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## U.S. BANKS 2Q10 EARNINGS: POSITIVE TRENDS CONTINUE, BUT DOWNSIDE RISKS REMAIN

With the majority of large banks having reported quarterly results to date, DBRS views the U.S. Banks 2Q10 results favorably, but the operating environment remains extremely uncertain. Generally speaking, delinquencies, nonperforming assets (NPAs), and net charge-offs (NCOs) were all down leading to reduced loan loss provisioning needs and improved profitability. While the credit picture improved, after several quarters of robust trading results, those banks with capital markets businesses saw trading revenues decline significantly from lower client activity and increased competition. The Southeast region, which is dealing with significant real estate issues, appears to be lagging other regions where the boom and bust cycle of real estate was not as pronounced. It appears larger banks have been more aggressive in charging off and selling problem assets compared to community banks who often prefer to work with the borrower and try to minimize losses resulting in a longer resolution process.

Net interest margin (NIM) dynamics at banks were mixed given lower funding costs and declining loan balances. Some banks have been able to lower funding costs more quickly than asset yields have fallen, while other banks have not been as fortunate. Fee-based revenues have held up well with over two-thirds of all banks showing a linked-quarter increase. This combined with recent acquisitions (primarily FDIC-assisted deals) helped fuel higher revenues at most banks. Recent legislation will impact banks' overdraft fees and debit card interchange fees, but DBRS expects these costs to be very manageable, as most banks are reporting high opt-in rates from their habitual users of overdraft protection. Lastly, expenses remain well controlled.

While earnings at banks and companies in general have seen substantial improvements, many issues remain. Specifically, consumer confidence is dropping, housing remains weak and unemployment remains elevated. Issues with the Euro and substantial deficits in the U.S. and abroad are lowering growth prospects. Moreover, uncertainty remains over taxes and business costs in general, which has kept many employers on the sidelines. DBRS expects the economic recovery to be sustained, but the pace of the recovery is likely to be uneven keeping unemployment elevated. The slow pace of economic recovery may put additional borrowers in jeopardy, as their liquidity runs down or they become unemployed. In DBRS's opinion, a robust economic recovery is more difficult to achieve with a stressed financial system, continued loan contraction and fiscal concerns that are constraining revenues.

Given the improving, albeit uncertain, operating environment and capital raises at most banks, DBRS expects bank ratings to be generally stable. However, banks that continue to report losses from elevated asset quality problems will likely see pressure on their ratings. Moreover, the uncertain operating environment and questionable strength of the economic recovery will likely keep upgrades muted until new job creation climbs driving unemployment down.

Besides asset quality, the biggest challenge for banks remains the return of loan growth, which would help bolster banks' income before provisions and taxes (IBPT) and provide added protection to bondholders. Approximately two-thirds of all banks saw their loan portfolios contract and this amount would be even higher if acquired loan portfolios were excluded. Headwinds include weak loan demand, the selling of virtually all residential mortgage originations into the secondary market and the purposeful run off of riskier asset classes like construction. Positively, loan pipelines have improved and banks are expecting loan balances to at least stabilize, if not pick up during the second half of 2010.

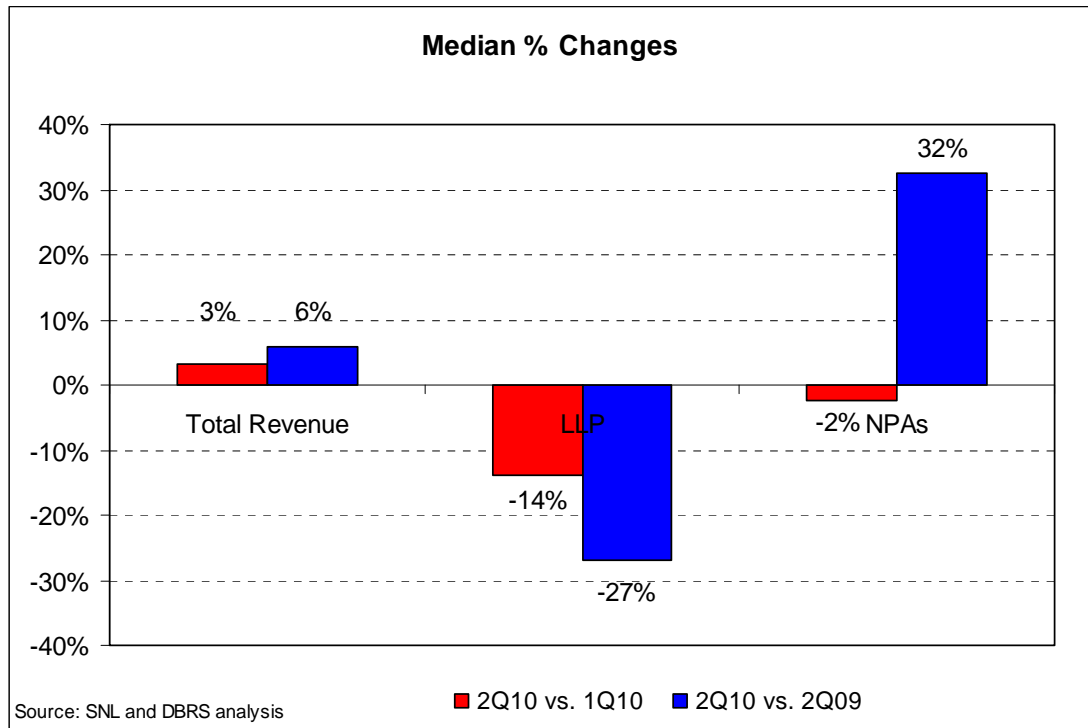
With the recent passage of financial regulatory reform, DBRS anticipates that the higher costs associated with regulation could force smaller banks to sell to larger banks, which can more easily absorb the added costs of the extra compliance across their larger organizations. Banks are still more focused on completing FDIC-assisted deals rather than open market transactions, even though the bidding is now more intense and the loss sharing agreements less favorable. Nonetheless, DBRS expects continued consolidation within the banking industry over the next several years.

