AVOIDING TEARS WHEN PEELING BACK THE 1Q LAYERS

by Steve Brown

There is an old saying that goes something like "If you don't want to cry, then don't peel back the layers of an onion." As we all await the results of the 1Q for the banking industry and closely monitor press releases by those who have already reported, we thought it might be worthwhile to peel back the layers of last year that were only recently reported by the FDIC, to see whether some of the trends might continue.

On the earnings front, 62% of banks reported better net income in 2010 than the year earlier, but about 25% reported a 4Q net loss. Overall, about 21% of banks were unprofitable in 2010. Meanwhile, 54% reduced loan loss provisions in the 4Q, compared to the year prior (setting aside about 50% less and marking the smallest quarterly provision since 2007). Based on the data, the three biggest drivers supporting improvement in net income were a 37% reduction in provisions, a sharp drop in goodwill charges and more gains on securities sold. So far in the 1Q, based on the data reported by JPMorgan, Bank of America, Citigroup, etc.; the trend toward reducing reserves has remained the largest driver again, as loan performance improved further.

Peeling back the loan growth layer, we find banks shrank loan portfolios once again in the 4Q (down 13.6% from the 3Q). Overall, portfolios have contracted for 9 of the past 10 quarters, with the only positive increase coming in 1Q 2010 when banks were required under FAS 166 and 167 to consolidate large amounts of securitized balances back onto balance sheets. During the quarter, loan balances fell at 60% of banks. Here again, if the major banks are any indication, average loans contracted about 2% from the 4Q to the 1Q and about 10% to 14% or so compared to the 1Q of 2010. Clearly, competition is running high, loan demand is off and banks continue to struggle to hang onto quality customers.

By peeling back the funding layer, we find not surprisingly that banks are continuing to reduce reliance on wholesale sources. Last year, for instance, banks recued their usage of FHLB Advances by about 28%, given large amounts of liquidity already on the balance sheet. This trend is expected to continue in the 1Q, as bankers await further action from the Fed to reduce the flood of liquidity in the system sometime later this year or early next year (based on market projections).

Conditions remain difficult, as can be seen with the number of problem banks (those rated either a 4 or 5 per the FDIC) that reached 884 at the end of the year, or nearly 12% of all banks in the country. Given 26 closures in the 1Q and assuming no new banks dropped down into this classification, the level of problem banks is projected at 858 or just below Sep 2010 levels.

As banks continue to report 1Q numbers, we will be comparing performance against hard data points for 2010. For comparison, the 6,990 community banks with assets under $1B ended the year with ratios that included: 3.81% NIM; 0.33% ROA; 2.98% ROE; 76.0% efficiency ratio; 10.5% leverage ratio; 16.0% Tier 1 RBC; 17.1% total RBC and a 74.1% loan to deposit ratio. Depending on where your bank is located and the individual situation, these will likely be interesting data points for you to know, as you work toward meeting your own strategic objectives for 2011 (particularly in context of peers).

BANK NEWS

Earnings

US Bank profit jumps 56% to $1.05B coming in above estimates due to improved asset quality and lower provisions. Loan growth was 2.4% and NIM was stable at 3.69%. Zions posted an unexpected profit of $53mm (vs. a loss last 1Q) due to a 65% drop in provision expense. Comerica posted a higher than expected profit of $102mm (vs. a loss last 1Q) due to improved credit quality and a 72% drop in provisions. Keycorp earned $184mm (vs. a loss last 1Q) due to improved credit quality and lower provisions.

S&P Credit Watch

The rating agency placed US long term debt on watch with negative implications. The move increased credit spreads and global concern. Since S&P began assigning outlooks to gov't debt in 1989, 5 AAA-rated countries have been assigned negative outlooks, including Britain in 2009. Three were subsequently downgraded with 2 returning back to a stable "AAA" position.

Citigroup

The Bank plans to open 200 new branches with many targeted around Seattle and Atlanta areas

Lehman Rewrite

The FDIC issued a report that walks through the 2008 Lehman Bros. failure and models it as if the DFA orderly liquidation authority would have been in place. The FDIC claims the alternative outcome could have resulted in a loss of 3 cents per dollar versus 79 cents per dollar.

HC Supervision

The Fed asked for comments on how it plans to regulate S&L bank holding companies when it takes over as a primary supervisor for the OTS on July 21st. Of particular issue - consolidated capital requirements.