December 2011

Trepp®

2012 U.S. Banking Sector Outlook: Happy Days Are Gone Again

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EXECUTIVE SUMMARY

Trepp does not expect 2012 to be a repeat of 2008, but there will be more disappointments than pleasant surprises in the new year.

Earnings Growth

- The banking industry has not yet returned to "normal" despite two years of earnings growth. The industry will face more—not fewer—headwinds in 2012. Banks will earn less, putting 2012 a bit behind 2003 in terms of overall industry profitability.
- Net interest margins compressed in 2011, but the damage was modest. We forecast a much more significant drop in 2012—net interest margins could fall below 3%, which has only happened once in the last decade (4Q 2008). In 2012, banks will take additional risk to preserve those margins.
- Banks will attempt to recover lost revenue by introducing new fees, requiring higher minimum balances on customer deposit accounts, and providing incentives for customers to use credit cards. However, these attempts to grow fee revenue will contribute only marginally to non-interest revenue.
- The benefits banks have received from loss reserve "releases"—the difference between loss provisions and charge-offs—during the past two years will run out by mid-year and will only amount to 5% to 10% of net income in 2012.

Balance Sheet Exposures and Trends

- Low demand, elevated charge-offs, and the sale of distressed and non-core assets will put pressure on banks' loan growth in 2012. Deposit growth will be relatively strong, given the absence of other attractive low-risk investment opportunities and volatile equity markets.
- While the largest U.S. commercial banks have meaningful direct exposure to Europe, the potential costs to banks as a result of the European sovereign debt crisis should prove manageable. A prolonged crisis, which would create higher global spreads and greater volatility, would have negative consequences for all U.S. banks, through diminished capital markets and economic activity.
- Banks' commercial real estate loan performance will improve incrementally during 2012. Relatively tight lending conditions and still-high delinquency rates will prevent a substantial recovery for several years. Charge-offs will persist as banks shed more problem assets in 2012.

Regulatory and Distress Outlook

- The regulatory environment has become more difficult and costly for banks. Although higher capital requirements and increased costs associated with regulatory compliance will create a drag on bank profitability, banks are aware of new regulations and have had time to adjust and adapt their business models accordingly.
- Bank failures during 2012 will occur at a slower pace than in 2011, but will extend into 2013 and potentially beyond. If the economy stabilizes, the pace of failures will slow, but if it falls back into recession, the number and cost of failures will increase.

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Trepp, LLC is the leading provider of information, analytics and technology to the CMBS, commercial real estate and banking markets. Trepp provides primary and secondary market participants with the tools and insight they need to increase their operational efficiencies, information transparency and investment performance. For more information visit www.trepp.com.

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Trepp Bank Navigator is a comprehensive web-based financial institution surveillance and risk management system. With detailed financial reports, risk scores and rankings on nearly 12,000 commercial banks and bank holding companies, the Bank Navigator is an ideal solution for anyone concerned about bank financial performance and risk. The Bank Navigator is also an excellent solution for helping commercial banks establish successful enterprise risk management (ERM) programs.

The Bank Navigator's financial intelligence is based on call reports, enforcement actions and capital raising events interwoven with Trepp's proprietary data and analytics. The risk scores and rankings are the product of robust models that factor in significant proprietary information—macroeconomic forecasts and CRE delinquency and default data—plus 15 years of bank financial, regulatory and loan history. The forecasting capabilities of the product have been rigorously back-tested and validated by the academic community. For a free trial or more information on the Bank Navigator visit www.trepp.com

EARNINGS TRENDS - RECOVERY IN RETREAT

The good news for banks is that they have posted strong earnings growth over the last two years, which has allowed for some balance sheet healing and for confidence to be restored to the U.S. banking system.

The bad news is that the industry has likely seen a near-term peak for earnings as benefits from the last few years recede and new challenges emerge.

[Editor's Note: For the ease of readability, we refer to results from 2011 in the past tense throughout this report, although it was written and published before final numbers were available. Therefore, all numbers offered for 2011 are expected results.]

Strong Results for 2011

First the good news:

U.S. Bank earnings continued to recover in 2011, rising 47% from 2010 to an estimated $126 billion (see Exhibit A).

The primary contributor to the increase in earnings was a reduction in loss provisioning. Loss provisions fell to an estimated $74 billion for the year, down from $158 billion in 2010 and $250 billion in 2009.

Other contributors to increased income included relatively stable revenues and expenses. Banks experienced only slight declines in major income items, with net interest income only falling by 3.2%, and non-interest income falling a scant 0.1%. Non-interest expenses rose a modest 2.7% for the year.

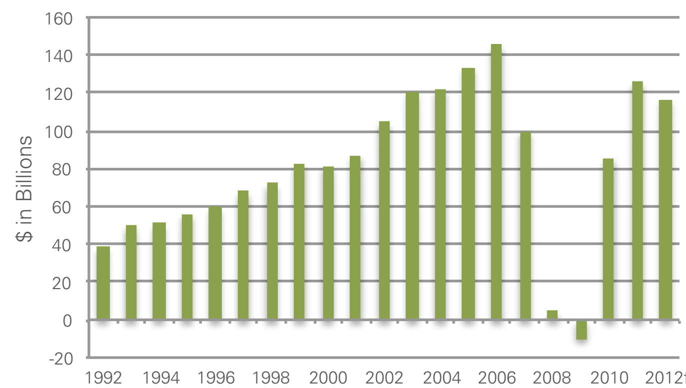
Profitability improved for a large number of banks, as the proportion of banks posting a profit rose to 84% in 2011, up from 79% in 2010 and 70% in 2009.

Profitability also improved throughout the size spectrum, although the most significant shift from loss to profit during 2009 to 2011 came from the largest banks. For the full year 2011, none of the largest banks (defined as more than $100 billion in total assets) posted losses, while more than 15% of smaller community banks posted full-year losses.

Plenty of Concerns for 2012

The bad news is that the positive trends from the last two years will end and new growth will not bridge the gap.

Exhibit A - Net Income, Total - All Insured Banks



Sources: FDIC, Federal Reserve, Trepp LLC

First, the loss reductions that gave a great lift to bank earnings over the last eight quarters have now run their course. Without the impact of reduced loss provisioning, bank earnings growth will have to come from other areas.

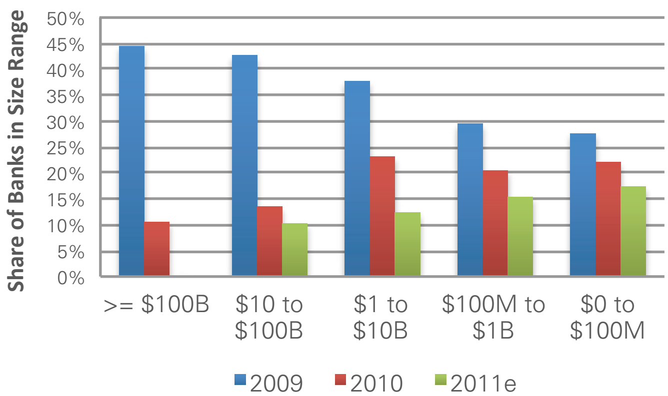
Unfortunately, we do not see any of the other large contributors to earnings growing sufficiently to move the needle in a positive direction.

The main engine of bank revenue—interest income—is under pressure from low interest rates and sluggish loan growth dynamics. If interest rates and loan growth stay low, we estimate that net interest income could fall 13% in 2012 (see Page 4: Net Interest Margins).

Other limiting factors on bank earnings include: difficulty in raising fees, a volatile global economy, and increased overhead as banks absorb the costs of new regulatory compliance requirements. As a result, we expect bank profits to fall by 7% in 2012 to $117 billion for the full year (see Exhibit B).

Despite the improvement in 2011, the industry is far from "normal" profitability. In 2005, for example, 94% of the industry's banks posted profits, as compared to 84% in 2011 (see Exhibit B). Furthermore, with declining industry profits in our outlook, it is likely that few banks will improve in 2012.

