The IRA Advisory Service

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Talking Points: "2011 Banking Industry Outlook"
Federal Reserve Bank of Atlanta

The full year 2010 represented a recovery of sorts for the US banking industry from the previous several years. Quarterly net income for the industry has settled down in the $20 billion run rate range after more than two years of losses. This is a little more than half the run-rate income for the banking industry pre-2008. A good bit of this reported income in 2010 was reliant on reductions in credit loss provisions and/or reversing provisions back into income. Revenue during the period was flat to down.

The decline in industry revenue and loan balances confirms anecdotal reports that volumes in CRE, RES lines remain weak as 2011 begins. Strength in credit card portfolios is a hopeful sign, but may be seasonal. A secular decrease in loan portfolios is hopefully nearing an end, which would be a significant positive for the economy, but real estate is 60% of total bank portfolio and remains flat to down. Growth in C&I balances are starting to suggest stability in terms of business volumes. Keep in mind, though, that we are working off of a very low floor. There is no confirmation of an improving trend.

One major worry is the overall shrinkage of available credit for real estate. Of the $2 trillion in subprime RMBS at start of 2008, half of the original principal balance has either run off, been charged off or is reported as delinquent. Likewise the bank construction and development loan portfolio is now half the balance of pre-2008 period, giving an example of the shrinkage in credit utilization which has occurred due to charge-offs and natural runoff of loans. A good bit of the strength seen in Q4 2010 C&I balances also may be seasonal.

A large goodwill adjustment by Bank of America ("BAC") resulted in a restatement for three past quarters of FDIC data. "Full year 2009 net income declined from a $12.5 billion profit to a $10.6 billion net loss," said FDIC. "Most of the revisions resulted from changes in expenses for goodwill impairment at one large institution." Not impossible we will see further goodwill impairments out of large banks in 2011.

During the Q4 2010 earnings calls, many banks reported flat loan applications and other indicia of forward revenue. As FDIC Chairman Sheila Bair said earlier this week, the banking industry can only support earnings via reversing provisions back into income for so long. The bulk of the low-hanging fruit in terms of residential mortgage refinancing transactions seem to have been done as well, leaving banks to fight over a dwindling pool of eligible borrowers.

The sweet spot for FHA/FNM/FRE production today is 70% LTV and a FICO north of 700 despite what the news reports and bank press releases suggest. This means well-more than half of all US homeowners are not bankable and much of this population is well underwater. The fact of home prices falling further from current depressed levels begs the question of the fair value of bank loan portfolios.

The tables below give you a top level view of the ratings distribution of the US banking industry as seen from The IRA Bank Monitor Bank Stress Index ("BSI"). The BSI scores are the result of a quarterly survey of five equally weighted factors -- ROE, Capital, Charge-Offs, Efficiency and Lending Exposure -- arrayed for all FDIC insured banks and using the data gathered by the FDIC.

The table below shows the average BSI scores for the entire industry and the numerical scores for the top five banking groups by assets. The benchmark year of the IRA index is 1995 and equals "1" in the BSI numeric score.

IRA Bank Stress Index Scores

	Industry	JPM	BAC	C	WFC	USB	1995
12/31/2010*	> 2.5	> 3	> 3	> 3	> 2.5	> 3	1
9/30/2010	2.3	2.17	2.28	2.37	1.59	1.55	1
6/30/2010	2.4	2.33	2.45	2.38	1.65	1.61	1
3/31/2010	2.2	2.41	2.51	2.37	1.72	1.64	1
12/31/2009	21.5	2.16	2.50	21.99	1.49	1.51	1
9/30/2009	4.4	2.09	2.29	21.93	1.43	1.51	1
6/30/2009	3.1	2.02	2.04	21.92	1.34	1.45	1
3/31/2009	2	1.88	1.74	2.32	1.23	1.38	1

** Estimate based on preliminary data.*
Source: FDIC/The IRA Bank Monitor

The BSI scores that equate to "A+" through "B" ratings bands correspond with the top 30% of the industry in terms of financial performance and generally fall at or below the "1" score value for the benchmark year 1995. Once you as a bank are at or above about a "2" BSI numeric score, you drop below a "B" letter grade rating.

