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Banks and Brokers

Industry Update

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Advantage Moves to Firms w/Less Wholesale Funding

Recent events highlight risk w/wholesale funding which, for U.S. commercial banks, increased from 1/3rd in the early 1990s to 1/2 today, reflecting additional risk in funding. Current events show the benefit of a business model that is either more diversified or especially funding from less volatile sources, such as core deposits. The newer issue is the lower margin of safety for any short-falls or changed outlook by companies, given less ability to have orderly disposition of good assets in times of stress, and more rapid downgrades by rating agencies when there are signs of new problems.

Capital is King, Even More So

On last week's DB conference call, ex-Fed chairman Alan Greenspan gave a reminder that the equity-to-asset ratio for banks in 1870 was 40%. This was an extreme example of an important point: banks will need significantly more capital than in the past. If the market senses even a chance that a firm needs new capital, its stock could get punished, starting a downward spiral. For all, weakness begets more weakness than in the past. Near-term, capital can get hurt due to additional capital market write-downs, such as due to new weakness at AIG (insured $65B of ABS CDOs), more aggressive marks at some vs. others, and possibly new pressure on asset values if problem assets are sold more often vs. merely marked to market.

Bank Loan Losses are Increasing

The other issue remains likely higher loan losses at banks. These increased from a low of around 40 bp earlier this decade (all commercial banks) to close to over 1% as of 2Q08. We estimate that if this increases to 200 bp (if, for example, unemployment gets weaker), it could add $300B of loan losses at U.S. firms on top of the $300 of capital market write-downs already taken. The wildcard is consolidation, which is likely to only accelerate.

Price targets based on multi-faceted approach.

We employ various methodologies to derive price targets for the stocks under our coverage, including P/E, price/book value, P/E to growth (PEG), return on equity, and dividend discount models. Key industry risks include a worse/better-than expected economy, a rebound in the housing market, and a steeper yield curve, among others.

Current Events

Companies featured	
Bank of America Corp (BAC.N),USD33.74	Hold
BB&T (BBT.N),USD34.05	Sell
Bank of New York Mellon (BK.N),USD39.95	Buy
Citigroup Inc (C.N),USD17.96	Hold
Comerica (CMA.N),USD32.49	Buy
Fifth Third Bancorp (FITB.OQ),USD15.31	Sell
Goldman Sachs (GS.N),USD154.21	Hold
JPMorgan Chase & Co (JPM.N),USD41.17	Hold
KeyCorp (KEY.N),USD13.37	Sell
Lehman Brothers Holdings In (LEH.N),USD3.65	Hold
Merrill Lynch & Co Inc (MER.N),USD17.05	Hold
Morgan Stanley Group (MS.N),USD37.23	Hold
Northern Trust Corp. (NTRS.OQ),USD87.09	Hold
PNC Financial Services Grou (PNC.N),USD72.97	
SunTrust Banks (STI.N),USD47.31	Hold
State Street Corp (STT.N),USD71.70	Buy
U.S. Bancorp (USB.N),USD33.83	Sell
Wachovia (WB.N),USD14.27	Buy
Wells Fargo (WFC.N),USD34.29	Hold

Discussion

Funding and Capital Even More Important

The U.S. banking industry increased reliance on non-core funding (that is, everything other than core deposits) from 1/3rd in the early 1990s to 1/2 today, reflecting additional risk in funding. Current events show the benefit of a business model that is either more diversified or especially funding from less volatile sources, such as core deposits. Among U.S. firms, the investment banks (Merrill, Morgan Stanley and even Goldman Sachs) rely the most on wholesale funding. In comparison, U.S. universal banks (Citigroup, JP Morgan, Bank of America) have about 1/2 of their liabilities via borrowed funds, and regional banks have among the least (1/4th - 1/3rd).

The newer issue is the lower margin of safety for any short-falls or changed outlook by companies. For the investment banks, we think the Fed's discount window is clearly not enough to prevent bankruptcy. For all, weakness begets more weakness than in the past. First, the ability to use asset sales to offset charges is less because now these sales may need to be viewed - not under an orderly liquidation scenario - but under a forced one.

Second, the rating agencies seem more apt to downgrade based on market sentiment. On a Friday call, S&P said that it downgrades ratings based on CDS spreads, “rumors”, press reports, and general confidence, especially if it impacts funding, as it has done in the past week in a couple of cases. Thus, any company short-fall could be punished more quickly, leading to a vicious cycle downward.

The result is that banks and financial firms need to have more core funding and capital than in the past. Also, it is no longer enough to say that a bank "does not need to raise capital" but the bar is now that it "does not need to raise capital even under a stress scenario". The reason is simple: if the market senses even a chance that a firm needs new capital, its stock could get punished, starting a downward spiral. At the bottom of the page is a screen that shows banks with wholesale funding followed by data for all U.S. commercial banks.

More generally, we think one of the best measures of funding stress for the global financial system is the Libor/Fed Funds spread, which can be tracked on a forward basis. This is one of the best market based measures for the duration of the credit crises. This spread was 80 bp earlier last week and now does not decline to under 50 bp (which Greenspan said is the point when the credit crises starts abating) until June 2010 vs. June 2009 only 3 months ago (this is before any potential negative reaction due to events of the past couple days).

The Fed's enhanced liquidity facility, announced tonight, should give extra relief to liquidity and capital markets, though the extent that this will mitigate other market concerns is uncertain at this point.