Exhibit B - Banks With Annual Losses By Size



Sources: FDIC, Trepp LLC

Lower profits will also put pressure on bank employment growth as banks look to job cuts as a way to trim expenses. Since 1Q 2010, banks have added 83,000 jobs, or 42% of the 196,000 jobs that were shed during 2008 and 2009. However, this growth is set to top out in 2011, as banks see a diminished profit picture in the future. We expect job cuts will outweigh gains during 2012, resulting in bank employment posting a 0.2% decline for the year.

The Bottom Line

After two years of strong earnings growth, the banking market is far behind a normal recovery, and the industry will face additional—not fewer—headwinds in 2012. Banks will be less profitable, putting 2012 behind 2003 in terms of net profits for the entire industry.

NET INTEREST MARGINS—2011 EROSION WILL ACCELERATE

U.S. Banks struggled with shrinking interest margins during 2011 as low interest rates and a lack of loan growth led to falling interest income.

Banks were able to contain much of the erosion in margins by cutting interest expense and shifting asset exposure to longer maturities. Even after taking all of these steps, net interest margins fell by nearly 40 basis points from early 2010 levels.

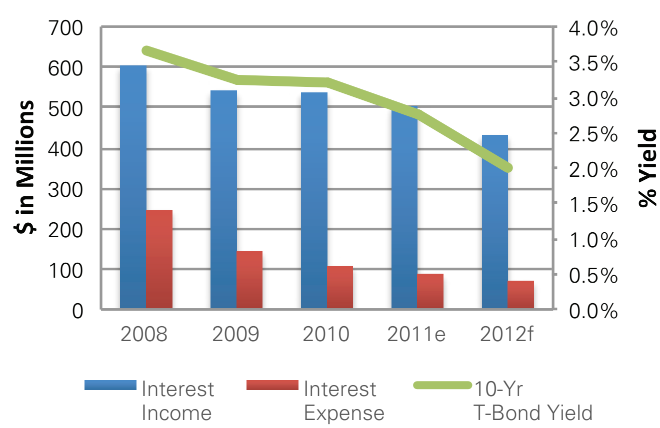
In 2012, banks will inevitably see shrinking margins.

The flattening of the yield curve will force banks to face even lower margins during 2012. Many banks will compensate by shifting assets toward longer maturities, taking on greater interest rate risk in the process. Ultimately these shifts threaten to lock in lower yields and will generate disappointing earnings should interest rates rise again.

In addition, the mark-to-market value of these longer-term assets would fall if interest rates rise substantially, putting additional strain on bank capital.

- Net Interest Income for 2011 fell to $416 billion, down 3.2% from $430 billion in 2010. This decrease represents a reversal from the 8.1% gain in net interest income during 2010.

Exhibit C - Interest Income and Expense vs. 10 Year T-Bond Yield



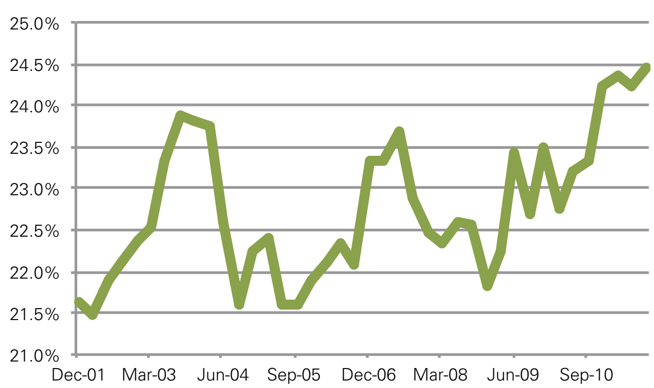
Sources: FDIC, Federal Reserve, Trepp LLC

- Interest income (before deducting interest expense) fell 6.2% to $504 billion.
- Interest expense fell 18% to $88 billion (see Exhibit C).

In 2012, we expect the erosion to accelerate:

- Net Interest Income will fall by 13% to $362 billion in 2012, roughly in line with the level in 2008. This projection assumes low interest rates and sluggish loan growth will persist. This forecast also assumes that banks will persist in shifting toward longer-term assets, pushing the proportion of those assets up to 25% of earning assets. This would be the highest share in more than a decade (see Exhibit D).
- In a flat yield curve environment, our model suggests that banks would have to further shift toward long-term assets to preserve net interest margins. If long bond yields stay in the low 2% range, banks would have to increase long-term assets to 30% of earning assets or higher in order to maintain net interest margins in the 3.5% range. Shifting toward longer-term assets would increase banks' exposure to interest rate risk, a concern specific to a low-yield environment.

Exhibit D - Long-term Assets / Earnings Assets



Sources: FDIC, Trepp LLC

The Bottom Line

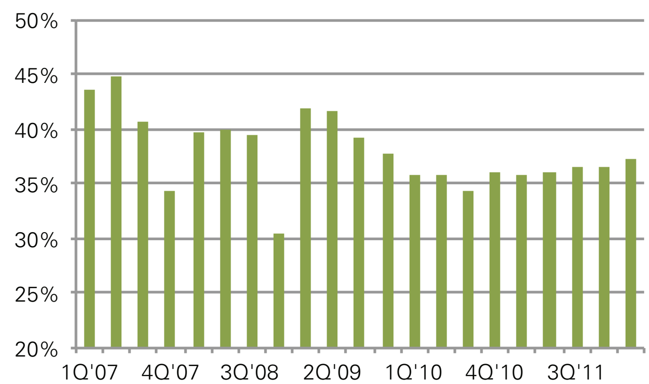
\While margins compressed in 2011, the damage was modest. We expect 2012 will not be as kind to net interest margins and banks will take on more risk in an attempt to preserve those margins. Net interest margins could fall below 3%, which has only happened once in the last decade (4Q 2008).

BANK FEE REVENUE—UNDER PRESSURE

Banks continued to search for alternative sources of income in 2011, as regulatory reform and the macroeconomic environment put significant pressure on banks' non-interest sources of revenues.

Non-interest revenues as a percentage of overall revenue declined from more than 40% in 2007 to around 36% in 2011(although they have been moderately improving since the beginning of the year (see Exhibit E).

Exhibit E - Non-interest Income / Total Revenue



Sources: FDIC, Trepp LLC

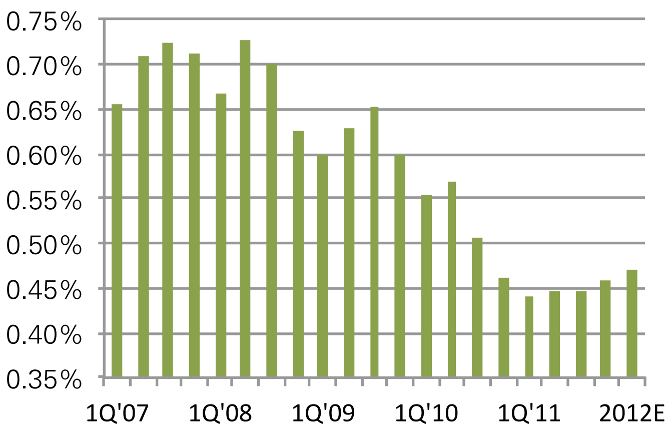
One of the main drivers of the overall decline in fee revenues has been the reduction in deposit service charges, which have declined from around 0.70% of domestic deposits to only around 0.45% in 2011 (see Exhibit F). The decline was not as dramatic as initially expected and the ratio of deposit service charges to deposits stabilized in 2011.

Several bank regulations have already impacted banks' deposit service charges and credit card revenues.

- <u>Regulation E</u> went into effect in 2010 and impacted banks' profitability throughout 2011 by prohibiting banks from charging consumers fees for overdrafts (NSF fees) at ATMs or on one-time debit card transactions in most cases.
    - With Regulation E fully implemented, we

expect to see stable to improving deposit service charges as banks implement a range of products and services intended to replace lost revenue.

