

Earnings Put Consumer Banking in the Shadow

Lauren Tara LaCapra

01/28/11 - 07:00 AM EST

<http://www.thestreet.com/story/10984911/1/earnings-put-consumer-banking-in-the-shadow.html#>

NEW YORK ([TheStreet](#)) -- Consumer banking -- once reliable contributor to big-bank earnings -- is moving from a low margin to a no-margin business that is forcing executives to place their growth bets on other business lines.

If the most recent earnings season proves anything, it's that banks will not rely on consumer banking for growth in the near future.

The biggest news out of big banks' quarterly reports this month was **Bank of America's (BAC)** discomfiting losses and the lack of certainty about when, exactly, its gaping mortgage wounds will heal.

Fast Profits, Slow Growth

Analysts estimate that big banks will see net income soar in 2011, even as revenue is held back by economic challenges.

	2011 net income (B)	Change from 2010	2011 Revenue (B)	Change from 2010
Bank of America	\$14.40	N/A	\$108.60	-1%
Citigroup	\$13.30	26%	\$84.40	-3%
Wells Fargo	\$14.90	20%	\$85.70	1%
JPMorgan Chase	\$18.90	9%	\$102.70	0%

Source: Thomson Reuters, the companies

The company reported a \$1.2 billion loss, reflecting \$4.1 billion worth of mortgage repurchases and \$1.5 billion worth of litigation expenses. Bank of America estimates that it has another \$7 billion to \$10 billion in buyback exposure - a number that's questionable, considering management deemed the exposure unquantifiable just a few months earlier.

On the flip side, there was the biggest pure-play U.S. consumer bank, **Wells Fargo (WFC)**. The company's \$3.4 billion of fourth-quarter profit was in line with expectations and attributable to gradual credit improvements, modest loan growth and cost cutting.

Ho-hum.

"They're right in the heart of plain-vanilla U.S. banking," says Mac Plumart, principal of Marietta, Ga.-based investment advisory firm Narwhal Capital Management, which manages about \$400 million in assets.

Those who were seeking something sexier in consumer banking were probably disappointed with **JPMorgan Chase's (JPM)** stunning quarterly beat. The firm reported a 47% jump in fourth-quarter profits, but its retail business was far from the belle of the ball; rather, its investment bank's deft navigation of volatile credit conditions last quarter was what impressed Wall Street.

On a conference call, analysts ignored the \$750 million in retail banking profits and \$1.3 billion in credit card earnings. Instead, they hammered away with questions about the JPMorgan's exposure to mortgage litigation and buyback related expenses.

"We'll be talking about this every quarter for the next three years," said an exasperated Jamie Dimon, after the CEO fielded the same question asked multiple ways.

Of course, there was nothing bad about the consumer banking results at Wells Fargo or JPMorgan Chase, but nothing exhilarating either. Their businesses are doing well, spending less on bad loans, investing in areas where it makes sense and squeezing efficiencies out of every possible corner.

Plumart calls both firms "best in class" banks. He sees growth ahead for all of the big banks as the economy starts to improve. But much like the analyst community Plumart believes the upside potential in battered bank stocks outweighs the risk of short-term pressure.

For instance, Bank of America, trading around \$14, represents just 67% of book value, according to estimates from Sandler O'Neill. Meanwhile, JPMorgan, at \$45, is 104% of book value and Wells Fargo, at \$32.50, is trading at 145% of book value

"I look at JPMorgan - yeah, it'll go from 45 to 60 when things calm down," Plumart said earlier this week. "But I think Bank of America goes from - what is it today? 13 and change? It goes from 13 to 26. There's probably 100% upside in the stock if you give it two years."

Plumart started buying Bank of America back in 2009 when the stock hovered around \$4. He later added to his position at \$7 and again at \$11. "If it pulls back further," he says, "we'd definitely be buyers of Bank of America again."

In the near-term, however, the share prices of banks with heavy exposure to U.S. consumers may find it difficult to gain significant traction based on fundamentals alone.

The U.S. is moving into a phase of slow and steady economic recovery, with fewer federal subsidies to spur growth and more federal regulations that will curb profits. Banks that have heavy exposure to mortgages, credit cards and basic deposit accounts are transforming their business models to adjust to the new reality.

For instance, new regulations will limit banks' ability to charge merchants fees for debit-card transactions or to indiscriminately raise interest rates on credit cards the way they had in the past. As a result, the industry is testing new fees on checking and savings accounts that were once free of charge.

It's a delicate dance, because banks don't want to chase away depositors who might be profitable using another financial service down the line. But they also don't want to let customers park money in deposit accounts for free if the operating costs around them - whether branches, ATMs, online banking, customer service or insurance on transactions - outweigh the uptick in market share.

Lee Kyriacou, a director at the consulting firm Novantas who focuses on financial services firms, says he's been working with banking clients to try to figure out how to implement effective strategies to re-establish lost revenue.

