

October 2011

U.S. Banking Sector:

Fundamentals have been improving, but environment is weakening

Executive Summary

While the large U.S. banks face a mountain of potential legal and regulatory costs, improved profitability as credit costs have dropped have allowed them to position themselves defensively. Current economic growth suggests moderate profitability at best going forward. The U.S. regional banks are experiencing trends similar to those of the large banks, but competitive pressures seem less intense and potential legal claims are less of an issue, suggesting potential for more favorable performance versus the large banks in a generally stable environment. In a downturn, relatively larger real estate exposures could translate to weaker performance. The trust banks remain a spot of relative stability, although slower capital markets in 3Q signal earnings restraint. The credit card banks may represent the “most improved” group as credit costs have receded markedly, and the banks have significantly improved their liquidity profiles. Still, lack of diversification and less robust liquidity remain important unfavorites for these banks. A dramatic slowdown in capital markets activity through the third quarter suggests a highly pressured operating

environment for investment banking. In summary, those U.S. financial institutions with the size and franchise strength to actively participate in wholesale liquidity markets face notable challenges, but they have generally positioned themselves to maintain sound fundamentals.

Large Banks

Despite headwinds in 2Q11, earnings at the large U.S. banks increased on average due to continued reserve releases as credit metrics showed further improvement. In particular, the banks saw lower net charge-offs from their credit card portfolios, and a steepening decline in nonperforming loans largely due to improvements in residential mortgages and C&I loans. Still, we remain cognizant of the banks’ sizeable residential and home equity portfolios, particularly high loan-to-value books, which are susceptible to weakening home prices and a continued soft U.S. economic recovery. Earnings were pressured by constrained revenue growth due to continued weak loan demand and low interest rates, which pressured asset yields and net interest margins. While lower funding costs

have been a significant offset, there are generally fewer deposits left to reprice, and with rates now expected to remain low for at least another two years banks have forecast a stable to declining margin for the second half of 2011. Compounding the revenue growth challenge were weaker capital markets activities and lower fees associated with regulatory changes such as overdraft and credit card fee restrictions, with a further impact from new regulatory limits on interchange, or swipe fees, to hit in 4Q11. Furthermore, banks continued to face representation and warranty expenses, albeit down from the prior year and significantly lower at some banks than others. The banks could also face a one-time settlement charge pending the outcome of the current nationwide state Attorney General's investigations of mortgage-servicing abuses, in addition to risks related to settlements with private-label investors and monoline insurers, as well as potential legal claims like the recent Federal Housing Finance Agency securities fraud lawsuit. That said, banks have been building legal reserves, which should make a potential impact more manageable. Still, expenses have gone up mostly from litigation costs and default-related servicing costs. Steeper costs together with revenue constraints have prompted banks to focus on cost-cutting initiatives and realignment of businesses to facilitate more streamlined franchises. Liquidity and

funding profiles have been significantly strengthened with an aggregate loan-to-deposit ratio of 80% versus 87% a year ago. Capital levels are much improved and while some banks have the capacity to be Basel 3 compliant earlier than the specified timeline, all banks should be able to meet regulatory requirements through retained earnings and continued balance sheet shrinkage. Exposures to the Eurozone, net of hedging, seem manageable given that a majority of the exposure at each bank is to non-sovereigns, and also when looked at in the context of the banks' earnings capacity and equity.

Regional Banks

The large U.S. regional banks all remained profitable in 2Q11 with income mostly improved from the prior quarter, continuing a trend of recent quarters following a prolonged period of losses. On an aggregate basis, the increase in income largely reflected lower loan loss provisions, reserve releases and moderately higher loan levels. Nonetheless, net interest margins were flat to down as lower yields on loans and securities offset lower funding costs. Managements across the board have reiterated improvements in loan pricing, growing low cost deposits and repurchasing or refinancing debt as potential ways to combat margin compression going forward. Representation and warranty

costs were flat to down during the quarter, remaining very manageable but immaterial for most banks. Cost containment is a growing focus at many banks, and expenses that are OREO-related are expected to be reduced as credit deterioration further abates. As was the case with the large banks, asset quality further improved with a slowdown in nonaccrual inflows, criticized loans and delinquencies. Net charge-offs were also down, with a few exceptions that related to nonperforming asset disposition strategies. With a larger proportion of commercial real estate loans on balance sheet, regional banks remain more vulnerable to a downturn in this market; however, banks have been reducing such exposures and performance is trending better and remains manageable, albeit historically weaker. Liquidity has been enhanced with cash at holding companies bolstered by both equity and debt issuances. Likewise, capital levels have grown from retained earnings and remain favorable. Despite banks returning capital to shareholders, they are in a position to be compliant with Basel 3 requirements within the framed timeline.