Exhibit F - Deposit Service Charges / Domestic Deposits



Sources: FDIC, Trepp LLC

- The Credit Card Act, which also went into effect in 2010, has reduced banks' credit card revenues by prohibiting some common credit card industry practices such as Retroactive Rate Increases and Universal Default, Double-Cycle Billing, and Over-the-Limit Fees. Also included are numerous other provisions regarding fees, payment allocations and disclosures.
- The Durbin Amendment (part of the Dodd-Frank Act) authorized the Fed to establish rules surrounding the interchange fees that banks can charge for debit card transactions. As the Durbin Amendment became effective on October 1, 2011, banks were set to lose a chunk of their debit interchange revenue—fees they receive from retailers when consumers swipe their debit cards. Bank plans to offset that loss by imposing additional fees on consumers and debit card use have been met with resistance by consumers.
  - In the case of Bank of America, the bank experienced such a strong consumer backlash to its proposed $5 monthly fee for debit card use that it reversed its decision, abandoned the program, and refunded any fees collected over the short time the requirement was in place.

In anticipation of more stringent regulations, some banks have been getting rid of free checking accounts and have started imposing fees on accounts below a specified size. In addition, banks have been reducing the number of perks and incentives for customers with debit cards. Meanwhile, other banks have advertised free checking accounts in an attempt to attract customers by characterizing themselves as customer friendly.

The Bottom Line

We expect to see more creative attempts by banks to recover lost revenue through the introduction of new fees, the introduction of higher minimum balances on customer deposit accounts or the establishment of incentives to customers to use credit cards. However, we are not optimistic that these steps will improve profits in a meaningful way. Banks' attempts to grow fee revenue are likely to be hampered by ongoing regulatory actions, and at best will only contribute marginal additional amounts to non-interest revenue.

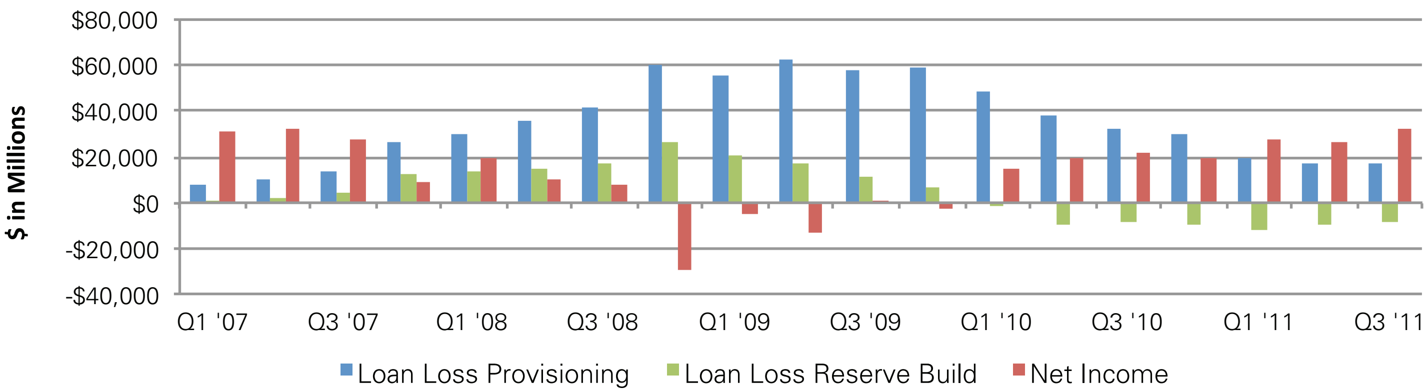
LOSS PROVISIONING—END OF THE LINE FOR LOSS ALLOWANCE "RE-LEASE"

The greatest contribution to profit increases in the last two years has been from lower loss provisioning and the related reduction in loss reserves. As a result of improving credit quality, banks trimmed loss provisions in 2011. The impact has been unevenly distributed, as the largest banks have had the most significant reductions throughout the year.

visions (additions to loss reserves) that have lagged behind charge-offs (subtractions from loss reserves) and a net "release" of loss reserves.

The impact on banks' net earnings has been significant, with the reserve release accounting for approximately one-third of net income during 2011. We expect that the impact on the bottom line will be diminished in 2012, as the excess reserves are burned off and loss provisioning tracks more closely with charge-offs.

Exhibit G - Provisioning vs. Net Income and LLR Build



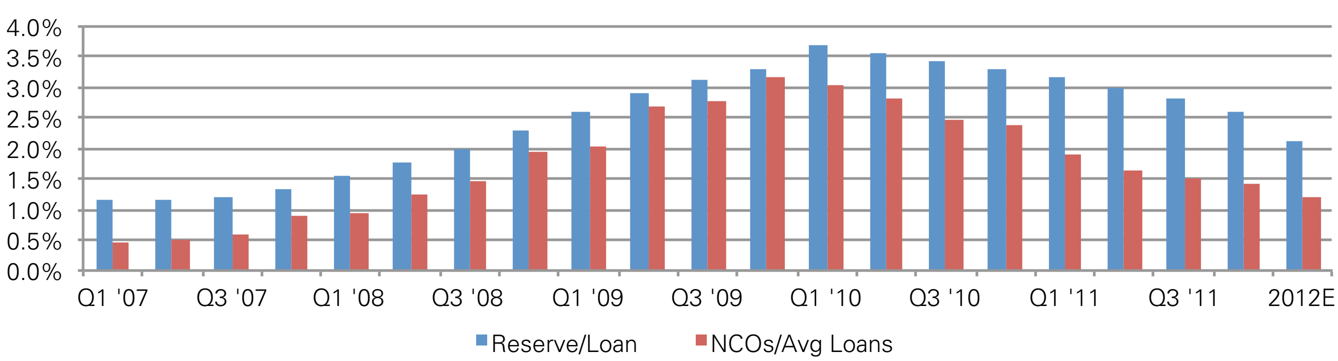
Sources: FDIC, Trepp LLC

Reduced loss provisions have led to a "release" of loss reserves. When the recession and credit crisis hit in 2008, banks boosted loss reserves, adding a net $160 billion to loss reserves between year-end 2007 and 1Q 2010. Since then, banks have used the previously built up loss reserves to handle a substantial portion of charge-offs. The result is loss pro-

Reserve releases amounted to an estimated $38.3 billion in 2011, up from $29.7 billion in 2010, although the pace of reserve releases has moderated since 1Q 2011(see Exhibit G).

The growth in net income through the reserve release is not sustainable. We expect it to run out

Exhibit H - Reserve/Loan Ratio vs. NCOs/Avg Loans



Sources: FDIC, Trepp LLC

in the second half of 2012, as both reserves and charge-offs reach more normal levels (see Exhibit H). We expect reserve releases to boost banks' net income by 5% to 10% in 2012, in comparison to more than 30% in 2011.

The Bottom Line

After two years of benefiting from reserve releases, loss provisions and charge-offs will be more in balance in 2012. The contribution of loss reserve releases will only amount to about 5% to 10% of net income in 2012.

U.S. BANK BALANCE SHEET TRENDS—RISK APPETITE LACKING

Banks Hesitate in 2011

Bank assets grew by just over 5% (annualized) during 2011. Roughly half of the growth went into cash (deposits with other banks), while about a quarter went into securities. Fed funds and repurchase agreements, trading assets, and other assets accounted for the rest of the increase in 2011, while loan growth was virtually zero (see Exhibit I).

Despite historically low interest rates, loan growth has been weak for most major loan types. C&I loans

Exhibit I - U.S. Commerical Banks Balance Sheet

($ in Billions)	**2010 Q4**	**2011 Q3**	**Growth Rate (Annual)**
Assets			
Cash and due from depository Institutions	923	1,220	45%
Securities	2,352	2,478	7%
Federal Funds Sold & Reverse Repurchase Agreements	454	473	5%
Net Loans & Leases	6,377	6,397	0%
Loan Loss Allowance	218	185	- 20%
All Other Assets	1,960	1,992	2%
Total Assets	**12,066**	**12,560**	**5%**
Liabilities			
Total Deposits	8,514	9,077	9%
Federal Funds Purchased & Repurchase Agreements	528	474	-14%
Trading Liabilities	287	333	22%
Other Borrowed Funds & Subordinated Debt	1,065	893	-21%
All Other Liabilities	306	353	21%
Total Liabilities	**10,701**	**11,130**	**5%**
Total Bank Equity Capital	1,338	1,412	7%
Common/Preferred Stock + Surplus	1,079	1,093	2%
Undivided Profits	259	319	32%
Noncontrolling Interests in Consolidated Subsidiaries	27	18	- 40%
Total Equity Capital	**1,365**	**1,430**	**6%**
Total Libabilities and Capital	**12,066**	**12,560**	**5%**

Sources - FDIC, Trepp LLC

have been the one real bright spot, expanding at an annualized pace of 11% since the beginning of the year. Construction loans have declined the most, as was expected, shrinking 26% in 2011. Credit card balances decreased at an 8% annual pace, as consumers have been more careful with credit card use and banks have reduced or canceled high-risk lines and focused on lower-risk consumers (see Exhibit J).