### Positive Credit Trends Continue

Positively, median delinquencies, NPAs, NCOs and loan loss provisions all showed improvements relative to 1Q10. This was the primary driver in improved net income for the quarter. Specifically, the median decline in delinquencies was 7.2%, which should slow the pace of new NPA generation. Additionally, the median linked-quarter decline in NPAs was 2.7% (see Exhibit 1), while NCOs decreased 9 basis points (bps). As a result of improving credit fundamentals, the median loan loss provision fell 13.9% during the quarter and 27.0% from 2Q09. Showing banks still have considerable problem assets to work through, however, median NPAs were still up 32.4% from 2Q09. DBRS expects these positive credit trends to continue, which should bolster financial results.

Commercial real estate remains our largest concern, given higher vacancies, rent concessions and slow job growth, which have all pressured collateral values. DBRS notes that the low interest rate environment has helped commercial real estate borrowers weather the storm, as many CRE loans have floating rates.

Exhibit 1

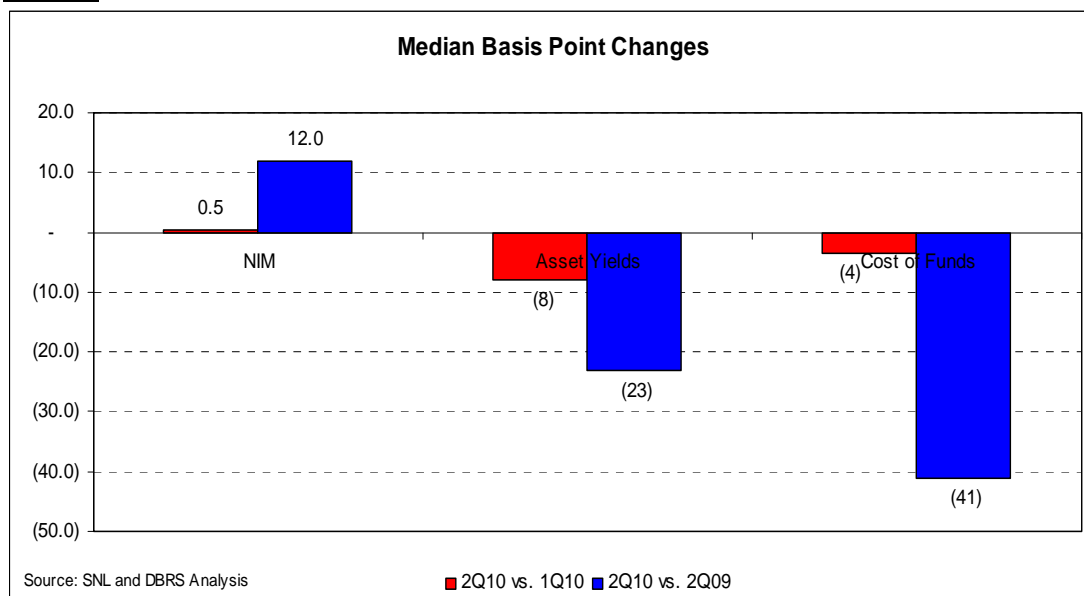


### Mixed NIM Results

Margins at banks have showed mixed results with about half of all banks reporting higher margins and the other half showing declines (see Exhibit 2). With loan demand weak, banks have not needed deposits, which has helped bring deposit costs down. Also helping to a lesser extent, some of the banks that had previously been offering above market rates on deposits have either been acquired or failed, bringing more discipline to most markets. As a result, median funding costs are down four bps during the quarter and 41 bps from 2Q09.

On the negative side, loan growth has yet to materialize. Banks generally saw their loan portfolios still declining, with a median sequential quarter decline of 0.7%. With higher yielding loans coming off the balance sheet, banks continue to add shorter duration, lower yielding securities. This has helped maintain net interest income, which had a median increase of 1% from 1Q10, but has pressured margins. DBRS anticipates that margins should remain relatively stable the remainder of the year.

## Exhibit 2



### Bolstered Capital Cushions

DBRS notes that most bank capital positions are in much better shape relative to the beginning of the year, as earnings strengthen for more banks. Other factors bolstering capital metrics include banks shedding risk-weighted assets, and raising capital either through common equity issuances or debt exchanges. Moreover, some banks who took a valuation allowance against their deferred tax asset have been able to reduce the allowance given the improved profitability. With strong capital and weak loan demand, some banks have even started repurchasing shares again. However, most banks will continue to build capital until there is clarity regarding the new regulatory capital requirements.

### 3Q10 Expectations

DBRS remains cautious as to the extent and timing of the economic recovery. Nonetheless, we still expect continued gradual improvement in asset quality and earnings in the second half of the year. We expect loan balances to basically stabilize in 3Q10 and return to growth in 4Q10, which should help bolster banks' core earnings power. The upturn is more likely to occur in business loan demand, rather than consumer lending. Margins should remain relatively stable, as most banks have just a little more room left to bring down funding costs further. Lastly, DBRS expects the trading environment to remain down from the robust results seen late last year and into 1Q10.

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