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## **BANKING OVERVIEW**

**APRIL 2009**

### **BANK PERFORMANCE**

In a recent “Business Week” interview, David Cameron, the leader of Britain’s Conservative Party, stated:

“That means we have to recognize that because banks have a unique ability to bring down the economy, they need to be properly regulated. We need to make sure we don’t have people inventing financial instruments, profiting hugely from their creation but not understanding the contagion they can spread.”

We totally concur with Mr. Cameron on that point and would add that the prescription for moving forward on a comprehensive, long-range banking plan must incorporate both effective regulation and the realization that market discipline, based upon appropriate due diligence from both creditors and counterparties, is vital.

The March 25th edition of the “American Banker” states:

“Though Federal Reserve Board Chairman Ben Bernanke argued in congressional testimony Tuesday that there is, in fact, a master plan, most observers see it as a collection of piecemeal efforts targeting individual problems.”

The nation’s 7,085 commercial banks currently hold assets in excess of \$12.3 trillion, and, within that segment of U.S. financial intermediaries, individual problems relating to capitalization, asset quality, and profitability most assuredly do exist.

During the year ended December 2008, the composite Total Risk-Based Capital Ratio for U.S. commercial banks registered a modest 0.6% gain, from 12.2% at December 31, 2007 to 12.8% at December 31, 2008. However, the sector’s tangible capital ratio, the capital measure now most heavily weighted by bank analysts, declined from 6.7% to 6.4% between those dates. Equity-to-Assets, another common capital gauge, amounted to 9.5% for the industry at year-end 2008. VERIBANC data reveals that small institutions, with assets of less than \$100 million, reported an Equity-to-Assets norm of 12.6% (the highest percentage for any of the seven groups reviewed), at that date. Commercial banks with total assets in excess of \$100 billion revealed an 8.9% year-end average (the lowest Equity-to-Assets percentage calculated).

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As noted, a sharp bifurcation does exist. Small commercial banks, those with total assets of less than \$100 million, accounted for nearly 40% of the number of all such institutions and exhibited, as a group, a significantly better 2008 overall financial performance than did the remainder of the sector, as shown below:

	<u>All Insured Commercial Banks</u>	<u>Banks with Assets less than \$100 Mil.</u>
Equity/Assets	9.5%	12.6%
Noncurrent Assets plus Real Estate Owned/Assets	1.8%	1.7%
Return on Assets	0.2%	0.4%

The industry's aggregate of noncurrent assets plus other real estate owned increased by nearly 134%, to \$224 billion, between year-end 2007 and year-end 2008, as shown below:

	<u>12/31/07</u>	<u>12/31/08</u>	<u>% Change</u>
Noncurrent Assets plus Real Estate Owned	\$96.1 Bil.	\$224.2 Bil.	+133.3%
Noncurrent Assets plus Real Estate Owned / Assets	0.9%	1.8%	+100.0%
Noncurrent Assets plus Real Estate Owned / Equity plus Loss Reserves	7.8%	17.0%	+117.9%

Between December 2007 and December 2008, loans at all commercial banks increased by 3.2% to more than \$6.8 trillion, and, on a percentage of assets basis, year-end 2008 concentrations for the industry were:

Real Estate Loans	31.2%
Commercial & Industrial Loans	11.5%
Loans to Individuals	8.1%
Farm Loans	0.5 %
Other Loans	4.3%

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With respect to asset quality, VERIBANC data once again shows that small banks (with assets less than \$100 million) did best, with a total December 2008 problem asset ratio of 1.3%, the lowest for any of our seven groupings. Further evidence of the asset quality disparity between large and small institutions is contained below:

<u>Asset Size Banks</u>	<u>2008 Loan Loss Provisions/Assets</u>
Less than \$100 Mil.	0.5%
\$100 Mil. - \$1Bil.	0.7%
\$1Bil. - \$10Bil.	1.2%
More than \$10Bil.	1.4%

Bank profitability, as measured by return on average assets, fell sharply, from 0.9% to 0.2%, between 2007 and 2008, and severely heightened 2008 loan loss provisions, 164% above the year earlier level, were a key contributing factor. Between 2007 and 2008, the industry's annual net interest margin decreased moderately, from 3.4% to 3.2%. During the period, commercial banks sustained a decline in noninterest income, but, as a minor offset, achieved reduced overhead ratios.

