The IRA Bank Book
Q3 2022 Outlook

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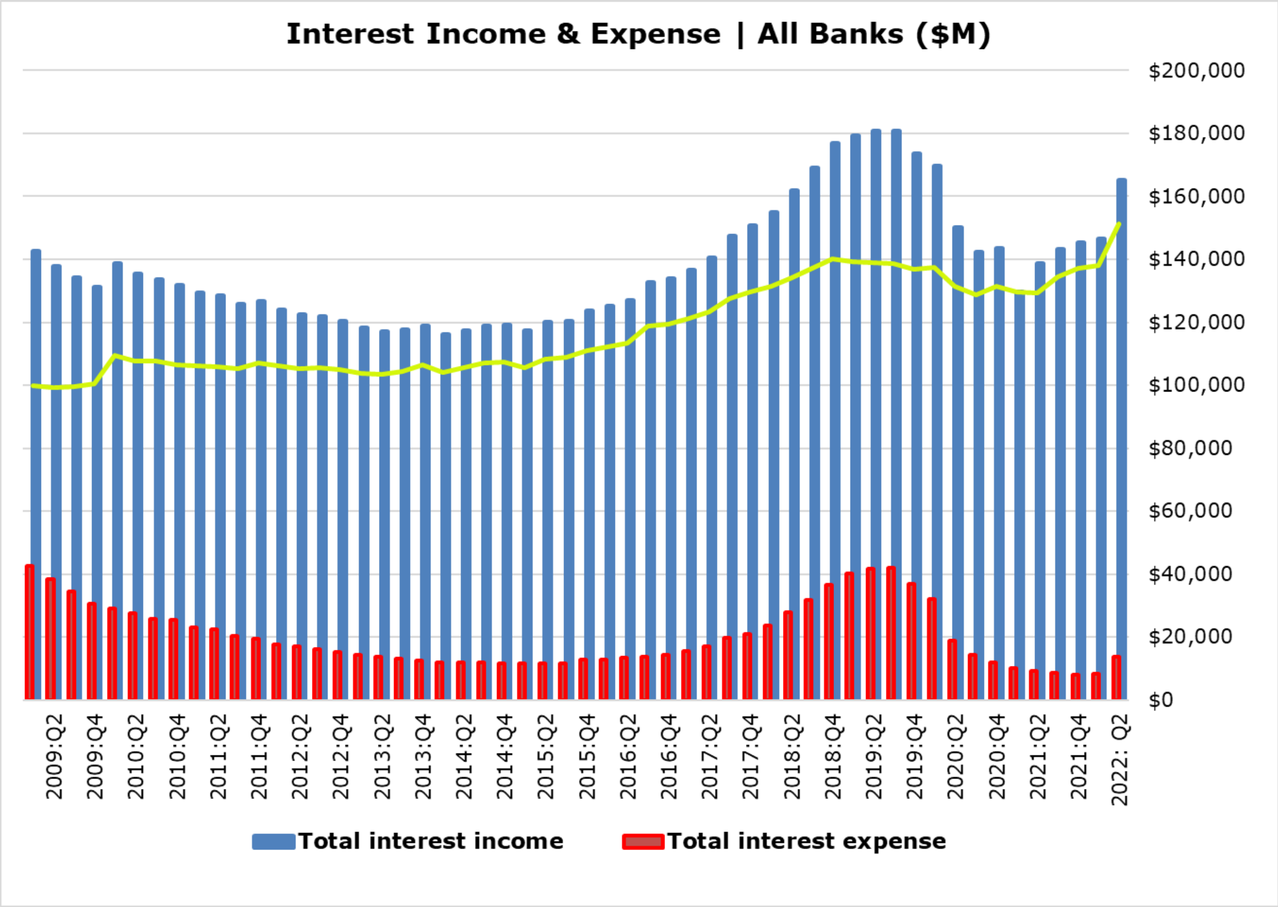
Bank Earnings Surge in Q2

Net interest income for industry jumped $20 billion (14%) in Q2 2022. Interest expense barely moved. Result: higher bank asset returns for the second quarter in a row with positive outlook for year

Expect continued improvement in bank operating results in Q3 2022. As Wall Street equity managers flee the financial sector, low funding and credit costs provide significant upside leverage for better lenders



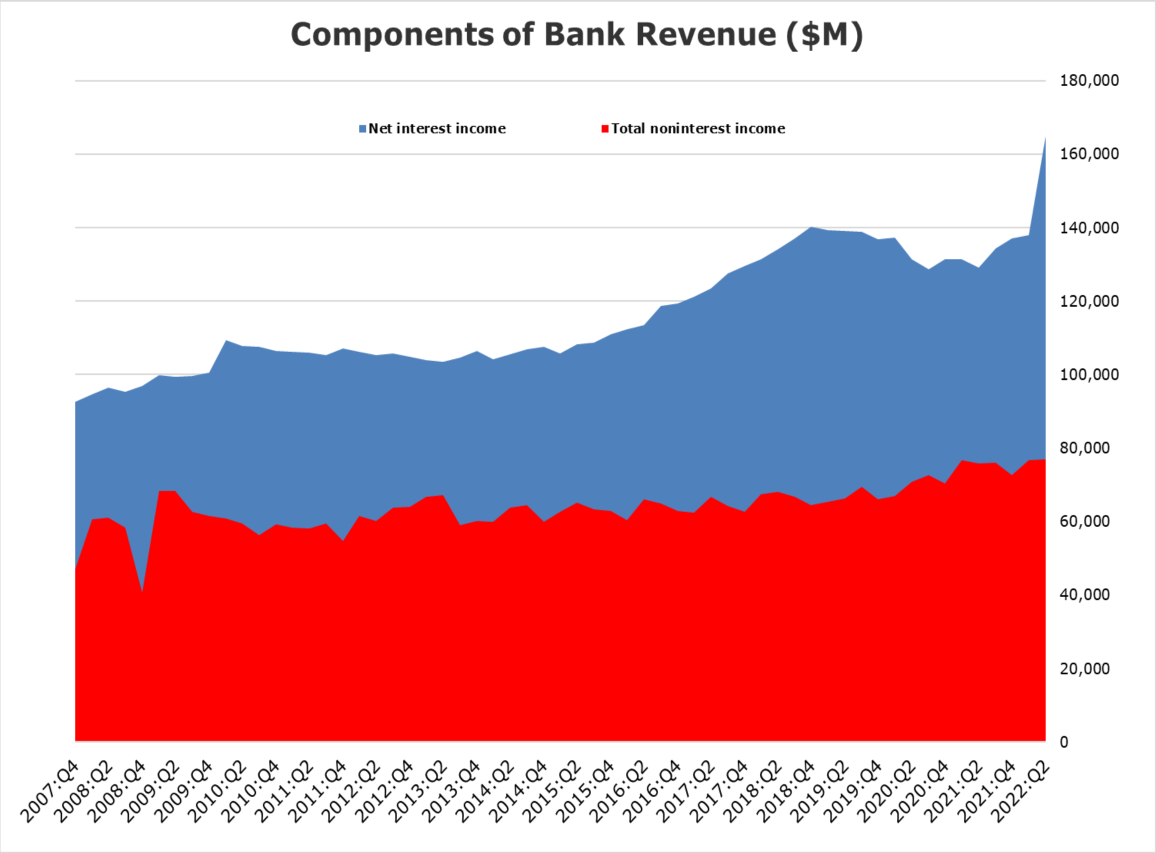
Source: FDIC

Net Profits Better that Expected

We raise our forward estimates for bank industry revenue and earnings based upon the sharp jump in interest earnings in Q2

Net interest income bounced nicely in Q2, but non-interest income is going up slowly as new market-facing revenue and fee opportunities dwindle

The rapid repricing of risk and related drop in bond market issuance is positive for banks with core deposits and lending lines. Market facing banks likely to see lower transaction revenue, AUM in 2023

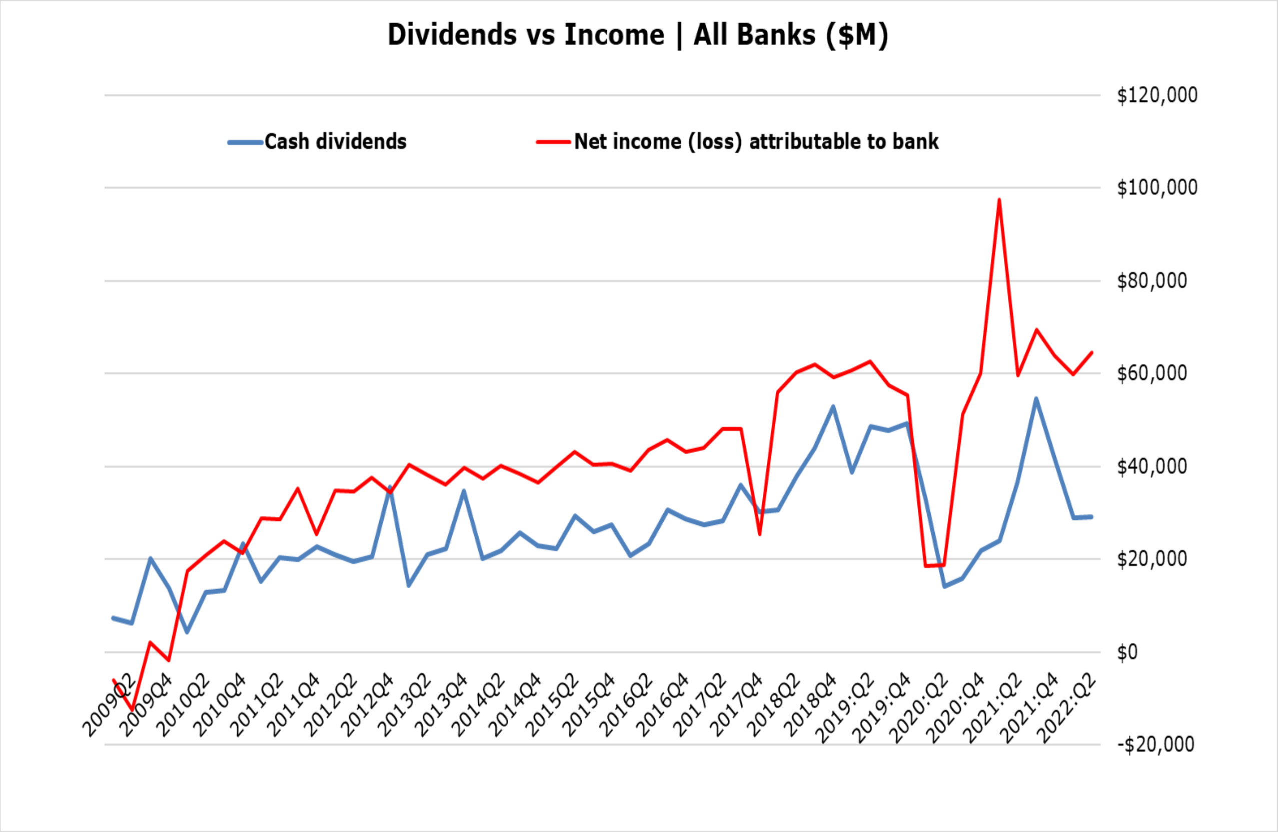


Source: FDIC

Dividends Constrained

Improved profitability for banks not necessarily going to mean higher dividends. Regulators compelling banks to increase reserves in anticipation of *higher loan losses* in 2023 as credit normalizes under QT

Surge in bank dividends paid in 2021 was a function of the one-time upward GAAP adjustments of COVID loss provisions. Look for bank dividends *and* share buybacks to track below-average through 2023



