

United States: Banks

Losses - modifying the tune, but the song remains the same

Bad loans = big losses

We are entering the final third of loss recognition with \$1.6 tn of losses realized to date. Key points:

(1) Stable estimate, changing composition: We have estimated \$2.1-\$2.6 tn of total losses from US credit since March of 2009. We still believe this is the right range but update the composition with more for prime mortgage and commercial real estate and less for consumer and C&I.

(2) Two-thirds through recognition: \$1.6 tn of losses have been recognized, putting us about 2/3 through the cycle. Bank NPA and reserve levels are also about 2/3 of the way to the peak in prior regional home price depressions, which have exhibited similar cumulative loss rates.

(3) Remember the cause- bad lending: The core cause of the crisis – bad lending, particularly in real estate. 98% of losses can be traced to bad loans in general, and 70% of losses can be traced back to bad real estate loans. Regulators will likely re-focus on this. Consider that almost every bank that has failed cycle to date has either been overweight Option ARMs or construction loans.

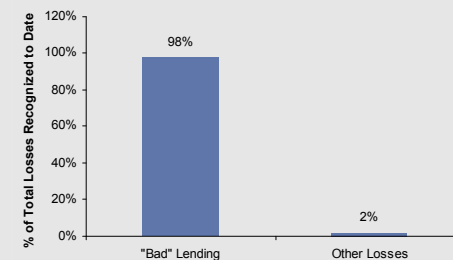
(4) Prime problems: Prime mortgage credit trends continue to disappoint while commercial real estate will be increasingly evident as well. Conversely, consumer and C&I losses seem likely to come in below our original expectations given recent improvement in the data and outlook.

(5) Q: Was the stress test enough? A: Yes: With unemployment at 10.2% vs. a 10.3% stress test peak, it is reasonable to ask if the stress test was enough. 2009 loan losses, trading results, and pre-provision earnings have all tracked better than the stress test forecast. Moreover, banks raised \$10 bn more capital than the stress test required.

Continue to favor consumer credit

A lower consumer cumulative loss outlook simply formalizes what we have been saying for some time – rate of change of unemployment matters more than the level. If unemployment flattens out at a high level, consumer credit will improve. Thus we remain positive on big banks and credit card stocks with JPMorgan Chase, Bank of America and Capital One rated CL-Buy.

BAD LENDING = BIG LOSSES:



Note: "bad" lending includes losses from direct loans and securities backed by loans.

Source: Goldman Sachs Research.

RELEVANT RESEARCH:

January 13, 2009: *As mortgage loss estimates continue to rise, further policy response likely to follow.*

February 26, 2009: *Making sense of the next round of government capital.*

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\$2.1-\$2.6TN of total US credit losses; more for prime mortgage, less consumer and C&I

We have estimated \$2.1-\$2.6 tn of total losses arising from US credit since March of 2009. We still believe this is the right range although with some modifications in the composition. Specifically:

- We are increasing our prime mortgage loss range from 3%-4% to 5%-6%. This reflects recent deterioration in credit trends with delinquencies accelerating and severities still rising. This total includes both conforming prime mortgages (e.g. Fannie and Freddie) as well as prime jumbos.
- Increasing our commercial real estate loss range to 8%-10% from 7%-9%. This reflects the work done last month in our report "Commercial Real Estate Take III: Reconstructing estimates for losses, timing". Within that range we assume 20% cumulative losses for construction loans and 6% for commercial mortgages.
- Reducing our loss range for credit cards to 20%-23% from 23%-28% before. This reflects recent moderation in both delinquencies and losses. Similarly we reduce auto from 12%-16% to 9%-14% given improvement in delinquencies and collateral values (i.e. used car prices).
- Reducing commercial losses to 5%-7% from 6%-8%. This reflects expectations for lower corporate defaults in 2010 vs. 2009.

Aggregate losses on US debt should be about 10%. While this is unprecedented in the sense that it has never happened to the whole US, it is similar to prior regional home price depressions such as Texas in the mid-80s, Arizona in the late 80s, etc (see Exhibit 2).

Exhibit 1: Total expected losses: \$2.1-\$2.6 tn

\$ in trillions

\$ trillions	Out-standing	Low		High	
		Losses	Cumulative Loss Rate	Losses	Cumulative Loss Rate
Subprime	0.9	0.3	32%	0.3	38%
Option ARM	0.5	0.1	27%	0.2	33%
Home Equity	1.1	0.1	13%	0.2	16%
Other (FHA, GNMA)	0.9	0.1	11%	0.1	14%
Alt-A	2.2	0.2	11%	0.3	14%
Prime	5.7	0.3	5%	0.4	6%
Resi Mortgage	11.3	1.2	11%	1.5	13%
Commercial Real Estate	3.3	0.3	8%	0.3	10%
Cards	1.0	0.2	20%	0.2	23%
Auto	1.1	0.1	9%	0.2	14%
Commercial	6.8	0.4	5%	0.5	7%
Total	23.5	2.1	9%	2.6	11%

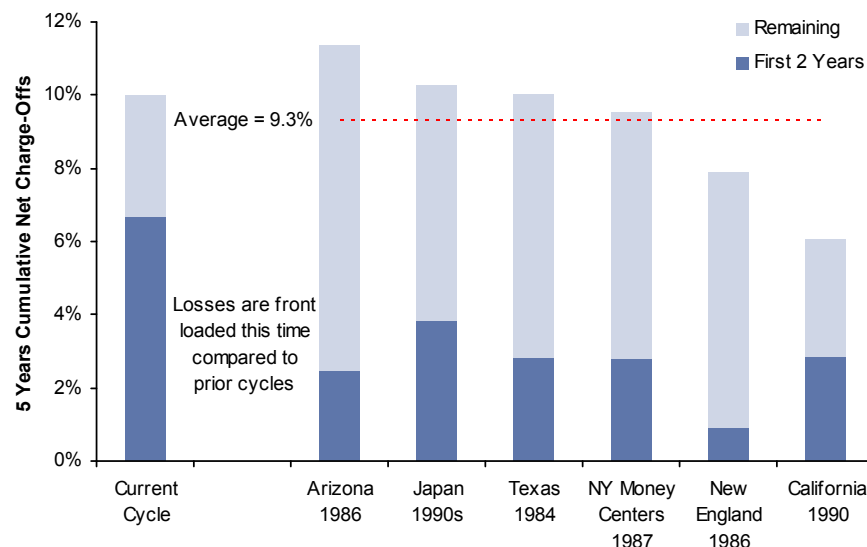
Losses Recognized as of 3Q09



\$1.6TN

Exhibit 2: Current losses versus prior Cycles

cumulative losses : current vs. prior cycles



Source: Company data, SNL, Goldman Sachs Research.

Source: Company data, Goldman Sachs Research.

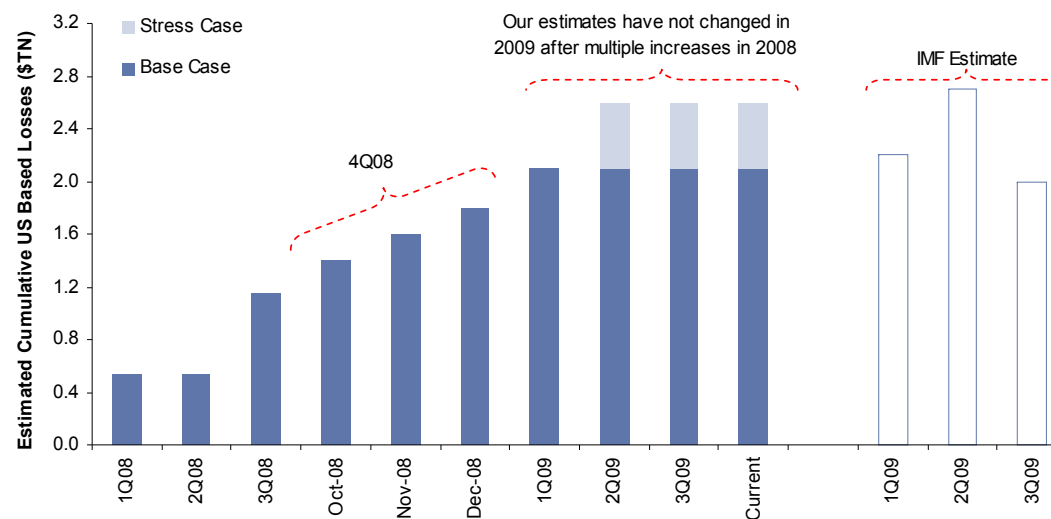
Exhibit 3: Cumulative loss estimates by loan category: old vs. new

