



Trends in U.S. Banking Institutions – First Quarter 2009

The financial condition of the Commercial banks continued to deteriorate in the first quarter of 2009. The FDIC reported industry earnings of \$7.6 billion; banks with high concentrations in credit card lending lost \$1.9 billion, banks with international operations made \$5 billion, and all other banks under \$1 billion made \$232 million. Although there was significant improvement over the \$36.9 billion loss in the 4th quarter of 2008, it was still, on all accounts, a dismal quarter for the banking industry. It must be emphasized that the majority of earnings, although low, are attributed to the larger banks and not the smaller banks. Poor earnings resulted mainly from increased loan loss provisions, higher charges for goodwill and reduced income from securitizations. On the positive side, non-interest income from trading activities was up \$7.6 billion, servicing fees increased by \$2.4 billion, and realized gains on securities of \$1.9 billion and lower funding costs aided large bank earnings.

From the 4th quarter of 2008 to the 1st quarter of 2009, total assets for the banking industry declined 2.2% and loans and leases declined 1.8%. The decline in bank loans is a very serious issue because without loan growth it will be difficult for the U.S. economy to grow. Deposits for the industry declined 2.2%, in part because banks did not need this source of funding due to the \$82.1 billion increase in capital and the decline in assets.

The deterioration in asset quality is currently, and at least for the rest of 2009, the biggest concern for the banking industry. Nonperforming assets increased \$59.2 billion from the 4th quarter of 2008 and 112.7% from the 1st quarter of 2008. The FDIC reported that nonperforming loans increased in all loan categories but real estate loans accounted for 84% of the increase. The banking industry charged-off \$37.8 billion of its loans and leases, resulting in a charge-off rate of 1.94%, the highest level in 25 years. The reserves-to-nonperforming assets ratio fell from 74.8% to 66.5% during the quarter, an extremely low level.

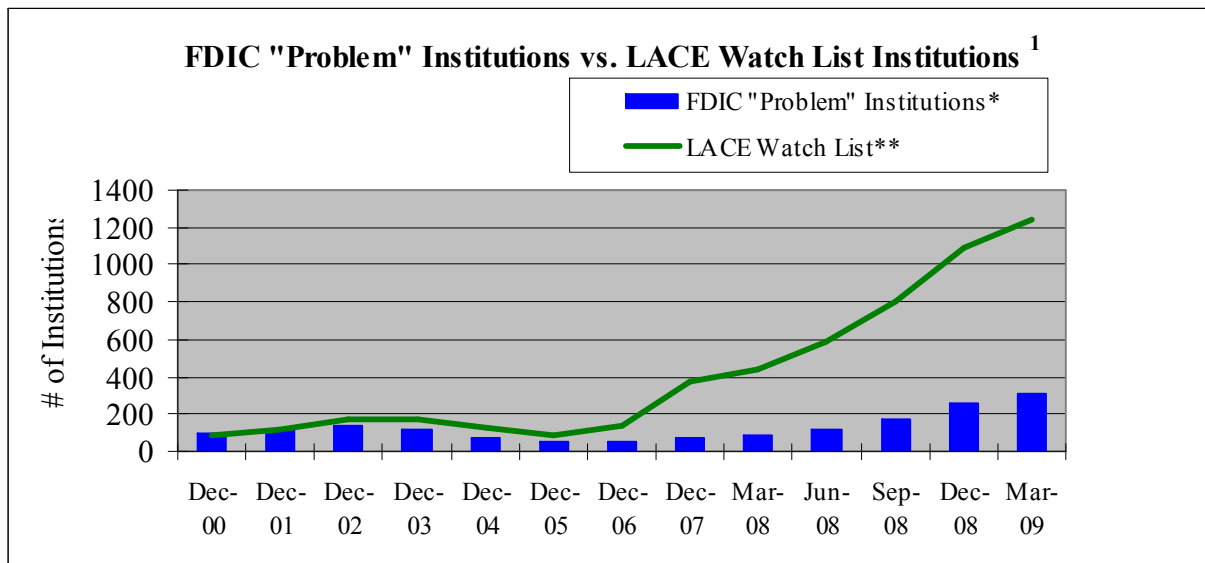
The FDIC reported that equity capital for the industry increased by \$82.1 billion, but most of the increase was concentrated in a relatively small number of institutions, some of which received TARP funds. To retain capital, many commercial banks have been reducing or eliminating their dividends.

Outlook:

Although we have been fairly accurate in predicting the last two quarters of GDP growth rates, estimating growth for the second quarter and the rest of 2009 is difficult. Our best “guess” is that GDP growth will be somewhere between a -3% to a 1%, but probably negative. It appears that there is a general feeling among leading economists and LACE Financial that the credit markets are stabilizing and that the stock market prices reached their lowest level in March 2009. Consumer confidence appears to be improving; however, we believe that one must be careful because consumer judgments may be based on the feeling that “the worst is over” and consumers may not realize that the road to recovery will be long and slow. A fear is that after the effects of the second U.S. stimulus package and the current Chinese stimulus package diminish, we may face another downturn in world economic growth.

The condition of the banking industry is still in decline and probably won't stabilize (hit bottom) until the first quarter of 2010. The larger banks will improve first because of government aid and consolidation. The concern is for the regional and community banks that face severe problems of continued rises in unemployment, low and falling housing prices, increasing defaults in commercial real estate (3,000 banks and savings and loans have commercial real estate loans that exceed their risk-based capital), and the refinancing of approximately \$314 billion of adjustable rate option (arm) mortgages over the next two years that could have as high as a 35% default rate.

The LACE Watch List for commercial banks increased from 1,095 banks in the 4th quarter of 2008 to 1,242 banks in the 1st quarter of 2009, or an increase of 13.4%. The FDIC Watch List increased from 252 banks in the 4th quarter of 2008 to 305 banks with assets totaling \$220 billion. LACE Financial currently believes that there are 248 banks in danger of failing at this time with \$226 billion in total assets. As of the date of this letter, 40 banks have failed in 2009 and we still expect 100 to 150 bank failures by the end of the year.



* Defined as having a composite CAMELS rating of "4" or "5".

**LACE figures represent the number of institutions that were rated either "D" or "E" for the period.

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¹ The likely reason for the difference between the LACE Watch List and the FDIC Watch List is because LACE ratings are derived four times a year and the CAMEL ratings are derived once or possibly twice a year. There is also a longer time period to derive a CAMEL rating than there is a LACE rating. LACE also feels that in mid 2006 the Feds loosened the criteria for receiving 1, 2, and 3 CAMEL ratings, in part due to the tie-in with FDIC deposit insurance rates.