THE CLEANLINESS OF KITCHENS AND THE INDUSTRY

by Steve Brown

We are pretty good at cleaning up the kitchen - unless of course if you ask the Wife. Our definition of "clean" differs in so far as once the dirty dishes are taken care of, we roll out the "Mission Accomplished" banner. The Wife, on the other hand, goes down to the molecular level.

In similar fashion, we have a different definition than the market of what constitutes a banking industry turnaround. Based on the rally last week, sparked by the Wells Fargo 1Q earnings release, pundits were gushing that we have hit bottom and are on the way up. While we love the optimism, we believe it is misplaced at this point of the recovery.

The problem is in the details - loan performance, servicing value, an increase in Level 3 FAS 157 classifications and other issues continue to surface. Wells' 1Q performance seems odd to us, given that we still show credit quality deteriorating. Wells reported charge offs of $3.3B in 1Q, versus $6.1B in 4Q. Maybe their portfolio has improved compared to the rest of the loan market, but we are skeptical. The other factor that the market is overlooking is their loan loss allowance. As of 4Q, Wells was running at 2.4x reserves to total loans, versus 2.5x for BofA, 3.1x for JP Morgan and 4.0x for Citigroup. 2.4x seems very low, given what we know about Well's home equity portfolio and Wachovia's ARM portfolio.

In the broader picture, we are also concerned with what the differences will be surrounding the regulatory credit stress test. Not even released yet, analysts over the weekend were predicting positive outcomes. Here is our take - almost all banks will pass, those that don't will quickly be given more capital. The market will rally on the basis that all 19 of the subject banks are once again in good shape. This is similar to the "I am saving this food, just so I don't have to clean the plate" move when cleaning the kitchen. You are basically leaving the problem for another time. In similar fashion, since we have been conducting loan-level credit stress testing and allowance for loan loss validation for more than 4Ys, some of these 19 banks might not pass a true credit stress test. We may be speaking out of turn here, but it feels like we are about to be mislead. Given the 19 bank's geographical/loan type concentrations, current loan loss allowance and underwriting issues - the reality is that many of these banks are probably under-capitalized and under-reserved.

Under regulatory stress testing, the Fed's "worst case" of 10% unemployment, a 3% dip in GDP and 22% peak-to-trough fall in housing prices should be the "base case." Further, from what we understand, the correlation and cross-correlation on effective rents for CRE and multifamily at several major banks are nowhere near what we are experiencing today in areas like CA, FL and GA. The combination of these factors, we predict will result in output that is too rosy.

We don't want to throw water on the rally, but we believe that optimism at this point will only serve to disappoint. While our data indicates that March was better for construction, hotel occupancy and capital expenditures than January and February; spending is still anemic. Until we have sustainable improvements in non-farm payroll, consumer spending and the Baltic Dry Index, there is little chance that asset prices are on their way up. Until then, it feels like we are just moving stuff around in the kitchen instead of really cleaning it - and we should know.

BANK NEWS

Bank Closures

The FDIC closed Cape Fear Bank ($492mm, NC) and New Frontier Bank ($2B, CO) on Friday. Cape Fear Bank's $403mm in deposits were purchased by First Federal Savings and Loan Association of Charleston ($3B, SC). A buyer could not be found for New Frontier Bank, which was instead placed into an FDIC-created entity called Deposit Insurance National Bank of Greeley. Deposit Insurance National will remain open for approximately 30 days, in order to allow depositors time to open accounts at other insured institutions.

FHLB SF

Following action taken by other FHLBs, the FHLB of SF told bankers it would not pay a dividend for 1Q 2009, or repurchase excess capital stock on Apr. 30. FHLB SF said it was taking this action to rebuild retained earnings and capital, due to economic uncertainties that could result in additional OTTI charges on non-agency MBS.

Consumer Credit

According to Equifax, 8mm credit card accounts were closed in Feb. At its highest, in Jul., 483mm accounts were open compared to 400mm in Feb.

FHA Loans

While many housing subsectors are moderating in delinquencies, FHA loans continue to deteriorate at an increasing pace. Delinquencies are up to 7.5% for Feb, compared to 6.2% in 2008.

Fraud Risk

A study by the Mortgage Asset Research Institute finds the number of fraud reports related to loans made last year jumped 26% compared to 2007. RI, FL and IL were the top 3 troubled states. In a tandem study that was just released, FINCEN found people that are reported for suspected mortgage loan fraud may also be involved in other financial crimes such as check fraud, money laundering, stock manipulation and structuring to avoid currency transaction reporting requirements.