

# 2008 OUTLOOK THE SECOND HALF Anat Bird

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## 2008 Outlook

- The economy
- Margin management: the light at the end of the tunnel?
- The credit crunch
- Credit is cratering
- Deposit pricing remains harsh
- The payments business opportunity: still underutilized and expanding
- The acquisition business: hot and heavy? Or dead and buried?
- What's on the regulators' mind?
- Industry trends and observations

## The economy

- Mixed signals
- Major government intervention
- Residential real estate in the tank (average home prices will have to decline \$191,000 to reach buyers who qualified to buy the same home in 1Q04)
- Residential inventory will have to decline 116,00 to reach equilibrium
- Fed determined to help
- Problems VERY regional

## Margin Management

- Margin pressure persists for many banks, mainly due to stiff pricing competition
- The yield curve is beginning to normalize
- Trends are still unclear (up or down?)
- Checking accounts continue to dry up
- Deposit mix – shift to CDs
- The role of pricing
- Innovation and execution are at a premium

## Margin Behavior - Continued

- Wide range of bank responses to the uncertain rate environment—from heavy margin compression to great expansion; overall, compression is expected to continue (in past 10 years margin fell from 4.5% TO 3.8%)
- Pricing competition continues to be stiff, especially for deposits; Fed rate drops don't get absorbed into deposit pricing
- Overall, margin continues to experience pressure in many banks
- Larger banks offset margin deterioration through improvements in efficient and non-margin driven revenue sources
- Yield curve is getting curvy

## Margin pressure (continued)

- Checking growth strategy needs refreshing (beware of the 6% free checking account)
- Margin dependence is risky even if things are going your way
- Market conditions make pricing more challenging than ever; no relief in sight

## The Credit Crunch?

- Loan growth continues to outstrip deposit growth nationwide
- Is the crunch real and does it matter? YES and YES
- C&I loans are growing at a brisk pace (11% annualized in some markets), and even construction loans are holding up surprisingly well
- Certain credit markets are under pressure (e.g. CRE, sub-prime)
- Secondary markets for certain credit products have shut down “on a dime”, causing alarm and a perception (and, sometimes, a reality – especially if you’re Bear, Stearns)) of a crunch
- As always, being a contrarian might present an opportunity

## The Deposit Story: The Next Chapter

- Deposit balances are growing, albeit at a slower rate than loans; wide regional variations
- Competition still intense but growth comfortable in many markets
- Pricing is challenging
- Checking account growth daunting; segmentation strategy works for many (HOA, “un-banked”, medical practices etc.)
- Internet bank flourishing, and customer retention grazing 50% for many, 70%+ for some



## Credit is Finally Getting Worse

- The predicted credit deterioration has started; liberalized terms, covenants and razor-thin pricing have come home to roost in late 2007
- Non-accrual loans for all banks have risen for each of the last three quarters; magnitude of credit problem understated in 2007 but fully revealed in 2008/2009
- Some sectors (builders, contractors, sub-prime) have been hit hard
- We haven't seen the end yet (the housing inventory is still being digested; 2008 will show the full brunt of the foreclosure flow)
- Loan growth is getting even more robust in most places, especially in C&I
- Real estate has ground to a halt in many markets; builders are keeping the land unimproved, servicing the debt (hopefully) and waiting for the market to turn
- Ensuring “early warning” culture is inculcated within your lender force is key<sup>9</sup>

## Credit (continued)

- Lessons learned:
  - The boy who cried “wolf” is finally right
  - Credit issues are somewhat local both geographically and segment-wise
  - Small business is still under-banked both in credit and deposit generation
  - Will the SEC and auditors change their posture on reserves and mark-to-market?

