# BANK INDUSTRY

**The Bank Industry's revenue prospects may be looking up, and we look for moderate earnings growth in 2005, despite continued expense pressures and higher loan loss provisions.**

**Bank stocks, as a group, aren't timely, but some may be of interest for the long haul.**

**INDUSTRY TIMELINESS: 80 (of 98)**

## Cautiously Optimistic On Revenues

The growth in bank revenues (net interest income and fees) in the past few years has been generally underwhelming. Business borrowing to support inventories or capital improvements was weak for much of last year. Competition and the very low level of interest rates (which limited reductions in deposit account rates) depressed the net interest margin, the spread between interest rates on loans and investments, and the rates on bank borrowings. The narrower margin and soft loan demand restrained the growth in net interest income. And although a lot of banks bolstered noninterest income with gains on asset sales and other unusual items, underlying fee income trends were hampered by the stock market's lackluster performance during much of 2004 (which hurt trust income) and the falloff in mortgage loan refinancing activity.

Lately, however, there have been signs that things may be improving. Recent surveys of loan officers by the Federal Reserve Board indicate that consumer and business loan demand strengthened late last year, and we believe the trend continued into 2005. Better economic activity in 2004 may have provided enough encouragement by the final quarter for businesses to replenish inventories, expand facilities, and update computer systems. In addition, competitive forces and banks' recent low levels of bad loans apparently prompted some in the industry to relax their lending standards a bit. And consumer demand for home equity loans remains healthy. More improvement in loan growth this year should help offset the growing margin pressure exerted by the flatter interest rate yield curve (which reflects the narrowing spread between short- and long-term interest rates).

Prospects for noninterest income may also have taken a turn for the better, with the exception of service charges on corporate deposit accounts (as more companies pay for bank services by maintaining deposit balances rather than paying fees). But continued healthy economic activity should boost demand for other fee-generating bank services. And in the final period of 2004, asset management income was helped by the stock market's improved performance since November, which, if sustained, should support better investment income in 2005. The recent string of merger announcements in the telecommunications and other sectors may have increased demand for advisory services, as well.

## Expense Pressures

There are still a lot of items exerting upward pressure on operating costs, including rising healthcare expenses, tighter reporting and corporate compliance requirements, and higher incentive compensation as business activity accelerates. Banks continue to wring costs out of recently acquired operations, but some are using the merger-related expense reductions to offset the costs of new activities. Banks will have to strike a balance between expense management and the costs of growth initiatives.

## A Small Hurdle

Quite a number of banks took some of their loan loss reserves into earnings last year. They may have been justified in doing so, since problem loans fell to very low levels in 2004 and most banks still have generous loan loss reserves. Although more reserve reductions are possible in the first half of 2005, we think banks will resume making provisions to the loan loss reserve by the second half. Some rise in problem loans probably is unavoidable as loan growth picks up, and banks may be reluctant to reduce reserves further. Sharp increases in provision expense may restrain some banks' earnings in 2005, but for the most part, the industry should enjoy moderately higher results this year.

## Investment Interest

Bank stocks have been underperformers recently, even lagging other financial sectors. Many still have attractive dividend yields, but this advantage over other financial instruments will lessen as interest rates rise. Some bank stocks may be of interest for their total return potential to late decade, however.

*Theresa Brophy*

Composite Statistics: LARGEST BANKS
Incl.BAC,JPM,STI,WB,WFC

| 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | | 07-09 |
|---|---|---|---|---|---|---|---|
| 2167.2 | 2279.2 | 2418.1 | 2621.8 | ***3350*** | ***3575*** | Total Assets ($bill) | ***4300*** |
| 1042.6 | 1057.4 | 1088.7 | 1198.2 | ***1525*** | ***1650*** | Loans ($bill) | ***2025*** |
| 55.9 | 62.0 | 66.8 | 70.1 | ***81.5*** | ***91.5*** | Net Interest Inc ($bill) | ***111*** |
| 7.3 | 12.5 | 14.5 | 8.0 | ***9.5*** | ***10.0*** | Loan Loss Prov'n ($bill) | ***15.5*** |
| 63.6 | 54.5 | 57.4 | 67.5 | ***74.5*** | ***86.0*** | Noninterest Inc ($bill) | ***108*** |
| 73.2 | 76.1 | 76.2 | 82.4 | ***92.5*** | ***103*** | Noninterest Exp ($bill) | ***115*** |
| 24.9 | 18.6 | 23.3 | 31.9 | ***36.5*** | ***43.0*** | Net Profit ($bill) | ***58.0*** |
| 35.8% | 33.4% | 30.5% | 32.4% | ***32.5%*** | ***33.5%*** | Income Tax Rate | ***34.5%*** |
| 1.15% | .81% | .96% | 1.22% | ***1.10%*** | ***1.20%*** | Return on Total Assets | ***1.35%*** |
| 225.3 | 229.0 | 233.0 | 263.4 | ***350*** | ***365*** | Long-Term Debt ($bill) | ***450*** |
| 156.2 | 171.3 | 180.7 | 189.0 | ***295*** | ***320*** | Shr. Equity ($bill) | ***420*** |
| 7.2% | 7.5% | 7.5% | 7.2% | ***9.0%*** | ***9.0%*** | Shr. Equity to Tot Assets | ***10.0%*** |
| 48.1% | 46.4% | 45.0% | 45.7% | ***45.5%*** | ***46.0%*** | Loans to Tot Assets | ***47.0%*** |
| 15.9% | 10.8% | 12.9% | 16.9% | ***12.5%*** | ***13.5%*** | Return on Shr. Equity | ***14.0%*** |
| 9.2% | 4.4% | 6.4% | 10.3% | ***7.0%*** | ***8.0%*** | Retained to Com Eq | ***8.5%*** |
| 44% | 60% | 51% | 41% | ***43%*** | ***41%*** | All Div'ds to Net Prof | ***38%*** |
| 13.0 | 19.4 | 14.7 | 11.3 | | | Avg Ann'l P/E Ratio | ***13.0*** |
| .85 | .99 | .80 | .66 | *Bold figures are Value Line estimates* | | Relative P/E Ratio | ***.85*** |
| 3.3% | 3.1% | 3.4% | 3.6% | | | Avg Ann'l Div'd Yield | ***3.0%*** |