Economic Research Department

BBVA

U.S.

Banking Observatory

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Delinquent loans still cooking, but the kitchen is closed

- Tight credit conditions hold 30-89 past due loan inventory growth down while more severe categories progressively develop
- Total delinquency for domestic loans increases to 7.2%, with domestic residential real estate loans reaching 9.5% delinquency

Asset quality: tightening starts to bind

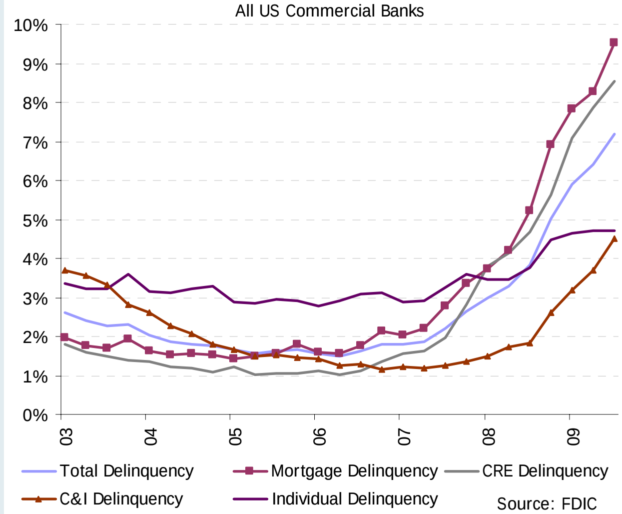
Over the past several months, commercial banks increased their lending requirements and criteria for borrowers, as witnessed in tight lending conditions in the Senior Loan Officer Survey produced by the Federal Reserve. The effects of this posture are visible in the past due loan hierarchy. Levels of loans 30-89 days past due are roughly holding, while more severe loan categories continue to grow, with nonaccrual assets increasing by $24.2bn in 2009Q3. In the previous 2009Q2 quarter, nonaccrual assets grew by $32.8bn. These trends suggest that the banking system will continue to keep incoming loans under control as loans 30-89 days pays due level out, but existing loans will trouble the banking system for many more months, as the increases in loans 90 days or more past due and nonaccrual status loans imply. An instructive example is consumer lending. Banks are reducing consumer lending to individuals and tightening standards, a regime shift that occurs with much greater speed than longer-maturity loans like real estate and other loans. The consumer delinquency rate, as a result, is comparatively stable, registering at 4.73%, 4.70% and 4.64% in 2009Q3, 2009Q2 and 2009Q1, respectively. This is the case even in the light of a strongly-rising unemployment rate.

Balance sheet effects and deleveraging

Domestic loan levels at commercial banks declined across the board as banks progress in their deleveraging. Total assets in the commercial banking system are down by $444bn since the 2008Q4 crisis. Additionally, total equity capital at commercial banks has increased by $160bn. This represents a total deleveraging over the three quarters of 2009 of -17.5% and -3.4% for 3Q2009. We expected a somewhat stronger deleveraging pace for 3Q2009, though this deleveraging is still significant in scope. For 2009 as a whole, our estimated scenario is for more than $800bn in deleveraging. Nonetheless, we expect significant balance sheet reconstruction to occur in the fourth quarter as banks are likely to use this quarter to clear the decks for 2010. Part of the discrepancy could be related to prepaid FDIC assessments booked as assets on bank balance sheets.

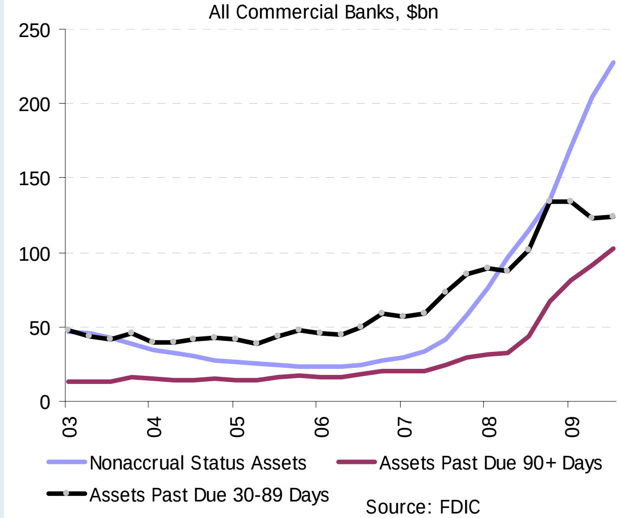
Bottom line: The data does not yet suggest a turning point for the banking system. Loan level declines and tight lending standards will impart downward pressure on economic activity. Existing loans will continue to trouble banks' performance ratios, but an orderly workout is under way. Banks may also be reluctant to loan given uncertainty over regulatory changes and accounting rules that return to books items previously considered off-balance sheet.