## The Payments Business Opportunity

- Still underutilized and growing
- Debit card activation
- Credit card portfolio building and usage
- Remote Deposit capture for both commercial and retail customers (USAA)
- Payments strategy gaining acceptance and fee income beginning to show results in some banks
- Opportunity window beginning to close

## The payments opportunity (ctd.)

- Non-cash payments growing at 4.6% for past 5 years, checks declining at 6.4%
- Debit cards growing at 17.5% and surpassed credit cards in transaction numbers
- ACH is the fastest growing payment vehicle at 18.6% CAGR; constitutes only 15.6% of non-cash payments but 40.8% of the value
- ATM activity plunged to new lows (25% off the 2004 peak); transactions per ATM down from 6300 average per month in 1996 to 2000

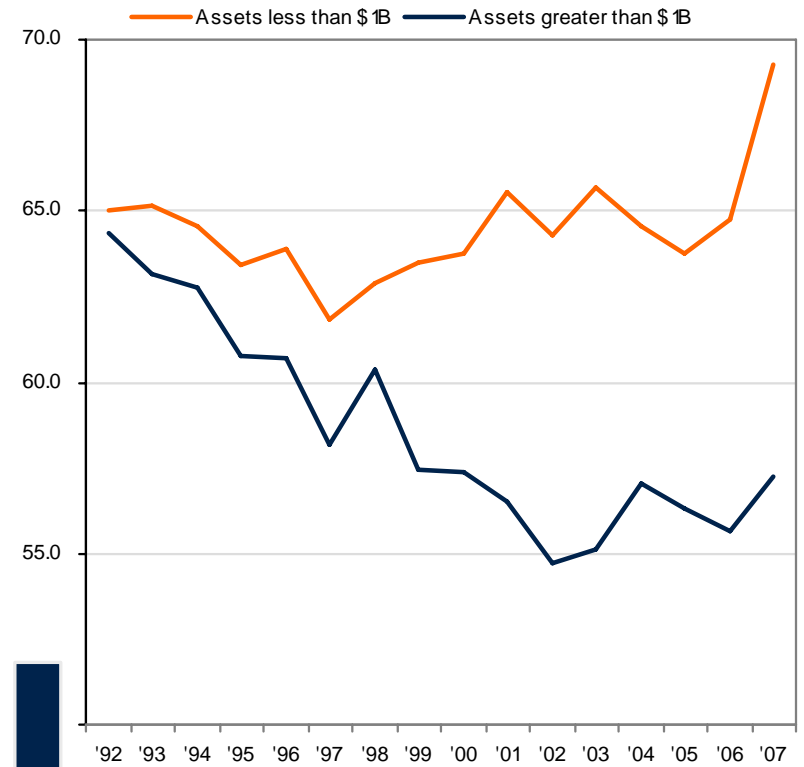
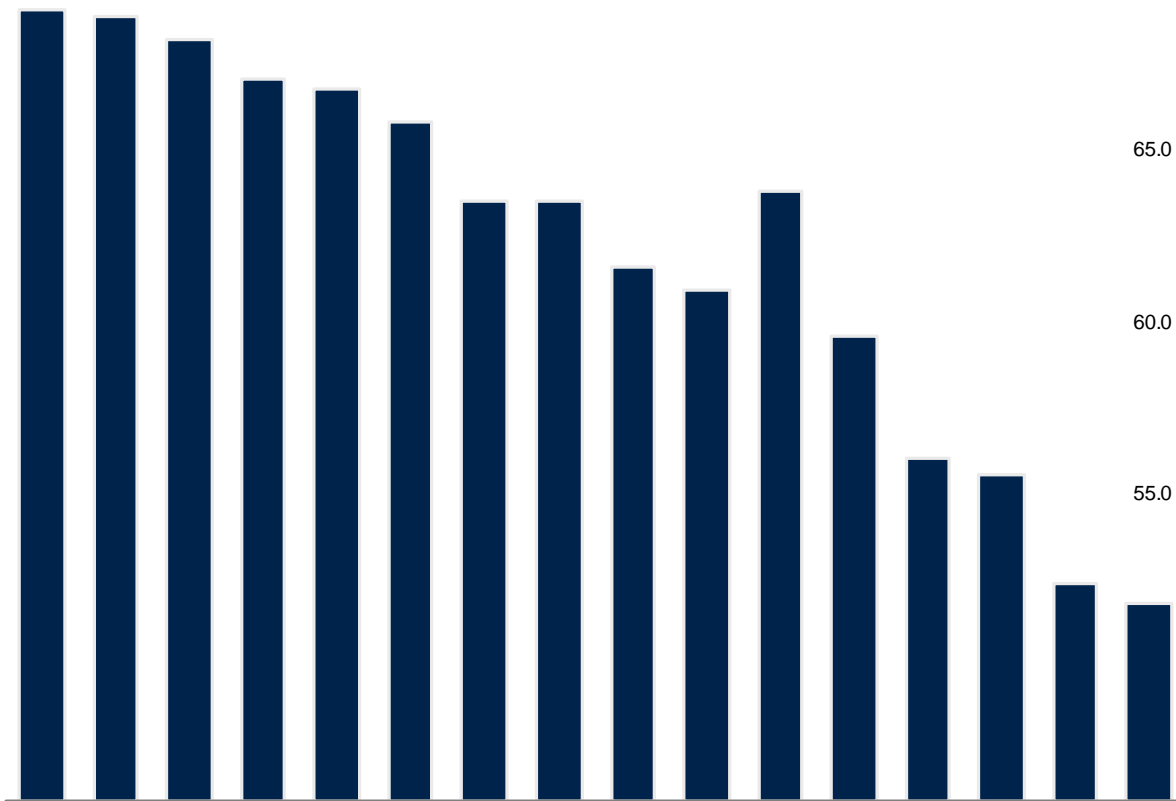
## The Acquisition Business – Hot and heavy or dead?

