

# Understanding and Profiting from the Next Banking Crisis

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Third Annual Value Investing Conference  
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October 29, 2010

# The American Dream

- Since the turn of the 20th Century, the world has been confronted by the paradox of rising productivity. Innovation in the form of new technologies and processes creates opportunities every day, but also leads to overcapacity in legacy industries, and chronic under employment and deteriorating credit quality in banks.
- Post-WWII policy of allowing other nations to rebuild their economies via free access to the American market created structural imbalances in the U.S. Focus on housing as a substitute for productive industries is the root of the current U.S. malaise.
- Decline of American industry and accumulation of public and private debt has led to a banking system with excessive exposure to real estate and government debt, and few alternatives for diversification of risk.

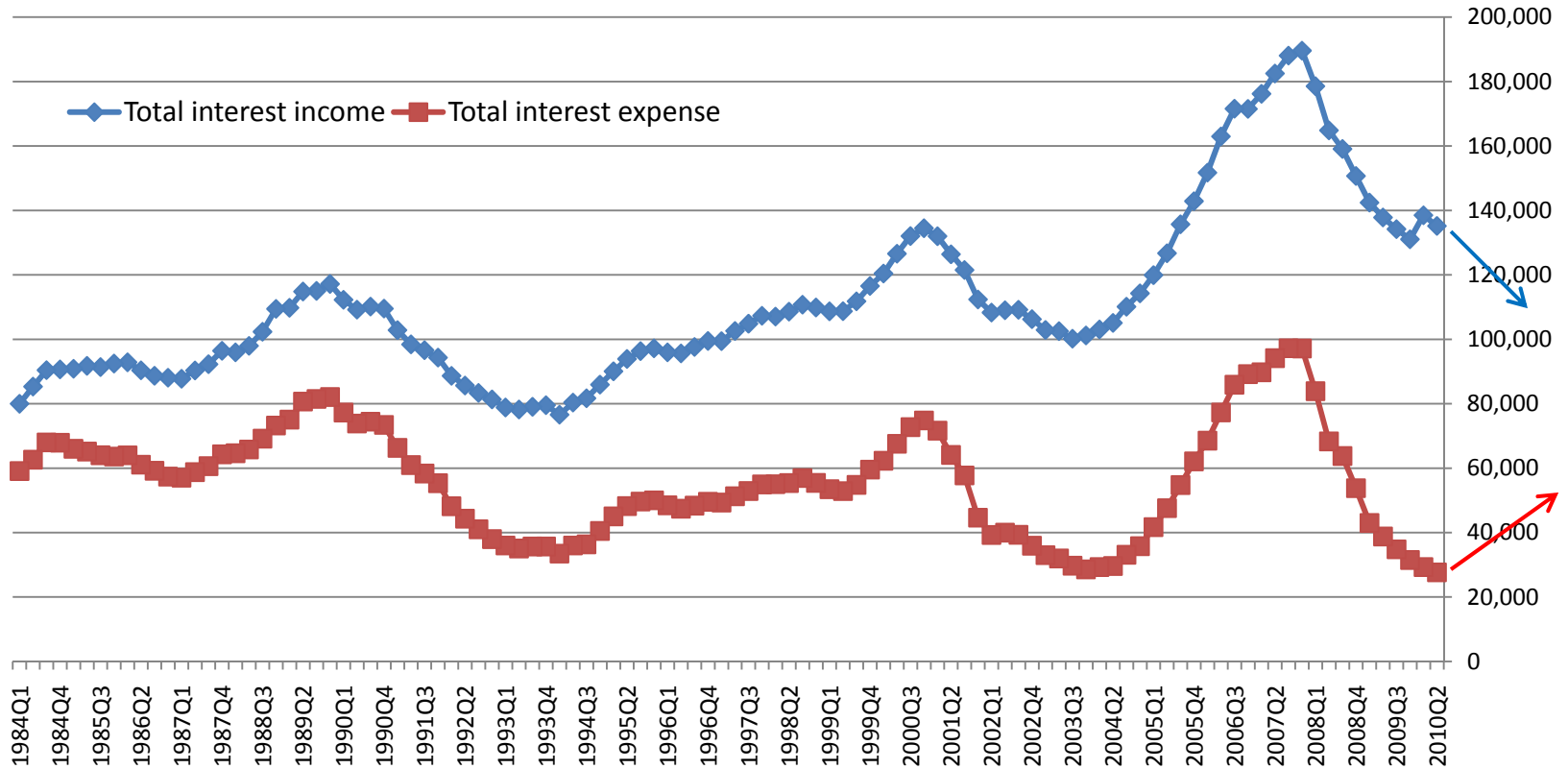
# A Crisis or Metastasis?