Delinquency Rates
All US Commercial Banks



Source: FDIC

Past Due Loan Inventory
All Commercial Banks, $bn



Source: FDIC

Leverage Indicators

QoQ %	2009Q3	2009Q2	2009Q1	2008Q4	2008Q3
Assets	-0.2%	-0.9%	-2.5%	2.2%	5.5%
Equity	3.1%	3.1%	7.2%	-0.9%	0.8%
Leverage	-3.4%	-4.0%	-9.6%	3.0%	4.6%

Source: BBVA ERD and FDIC

Leverage is Asset% less Equity%

BBVA Viewpoint: Four Themes for the Next Quarter

Theme 1: The Kitchen Sink Quarter and Charge-offs

The final quarter of the year presents many firms, especially publicly-listed companies, to clear out as much as possible their nonperforming loans. The purpose of this behavior is to provide as clean a slate as possible for the new performance year. The charge-off rate to total loans for 2009Q3 stands at 2.46%, up from 2.32% in the previous quarter. One difficulty arising from this behavior is that banks will encounter more difficulty recovering value from nonperforming loans if all firms are dropping such loans at the same time. This adds to the potential rise in the net charge-off ratio as recovery value is depressed. Given the presumption that banks will take the final quarter as an opportunity to charge off loans at a higher rate, the net charge-off to total loans indicator should rise further. Asset balance declines, as a result, will be more robust as bad loans are deleted from bank balance sheets.

Theme 2: Net Interest Margin

The FDIC's 2009Q3 data demonstrated that the net interest margin for commercial banks increased to 3.49%. An increase in this margin improves profitability more generally for banks. The main components of the profit and loss account for banks are net interest income, noninterest income, general and administrative expenses and net charges for provisions. While provisions reflect the asset quality environment, net interest margin reflects competition and interest rates in the economy. Going forward, it will be instructive to see how competition evolves through new regulation and bankruptcies. Additionally, the macroeconomic environment as proxied through the Federal Reserve's funds rate will be another influence on the net interest margin. We expect the net interest margin to continue to increase, but there exists great uncertainty over the degree and duration of this increase.

Theme 3: Bank Failures and FDIC funding

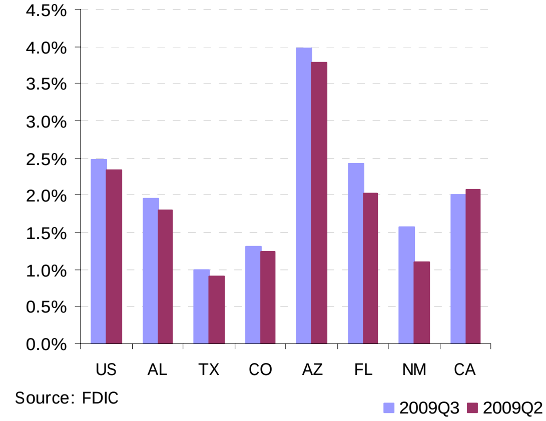
The FDIC's recent release of data also shows that the institution's reserve ratio stands at -0.16%, with a fund balance of -$8.2bn. The FDIC also in the past few months mandated that FDIC-insured firms prepay 2010 to 2012 insurance fees. At the time, the FDIC reported that it expects bank failures to cost the Deposit Insurance Fund $100bn through 2013. The prepayments and the increased usage of reserve funds have focused attention on the FDIC's financial strength during a time when the institution is deeply enmeshed with banking sector restructuring. Bank failures are likely to continue to trickle forward, although mostly small- to medium-sized banks are at risk as the largest firms have been stress-tested during the Supervisory Capital Assessment Program. The combination of bank failures, funding of the FDIC and the role of existing banks' payments into the fund will increasingly focus public attention.

