

Hello CFG clients,

Brian Harris here, tax manager of CFG Tax & Accounting. I have come to know many of you by doing your tax returns over the past few years; if I don't do your tax returns, you may have heard me speak at one of the recent client seminars. Valerie has offered me this wonderful opportunity to contribute to her weekly email updates to you folks, which I have graciously accepted!

As a precursor, you will find my commentaries to be widely varied; sometimes I'll take a "just the facts" approach, at other times I'll be in a subjective commentary mood. Still other times, I will borrow a published article that I feel is timely and/or may not get the mainstream exposure that it is rightly due. In any event, I trust you'll find my emails as informative and as useful as that which you've come to expect from Valerie.

Today's email will be a combination all three categories; a just-the-facts borrowed article with some subjective commentary. Val, Shari and I read well over 100 articles a week ranging from mainstream to the more obscure; all in an effort to get to the bottom line truth. Too often lately, however, it seems the mainstream media is either hiding/obscuring the truth or their journalists are compensated on the sheer volume of articles they write so they just don't "dig in". Or maybe the media outlets themselves are politically steered into the perspective from which they write. In any event, we feel it is our duty to you to sift through and find the relevant data that has the potential to save or make you money in these turbulent times.

I'll start with the subjective commentary first, because as many of you know I spent 20-years in the banking industry. And the article (actually it's a publication) I'm borrowing is the most recent FDIC Quarterly Banking report dated 03/31/09 ([link here](#)). While this quarterly report contains a significant amount of useful data, I am focusing on the number of "problem" banks buried in this report. While the names of the problem Banks are not revealed, the number of problem Banks is reported. For perspective, I have compiled the following chart from the quarterly data presented in these reports going back to 2001:

| REPORTING PERIOD | # OF FDIC INSURED BANKS REPORTING | # OF PROBLEM BANKS | INCREASE (DECREASE) | % OF PROBLEM BANKS | BANK FAILURES | FOOTNOTES |
|------------------|-----------------------------------|--------------------|---------------------|--------------------|---------------|-----------|
| 3/30/2001        | 8,237                             | 78                 | 2                   | 0.95               | 0             | -1        |
| 6/30/2001        | 8,178                             | 80                 | 2                   | 0.98               | 1             | -2        |
| 9/30/2001        | 8,149                             | 74                 | -6                  | 0.91               | 1             | -3        |
| 12/31/2001       | 8,080                             | 95                 | 21                  | 1.18               | 0             | -4        |
| 3/31/2002        | 8,005                             | 102                | 7                   | 1.27               | 6             | -5        |
| 6/30/2002        | 7,966                             | 115                | 13                  | 1.44               | 1             | -6        |
| 9/30/2002        | 7,933                             | 126                | 11                  | 1.59               | 2             | -7        |
| 12/31/2002       | 9,354                             | 136                | 10                  | 1.45               | 2             | -8        |
| 3/31/2003        | 9,314                             | 129                | -7                  | 1.39               | 1             |           |
| 6/30/2003        | 9,267                             | 125                | -4                  | 1.35               | 1             |           |
| 9/30/2003        | 9,236                             | 116                | -9                  | 1.26               | 0             |           |
| 12/31/2003       | 9,182                             | 116                | 0                   | 1.26               | 1             |           |
| 3/31/2004        | 9,116                             | 114                | -2                  | 1.25               | 3             |           |
| 6/30/2004        | 9,079                             | 102                | -12                 | 1.12               | 1             |           |
| 9/30/2004        | 9,025                             | 95                 | -7                  | 1.05               | 0             |           |
| 12/31/2004       | 8,975                             | 80                 | -15                 | 0.89               | 0             |           |
| 3/31/2005        | 8,930                             | 79                 | -1                  | 0.88               | 0             |           |
| 6/30/2005        | 8,867                             | 74                 | -5                  | 0.83               | 0             |           |
| 9/30/2005        | 8,853                             | 68                 | -6                  | 0.77               | 0             | -9        |
| 12/31/2005       | 8,832                             | 52                 | -16                 | 0.59               | 0             | -10       |
| 3/31/2006        | 8,790                             | 48                 | -4                  | 0.55               | 0             |           |
| 6/30/2006        | 8,778                             | 50                 | 2                   | 0.57               | 0             |           |
| 9/30/2006        | 8,743                             | 47                 | -3                  | 0.54               | 0             |           |
| 12/31/2006       | 8,681                             | 50                 | 3                   | 0.58               | 0             |           |
| 3/31/2007        | 8,650                             | 53                 | 3                   | 0.61               | 1             |           |

