

## CHAIRMAN'S CORNER

by James A. Kaplan



### It's "Extend and Pretend" All Over Again

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Getting older has its comforts. One of them is that you get to experience a number of historic events and can gain perspective on consequences that result from those events.

It's been well over a decade since the Japanese economy imploded. That implosion was based on a speculative frenzy that drove values to the extreme, where it was discovered the effects of gravity could not be overcome.

The Japanese government's response to this dramatic situation was to slash interest rates and rapidly increase government spending. (Note: they did not substantially increase their money supply.) The government claimed to be making substantial efforts to correct the impact of the shrinking private economic sector. The private economic sector, while paying lip service to growth opportunities, continued to stagnate as the banking/industrial complex refused to take risks. The national economy floundered between underwater loans and lack of demand. To this day, over a decade after the implosion, Japan is still struggling with lackluster economic growth.

That sounds a lot like déjà vu, doesn't it? Of course, in the "good old U.S. of A.," we are different – or so we say. As best I can tell, our response to date looks much like Japan's response of a decade ago. The Fed has lowered the cost of short-term borrowing to nearly Zero (a rate that discourages long-term savings) and increased government spending to the point where the credit of the United States is in jeopardy. Financial institutions continue to stagger under the weight of non-performing loans. Industry is reluctant to invest without evidence of a pick-up in demand, while consumers' wealth and savings have dropped so precipitously they are reluctant -- or unable -- to spend.

One can only hope that the rapid increase in money supply, both domestically and globally, will result in a different outcome than that suffered by the Japanese. I would not like to see the U.S. endure a protracted economic struggle. However, if we look specifically at the actions of our commercial banking system, we find little comfort.

I refer to our recent INSIGHT, "Financial Institutions and Commercial Real Estate Risk" (attached), that directly addresses the reality of "Extend and Pretend." Commercial banks hold over \$1.7 trillion of commercial real estate, and are reluctant to write down their holdings. In fact, FASB has changed its interpretation of FAS 115-2 and FAS 124-2, making it extremely easy to avoid recognizing loss in value.

According to the Congressional Oversight Panel<sup>1</sup>, over 2,988 commercial banks are classified as having a high commercial real estate concentration. The FDIC currently has 702 publicly-held banks on its watch list.

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<sup>1</sup> "February Oversight Report: Commercial Real Estate Losses and the Risk to Financial Stability," Congressional Oversight Panel, February 10, 2010

Much like Japan, we have turned a blind eye to a major potential implosion, and in fact, are working hard to cover it up. Of course the banks are taking FASB's lead and not writing down assets. Remember, unwillingness to fairly reflect values was a criticism placed on Japanese banks one decade ago. .

Bank charge-offs of the 4<sup>th</sup> Quarter of 2009 totaled \$59 billion, an increase of 47.7% year over year. The bulk of these charge-offs related to single-family home loans – not to distressed commercial real estate. I believe the real charge-off rate should be three to four times higher than the banks are willing to admit.

A charge-off rate that more accurately reflects commercial real estate values would drive banks into a substantial negative earnings position. That's a position no one likes to be in, but denying it does not change the fact that a bank in that kind of financial distress represents a substantial risk to stakeholders, taxpayers, and the economy overall. We've seen the impact "Extend and Pretend" has had historically, and the results are not pretty.

Below is a select list of mid-sized commercial banks that I believe are representative, to a greater or lesser degree, of the problems the industry faces. They are all talking a good game. I certainly endorse the power of positive thinking – but not when it is used to distract investors from the truth.

### Commercial Real Estate (CRE) Data

as of 9/30/2009 (in \$mm)

<u>Company</u>	<u>Ticker</u>	<u>CRE Loans Outstanding</u>	<u>Total Loans Outstanding</u>	<u>Total Assets</u>	<u>CRE as % of Total Loans</u>	<u>CRE as % of Tier 1 Capital</u>	<u>Total NALs*</u>	<u>CRE NALs/ Total NALs</u>
Regions Financial Corporation	RF	28,293.0	92,754.0	139,986.0	30.5%	218.3%	3,216.0	50.8%
PNC Financial Services	PNC	24,064.0	160,608.0	271,407.0	15.0%	94.3%	5,126.0	36.5%
M&T Bank Corporation	MTB	20,843.0	52,560.9	68,997.5	39.7%	378.0%	1,228.3	51.9%
Fifth Third Bancorp	FITB	16,520.0	78,419.0	110,740.0	21.1%	138.5%	2,947.0	54.7%
Comerica Incorporated	CMA	14,250.0	43,571.0	59,590.0	32.7%	184.2%	1,194.0	56.9%
Marshall & Ilsley Corporation	MI	13,884.0	45,835.2	58,545.3	30.3%	282.5%	2,250.0	22.6%
Zions Bancorporation	ZION	13,366.0	39,782.2	53,403.7	33.6%	253.3%	1,812.0	61.5%
Synovus Financial Corp.	SNV	11,173.1	26,331.7	34,610.5	42.4%	375.7%	1,519.0	80.5%
Huntington Bancshares Incorporated	HBAN	8,715.0	37,304.1	52,512.0	23.4%	151.4%	2,181.1	54.8%
Wilmington Trust Corporation	WL	4,025.7	9,021.2	10,873.8	44.6%	369.3%	365.9	66.0%
Wintrust Financial Corporation	WTFC	3,392.1	8,275.0	12,136.0	41.0%	418.8%	231.7	63.8%
First Horizon National Corporation	FHN	2,667.8	18,524.7	26,465.9	14.4%	74.9%	1,119.7	17.9%

\*Non-Accruing Loans

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