

Pictures of Deflation

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American Enterprise Institute

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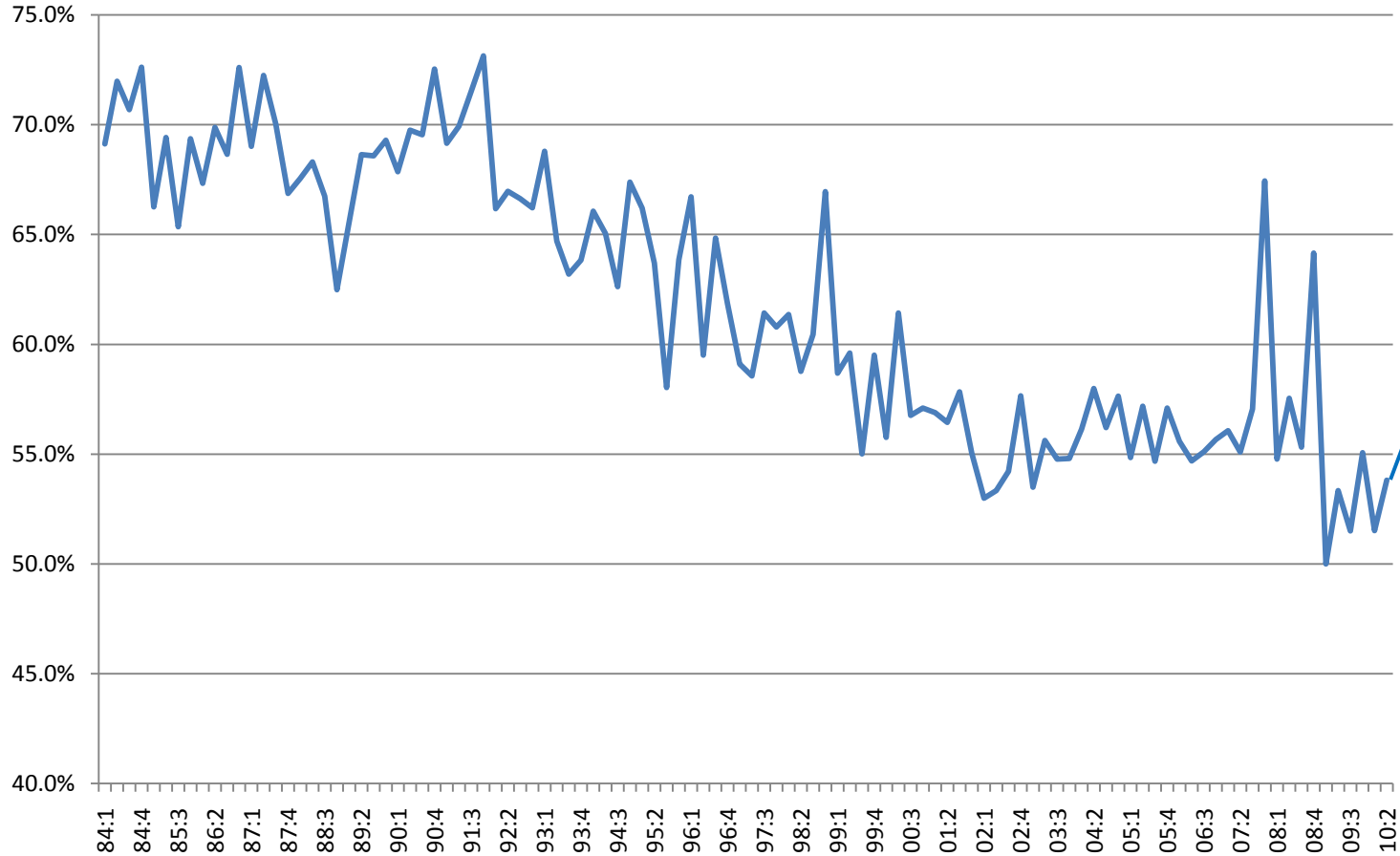
Is the Subprime Crisis Over?

