

The Deflating Mortgage and Housing Bubble, Part IV: Where Is the Bottom?

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Where Are We in the Credit Adjustment?

- Our view of the US banking and credit sectors is that the credit adjustment process is nearing half way.
- The first portion of the crisis starting from the collapse of New Century Financial early in 2007, was about loss recognition.

Where Are We in the Credit Adjustment? (2)

- The second phase of the crisis is more focus on loss realization, that is, the sale of distressed assets and the charge-off of bad or doubtful credits.
- Loss rates on banks already reporting Q3 2008 results continue to climb rapidly and provisions flowing into reserves at more than 2x current charge-off rates.

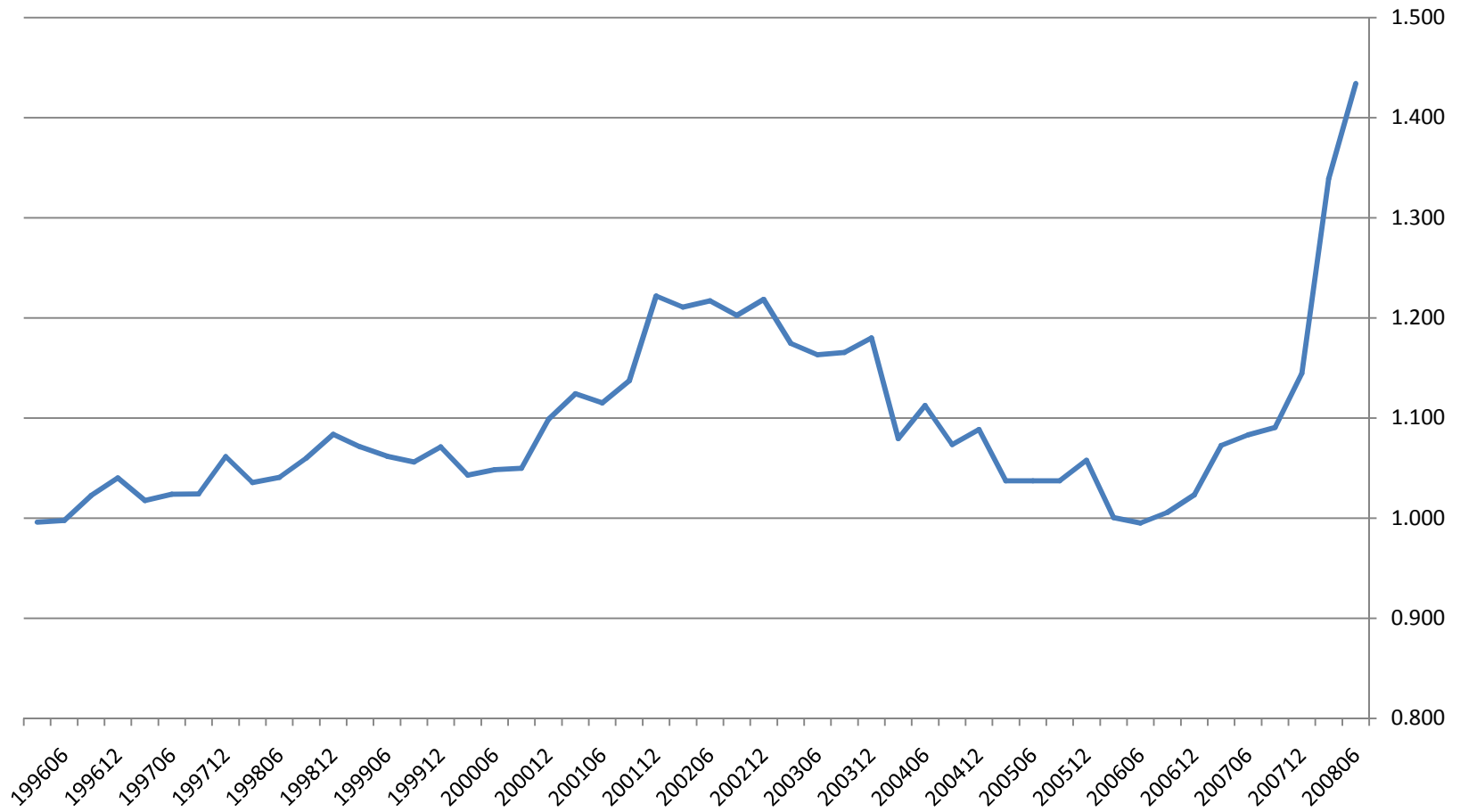
Where Are We in the Credit Adjustment? (3)

- The third phase of the crisis involves a broadening of losses from asset classes such as mortgages and financials into a more general credit loss peak cycle affecting entire economy.
- There will be continuing need for government support of large banks as on- and notional off-balance sheet obligations become very real and must be funded.