\$ trillions	Old		New		Change
	Base	Stress	Base	Stress	
Subprime	32%	38%	32%	38%	↔
Option ARM	27%	33%	27%	33%	↔
Home Equity	13%	16%	13%	16%	↔
Other (FHA, GNMA)	11%	14%	11%	14%	↔
Alt-A	11%	14%	11%	14%	↔
Prime	3%	4%	5%	6%	↑
Resi Mortgage	10%	12%	11%	13%	↑
Commercial Real Estate	7%	9%	8%	10%	↑
Cards	23%	28%	20%	23%	↓
Auto	12%	16%	9%	14%	↓
Commercial	6%	8%	5%	7%	↓
Total	9%	11%	9%	11%	↔

Source: Goldman Sachs Research estimates.

The difference between 2009 vs. 2008 is the estimates have not changed much. During 2008 we were constantly forced to revise up losses (Exhibit 4). Our \$2.1-\$2.6 tn is now similar to other forecasters. During early 2009 many moved to higher levels. For example, the IMF is now down to \$2 tn of losses which is slightly below our range after reaching a peak of \$2.7 tn of US losses in April.

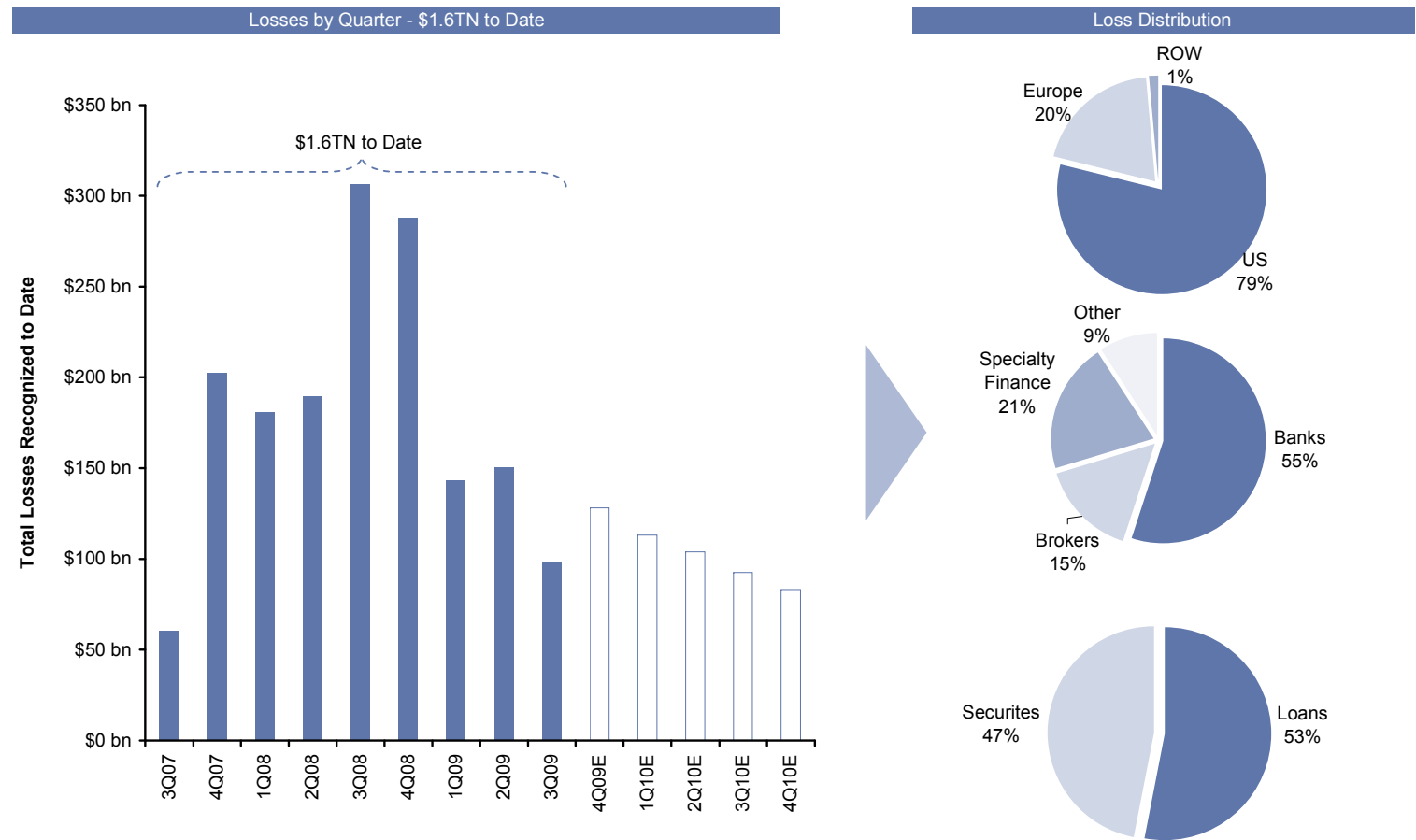
Exhibit 4: We have estimated \$2.1-\$2.6 tn of total losses arising from US credit since March of 2009



Source: IMF, Goldman Sachs Research estimates.

The losses are coming through faster with about two-thirds of total losses recognized to date – at the comparable point of prior cycles only one-third of losses had been recognized. Much of this is due to mark to market of securities which have accounted for half of the losses so far (see Exhibit 5).

Exhibit 5: \$1.6 tn of losses recognized to date
forecasts based on qoq change in provision forecast for GS-covered banks



Source: Company reports, Goldman Sachs Research estimates.

Exhibit 6: Top 10 companies account for about 50% of total losses recognized to date
 cycle to date recognized losses: top 10 US companies

Company	Data Through	Top 10 US Companies			
		Total Losses	% of Total	% from	
		3Q07 - Current		Loans	Securities
Fannie Mae	3Q09	143	8.8%	52%	48%
Bank of America *	3Q09	121	7.5%	35%	65%
Freddie Mac	3Q09	117	7.2%	57%	43%
Citigroup	3Q09	101	6.2%	28%	72%
Wells Fargo **	3Q09	92	5.7%	80%	20%
AIG	3Q09	89	5.5%	0%	100%
JP Morgan Chase ***	3Q09	87	5.4%	67%	33%
UBS ****	3Q09	49	3.0%	0%	100%
Morgan Stanley	3Q09	27	1.7%	0%	100%
PNC Financial *****	3Q09	26	1.6%	96%	4%
Top 10 Total	--	853	53%	43%	57%
Total US-based Losses	--	1,621	100%	53%	47%

Note:

*: including Merrill Lynch and Countrywide.

