CHEF SURPRISE AND 2008 BANK PERFORMANCE

by Steve Brown

Late last week, the FDIC reported the banking industry lost $26.2B in the 4Q, marking the worst loss in 18Ys. Economic disruption led to sharp writedowns and much higher than expected loan losses. These factors and others served up a plate full of "chef surprise" for the industry - just like we used to get in elementary school every Friday.

Overview: As of the end of 2008, the FDIC had boosted the number of institutions on its "problem list" from 171 to 252 (a nearly 50% increase) and loan loss reserves more than doubled to $69B. As if that weren't enough, nearly 25% of all institutions were unprofitable - the highest number in at least 25Ys. Finally, those banks that were able to generate profit produced a grand sum of $16B (the lowest level since 1990 when banks earned a mere $11B) which was down from just over $100B in 2007.

Deposits: On the good news front, volatile economic conditions drove consumer fear, pushing domestic bank deposit growth higher by 3.5% - the largest percentage increase in 10Ys. The growth came in domestic time deposits (+1.8%), other domestic interest-bearing deposits (+6.4%) and domestic non-interest bearing (+2.2%). Also of note, brokered deposits increased 15.3% (marking the largest quarterly percentage increase in 8Ys), however 10 institutions accounted for more than 67% of this growth. Finally, by the end of the year, 523mm deposit accounts were covered under the FDIC Transaction Account Guarantee Program. The amount left in noninterest bearing transaction accounts (such as business payroll accounts) soared to $814B. Also of note, 87% of all institutions opted-in for this program, while 55% opted-in for the TLGP.

Loan Problems: Banks took slightly more than 50% of net operating revenue and set it aside in loan loss provisions during the 4Q. This was the highest proportion for any quarter in at least 21Ys. It was no wonder, either, as the industry experienced an industry net charge off rate of 1.91%, the highest quarter since 1989. Finally, the amount of loans noncurrent (90D or > plus nonaccrual) soared to 2.93%, the highest level since 1992.

Dividends: In an effort to conserve capital, the FDIC reports that of the 5,621 banks that paid dividends, 54% reduced their payout in 2008. In addition, about 10% of institutions eliminated the dividend altogether.

COMMUNITY BANKS

Looking more closely at community banks under $1B in assets for the full year of 2008, we found some interesting facts that served up a different meal than the industry at large. This group represents 7,629 banks and thrifts or about 92% of institutions.

Performance: Community banks produced an ROA of 0.32% (vs. 0.12% compared to larger banks) and an ROE of 2.76% (vs. 1.24%). Things were tough out there, but the data shows community bankers were able to outperform larger peers. In a side note (closely related to performance), 50% of OREO was in construction/development.

Reserves: Community banks reserved 1.37% in loss allowance, compared to 2.20% for the industry. While larger banks certainly have been more negatively impacted by recent events, we would expect community banks to have to increase this level in coming months, reducing profitability.

Hedging: Despite perception that only large banks use hedging instruments (derivatives), we found it quite interesting to note that 68% of all institutions using hedging instruments were actually community banks.

Loan Mix: Loan portfolios by type were composed of nonfarm nonresidential (28%); single family residential (27%); construction/development (14%); C&I (14%); other consumer loans (5%); other loans, including farm (5%); home equity (4%); multifamily (3%); and credit cards (0%).

Deposits: Funded more than 67% of their assets with interest bearing domestic deposits, compared to less than 50% for larger banks.

Leverage: Showing more constraint than larger banks, community banks also held their loan-to-deposit ratio at an average of 83%. That is about 7% less than larger banks and is another reason community bankers have been able to perform better than the large banks during this downturn. In short, lower leverage has proven to produce a lower risk profile.

The meal may now be finished, but digesting it will likely take some additional time.

BANK NEWS

TLGP Capital

The FDIC approved an interim rule that allows banks to utilize the TLGP guarantee to support mandatory convertible debt.

Returning TARP

TCF Financial ($16.7B, MN) becomes the 2nd bank in the country to announce that it will return its $361mm in TARP money to the Treasury. TCF said actions by the Treasury, possible restrictions changing the rules and negative public perception drove the decision.

OCC On Reserves

Because banks are heavily dissuaded from building loan loss reserves in times of economic growth, the OCC expressed concern that loan loss provisioning has become "pro-cyclical" (magnifying earnings losses) instead of counter-cyclical.