consumer lending follow just 50% of the trajectory (slope) that non-performing construction loans have endured over the past 3 quarters, a significant number of banks (like 40%) will run out of capital in less than a year.

On the liability side, core deposits increased slightly by 3%, driven by new customers. However, average deposit balances decreased by 2%, resulting in the conclusion that more customers are coming from larger banks and brokerage firms (but the entire customer base now has less excess cash to leave on account). Wholesale funding over total assets, went up 2% to 20.56%, as banks utilized lower cost FHLB advances to protect their core deposits. Brokered CDs, as a percent of total deposits, came in at just under 12%, or a 13% increase.

We promised some good news and here it is. While lending is vastly curtailed, community banks are still trying their best to make loans (as resources allow) to stimulate the economy (and their shareholders). More importantly, the new loans that were put on the books in 4Q are vastly superior in terms of cash flow coverage and probabilities of default (coming from our Loan Pricing and Credit Stress data). This means, that over time, these banks will have more stable earnings (which is less risk).

For a complete analysis, including the optimal loan growth, branch structure, loan mix, loan/liability pricing and a host of other metrics, be sure to come to our Executive Management Conference in San Francisco, May 3rd to 6th. Our analysis, based on hundreds of top and bottom performing banks, is a graduate-level education that you can't afford to miss. By spending 4 days with us, you will take home statistical evidence of the best products, strategies and tactics for banking in this environment. Go: http://www.pcbb.com/2009Conf_Summary.asp

BANK NEWS

FDIC Deposit Warning

Responding to a banker that gave a hypothetical example (where an accountholder deposits $1mm into a noninterest-bearing transaction account and $225k into an interest-bearing account), the FDIC warned such "linked-accounts" (that are designed to obtain unlimited deposit insurance coverage for interest-bearing accounts) are illegal. The FDIC said any arrangement between a bank and a depositor in which the interest amount paid on a time deposit will increase with the amount of money deposited in another non-time deposit account is a violation of the federal prohibition against the payment of interest on demand deposits.

Pay Cap

President Obama will reportedly announce that he will cap compensation of top executives receiving significant federal assistance at $500k and that additional compensation will be paid in restricted stock that would not vest until taxpayers had been paid back.