DBRS U.S. Financial Institutions Weekly

Volume 5, Issue 1, February 16, 2010

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U.S. BANKS 4Q09 EARNINGS: BANKS STILL STRUGGLING, BUT CREDIT IMPROVING

DBRS views the U.S. Banks 4Q09 results as still weak, but expects banks to benefit from lower credit costs and strengthening demand as 2010 progresses. For most banks, net income was down versus 3Q09, even though loan loss provisions declined (see Exhibit 1). A still significant number of banks, large and small, had losses that for some will extend well into 2010 given their elevated credit problems. For larger banks with capital markets businesses, significantly weaker trading results from tightening spreads, lower market volatility and reduced client activity more than offset lower credit costs resulting in decreased earnings quarter over quarter (QoQ). These banks, nevertheless, continue to benefit from their diverse sources of noninterest income. For smaller banks that rely more heavily on spread lending, expenses associated with the collection and carrying of nonperforming assets (NPAs) and higher FDIC assessments weighed on results.

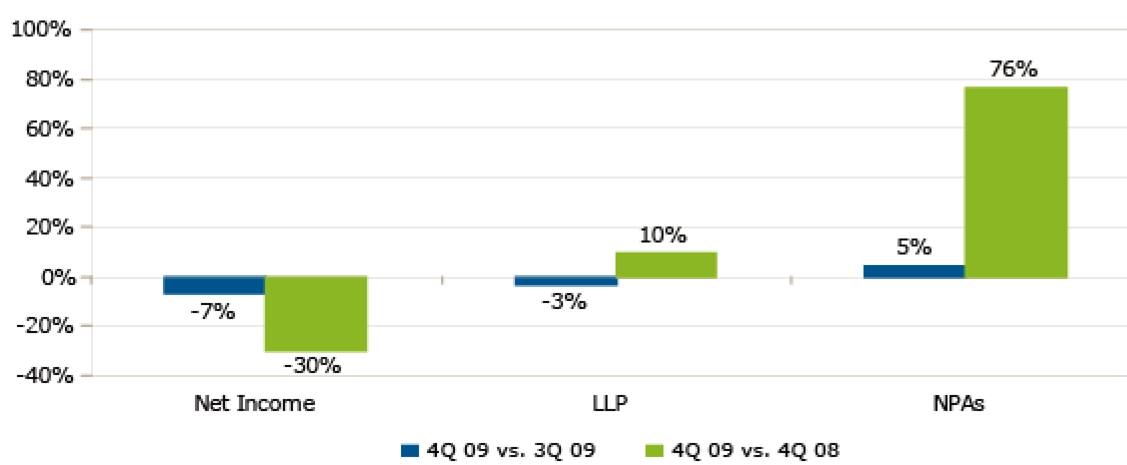
Positively, banks generally have been able to bolster income before provisions and taxes (IBPT), which is helping many of them to earn their way through still elevated asset quality problems. Funding costs are benefiting as most banks continue to grow lower cost core deposits. But, many are having to deploy the additional funding into lower yielding securities with short maturities, as loan growth has yet to return and interest rates remain low. This has put pressure on asset yields, but securities growth and/or an improving net interest margins have resulted in higher net interest income.

Looking ahead in 2010, downside risks remain significant. Commercial real estate distress could negatively impact earnings. Unemployment may remain high for some quarters. Foreclosures are still rising and the housing overhang remains problematic. Nonetheless, DBRS expects bank results to show modest improvement each quarter in 2010, as the economic recovery gains more solid footing.

Credit costs improving, but still elevated

Even though NPAs still have not peaked at most banks, the pace of generation has slowed dramatically. Median NPAs were up only 5% QoQ versus 76% from 4Q08 (See Exhibit 1). Additionally, delinquencies are generally improving, which portends well for current provisioning and future credit losses. Indeed, over half of all banks had lower credit costs in 4Q09 with the median loan loss provision declining 2.9%. This modest decline shows banks still have elevated asset quality issues, but appear to have turned the corner. Meanwhile, net charge-offs (NCOs) continue to increase at most banks with a median increase of 13 basis points during the quarter, as banks work through their problem loans. Construction loans continue to take a high toll, but the burden has shifted from residential construction to commercial construction. Also unknown is the potential impact of restructured and modified loans that may redefault.