- No. The improvement in bank loan default rates is a mirage. The use of loan modification to make bad credits appear “current” is an economic fraud perpetrated by Washington that is already becoming apparent via foreclosure moratoria.
- Mounting cash flow stress on all lenders is reaching crisis levels. Non-payment by borrowers and mounting foreclosure backlogs are creating the conditions for the collapse of some of the largest U.S. banks in 2011.

Chart 1: Efficiency

- First stage of the banking crisis involved stress on liquidity due to market contagion. TARP, the Fed, FDIC responded with liquidity and debt guarantees.
- The second stage involved stress on capital via charge-offs and loan loss reserves, both of which drove banks into record levels of loss.
- The third stage of the banking crisis involves degradation of bank operating efficiency as restructuring accelerates, expenses rise and lenders involuntarily become non-operating REITs.

Efficiency: Banks > \$10b Assets

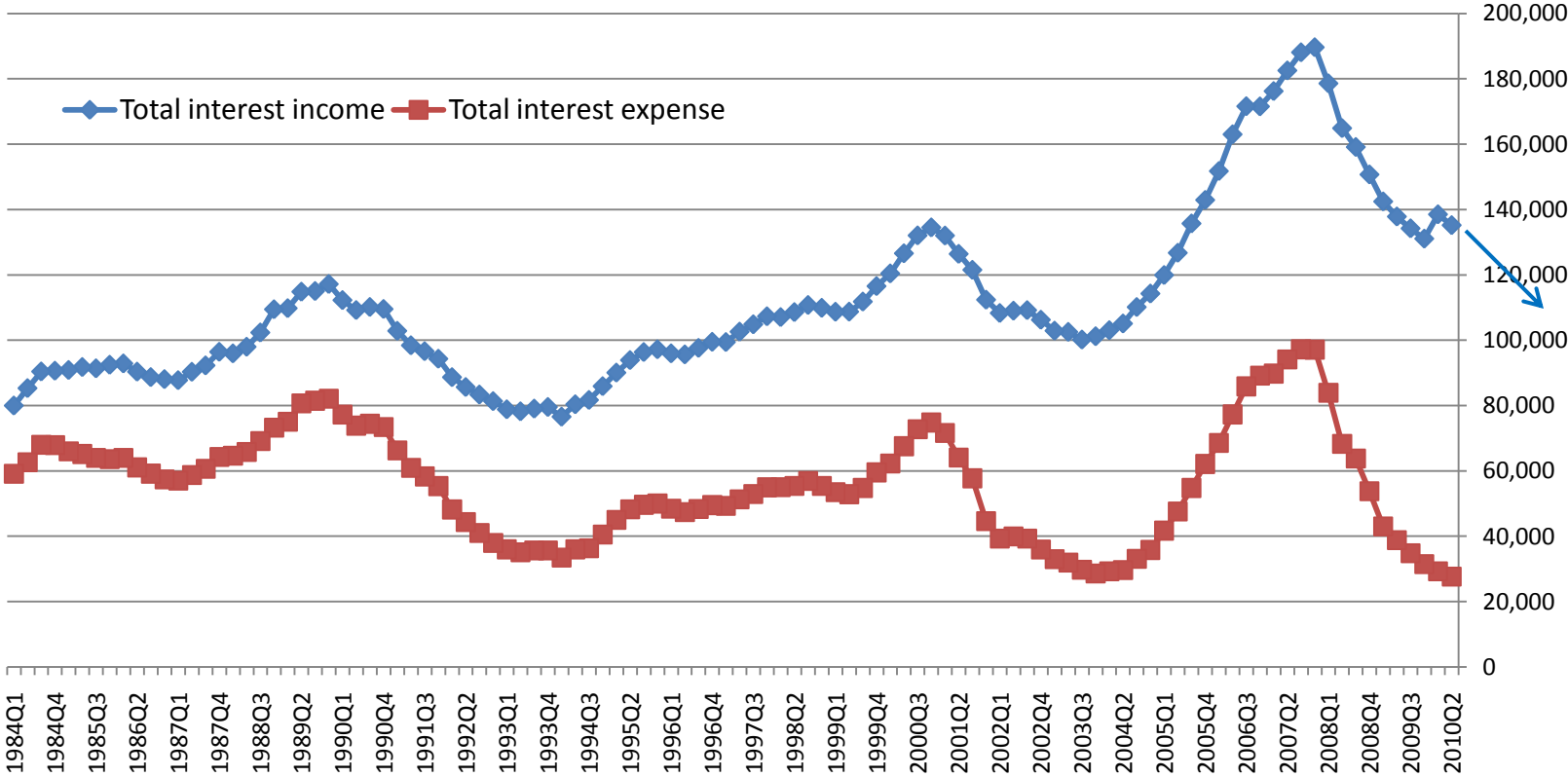


Source: FDIC Quarterly Bank Profile

Chart 2: Net Interest Income

- Many on Wall Street believe that net interest margin or NIM among U.S. banks is at record levels. They are right, but not in the way that many investors and analysts expect.
- Unfortunately, measured *in dollars*, the NIM of the banking industry has been cut by a third over the past three years due to the Fed's zero interest rate policy. Banks are literally dying from lack of yield on assets due to the Fed's ZIRP.