- The acquisition market is very mixed, due to huge uncertainty on balance sheet values and low bank currency
- Pricing is better but still not rational, especially in growth markets, especially for 5-10 year old banks with wholesale balance sheets
- Banks of all sizes are on the block; banks of all sizes are buying
- Bank de novo activity still robust; branch de novo activity ebbing
- MOEs are creeping back in

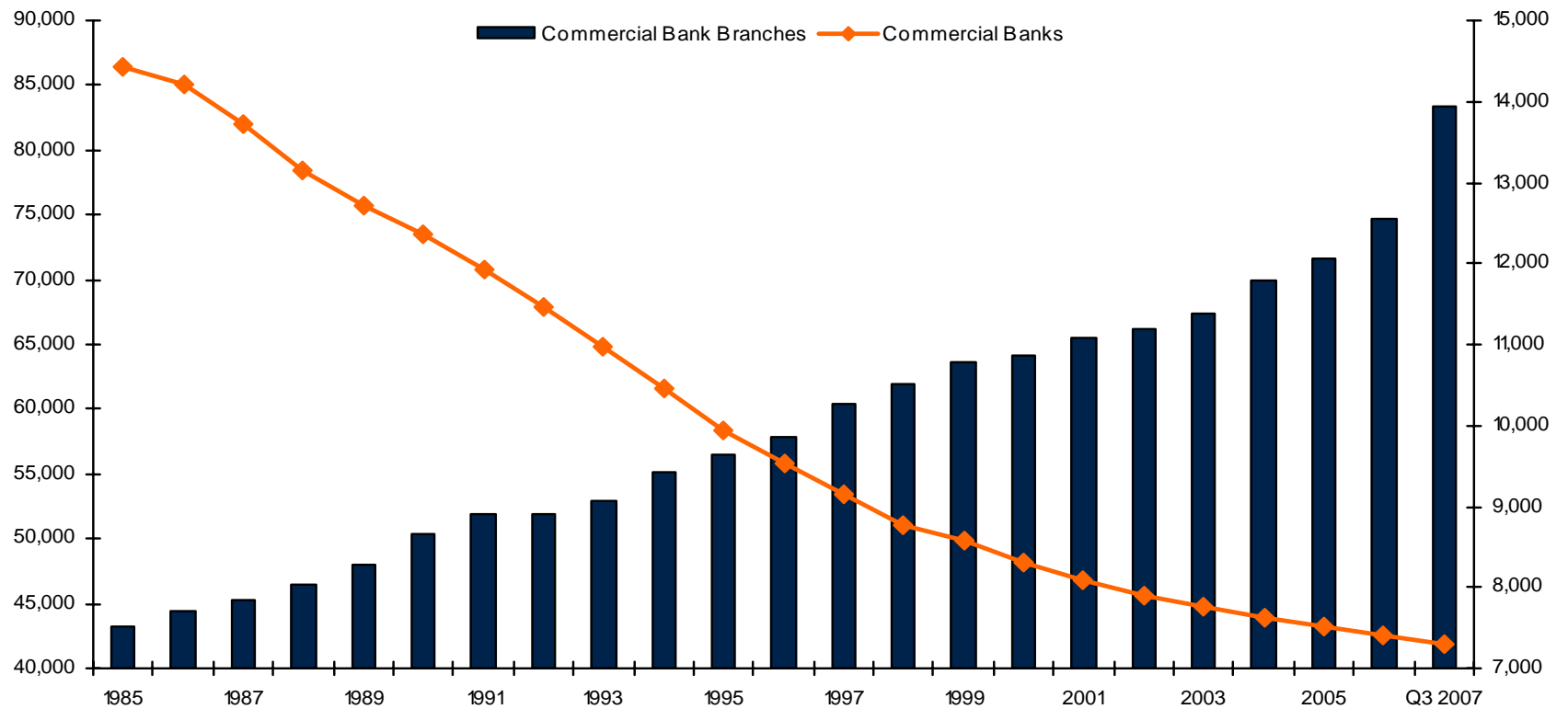
## What's on The Regulators' Mind?

