

# Outlook and Opportunities in the Domestic Banking Sector

Despite expectations of continued asset quality deterioration, we have become more positive on the domestic banking sector. Investment opportunity exists in the near term, resulting from refinancing activity and negative headlines from the release of the Shared National Credit Exam.

## U.S. Banking System Outlook

We are broadly constructive on the domestic banking sector, as regulatory interventions designed to reinforce bank balance sheets (Troubled Asset Relief Program (TARP), Capital Purchase Program (CPP), Supervisory Capital Assessment Program (SCAP), etc.) and assure access to liquidity (Temporary Liquidity Guarantee Program (TLGP), Term Asset-Backed Securities Loan Facility (TALF), Term Auction Facility (TAF), etc.) have established a sense of stability following the panic that set in at the end of 2008. Our outlook factors in expectations of continued asset quality deterioration arising from secular economic conditions, and correspondingly weak earnings performance on elevated loss provisioning. Loan charge-offs, weak demand, and tighter lending standards will result in smaller balance sheets, further dampening profitability. Many institutions have, however, regained access to the unsecured funding market, and those mandated to source equity capital following the spring 2009 stress tests comfortably met or exceeded regulatory deadlines.

## Risk Expectations in the Near/Medium Term

Despite the relative calm, we would caution that credit spreads are likely to be volatile in the near- to medium-term, as the system works through the unemployment-driven impairments and deterioration in other asset classes that tend to evolve later in economic cycles (commercial and industrial loans, commercial real estate, etc.).

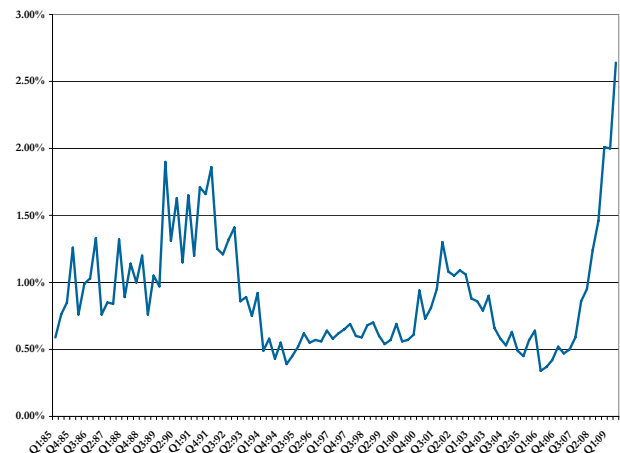
Regulatory accounting rules stipulate that a given loan generally pass through a series of delinquency triggers before being impaired, interest accrual is suspended, and the loan is ultimately written off. Broadly, loans are impaired after being delinquent for 90 days, and are written off after remaining delinquent for 120 days. Retail borrowers are typically able to service debt for a period of time immediately after becoming unemployed using severance payments, unemployment insurance compensation, and/or drawing upon accumulated savings. Consequently, there is a lag

effect between initial unemployment and when available resources are exhausted, delinquencies begin to aggregate, and consumer loans begin the migration through impairment and ultimate charge-off.

Commercial asset quality delinquencies have only begun to emerge in recent periods. We expect deterioration to accelerate into 2010 as borrowers confront lower sales, higher vacancy rates in commercial properties, falling rents, and limited opportunity to “roll” existing debt given tighter lending standards.

**Exhibit I** below plots quarterly net charge-off rates using U.S. Federal Reserve records. The chart captures the periods encompassing the bursting of the “dot-com” bubble of the early 2000’s, as well as the Savings & Loan collapse of the early 1990’s to illustrate the order of magnitude in loss rates in the current environment.

**Exhibit I:**  
**Net Charge-Off Rate**



Source: Federal Reserve

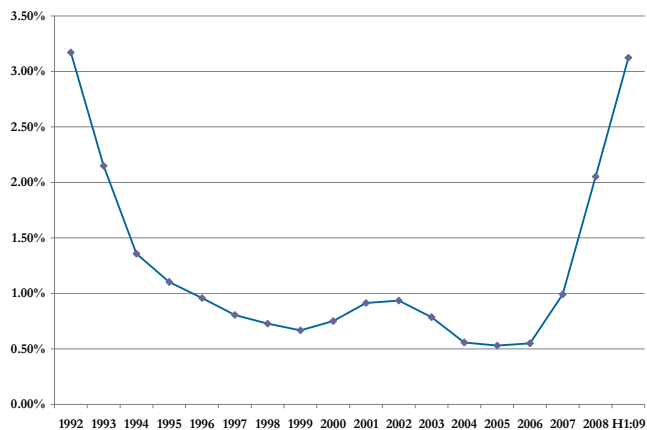
As commercial loan balances are inherently larger than those extended to a typical retail borrower, and that the unemployment rate has not leveled off (or even peaked),

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the net charge-off rate is expected to easily pass through 3% in the near future.