**: including Wachovia.

***: including Bear Stearns and Washington Mutual.

****: for UBS, we estimate US based credit accounts for 90% write-downs.

*****: including National City.

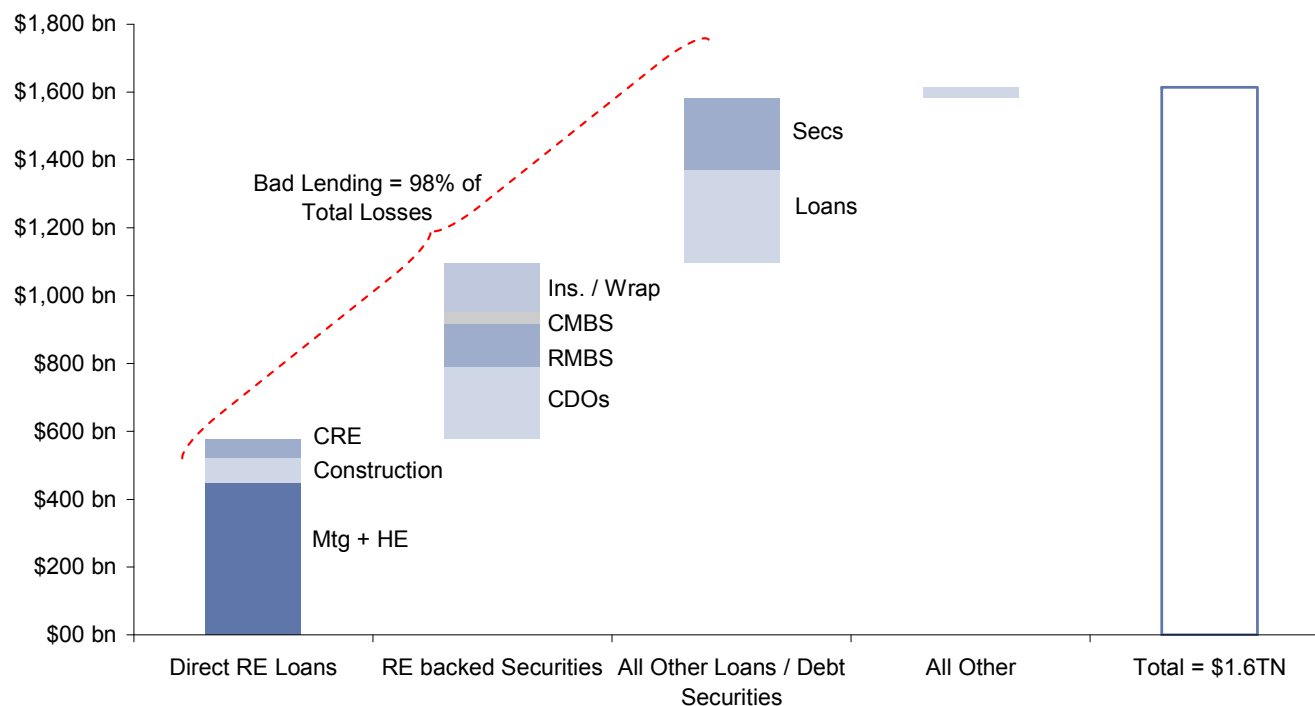
Source: Company reports, Goldman Sachs Research estimates.

Bad lending standards, especially real estate was the heart of the crisis

The core cause of the crisis was bad lending, particularly in real estate. 98% of losses can be traced to bad loans in general, and 70% of losses can be traced back to bad real estate loans. See Exhibit 7.

Exhibit 7: Bad lending account for 98% of total losses when tracking both direct loans and debt backed securities

\$ in billions



Methodology

To estimate direct loan losses:

- We calculate losses by product reported by banks since 3Q07 - 3Q09.
- We estimate provision by product assuming reserves build is proportionate to losses recognized to date.
- We then gross up losses based on the banks' market share of loan outstanding by product.

Real estimate backed securities:

- Including both securities backed by real estate loans (eg., CDOs, CMBS) and CDS/monoline wrap on these securities.

All Other:

- Including write-downs on private equity investments, MMF capital supports, etc.

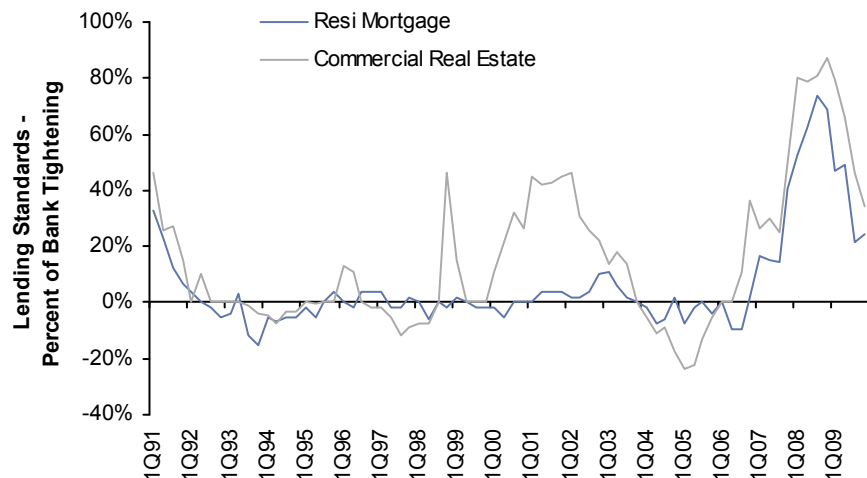
Source: Company reports, SNL, Goldman Sachs Research estimates.

Despite the current attention being paid to derivatives and other trading activities, such activities accounted for less than 2% of total losses to date. 98% of losses to date began with loan decisions and consequently, we believe that regulators will likely re-focus on the topic of lending standards.

Consider that during the entire 1992-2006 period banks were easing residential and commercial real estate lending standards – i.e. 15 straight years of progressively easier lending standards. See Exhibit 8.

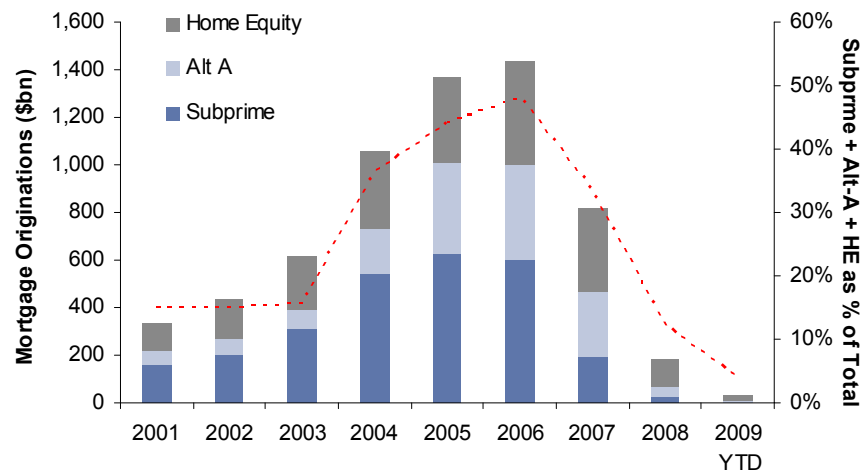
While it never looked that bad on the Fed senior loan officer survey in Exhibit 8, as banks reported only modest loosening of standards each quarter, the real proof was in the numbers - by the 2006 peak subprime, Alt-A and home equity accounted for \$1.4 tn of loans or 48% of total real estate lending (see Exhibit 9).

Exhibit 8: Lending standard easing never looked that bad...
Senior Officer Loan survey



Source: Federal Reserve, Goldman Sachs Research.

Exhibit 9: ... but the proof was low quality mortgages at 50% of the market
mortgage origination by product, \$bn



Source: Inside Mortgage Finance, Goldman Sachs Research.

Consider also that almost every bank that has failed cycle to date has either been overweight Option ARMs or construction loans.

Exhibit 10: Two products caused bank failures – Construction and Option ARM
option ARM and construction loans as % of total loans at failed banks

Option ARM driven Failed Banks	
Option ARM as % of Total	
Downey	65%
BankUnited	59%
Indymac	29%
WaMu	22%
Average	44%
Industry	5%

Construction driven Failed Banks	
Construction as % of Total	
Colonial	25%
BPOP	32%
Corus Bank	88%
Other Failed banks	36%
Average	36%
Industry	7%

Source: Company data, FDIC, Goldman Sachs Research.

Securities/ leveraged loss cycle mostly over, but again what's left is bad real estate

The leveraged loss phase of the cycle is over and at this point banks are actually recouping some capital as unrealized securities losses shrink. This added 34 bp to tangible common equity ratios in 3Q and in 4Q to date has added another 10-15 bp so far.