More stringent underwriting criteria also contributed to tepid loan growth, as banks became more focused on streamlining their balance sheets and exiting non-core portfolios in preparation for tougher capital requirements.

Facing a low interest environment and an absence of lending opportunities, banks boosted their interest income by investing in securities, which grew at a 7% annual pace.

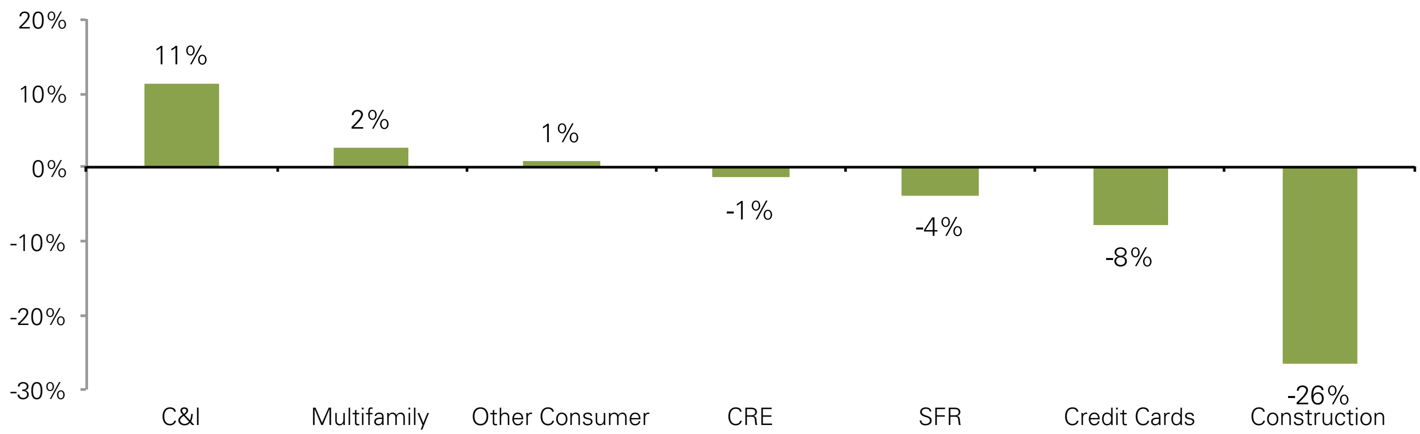
Deposit growth was fairly strong at a 9% annualized pace in 2011, as consumers and businesses facing volatile equity markets decided to deposit available cash at banks.

Transaction accounts showed the strongest growth, at a 33% annualized pace, while time deposits declined as consumers became discouraged by low yields (see Exhibit K).

Consequently, loan to deposit ratios have been declining—a trend that has become more pronounced since 1Q 2010 (see Exhibit L).

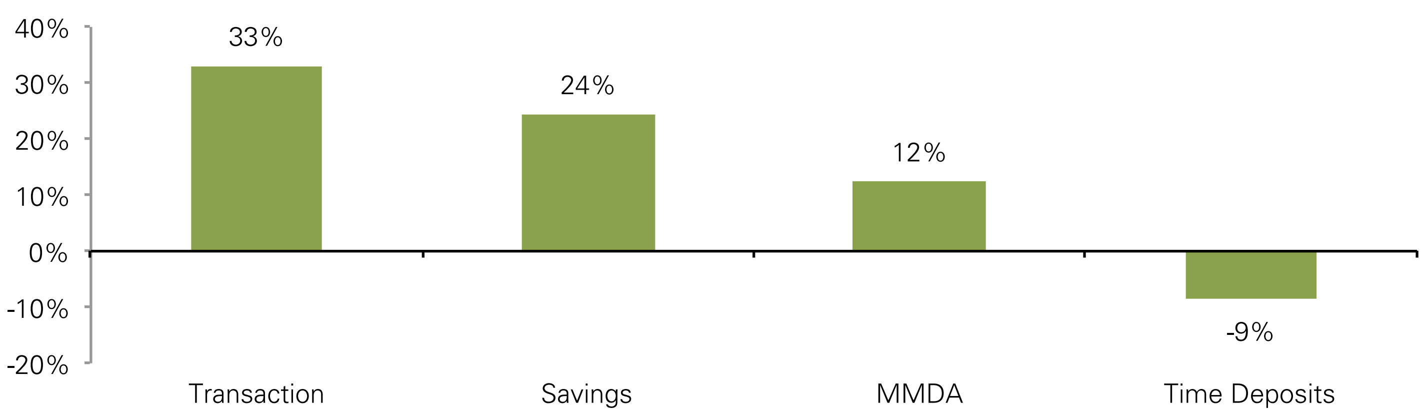
Total bank equity capital grew at a 7% annualized pace in 2011, mainly driven by the growth of retained earnings which grew by 32% in 2011. This trend is the reverse of the 2009/2010 trends when

Exhibit J - Annualized Loan Growth at U.S. Commercial Banks in 2011



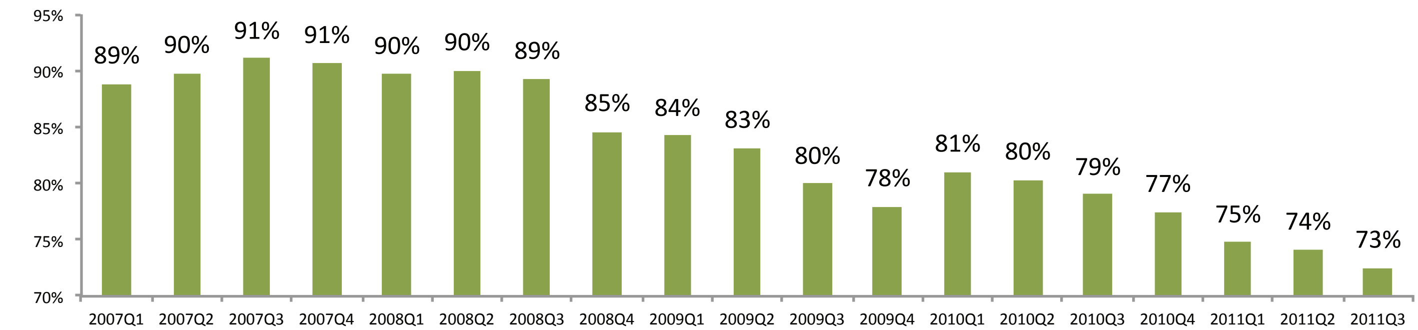
Sources: FDIC, Federal Reserve, Trepp LLC

Exhibit K - Annualized Deposit Growth at U.S. Commercial Banks in 2011



Sources: FDIC, Federal Reserve, Trepp LLC

Exhibit L - Loans to Deposit Ratios at U.S. Commerical Banks



Source: FDIC, Trepp LLC

banks were forced to aggressively pursue external capital raising to strengthen their balance sheets and/or exit TARP.

2012 Looks to be More of the Same

We expect 2012 to reflect a continuation of 2011 trends given the outlook for interest rates, housing market and unemployment. Banks will once again seek to strengthen their balance sheets and capital ratios through the disposition of nonperforming assets and other non-core portfolios.

We expect loan growth to be challenging in 2012 due to low demand, elevated charge-offs, runoff of distressed assets and the disposition of non-core portfolios through loan sales.

Deposit growth will most likely approximate 2011's pattern as consumers lack other investment opportunities and remain wary of volatile equity markets and more risk averse due to the debt crisis in Europe and other global risks.