|            |       |     |    |      |    |     |
|------------|-------|-----|----|------|----|-----|
| 6/30/2007  | 8,615 | 61  | 8  | 0.71 | 0  |     |
| 9/30/2007  | 8,560 | 65  | 4  | 0.76 | 1  | -11 |
| 12/31/2007 | 8,533 | 76  | 11 | 0.89 | 1  | -12 |
| 3/31/2008  | 8,494 | 90  | 14 | 1.06 | 2  | -13 |
| 6/30/2008  | 8,451 | 117 | 27 | 1.38 | 2  | -14 |
| 9/30/2008  | 8,384 | 171 | 54 | 2.04 | 9  | -15 |
| 12/31/2008 | 8,305 | 252 | 81 | 3.03 | 12 | -16 |
| 3/31/2009  | 8,246 | 305 | 53 | 3.7  | 21 | -17 |

- (1) Gains on security sales lift industry profits to new record, despite decline in operating earnings Troubled Commercial & Industry loans continue to grow
- (2) Gains on security sales buoy profits; problems worsen in large Banks' commercial loans Charge-offs increase in credit card portfolios
- (3) Quarterly loss provisions reach highest level in more than 10-years Asset-quality indicators show further deterioration
- (4) Best 4th quarter ever helps full-year earnings to record level; Number and assets of "problem" banks surge during the qtr
- (5) Bank earnings rise to new record of \$21.7 billion; asset-quality weaknesses continue to grow.
- (6) Earnings climb to record-high \$23.4 billion; troubled commercial & industrial loans continue to rise
- (7) Gains on securities sales help keep earnings near record level; asset-quality problems continue to grow at large banks
- (8) Fourth-quarter earnings are third highest ever; largest number of Bank failures (11) in a year since 1994
- (9) Lowest total of problem banks since compiling data (36 yrs). Longest streak w/o a failure since 08/96 - 10/97
- (10) The most quarters w/o a failure since the inception of FDIC (1933)
- (11) Credit quality problems drag down earnings; real estate mortgage delinquencies skyrocket
- (12) Non-current rate on mortgages reaches new high; net charge-offs reach 5-yr high
- (13) Industry earnings decline 46% from a year earlier; troubled loans accumulate in RE portfolios
- (14) Industry income falls to \$5 billion; Quarterly loss provisions surpass \$50 billion; asset quality indicators continue to deteriorate
- (15) Highest quarterly failure since 1993 when 16 failed; asset quality problems continue to depress earnings
- (16) Industry posts \$32 billion loss (first quarterly loss since 1990); loan loss provisions/goodwill write downs/trading losses outstrip revenues; asset quality indicators show further deterioration
- (17) Charge-offs of \$37.8 billion only slightly less than 4th qtr charge-offs of \$38.5 billion; charge-offs did not stem non-current loans which saw the largest quarterly increase (\$59 billion) & at highest rate since 1991; largest number of failures since 1992;

First, let me explain how to use the FDIC's report. Once you click on the blue link provided above, use the drop down box where it says "Report Date:" Choose the quarter that you wish to review then click the "Complete QBP" link in blue below the drop down box wherein the complete report will be opened. Typically, the first 3-4 pages provide written narrative which I find to be extremely informative. The section that outlines the problem Banks is the last paragraph of written narrative before all the figures/numbers are presented (typically page 3 or 4).

### **SOME TELLING SIGNS**

The chart I put together from these quarterly reports reveals some interesting trends; the 2<sup>nd</sup> column in the chart reflects how the number of Banks reporting is declining. This reflects a trend that began in the late 90's wherein the banking industry began consolidating (i.e. mergers and acquisitions). This is actually a good thing since the United States has had way too many banks for its size. By contrast, Germany has 2,400 banks; Russia has 1,350, India has 282, Canada has 60 . . . so you can see the U.S. has by far the greatest number of banks in the world. This must be a profitable business here in the U.S. eh?

The 3<sup>rd</sup> column shows the number of problem Banks and the 4<sup>th</sup> column shows the net increase (decrease) from the prior quarter. As you can see from these numbers, beginning in 06/08, the number of problem Banks crossed the 100 mark for the first time since the period from 2002-2004 which was during the last U.S.

recession. More interestingly, the number of problem banks began rising in 12/06. While I've not dug into any longer term patterns on this, the data from these reports certainly could have been an early indicator that something was amiss in our economy as early as 12/06, a full year before The National Bureau of Economic Research officially deemed 12/07 as the start of the current recession. I have footnoted some highlights of the written narrative taken from several of the quarterly reports which I also found very revealing. During the 2001 recession, the number of problem Banks was rising; additionally, footnotes 1-8 outline how the Banks problem loans were increasing, but their earnings or profits were also increasing . . . more on this later.