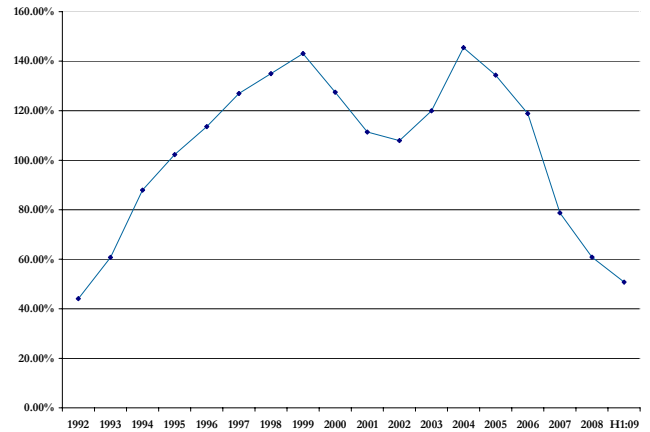
**Exhibit II:**  
Nonperforming Assets with +90 Day Delinquency as a Percentage of Total Assets



Source: FDIC

**Exhibit II** above charts nonperforming assets (NPA's) as a percentage of total assets among all FDIC insured institutions. While the trajectory appears alarming, we would point out that asset quality system-wide between 2004 and 2006 was at historically strong levels, and some deterioration was expected moving into 2007. The rate of increase in NPA's, however, has been far more rapid than that experienced in the more recent prior downturn, and loan loss reserve coverage of NPA's was not as deep pre-cycle as it was in the years preceding the dot-com / September 11 downturn (see **Exhibit III**). The result has been reserve coverage narrowing to levels not seen since the early 1990's, and loss provisioning, already aggressive in recent periods, will remain so indefinitely in order to rebuild loss reserves.

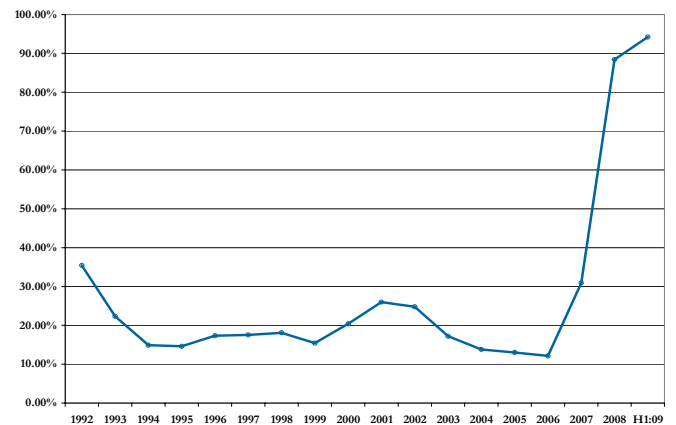
**Exhibit III:**  
Loan Loss Reserve Coverage



Source: FDIC

Loss reserves are established by taking a loss provision against pretax earnings, reducing net income (and retained earnings by extension), and ultimately thinning the equity capital base. Rebuilding loss reserves is consequently limited to a given institution's underlying earnings power, plus any additional fungible assets or businesses that can be divested at gains. The rapid deterioration in bank asset quality has resulted in virtually all of the pretax earnings in the system being allocated to loan loss reserves (see **Exhibit IV**). Given the expectations for asset quality trends discussed above, we expect the provisioning posture to be maintained well into 2010, and possibly beyond.