Theme 4: Loan Loss Reserves

The last important theme for the next quarter will be the growth of the stock of loan loss reserves at commercial banks. The most recent data suggests that the loan loss allowance to loans ratio for all commercial banks increased from 2.9% in 2009Q2 to 3.12% in 2009Q3. These reserves reflect earnings set aside for loans than a bank believes will result in a loss. Loan loss reserves represent a lagging indicator of crisis, but their decline signals future increases in banks' profitability. Going forward, loan loss reserves will be closely watched as a measure of the banking system's health. Our expectation is that loan loss reserves will peak in the second half of 2010.

Net Charge-off Rates

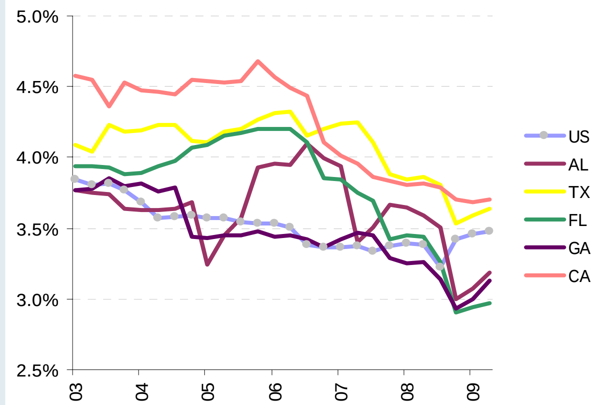
Banks with Assets >$100mn



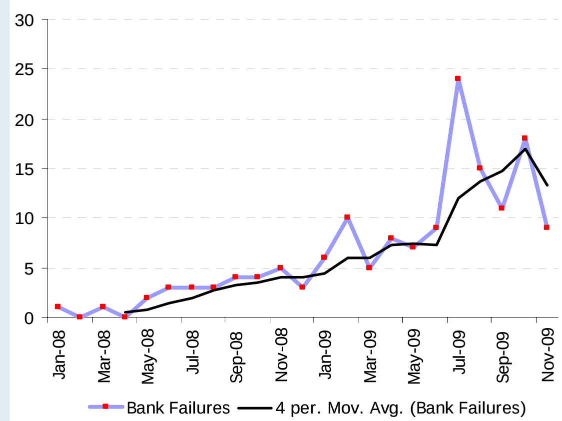
Source: FDIC

Net Interest Margin

