PROTESTING BANK PERFORMANCE

by Steve Brown

In case you passed up the ABA Banking Conference 2 weeks ago - you missed out. While the conference wasn't anything to write home about, the event was underscored by some vehement protesting, an experience that was new to many attendees. There are nothing like chants of "Jail 'em, Don't bail 'em," Jesse Jackson leading a crowd, and sad stories to make bankers feel worse than they already do. Why were these people protesting? The answer is because they have the same brain structure as a walnut. While we know we are preaching to the choir, these protestors at best were equally culpable in causing their problems or worst, deserve a majority of the blame. While we can't prevent the public ire, we need to point out that bankers should prepare themselves as things are going to get worse before they get better. Our model, driven by credit quality, shows community bank performance will continue to deteriorate thru the end of 1Q. To shed more light on this statement, we wanted to update our data on 3Q performance for banks that are under $2B in total assets (as we now have more than 91% of community banks reporting).

ROE came in at a negative 16bp (down from a positive 73bp in 2Q), while ROA was a negative 2bp. Core margins continued to improve for the 2nd Qtr in a row, as banks were more successful with instituting floors and were able to reduce their cost of funds (by bringing down their CD rates). NIM was 3.69%, up 10bp from 2Q. It is interesting to note that most bank's COF was reduced despite a 6% reduction in cheaper wholesale funding (which now makes up 16% of a community bank's deposit structure on average).

In terms of capital, banks continued to deleverage in order to bring ratios in-line. Loans to deposit ratios dropped from 85% to 80%, quarter over quarter, which helped equity to assets come up from 10.1% to 10.6%. The Tier 1 risk-based capital ratios improved from 12.7% to 12.8%.

The real story that will invite more problems and more protesting is deteriorating asset quality. Problems continued, as non-current loans to total loans rose from 3.2% in 2Q, to 3.4%. Net charge offs to total loans went from 1.0% to 1.2% QoQ. Non-current loans to total capital and reserves went from 21.4% to 22.0% from 2Q to 3Q. This is one of the largest discrepancies across banking. While many banks have dramatically improved their problem loans to capital and reserves, many banks have not and are now markedly worse. Until asset quality deterioration abates, banks will need to keep adding to reserves, which will continue to erode capital and profitability. This trend, we predict will unfortunately continue to at least April 2010.

As of 3Q there were more than 850 banks with risk-based capital ratios below 11% and 300 below 10%. More than 125 banks have leverage ratios of less than 5%.

One trend that is disconcerting is the fact that many banks seem to be keeping a large amount of distressed loans just below the edge of non-performing status, with partial payments and other accommodations. We draw this conclusion from a recent phenomenon whereby recorded loans no longer go through the standard aging cycle of delinquent status. Volumes of loans now go directly from "performing" to non-accrual or REO without even stopping at 30-89 day or 90+ day PD. Similarly, we don't recall ever seeing such consistent volumes of 30-89 day past due loans in banks (this may be related to efforts to keep impaired loans just shy of 90+ day status).

While we can't help the protestors, this week we will be looking at more 3Q data and highlighting what some banks are specifically doing to improve performance. For banks interested in a more interactive general overview, we encourage all to attend a complementary "BIG Metrics Q3 Data Review" that we will host online this November 12th (Thurs.), at 11:30am PT. To register, please follow link at the bottom right.

BANK NEWS

Bank Closures (120 YTD)

On Friday, the FDIC closed: [1] United Security Bank ($157mm, GA) and sold it to Ameris Bank ($2.28B, GA). Ameris will assume all deposits for a 0.36% premium and essentially all assets under a loss share. [2] Home Federal Savings Bank ($14.9mm, MI) and sold it to Liberty Bank and Trust Co. ($412mm, LA). Liberty will assume all deposits for no premium and in effect all assets. [3] Prosperan Bank ($200mm, MN) and sold it to Alerus Financial, NA ($761mm, ND). Alerus will assume all deposits for a 1.02% premium and essentially all assets under a loss share. [4] Gateway Bank of St. Louis ($27.7mm, MO) and sold it to Central Bank of Kansas City ($172mm, MO). Central bank will assume all deposits for no premium and nearly all assets. [5] United Commercial Bank ($11.2B, CA) and sold it to East West Bank (CA). East West will assume all deposits for a 1.10% premium, 63 branches (plus locations in China and Hong Kong) and approximately 91% of assets under a loss share.

FOMC

St. Louis FRB President James Bullard (non-voter) said the FRB would not likely raise rates until "the recovery was well established."