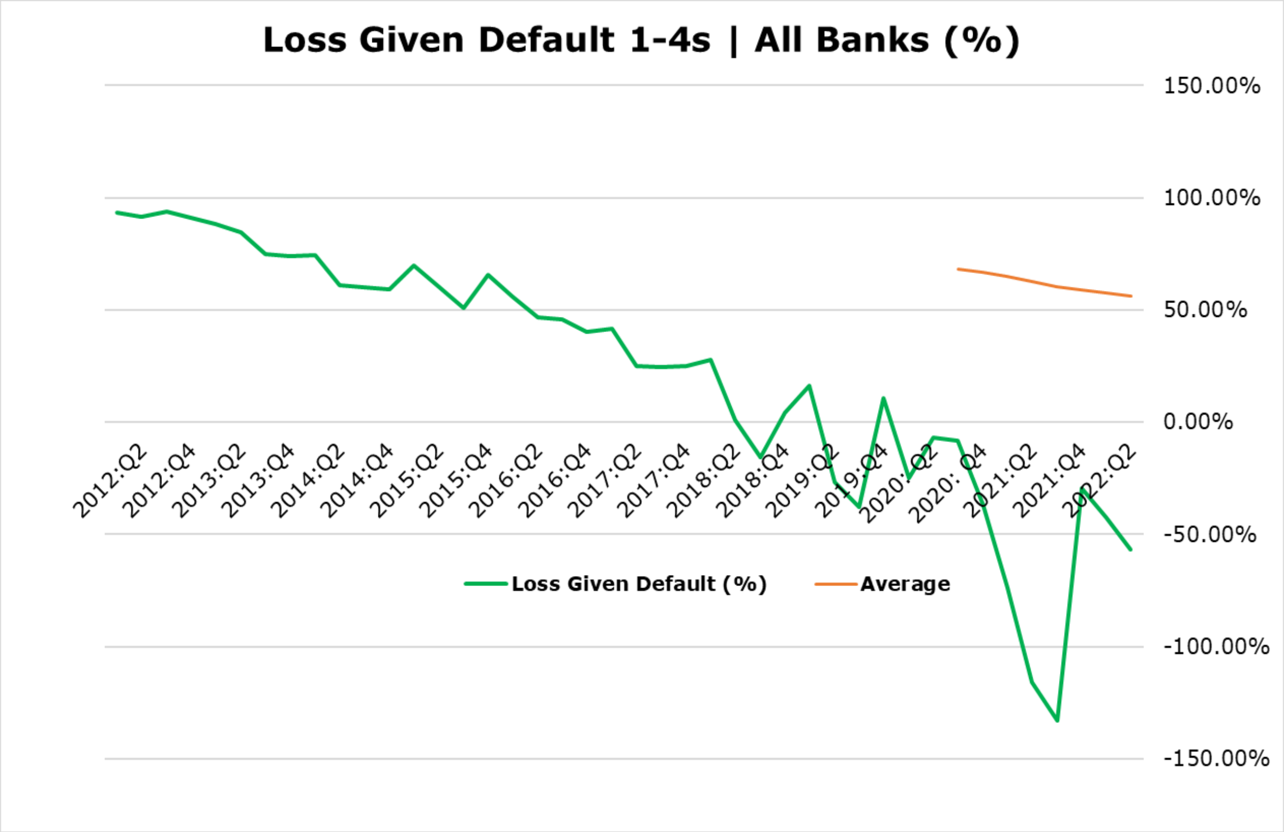
Source: FDIC

Credit Mean Reversion

Q: Why are bank regulators increasingly cautious about bank capital even as credit losses continue to decline?

Q: Why did the Federal Reserve Board fail JPMorgan Chase on capital stress test based upon bank's pristine portfolio of jumbo 1-4 family loans?

A: Because of chart like the example at right, showing a huge drop in credit loss rates in prime, bank-owned 1-4s since QE 2 . Mean reversion is the obvious risk now seen by regulators



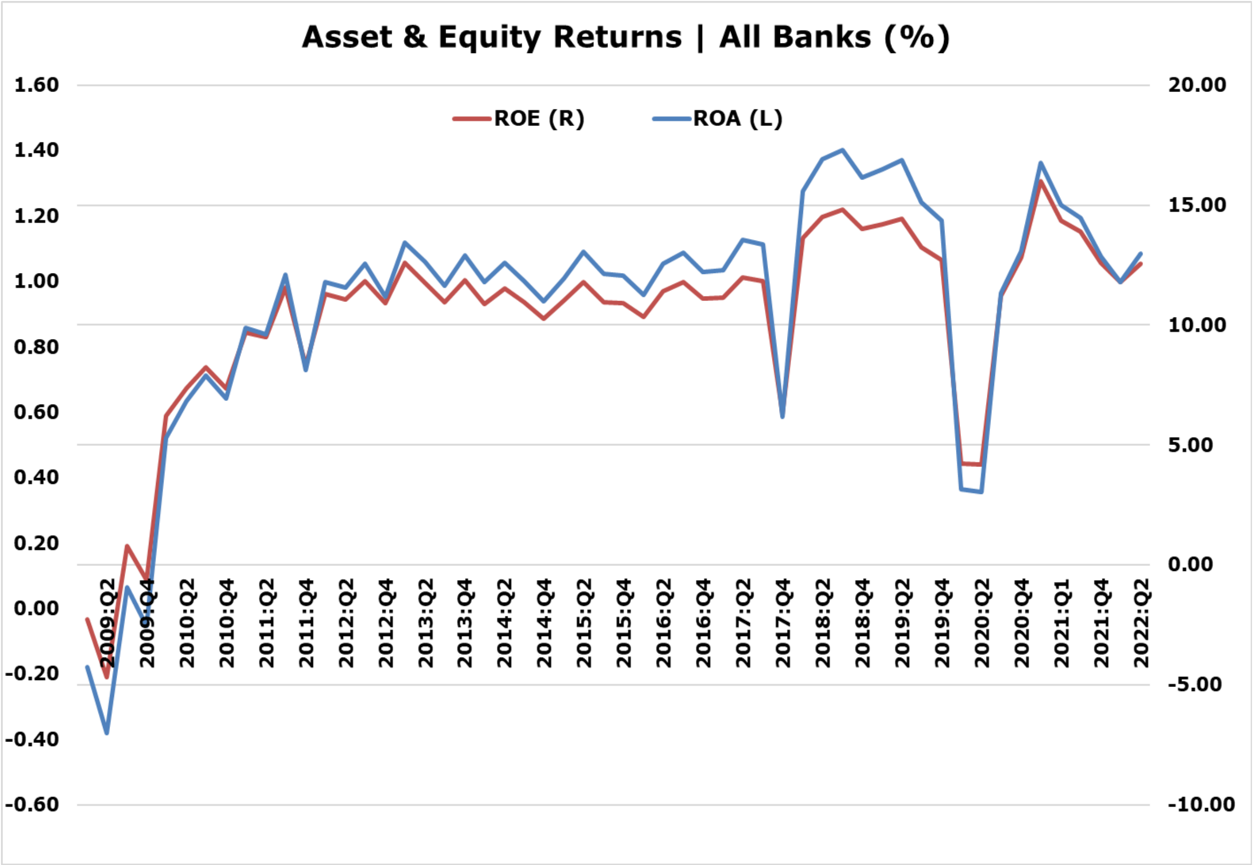
Source: FDIC/WGA LLC

Earnings Normalization Underway

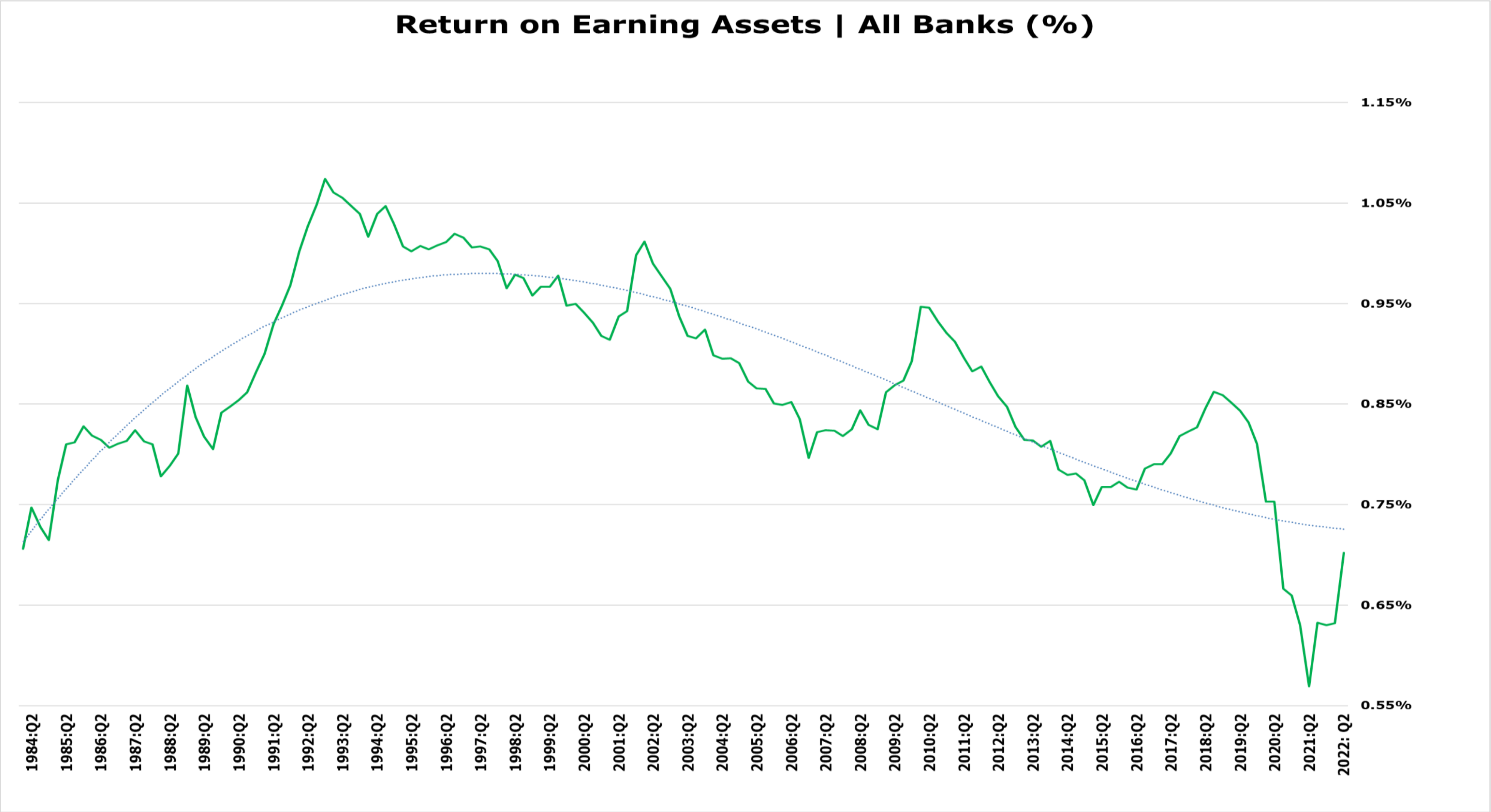
Even with the remarkable uptick in operating earnings in Q2 2022, banks have a long way to go to repair damage done by QE to balance sheets, earning assets

Industry must 1) shrink *total assets* and 2) reprice *earning assets* to exploit the big opportunity afforded by low funding/credit costs through at least 2023

Market facing banks under particular pressure to adjust to QT due to rising funding costs