Where Are We in the Credit Adjustment? (4)

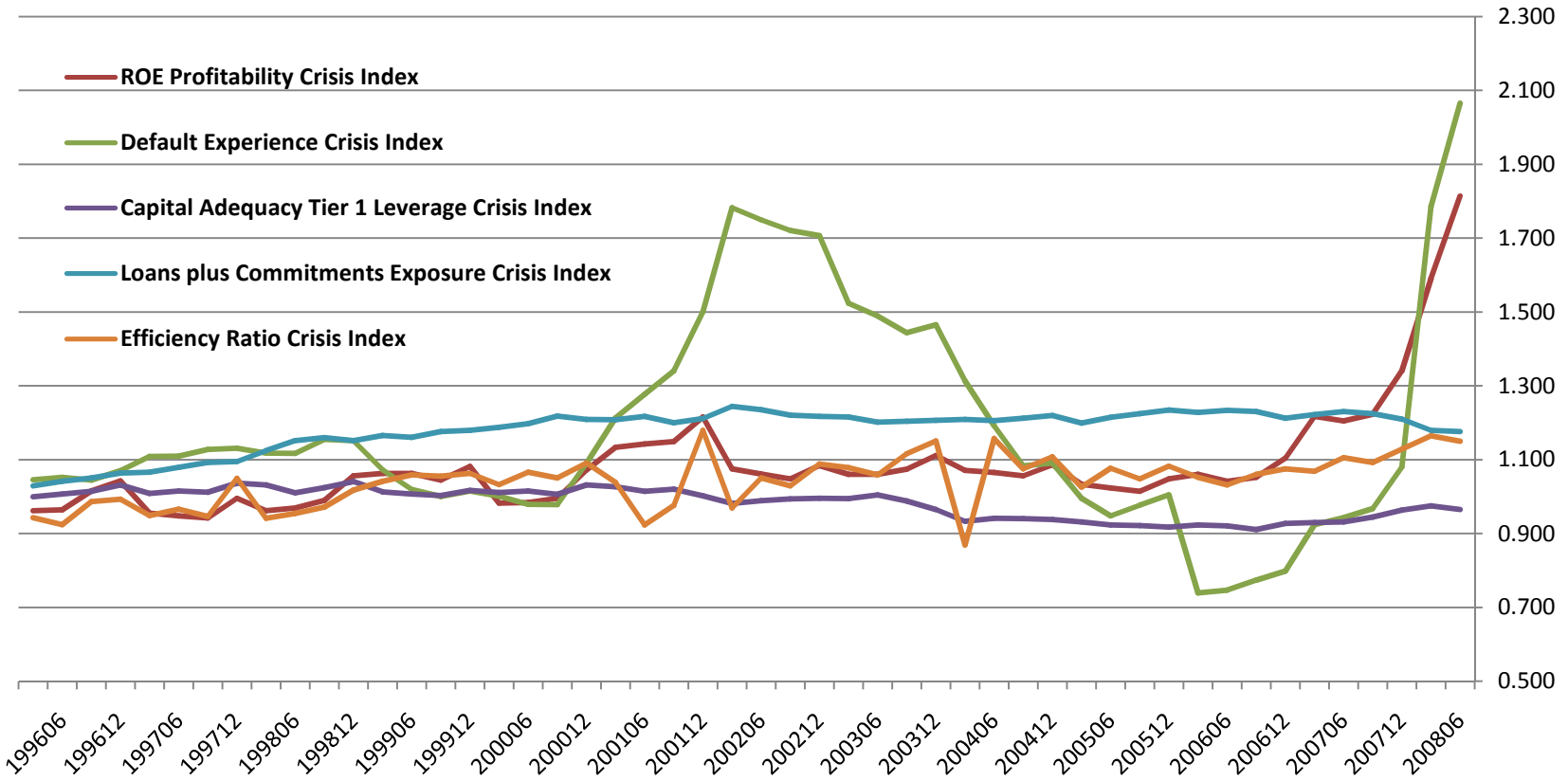
- Funding needs for financial institutions are going to be dominated by first loss absorption, then reserve/capital replacement, and finally balance sheet expansion via new lending.
- The full weight of the funding required to liquefy/subsidize OTC credit default and other derivatives still not recognized by Fed, G-7 central banks.