The unrealized securities losses that remain are heavily concentrated in bad real estate bets. Specifically, although non-agency MBS (i.e. subprime, Alt-A and prime jumbo, not Fannie/Freddie) only make up 9% of banks securities holdings they account for 90% of the unrealized losses.

Exhibit 11: Non-agency MBS accounts for only 9% of the banks' securities portfolio but 90% of unrealized losses
AFS securities (\$bn) and unrealized losses by product; unrealized losses as of 2Q

Total AFS Securities			Unrealized Losses		
	\$tn	% of Total		\$bn	% of Total
Agency MBS	0.9	44%	Non-agency MBS	-34	91%
Gov't Debt *	0.5	22%	ABS	-7	19%
Other **	0.3	15%	CMBS	-5	14%
Non-agency MBS	0.2	9%	Other **	-4	10%
ABS	0.2	7%	Gov't Debt *	-2	6%
CMBS	0.1	2%	Agency MBS	15	-40%
Total	2.1	100%	Total	-37	100%

Source: FDIC, SNL, Goldman Sachs Research.

Exhibit 12: Banks likely to get another capital boost in 4Q given continued decline in unrealized securities losses

US large domestically chartered banks, latest data point as of November 4, 2009

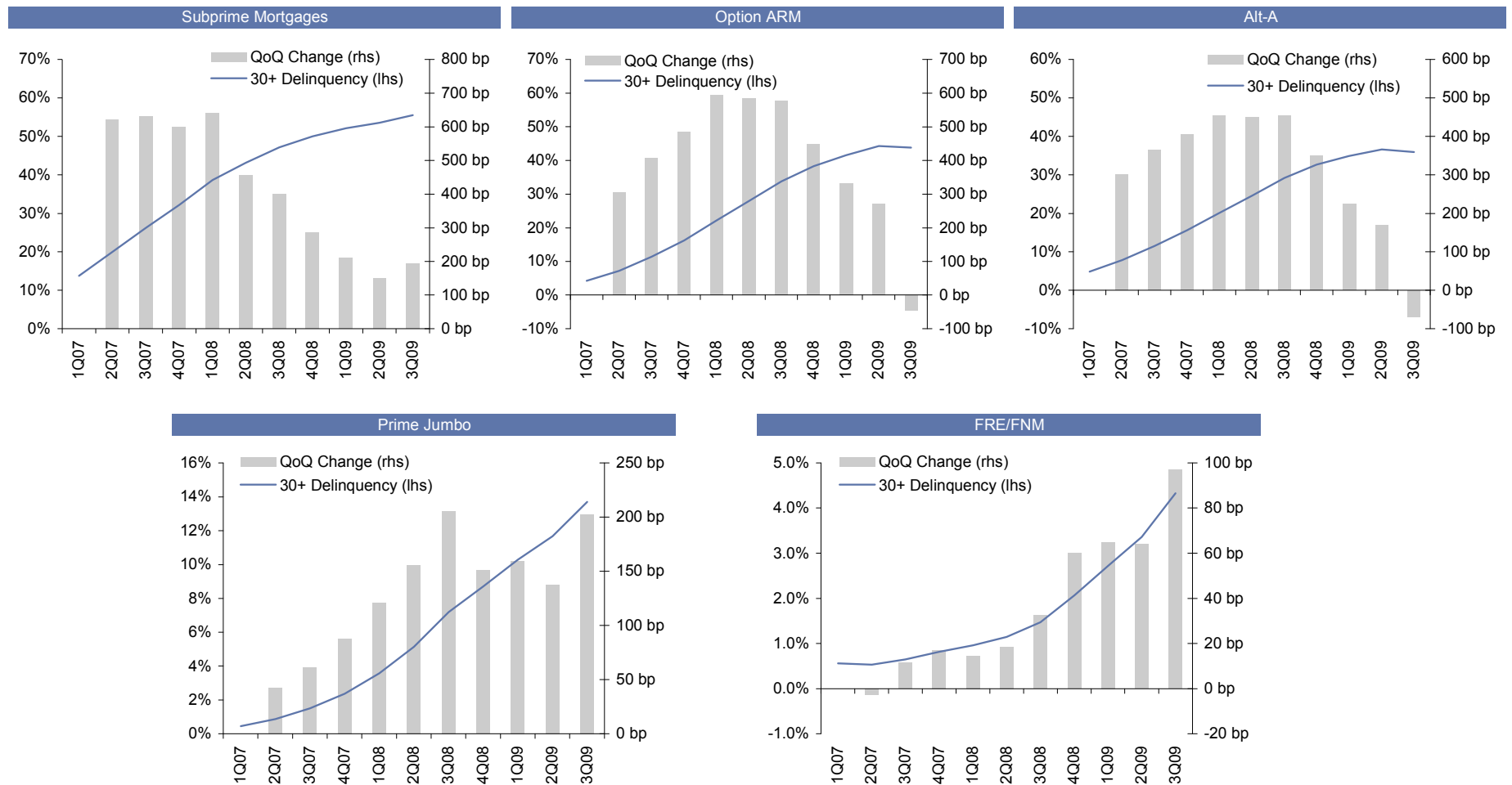
	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09
Unrealized securities losses	-3	-13	-12	-9	-16	-32	-47	-67	-47	-40	-16	-9
QoQ change	-11%	290%	-4%	-26%	73%	105%	47%	44%	-30%	-16%	-59%	-46%
Impact to TCE/TA ratios	-6 bp	-24 bp	-22 bp	-16 bp	-26 bp	-54 bp	-71 bp	-98 bp	-71 bp	-60 bp	-26 bp	-14 bp
QoQ change in TCE impact	1 bp	-18 bp	2 bp	7 bp	-11 bp	-28 bp	-17 bp	-27 bp	27 bp	11 bp	34 bp	12 bp

Source: Federal Reserve, Goldman Sachs Research.

Increasing prime mortgage loss estimates

Our increase in prime mortgage losses reflects recent deterioration in performance. The level of delinquency for prime mortgage is still clearly much lower than non-prime mortgages. That said, the rate of change in the problem as prime mortgage delinquency keeps accelerating quarter after quarter while non-prime is now decelerating. See Exhibit 13.

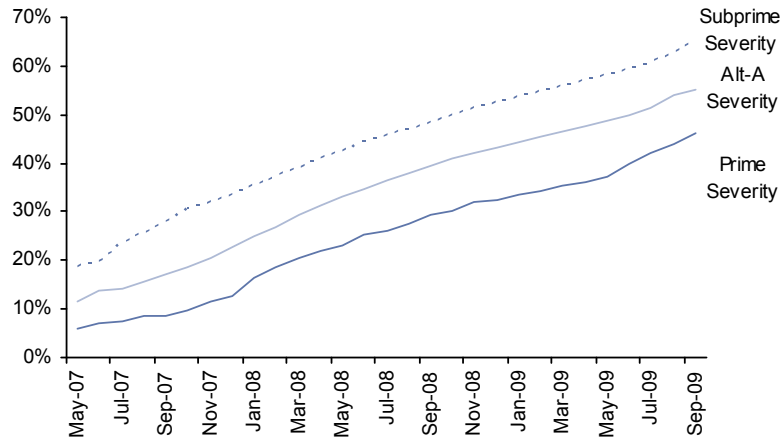
Exhibit 13: Prime mortgages are deteriorating at an accelerating pace while other products have shown signs of stabilization
 mortgage loan performance: 30+ delinquency curves (average of 2006 and 2007 vintages)



Source: Loanperformance, Goldman Sachs Research.

