Financial Condition of the U.S. Banking Institutions – Four Quarter 2009

March 4, 2010

The U.S. banking system reported dismal results for the 4th Quarter of 2009. Banks with assets less than $10 billion reported a loss of $2.2 billion while banks with assets greater than $10 billion reported earnings of $3.1 billion. In all, the banking industry reported net earnings of $914 million for the quarter. Asset quality for the industry continued to deteriorate in the fourth quarter as nonperforming assets increased 6.6% and growth in equity capital was only .3%. Of major concern is that loans and leases declined 1.7% which will slow economic growth.

Earnings for the year 2009 amounted to $12.5 billion compared to $4.5 billion reported for 2008. The improvement in earnings was driven by higher net interest income (up 53%), increased servicing income ($8.0 billion compared to a year ago loss of $390 million), an $18.1 billion decline in goodwill impairment and other intangible asset expenses, and a $10 billion decline in loan loss provisions. These improvements in income and expenses are mainly attributable to the larger banks and we would expect them to continue to slowly improve over the rest of the year. Of the 20 largest U.S. banks for the 4th quarter of 2009, Wells Fargo Bank, NA had the largest earnings ($2.49 billion, ROA of 1.68%) and FIA Card Services, NA had the largest loss ($947 million, ROA of -2.59%).

Total Assets for the industry actually declined $137 billion from the 3rd quarter to the 4th quarter, due mainly to a decline of $129 billion in loans and leases. The FDIC reported that commercial and industrial loans declined $54.5 billion (4.3%), real estate commercial development loans declined $41.5 billion (8.5 %) and residential mortgage loans declined $11.2 billion, or .6%. The only loan category that increased was credit card balances, up 7.4%, which is ironic since credit card nonperforming loans were up 41.4%. This is the sixth quarter that loans and leases have declined due, in part, to lack of loan demand, higher bank lending standards, capital restraints and high levels of nonperforming assets at the banks. Of the twenty largest banks, Wells Fargo, Sioux Falls, SD, had the largest increases in loans of $43.6 billion while Citibank also of Sioux Falls, SD, had the largest decline of $29.7 billion. Commercial banks continued financing their assets by increasing deposits and reducing their use of non deposit liabilities. Total deposits increased during the 4th quarter of 2009 by 1.4%. The ratio of the industry assets funded by deposits was 70.4% at year end 2009.

The overriding problem for the banking industry is its high level of nonperforming assets which increased $24.3 billion (6.6%) in the 4th quarter. The FDIC reported that the banking industry's nonperforming assets are $391.3 billion and equal to 5.37% of all loans and leases; this is the highest level ever recorded over the last 26 years. On the positive side, $19.1 billion of these loans were rebooked GNMA loans which have government guarantees. It is important to note that nonperforming assets for C&I loans and real estate construction and development declined by 7.7% and 2.7% respectively. Although these declines are a good sign, the financial condition of the banking system is being and will be severely affected by the high level of non performing assets. Commercial banks increased their reserves for loan losses by $7.0 billion in the 4th quarter of 2009 but the coverage ratio for nonperforming assets fell from 60.1% to 58.1%. LACE Financial feels this ratio should be closer to 80%. Equity Capital increased $5.2 billion or .35% for the 4th quarter. The small increase is most likely due to lower retained earnings and the high level of earnings diverted to loan loss reserve accounts needed to write off nonperforming assets.

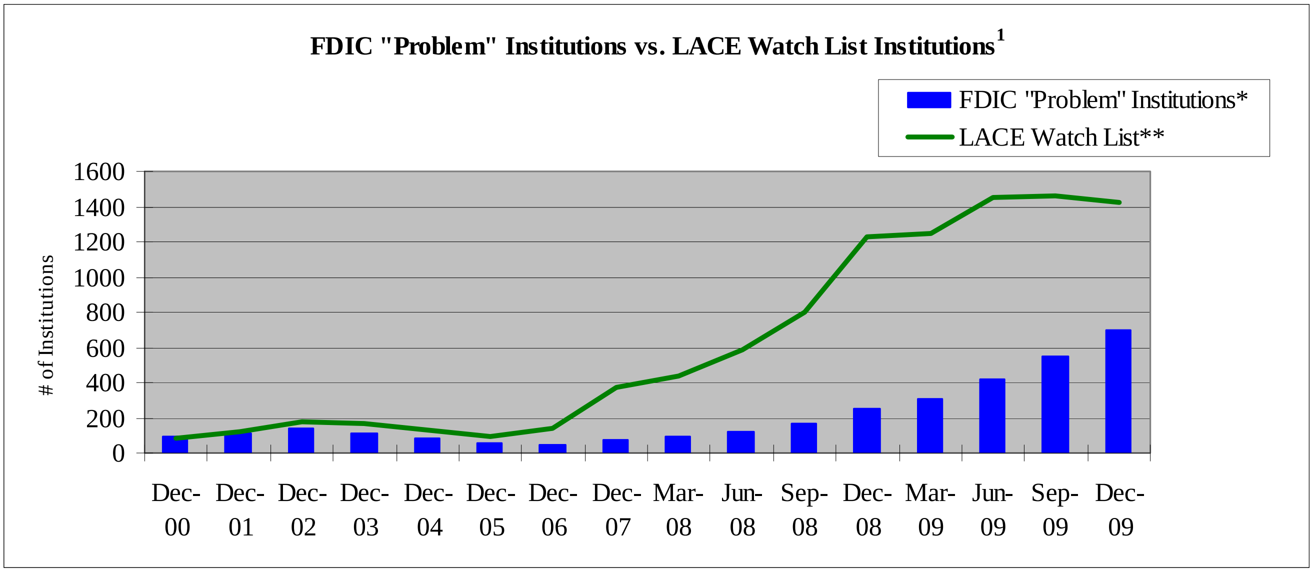
Outlook:

We expect economic growth (GDP) to slow significantly from the 4th quarter of 2009 of 5.9% to around 3 to 3.5% for the first quarter of 2010 and average about the same for the rest of the year, barring any severe economic shocks. Fourth quarter 2009 growth was driven by slower inventory liquidation, higher exports, and higher non residential investment. This type of business spending is typical after a deep business down turn and is not sustainable over time. Although, the beginning of 2010 will be a business led recovery, the economy will become more dependent on consumer spending for the rest of 2010 and into 2011.

As mentioned in our last release, consumer behavior has changed to reflect a higher savings rate (between 4 and 5% from 1.2% prior to the financial crisis) and there will be less availability to credit and home equity financing. Neither wages nor employment is likely to improve much for the rest of 2010, causing consumer spending to rise by approximately 1.8% and resulting in slow economic growth.

Slow growth in the U.S. Economy will lengthen the time it will take for the banking industry to return to normalcy. Currently, the banking industry is in a very serious financial condition; approximately 50 banks could fail at the moment if not recapitalized. The LACE Watchlist contains 1,420 banks with D and E ratings controlling assets of slightly over $1.25 trillion compared to 1,415 banks controlling assets of $1.86 trillion in the 3rd quarter. From this information, it appears to us that the deterioration in the financial condition of the U.S. banks may have reached its low point and we don’t expect much change for several quarters. Three large banks with total assets of $790.1 billion were dropped from the Watchlist in the 4th quarter while 5 relatively large banks with assets of $274.4 billion were added.

For the first quarter of 2010 we would expect bank earnings to be low but positive, with nonperforming assets to remain high and increasing but at a lower rate. The number of banks that are likely to fail for the 1st quarter of 2010 will be around 34 and although it is a little early to predict, a little over 140 for the rest of the year.



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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 the with FDIC deposit insurance rates.