**Exhibit IV:**  
Loss Provision/Pre-Provision Income



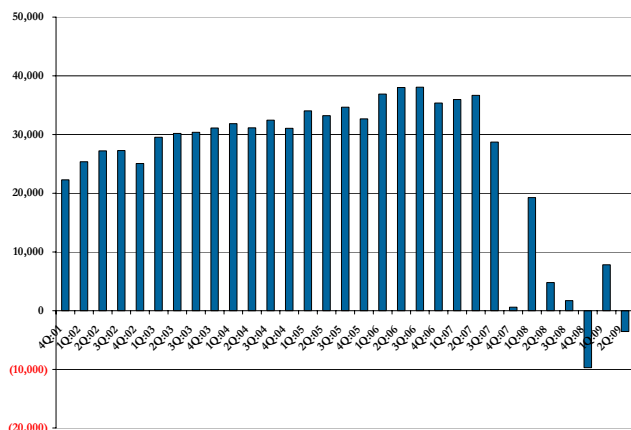
Source: FDIC

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The sudden need to reinforce loan loss reserves, coupled with securities portfolio marks, has introduced a level of quarterly earnings volatility not observed in the better part of a decade (**Exhibit V**), with the entire system reporting realized operating losses in the fourth quarter of 2008 and the second quarter of 2009. This capital destruction has driven the well-documented acceleration in bank failures that has resulted in approximately 380 fewer operating institutions from the end of 2007 to the date of this writing, chiefly among smaller institutions, but with some well-documented exceptions (Washington Mutual, Colonial Bancgroup, etc.).

**Exhibit V:**  
FDIC Insured Institutions Earnings (\$MM)



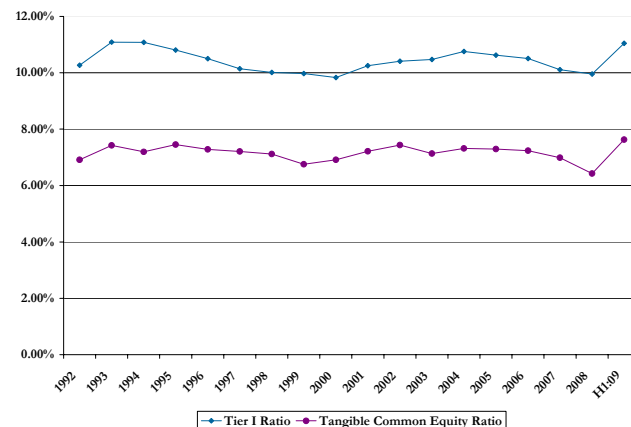
Source: FDIC

### Reasons for Optimism

Despite the asset quality overhang, the system appears to be adequately resilient to navigate the remaining pitfalls of the economic down cycle, with surviving institutions emerging in a stronger competitive position relative to their situation pre-panic. In particular, those banks participating in regulatory-driven “resolutions” (JPMorgan/Washington Mutual, Wells Fargo/Wachovia, Bank of America/Merrill Lynch, PNC/National City, etc.) have expanded branch networks, product offerings, and market share at deeply discounted valuations and look to emerge as “national champions” on the far side of the cycle. More importantly, regulators have assumed a more proactive posture with respect to regulatory intervention, and prior actions to bridge the gaps (funding, capital markets, etc.) created when respective markets seized up have proven effective.

Broadly speaking, the system has recovered sufficiently for government-sponsored funding and capital programs to be allowed to expire or otherwise wind down. Early in June, 2009, ten recipient institutions were cleared to begin buying equity injected within the government Capital Purchase Program under TARP. In recent weeks, even those entities receiving “extraordinary support” (i.e., Citigroup and Bank of America) were in positions to begin exploring their respective exit strategies from the program. Moreover, all banks charged with sourcing additional equity capital following the supervisory stress tests (Supervisory Capital Assessment Program) in the spring of 2009 met or exceeded their respective deadlines, and capital ratios (**Exhibit VI**) are currently at peak levels since the implementation of the current regulatory regime (Bank of International Assessments (BIS) protocol established in the late 1980’s).

**Exhibit VI:**  
Capital Ratios



Source: FDIC

### Investment Opportunities

The near-term risks notwithstanding, we remain positive on the banking sector longer-term. Funding markets have creaked back to life, and while the sector is unlikely to see the spread levels relative to benchmarks that it enjoyed in the 2004 – 2007 period in the foreseeable future, issues recently placed (even with concessions) are adequate economically to generate healthy net interest margins. Unsecured funding markets have recovered to the point that the FDIC-sponsored Temporary Liquidity Guarantee Program (TLGP) is scheduled to expire at the end of October.