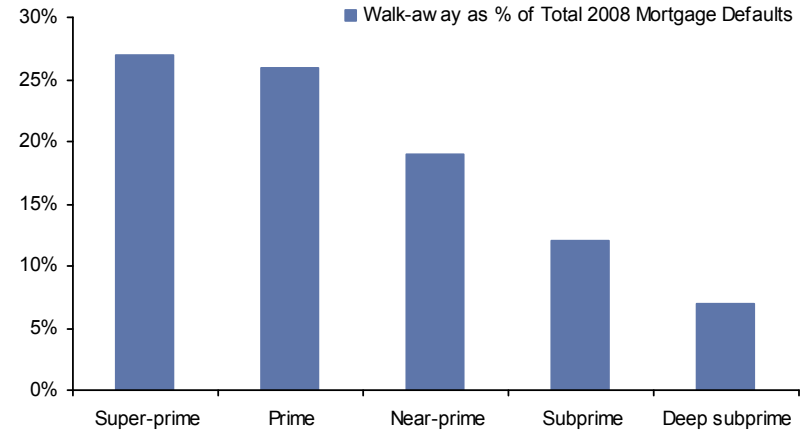
Moreover, severities for prime mortgage loans keep rising as shown in Exhibit 14. Our 5%-6% cumulative loss corresponds to 12%-15% frequency and 40%-50% severity. Part of the issue for prime mortgages is that walk-aways are more prevalent as a percentage of overall defaults than in subprime. Walk-aways are estimated based on consumers who have defaulted on a mortgage but (a) not defaulted on any other debt and (b) not made any partial mortgage payments during the delinquency process – i.e. no attempt to avoid foreclosure (see Exhibit 15). As a result, even prime mortgage delinquencies strongly correlate with LTVs and with home prices now down 35% nationwide, prime mortgage borrowers in negative equity are choosing to default (see Exhibit 16).

Exhibit 14: Severities have yet to level off for prime jumbo, now over 40%
severity on defaulted loans based on securitized loans



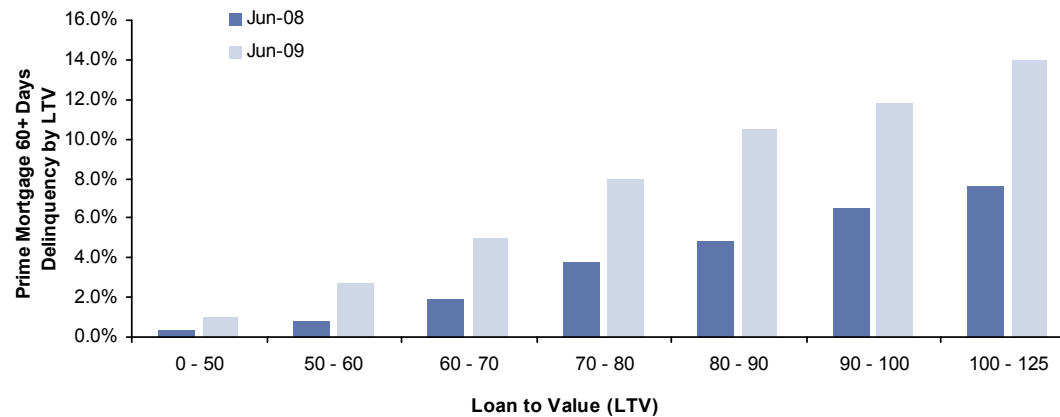
Source: Loanperformance, Goldman Sachs Research.

Exhibit 15: Walk-aways actually more prevalent for prime mortgage
walk-away as % of total 2008 mortgage defaults



Source: Oliver Wyman, Experian Information Services.

Exhibit 16: Prime mortgages delinquencies strongly correlate with LTVs (prime mortgage 60+ days delinquency by LTV)



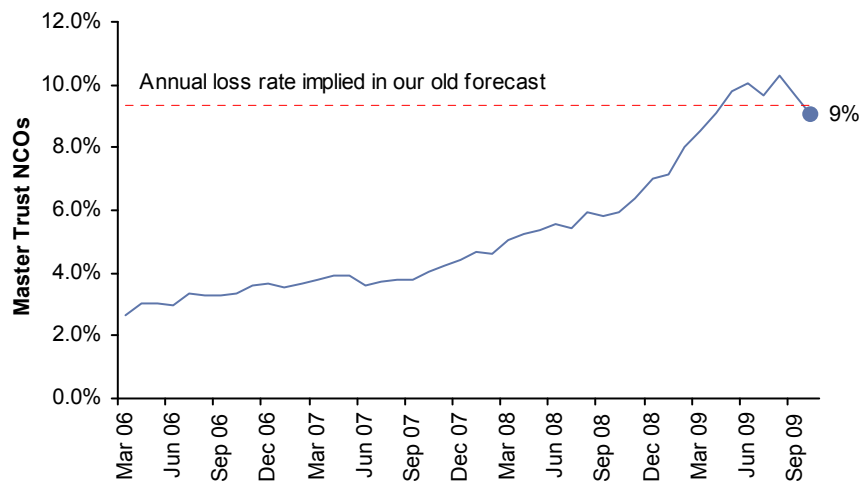
Source: Loanperformance, Goldman Sachs Research.

Decreasing consumer and C&I losses

While we are ratcheting up prime mortgage losses there is an offsetting downward adjustment to commercial (C&I) and consumer losses. Specifically we are:

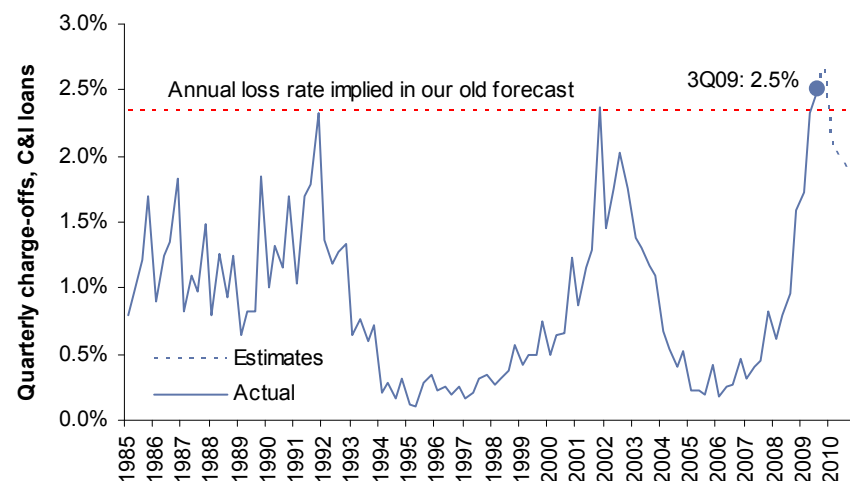
- Reducing our loss range for credit cards to 20%-23% from 23%-28% before. This reflects recent moderating delinquencies and losses. Similarly we reduce auto from 12%-16% to 9%-14% given improvement in delinquencies and collateral values. As shown in Exhibit 17, losses are already rolling over and falling below the annual loss rate implied by our old forecasts. That is, our old 25% mid-point estimate for card losses implied 10% annual loss rates based on a 2.5 year weighted average life.
- Reducing commercial losses to 5%-7% from 6%-8%. This reflects expectations for lower corporate defaults in 2010 vs. 2009. We base this statement on:
 - our C&I loss regression model which primarily relies on GDP on a one year lag – since the trough of GDP was late 2008/early 2009, the peak of C&I losses should be 4Q09 at about 3%;
 - our GS credit research team expects high yield defaults to decline from 13% this year to 11% next, while Moody's and S&P are more optimistic on 2010 at 4% and 7% default rates respectively. In all three cases, the fact that defaults are down would support our bank C&I loss model's prediction that losses begin declining in 1Q10 as shown in Exhibit 18.

Exhibit 17: Credit card loss rate is turning...
monthly credit card master trust net charge offs



Source: Company data, Goldman Sachs Research.

