



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

December 16, 2009

The condition of the banking industry continued to decline during the third quarter of 2009. Although earnings were up slightly, they occurred mainly at the larger banks. For the quarter, the industry reported earnings of \$2.8 billion. Commercial banks with assets greater than \$10 billion made \$4.6 billion while all other banks lost \$1.8 billion. These results could be interpreted as indicating that the condition of some of the larger banks is improving while the condition of most banks in the industry is still deteriorating. The banking industry revenues were aided by the Fed's low interest rate environment which contributed to an increase in net interest rate margins of 3.51%, the highest in four years. Revenues were also aided by "lower" realized losses on securities and other assets and higher non-interest income. The main cause for the industry's poor earnings was charges against income to build loan loss reserves due to increasing asset quality problems.

A concern for the industry and economic growth is a decline in industry assets of 0.4% driven by a 2.8% decline in loans and leases. The FDIC reported that this was the largest percentage decline between quarters since banks began reporting the information in 1984. Commercial and Industrial (C&I) loans declined 4.2% and real estate development loans (C&D) declined 8.1%. A major reason for the decline in loans is the high charge-off rate of 2.71%, another record. Banks charged-off \$50.8 billion during the third quarter, an 80.5% increase over the year ago period. Deposits for the quarter increased slightly by .087%. Banks are relying more on core deposits to fund operations and reducing non-deposit sources of funds which declined 6.2%. The FDIC reported that during the third quarter deposits funded 68.7% of the banking industry assets which was the highest proportion since 1997.

Nonperforming assets increased \$34.7 billion to \$366.6 billion at quarter-end, equaling 4.94% of loans and leases. This is the highest level in the 26 years that data has been reported. These are horrific numbers which tell us that the banking system is not going to turn around for some time. Nonperforming assets increased 13.9% for residential mortgage loans, 19.2% for C&I loans, and other real estate loans increased by 18%. The high increase in nonperforming assets was greater than the banks contributed to their loan loss reserve account resulting in the nonperforming asset coverage ratio declining from 63.6% to 60.1%. This is a very low coverage ratio and LACE believes a more acceptable level would be closer to 80%.

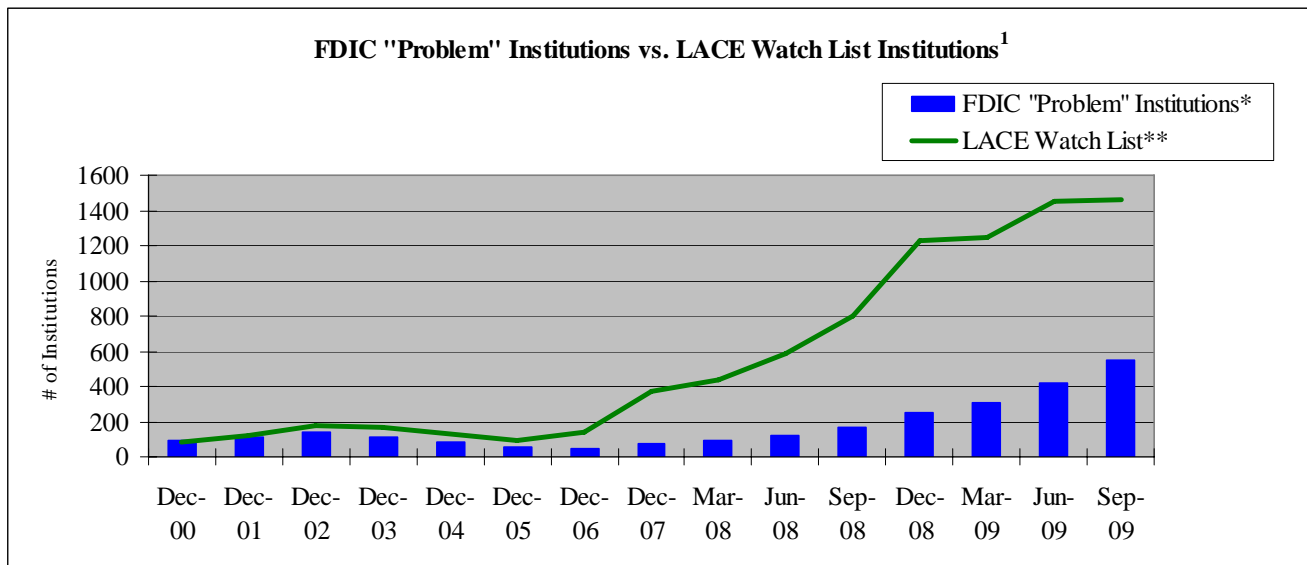
The banking industry capital levels might be considered strong if one doesn't take into account the low reserve levels and high levels of nonperforming assets. Equity capital increased 3% over the quarter and 12.0% from the year-ago period. The increase in equity capital was due mainly to the appreciation in the value of banks securities and investments.

Outlook:

It is not likely that GDP growth of 2.8% for the third quarter will be sustained for the fourth quarter of 2009 and the first quarter of 2010 without further government stimulus. The realization in Washington about high deficits will favor monetary policy over fiscal policy prolonging the low interest rate environment and raising concerns about asset bubbles.

Consumers and businesses are reducing their borrowing needs by strengthening their balance sheets through the down payment of debt and increased savings. Banks are basically doing the same thing by writing off their bad loans and increasing their lending standards. Together these behaviors will create a drag on economic growth. The wealth affect from recent stock market price increases will help as well as the recent improved earnings from corporations. However, the slow recovery in the housing market and high unemployment will offset some of these gains.

For the third quarter 2009 the LACE Watchlist increased to 1,464 banks with \$2,071 billion in assets from 1,386 banks with \$1,910 billion in assets for the second quarter, or 5.6% and 10.9%, respectively. The number of banks that have failed so far in 2009 is 133 and it appears that for the year the number will be around the high end of the range we predicted at the beginning of the year of 140. We expect the serious banking problems outlined above for the third quarter to continue in the fourth quarter and the first quarter of 2010. Although it is a little early to predict the number of bank failures for 2010, we would expect them to be about the same as in 2009 and possibly higher.



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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 required 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 the FDIC deposit insurance rates.