The Bottom Line

Low demand, elevated charge-offs, runoff of distressed assets and exits of non-core portfolios through loan sales will again put pressure on banks' loan growth in 2012. Deposit growth will be relatively strong given the absence of other attractive low-risk investment opportunities and volatile equity markets.

EUROPEAN EXPOSURES – MEANINGFUL, BUT NOT LIFE-THREATENING

U.S. capital markets and bank shares in particular have experienced heightened volatility stemming from the European sovereign debt crisis. Concerns over banks' exposure to potentially insolvent debt from the most troubled countries in the European Union have been a consistent worry for investors, with headlines from Europe seen as a major driver of stock market movements.

While the initial focus was only on the five most troubled nations (Greece, Ireland, Italy, Portugal and Spain—the "GIIPS"), in recent months these concerns have expanded to all of Europe. Markets have been buffeted in recent months by unprecedented moves to address the sovereign debt crisis.

- In October, a tentative agreement to restore confidence in the European banking system was reached. The plan called for the strengthening of banks' capital positions, a larger European stability fund, and 50% voluntary haircuts on Greek debt. As of our publication date, challenges remained in getting all the member countries to agree upon the actual steps needed to implement the plan.
- At the end of November, the Federal Reserve and other major central banks took coordinated action to provide liquidity to financial markets by increasing the availability of dollars outside the U.S.

- In early December, Euro Zone members agreed to sign an intergovernmental treaty. This treaty requires stricter social and financial discipline in future budgets and is seen as addressing a major shortcoming in the European Monetary Union.

Despite these efforts to improve confidence, liquidity in the global money market has remained impaired over the last several months of 2011. The stress in the interbank market has been increasing as the widening of government yield spreads is affecting banks' ability to access the interbank market.

Unable to access wholesale funding markets, banks in Europe have become more reliant on borrowing from the European Central Bank as a lender of last resort. At the same time, banks have been reluctant to lend to other banks while also parking their overnight deposits with the European Central Bank, which reached a high of $457 billion (€346 billion) on December 9, 2011.

European Banks

In order to establish banks' capital needs and restore confidence in the European banking sector, the European Banking Authority (EBA) published the results of bank stress testing for sovereign debt exposures on December 8, 2011. The results require European banks to raise $153 billion (€115 billion) in additional capital by June 2012 to absorb potential losses on European sovereign debt. This capital can be raised by selling assets, retaining earnings, or issuing shares, among other means (see Exhibit M).

U.S. Banks

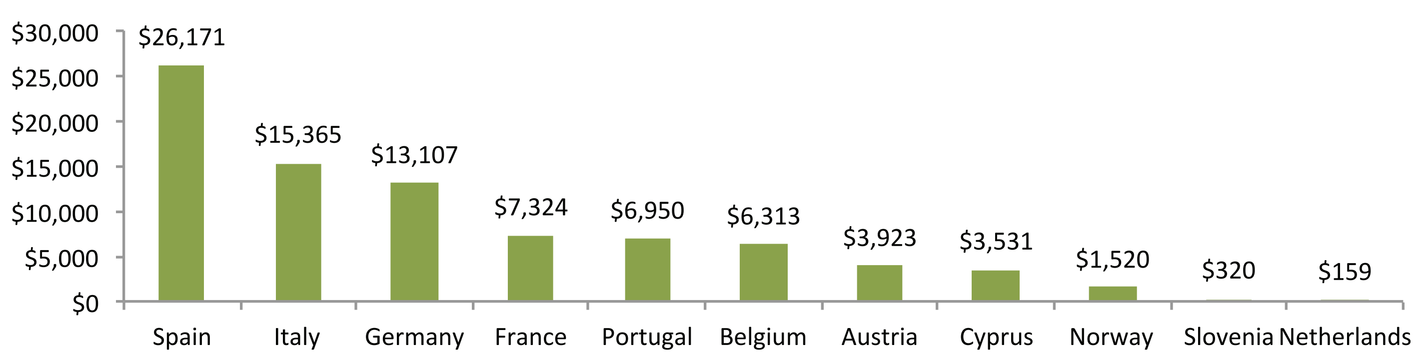
The largest U.S. commercial banks appear to have manageable exposure to Europe, both directly and indirectly. Of the major U.S. banks, Citigroup has the largest direct exposure to the "GIIPS" countries, with $25.6 billion of gross exposure and $16.2 billion of net exposure (see Exhibit N). JP Morgan Chase is second, with $20.3 billion of gross exposure and $15.1 billion of net exposure. Most of the banks have hedged their exposures to reduce their net exposure.

These exposures, while large in dollar amounts, are not that significant relative to the banks' balance sheets. All the "GIIPS" exposures are less than 1% of the banks' total assets, and most are less than 10% of their Tier 1 capital. The ultimate cost of the European crisis is not yet known, but it appears that the losses—even in the most extreme scenario—will be relatively contained for U.S. banks.

The Bottom Line

While the largest U.S. commercial banks have meaningful direct exposure to Europe, the potential costs to banks as a result of the European sovereign debt crisis are relatively small in comparison to banks' total assets and should prove manageable. Indirect impacts—from a prolonged crisis and additional increases in counterparty risk—could have negative consequences on all U.S. banks, resulting from higher global spreads, higher risk aversion, foreign exchange volatility and reduced capital markets activity.

Exhibit M - EBA Bank Recapitalization Needs By Country (millions Euro)



Source: EBA - European Banking Authority, Trepp LLC

Exibit N - Banks Exposure to GIIPS Countries

	BAC	C	JPM	WFC	GS	MS
Net Exposure	$13.00	$16.20	$15.10	$3.10	$2.50	$4.30
Sovereign	$0.40	$1.90	-	-	-	-
Hedges	$1.70	$9.40	$5.20	-	$1.70	$3.60
Gross Exposure	$14.60	$25.60	$20.30	$3.10	$4.20	$7.90
Net Exposure / Total Assets	0.60%	0.80%	0.70%	0.20%	0.30%	0.50%
Net Exposure / Tier 1 Capital	8.30%	12.20%	10.20%	2.80%	3.90%	8.20%

Sources: Company Reports, Trepp LLC

COMMERCIAL REAL ESTATE (CRE) – LONG ROAD TO RECOVERY

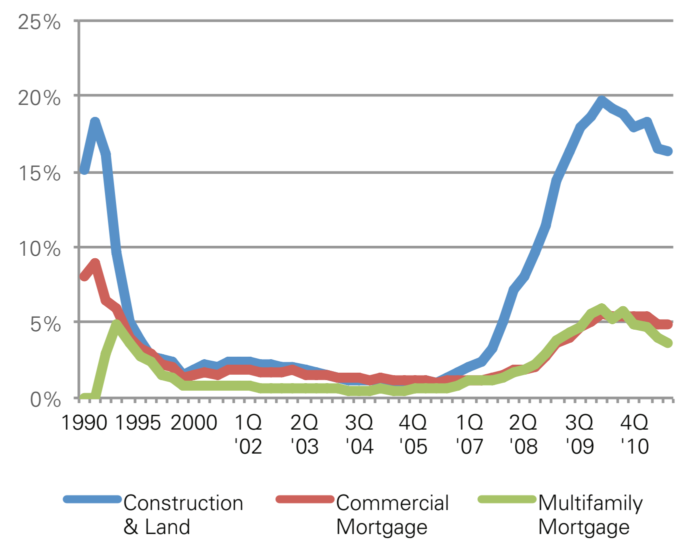
Bank commercial real estate (CRE) loans experienced a halting recovery in 2011. Delinquency rates for each of the major CRE components—construction loans, commercial mortgages and multifamily mortgages—declined for the year (despite an uptick in the second quarter). However, delinquency rates will stay at "distressed" levels, and charge-offs will once again drain banks' loss reserves during 2012.

Outstanding loan balances have contracted as banks have sought to trim exposure to CRE. This contraction has reduced liquidity in the commercial real estate market, complicating the outlook for improved conditions.

