The United States' banking system - recovery stage

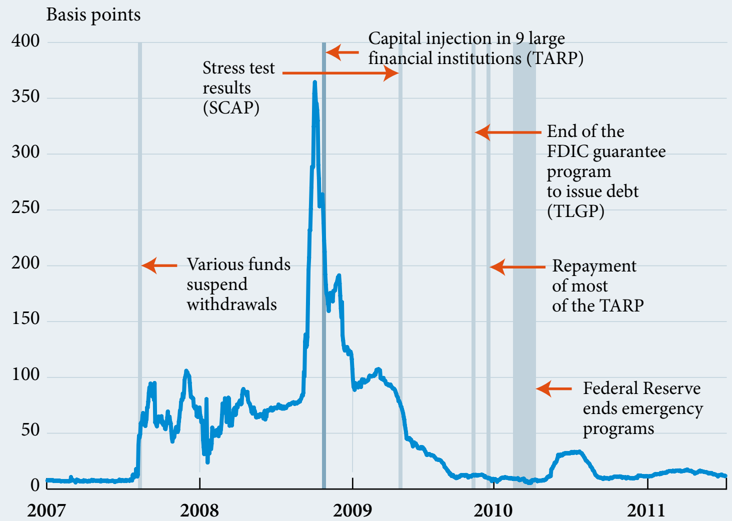
In the first half of 2012, the profits of US banks exceeded analysts' expectations and reached a figure similar to that of the same period in 2007. After posting their lowest profits since 1985 in 2009, profitability has maintained a sustained and widespread improvement, reducing the number of banks with losses,(1) institutions with problems of viability and bankruptcies.(2) These positive developments have generally occurred in the more than 7,200 retail banks(3) and 5,000 bank groups in the country.(4)

Several different factors have boosted this profitability (see the second graph). The first, and most relevant, is the reduction in provisions within a context of economic recovery. Higher credit quality of assets has meant that provisions have gone from consuming more than 100% of the profit in 2009 to 24% in the first half of 2012.(5)

The second positive factor is the great resistance of the interest margin, achieved thanks to a more balanced financing structure, partly possible due to the special measures applied to support the financial sector. Among these, of note is the provision of guarantees, the carrying out of stress tests and government injections of capital.

THE MAIN MEASURES FOR FINANCIAL STABILITY AND THEIR EFFECT ON THE INTERBANK MARKET

3-month LIBOR-OIS spread



SCAP: Supervisory Capital Assessment Program.
TARP: Troubled Asset Relief Program.
FDIC: Federal Deposit Insurance Corporation.
TLGP: Temporary Liquidity Guarantee Program.

SOURCE: Bloomberg.

(1) This went from 30.8% in 2009 to 10.9% in June 2012. FDIC statistics (Federal Deposit Insurance Corporation).
(2) Bankruptcies went from 157 in 2010 to 31 in the first half of 2012. FDIC statistics.
(3) Financial institutions supervised by the FDIC.
(4) Bank holding companies usually include a retail bank and other non-banking subsidiaries.
(5) The non-performing loan (NPL) rate for financial institutions guaranteed by the FDIC stood at 5.5% at the beginning of 2010 and 3.9% in June 2012.

As a result, financing costs have moderated and substantial interest margins have been achieved, even within a context of deleveraging and with official interest rates close to zero. Specifically, between 2005 and 2012, the average interest margin has remained at around 3% of assets.[6] This is partly due to wholesale funding being replaced with low-cost guaranteed deposits. In bank holding companies, deposits have gone from accounting for approximately 45% of assets in 2008 to 65% in June 2012. This increase stems from the risk aversion of some institutional investors but also from the greater cover provided by the deposit guarantee scheme. In December 2010, cover increased from 100,000 dollars to 250,000 dollars. At the same time, additional unlimited cover was also established for current accounts, up to December 2012. Similarly, the option to issue government-backed securities has helped to reduce wholesale funding in the short term (over 34% of the total financing in 2006 but less than 20% in March 2012). The differential effect of the new financing structure on costs and revenues has also been significant. Between 2006 and 2011, while costs contracted at an average rate of 23% annually, revenue only shrank by 5%.

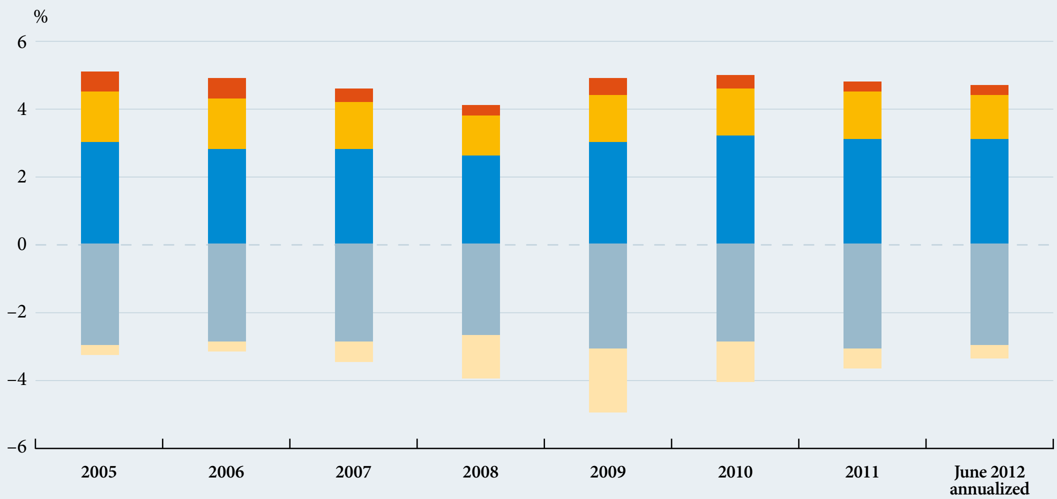
A third factor that has contributed to the recovery in profitability is the growth in profits from trading. The contribution of this source of income has been moderate for banks but substantial for bank holding companies. These saw their income multiply by five between 2008 and 2009. This big increase was due to the change in the financial sector's competitive structure, which has brought large independent investment banks under the umbrella of holding companies.[7] In the decades prior to the crisis, the capital markets gradually gained territory from banks, eventually channelling 70% of the economy's financing needs. But after the crisis, many of the most active institutions in these markets saw the business carried out in capital markets shrink and their size decreased considerably as well. In 2008, some large financial companies and four of the five largest independent investment banks were acquired by bank holding companies or became a holding company to broaden their financing options and access guaranteed deposits. Consequently, since 2009 the resulting companies have increased their profits although their greater dependency on trading has also increased their volatility.