Exhibit 1: Median % Change



Source: SNL Financial; DBRS analysis

To date, DBRS notes that commercial real estate loan portfolios have held up well outside of construction, but higher vacancies, lower rents and depressed valuations are weakening the credits, as the weakness in the economy feeds through to demand for commercial space. With the cost of residential real estate beginning to recede, CRE is likely to be the weak link in the earnings recovery for many banks. Bank by bank, the impact is likely to vary with each bank's underwriting and mix of property types. The geographic distribution of a bank's exposure is also an important factor, as the distress in commercial real estate varies significantly across markets.

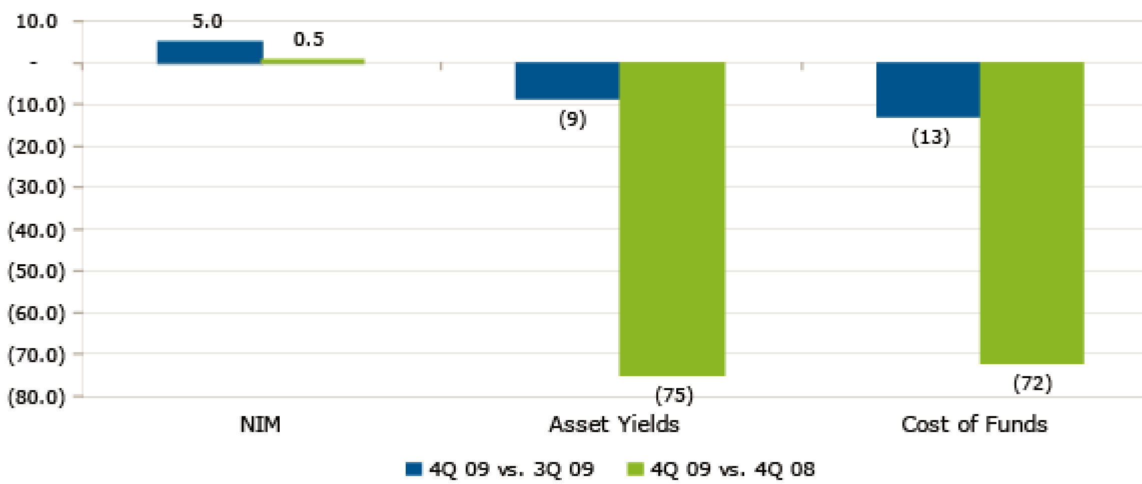
Deposit growth improving funding costs

Banks continue to attract deposits with median deposit growth of 1.7% during the quarter. More importantly, the mix of deposits has significantly improved. Specifically, banks have been able to attract lower cost, core deposits at the expense of higher cost CDs. Banks have benefitted from higher savings rates, government guarantees on certain deposit balances and lack of better investment options for customers. Also helping reduce borrowing costs, banks have been able to use their increased deposits to repay more expensive wholesale funding, such as FHLB advances.

Better NIM and Rising Net interest Income

Not all trends are positive for bank margins. With loan demand still tepid, banks are deploying excess funding into lower yielding securities. Nonetheless, higher average earning asset balances and margin improvement has led to higher net interest income at most banks. On a sequential quarter basis, the median NIM improvement was 5 basis points, while the median net interest income grew 2.6% despite asset yield pressure and weak loan demand (See Exhibit 2).

Exhibit 2: Median Basis Point Changes



Source: SNL Financial; DBRS analysis

Loan demand still tepid

The median bank loan portfolio declined 1.1% during the fourth quarter. Consumer credit has declined for eleven straight months. Commercial clients are delevering as well. Businesses and consumers alike remain wary of investing/spending in today's uncertain economic environment. However, DBRS expects loan demand to pick up modestly as 2010 progresses, driven by an expanding economy. With the economic recovery gaining more strength, banks may regain their appetite for risk and be more willing to lend again.

More stable ratings, but still negative pressure on weaker banks

The environment remains challenging, but the industry appears to be turning a corner, benefitting from significant government assistance and an improving economy. DBRS expects earnings to remain pressured, but show modest improvement over the course of 2010 even with several government support programs expiring. DBRS notes that elevated FDIC assessements and new regulatory fees may also weigh on earnings. DBRS will closely monitor commercial real estate exposures, as well as looming refinancing needs for these properties. DBRS views TARP repayment favorably and those banks who do not repay TARP during 2010 will likely face ratings pressure. DBRS believes some banks will outperform others given more conservative underwriting and more diverse business models, which could lead to positive rating pressure. While DBRS expects downgrades to still exceed upgrades, ratings should be more stable for most banks in 2010 in a recovering economy.

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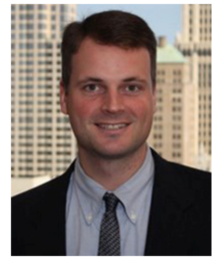

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