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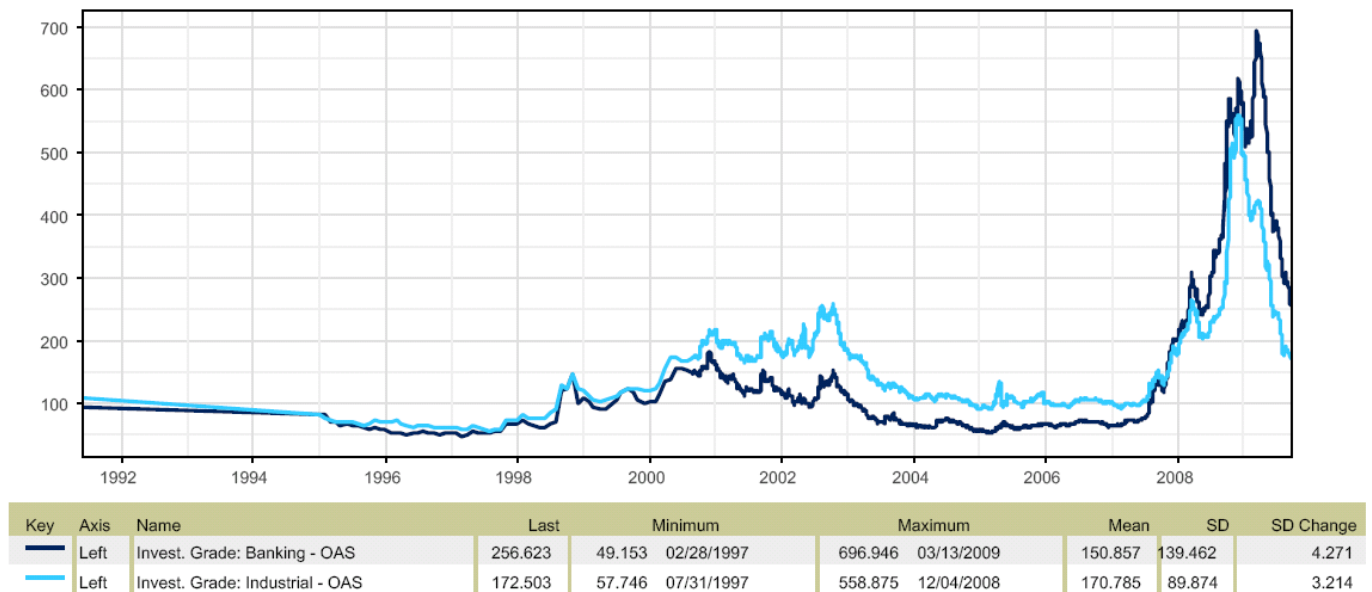
We recommend adding exposure to the sector as existing debt (issued under TLGP or otherwise) is rolled over. New issue concessions have tended to be attractive, and participation in those placed by quality issuers has been rewarded by solid performance when bonds have been freed to trade. A recent issue by PNC Funding (A3/A/A+/AAM: A-) maturing 9/21/15 illustrates the point, as the bonds were priced at +185 basis points over the five-year Treasury benchmark (+153 versus the curve). The issue tightened five basis points immediately upon being released to the secondary market. We view PNC as one of the best-managed regional banking institutions in the system, and its regulator-assisted acquisition of National City Corp. in January of 2009 represented a franchise extending coup. The company appears to be one of the clear winners

emerging from the financial panic. Other domestic names that we would highlight as being longer-term

beneficiaries of the market dislocation include Bank of America (regardless of headline risk), JPMorgan, US Bancorp, and Wells Fargo. Also, non-traditional banking institutions, including “processing” banks and bank-charter holding broker-dealers include Bank of New York Mellon, Goldman Sachs, Morgan Stanley, Northern Trust and State Street Corp. have performed well through the volatility, and their “systematically important” status is a compelling factor mitigating near-term concerns.

**Exhibit VII:**  
**Absolute Difference in OAS**

Banks vs Industrials



Source: Barclays

**Exhibit VII** above illustrates the relative value opportunity versus industrial sectors. After trading through industrials for the better part of the past 15 years, bank spreads currently are visibly lagging industrials in the recovery, and remain far from levels observed in the years leading up to the current recession.

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**Exhibit VIII** below offers a different view illustrating the relative attractiveness of bank credit valuations vis-à-vis industrial spreads. While spreads have compressed from those observed early in the crisis, they remain significantly above the typical band in which they have generally tracked since 1992.

**Exhibit VIII:**  
Residual OAS Variance



Key	First	Last	R-Square	Std. Error	BestFit	Durbin Watson
	05/28/1991	09/16/2009	0.338	46.382	$Y = -400.346 + 0.000 \times x$	0.006

Source: Barclays

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