- Credit quality #1 concern
- Liquidity comes next, with demand for detailed liquidity plans
- Risk-based capital is an issue for many
- Mark-to-market implications
- BSA/AML – civil money penalties continue
- No “pass” on pandemic preparedness plan

## Margin and efficiency

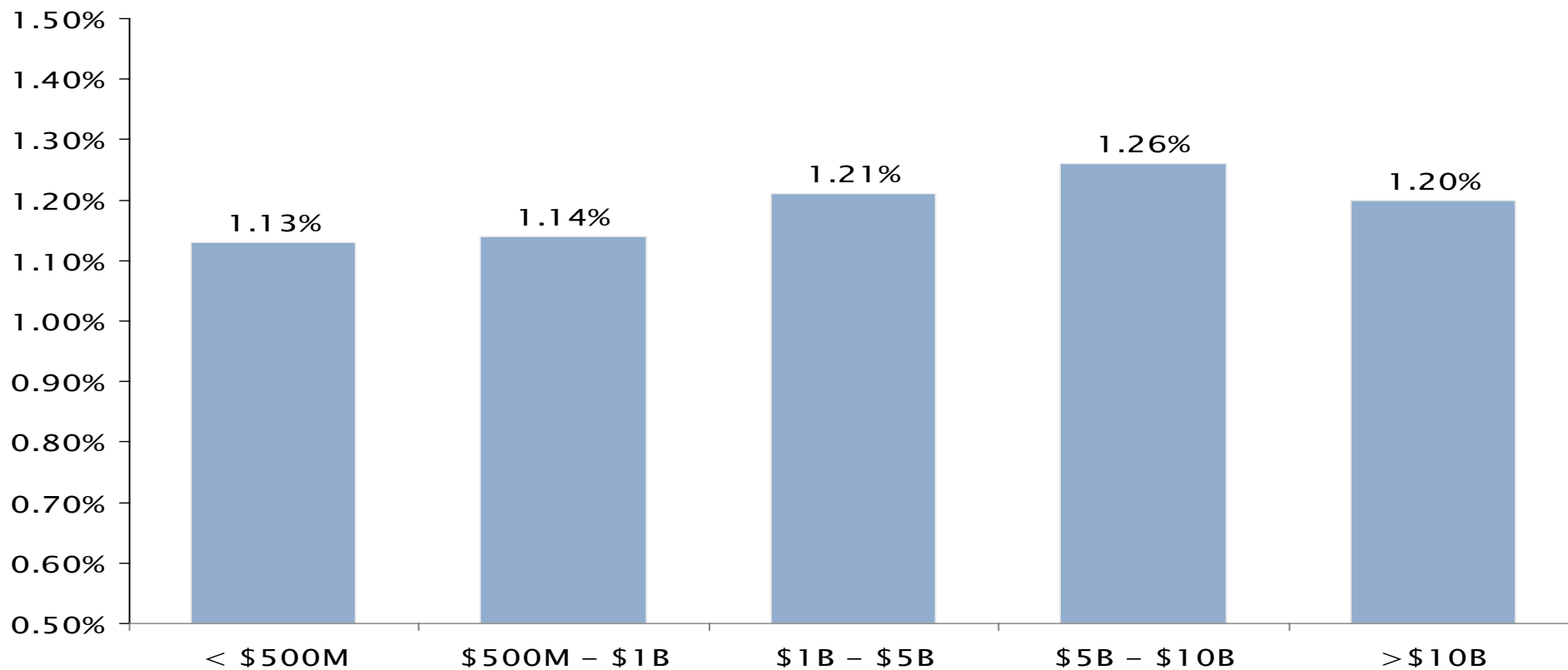