Trends by CRE loan type have been mixed:

- Construction and land loan delinquency rates have fallen to 16.3%—from a peak of 19.6% in 1Q 2010 —as banks have worked through their problem loan portfolios, taking losses and shedding $38 billion in nonperforming construction and land loans since 4Q 2009. Nevertheless, liquidity has been constrained, with outstanding loans contracting by 60% since peaking in 1Q 2008.
- Multifamily mortgage delinquency rates have fallen to 3.6%, as liquidity in this segment improves and fundamental market conditions (rents and occupancy rates) have strengthened. The multifamily segment is the best performing property type within the commercial real estate market, with corresponding strong investment demand and property prices.
- Delinquency rates in the large commercial mortgage (nonresidential) segment have improved less markedly than those of construction and multifamily loans, falling to 4.9%, down 80 basis points from the peak in 1Q 2010. The slow improvement is being driven by stabilization in major property type fundamentals and ongoing efforts to get borrowers to pay down loan balances. However, loan paydowns are being hampered by low property values and impaired liquidity.

Exhibit O - Bank CRE Delinquency Rates



Source: Trepp LLC

CRE Charge-Offs

The improvement in delinquency rates has come at a cost. Banks charged off $22.2 billion of CRE loan losses in 2011, resulting in a cumulative $122.5 billion in charge-offs from 2007 to 2011. CRE losses have accounted for a little under 20% of charge-offs for all banks over the last four years, but make up more than half of charge-offs for community banks in the $100 million to $10 billion asset size range.

Construction and land loans have accounted for about two-thirds of CRE losses, with commercial mortgages accounting for the other third. Loss severity for construction loans has been approximately double that of commercial mortgages, underscoring the risks in that segment of the market.

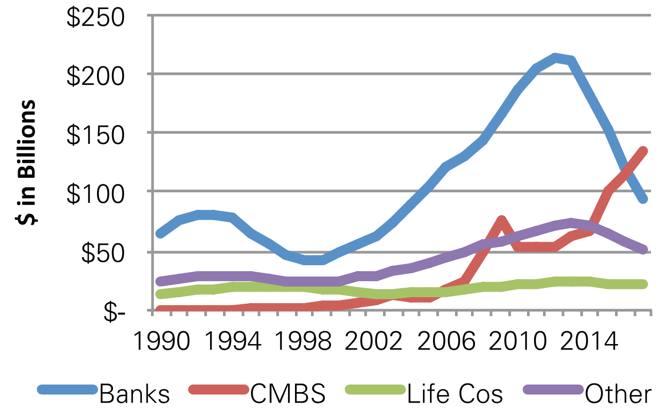
Losses will pile up again in 2012. We estimate that banks are about 60% to 70% of the way through their CRE loss recognition, with another $40 billion to $80 billion in losses to be written off going forward.

Liquidity and CRE Debt Maturities

Maturing debt will put pressure on the commercial real estate market. A wave of maturing CRE debt has hit the market in the wake of the investment and debt boom from the last decade. We estimate that nearly $350 billion of CRE debt matured in 2011, and another $360 billion and $370 billion will mature in 2012 and 2013, respectively (see Exhibit P). Bank loan maturities will peak in 2013—owing to the typical three to seven year term for bank debt—and then decline, while CMBS' share of maturities will increase in 2015 through 2017, as ten-year loans from the boom years of 2005 to 2007 mature.

When the CMBS and bank lending markets dried up in 2008, liquidity was severely impacted. We estimate that there has been a lending "shortfall" of more than $400 billion during 2009 to 2011. Of the loans that came due during that time, many have been extended (frequently dubbed "extend and pretend"). Meanwhile, some have been paid down (in cases where the borrower had additional resources

Exhibit P - Commerical Real Estate Debt Maturities



Source: Federal Reserve, Trepp LLC

to draw upon) while a smaller amount has been restructured or charged-off.

Lower valuations and reduced liquidity still plague the CRE market, posing risks to future loan performance and complicating banks' efforts to trim CRE exposures. Liquidity in the CRE market is still impaired, as the nascent CMBS recovery in the first half of 2011 has since stalled.

Under a best case scenario, the CMBS market would continue to heal, spreads would fall as various desks compete for loans, and the velocity of lending would rise. Banks would benefit either by seeing some of their marginal loans get taken out or by being able to mark their performing loans at better spreads.

While this seemed a plausible possibility in early 2011, it seems much more remote at this point. In the near term, little evidence exists that the securitization market will provide any "comfort" for banks in 2012, as issuance is not expected to pick up in the first half of the new year.

Only adding to the woes of the market was evidence late in the year that a second safety valve—insurance company lending—also started to retreat. While that segment of the market was active in lending in the middle of the year, there was evidence of a pullback late in 2011.

One trend that banks will want to keep a keen eye on is the possibility of a "distressed asset" CMBS program emerging in 2012. As of late 2011, a few rumors were circulating that some banks were preparing to sell off their non-performers via securitization.

The early deals of this ilk will likely be limited to the largest banks in the U.S. that can achieve scale. However, if these deals provide strong execution for the sellers, opportunities may arise for smaller institutions to join the party.

Lastly, our expectations indicate that delinquency levels in the securitized space will worsen as the first wave of loans that were originated in 2006 and 2007—those made at the height of the commercial real estate bubble—reach their maturity dates in 2012.

To the extent that headline numbers spook traders and investors, the data could push spreads higher in 2012. Should the delinquencies move into double digits, a psychological reaction could also undermine the market and further reduce CRE liquidity.

The Bottom Line

Banks' commercial real estate loan performance will show incremental improvement during 2012. Relatively tight lending conditions and still high delinquency rates will constrain liquidity and prevent a substantial recovery for several years. Charge-offs will persist as banks shed more problem assets in 2012.

REGULATORY ENVIRONMENT—LIFE FOR BANKS GETS MORE COMPLICATED

Legislation Makes Bankers' Lives Difficult in 2011

While bank issues are gradually shifting from credit concerns to future revenue prospects, the current and prospective regulatory environment is one of the main factors affecting banks' profitability and capital management decisions. It is also one of the major hot buttons for the industry, as many proposed regulations could materially reduce banks' profitability and force them to meaningfully change their business models.

Banks faced a number of headwinds on a regulatory front in 2011:

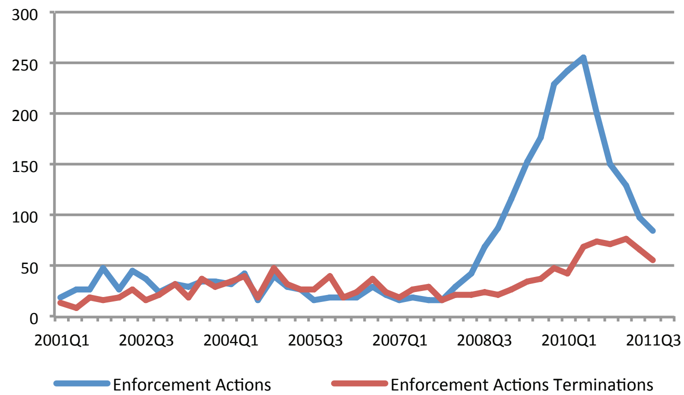
- The Dodd-Frank financial overhaul legislation
- The Durbin Amendment, which was put into full effect in October 2011
- The Consumer Financial Protection Bureau (CFPB)
- The Volcker Rule (ban on proprietary trading), to be implemented July 2012
- State Attorney General settlements regarding mortgage practices
- Higher FDIC premiums in 2Q 2011
- Evolving Basel III requirements, including capital rules for large financial institutions

As a result of these new regulations and other legal challenges, related mainly to banks' residential mortgage practices, banks have experienced elevated legal and compliance expenses. This has manifested itself in increased headcount, greater investment in information technology systems development for risk management, and higher costs for aggregate centralized data processing.

Enforcement Actions

The number of new enforcement actions gradually declined throughout 2011. At the same time, ter-

Exibit Q - Safety and Soundness Enforcement Actions



Sources: Federal Reserve, FDIC, OCC, OTS, Trepp LLC

minations of previously issued enforcement actions have increased, reflecting some improvements in bank distress (see Page 17: Bank Distress). We expect to see a steady number of enforcement terminations in 2012 with the number of actions being similar to those of 2011.