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IRA Bank Stress Grade Distributions (# Banks)

Period	A+	A	B	C	D	F
2010 09	3,493	1,592	519	400	67	1,638
2010 06	3,551	1,575	480	463	77	1,632
2010 03	3,676	1,592	504	480	93	1,534
2009 12	2,978	1,539	480	432	85	2,441
2009 09	3,308	1,481	410	429	77	2,337
2009 06	3,518	1,449	417	421	72	2,256
2009 03	3,959	1,431	452	437	88	1,820
2008 12	3,918	1,448	376	390	98	2,003
2008 09	4,498	1,293	315	356	63	1,793
2008 06	4,884	1,323	329	326	66	1,458
2008 03	5,167	1,271	349	334	68	1,233
2007 12	5,556	1,196	298	315	70	1,029

Source: FDIC/The IRA Bank Monitor

IRA Bank Assets Stress Distributions ($B)

Period	A+	A	B	C	D	F
2010 09	$2,218	$3,185	$4,985	$1,173	$336	$1,464
2010 06	$2,164	$2,837	$4,942	$1,337	$465	$1,458
2010 03	$2,109	$1,295	$6,622	$1,088	$381	$1,843
2009 12	$1,457	$1,826	$3,072	$1,839	$295	$4,601
2009 09	$1,756	$1,938	$4,316	$584	$94	$4,535
2009 06	$2,005	$2,097	$4,132	$518	$68	$4,458
2009 03	$3,202	$3,131	$3,587	$729	$86	$2,784
2008 12	$2,366	$5,398	$403	$694	$46	$4,033
2008 09	$2,907	$5,504	$525	$704	$144	$3,772
2008 06	$2,897	$5,256	$400	$695	$51	$3,983
2008 03	$3,461	$5,119	$384	$630	$36	$3,719
2007 12	$7,613	$1,719	$1,629	$1,248	$107	$705

Source: FDIC/The IRA Bank Monitor

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In terms of the largest banks, the visible levels of stress are rising as 2010 ends. These large banks include the largest loan servicers in the US. Large bank losses on loans secured by real estate are still near 3%, a full point above the industry average. An indeterminate portion of first and second liens currently carried as accrual by these large servicer banks are in the process of modification and/or restructuring. We expect that operational expenses related to the large servicer banks will continue to build through 2011, when we hope to see the peak in volumes related to home foreclosures.

Below are some preliminary Q4 2010 ratings changes from The IRA Bank Monitor for specific institutions using data from FDIC. Again, the benchmark year of the index is 1995 which equals “1.”

- **Bank of America ("BAC")** $1.4 trillion lead unit, Bank of America, NA came in with a Bank Stress Index ("BSI") score of 3.4 or "C" in Q4 2010 vs. 1.6 or "B" in Q3 2010. The credit card unit, FIA Card Services, improved its BSI score from 25 or “F” in Q3 2010 to 20.1 and still an “F” in Q4 2010. The overall rating for BAC in Q3 2010 was 2.3 or "C", thus the deterioration in the lead bank preliminary results will likely push the group's aggregate score lower when we release the final Q4 2010 ratings at the end of this week.

- The lead unit of **Citigroup ("C")**, Citibank NA, slipped sharply from a Q3 2010 BSI score of 1.6 or "C" to 9.3 or "D" as of Q4 2010. The credit card unit of C, Citibank South Dakota, NA, likewise saw increased stress, with its BSI score rising from 7.5 of "D" in Q3 2011 to a BSI score of 15 or "F" in Q4 2010. The deterioration in the lead bank results will likely push the group's aggregate score lower when we release the final Q4 2010 ratings at the end of this week.

- The lead unit of **Wells Fargo & Co. ("WFC"),** Wells Fargo Bank NA, slipped from a BSI score of 1.6 or "B" in Q3 2010 to a BSI score of 3.6 or "C" in Q4 2010. The industry average BSI in Q3 2010 was 2.3 or twice the level of stress visible in the benchmark year of 1995.

- The lead unit of **JPMorgan Chase ("JPM"),** JPMorgan Chase Bank, NA, slipped from a BSI score of 1.5 or "A" in Q3 2010 to a BSI score of 3.8 or "C" in Q4 2010. The credit card unit, Chase Bank USA, saw its BSI score slip from 6.1 or "D" in Q3 2010 to 18.1 or "F" in Q4 2010.

The fact that these large institutions are showing increasing stress at a time when many banks in the industry are recovering and displaying lower BSI scores illustrates an interesting aspect of the financial crisis and its aftermath. Immediately after the collapse of Lehman Brothers in 2008, the Fed and Treasury began to pump subsidies into the largest money center banks.

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Public subsidies, including low interest rates and credit lines from the Fed, TARP capital from Treasury, FDIC guarantees on debt, forgiveness of reps and warranties claims by the GSEs, and other governmental support, made the largest banks appear less risky than their smaller peers, an anomalous position compared with pre-crisis performance.

Now, however, as the public sector subsidies are receding and the losses from on-balance sheet and servicing exposures continue at historically high levels, the largest banks are showing more visible stress in their public disclosure, but the true levels of risk are really unchanged. The major difference between the 2008-2010 period and the months and years ahead will be that the operational stresses within the largest banks will continue to hurt performance, while the performance of well-managed smaller and medium size banks should continue to improve.

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