Exhibit 18: ... and C&I could be next
quarterly C&I net charge offs

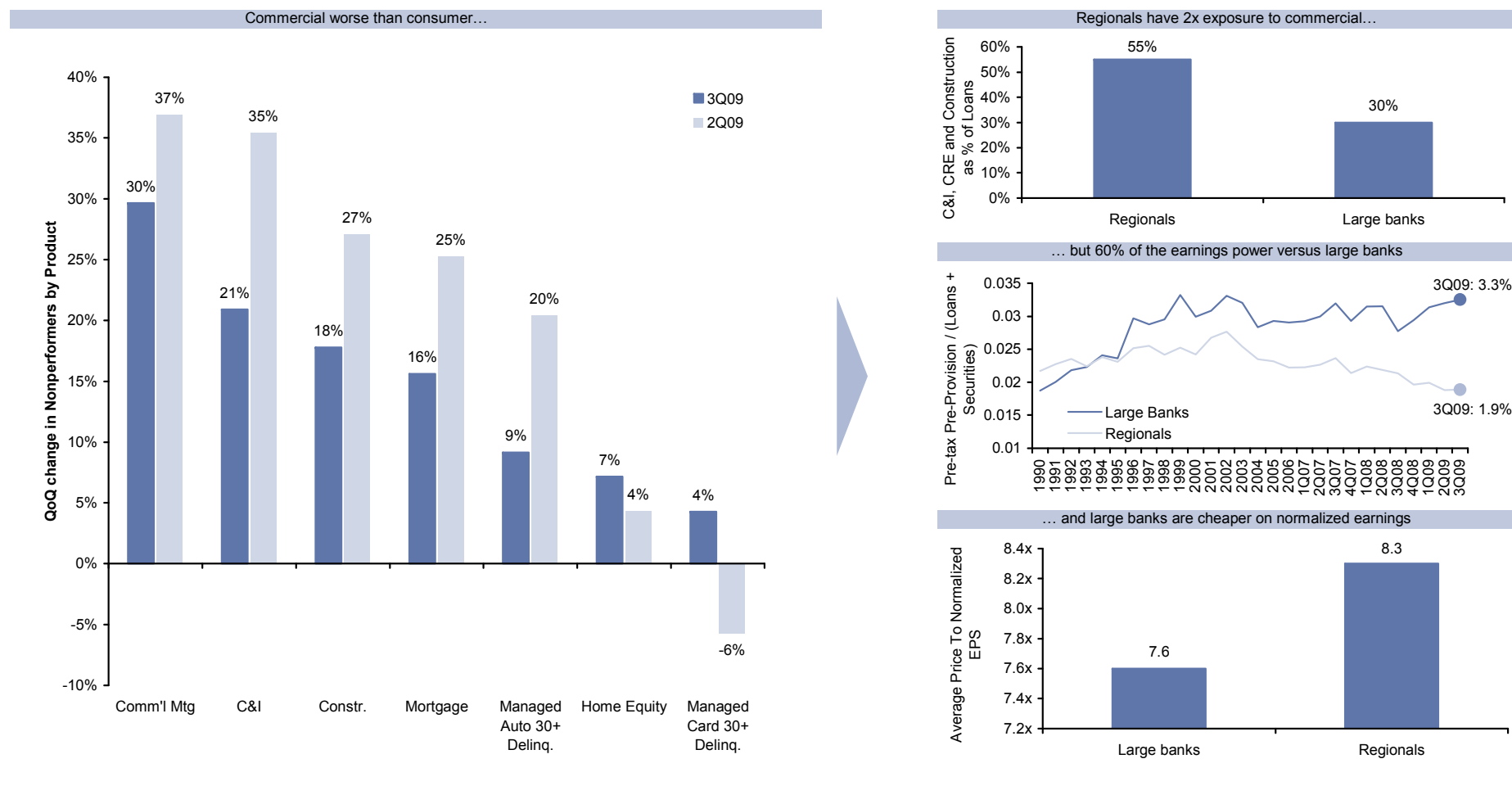


Source: Federal Reserve, Goldman Sachs Research.

We continue to favor large banks (Attractive) over regionals (Cautious)

A lower consumer loss outlook formalizes what we have been saying for some time. As a result, we remain positive on big banks and credit card stocks with JPMorgan Chase, Bank of America and Capital One rated CL-Buy. On the other hand, we remain cautious on regionals, given diverging credit trends between consumer and commercial real estate coupled with over-earning on fees vs. a continue depressed environment for net interest income.

Exhibit 19: Large banks vs. regionals – key metrics



Source: Company reports, Goldman Sachs Research.

Exhibit 20: Exposure to loan products where we are revising cumulative loss estimates

data based on regulatory filings as of 3Q09; averages excluding card issuers

	Consumer		Commercial		CRE & Construction		Prime Resi Mortgages		Consumer (ex HE and Mtg)
HCBK	100%	CMA	51%	WAL	66%	HCBK	99%	DFS	100%
DFS	98%	KEY	37%	ZION	57%	CYN	29%	AXP	86%
COF	63%	CYN	35%	MI	41%	BAC	25%	COF	58%
BAC	62%	FITB	33%	FNFG	41%	FNFG	24%	JPM	30%
JPM	61%	PNC	30%	PBCT	39%	STI	23%	C	28%
C	58%	MI	27%	BBT	38%	C	21%	BAC	26%
WFC	58%	PBCT	27%	RF	37%	BBT	21%	USB	21%
STI	52%	USB	26%	CMA	34%	WFC	19%	FITB	14%
USB	51%	ZION	24%	HBAN	32%	USB	18%	WFC	14%
AXP	51%	STI	23%	CYN	26%	PBCT	18%	KEY	12%
FHN	50%	FHN	21%	KEY	26%	JPM	18%	BBT	11%
PNC	45%	HBAN	20%	FITB	23%	FHN	17%	STI	10%
HBAN	44%	C	20%	FHN	23%	HBAN	16%	HBAN	10%
BBT	43%	WFC	20%	PNC	22%	MI	16%	PNC	10%
FITB	41%	FNFG	20%	STI	20%	PNC	13%	RF	4%
CYN	38%	BAC	20%	COF	20%	RF	12%	MI	4%
FNFG	36%	JPM	19%	USB	17%	COF	11%	CYN	3%
PBCT	34%	RF	17%	WFC	16%	WAL	10%	FNFG	3%
RF	34%	WAL	17%	BAC	11%	ZION	9%	PBCT	2%
KEY	32%	COF	15%	JPM	10%	FITB	9%	FHN	2%
MI	28%	BBT	14%	C	3%	KEY	5%	WAL	2%
ZION	17%	DFS	2%	HCBK	0%	CMA	4%	ZION	2%
WAL	17%	HCBK	0%	AXP	0%	DFS	0%	CMA	2%
CMA	10%	AXP	0%	DFS	0%	AXP	0%	HCBK	0%
Average	47%	Average	21%	Average	25%	Average	18%	Average	19%
Regionals	37%	Regionals	24%	Regionals	33%	Regionals	21%	Regionals	5%
Large Banks	65%	Large Banks	22%	Large Banks	13%	Large Banks	19%	Large Banks	22%

Source: SNL, Goldman Sachs Research.

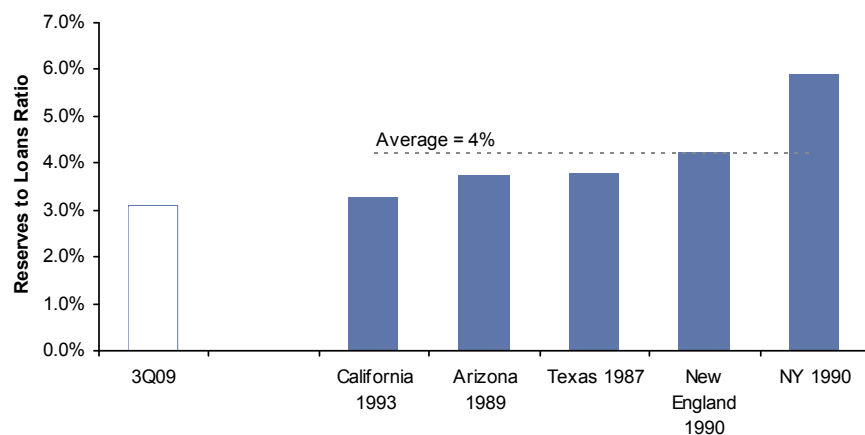
Just as we are two-thirds through losses, we are two-thirds through reserve + NPA cycle

Given our reliance on prior regional home price depressions as a guide to this cycle, it is important to sanity check our conclusion that we are two-thirds of the way through the cycle against these benchmarks.

