BBVA | RESEARCH

Banking Watch

US

November 22, 2011
Economic Analysis

US

Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

FDIC Banking Profile 2011Q3

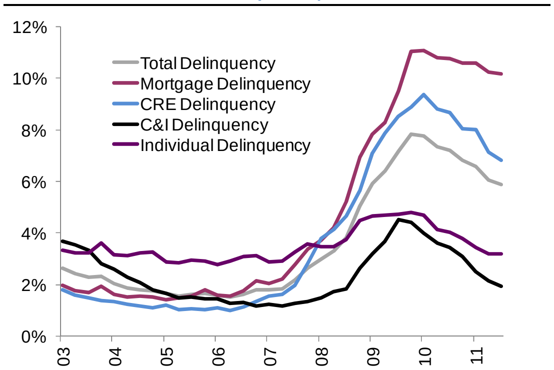
Hunkering down for the winter

- **Asset quality improvements now dependent on real estate**
- **Industry net income rises, problem institution list declines**
- **Shrinking net interest income to continue into 2012Q1**

A flatter yield curve and slight improvements in asset quality

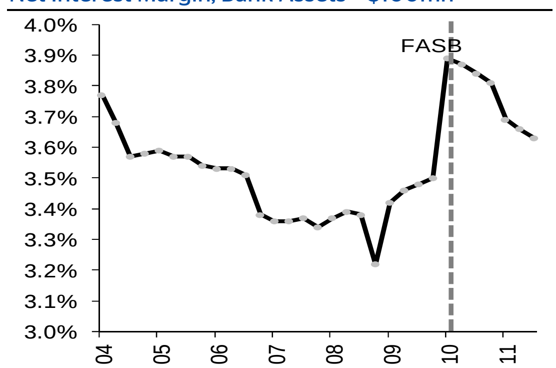
Data from the Federal Deposit Insurance Corporation's (FDIC) Quarterly Banking Profile for 2011Q3 suggests that the total delinquency rate for commercial banks declined slightly, but that net interest income declined for the third straight quarter. The decline in net interest income was largely the result of declines at large banks, with the FDIC reporting that these firms' average asset yields fell faster than average funding costs. The Federal Reserve's actions via a lengthening of the average maturity of its System Open Market Account (SOMA) portfolio and general investor risk aversion have significantly flattened the slope of the Treasury yield curve over the past few months. This in turn has placed strains on net interest income at selected banks, an issue we highlighted in our previous analysis of the Quarterly Banking Profile. As the case of the past few quarters, residential real estate remains a thorn in the side of more rapid improvements in asset quality. While commercial real estate delinquency declined from 7.1% to 6.8% in 2011Q3, residential delinquency declined only from 10.2% to 10.1%, a level that is still stressed. Previously we mentioned that gains from additional asset quality improvements in consumer lending were limited. For 2011Q3, consumer delinquency remained the same as last quarter. Net charge-offs to total loans staged another notable improvement from 1.77% to 1.68%, although other real estate owned (OREO) as a percentage of assets did not decline as quickly. Earnings coverage of charge-offs finally crossed the 2.0 barrier as net income for the industry rose in 2011Q3. Turning to the liabilities side of commercial banks, deposits grew robustly at a 8.4% YoY rate. This is sharply up from the extremely low growth rates of only a few quarters ago. Most of the increase can be attributable to savings, demand and money market accounts. Time deposits are losing balances due to extremely low interest rates and consumers' preference for liquidity.

Chart 1
Commercial Bank Delinquency Rates



Source: FDIC

Chart 2
Net Interest Margin, Bank Assets > $100mn

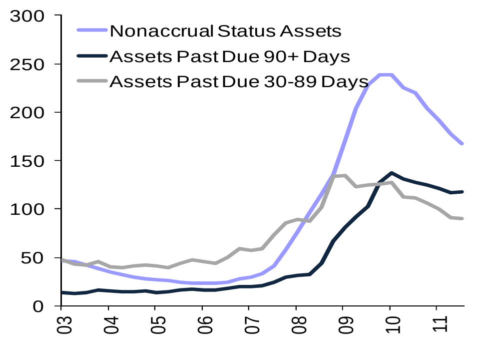


Source: FDIC

Income stabilizes alongside largely unchanged capital ratios

Income for the banking industry as a whole rose to $35.3bn in 2011Q3 and the list of problematic institutions shrank for the second quarter in a row. Loan losses for commercial banks declined from $195bn in 2011Q2 to $185bn in 2011Q3. Tier 1 and core capital ratios were largely unchanged QoQ. Commercial and industrial loans at commercial banks grew 10.3% YoY, a very strong reading and a trend that is supportive of growth moving forward. However, given the sluggish expected economic environment, we do not expect this high pace of commercial and industrial lending to persist.

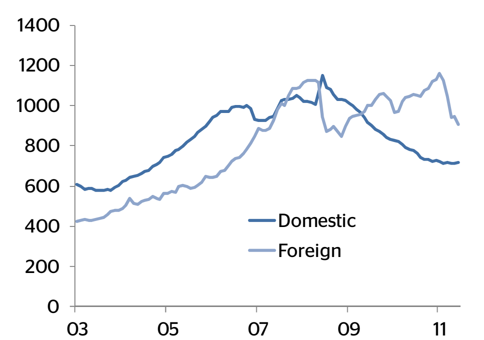
Chart 3
Past Due Loans at Commercial Banks, in $bn



Source: FDIC

Assets past due 90 days or more staged a slight increase, although this occurred alongside declines – as expected – in nonaccrual assets and assets past due 30-89 days. Some third and fourth quarter effects may be at work in commercial real estate, whose delinquencies witness large seasonal effects as banks remove high amounts of CRE assets at the end of the year as they acquire better knowledge on the sustainability of various development projects.