Source: FDIC

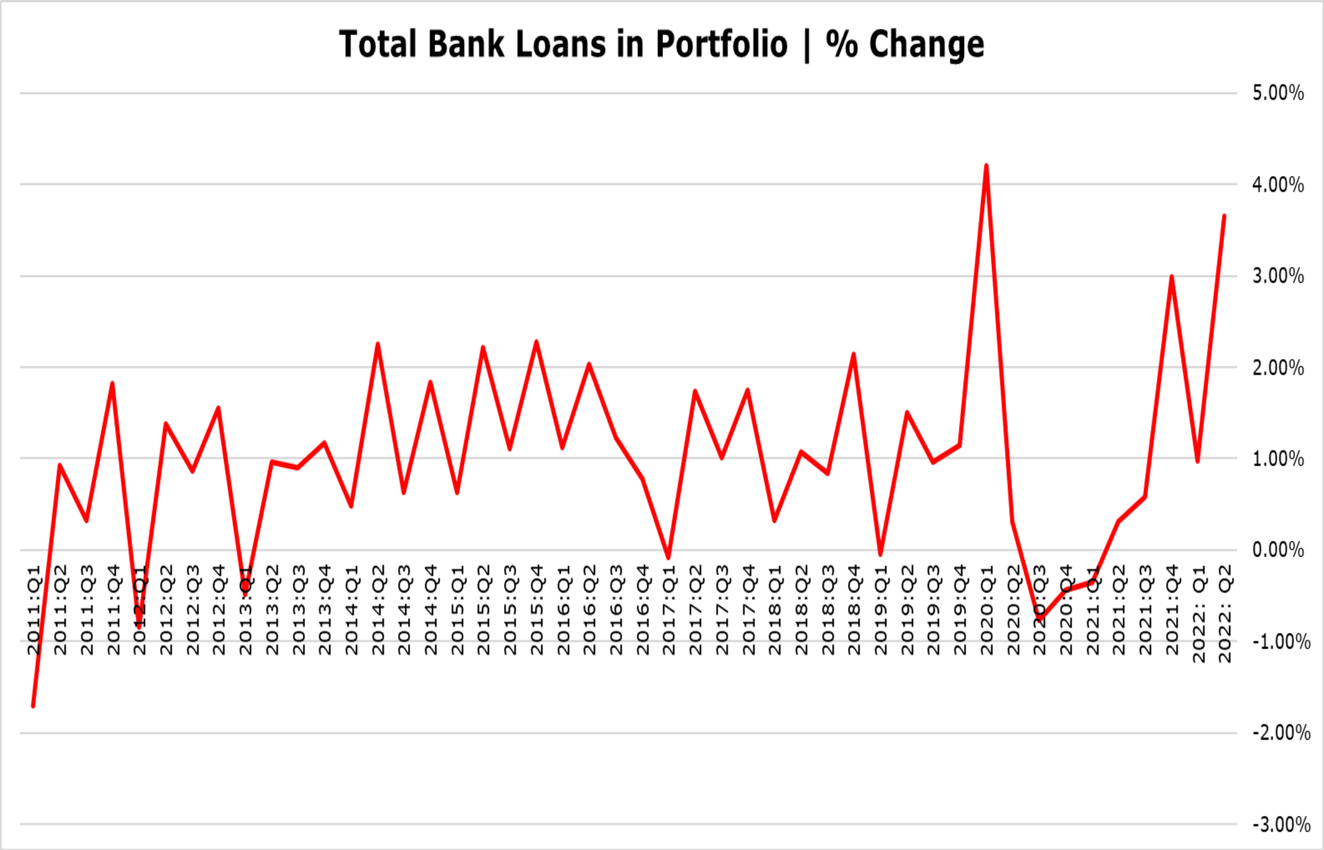


Source: FDIC/WGA LLC

QE Ends, Loan Growth Resumes

During QE, even as the FOMC boosted bank balance sheets with sterile risk-free reserves, bank loan portfolios did not grow and in fact declined in 2021. Gross yields on bank loans also fell

Now under QT, with industry balance sheets shrinking, bank loan portfolios are starting to grow strongly for the second quarter in a row and with higher gross yields as market assets reprice

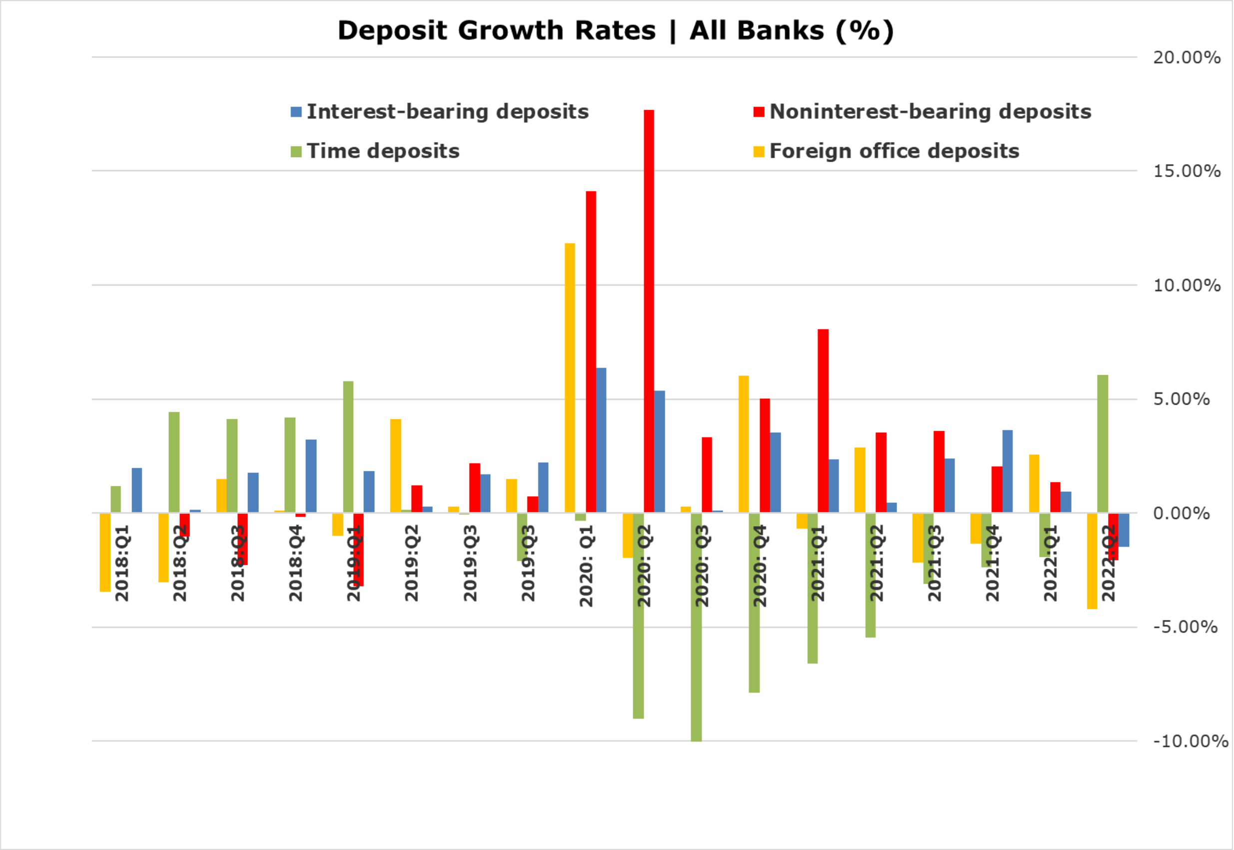


Source: FDIC

Deposits: Runoff & Duration Shift

During QE, deposits ran into non-interest bearing instruments and out of time deposits, particularly in Q2 2020 as investors sought safety in risk free assets

Today time deposits are growing strongly (green bar) and non-interest bearing deposits and foreign deposits are running off. Rising market yields make money market funds more attractive to short-term investors



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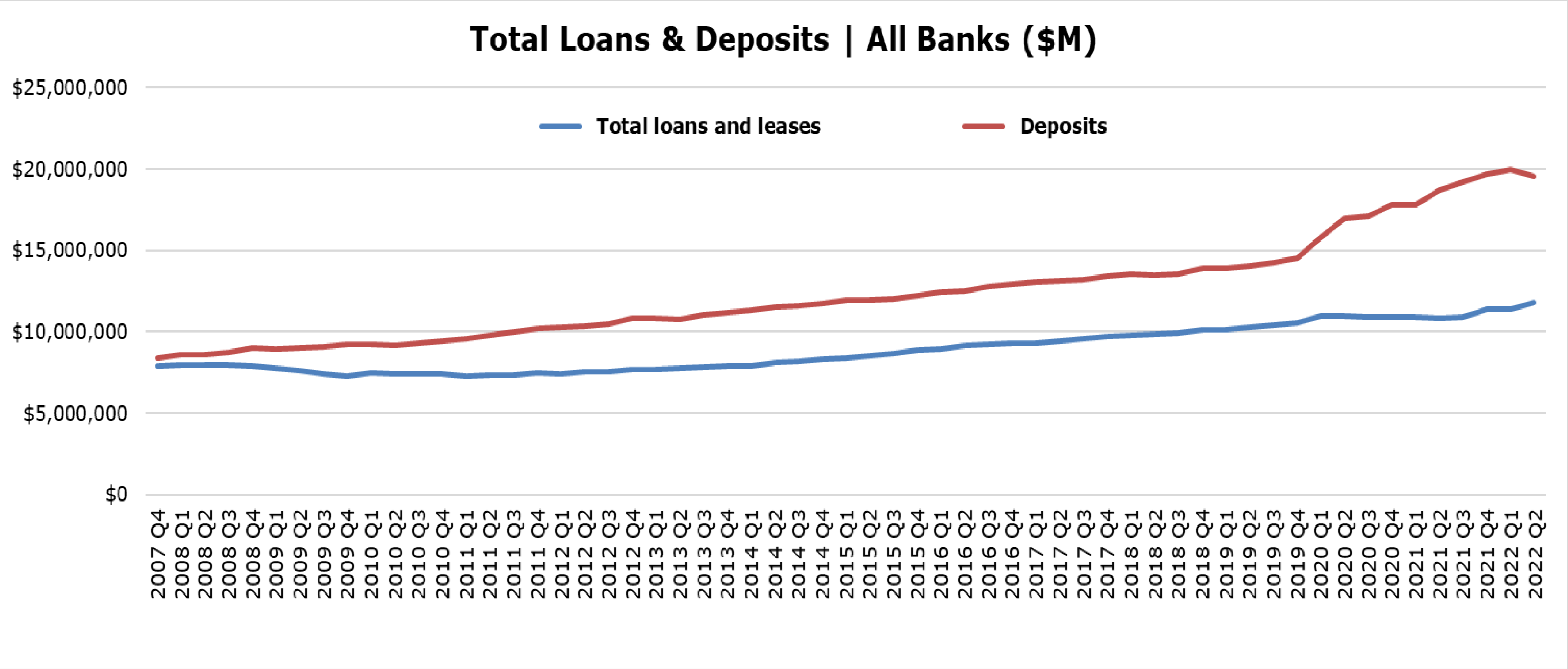
Total Loans & Deposits | All Banks ($M)
Total loans and leases
Deposits
$25,000,000
$20,000,000
$15,000,000
$10,000,000
$5,000,000
$0
2007 Q4
2008 Q1
2008 Q2
2008 Q3
2008 Q4
2009 Q1
2009 Q2
2009 Q3
2009 Q4
2010 Q1
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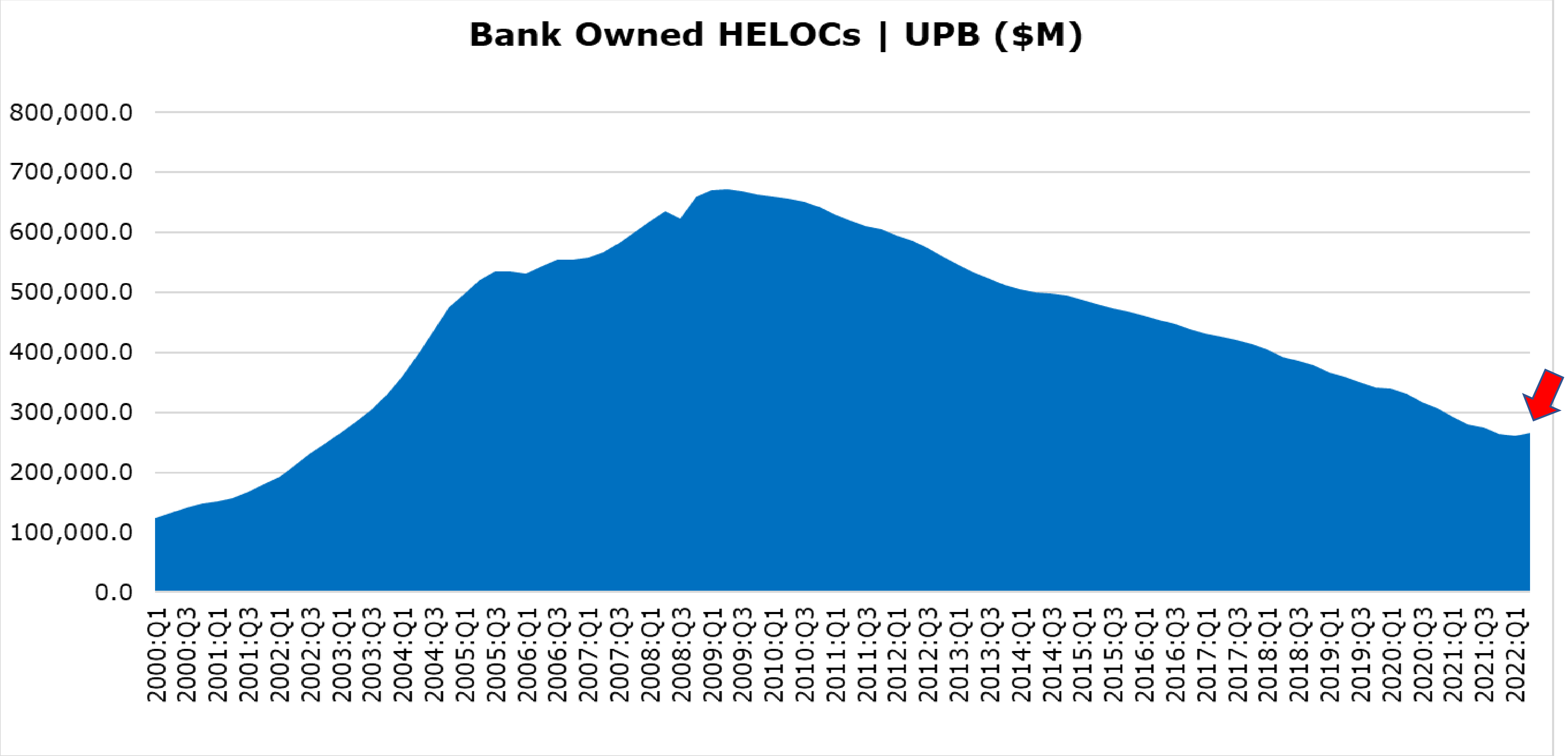
2020 Q3
2020 Q4
2021 Q1
2021 Q2
2021 Q3
2021 Q4
2022 Q1
2022 Q2