No statistic better highlights the substantial performance differential, by asset size, recorded by defined segments of the nation's banking industry than does quarterly annualized return on average assets. For the fourth quarter of last year, institutions with total assets greater than, or equal to, \$100 billion sustained, as a group, a net loss of nearly \$83.5 billion, which represented both a 4.1% annualized negative return on average assets and an amazing 49.8% annualized negative return on equity. Losses of that magnitude are hardly sustainable and, therefore, must be mitigated if the nation's largest banks are to remain functioning and viable. Institutions with assets less than or equal to \$100 million reported a much more modest fourth quarter negative return on average assets of just 0.2%.

### **ECONOMIC ENVIRONMENT**

As we begin this section with an assessment of the current economic environment and then attempt to discern the causes for the now global downturn, we must face a 2008 fourth quarter U.S. Gross Domestic Product, which, on an annualized basis, was 6.2% below the reported third quarter. Accompanying that change were reports of reduced consumer spending and sharp declines in business investment, housing activity, and U.S. exports. Further, the nation's unemployment rate is now at 8.5%, and some economists envision a 12% rate before reductions can be achieved. Current Federal Reserve Board policy is, in our view, correct, and we acknowledge Chairman Bernanke's very recent

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statement that the Fed's efforts to bolster credit availability are beginning to show results. The March 2009, 90-Day Treasury Bill Rate of 0.19% was substantially below the year earlier 1.29%, and the current 30-Year Treasury Bond Rate of 3.74%, significantly beneath the March 2008 rate of 4.30%, suggests that markets are not currently worried about prospects for substantially heightened U.S. inflation. However, the resulting positive sloping yield curve does coincide with future economic growth.

Contrast the foregoing assessment with our previous concerns, set forth below, regarding Federal Reserve policy, during the years leading to our current recession:

“A measure of prices paid for GDP components increased, during the third quarter, by 1.8%, hardly a sign of runaway inflation, and, since the end of the 2001 recession, the annual change in the nation's Producer Price Index (PPI) (for finished goods less food and energy) has remained below 4%. For comparative purposes, we note that for 1981, just after the 1980 recession, that PPI measurement increased by nearly 10%.

A negative Treasury Yield Curve (where short rates exceed those on long-term debt) often times becomes a self-fulfilling prophecy of recession. At year-end 2006, that condition did exist. Currently, however, the rate on Ten-Year Notes exceeds the Ninety-Day Treasury Bill Rate by close to 1.2%.

In our view Monetary Aggregates (especially M1 – Currency in Circulation plus Checking Deposits in Banks), which are highly influenced by Federal Reserve Secondary Market Operations, and the value of goods and services in the economy strongly impact U.S. inflation rates. Other factors, such as oil prices and agricultural conditions, are quite influential, as well, but those components are subject to uncontrollable, external forces. Between 2002 and 2007, M1 increased by roughly \$400 billion, from approximately \$1 trillion to \$1.4 trillion. Most of that increase occurred early during the period; the measure was essentially flat between 2005 and 2007. From the end of the 2001 recession through 2007, U.S. GDP grew consistently, and the ‘Business Week Production Index’ rose by 8.7% during 2007. As we re-visit our aforementioned comment regarding annual 4% PPI increases, we can recognize that Federal Reserve tightening since 2005 (Money Supply is the numerator of our equation.), coupled with solid GDP growth (Goods and services became our denominator.) yielded a strong downward influence upon overall U.S. inflation (our quotient).

