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By [GRETCHEN MORGENSON](#)

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THE big banks that reported earnings last week made clear that the days of fat profits are over. Now the questions are these: How long will the lean times last, and what will they do to banks' earnings and stock prices in the future?

After last week's earnings announcements, financial services stocks took a dive. The Russell 1000 Financial Services index lost 7.2 percent of its value for the week.

Because financial companies are such a large part of the economy, their declines helped bring down the overall market as well. Financials currently make up almost one-fifth of the Standard & Poor's 500-stock index; the sector's 8.7 percent drop in value so far this year makes it the worst performer in the index.

Some investors seem to think that banks' current share prices reflect whatever grim earnings news remains ahead for the sector. But anyone who thinks that we have hit bottom in the increasingly scary lending world is paying little mind to the remarkably low levels of reserves that the big banks have set aside for loan losses. Indeed, loss provisions as a percentage of total loans held for investment plummeted to a historic low in the second quarter of 2007, the most recent period for which comprehensive figures are available.

Now that the credit cycle has turned from boom to bust, those falling reserves must be replenished. And that will have to come from earnings.

That process of reserve-bolstering started in earnest last week. As the major banks reported their third-quarter results, all moved to raise their reserves significantly. [Bank of America](#) set aside \$2 billion in loan loss reserves in the third quarter, a 74 percent increase from the same period in 2006. [Wachovia](#) more than doubled its provision for losses, bringing it to \$408 million from \$108 million in the same period last year.

BUT Zach Gast, an analyst at the RiskMetrics Group, thinks these increases are just the beginning of a series that will put pressure on bank earnings for several years, not just a few quarters. Indeed, under a moderate-case scenario that Mr. Gast recently outlined in an interview, bank earnings could fall as much as 18 percent over the next three years as a

result of rising loss provisions. Deteriorating credit quality, combined with historically low reserve levels, could force the banks to bolster their loan loss provisions by \$30 billion to \$85 billion over the same time frame, he said.

“The nonperforming loan numbers are going up so quickly,” Mr. Gast said. “We do expect those loan loss provisions to be higher for quite some time.”

Even though the loan loss reserves that banks disclosed last week looked relatively large, they shrank considerably when compared with the nonperforming assets saddling the banks' balance sheets. For example, while Bank of America's \$2 billion loss provision was up 74 percent, year over year, nonperforming loans more than doubled in the period, to \$3.37 billion from \$1.66 billion.

Nonperforming loans as a percentage of assets at Bank of America rose to 0.43 percent in the third quarter of 2007, from 0.25 percent in the 2006 period. The aggregate figure set aside for loan losses — \$9.54 billion — grew 7.5 percent at the bank, but the reserves as a percent of total loans fell to 1.21 percent from 1.33 percent in the same period last year.

Part of the problem for banks is a result of an almost two-decade drop in loan loss reserves. Now everybody has to play a serious game of catch-up. Over the past 17 years, Mr. Gast said loss reserves as a percent of total loans held for investment at banks have plummeted, falling to 1.23 percent in the second quarter of 2007 from 2.46 percent in 1990.

Of course, bankers are optimists by nature, and a rosy outlook can lead to under-reserving. But there is another factor helping to drive down reserves, as Mr. Gast points out — a 1998 Securities and Exchange Commission examination of how SunTrust Bank engineered its reserves. The review resulted in a restatement which increased the bank's earnings and caused it to reclassify \$100 million it had set aside as loan loss reserves.

Regulators scrutinizing SunTrust's accounting contended that the bank had improperly over-reserved for loan losses, creating a sort of rainy-day fund that it could use to manage its earnings when necessary. SunTrust agreed to restate three years of financial reports and reverse \$100 million in reserves.

Bankers took note of the investigation, Mr. Gast said, and became reluctant to reserve too heavily in anticipation of a deteriorating credit cycle. Now that a credit bust looms, banks have far fewer reserves on their balance sheets than they might have had in previous cycles.

While troubles in residential mortgage loans have been evident for months, Mr. Gast notes that the credit cycle has not yet begun to turn down among other sectors — like commercial and industrial loans and consumer debt, which includes credit card obligations and [student loans](#). Residential real estate accounts for 59 percent of loans at United States banks, he said, while commercial loans total 18 percent. Consumer debt accounts for 15 percent of total loans.

“In residential mortgages, people are clearly aware of the problem,” Mr. Gast said. “Construction loans they are becoming more aware of, but there are entire segments of loans that haven't turned yet. If your take on the economy is bearish, then there is probably still more out there.”

The good news is that the nation's banks have enjoyed such a rich long run of profitability that they have a sizable chunk of capital to handle loan losses. Nevertheless, the hits to earnings caused by future increases to reserves are likely to be neither pretty nor brief.

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