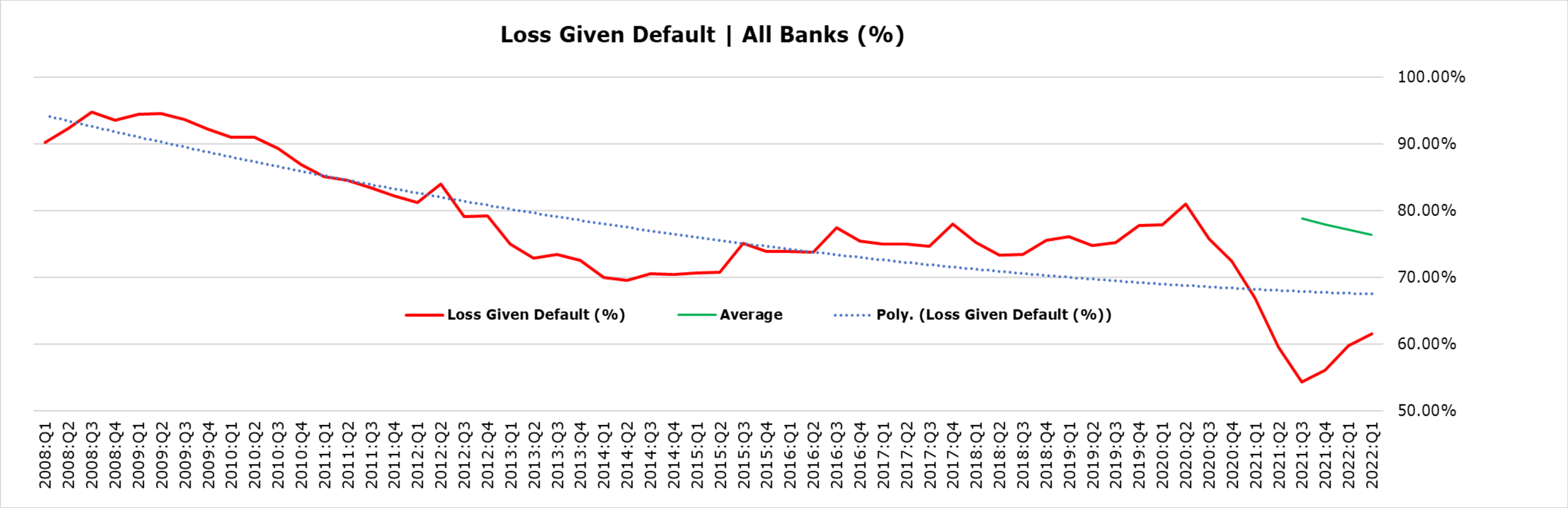
Source: FDIC

Credit Charts

In Q2, portfolio of bank-owned home equity lines of credit rose for the first time since 2008!



Total Loans & Leases



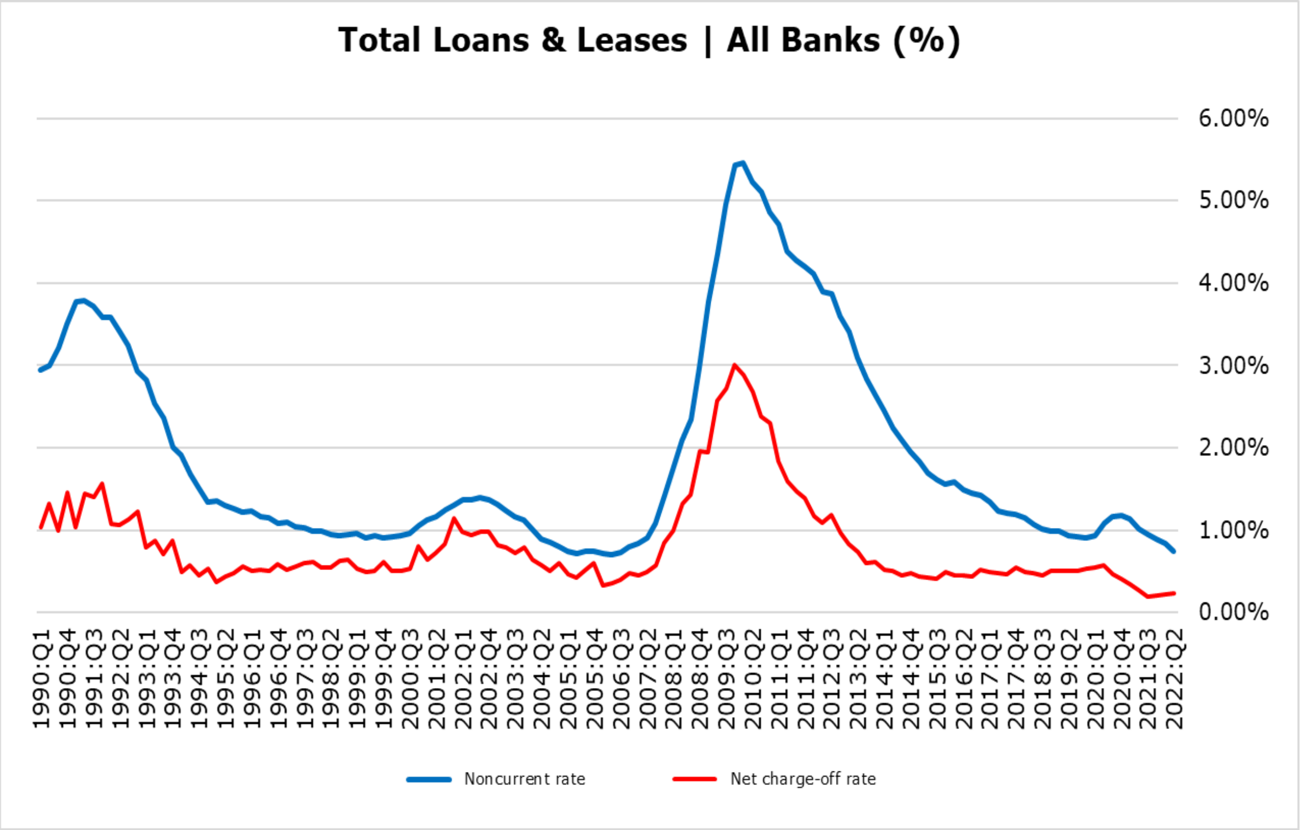
Source: FDIC/WGA LLC

Loss given default (LGD) for the $11.7 trillion of bank loans has risen for the past year after setting a record low in the 50s in Q3 2021 vs the LT average of 77%.

Total Loans & Leases

Even as post-default recovery rates fall, credit losses realized by banks remain at very low levels. Regulators fear a sharp uptick in delinquency in 2023 and beyond, but timing is uncertain

FDIC: “Loans and leases that are 90 days or more past due or in nonaccrual status declined $7.2 billion (7.6 percent) from first quarter 2022”



Source: FDIC

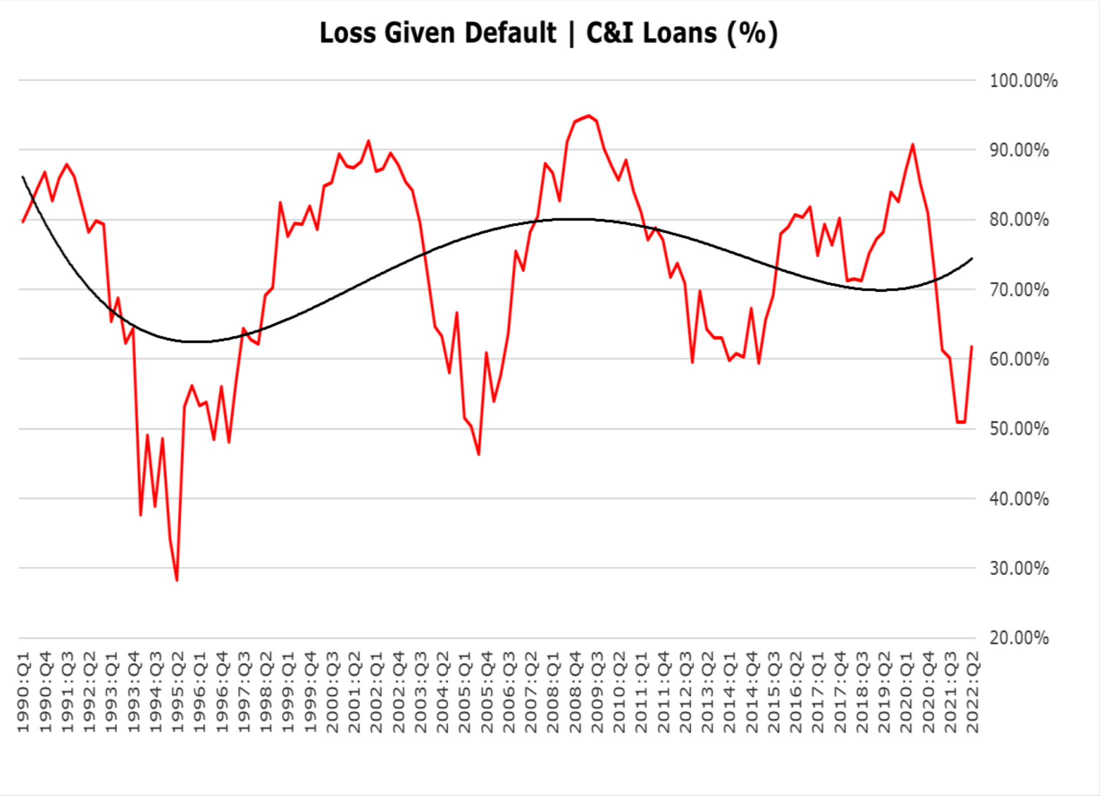
Commercial & Industrial Loans

C&I loans were up mid-single digits in Q2 2022 and we expect continued growth, albeit in a shifting mix of business. With the housing sector rapidly slowing, look for greater focus on higher yielding commercial loans

