

HCP NOTES

Banking – United States

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The Myths (and Realities) of U.S. Banking

Bank reporting season for the first quarter of 2011 is now essentially over. As we were summarizing this quarter's aggregate results, we thought it would be interesting to discuss some significant myths in U.S. banking. Namely, we will discuss:

- Myth #1: U.S. Banks Continue to Struggle
- Myth #2: The U.S. Banking Business Model is Broken
- Myth #3: Bank Analyst Estimates are Relevant During a Credit Cycle
- Myth #4: Banks are Fragile, and Vulnerable to Another Crisis
- Myth #5: Current Earnings are of Low Quality

We explain these myths and why reality is different in more detail below.

Myth #1

U.S. Banks Continue to Struggle

Reality

Banks Have Recovered ~90% of Profitability Lost this Cycle

Far from struggling, bank profitability has almost recovered to pre-cycle levels of \$25 bln per quarter (i.e., before the credit downturn began in 2007). This may seem surprising, since stock prices continue to lag, and the primary indices remain ~50% below their all-time highs.

Reported earnings this quarter were ~\$20 bln. However, core earnings (i.e., excluding one-time gains and losses) were ~\$22 bln, meaning the banks have now recaptured nearly 90% of profitability lost this cycle. Note, these earnings *include* mortgage repurchase expenses, which declined ~50% Q/Q (to \$2.5 bln) and are likely to be immaterial by the end of this year.

With a significant increase in pre-tax pre-provision earnings (PTPPE) during the downturn (see [Myth #2](#)), "fully recovered" or "normalized" earnings is now well in excess of \$30 bln a quarter, a level we expect to be reached sometime next year.

This credit cycle is now ~70% complete. By the time it is over, the cycle will have spanned 6 years, or 72 months, split almost exactly between 3 years of rising losses and 3 years of falling losses.

Yet, despite the maturity of the current cycle, and that nearly 90% of core profitability has been restored, over 200 (or 40%) of all public banks still trade below tangible book value - i.e. their presumed liquidation value.

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Myth #2

The U.S. Banking Business Model is Broken

Reality

Pre-Tax Pre-Provision Earnings are up ~25% Since the Cycle Began

One of the most pernicious myths about U.S. banks is that the business model is broken. This notion gets a good airing in the media by pundits and non-bank commentators, and generally goes unchallenged. Clearly this view has some traction, given lagging stock prices.

The fact is that for the publicly traded banks, pre-tax pre-provision earnings (PTPPE), a critical measure of franchise profitability, is now **actually ~25% higher than it was before the cycle began**. In 2010, PTPPE was over \$200 bln despite absorbing \$19 bln (pre-tax) in mortgage expenses¹ and over \$10 bln in goodwill write-downs (from Bank of America), which compares to \$160 bln in 2006, the last full year before the credit cycle began. This is the most important evidence that the banks' primary challenge is a severe cyclical downturn in credit, not an impairment of the business model.

Myth #3

U.S. Bank Analyst Estimates are Relevant During a Credit Cycle

Reality

They Aren't

The next time you read a report that mentions the U.S. banks are trading at some multiple to 2012 estimates, take it with a cow-sized block of salt. In the past 4 years, Street estimates for the 24 largest and best covered banks (i.e. in the BKX) have been nothing short of horrendous.

How horrendous?

Over the past four years bank analysts have missed actual results by an astounding \$50 bln per year, or 50% of pre-cycle earnings². The only group covering the banks with a worse record than the brokers are the rating agencies. Last year, analysts did only slightly better and **under**estimated earnings for these large and well covered banks by a still huge \$30 bln (estimate = \$43 bln; actual = \$73 bln).

The reality is the Street almost always assumes 9%-10% earnings growth, no matter what the environment. Going into this most recent quarter, forecast 2011 earnings for this heavily followed group of banks were ~\$80 bln (or ~\$20 bln a quarter), which equates to (surprise, surprise) ~10% earnings growth for the year. We expect actual earnings to be closer to \$100 bln.

¹ In 2010, the four largest banks – i.e. **BAC, WFC, JPM, and C** – incurred mortgage-related expenses of \$19 bln consisting of: (i) ~\$12bln in repurchase expenses, and (ii) ~\$7 bln in litigation charges/settlements.