Credit Crisis Index



Source: FDIC/IRA Bank Monitor

Banking Stress Indices

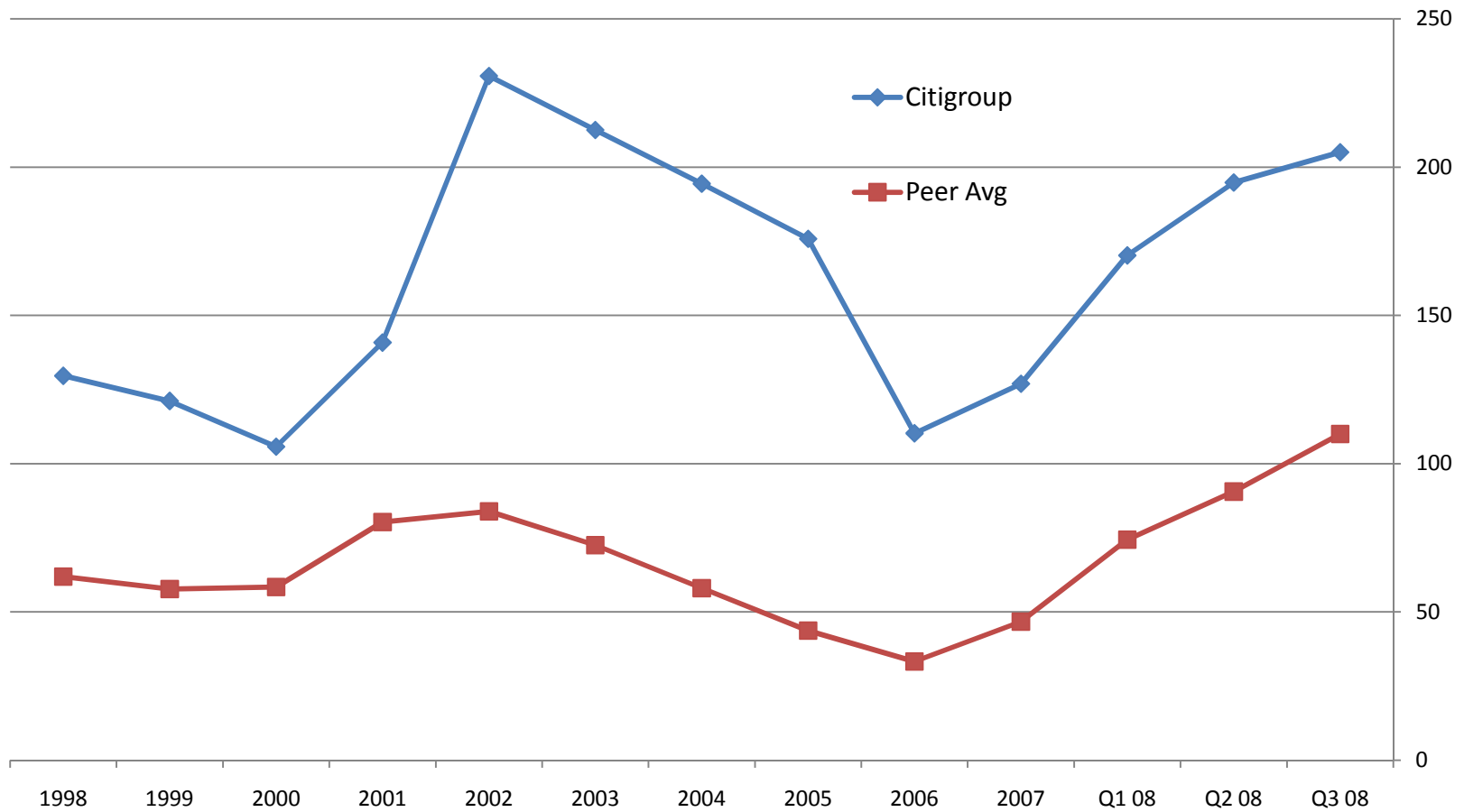


Source: FDIC/IRA Bank Monitor

Outlook for 2009

- We expect to see charge-offs by US banks peak in Q2 2009, but timeframe could be effected by economic trends.
- Depending on severity of recession, loss rate peak in 2009 could exceed 2x 1990-91 loss rate peak from last major recession.

