

## E-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS  
**FROM:** Karl Ostby, Managing Director  
**DATE:** April 29, 2011  
**SUBJECT:** Candid Optimism from Wall Street *and* Main Street

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The first quarter earnings season for public banks is near complete and call reports for privately held banks will soon be available. Interpreting the data along with 2010 annual reports shows a number of significant trends for the banking industry. No one does this better than Jamie Dimon, the CEO of JP Morgan Chase. If you haven't already, we highly recommend reading Dimon's letter to JPM shareholders. Dimon's directness and insight has justly earned him a reputation as the Warren Buffett of bank shareholder letters. He writes from a large bank perspective providing a thoughtful review of JPM along with the regulatory and economic headwinds and opportunities facing the financial industry.

His letter spans 32 pages, so we'll summarize a few observations. Dimon is not one for excuses, and his willingness to address mistakes is refreshing. Unlike other bank CEOs, he doesn't dwell on regulatory or economic challenges to defend the bank's shortcomings. For example, in the shareholder letter he makes an open apology to the military for his bank's fumbling of its mortgage foreclosure process. He also provides a candid review of the Washington Mutual acquisition results compared with their initial expectations. But he is also an advocate for his bank. He provides a helpful review of JPM's stress tests of capital and makes a strong case for being well-capitalized and for their ability to pay dividends. He has a refreshing definition of risk management: "[O]ur goal is not to guess the future; our goal is to be prepared to thrive under widely variable conditions."

On the regulatory front, Dimon strongly supports the government's moves at the peak of the financial crisis: "A great number of the actions that the Treasury and Federal Reserve took. . . helped sustain numerous institutions and probably prevented many from failure and bankruptcy." Generally, he supports regulatory changes requiring higher capital and liquidity standards. But, like the rest of the industry he heaps scorn on the Durbin Amendment (which caps debit card exchange fees), referring to it as "price fixing at its worst." He said it, but everyone else was thinking it.

Jamie lays out a positive view for the banking environment going forward. Picking up on Jamie's observations, there are several notable trends that played out in the 2010 results and early indications of the first quarter:

- **Improving credit quality and earnings.** 62% of banks reported better net income in 2010 compared with 2009. This was driven by a 37% reduction in loan loss provision (due to improving loan quality), a drop in goodwill charges and more gains on securities. Despite the asset quality improvements, about 25% of US banks reported a loss in the 4<sup>th</sup> quarter and about 12% of the banks are considered problem banks (those rated a 4 or 5) by the FDIC.
- **Weak loan growth.** Reflecting the poor economy, bank loan portfolios have contracted for 9 out of the past 10 quarters. During the fourth quarter, 60% of the banks saw loan balance declines. Although many banks are willing to lend, there is a scarcity of loan demand and quality borrowers.
- **Net interest margins are mixed.** Banks reporting improvement in net interest margin are successfully running off high cost deposits and borrowings and lowering nonperforming assets. Many banks, however, are challenged by elevated liquidity, low securities yields and weak loan demand. The majority of banks have positioned their balance sheets for increasing rates.

- **Shift to PE multiples from tangible book value.** Valuing bank stocks has been focused mainly on price to tangible book value for the last two years due to low or nonexistent earnings and major asset quality problems. As earnings improve, the focus is shifting back to price to earnings or, in many cases, normalized earnings.
- **Continued concern on regulatory implementation and cost.** The true cost of regulation brought on by Dodd-Frank and the Consumer Financial Protection Bureau is still difficult to know. There is a movement to blunt the impact and there is still a great deal of regulatory interpretation to come. We are optimistic banks will find cost-efficient ways of addressing these new burdens as they have in the past. Increased compliance burdens and uncertainty are creating a downward impact on bank valuations—especially those of community banks. There is a great deal of discussion that the added compliance cost leads to banks under \$ 1 billion in assets not being large enough to efficiently absorb the added expense. This is one of the factors suggesting continued consolidation.
- **Fewer FDIC-assisted transactions and increased M&A.** Comments by regulators suggest we will see a decline in FDIC-assisted transactions in 2011 and the relative size of banks that fail this year will be smaller. There are indications that regulators are becoming more patient in working with problem banks. This is encouraging a trend to more traditional whole bank acquisitions. This is also dampening the prospects of investor groups that have organized to purchase failed institutions.
- **Sharp decline in first quarter mortgage origination despite markedly less competition from brokers.** Residential mortgage origination is going through significant change. Originations are down substantially in the first quarter as mortgage rates have edged up. Borrowers who can refinance have likely already done so, underwriting standards are more stringent (in some markets cash purchases exceed 30%), and the housing market remains sluggish. Many banks (including Wells Fargo) reduced their mortgage staff in the first quarter. Because of increased underwriting standards, tighter mortgage originator compensation standards, and a weak market, there has been a significant decline in the number of mortgage brokers. Many are finding homes in traditional banks. The positive news is the banking industry is capturing more of the market share for mortgage originations.

Although the news is mixed, asset quality burdens are clearly improving. There is a shift to more focus on top line revenue growth. Bank performance and valuations should show continued improvement as the economy improves. As banks navigate the uncertain future, there is a premium put on skilled and experienced management teams. We share Dimon's optimism for the future of our industry, but know the headwinds will not die out overnight. However, as the economy improves, investors who can identify such teams will benefit greatly from the continued improvement in bank performance and valuations.

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