² Using mid-February estimates from Bloomberg for each year (i.e. after Q4 reporting season ended) we compared consensus estimates for the 24 largest and best covered banks to the actual reported earnings for the year once it was completed. The large banks are generally covered by between 15 and 20 analysts, if not more.



Myth #4**Banks are Fragile, and Vulnerable to Another Crisis****Reality****Substantial Buffers Belie This Assertion**

We have read many times that this or that speculated event will create another financial crisis and that the U.S. banks remain vulnerable. While tail risk is obviously a factor for financial intermediaries, the reality is that the U.S. banks are much stronger than they were before the crisis began.

First, some perspective: it is worth noting that, in aggregate, U.S. banking-only subsidiaries reported profits in every full year of the crisis, including 2008³. So, even in the worst crisis since the Great Depression, the banking business did not draw down capital. Since then, the sector has become much stronger, and investors can take comfort in the following.

First, pre-tax earnings are now ~\$30 bln a quarter (and rising). This provides a powerful buffer against any event potentially negatively impacting capital. **Second**, capital levels have nearly doubled since 2006 as the banks added nearly \$300 bln to tangible common equity during the downturn⁴. By banking standards leverage is now very low at less than 14x (the Canadian banks are significantly higher at 28x, or 26x excluding insured mortgages). **Third**, even after recent drawdowns, allowances for loan losses quadrupled over the last four years providing a formidable cushion against credit costs rising materially – a very unlikely event⁵.

So, while it is possible that some exogenous event stresses U.S. banks again, the banking system is now significantly stronger than it was before the crisis began.

Myth #5**Current Bank Earnings are of Low Quality****Reality****Reserve Releases Become “Permanent” Earnings Almost Immediately**

You may hear in the press or read in analyst reports that quarterly bank earnings are compromised or of low quality because of so-called “reserve releases”, a trend which began in Q1 of last year. In effect, U.S. bank analysts argue that the reporting bank has “under-provided” because the *reported* credit costs going through the income statement (provisions, or PCLs) are not as high as the *actual* credit costs (write-offs/net charge-offs, or NCOs)⁶.

³ Source: FDIC. This refers to regulated banking subsidiaries in the U.S. only, and includes U.S. bank subsidiaries of foreign banks. It does not include non-bank subsidiaries, most notably the broker-dealers. We would note that 2009 data was retroactively restated in February 2011 to account for a Bank of America (non-cash) goodwill write-down, which resulted in the originally reported positive net income of \$12.5 bln to be restated to a net loss of \$10.6 bln for the year.

⁴ In most credit cycles, banks draw down capital to fund credit losses and to build reserves. This cycle was very atypical, as the banks built substantial capital during a very severe credit cycle, owing to TARP equity raises and dividend cuts.

⁵ Interestingly, even in 1938 following the Great Depression, the U.S. experienced arguably the worst double dip recession in modern history, credit losses did not rise materially.

⁶ A reserve release occurs when the income statement expense, provision for loan losses (PCLs – which *build* the reserve) is less than the loan write-offs (i.e. net charge-offs, or NCO – which *reduces* the reserve). For greater clarity, the allowance for loan losses is also referred to as the reserve.



In effect, they conclude that the banks have artificially boosted earnings⁷. However, this assessment has generally been proven incorrect almost immediately, as it has taken, on average, between 12 and 24 weeks for reserve releases to become permanent earnings through ongoing declines in charge-offs.

In general, bank earnings are considered low quality if they are not sustainable, or are at levels above what is considered by investors to be greater than the long-term earnings power. With bank earnings still two-thirds of fully recovered (i.e. ~\$30 bln/quarter), and rising dramatically, it is difficult to conclude anything other than current earnings are of very high quality.

Conclusion: These Myths are Powerful, But Their Impact Will Eventually Fade

There is no question that the above myths have significant traction and have endured despite powerful evidence to the contrary. They, among others, continue to negatively influence bank stock prices.

However, over time, it will be difficult for sector valuations to not rise as quarterly earnings continue to normalize to more than \$30 bln, a level we believe the banks will reach sometime next year.

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⁷ Interestingly we would also highlight an important lack of consistency; when reserves were rising by over 300%, analysts did not argue the opposite (i.e. that earnings were understated).