"First you had card fees being regulated, then you had overdraft fees being regulated and now interchange is next," says Lee Kyriacou, a director at the consulting firm Novantas who focuses on financial services firms. "What I think you're going to see in the next year is lots of changes in the pricing of basic retail consumer checking accounts. There's no choice."

JPMorgan CEO Jamie Dimon estimates that 5% of his bank's depositors may become "unbanked" as a result of the added fees.

"You will not be able to profitably serve them...and I am not sure that was a good public policy issue either," he said during a conference call on Jan. 14. "I think the general banking customer base may be pushed out of the banking system."

Apart from deposits, the consumer lending business - particularly mortgages - may be held back for an extended time.

Mortgage banking has been the biggest contributor to Wells Fargo's results over the past two years, thanks to a low rate environment, refinancing incentives and an aggressive push by Wells to gain market share. But, by now, many of the consumers who would be eligible for a lower rate have already refinanced. Borrowers who were defaulting and going delinquent haven't necessarily gotten back on their feet, with unemployment still elevated. Those in the middle may be stuck in neutral until the jobs picture finally brightens.

"If your business is focused just on mortgages, it's going to be tough sledding," says Plumart. But, he adds optimistically, "you just never know. If we get employment to start ticking higher, if we get consumer spending to start ticking higher, and we keep these rates low, maybe there is a bump higher in the housing and, therefore, the mortgage market."

For the time being, though, consumer banking operations are still in a nascent recovery mode. About 25% of Wells Fargo's quarterly profit came from "reserve releasing," or moving extra capital to the bottom line because loan losses are trending lower. Similarly the sharp turnaround in profitability of JPMorgan's card business was largely ignored, since most of that \$1.3 billion in profit was attributable to reserve releasing. CFO Doug Braunstein characterized it as "really the first quarter since first quarter of 2009 that we are breakeven," with \$61 million worth of pretax, pre-loan loss reserve income.

The big four consumer banks -- Bank of America, Wells Fargo, JPMorgan and **Citigroup (C)** -- collectively earned \$8.5 billion last quarter, including \$6.85 billion of reserve-release padding. Across the industry, Kyriacou says more than 100% of net income improvements over the past six quarters have been attributable to letting go of that excess capital.

"The big piece that is contributing to earnings is reserve release," he says.

In a note titled "turning the page on a rough year," Collins Stewart analyst Todd Hagerman summed up Bank of America's quarterly results.

"Exclusive of the company's outsized reserve release this quarter, results were again light of conservative expectations," he said. "Revenue again fell across most primary business lines, including disappointing market sensitive revenues, and expenses remained excessively high as environmental costs and incremental investment spend continue to more than offset efficiency gains."

Nonetheless, he holds a buy rating on Bank of America shares, believing the stock is priced cheaply, primed for upside when the economy starts to improve.

For investors seeking opportunity in a big U.S. bank whose stock is still priced below book value, but has limited exposure to the U.S. consumer, Citigroup may be the answer.

The bank made significant progress on its turnaround strategy in 2010, divesting \$128 billion worth of bad U.S. assets and honing in on growth opportunities abroad. North America now contributes just 28% of Citi's revenue and 20.5% of income from continuing operations. The majority of Citi's loan growth last quarter came from emerging markets where other big bank competitors barely have a toehold.

"We expect to see continued increase in loan demand," CEO Vikram Pandit said, discussing emerging markets. "We expect to see continued increase in capital markets activities. We expect to see continued growth not only in the Asian markets, but also in the Latin American and some of the African markets."

Yet, like most investment banks, the firm's trading business took a beating last quarter due to volatility in the credit markets. As a result, Citi missed Wall Street's earnings expectations by half. Its stock has shed more than 5% since its report on Jan. 18, dropping from \$5.13 to below \$4.90 in recent sessions.

"Given the inherently volatile nature of trading revenues and the apparent non-recurring nature of the expense items, we do not believe the 4Q10 earnings miss indicates a reduction in franchise earnings power," said Sandler O'Neill's Jeff Harte, who rates the stock a buy with a \$5.50 price target.

Plumart thinks the biggest near-term catalyst for bank stocks is the potential for dividend increases, which appears closer for some than others. The **Federal Reserve** is expected to complete its review of stress tests on the largest 19 U.S. banks and announce results in March. Well-capitalized banks with strong balance sheets and manageable credit risk - including JPMorgan and Wells Fargo - are expected to be among the first to gain approval for dividend hikes.

"The first mandate of a publicly traded company's CEO is to maximize shareholder value," says Plumart. "If you can't pay your shareholders a dividend, why would you make a loan that's anything but triple-A essentially guaranteed to be paid back on time? You're not. You're going to pay shareholders first."

Interestingly, though, after being peppered with questions about the dividend - When? How high? How long will that take? - Dimon said that while the board would probably institute a dividend payout of 35% as soon as possible, "Me, I prefer [we] don't pay dividends at all so we can use it for some other purpose down the road."

-- *Written by Lauren Tara LaCapra in New York.*

>To contact the writer of this article, click here: [Lauren Tara LaCapra](#).

>To follow the writer on Twitter, go to <http://twitter.com/laurenlacapra>.