## Banks vs. branches

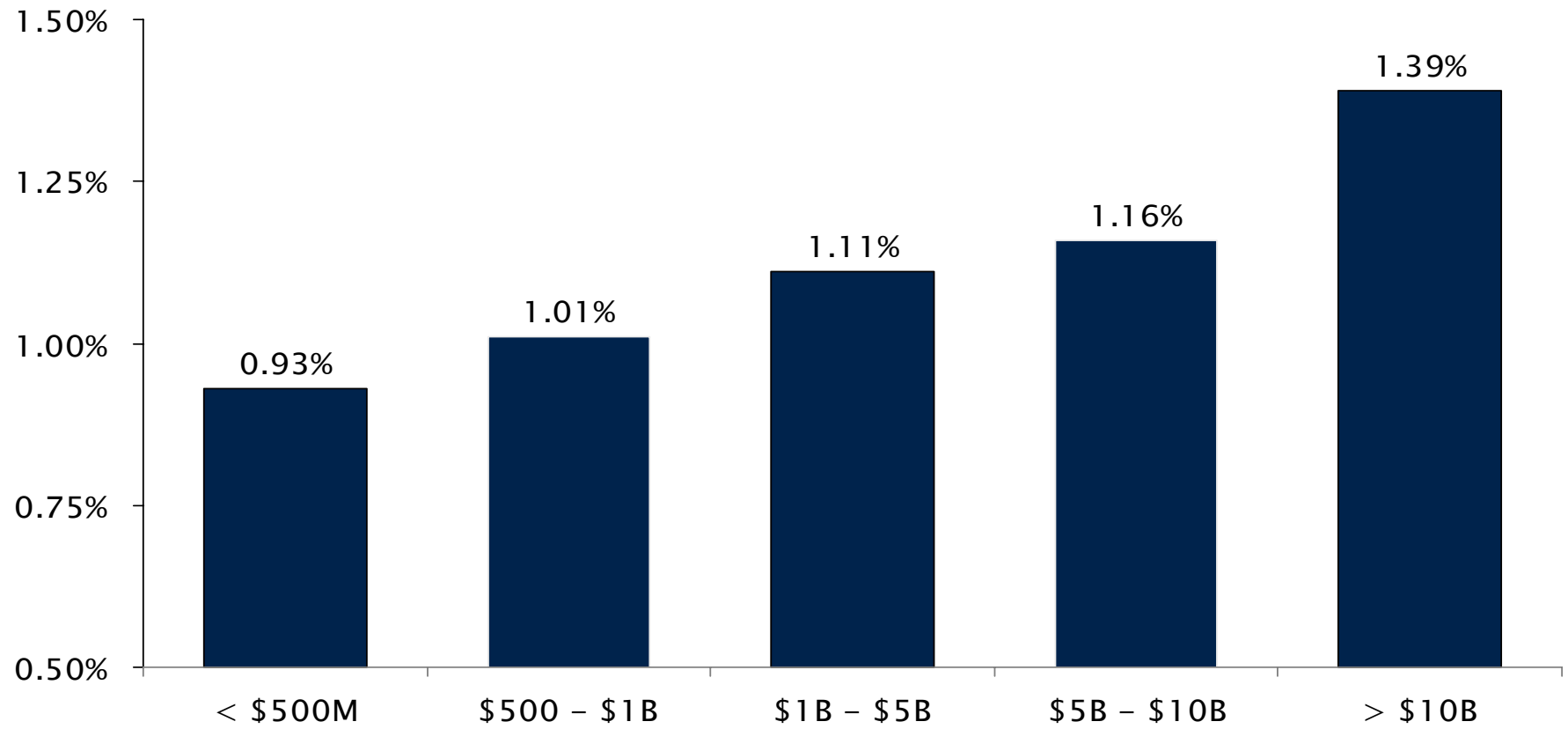




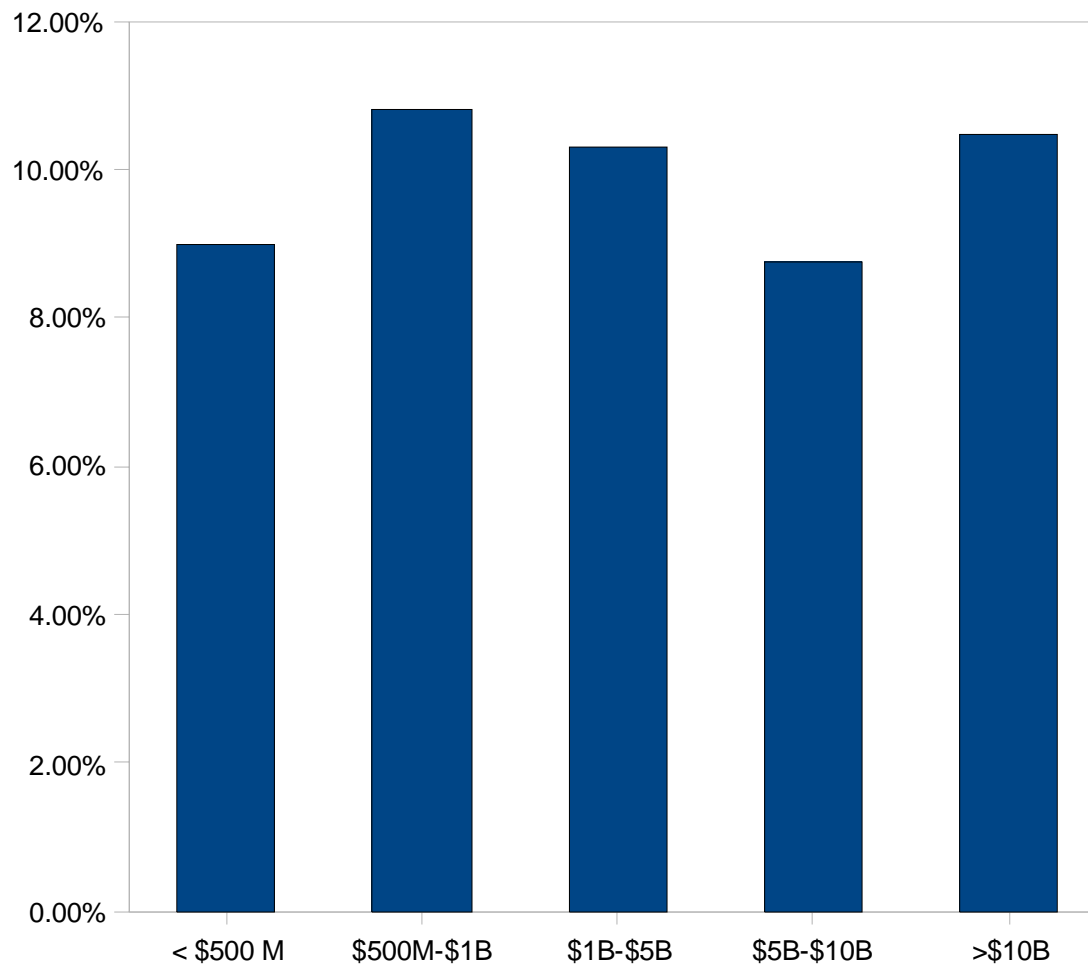
## Profitability 1996



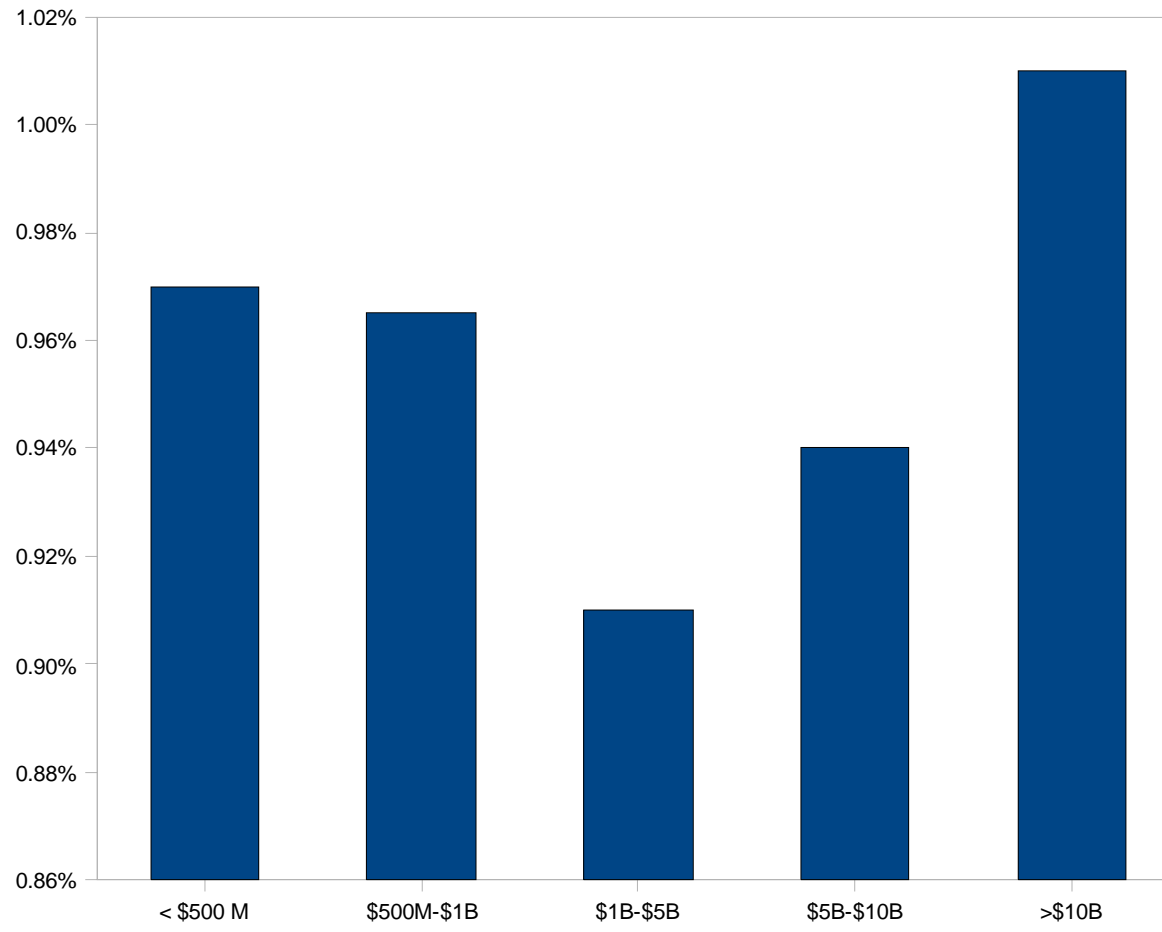
## Profitability 2006



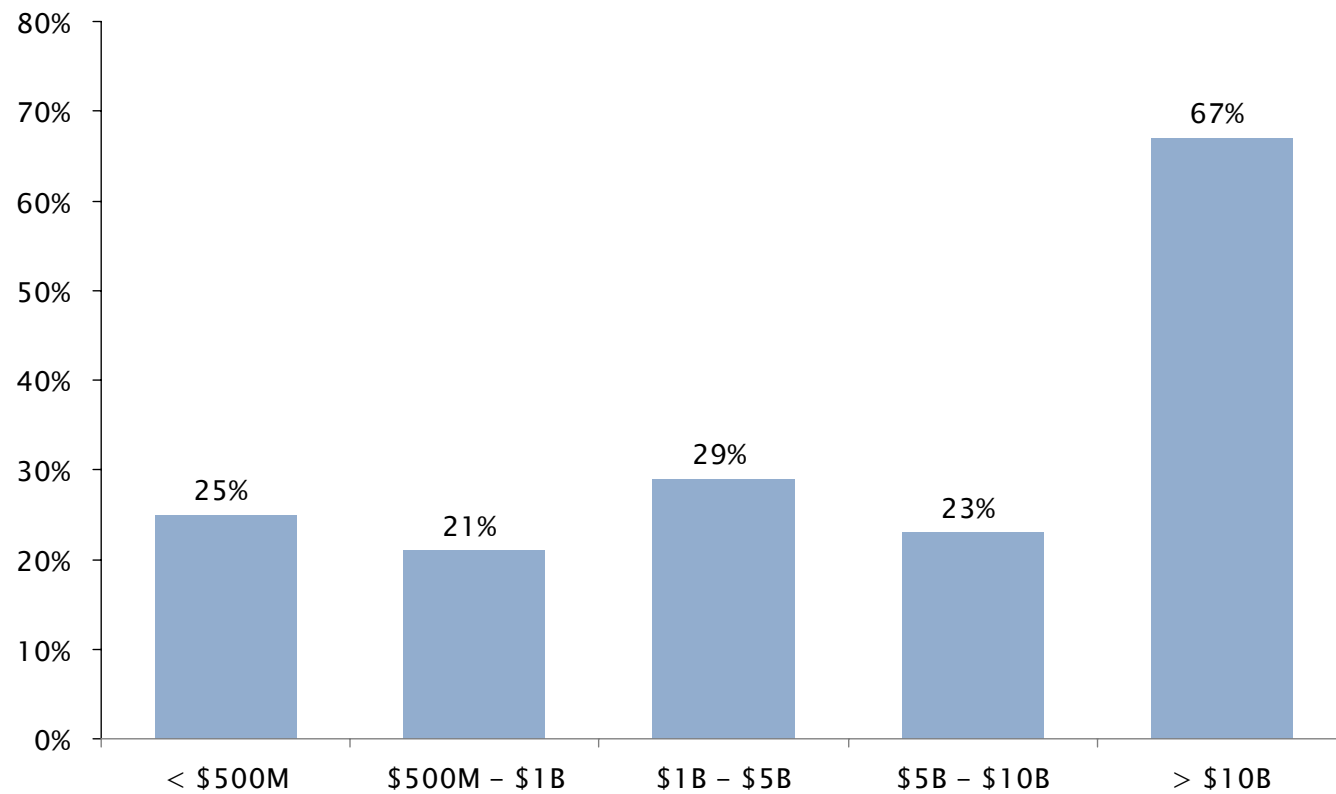
## FY 2007 - ROAE



## FY 2007 - ROAA



## Efficiency improvement 1996-2006



## Industry Trends

- Uncertainty abound
- Cash and capital are kings
- Stock prices in the tank; less differentiation among companies
- Regulatory scrutiny intensifying
- More volatile earnings are expected in the future due to credit issues and inconsistent margin behavior
- 2009 will be better for many
- Innovation at a trough
- Time of opportunity for capital-rich banks

## Observations

- Growing importance of cash flow between operating company and parent company, as obtaining credit at the holding company level becomes tougher and the TP market has shut down
- Capital infusions take longer as equity investors intensify their due diligence and increase reliance on regulatory exams
- Sellers begin to rationalize expectations given expensive funding, harsh non-depository competition and falling stock prices