Federal Reserve efforts to moderate inflation rates, however, were, in our opinion, excessive and, of course, did not come free of charge. Increases in short-term interest rates, the consequence of reduced growth in the nation's available money

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supply, negatively impacted many ARM borrowers, both prime and sub-prime, with new affordability issues. That factor, combined with weak lending standards, prominent during the 2005 and 2006 housing boom, produced our current housing crisis.”

Clearly, the Federal Reserve recognizes that supervisory and monetary policies of the past contributed to the nation’s present downturn. We would contend that current Fed monetary policy will, with an expected period of delay, work to alleviate present conditions, and, as noted previously, we do acknowledge, and at least tentatively concur with, Chairman Bernanke’s assessment.

### **THE FEDERAL RESPONSE**

Set forth below chronologically is a listing of governmental actions, along with our assessments, taken in response to conditions within the banking sector, during the Bush and Obama Presidencies:

<u>Date</u>	<u>Action</u>	<u>Assessment</u>
10/14/08	Treasury begins investing \$250 bil. in bank equities.	Criteria for inclusion is not clear, and stigma for refusing to participate exists. Taxpayer exposure is enormous.
10/14/08	FDIC to insure senior bank debt and all noninterest bearing deposits.	Improves liquidity stability of participating institutions, for a fee. (Does increase “Moral Hazard.”)
10/27/08	FRB decides to buy investment grade commercial paper from financial institutions.	Provides funds for lending activities.
2/26/09	Revealed economic stress tests to determine which banks need to raise equity or accept a government infusion.	Economic scenarios are only a guess, and effectiveness of recent regulatory actions is most certainly questionable.

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2/27/09	FDIC to impose special assessment to recapitalize fund. Proposal includes higher fees for heavy use of brokered deposits and secured liabilities.	Recognizes certain factors that have led to bank failures and the need for public confidence in the FDIC. (Could imperil some institutions.)
3/5/09	Treasury and regulators announced plan for loan modifications that would impact four / five million strapped borrowers who took loans prior to 1/1/09.	May lead to improvement within key housing market by reducing foreclosures. (Anecdotal information indicates that modifications that lower monthly payments by more than 10% significantly reduce re-defaults.)
3/26/09	FDIC announced Legacy Loan Program, a 50/50 public – private program, which will include FDIC financing, to remove bad assets from bank balance sheets.	Wait and see! May require write-downs in excess of what banks are willing or able to take. (Some banks may wish to hold such assets in hopes of a recovery in value.) (This plan confers very sizable government, hence taxpayer, exposure.)
4/3/09	Congress influenced FASB to ease mark-to-market adjustments on Available-for-Sale securities and other permanently impaired assets.	Accounting conventions should not determine failure. (Some analysts believe that this change may reduce the willingness to participate in the Legacy Loan Program.)

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## **CONCLUSION**

A large disparity between the performance ratios of large and small banking companies, during the past year, has become quite evident, and the smallest asset size group, those banks with total assets of less than \$100 million, stood out prominently, with better capital, asset quality, and earnings measures than generally reported by the entire U.S. banking sector. The net losses incurred by the largest banks during the final quarter of last year were undoubtedly related to asset quality issues and are clearly not sustainable. Enhanced regulation, perhaps coupled with legislative change, is clearly required.

Any government master plan relating to the U.S. economy and our nation's financial system must take into account that a strong, private banking system, subject to enlightened regulation, is crucial to economic recovery. A series of piecemeal fixes that do not recognize the free market nature of the U.S. financial services sector will not lead to economic recovery. The regulatory effort must re-focus and revert to a system that fosters only prudent credit decisions by banks. From 2003 through 2006, U.S. banks performed well. What changes in the legislative, regulatory, and economic environments that altered that condition need to be reversed. Nationalization and unduly strict regulatory prescriptions are not the appropriate responses. Neither is a hastily crafted regulatory overhaul. Dedicated federal supervision and free market discipline on the part of bank creditors, working in concert with an insightful Federal Reserve, will lead, once again, to what industry professionals referred to, in the not too distant past, as "banking heaven."