Net Interest Income

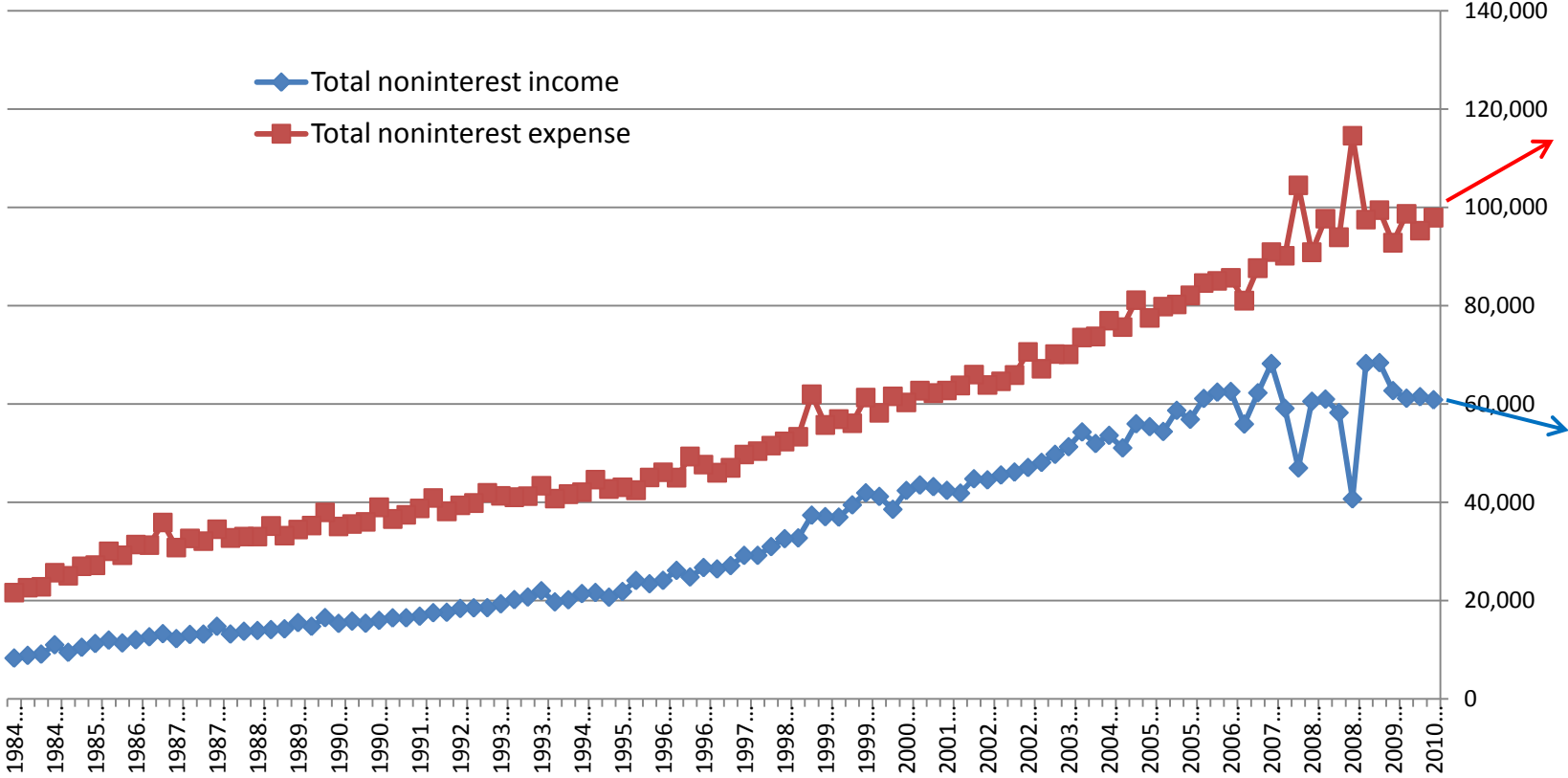


Source: FDIC Quarterly Bank Profile

Chart 3: Non-Interest Income

- In 2005-2007 period when the subprime frenzy peaked, non-interest revenue for U.S. banks reached a record \$80 billion. Expenses, conversely, were muted as defaults disappeared, but are now growing rapidly.
- Since 2007, the non-interest revenue of all U.S. banks has fallen by over \$10 billion. Non-interest expenses at U.S. banks will continue to increase due to residential and commercial foreclosures.

