Banking Watch

US

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Economic Analysis

US
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FDIC Banking Profile 2011Q2

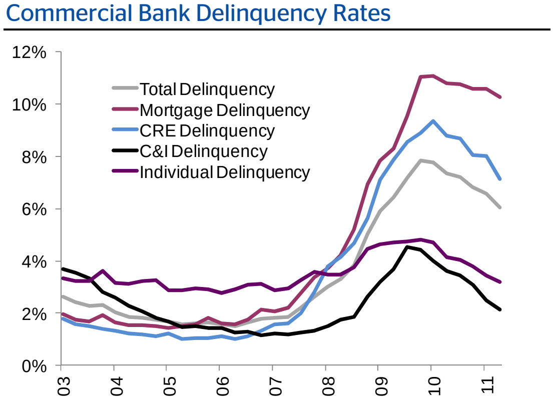
Declining provisions kick in to help muted revenue

- **Net charge-off to loans declines from 1.91% to 1.77% in 2011Q2**
- **Loan growth remains skittish, while deposit growth is strong**
- **Asset quality stabilizes, but new problems from a flatter yield curve**

Residential loan asset quality continues to hold back more widespread improvement

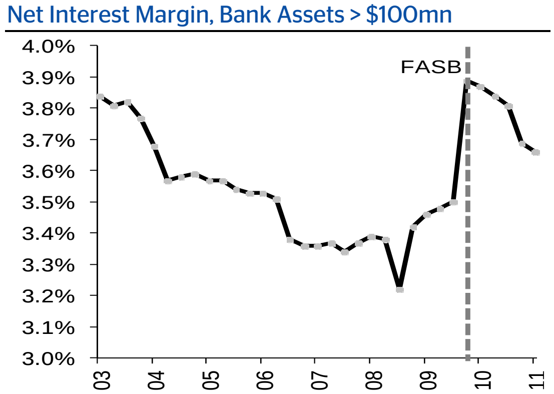
Data from the Federal Deposit Insurance Corporation's (FDIC) Quarterly Banking Profile for 2011Q2 suggests that the total delinquency rate for commercial banks declined moderately, but that operating revenue slowed for the second straight quarter. Similar to the past three quarters, the lack of improvement in residential real estate delinquencies is holding back a more widespread recovery in balance sheet conditions, evidenced also by a sluggish reversal of other real estate owned (OREO) as a percentage of total assets. Residential asset quality is also hampered by slow loan growth that would expand the denominator of asset quality. Interestingly, despite the improvement in overall asset quality and strong capital and liquidity levels, the banking system is now experiencing difficulty in generating margin given high levels of holdings at Federal Reserve banks. The FDIC reported that lower asset yields on Fed holdings at the largest banks contributed to a decline in net interest margin. On the other side of operating revenue, noninterest income also declined via lower loan-servicing fees and lower service charges on deposit accounts. This occurred despite high growth in deposits this quarter in noninterest-bearing deposits, with commercial banks' deposits in domestic offices increasing over the quarter by $251bn. Thus, banks are experiencing rapid deposit growth and are at the same time holding high reserves at the Fed, which are generating lower margins than in previous quarters. Commercial Real Estate (CRE) staged an important improvement in asset quality, with large improvements in multifamily, construction and development loans, and nonfarm-nonresidential categories. The total net charge-off to total loans ratio declined QoQ from 1.91% to 1.77% in 2011Q2. The efficiency ratio reached a new record high since 2003 and total allowances for loan losses declined by $10.3bn. For the first time since trouble emerged in subprime residential lending, the FDIC's list of problem institutions declined from 888 to 865, with the amount of problem institution assets declining by $25bn.

Chart 1
Commercial Bank Delinquency Rates



Source: FDIC

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

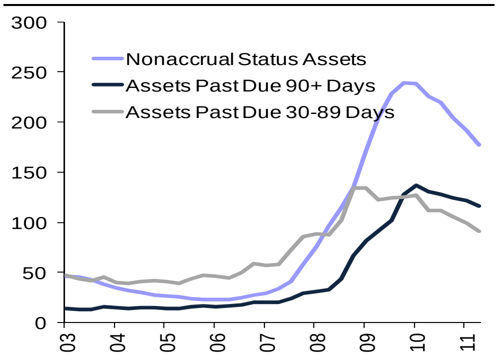


Source: FDIC

Signs of more strong stabilization emerging

The industry as a whole posted a net income of $28.8bn and commercial banks reported a return on assets of 0.88%. This return on assets figure continues a trend we expect to be established that is around two-thirds of the average return on assets in the years prior to the crisis. Both tier 1 and core capital ratios increased QoQ. For all FDIC-insured institutions, this quarter witnessed the first total loan growth since 2008Q2, excluding shifts in levels that occurred due to accounting changes. Commercial and industrial loans and auto loans led loan growth over the quarter.

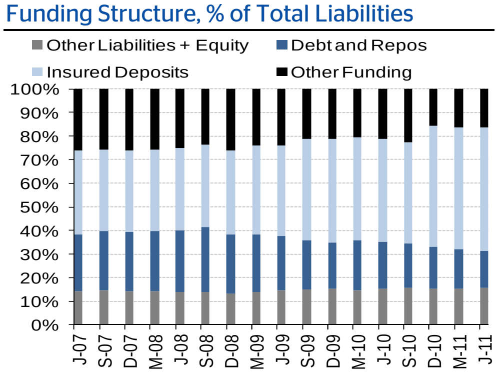
Chart 3
Past Due Loans at Commercial Banks, in $bn



Source: BLS and BBVA Research

Fears of a new wave of past due loans are not evident from the 30-89 days category of commercial banks within the present data. Nonaccrual status loans have staged a strong improvement over the past several quarters and this is expected to continue. In general, this suggests that the average severity of past due loans in the commercial banking system is on decline, a positive development moving forward.