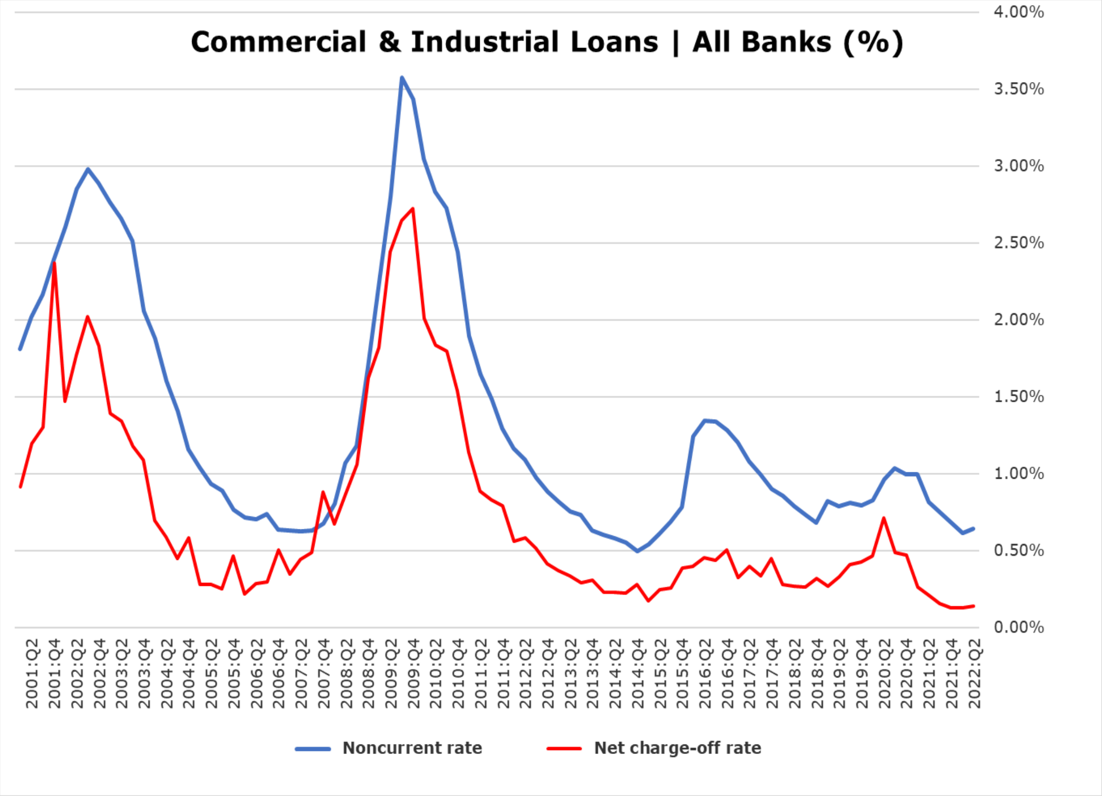
Q2 2022 C&I loan growth, up $151.8 billion or 6.5 percent, was tempered by Paycheck Protection Program (PPP) loan forgiveness and repayments. Excluding PPP loans, total loan growth would have been 11.5 percent and C&I loan growth would have been 22.4 percent from the year-ago quarter.

Total unused C&I loan commitments also increased nearly 6% or $540.3 billion from the year-ago quarter to $9.5 trillion. Look for C&I loan growth in Q3 2022 to confirm the improvement of bank operating income

Commercial & Industrial Loans



Source: FDIC/WGA LLC

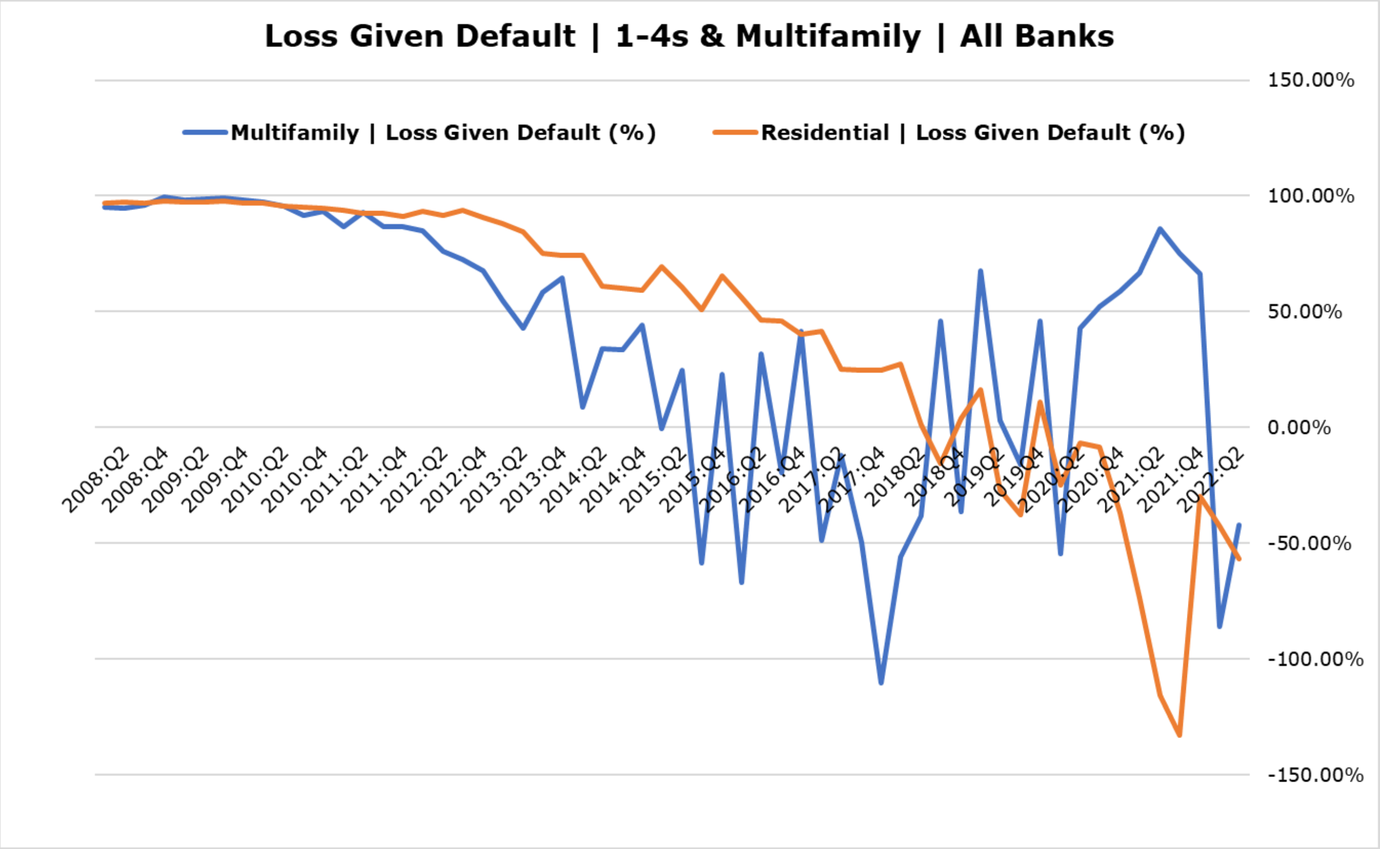


Source: FDIC

Residential and Multifamily Loans

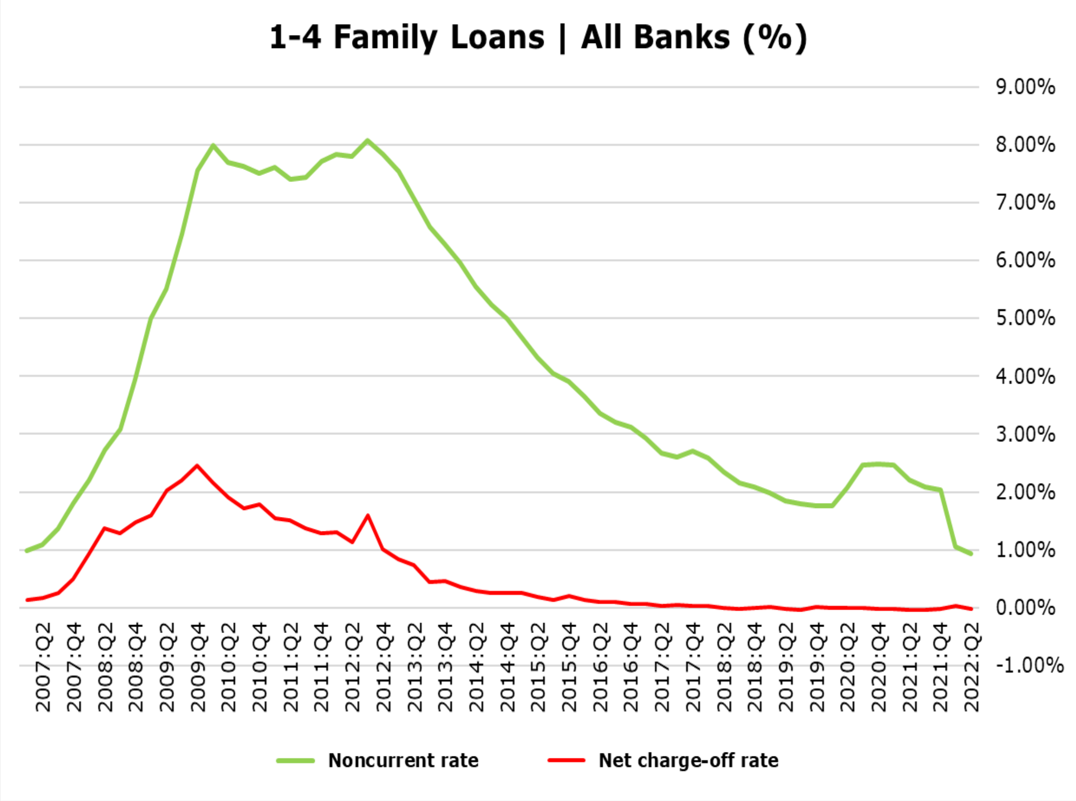
Several analysts are predicting down home prices in 2023, a remarkable turnabout that would push LGD back into positive territory next year. We remain dubious about price decreases in bottom half of market

LGD for 1-4s skewed *lower* into negative territory in Q2 2022. Multifamily loans are showing rising delinquency but also a great deal of volatility as recovery rates slowly normalize