- 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. Profits for past several decades completely wiped out by crisis of 2008.
- The third stage of the banking crisis involves degradation of bank operating efficiency as restructuring accelerates, loan servicing expenses rise and lenders involuntarily become non-operating REITs.

# Impact of QE/ZIRP on NIM

- 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*, gross interest revenue 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, savers are literally dying from lack of yield on assets due to QE/ZIRP.

# Net Interest Income -- Large Banks

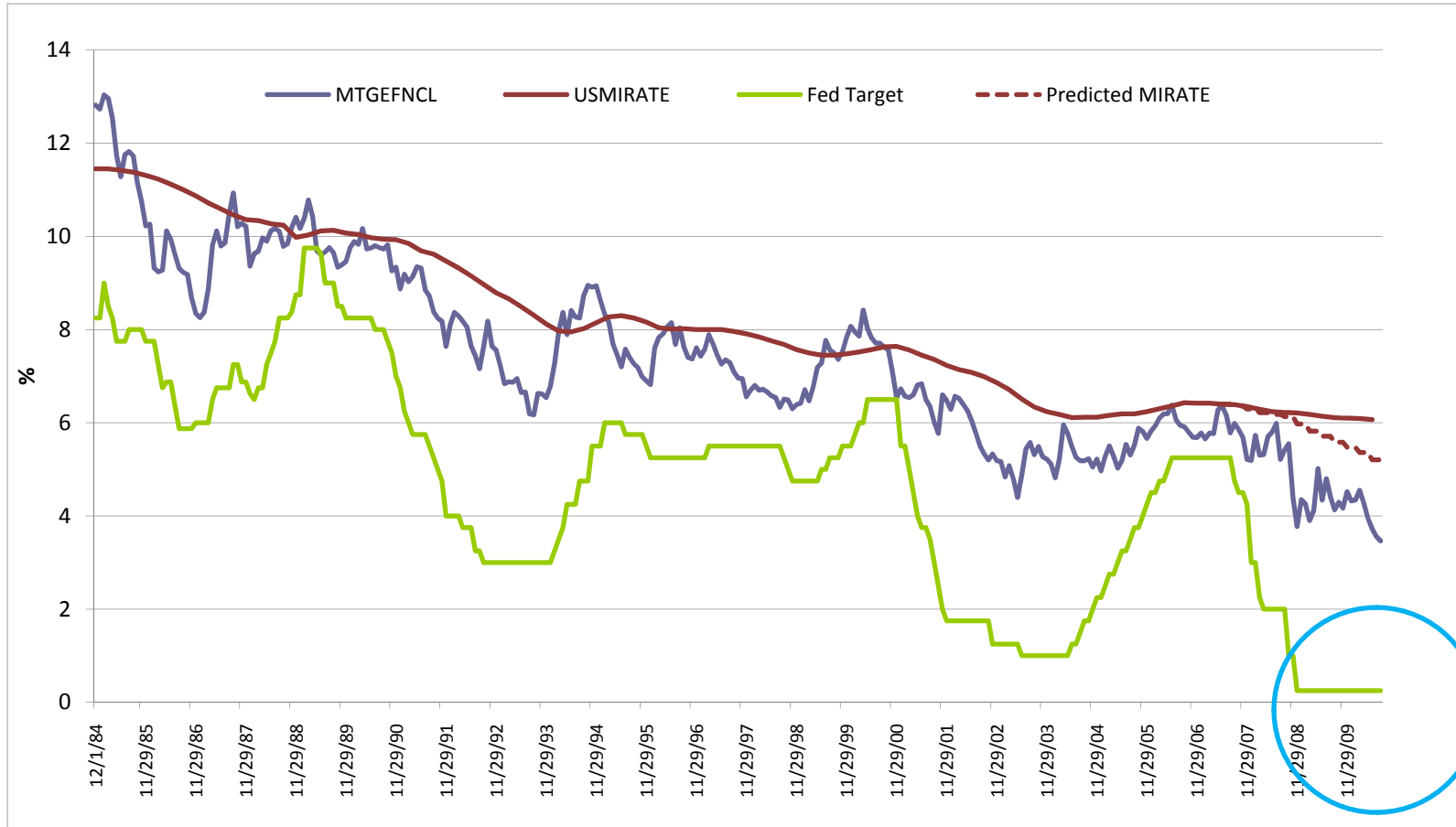


Source: FDIC Quarterly Bank Profile

# Why is ZIRP/QE Not Working?

- In the post WWII period, Fed interest rate cuts resulted in significant reduction in average mortgage borrowing costs for households -- until 2008, when mortgage rates implied by the bond market fell significantly but households were not able to refinance.
- Fees charged by Fannie Mae and Freddie Mac, and a mortgage origination cartel led by the big four banks (BAC, WFC, JPM, C), are now 4-5 points on new origination loans vs. less than 1 point during housing boom. Huge subsidy for largest zombie banks effectively blocks refinancing by millions of households.
- These fees, which can add up to 7 to 10% of the face value of the loan, raise mortgage rates to borrowers by hundreds of basis points. Banks and the housing GSEs, however, saw significant benefits in declines in funding costs thanks to low Fed rates.