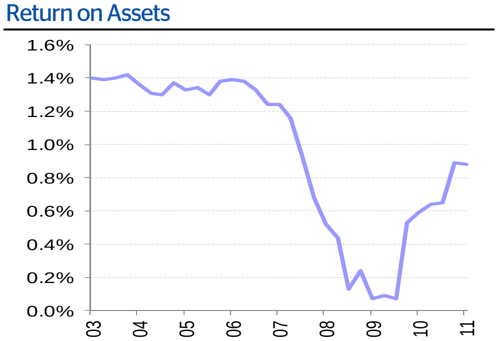
Chart 4
Funding Structure, % of Total Liabilities



Source: FDIC

Deposit growth rebounded to grow at a 7.4% YoY rate in 2011Q2, up from a 4.6% YoY growth rate in the previous quarter. Commercial banks are having no difficulty shifting to more deposit-based funding given recent deposit growth rates. A shedding of risk appetite is generally negative for growth of financial industry bonds and quarterly Flow of Funds data implies continued deleveraging in this category of bonds outstanding in real terms. Interbank loan levels in July stand at extremely low levels, suggesting continued neglect of this area.

Chart 5
Return on Assets



Source: SNL Financial

Return on assets (ROA) appears to be stabilizing around a trend of two-thirds the pre-crisis level. We believe there is scope for some marginal improvements to its current level. The FDIC reported that improved securities values enhanced equity capital in 2011Q2. Given we know that 2011Q3 will experience a reversal of this occurrence, we expect that capital buffers in the next quarter will require more use of internally-generated funds rather than improved values.

Asset quality improving, but a flattening yield curve presents new problems

Loan loss allowances are progressively drawn down and are supportive of income despite weakened noninterest income and tenuous yields on assets. Although operating revenues are slightly weaker this quarter, earnings coverage of charge-offs increased QoQ. Compressed long-run yields will only result in weaker margins in next quarter's FDIC data. With the Federal Reserve currently on hold until 2013, weaker growth prospects, low inflation prospects and flight-to-quality are additionally pressing down on long-term bond yields. This is combined, paradoxically, with a surge of deposits due to financial market volatility that is expected in the 2011Q3 data.

Table 1
Leverage Indicators

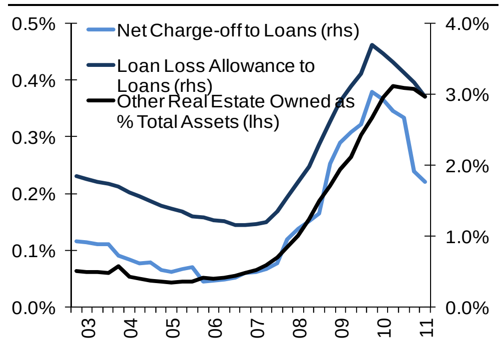
QoQ Change in Leverage

QoQ %	2011Q2	2011Q1	2010Q4	2010Q3	2010Q2
Assets	1.7%	0.8%	-0.4%	1.4%	-1.0%
Equity	1.9%	1.4%	-0.3%	1.9%	1.9%
Leverage	-0.2%	-0.6%	-0.2%	-0.4%	-2.9%

Leverage is Asset% less Equity%
2010Q1 Adjusted by $322.3bn for FASB

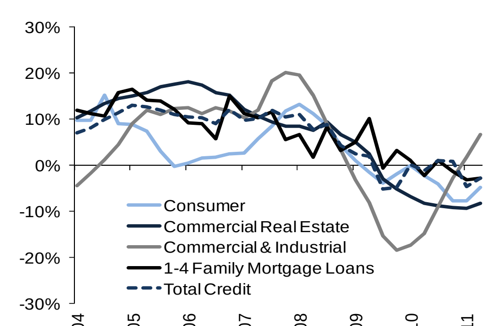
Source: FDIC and BBVA Research

Chart 6
Balance Sheet Conditions



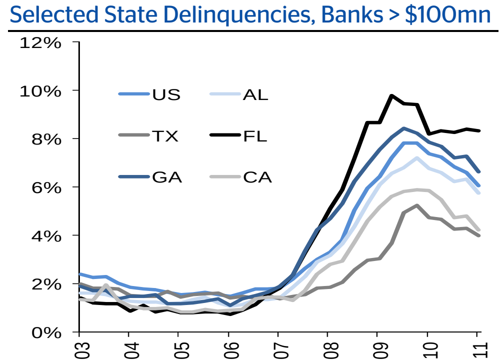
Source: FDIC

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	6/30/2011	3/31/2011	12/31/2010	9/30/2010	6/30/2010
Total Delinquency	6.0%	6.6%	6.8%	7.2%	7.3%
Mortgage Delinquency	10.2%	10.6%	10.6%	10.7%	10.8%
CRE Delinquency	7.1%	8.0%	8.0%	8.7%	8.8%
C&I Delinquency	2.1%	2.5%	3.1%	3.4%	3.6%
Individual Delinquency	3.2%	3.4%	3.8%	4.0%	4.1%
Net interest margin	3.66%	3.69%	3.81%	3.84%	3.87%
Net operating income to assets	0.89%	0.91%	0.60%	0.60%	0.56%
Return on assets (ROA)	0.88%	0.89%	0.65%	0.64%	0.59%
Return on Equity (ROE)	7.87%	8.01%	5.88%	5.83%	5.37%
Net charge-offs to loans	1.77%	1.91%	2.67%	2.77%	2.93%
Earnings coverage of net charge-offs (x)	1.96	1.86	1.42	1.42	1.38
Loss allowance to loans	2.97%	3.17%	3.30%	3.45%	3.58%

Source: FDIC