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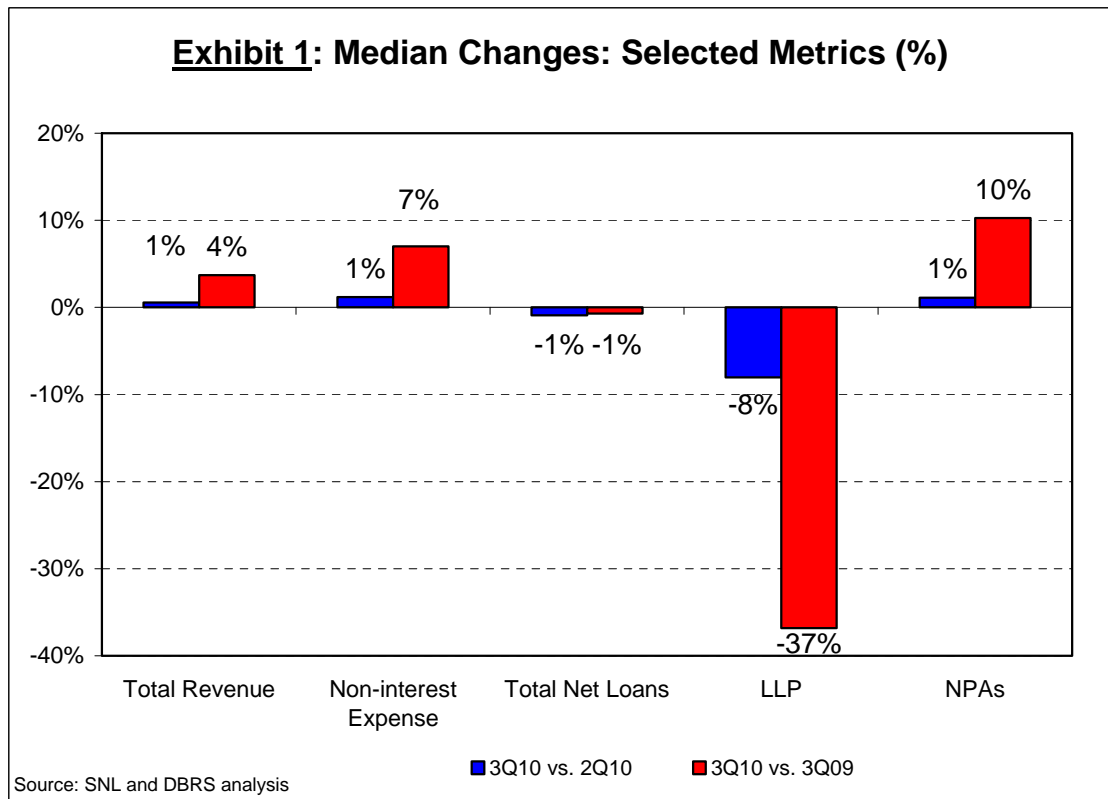
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## U.S. BANKS' 3Q10 EARNINGS: IMPROVING RESULTS DRIVEN BY LOWER PROVISIONING; HEADWINDS REMAIN

With almost all banks having reported quarterly results to date, DBRS views the U.S. Banks' 3Q10 results as mediocre. While results generally showed a sequential quarter improvement driven by lower credit costs from an improving asset quality picture, the improvement remains slow and uneven (See Exhibit 1). Results were bolstered by banks releasing reserves and strong mortgage banking results, not by sustainable revenue growth. Indeed, the largest banks especially benefited from releasing reserves as they were generally more aggressive in dealing with asset quality issues at the beginning of the cycle than the smaller regional/community banks. Despite solid expense control, expenses generally grew faster than revenues. This dynamic highlights the numerous revenue headwinds facing banks today, including shrinking loan balances and new regulatory rules that have negatively impacted revenues and increased regulatory compliance costs.

Given the improving, albeit uncertain, operating environment and capital raises at most banks, DBRS expects U.S. bank ratings to become increasingly stable. Banks still reporting losses from elevated asset quality problems will likely see pressure on their ratings. Moreover, the uncertain operating environment and questionable strength of the economic recovery will likely keep upgrades muted until new job creation climbs driving unemployment down.