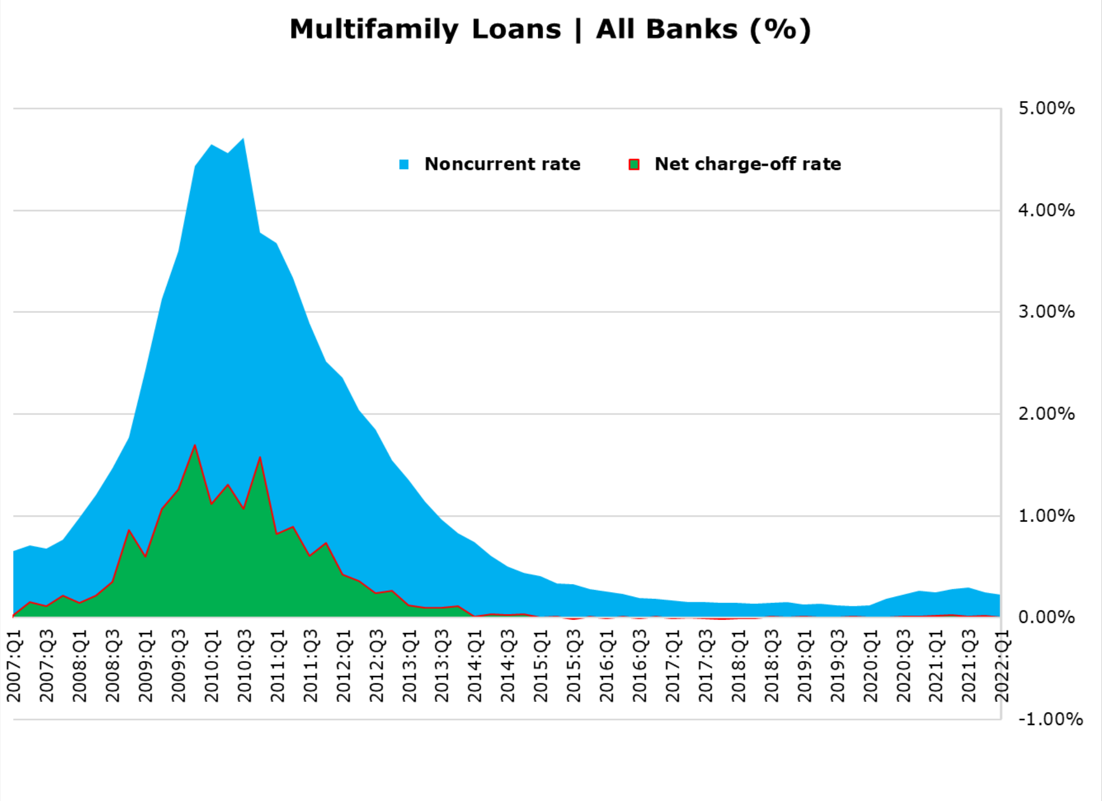


Source: FDIC/WGA LLC

Residential and Multifamily Mortgages

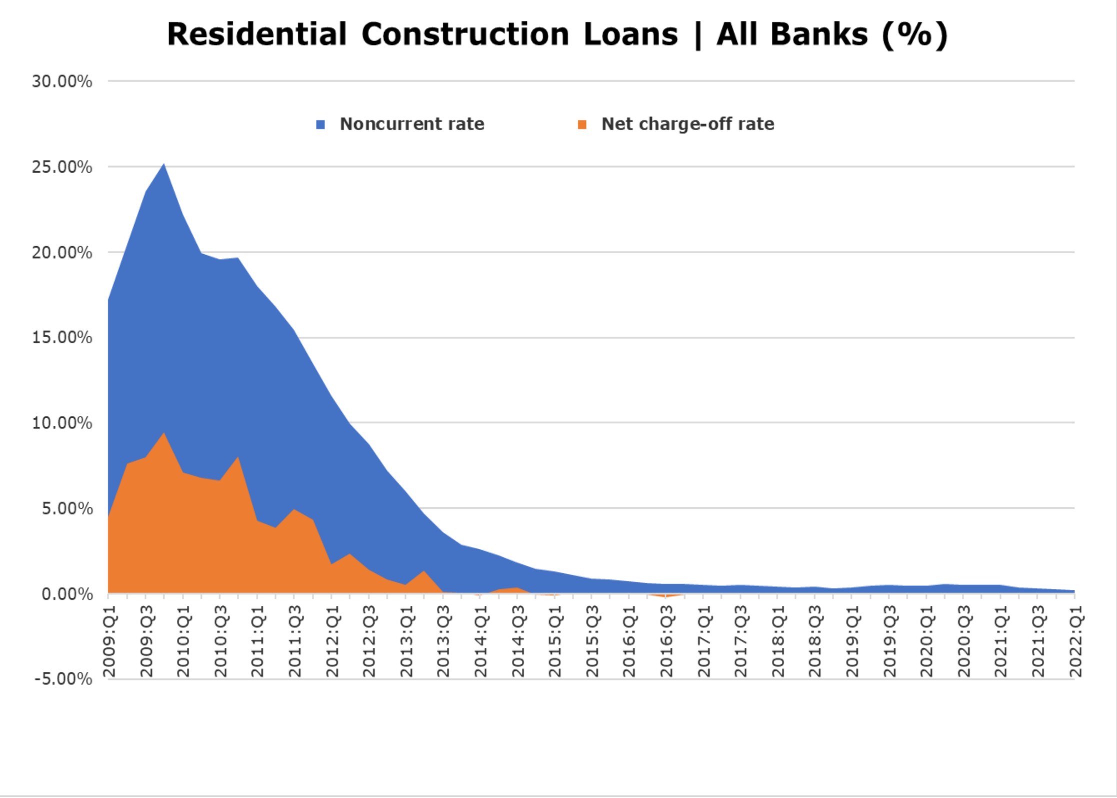


Source: FDIC

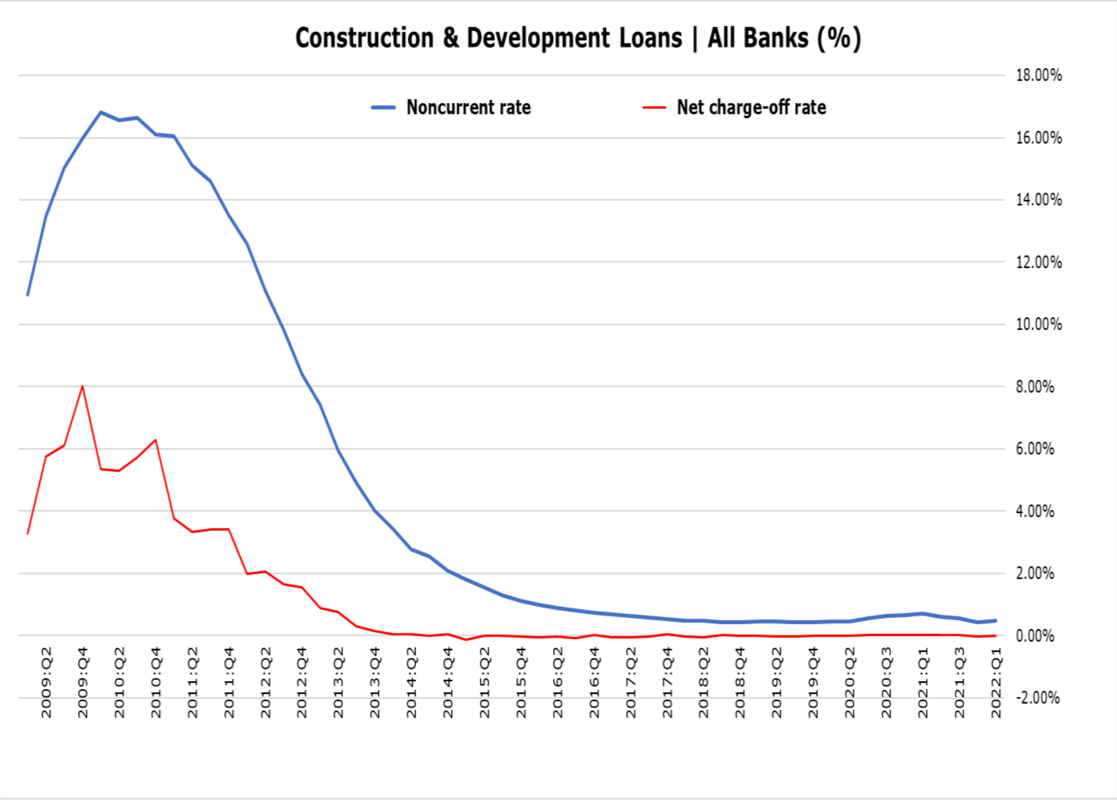


Source: FDIC

Residential and Commercial Construction

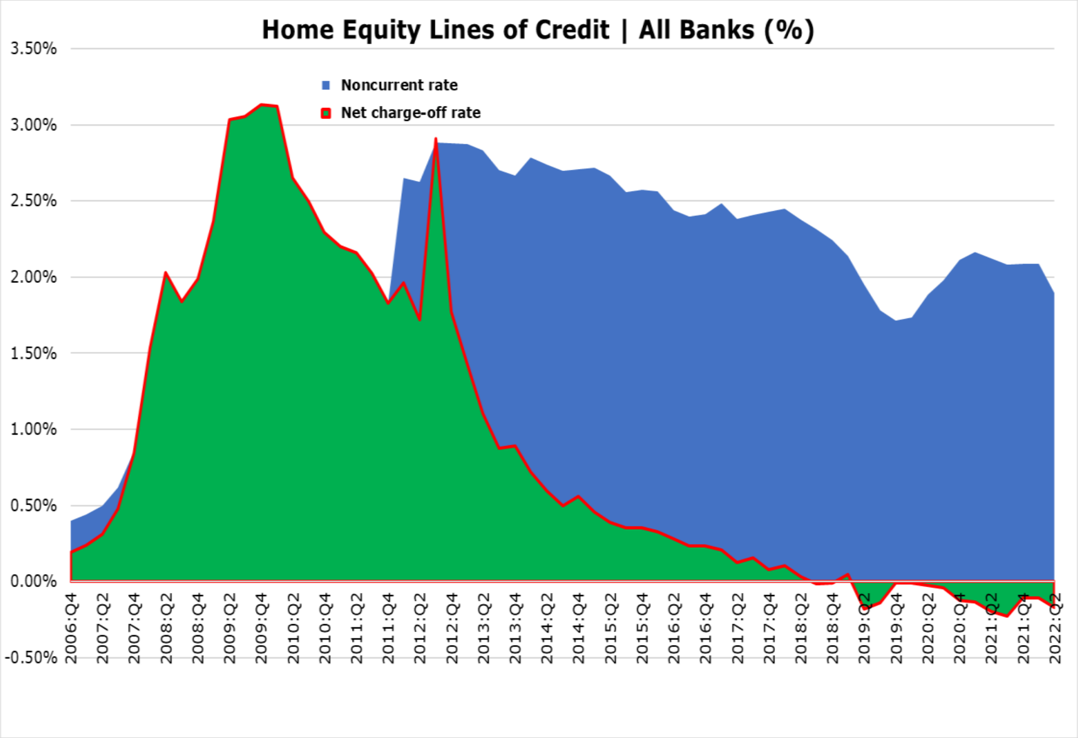


Source: FDIC

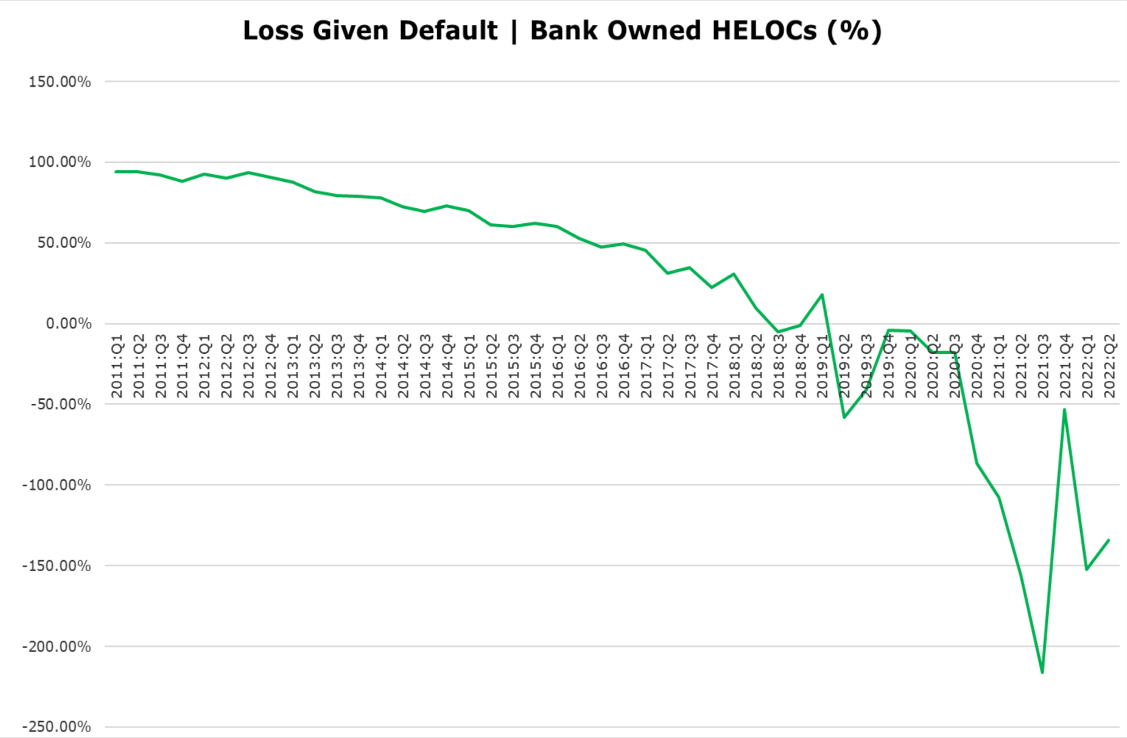


Source: FDIC

Home Equity Lines of Credit



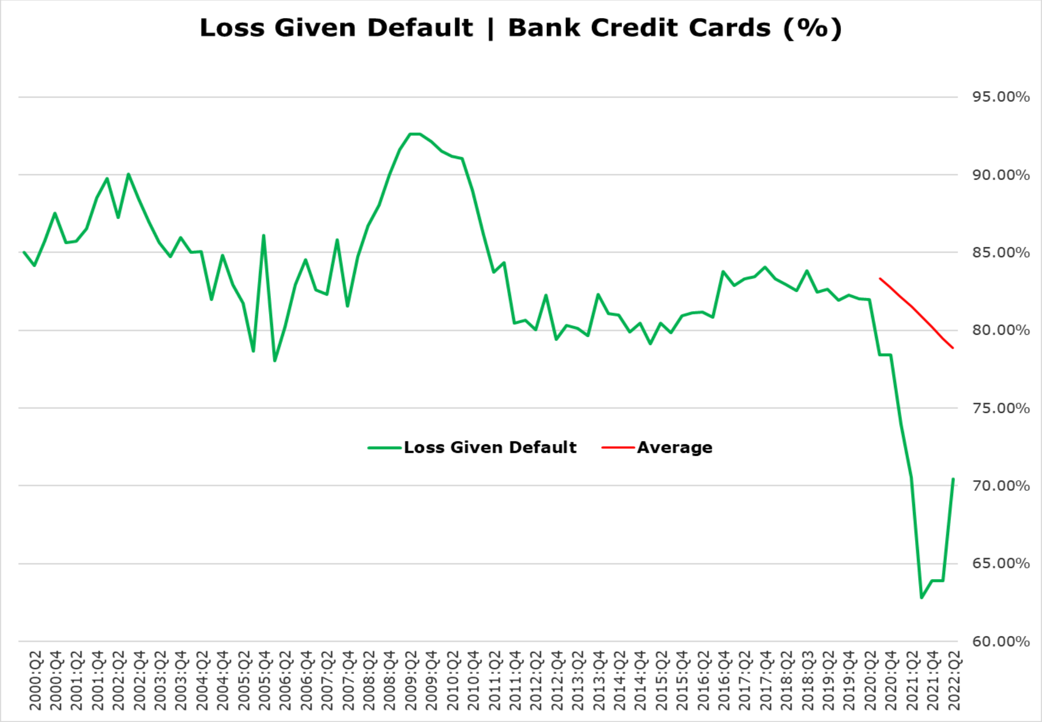
Source: FDIC



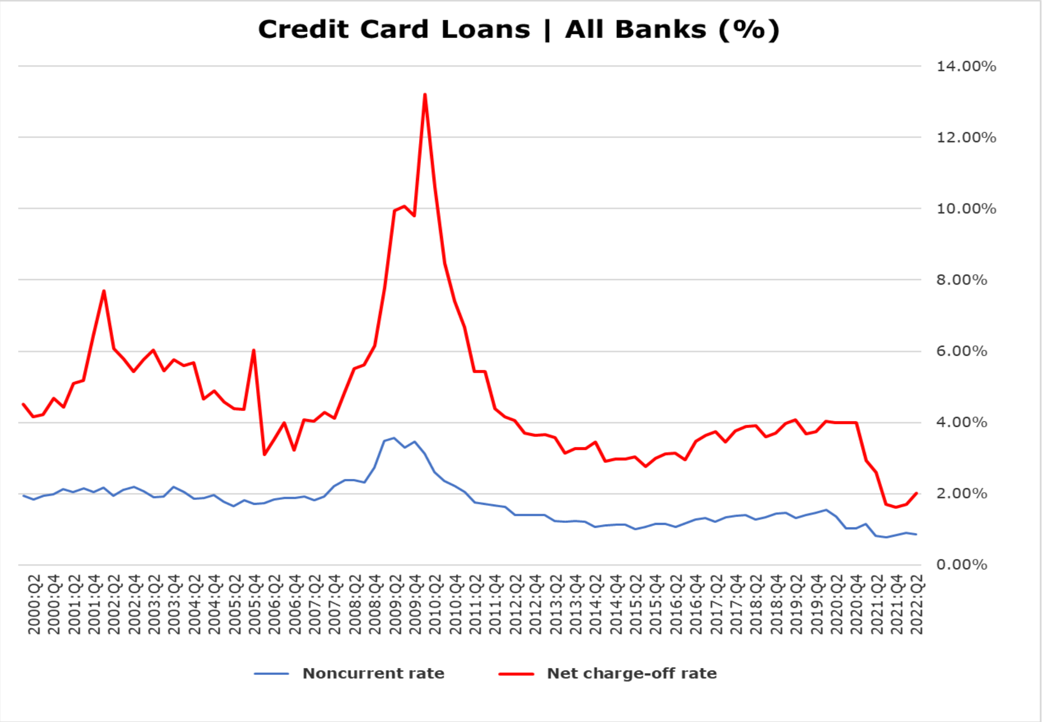
Source: FDIC/WGA LLC