More Capital Market Write-Downs Likely

The industry has had $400B of capital market related write-downs since early 2007 and recent events should increase this level for three reasons. First, according to our DB insurance analyst, weakness at AIG could result in marks on $65B of its insurance on ABS CDOs. This has NOT been disclosed by firms as part of monoline exposure, so we don't know who would be hurt (likely Citi, Merrill, UBS, others). Second, there will likely be additional concern about the adequacy of write-downs given that Lehman's marks on residential mortgage were actually more aggressive than peers in several regards (down to

39 cents on the dollar at Lehman), and raise ongoing concerns (whether justified or not) on commercial real estate (written down to 85 cents at Lehman).

Third, any forced liquidation would reduce prices in mortgage securities which, in turn, would require those which mark to market (investment banks and the investment bank divisions of commercial banks) to mark to these new lower prices. Potentially selling of Lehman assets would include residential mortgages of $17B (now at 39 cents on the dollar) and including securities ($9B), whole loans ($6B), and servicing/other ($2B), or put differently it includes U.S. ($9B), Europe ($8B), and Asia (under $1B). It also would include commercial real estate assets of $33B (now at 85 cents on the dollar) reflecting senior whole loans ($16B - almost all floating rate), mezzanine whole loans ($4B - 2/3rds floating rate) nonperforming loans ($2B), equity investments ($7B), and securities ($4B). The number of properties or positions is 2098 - i.e., tough to know "true" value given so many positions.

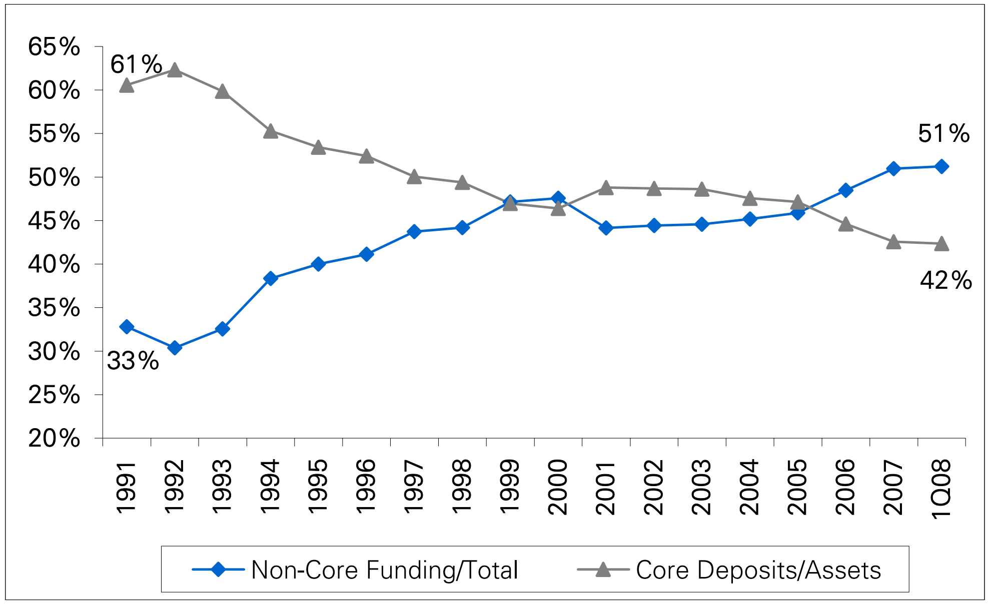
In addition to mortgage securities, there would be losses of exposure to Lehman and other spillover effects. For instance, forced sales could hurt even more vanilla products and generic mortgage backed securities since there would be much unwinding of structured products. For example, Lehman has $83B govt. and agency securities in their tri-party repo's.

Bank Loan Losses Only Beginning

Loans losses at U.S. banks increased from 40 bp a few years ago, past the long-term average of 80bp to a recent level of 120 bp. Almost all of the above-trend losses stem from higher losses on residential and more recently commercial mortgages. Excluding real estate, loan losses are around 80 bp. Having said this, a slower economy with a recent higher than expected US unemployment rate of 6.1% raises a greater chance for higher than expected losses in other consumer categories, such as car loans, credit cards, and related areas.

It seems increasingly possible that the credit cycle is rolling from asset class to asset class, having started in subprime mortgage to home equity to Alt-A and more to prime mortgages, and if this pattern might not get repeated in parts of commercial and then eventually to corporate. If industry losses increase to over 200 bp for a couple of years, this would amount to another $300B of loan losses for U.S. banks on top of the $300B of capital market write-downs already taken.

igure 1: Industry Funding Measures



Source: SNL

Appendix 1

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Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield) , we recommend that investors buy the stock.
Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock
Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.
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2. Ratings definitions prior to 27 January, 2007 were:
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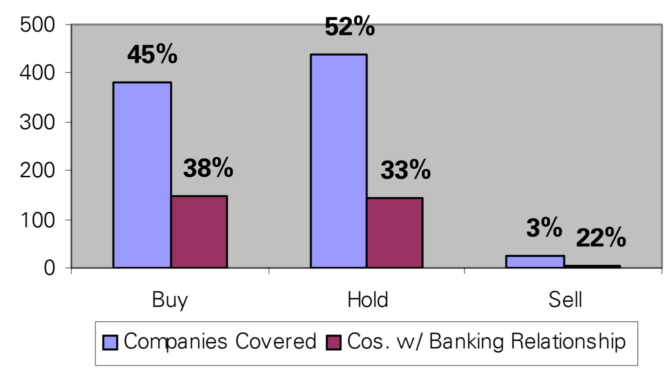
Equity rating dispersion and banking relationships



North American Universe

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