Non-Interest Income

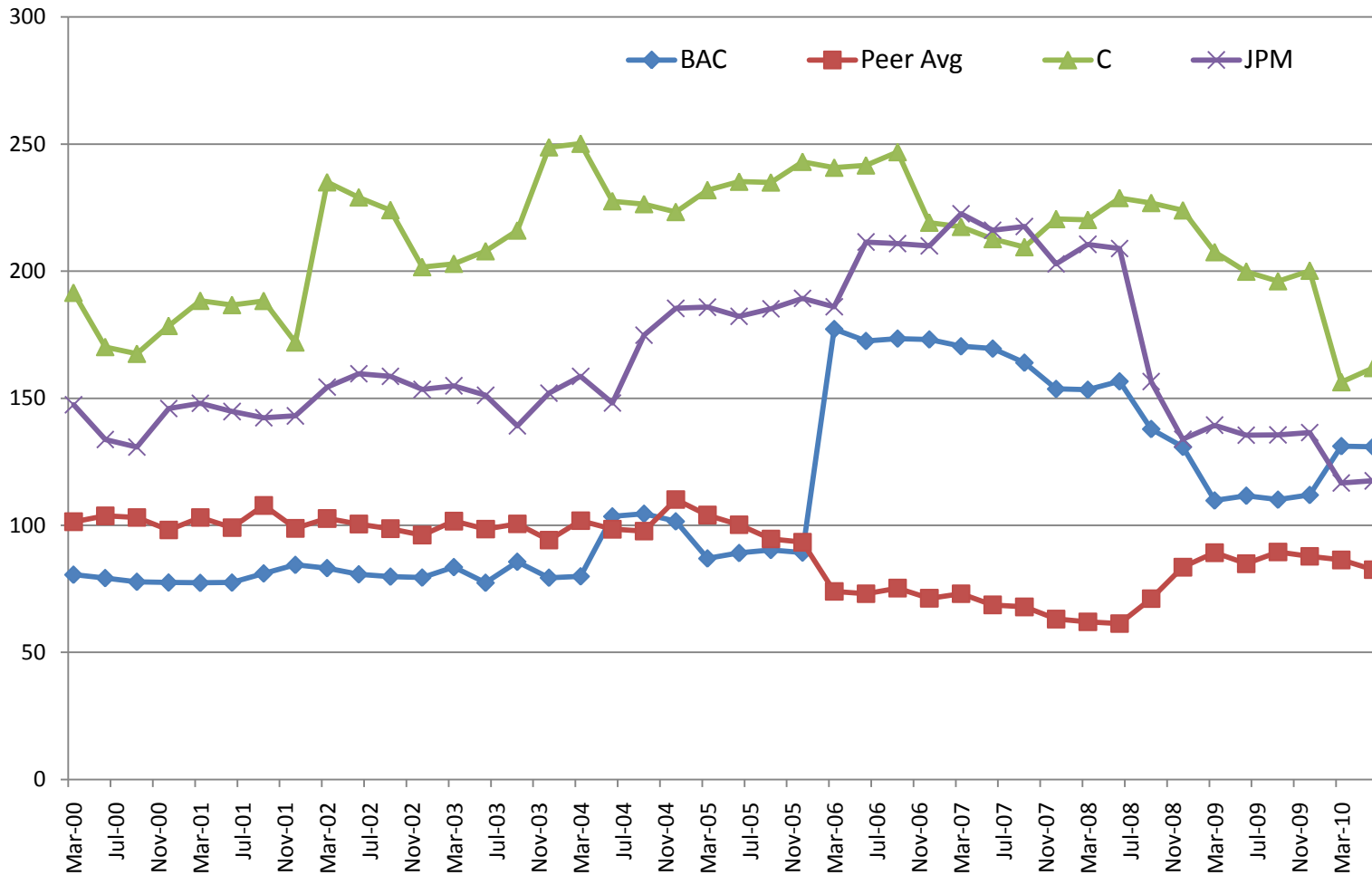


Source: FDIC Quarterly Bank Profile

Chart 4: Exposure at Default (EAD)

- U.S. banks continue to shrink their unused credit lines to limit exposure to default. The shrinkage in EAD is also a function of slack demand for credit in a deflating economy.
- The combinations of still-record default rates and rising servicing costs related to foreclosures is making banks hyper-cautious about credit. The muddle along policy of Obama and Geithner = no net credit growth.
- Chart on the following page shows unused credit lines for BAC, C. JPM and the large-bank peer group created by The IRA Bank Monitor. Note all have greatly reduced EAD.

Exposure at Default (%)



Source: FDIC /IRA Bank Monitor

Conclusions (1)

- The U.S. banking industry is entering a new period of crisis where operating costs are rising dramatically due to foreclosures and defaults. We are less than $\frac{1}{4}$ of the way through the foreclosure process. Laurie Goodman of Amherst Securities predicts that 1 in 5 mortgages could go into foreclosure without radical action.
- Rising operating costs in banks will be more significant than in past recessions and could force the U.S. government to restructure some large lenders as expenses overwhelm revenue. BAC, JPM, GMAC foreclosure moratoriums only the start of the crisis that threatens the financial foundations of the entire U.S. political economy.

Conclusions (2)

- The largest U.S. banks remain insolvent and must continue to shrink. Failure by the Obama Administration to restructure the largest banks during 2007-2009 period only means that this process is going to occur over next three to five years – whether we like it or not. The issue is recognizing existing losses -- not if a loss occurred.
- Impending operational collapse of some of the largest U.S. banks will serve as the catalyst for re-creation of RFC-type liquidation vehicle(s) to handle the operational task of finally deflating the subprime bubble. End of the liquidation cycle of the deflating bubble will arrive in another *four to five years*.

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