Gross Defaults: Citi vs. Peers (bp)



Source: FDIC/IRA Bank Monitor

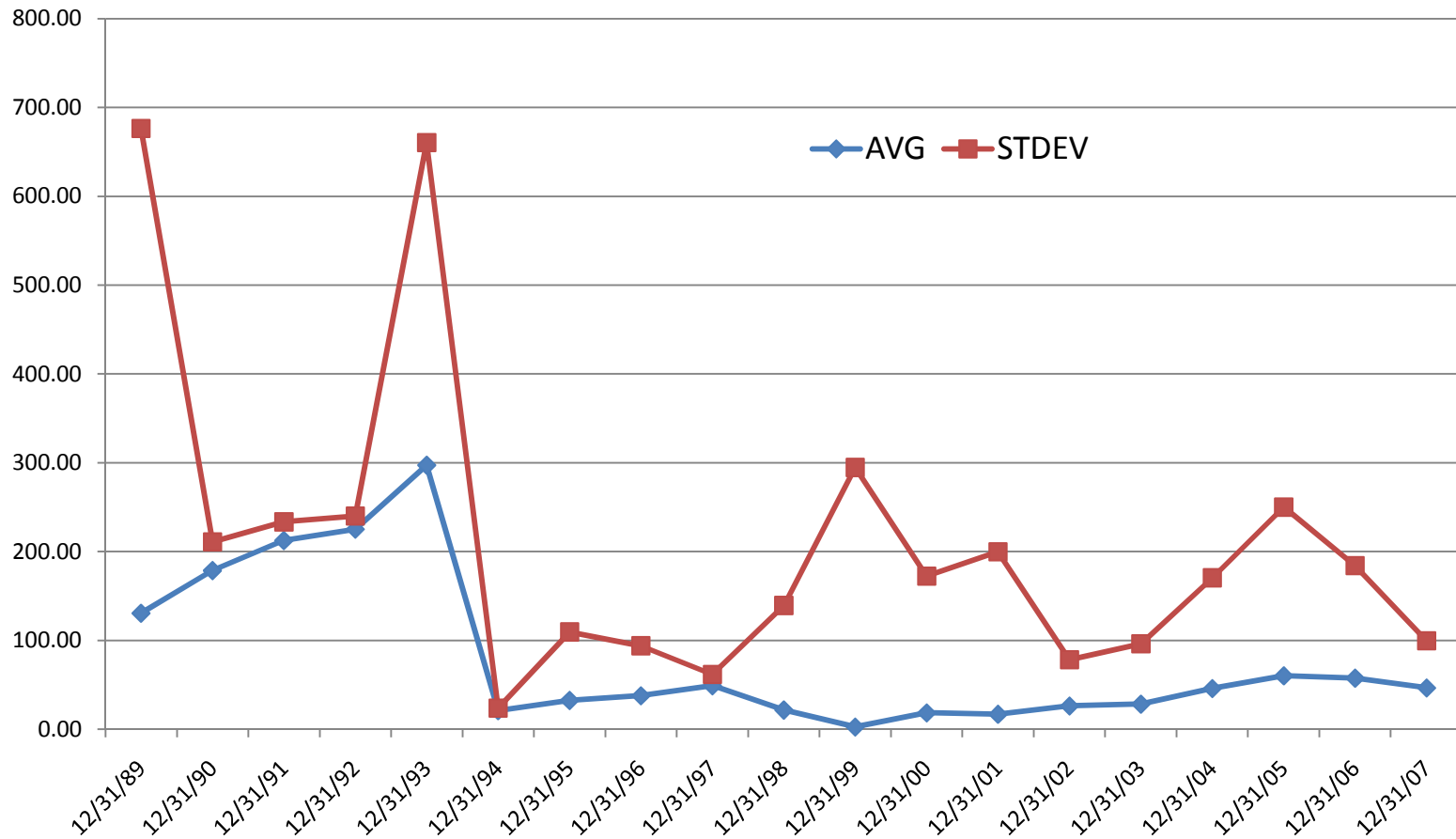
Outlook for 2009

- A loss rate peak in the 2x 1990-91 range implies that additional capital injections must be made into the largest US banks.
- In the event, Washington may be in explicit control of a large portion of US banking assets, raising public policy question of how to liquidate public stake.

What is the Business Model?

- Given the collapse of the US banking system, Basel II capital adequacy framework must be abandoned as ineffective.
- Key question for future is what types of activities will be permitted within a regulated, deposit-taking entity?
- Falling risk-adjusted returns suggest that expectations for banking industry profits may be significantly overstated.

RAROC (%) -- Top 100 Banks



Source: FDIC/IRA Bank Monitor

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