The first two factors mentioned above - the reduction in provisions and the defence of the interest margin, have been encouraged by various policies aimed at promoting financial stability and recovering economic growth. In the United States, maintaining financial stability is an explicit goal of the FDIC, the Treasury and the Federal Reserve. Moreover, the Treasury and the Federal Reserve also aim to stimulate economic growth. Unlike what is happening in Europe, having mutual goals and a single fiscal authority has encouraged fast, coordinated and decisive action against the crisis (see the first graph). The aid to maintain financial stability was designed with a very broad scope, given how interconnected the markets are. It provided its positive effects at the same time as traditional measures of expansionary monetary policy were being applied, combined with several rounds of quantitative easing (see the box «Benefits and risks of the new monetary policy instruments») and with a countercyclical fiscal policy. In retrospect, pursuing both goals simultaneously (economic growth and financial stability) made these measures more effective. At the end of 2009, the first signs could already be seen of an economic recovery that, albeit with some ups and downs, has continued until now.

As a result of all this, profitability has notably improved, helping to boost solvency and pay off government injections of capital. Some challenges still remain, however. Firstly, the interest margin may fall with the elimination of unlimited insurance cover for current accounts. Moreover, trading income is relatively volatile. On the other hand, the housing market is going through an initial phase of recovery which, if it does not consolidate, could

(6) The GAAP accounting standards allow derivatives to be reported net rather than gross.
(7) The large independent investment banks were Lehman Brothers, Morgan Stanley, Goldman Sachs, Bear Stearns and Merryl Lynch.

EARNINGS BEFORE TAX OVER AVERAGE ASSETS (*)



	2005	2006	2007	2008	2009	2010	2011	June 2012 annualized
RoA (%)	1.28	1.28	0.81	0.03	–0.07	0.65	0.88	0.99
RoE (%)	12.43	12.30	7.75	0.35	–0.72	5.85	7.86	8.84

NOTE: (*) Financial institutions guaranteed by the FDIC (Federal Deposit Insurance Corporation).
SOURCE: FDIC.

harm the NPL rate. At present, banks are still highly exposed to real estate and the NPL continues to be historically high. The real estate developer sector has the highest rate (10.8%), the NPL rate for mortgages has hardly fallen (7.8%), and this sector includes most of the doubtful loans (60% of the total).

Moreover, bank holding companies, encouraged by the meagre dynamism in credit, have increased their holdings of government bonds at a time when fiscal consolidation is still an ongoing challenge in the United States. Other elements that might jeopardize the consolidation of the recovery in bank profitability are the slow recuperation of the job market and the possibility of Europe's sovereign debt crisis affecting the U.S. Similarly, the new competitive structure, with trading existing side-by-side with classic retail banking, could lead to too much risk being taken on by institutions given the implicit government support.

Lastly, regulations will also apply additional pressure. For example, McKinsey has quantified the impact of the new Basel III requirements at 3.2 percentage points of Return on Equity (RoE).[8] For its part, Standard & Poors estimates that the new national financial regulation (Dodd Frank Act - DFA) could reduce the RoE by up to 2 percentage points.[9] The Financial Stability Oversight Council itself, created under the DFA, points out that this regulation could push up financing costs due to a possible downgrade resulting from lower expectations of a government bail-out although, for the moment, there is still the belief that the large banks will continue to benefit from some kind of government support.

(8) «Assessing and addressing the implications of new financial regulations for the US banking industry»; McKinsey Working Papers on Risk, Number 25. March 2011.
(9) «Two Years On, Reassessing The Cost of Dodd-Frank For The Largest U.S. Banks», Standard & Poors, 9 August 2012.

Nonetheless, this improved profitability has helped the US banking system to become more solvent today than it was in 2006. Specifically, Tier 1 capital over risk-weighted assets of bank holding companies has increased by 5 percentage points in three years, up to 11%. The financing structure is more balanced and, under the DFA, supervisory systems have been strengthened and have broadened their scope.

But the coast is not completely clear and there is a real danger of this recovery not becoming firmly established. In addition to the challenges mentioned above, in the new competitive scenario it will also be complicated to achieve any significant additional improvements in recurring revenue, so institutions will have to act on operating costs to avoid a squeeze on profits.

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