Cost of Compliance

Despite banks' aggressive efforts to keep non-interest expenses under control, the aggregate U.S. commercial banking industry efficiency ratio increased to about 62% in 2011, driven by higher costs related to mortgage workout efforts and litigation pressures (see Exhibit R). We expect this trend to continue throughout 2012.

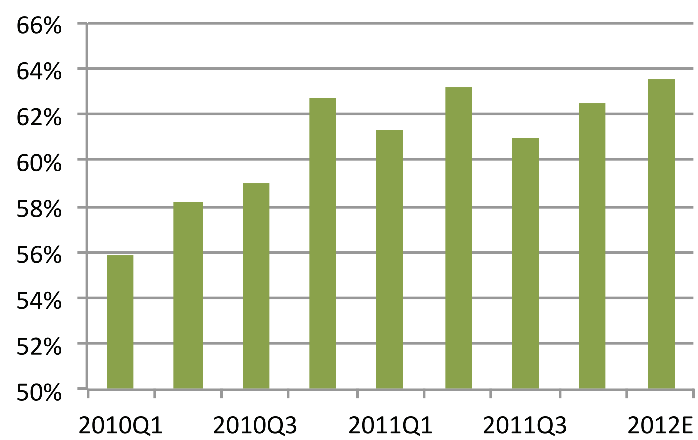
Given their size and complexity, the largest U.S. banks had the greatest number of regulatory challenges driving their legal and compliance expenses higher.

In addition, banks with large REO portfolios may experience a meaningful increase in expenses in relation to their loan loss mitigation efforts. Any foreclosure delays or procedural mistakes could result in additional fees and assessments from the GSEs. Moreover, mortgage put-back activity will continue on banks' legacy mortgage portfolios, and banks may need to allocate money for potential monetary settlements that result from their discussions with state Attorneys General over questionable foreclosure practices.

Basel III

Developed in response to the global financial crisis, the new Basel III global regulatory standard will go much further than Basel II and will have significant impacts on the world's largest banks. Meant to strengthen banks' capital adequacy and liquidity by imposing more stringent regulatory compliance ratios, it is primarily seen as a means of reducing banks' potential risk exposure, while also having the effect of reducing banks' profitability due to lower leverage.

Exhibit R - Efficiency Ratio



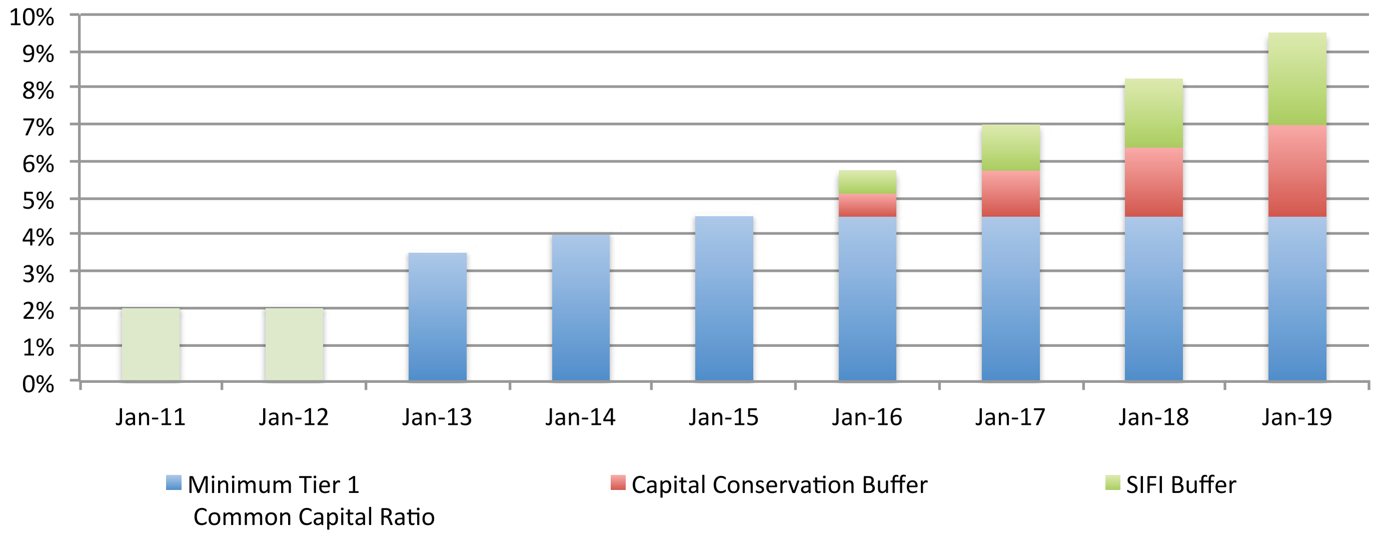
Source: FDIC, Trepp LLC

The new Basel III minimum requirements will be gradually phased in from 2013 through 2019, to give the largest banks enough time to optimize their balance sheets regarding minimum capital ratios and liquidity ratios.

The latest Basel III proposal has Tier 1 Common minimum capital requirements of 3.5% starting in 2013, which will rise by 50 basis points annually, to reach 4.50% in 2015 (up from 2% in Basel II). The required Tier 1 capital will be at 6% in 2015 (up from 4% in Basel II).

Two more capital buffers will be phased in beginning January 2016. The capital conservation buffer will add 2.5% to capital minimums over the next four years, bringing the total capital requirement to 7% in 2019. The second buffer, affecting systemically important financial institutions, has not been final-

Exhibit S - Basel III - New Capital Requirements



Source: Bank for International Settlements, Trepp LLC

ized yet, but the most recent proposal suggests an additional capital buffer of 2.5%, bringing the total capital requirement to 9.5% in 2019.

In addition, Basel III introduced a minimum non-risk based Tier 1 leverage ratio of 3% in 2018, as well as two liquidity ratios: liquidity coverage ratio and net stable funding ratio. Liquidity coverage ratio is the requirement for a bank to hold enough liquid assets to cover its total net cash flows over 30 days, while net stable funding ratio is the requirement for the available amount of stable funding to exceed the required amount of stable funding over a one-year period.

With a European liquidity crisis under way, it remains to be seen in what form these ratios will appear under Basel III as they may also offer incentives to banks to hoard cash and buy securities, rather than lend. Plus, banks may face difficulties in raising enough capital to comply with the new capital ratio standards.

Dodd-Frank

U.S. regulators are also required, under Dodd-Frank, to impose stricter regulations on the largest U.S. banks posing the highest systemic risk. Given that the U.S. banking industry has become more concentrated in the last three years, with the top 10 banks controlling roughly 65% of banking industry assets, many regulators have called for additional capital buffers and surcharges to avoid or offset potential too-big-to-fail costs.

While the Dodd-Frank bill defines a systemically important financial institution as one with $50 billion or more in assets, it remains to be seen exactly how the size of the additional capital buffer will be determined, and whether other factors, such as complexity, will be considered. We believe it is likely that the additional capital buffer will be tiered among banks depending on numerous bank specific factors aside from the asset size.

Going into 2012

While it seems that the regulators will give banks plenty of time to transition to the Basel III standard, discussions about the magnitude of the capital buffers imposed on the largest financial institutions to capture the "systemic costs" of their potential default have had a significant impact on banks' capital decisions and valuations in 2011.

We expect that most of the banks affected would be willing to act fairly quickly, provided that they are in a position to do so, which could lead to faster-than-expected capital building through the runoff of risk-weighted assets, recapture of disallowed deferred tax assets, and sales of minority interest stakes.

Additional regulations have made life more difficult for banks in 2011, and 2012 is shaping up to be no different. On a positive note, banks have had enough time to analyze these new challenges and therefore are proactively developing strategies to align their business models for a new "normal" in the regulatory environment.

We expect 2012 to reflect a continuation of elevated litigation, regulatory, compliance and mortgage workout expenses for banks. Despite a long implementation period for Basel III, banks have already been building capital toward future minimum capital requirements. Early and continuous focus on compliance with Basel III standards could prove beneficial for banks and we expect these trends to continue, particularly among the largest banks.