Banks with Assets > $100mn



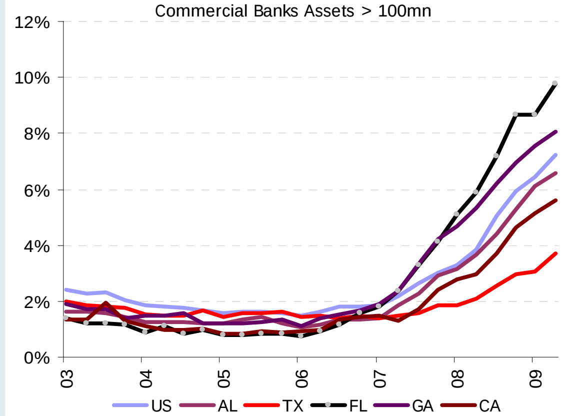
2008-2009 YTD Bank Failures



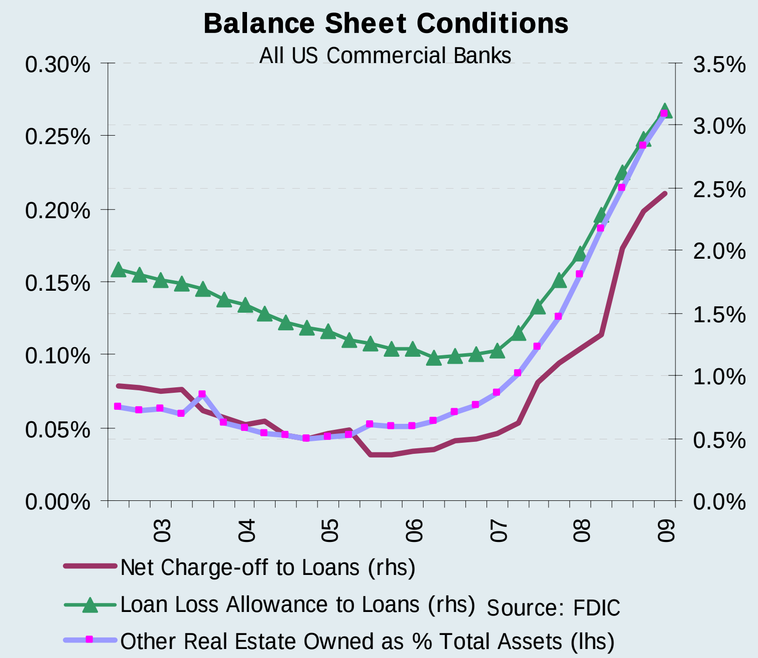
Source: FDIC

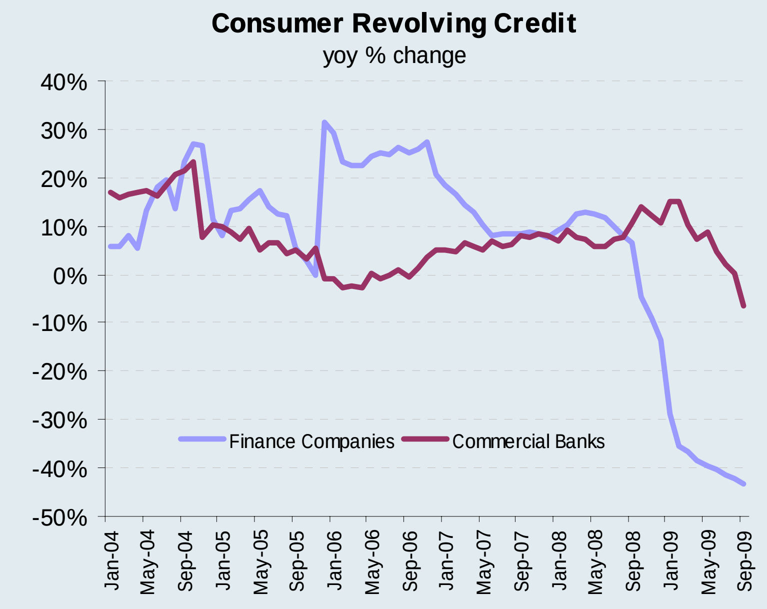
Total Delinquency

Commercial Banks Assets > 100mn

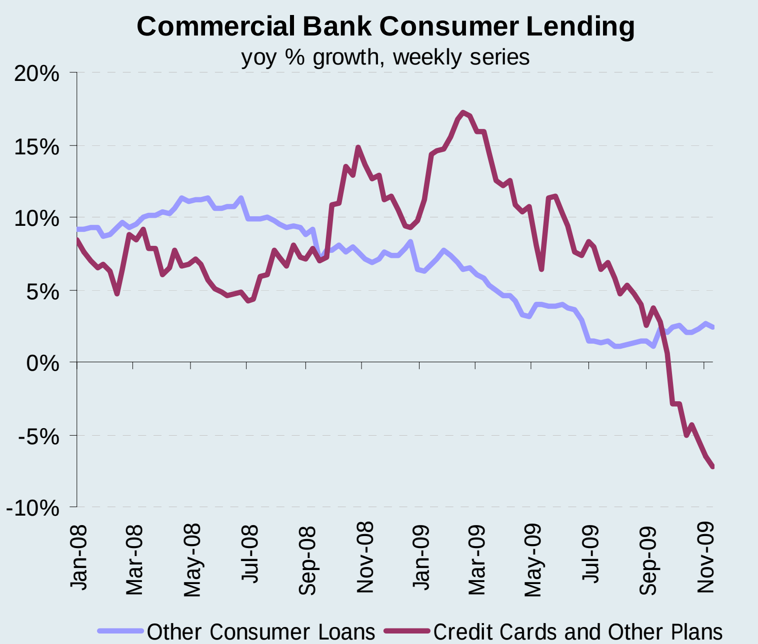


Source: FDIC

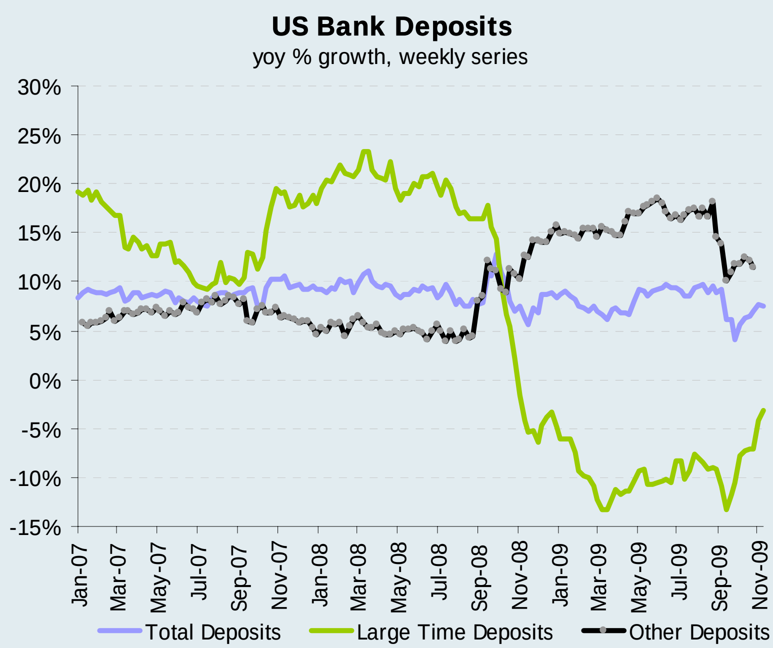




Source: Federal Reserve G.19 Release



Source: Federal Reserve



Source: Federal Reserve

FDIC Statistics on Depository Institutions	9/30/2009	6/30/2009	3/31/2009	12/31/2008	9/30/2008	6/30/2008	3/31/2008	12/31/2007
Total Delinquency	7.2%	6.4%	5.9%	5.0%	3.8%	3.3%	3.0%	2.6%
Mortgage Delinquency	9.5%	8.3%	7.8%	6.9%	5.2%	4.2%	3.7%	3.4%
CRE Delinquency	8.5%	7.9%	7.1%	5.6%	4.7%	4.1%	3.8%	2.8%
C&I Delinquency	4.5%	3.7%	3.2%	2.6%	1.8%	1.7%	1.5%	1.3%
Individual Delinquency	4.7%	4.7%	4.6%	4.5%	3.7%	3.5%	3.5%	3.6%