# The Refinance Gap

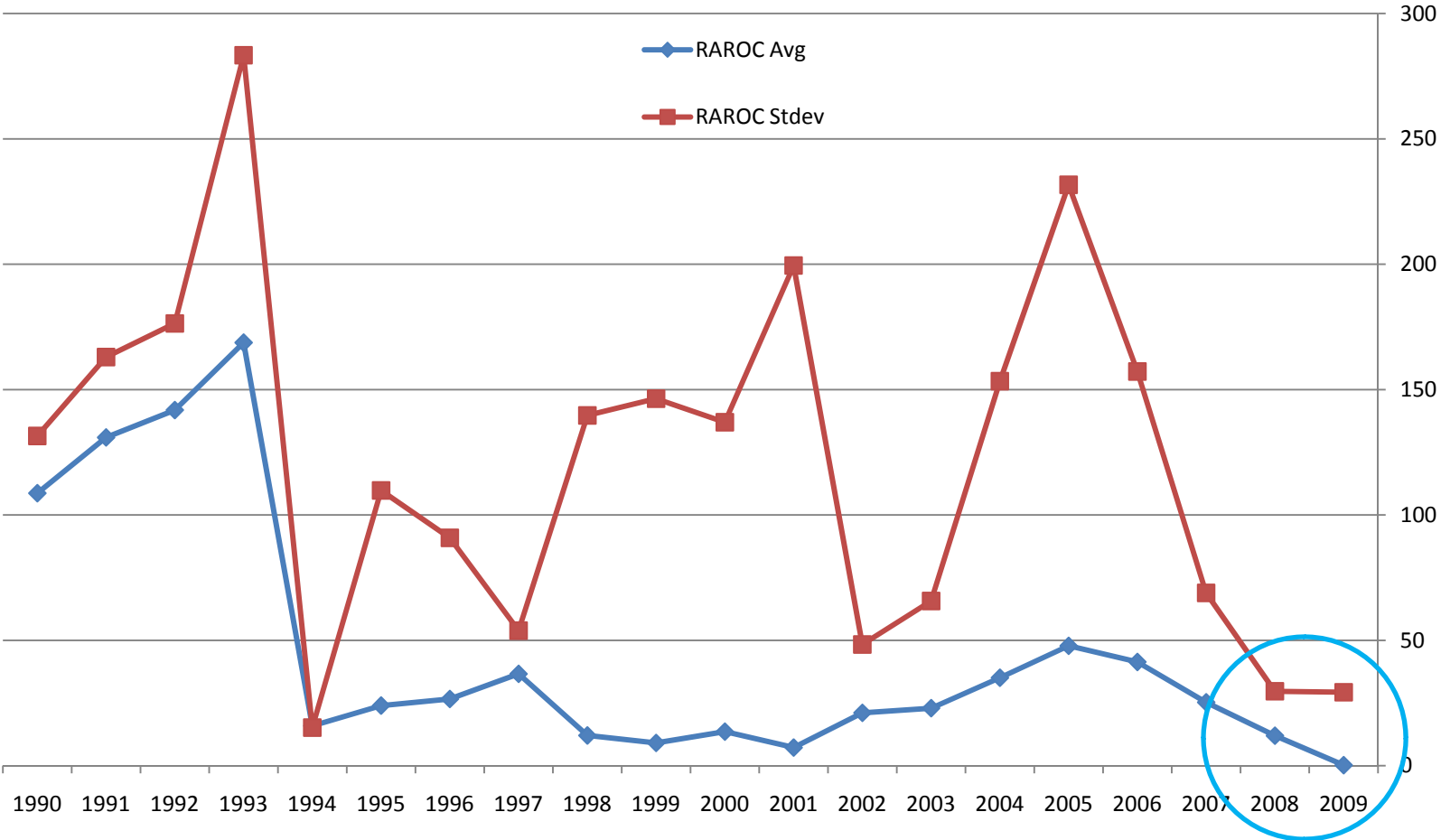


Source: Absalon

# Large Bank Risk vs. Return

- The next chart shows the risk-adjusted return on capital or “RAROC” metrics for the top 100 US banks from The IRA Bank Monitor. RAROC is simply net income/economic capital.
- The chart suggests that the real, risk-adjusted profitability of the US banking industry has been declining since the mid-1990s, when securitization and other types of “innovation” really kicked into gear.

# Large Bank RAROC (%)



Source: FDIC/The IRA Bank Monitor

# Bank Stress Ratings: Banks

(FDIC Insured Units)

	A+	A	B	C	D	F
2010 06	3,551	1,575	480	463	77	1,632
2010 03	3,676	1,592	504	480	93	1,534
2009 12	2,978	1,539	480	432	85	2,441
2009 09	3,308	1,481	410	429	77	2,337
2009 06	3,518	1,449	417	421	72	2,256
2009 03	3,959	1,431	452	437	88	1,820
2008 12	3,918	1,448	376	390	98	2,003
2008 09	4,498	1,293	315	356	63	1,793
2008 06	4,884	1,323	329	326	66	1,458

# Bank Stress Ratings: Assets

(Billions of \$)

	A+	A	B	C	D	F
2010 06	\$2,164	\$2,837	\$4,942	\$1,337	\$465	\$1,458
2010 03	\$2,109	\$1,295	\$6,622	\$1,088	\$381	\$1,843
2009 12	\$1,457	\$1,826	\$3,072	\$1,839	\$295	\$4,601
2009 09	\$1,756	\$1,938	\$4,316	\$584	\$94	\$4,535
2009 06	\$2,005	\$2,097	\$4,132	\$518	\$68	\$4,458
2009 03	\$3,202	\$3,131	\$3,587	\$729	\$86	\$2,784
2008 12	\$2,366	\$5,398	\$403	\$694	\$46	\$4,033
2008 09	\$2,907	\$5,504	\$525	\$704	\$144	\$3,772
2008 06	\$2,897	\$5,256	\$400	\$695	\$51	\$3,983