The Bottom Line

The regulatory environment has become more difficult and costly for banks, impacting banks of all sizes. Higher capital requirements and increased costs associated with regulatory compliance will once again provide a drag on bank profitability. Basel III and Dodd-Frank implementation will have extra impacts on large banks, with $50 billion or more in assets. The potential positive in all this is that banks are already aware of these implications and have had time to adjust and adapt their business models accordingly.

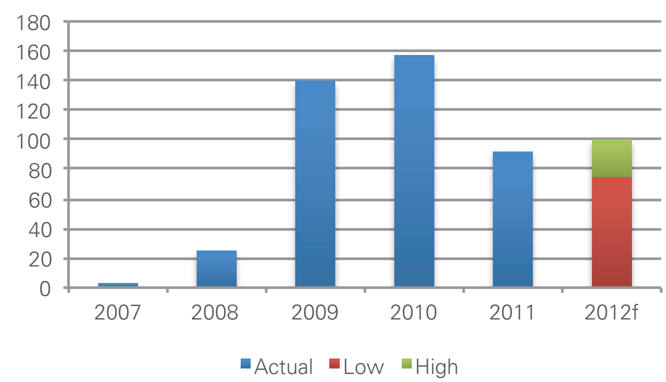
BANK DISTRESS—U.S. BANK FAILURES—NOT OVER YET

The pace of bank failures slowed in 2011, falling to 92 for the year, as compared with 157 in 2010 and 140 in 2009 (see Exhibit T). The worst part of the distress cycle appears to have passed, though it is by no means over, and risks abound.

Banks have tapped capital markets to boost their equity cushions over the last two years, but economic and capital markets conditions will be paramount to determining the volume and pace of bank failures.

Despite these positives, there are more than 200 banks at a high risk of failure, according to Trepp's Bank Navigator™. These banks are under particular pressure to raise capital and shed problem assets. Some will succeed, but many will not, leading us to believe that failures will remain a feature of the bank landscape in 2012 and beyond.

Exhibit T - Bank Distress per Year - Current Cycle



Source: FDIC, Trepp LLC

Geographic Distribution

In 2011, failures occurred in 28 states, down from 32 states in 2010. Georgia, Florida and Illinois were in the "top 3" for failures during 2011, as they have been throughout the current failure cycle, which we date from the September 2007 failure of NetBank in Georgia.

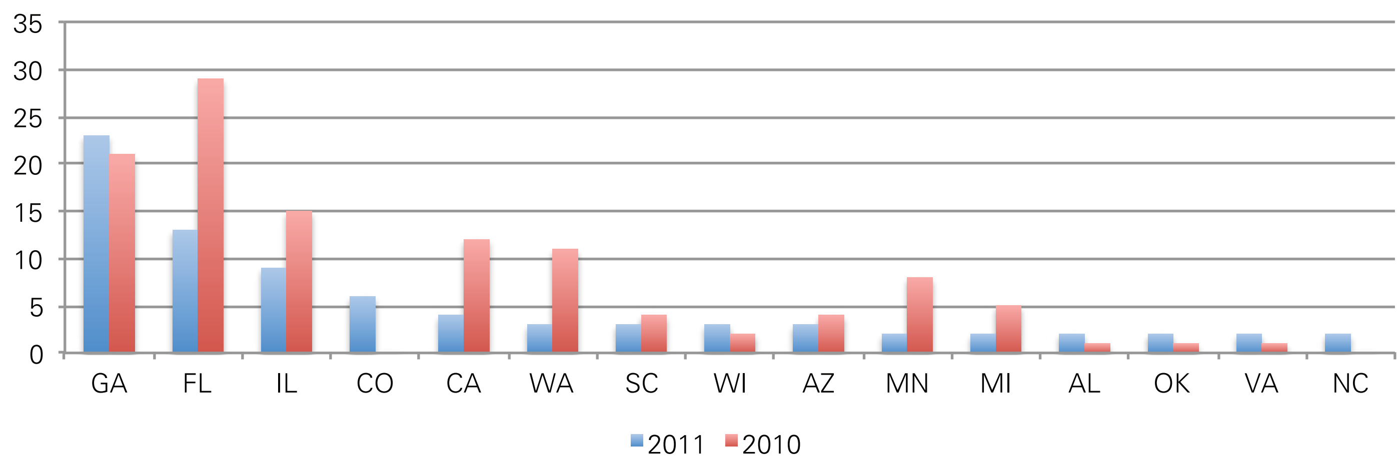
- Georgia ranked first for failures, with 23 failures in 2011, up from 21 in 2010 (see Exhibit U). Georgia also has the greatest potential for future failures—44 banks in Georgia are currently at high risk of failure, according to Trepp's Bank Navigator™.

- Florida ranked second, with 13 failures in 2011, down from 29 in 2010. Florida also ranks second in our outlook for future failures—currently 36 Florida banks are at a high risk of failure, according to Trepp's Bank Navigator™.
- Illinois ranked third, with nine failures in 2011, as compared to 15 in 2010. Risk remains high, with 26 Illinois banks still at high risk of failure.
- Colorado (six failures in 2011) and North Carolina (two failures in 2011) both experienced increases during 2011, after no failures in 2010. The cycle may have already run its course in Colorado, with only four banks remaining at high risk of failure. North Carolina, however, still has potential for several more failures, with 14 banks at high risk of failure.

Our forecasts underscore the importance of future economic conditions in determining bank performance and the number and cost of future failures. Trepp's Bank Navigator™ forecasts income and capitalization impacts for all insured banks across four scenarios, ranging from Deep Recession to Strong Growth.

- In a Deep Recession, the number of failing banks through 2013 would swell to approximately 430, roughly doubling the 414 banks that have failed in the current cycle, which began in September 2007.
- Even in a Moderate Recession, the number of failing banks through 2013 would increase to more than 300. With approximately 230 banks currently at high risk of failure, a modest economic downturn (a "slight" double-dip) would push these banks over the edge.

Exhibit U - Bank Failures (Top States)



Source: FDIC, Trepp LLC

Outlook—Number and Cost of Failures

Economic growth and capital market conditions will be key to the outlook for the number and pace of future bank failures. If economic growth resumes and banks are able to tap capital markets for fresh equity capital, it is reasonable to assume that the pace of failures will decline. Indeed, the FDIC's Problem Bank List has contracted for two consecutive quarters, and the FDIC will be downsizing its staff devoted to failed bank resolution.

- Conversely, even a Moderate Growth scenario would have positive implications for banks, reducing the number of failed banks through 2013 to approximately 150.
- In our Strong Growth scenario, the number of failures would be cut further, to approximately 100 banks through 2013.

The expected costs of failures (the impact on the

FDIC's Deposit Insurance Fund) range widely across our economic scenarios.

- At the lowest end, in a Strong Growth scenario, expected costs could be as low as $5 billion to $8 billion (see Exhibit V).
- Costs would rise somewhat in the Moderate Growth scenario, to the $9 billion to $13 billion range.
- In the Moderate Recession scenario, the higher number of failures would push failure cost estimates up to $19 billion to $30 billion.
- Failure costs would roughly double in the Deep Recession scenario—as compared to the Moderate Recession scenario—to $40 billion to $60 billion, as a higher number of larger banks would fail.
- The FDIC's own recent estimate of future failure costs is $19 billion for the 2011 to 2015 period, which would appear to be somewhere between our Moderate Recession and Moderate Growth scenarios.

Exhibit V - Economic Growth Implications - Bank Failure Results

Two-Year Failure Projections (through 2013)

		Expected Cost of Failures ($ Billion)	
Scenario	**Estimated Failures**	**Low**	**High**
Deep Recession	431	$39.40	$59.10
Moderate Recession	311	$19.50	$29.30
Moderate Growth	157	$8.60	$12.90
Strong Growth	107	$5.60	$8.40

Source: Trepp Bank Navigator™

The Bottom Line

Bank failures will persist in 2012 and will likely extend further into 2013. Failures will occur at a slower pace than in 2011, but will be stretched further into the future. Stable economic conditions will be key to the outlook for a reduced pace of bank closures. If the economy falls back into recession, the number and cost of failures will increase.

DISCLAIMER