Net interest margin	3.49%	3.47%	3.42%	3.23%	3.39%	3.40%	3.38%	3.35%
Net operating income to assets	0.14%	0.11%	0.21%	0.17%	0.49%	0.53%	0.68%	0.95%
Return on assets (ROA)	0.09%	0.07%	0.24%	0.13%	0.44%	0.52%	0.68%	0.93%
Return on Equity (ROE)	0.87%	0.74%	2.43%	1.35%	4.36%	5.08%	6.69%	9.12%
Net charge-offs to loans	2.46%	2.32%	2.02%	1.32%	1.21%	1.10%	0.95%	0.62%
Earnings coverage of net charge-offs (x)	1.54	1.62	1.90	2.06	2.74	3.03	3.62	5.25
Loss allowance to loans	3.12%	2.90%	2.62%	2.29%	1.98%	1.77%	1.55%	1.34%
Tier 1 risk-based capital ratio	11.15%	10.74%	10.39%	9.73%	9.46%	9.46%	9.39%	9.43%
Assets % change qoq	-0.2%	-0.9%	-2.5%	2.2%	5.5%	-0.6%	2.9%	3.6%
Total Equity % change qoq	3.1%	3.1%	7.2%	-0.9%	0.8%	-0.3%	1.3%	3.9%
Leverage %change qoq	-3.4%	-4.0%	-9.6%	3.0%	4.6%	-0.3%	1.5%	-0.3%
Noncurrent loans % of Total Loans	5.00%	4.36%	3.71%	2.91%	2.27%	1.91%	1.61%	1.31%

Source: FDIC