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## Bank Investors Expect Less as Losses Mount

By [ERIC DASH](#)

Can the bad news for banks get any worse?

After the last week brought another round of woeful quarterly results from the industry, capped by news on Tuesday of multibillion-dollar losses at the [Wachovia Corporation](#) and [Washington Mutual](#), that question is nagging banking executives and their investors.

[Kenneth D. Lewis](#), the chief executive of [Bank of America](#), insisted this week that the industry was turning the corner, after his company reported a mere 41 percent drop in profit. Many investors seem to see signs of hope in red ink that once would have shocked them.

But it has now been a year since the credit crisis erupted, and, so far, the optimists have been proven wrong time and again. Skeptics say it could take years for banks to recover from the worst financial crisis since the Depression. And even when things do improve, the pessimists maintain, banks' profits will be a fraction of what they were before.

There are many reasons for caution. Home prices continue to decline, and defaults are accelerating on a wide range of loans. As lenders struggle, loans are becoming even more scarce for hard-pressed consumers and companies. That, in turn, could slow any recovery in the broader economy.

For now, at least, some investors seem to have become so inured to the bad news that results that would have once been viewed as disastrous are now seen as good, or even great. The sober phrase often used on Wall Street to describe solid corporate results — “better than expected” — has been replaced by “not as bad as feared.”

“We are resetting expectations for bank profitability, and we are re-exploring what our expectations should be going forward,” said Christopher Whalen, managing partner of Institutional Risk Analytics. “We are redefining bad.”

That was clear on Tuesday, when Wachovia posted \$8.9 billion second-quarter loss — and its stock subsequently rose 27 percent.

Shares of Washington Mutual, rose 6.2 percent as that company reported a \$3.3 billion loss. Investors cheered even though Washington Mutual said a record number of borrowers were unable to keep up with mortgage payments.

Fifth Third Bank and KeyCorp, two lenders based in Ohio, fell short of analysts' earnings estimates and posted big losses, but their share prices shot up, too. [SunTrust Banks](#) of Atlanta reported a 21 percent drop in profit, reflecting bad real estate loans. No matter. Its stock rose 16 percent after telling investors it would not need to raise capital after selling its stake in [Coca-Cola](#).

Longtime industry executives warned that investors may be getting ahead of themselves.

“The market believed that this bad news was going to get dramatically worse — quickly,” said John Kanas, the former chief executive of North Fork Bank. “The bad news is going to get dramatically worse, but it will take time.”

For many banks, the housing crisis is entering a new — and potentially even more dangerous — phase. The problem is no longer subprime mortgages or complex investments tied to them, but rather the slowdown in the economy, which will make it more difficult for companies and consumers to keep current with their creditors.

Banks are pulling back. In the last six weeks, lending nationwide has remained flat after peaking at a record high, according to Federal Reserve data.

“We’ve gone from a credit crisis to a credit crunch,” said Ed Yardeni, chief investment strategist of his own research firm. “It could be more damaging to economy than it has so far.”

The recent bath of bank results underscored that many borrowers are in trouble already. Wachovia reported a sharp rise in defaults on so-called pay-option mortgages that were a hallmark of the housing bubble. Plunging home prices, particularly in Florida and California, have left 14 percent of the bank’s customers with zero or negative equity in their homes. Wachovia’s big portfolio of commercial real estate is suffering losses too.

The problems extend beyond well beyond housing. Delinquencies on auto, credit cards, and home equity loans have worsened across the industry. Even affluent people with sterling credit scores are falling behind on payments, as results this week from [American Express](#) showed.

Once people fall behind, “the likelihood that they will make good on the debt is much lower than it has been in the last five to 10 years,” said Michael Poulos, a financial services consultant at Oliver Wyman in New York. “If we have significant unemployment or a recession, that is what I would worry a lot about.”

Commercial loans may be a ticking time bomb. Bank of America showed a sharp increase in charge-offs related to small business loans this quarter. But bigger companies are increasingly squeezed.

“Up until this quarter, the majority of all the credit problems have been tied to one single issue: the decline of residential housing market,” said Gerrard Cassidy, a banking analyst at RBC Capital Markets. But if unemployment and the economy worsen, “then you are talking a traditional recession and the effects it has on commercial loans.”

Robert K. Steel, a former under secretary of the Treasury who recently became the chief executive of Wachovia, offered a measured assessment of the industry’s prospects on Tuesday.

“The reality is that we are really in challenging times in terms of the economy, housing, and financial services,” Mr. Steel said. “I can’t tell you that the improvement will be smooth and continuous, and the odds are high there will be new challenges that we will have to face.”

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