**Exhibit 1: Median Changes: Selected Metrics (%)**



### Uneven Economy, Uneven Results

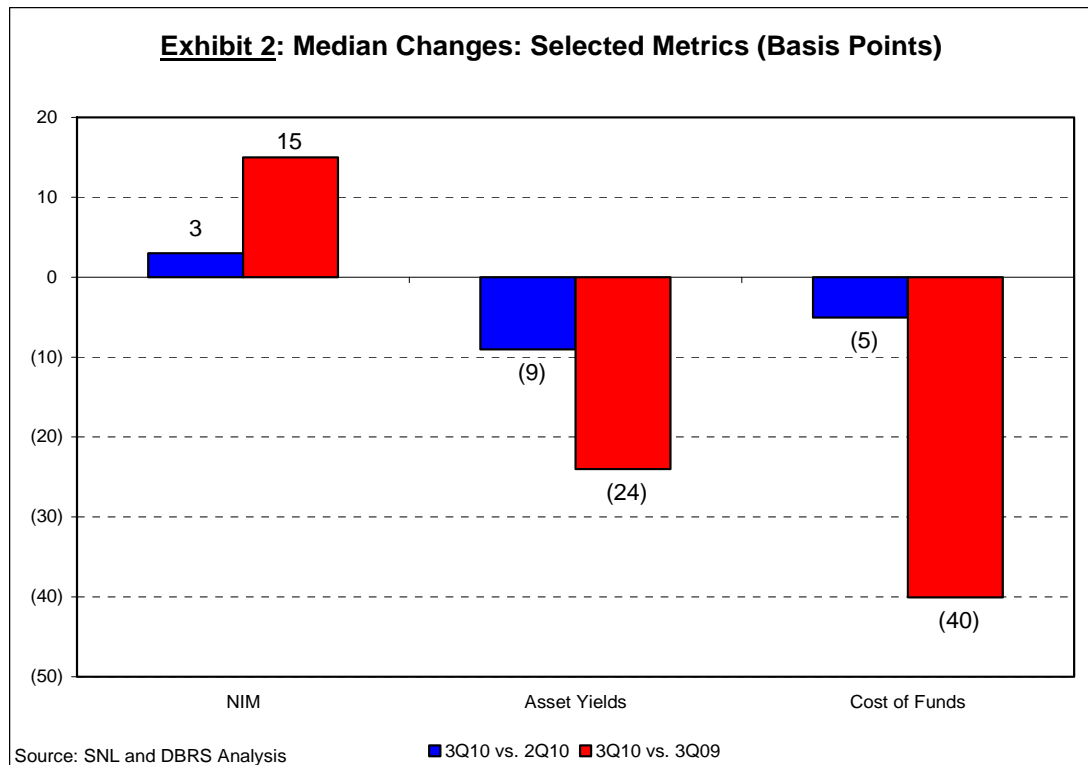
As stated in earlier commentaries, the uneven economic recovery is causing a divergence in results with some regions already seeing some loan demand and improving credit metrics, while others are still struggling with higher levels of nonperforming assets (NPAs) that necessitate additional loan loss reserve building. Earlier in the year, banks with capital markets businesses were able to benefit from robust trading results, particularly in fixed income, to help offset elevated credit costs. However, these revenues have declined significantly on lower volatility and less client activity. Even though the economy is recovering, the gradual pace of the recovery is not generating enough jobs to put a dent in the nation's high unemployment rate, which should keep the pace of the recovery subdued.

### Flat Net Interest Income

With funding costs declining more quickly than asset yields, the median bank net interest margin increased three basis points during the quarter with the majority of banks reporting margin expansion (See Exhibit 2). However, the median loan portfolio is still contracting, albeit at a very modest rate of 0.9% sequentially, which has pressured bank margins. This headwind will not abate until loan demand picks up and banks do not have to park excess liquidity into lower yielding, shorter duration securities. To help stem the contraction in loan portfolios from the targeted run downs in riskier assets like construction loans, as well as weak loan demand, some banks have started to portfolio some residential mortgage originations rather than sell them to Fannie or Freddie.

### Additional Margin Pressure Looms Absent Loan Growth

Positively, the majority of banks had reported higher net interest margins with a median increase of three basis points (See Exhibit 2). Bank cost of funds has declined more rapidly than asset yields. With loan demand weak, banks have not needed funding and have lowered deposit costs. Margins have benefited the most from higher priced CDs maturing and either running off or being replaced at much lower yields. DBRS notes that this benefit has largely run its course at most banks, and so, without loan growth, margins will be pressured.



### Diverse Sources for Non-Interest Income Growth

Even with weaker trading results and the implementation of new rules governing overdraft and debit interchange fees, non-interest income increased at over half of the banks with a median increase of 0.7%. Banks generally benefited from lower other-than-temporary impairment charges and harvested some securities gains, as market valuations improved. Most banks reported very high opt in rates, particularly for habitual overdraft users, so the revenue impact for overdraft fees was muted. Positively, low interest rates, better spreads, and high levels of refinancings contributed to very strong mortgage banking revenues. Nonetheless, with loan demand weak and regulatory changes pressuring revenues and increasing expenses, banks will have to adapt to the changing regulations and look for ways to make up lost revenues by charging more for other services.

### Credit Improvement Facilitates Reserve Releases

Once again, median delinquencies, NCOs and loan loss provisions all continued to trend in a positive direction. However, NPAs deteriorated with a median increase of 1.1% with over half of all banks having higher NPAs. Positively, both delinquencies and NCOs trended down as the majority of higher loss content construction loans have mostly been dealt with. Again, the improvements were not as strong or broad-based and were lower than DBRS had anticipated. The primary driver of the improved 3Q10 results were lower loan loss provisioning needs with a median improvement of 8% relative to 2Q10 and a 36.8% improvement from year ago levels. DBRS notes that the majority of banks actually had NCOs exceeding the provision for loan losses, which lowered reserve levels. DBRS expects continued improvements on the asset quality front, but the recovery should remain uneven and slow.

### **Stronger Capital Levels Could Lead to Share Repurchases and Higher Dividends**

DBRS notes that over 60% of reporting banks had better sequential quarter results. Improved earnings, combined with shrinking balance sheets and lower risk-weighted assets, led to materially better capital levels at banks. While there is still some uncertainty regarding the final outcome of regulatory requirements, some banks have begun repurchasing shares and have indicated that dividend increases are on the horizon. Nonetheless, most banks continue to build capital during the uncertain economic environment and many prefer to use capital for growth opportunities rather than returning capital to shareholders.

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