Trust Banks

Although revenues were impacted by the low rate environment, the trust banks remained solidly profitable. Fee income growth was good with securities

lending fees up due to seasonality and trading revenues benefiting from higher foreign exchange fees. Moreover, there was continued momentum in core businesses with increased levels of Assets under Management and Assets under Custody thanks to higher fixed income asset valuations and new business wins. While margins were slightly pressured, spread income was flat due to larger balance sheets from higher client deposits as investors sought a safe haven in light of concerns over the global economy. In light of revenue headwinds, the banks are implementing cost saving initiatives to help drive positive operating leverage. In particular, in addition to the usual 3Q seasonal weakness in trading revenue compounded by a weakened capital markets environment due to global concerns, the banks continue to face the low interest rate environment in the U.S. as well as a soft economic recovery. Asset quality problems remained immaterial for the trust banks. Balance sheets remained highly liquid due to cash holdings, deposits with banks and the securities portfolios, which are at least 80% triple-A rated. The banks were also solidly capitalized with ratios significantly above required thresholds as well as most large and regional banks.

Credit Card Banks

The consumer finance/credit card banking sector continued to experience

positive credit trends during the second quarter of 2011, with improving asset quality, strengthened capital ratios, and modest growth in lending and credit card receivables. Credit quality continues to show marked improvement, as evidenced by much lower delinquencies and fewer charge-offs since the height of the credit crisis. This has led to lower provisioning and substantial reserve releases that have bolstered quarterly earnings. Future profitability will be less dependent on the pace of reserve releases as asset quality metrics reach more normalized levels, which places a greater emphasis on margin expansion, receivables growth, and lending volumes. Overall liquidity management has improved significantly, attributable to a reduced reliance on short-term funding, a growing direct and brokered deposit base, and a balanced debt maturity profile. Increased funding diversification should provide ample financial flexibility to deal with any sustained lack of access to the capital markets, which was prominent during the credit crisis. Regulatory capital ratios have been further strengthened, as a result of retained earnings growth, fewer credit impairments, and the absence of securitization consolidation impacts that had previously pressured capital.

U.S. consumers continue to remain cautious in their spending habits, and changes in either fiscal or monetary

policy will not necessarily encourage consumers to increase discretionary spending from savings or from increasing household leverage. This could ultimately constrain banks' revenue generation in terms of loan growth, interest income, and purchasing volume-related fee revenues. Future credit card receivable and spending growth could be hampered by persistently high unemployment and sluggish economic growth. Despite the stagnant economic environment, consumer credit card spending has not been as severely impacted as originally thought, as evidenced by a rebound in spend metrics and historically high payment rates. Should the economy weaken moderately, consumers may initially turn to revolving credit in order to maintain living standards, which bodes well for the credit card issuing banks. We remain cautiously optimistic that the positive trend in credit quality will persist, spending growth will pick up, and solid regulatory capital levels will be sustained.

Investment Banks

Results in the investment banking sector for second quarter 2011 were modestly disappointing with mid-single digit ROEs and soft revenue trends, although capital levels improved and liquidity remained robust. In the third quarter, global concerns related to several Western world sovereigns

and the possible impact on the global financial sector have been devastating to capital markets. Issuance volumes have declined significantly in almost all businesses and many markets have performed poorly. Volatility, which often creates revenue opportunities for investment banks, has clearly been elevated, but volatility has stemmed from dysfunctional political processes, offering almost no potential for controlled risk taking. Consequently,

we expect third quarter 2011 financial results to be quite weak in the sector.

Those banks with primarily wholesale business lines have long been strong competitors with well established, even entrenched, franchises. Post 2008 they have increased and maintained capital and liquidity to unprecedented levels within the current era. Tier 1 capital ratios are in the mid-teens and liquidity buffers are multiples (in the neighborhood of 3-4 times) of

unsecured short debt. The banks are extremely skilled at managing both liquidity and market risk. However, the business model is inherently vulnerable to sudden shifts in liquidity availability and the banks' strong liquidity barricades since 2008 are as yet untested. Consequently, going into a period where revenues and hence profitability are vulnerable and at a minimum subject to volatility, we believe it is prudent to remain very defensive.

For more information, contact your BNY Mellon Fixed Income representative, call **1-800-374-6969**, or visit our website at **www.bnymelloncis.com**.

The statements and opinions expressed in this article are attributed as of the date of this article and are subject to change at any time. This article does not constitute investment advice, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. BNY Mellon Asset Management and its affiliates are not responsible for any subsequent investment advice given based on the information supplied.

Past performance is not a guide to future performance. This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management.