# Opportunities

- For banks and investors, one of the biggest opportunities for gain is to invest in the stronger regional banks that are acquiring troubled or failed institutions. Resolution results in losses, but also creates value for investors and society.
- Acquiring failed banks from the FDIC is extremely attractive for existing banks, which tend to get preference from regulators in failed bank sales. Attractive pricing, lack of legacy liabilities key positives for investment thesis.

# Opportunities

- Another way for investors to exploit the bank restructuring process is to purchase troubled assets. So far, Fed QE and ZIRP are enabling banks to resist selling bad assets.
- In addition, the FDIC, NCUA and other agencies are issuing RMBS and CMBS securities with government guarantees that offer attractive yields compared with Treasury debt.

# IRA Advisory Service

Ticker Symbol/ Name	Q3 09 Stress Rating*	Q4 09 Stress Rating*	Q1 10 Stress Rating	Q2 10 Stress Rating	Outlook**	RAROC
BBT	"A"	"B"	"B"	"B"	Positive	0.8%
BOH	"A"	"A"	"A"	"A"	Positive	30.1%
CFR	"A+"	"A+"	"A+"	"A+"	Positive	23.9%
HCBK	"A+"	"A+"	"A+"	"A+"	Positive	8.86%
IBKC	"A+"	"A+"	"A+"	"A"	Positive	12.32%
NTRS	"A+"	"A+"	"A+"	"A+"	Positive	- 8.56%
PNC	"A"	"B"	"A"	"B"	Positive	3.92%
TD	"C"	"A"	"C"	"B"	Positive	1.39%
USB	"B"	"B"	"B"	"A+"	Positive	-4.83%
WABC	"A+"	"A+"	"A+"	"A+"	Positive	9.04%

Source: FDIC/The IRA Bank Monitor \* Bank Stress Ratings \*\* Subjective outlook on forward operating results.

# IRA Advisory Service

Ticker Symbol/ Name	Q3 09 Stress Rating*	Q4 09 Stress Rating*	Q1 10 Stress Rating	Q2 10 Stress Rating	Outlook**	RAROC
WFC	"A"	"A"	"B"	"B"	Neutral	0.51%
BAC	"C"	"C"	"C"	"C"	Negative	-1.04%
FITB	"B"	"B"	"C"	"C"	Negative	-6.09%
ALLY	"F"	"F"	"A+"	"A+"	Negative	3.13%
HSBC	"F"	"F"	"C"	"C"	Negative	-1.79%
JPM	"C"	"C"	"C"	"C"	Negative	-1.04%
KEY	"F"	"F"	"F"	"C"	Negative	-11.17%
STI	"F"	"F"	"F"	"F"	Negative	-8.91%
WBS	"F"	"F"	"C"	"C"	Negative	1.13%

Source: FDIC/The IRA Bank Monitor \* Bank Stress Ratings \*\* Subjective outlook on forward operating results.

# Conclusions

- The U.S. banking industry entering a new period of crisis where operating costs are rising dramatically due to foreclosures and loan repurchase expenses. We are less than  $\frac{1}{4}$  of the way through foreclosures. The issue is recognizing existing losses -- not if a loss occurred.
- Failure by the Bush/Obama to restructure the largest banks during 2008-2009 period only means that this process is going to occur over next three to five years – whether we like it or not. Lower growth, employment are the cost of this lack of courage and vision.
- The largest U.S. banks remain insolvent and must continue to shrink until they are either restructured or the subsidies flowing from the Fed, Fannie Mae/Freddie Mac cover hidden losses. The latter course condemns Americans to years of economic malaise and further job losses.

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