- As of 3Q09, US banks had reserves to loans of 3.1%. The average peak of prior regional cycles is 4%.
- As of 3Q09, nonperforming asset ratios average 4.3%. The average peak of prior regional cycles is 7.6%.
- As a result, on these metrics we are 54% and 77% of the way through the cycle, respectively.

Exhibit 21: Reserves at 3%, going to 4%

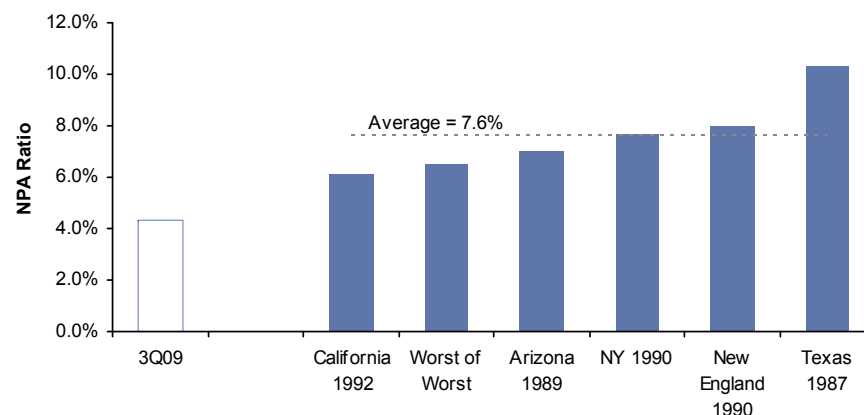
reserves to loans: current vs. past cycles



Source: Company data, SNL, Goldman Sachs Research.

Exhibit 22: NPAs at 4%, going to 7%

NPA ratio: current vs. past cycles



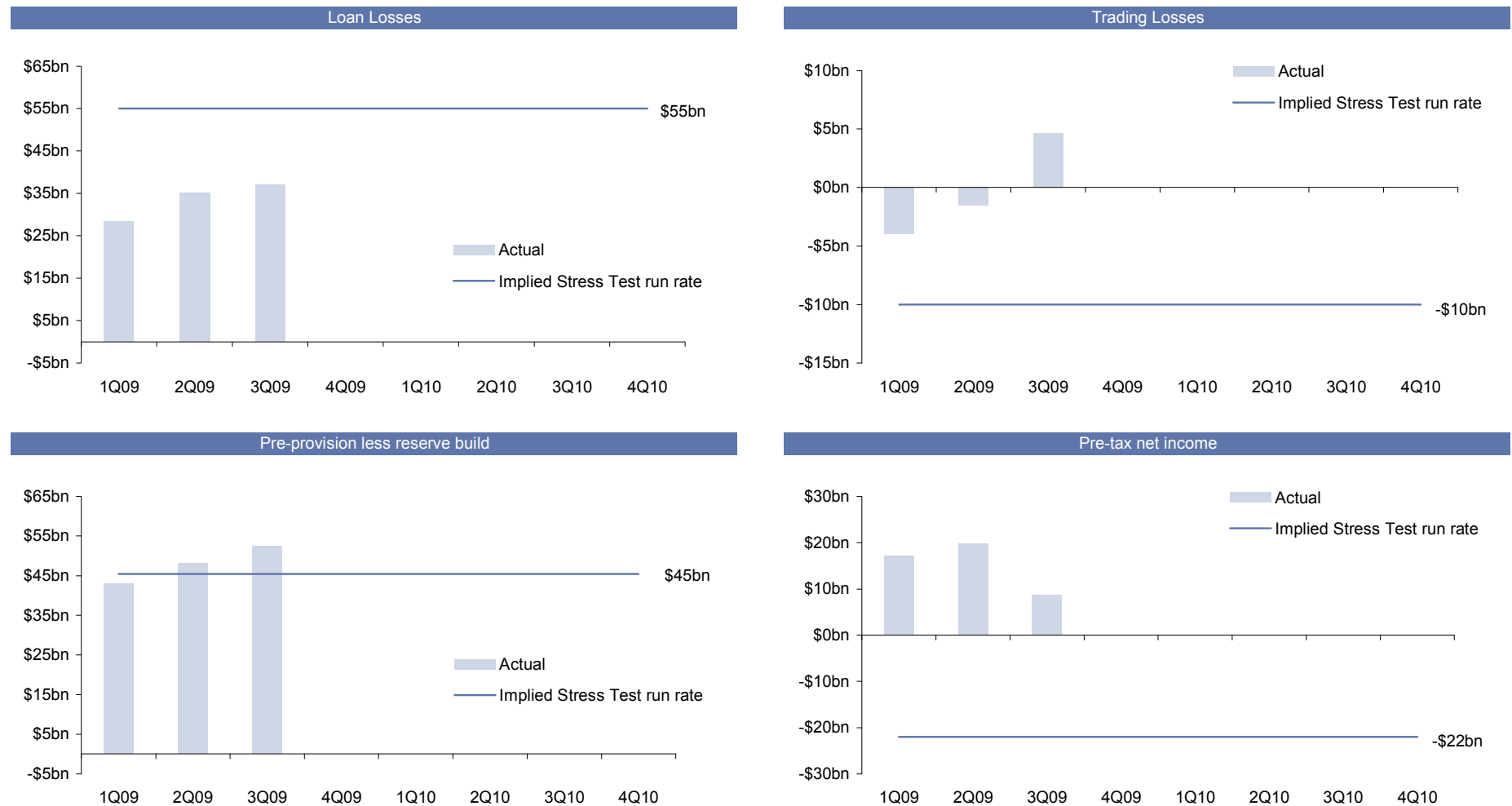
Note: "worst of worst" assumes peak NPA ratios by product happen at the same time.

Source: Company data, SNL, Goldman Sachs Research.

Stress test really was stressful

With unemployment at 10.2% vs. a 10.3% stress test peak, it is reasonable to ask if the stress test was enough. 2009 loan losses, trading results, and pre-provision earnings have all tracked better than the stress test forecast.

Exhibit 23: Implied stress test run rate vs. actual losses – based on 19 SCAP banks



Note: 2009 quarterly trading gains / losses calculated as reported trading income minus pre-crisis run rate (i.e., 2006 quarterly average).

Source: Company data, SNL, Goldman Sachs Research.

Exhibit 24: Banks recognized 20% of SCAP losses after 3 (of 8) quarters; annual NCO ratio run rate is 60% of SCAP implied ratio (data based on 19 SCAP banks)