### **SO WHERE ARE WE NOW?**

The concerning issue here is that **the number of problem Banks keeps rising and has hit 305 in the 1<sup>st</sup> quarter of this year, the highest level since 1991**. Maybe even more startling, we have come across information from lesser known but very reliable sources that the true number of Banks that **should** be on this list is over 1,000. These sources use a Bank solvency formula called the *Texas Ratio* to determine the health of a Bank. This [formula](#) grew out of the Texas savings & loan crisis of the 1980's and reveals that if a Bank's Texas Ratio is 100% or above, it is likely to fail. What is interesting about this formula is that two recently failed banks, IndyMac Bank and Washington Mutual Bank had Texas Ratios of 140% and 119% respectively, however neither Bank was on the FDIC's problem list. Another Bank, Wachovia, nearly failed before it was bought by Wells Fargo Bank; its last known calculated Texas Ratio was 86% but it too was not on the FDIC's problem list.

One of the components for both the FDIC's problem list and the Texas Ratio formula is the amount of a Bank's capital or equity. As you may have read lately, government TARP funds have been forced upon many Banks, funds which would be classified into a Bank's overall equity capital. Additionally, Banks have been on a race to raise additional equity capital to get out of their TARP commitments, so they have been bringing new public stock offerings to the market. As a result of increased equity capital, their Texas Ratio will drop. While this may help to keep a Bank afloat for awhile, it does not address the real problem of a continuing rise in bad loans. As unemployment continues to rise, more and more loans (i.e. credit cards, auto loans, home mortgages) continue to go delinquent; hence causing the Texas Ratios to rise again. So, as you can see, the TARP funds and additional public stock offerings may offer the Banks short-term band-aid fixes, but these funds do not address the underlying fundamental problems that will result from continued bad loans.

As footnote 17 highlights, **the amount of noncurrent (i.e. delinquent) loans reported in 03/09 saw the largest quarterly increase in the three years that noncurrent loans have been rising**. Remember, first loans become noncurrent/delinquent before they are deemed "bad loans" and are written off. **In addition, the rate of increase in delinquencies appears to be increasing**. This is terrible news in that the Banks' newly acquired TARP or newly raised equity capital will be reduced as this pipeline of noncurrent loans starts going bad and has to be written off. This could lead to more Banks being added to the problem list, more failures, and possibly a second TARP program being suggested by our elected leaders.

As I mentioned earlier, during the 2001 recession the number of problem Banks was on the rise; the footnotes reported an increasing trend of problem loans but Bank earnings were also rising. Ultimately, what was happening was the Federal Reserve's (via Alan Greenspan) slashing of interest rates coupled with Congress' push for Banks to generate loans, primary home mortgage loans. So it seems that the economy was trying to correct during this time period, but these two key events prevented this self-correcting mechanism from kicking in and, instead, they fueled the economy and prolonged the correcting process until 2008 . . . only now we have even further to correct and more pain to endure.

### **SO, WHAT NEXT?**

Many economists say the key to economic recovery is stabilization within the banking system. Other economists say it is the consumer that will lead the economic recovery. Still others will say that if businesses cannot get working capital loans from Banks to keep their operations running, then layoffs will continue to take place in an effort to reduce expenses. You can see how all three of these (banking, businesses and consumers) are so closely intertwined. When consumers feel the threat of being laid off is gone and their job is secure, their personal financial situation stabilizes and they stop defaulting on their personal loans. This behavior stems the tide of defaulting loans at the banks, thereby stabilizing the Bank's balance sheet and the Bank is more apt to loan again to both businesses and consumers.

Unfortunately, in spite of the sporadic “green shoots” being mentioned in the mainstream media, I just don’t see anything shaping up fundamentally in our economy that would stem the tide for banks to lend, businesses to borrow or consumers to spend. The Federal Reserve has slashed interest rates to zero, however Banks have tightened their lending standards and Congress cannot push the Banks this time to make loans. Given the fact that we are in a global recession, coupled with the large reduction in the US manufacturing base, other countries are not demanding the few goods the U.S. still produces, so exports cannot pull us out of this. As optimistic a person as I am, I truly believe we are several quarters (if not years) from a true economic recovery.

The FDIC’s Quarterly Banking Profile is released 50-60 days after the end of a quarter. Since the Banks will be reporting their 06/09 quarterly earnings to the market before this report is released, we will have a precursor to where the Banks are sitting before the report comes out. In any event, I’ll be sure to update you when the next quarterly report comes out sometime toward the end of August. It will be entertaining to follow this report over the quarters to come and see how much insight we can glean from its findings.

Val, Shari and Brian  
Cascade Financial Group

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