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More pain for America

John Thaine, the CEO of Meryl Lynch

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CHARLES DARWIN's most famous phrase - "the survival of the fittest" - is not quite what most of us think.

"In the struggle for survival, the fittest win out at the expense of their rivals because they succeed in adapting themselves best to their environment," runs the often misquoted passage in On The Origin of Species. It's the ability to adapt that matters.

Darwin's struggle is all too familiar in the American banking industry, where the credit crunch has hit the market like a new ice age. While some banks seem to be evolving to meet the challenge, others are going the way of the dinosaurs.

Last week was one of contrast as the winners and losers emerged, consumers worried about their savings and home loans and investors speculated on which bank would be the next to fall.

The credit crisis that has done so much damage to the banking sector has claimed some of its biggest victims in recent days with turmoil at mortgage giants Fannie Mae and Freddie Mac and the collapse of Indy Mac, once one of America's biggest lenders.

Merrill Lynch was last week's biggest loser. The bank, headed by chief executive John Thain, had already suffered sub-prime-related write-downs of more than $30 billion (£15 billion) in the previous three quarters that ended in March, and announced an additional $9.7 billion hit in the second quarter, which caused the bulk of the company's net loss of $4.6 billion.

Merrill, Citi and Lehman have all suffered huge declines in their share prices. But it's the smaller regional players like Indy Mac that are top of the deathwatch list. Last week the S&P 500 banks' index suffered its worst daily fall since its creation in 1989. Regional players suffered the most. As people queued to get their money back at Indy Mac, Washington Mutual in Seattle and National City in Cleveland both tried to reassure panicking investors that they were well capitalised.

Brad Hintz, senior analyst at Bernstein, is not expecting any sudden collapses at the big banks. "The regulators do not want a large-scale systems failure," he said. "If they bleed to death slowly and markets have time to adjust, that's fine. But you can't have any catastrophic failures out there. The big banks are just too interdependent."

For all the dire predictions of extinction, a significant number of banks are, if not flourishing, at least adapting to the harsh new environment. JP Morgan Chase posted a smaller-than-expected 53% decline in quarterly profit last week, just a month after it took over Wall Street's biggest sub-prime casualty, Bear Stearns.

Wells Fargo also turned in decent second-quarter results. Last month Goldman Sachs, which has skirted the worst of the credit crunch, posted an 11% drop in profits. It was a fall but a tiny one compared with its rivals.

Further down the chain, however, analysts are expecting casualties. "The US has a huge number of little banks and that is where the failure is going to be. They don't have exposure to Barclays, Société Générale or Citi. The Fed can allow them to fail," said Hintz.

Christopher Thornberg, principal analyst at Beacon Economics, said a number of smaller regional banks were bound to fail. "These guys are up to their eyeballs in construction loans, residential loans and mortgages. They have been making their money in this flurry of debt that people have been racking up, and now it's unwinding they don't have the deep pockets to survive this mess."

Thornberg said previous downturns in the economy had shown that most of the pain in the financial sector comes after the recession has ended, when the cost of bad loans comes home. "This time, more than ever before, there has been massive leveraging. Everybody seemed to ignore the laws of rationality. These guys had forgotten about risk." He said the banks had fought to make that quarter's financial targets but forgot that they were working in cycles that can last for 5, 10 or even 15 years.

The final blow to Indy Mac came when senator Charles Schumer notified the Federal Deposit Insurance Corp (FDIC) that the bank was in deep trouble. His move put Indy Mac's troubles at the top of the news agenda and triggered a run on the bank. Customers pulled out more than $1.3 billion in deposits.

Schumer has since been at pains to argue that most regional banks are safe. That's true, but Hintz doubts it will be the last time the FDIC will be called in. He said the banking regulator had been "hiring like crazy" in anticipation of more banks failing.