HELOC loans display the same skewed default characteristics as 1-4s, with the net-charge off rate negative

Credit Card Receivables



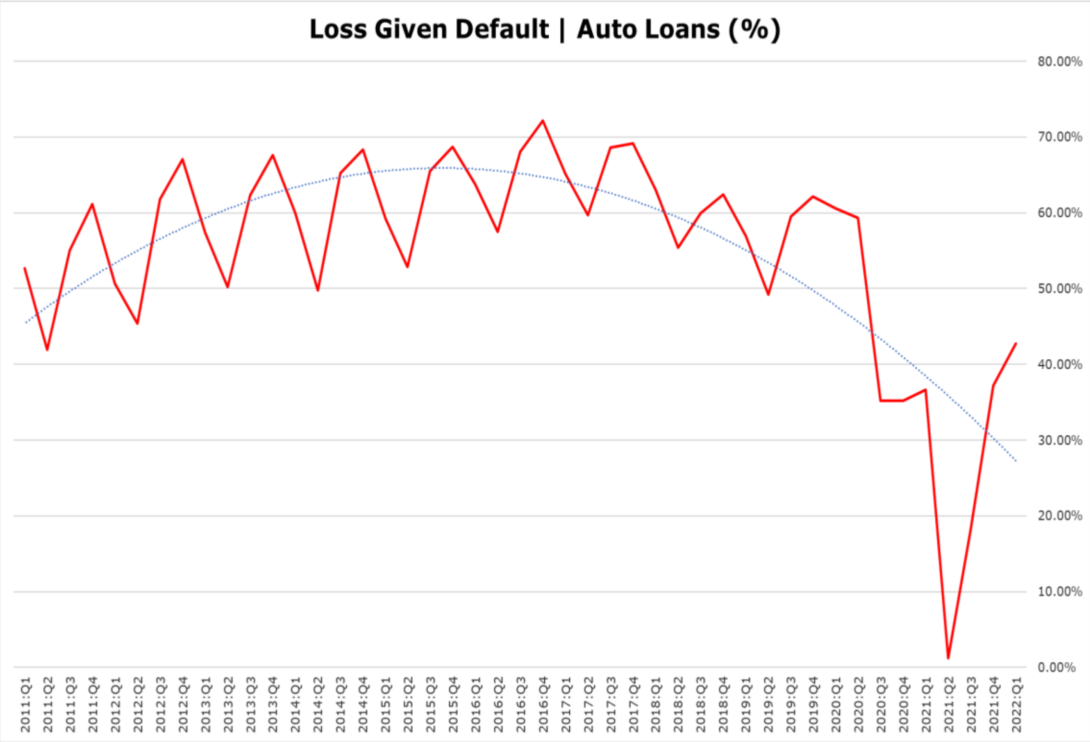
Source: FDIC/WGA LLC



Source: FDIC

Net losses on credit card receivables plummeted during the period of COVID loan forbearance, including moratoria on rent and mortgage payments. Now mean reversion is underway

Bank Auto Loans



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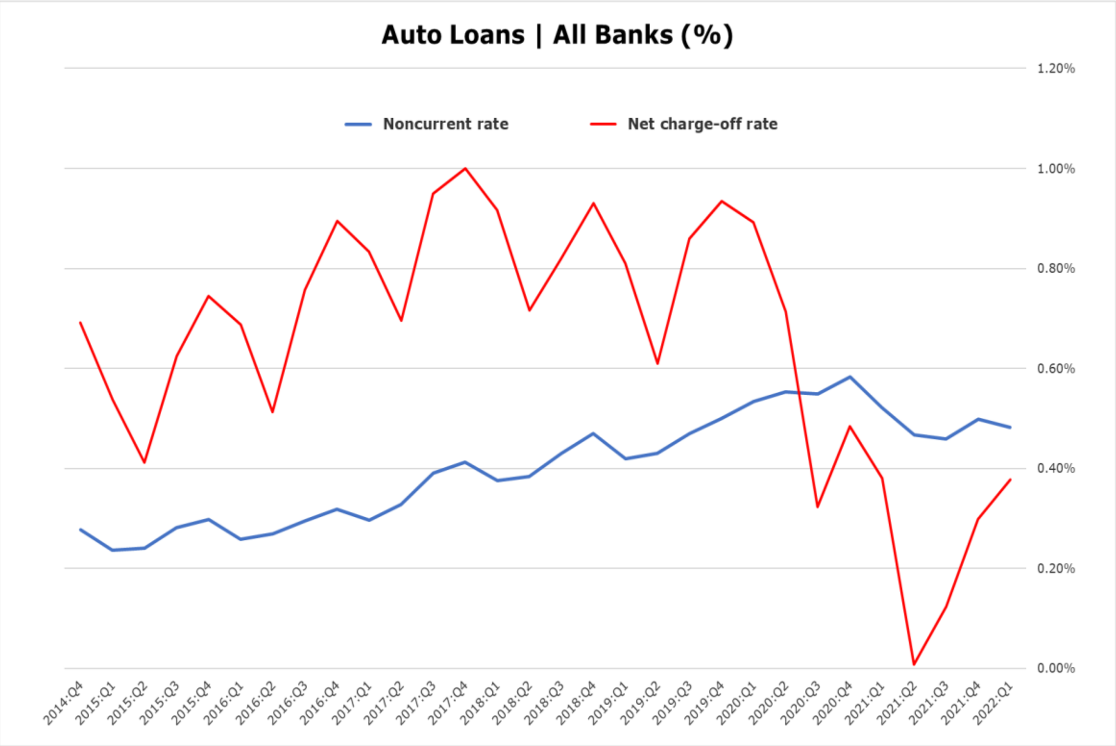