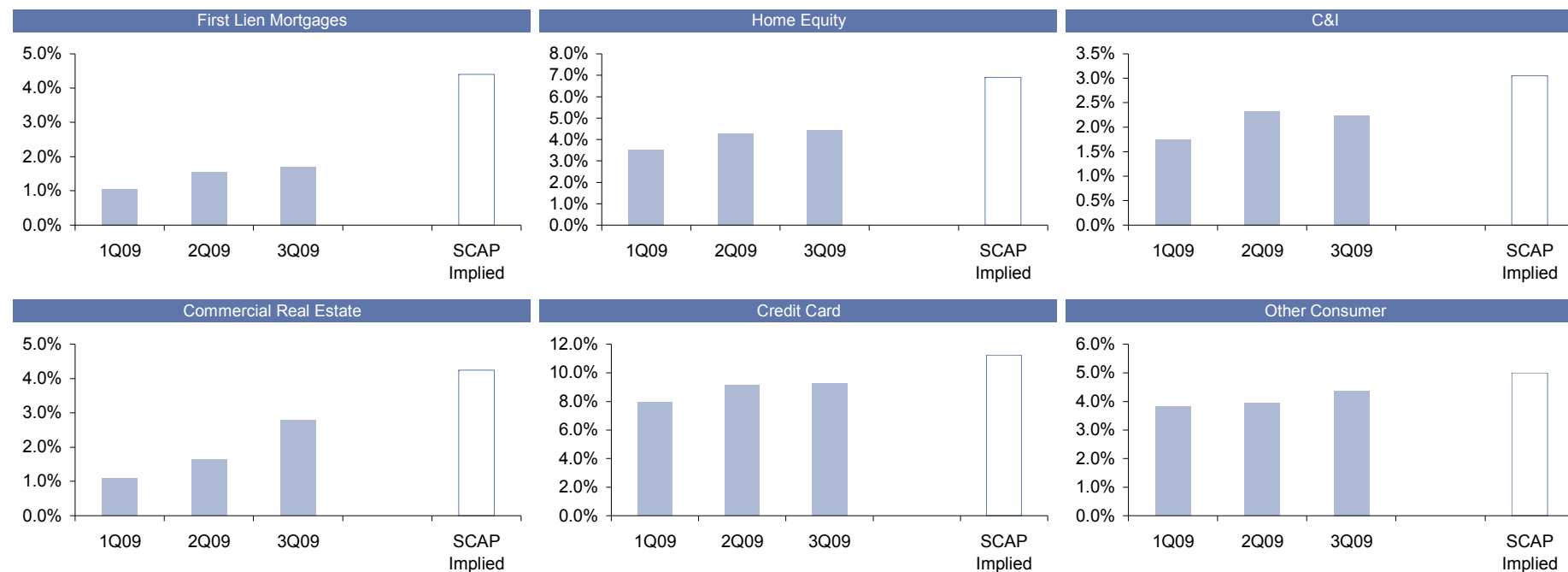
Summary of SCAP Losses and Losses Recognized to Date for 19 SCAP Banks							
\$bn	1Q09 - 3Q09		SCAP Forecast in More Adverse Scenario *			3Q09 NCO ratio vs. SCAP	1Q09-3Q09 NCO ratio vs. SCAP
	NCOs (\$)	NCO Ratio (%)	2-year Losses (\$)	2-year Losses (%)	SCAP (%) / Year		
Other Consumer **	15.7	4.0%	51.9	10.0%	5.0%	87%	81%
Credit Card	24.1	8.8%	82.4	22.5%	11.3%	82%	78%
C&I	15.6	2.1%	60.1	6.1%	3.1%	73%	69%
Commercial Real Estate	8.6	1.8%	53.0	8.5%	4.3%	66%	43%
Home Equity	18.5	4.1%	83.2	13.8%	6.9%	64%	59%
Other Loans **	5.3	1.3%	31.8	6.0%	3.0%	48%	42%
First Lien Mortgages	12.6	1.4%	102.3	8.8%	4.4%	39%	33%
Total Loans	100.4	2.8%	464.7	9.1%	4.6%	69%	61%

*: SCAP loss rates may include the impact of purchase accounting adjustment.

** : estimated using mid point of SCAP's loss range.

Source: Federal Reserve, SNL, Goldman Sachs Research.

Exhibit 25: Current annual NCO run rate vs. SCAP implied annual NCO ratio by product (current based on 1Q09 – 3Q09)

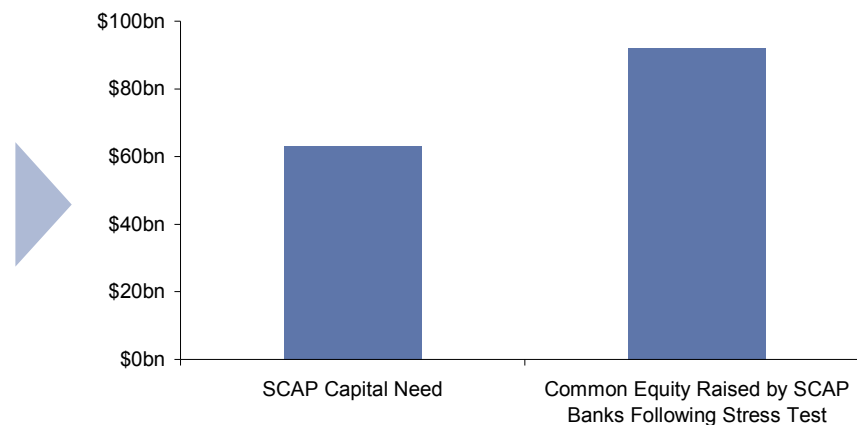


Source: Federal Reserve, Goldman Sachs Research estimates.

Moreover, banks that needed to raise capital per the stress test raised \$10 bn more capital than required. Banks that did not need to raise capital have raised \$20 bn. When we combine the \$90 bn raised by stress test banks with common equity raised by non-stress test banks, the total system has raised \$150 bn since the stress test vs. \$120 bn in the two years prior. Deal performance has also been supportive – with increased certainty on loss content, the average capital raise since the stress test is +20% from deal price.

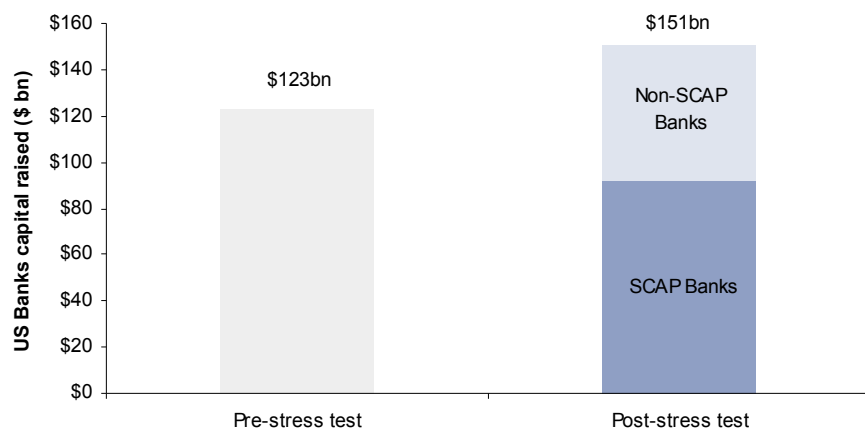
Exhibit 26: Banks that were required to raise capital under stress test have raised more than needed

Capital Required Under Stress Test		
\$bn	SCAP Capital Need	Common Equity Raised Following Stress Test
BAC	33.9	40.0
WFC	13.7	8.6
C	5.5	5.5
RF	2.5	2.5
STI	2.2	2.2
MS	1.8	7.2
KEY	1.8	2.4
FITB	1.1	2.6
PNC	0.6	0.6
Total - banks w/ SCAP need	63	72
Other SCAP Banks	0	20



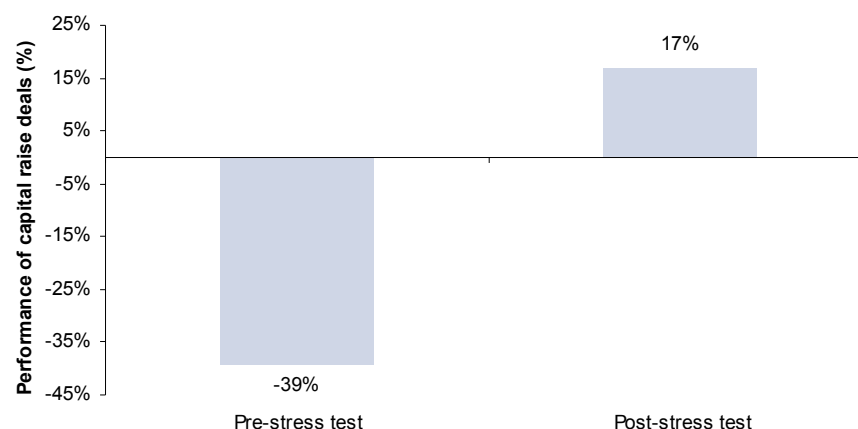
Source: Company reports, Goldman Sachs Research.

Exhibit 27: Capital raised accelerated post stress test...



Source: Company data, SNL, Dealogic, FactSet, Goldman Sachs Research.

Exhibit 28: ... and deal performance has been strong



Source: Company data, SNL, Dealogic, FactSet, Goldman Sachs Research.

Rating and pricing information: Bank of America Corporation (B/A, \$15.95), Capital One Financial Corp. (B/N, \$38.76) and J.P. Morgan Chase & Co. (B/A, \$42.16)

Reg AC

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