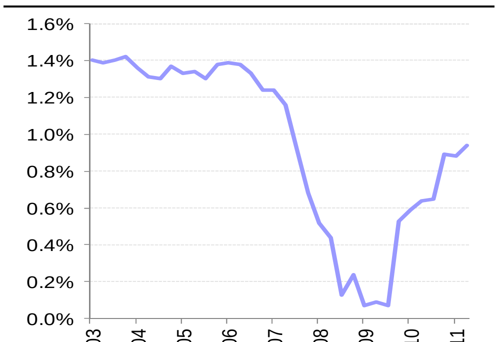
Chart 4
Large Time Deposits, in $bn



Source: Federal Reserve

Large time deposits at commercial banks are declining given low interest rates and economic uncertainty. Large time deposits at foreign-related commercial banks in the US dropped precipitously in the past few months given financial instability in Europe and challenges in raising dollar funding in the US. We do not expect large time deposits to increase and will most likely continue on its present trend of mild YoY declines.

Chart 5
Return on Assets



Source: SNL Financial

Return on assets increased slightly over the prior quarter. We continue to expect that return on assets will level out at around 1.0% and the recent data is commensurate with this presupposition. It is unlikely for return on assets to converge back to the prior trend of around 1.4% given the dislocations of the financial crisis and trends in regulatory reforms both domestically and internationally.

The Outlook for Next Quarter

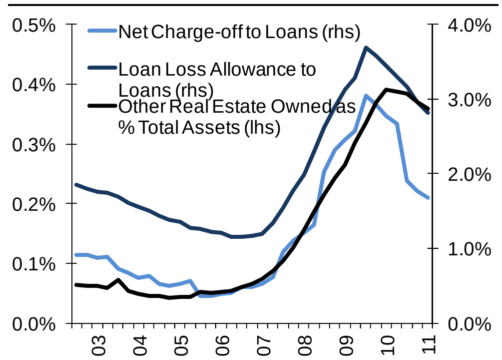
Indications of develeraging have shown stability over the past two quarters, with assets and equity generally increasing together enough to show constant leverage. At the present time, the banking system holds enough capital and liquidity to withstand most major shocks. However, the level of residential asset quality has not yet improved to encourage higher levels of loan growth. With loan standards tight in residential lending, the number of qualifying households given existing damage to income and net worth is lower than what is needed to appreciably boost lending. Next quarter's banking profile will be very similar to this quarter given continued economic uncertainty.

Table 1
Leverage Indicators

QoQ Change in Leverage					
QoQ %	2011Q1	2011Q2	2011Q1	2010Q4	2010Q3
Assets	1.6%	1.7%	0.8%	-0.4%	1.4%
Equity	1.6%	1.9%	2.0%	-2.2%	1.9%
Leverage	0.0%	-0.2%	-1.2%	1.8%	-0.4%
Leverage is Asset% less Equity%					

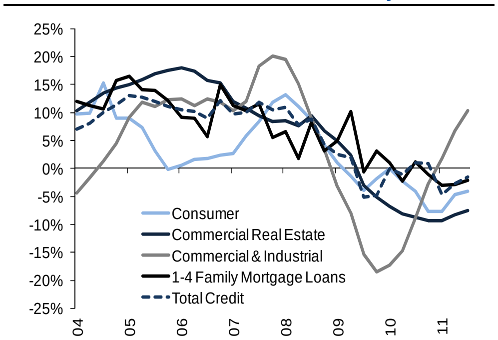
Source: FDIC and BBVA Research

Chart 6
Balance Sheet Conditions



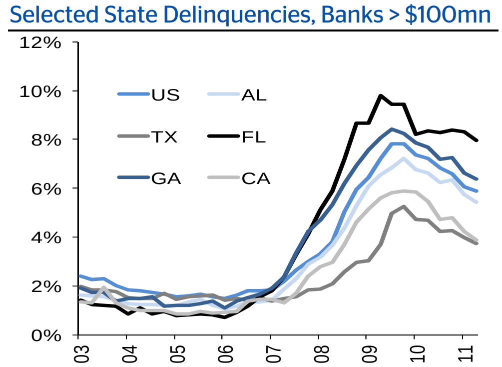
Source: FDIC

Chart 7
Loan Balances YoY%, FASB Break-Adjusted



Source: FDIC

Chart 8
Selected State Delinquencies, Banks > $100mn



Source: FDIC

Table 2
FDIC Data Summary

FDIC Statistics on Depository Institutions	9/30/2011	6/30/2011	3/31/2011	12/31/2010	9/30/2010
Total Delinquency	5.9%	6.0%	6.6%	6.8%	7.2%
Mortgage Delinquency	10.1%	10.2%	10.6%	10.6%	10.7%
CRE Delinquency	6.8%	7.1%	8.0%	8.0%	8.7%
C&I Delinquency	1.9%	2.1%	2.5%	3.1%	3.4%
Individual Delinquency	3.2%	3.2%	3.4%	3.8%	4.0%
Net interest margin	3.63%	3.66%	3.69%	3.81%	3.84%
Net operating income to assets	0.92%	0.89%	0.91%	0.60%	0.60%
Return on assets (ROA)	0.94%	0.88%	0.89%	0.65%	0.64%
Return on Equity (ROE)	8.42%	7.85%	8.00%	5.88%	5.83%
Net charge-offs to loans	1.68%	1.77%	1.91%	2.67%	2.77%
Earnings coverage of net charge-offs (x)	2.1	1.96	1.86	1.42	1.42
Loss allowance to loans	2.81%	2.97%	3.17%	3.30%	3.45%

Source: FDIC