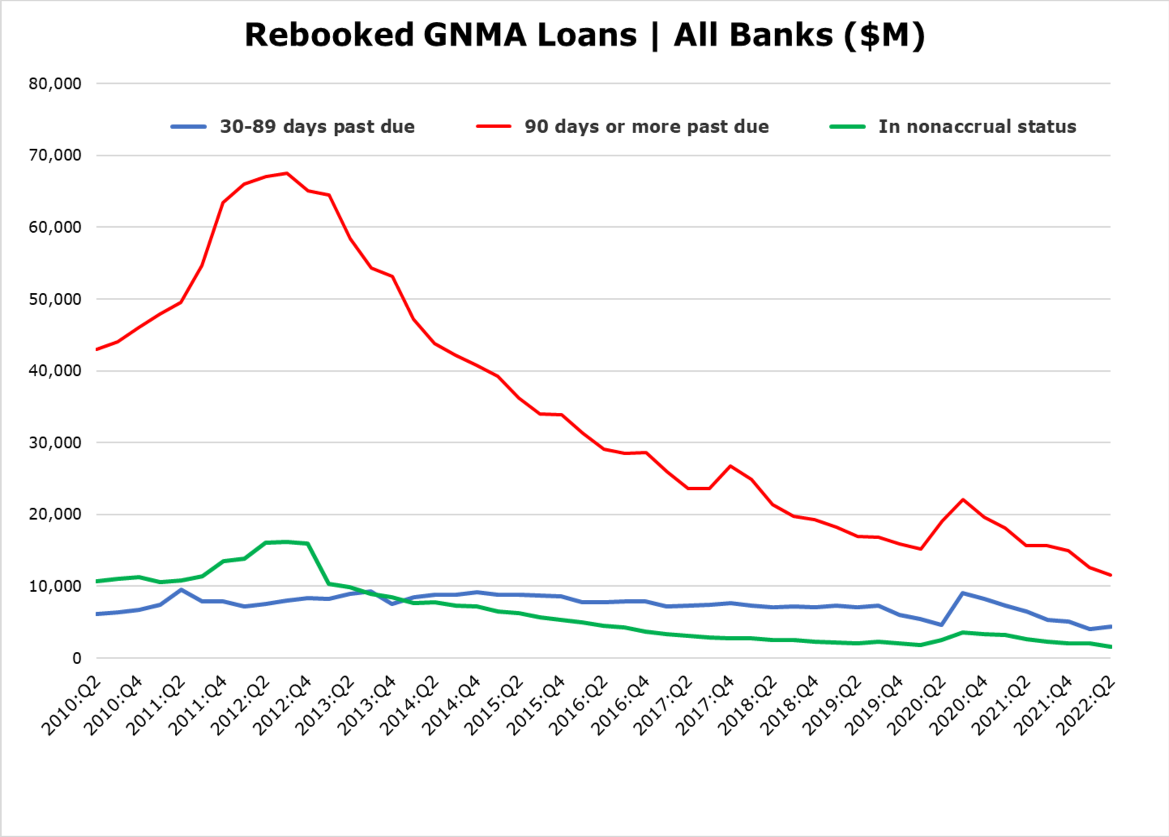
Source: FDIC

Net loss rates for auto loans nearly touched zero in 2021, a reflection of secondary prices for used cars. Auto loans are now tracking back toward the average LGD of 42% since 2011.

Ginnie Mae Early Buyouts (EBOs)

Buyouts of delinquent loans from Ginnie Mae MBS pools was a profitable trade for banking industry in 2020-21, both in terms of actual purchases and financing EBOs for nonbank issuers via warehouse lines. Higher interest rates killed demand

Increased interest rates and TBA market volatility left many issuers sitting on piles of defaulted, low coupon government loans that are hundreds of basis points out of the money, volatile and costly to hedge, and difficult to modify or sell



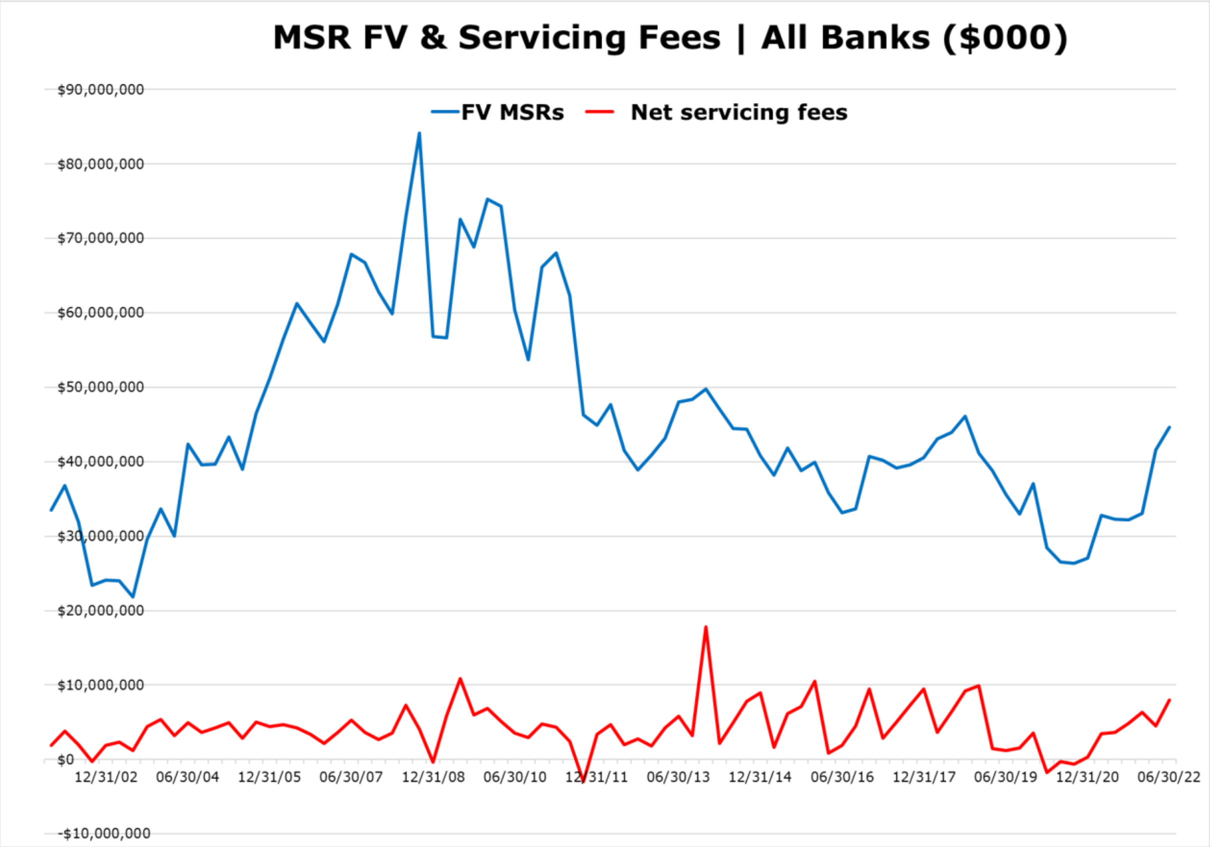
Source: FDIC

Wells Fargo & Co and Ocwen Financial both announced exit from government loan market in past month

Mortgage Servicing Rights

The fair value of mortgage servicing rights or MSRs continues to rise with interest rates and related changes in servicing income. MSRs have risen sharply in value through 2021, but lending income weakened in 2022 and asset sales also remained weak.

Banks are largely insulated from the capital rules for nonbanks from the FHFA and Ginnie Mae. Lower valuations for government loans and servicing assets could negatively impact banks that hold MSR.



Source: FDIC

Bank Asset Sales

Assets Securitized & Sold | All Banks												
Assets Sold ($M)	**2022:Q2**	**2022:Q1**	**2021:Q4**	**2021:Q3**	**2021:Q2**	**2021:Q1**	**2020:Q4**	**2019:Q4**	**2018:Q4**	**2017:Q4**	**2016:Q4**	**2015:Q4**
1-4 family residential loans	286,245.1	285,742.8	324,820.5	344,786.2	356,054.0	358,230.0	382,125.0	474,309.0	520,030.4	590,211.5	643,699.7	715,913.6
HELOCS	5,511.0	5,750.0	6,212.0	6.5	6.8	7.1	7.9	11.0	13.7	19.8	25.1	29.8
Credit card receivables	39,000.0	12,000.0	0.0	0.0	0.0	0.0	0.0	0.0	22.0	4,553.1	12,879.0	13,502.1
Auto loans	59,000.0	72,000.0	169.3	209	315.9	392.0	289.0	1,448.0	3,710.2	9,770.4	11,542.6	6,094.9
Other consumer loans	1,346.7	1,169.1	1,240.9	1,388.0	1,388.0	1,469.2	1,569.0	1,661.0	1,737.6	3,052.0	4,575.7	5,285.5
Commercial and industrial	5,265.0	6,228.0	6,624.0	6,285.0	0.0	0.0	0.0	0.0	453.0	380.0	276.3	15.4
All other loans, leases, and other assets	114,372.2	111,531.4	106,355.2	99,497.7	95,054.9	91,085.1	87,334.0	83,875.0	71,415.9	60,868.5	64,060.1	79,240.2
Total Securitized and Sold	**510,740.0**	**494,421.3**	**445,421.9**	**452,172.5**	**452,819.6**	**451,183.5**	**471,324.9**	**561,304.0**	**597,382.8**	**668,855.2**	**737,058.5**	**820,081.5**

Source: FDIC

Bank asset sales rose again strongly in Q2 2022 on increased volume of auto loans and credit card receivables, and even 1-4 family loans increased for the first time in a decade

Outlook 2022-2023

Rising Yields & Wider Spreads

- US banks continue to normalize income and credit performance after two years of extreme monetary policy. GAAP bank operating income will seemingly fall in 2022 compared with 2H 2021, but will in fact be growing. HY credit spreads now at five-year highs in many sectors and new issue volumes are at lows going back even further.

- As Q3 2022 ends, US banks are experiencing sharply higher interest income and widening spreads. The cost of funding lags well-behind the increase in asset returns due to size of QE. Banks able to reprice assets faster than deposits will benefit over next two years, while banks with more market funding will face a potential squeeze.

- Credit costs are again moving into positive territory, but remain at extremely low levels compared with pre-COVID. Loan loss provisions will become a headwind for earnings in 2023 and beyond. Loss rates on 1-4s will likely remain muted through next year.

Winners/Loser Post-QE

- Some of the banks in our surveillance group will be able to take advantage of rising loan yields and low funding costs, including BAC, WFC, USB, PNC, TFC, WAL

- Banks with low funding costs, moderate capital markets exposure and relatively small lending portfolios include: SCHW, RJF, TD, WSFS, FRC. Of note, RJF remains the best performing name in our surveillance group YTD.

- Banks with limited core deposits and/or larger market/credit exposures include: C, JPM, GS, COF, AXP, DFS, ALLY, OZK. Some of these names such as GS and JPM have already pre-announced lower Q3 market results and/or layoffs.

We will be providing specific comments on these and other names in our pre-earnings comment later this month in The Institutional Risk Analyst

IRA Bank Surveillance Group

Ticker	Last Price	1 Day%	1 Mnth%	%YTD	Price/Book	Beta 6M
ALLY	$32.00	6.99	10.65	32.80	0.86	1.25
AXP	$155.23	4.44	6.40	5.12	5.02	1.10
BAC	$33.95	3.76	6.49	23.70	1.14	0.96
BK	$44.03	0.58	1.95	24.20	0.98	0.95
C	$48.85	3.97	10.17	19.11	0.53	1.03
COF	$100.95	8.05	12.78	30.42	0.80	1.16
DB	$8.96	3.81	4.43	28.36	NA	1.13
DFS	$98.39	4.74	10.23	14.86	2.13	1.18
FRC	$151.22	4.43	10.47	26.77	2.12	1.03
GS	$328.17	4.21	7.25	14.22	1.05	0.98
JPM	$116.19	3.64	4.86	26.62	1.35	0.92
MS	$86.98	3.52	5.11	11.39	1.60	1.04
OZK	$41.20	3.18	4.26	11.47	1.15	0.94
PNC	$160.48	3.49	8.10	19.97	1.58	0.90
RJF	$106.86	2.68	2.27	6.43	2.45	1.12
SBNY	$177.75	5.36	13.89	45.05	1.53	1.48
SCHW	$72.86	2.76	2.86	13.37	3.94	1.06
SI	$89.24	8.04	16.62	39.78	1.99	2.44
TD	$66.04	3.69	2.47	13.88	NA	0.77
TFC	$47.11	4.92	8.98	19.55	1.11	0.83
USB	$45.20	4.97	7.33	19.54	1.62	0.80
WAL	$74.86	5.19	12.48	30.46	1.78	1.14
WFC	$43.17	5.18	6.03	10.03	1.05	1.01
WSFS	$48.70	2.11	3.77	2.83	1.34	0.85

Source: Bloomberg (09/13/22)

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