

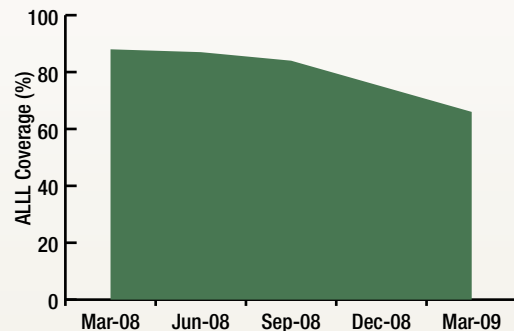
Issue Review

July 13, 2009

Sector

Banking

U.S. Banks – ALLL Coverage* Of Seriously Delinquent Loans



* ALLL Coverage = ALLL/Noncurrent Loans (90 days or more past due)
Source: FDIC

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Rating Analyst

Diane Goodheart, Senior Financial Analyst
+1 (908) 439-2200 Ext. 5649
Diane.Goodheart@ambest.com

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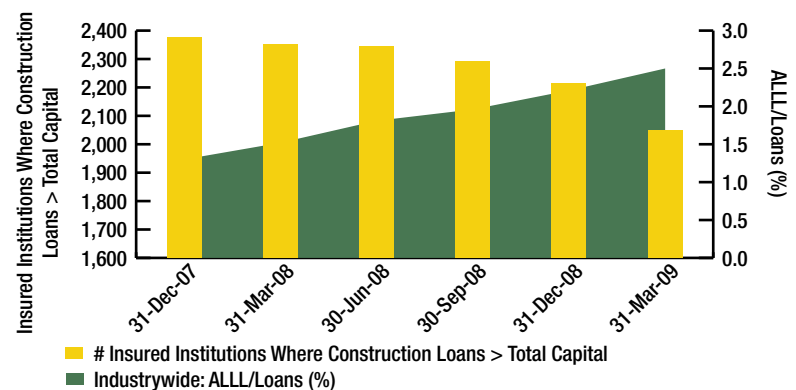
Bank Loan Reserves Too Cyclical; ALLL Methodology May Evolve

U. S. Banks' loan loss reserves are lagging behind delinquent loans, and the shortfall is drawing scrutiny to the methodology for calculating this reserve – the Allowance For Loan and Lease Losses (ALLL). Most agree that ALLLs should peak just before delinquencies surge, but historically the opposite has tended to occur.

- U.S. Comptroller of the Currency John Dugan has called for a new look at the methodology for determining the ALLL. The Treasury Department made a similar recommendation in its white paper, "Financial Regulatory Reform" issued in June 2009.
- At odds are accountants representing bank regulators, who are concerned about economic cycles and potential mismatches between banks' credit costs and loan revenue; and accountants representing standard-setters, who are concerned about theoretical accounting integrity and preventing earnings management.
- The accounting standard-setters, IASB and FASB, have jointly discussed various approaches to estimating the ALLL and issued a number of Agenda Papers on theoretical issues behind banks' difficulties with current accounting.
- The main controversy is over the "incurred loss model" and the feasibility of determining precisely when a loan loss occurs.
- Some believe "fair value," "Spanish provisioning" or "expected loss" may be viable alternatives to the incurred loss model.
- A.M. Best believes more attention should be focused on risk – especially relative to loan pricing – and the need for meaningful risk data in setting either capital or ALLL levels.

U.S. Banks – Construction Loan Concentrations Vs. ALLLs (4Q 2007-1Q 2009)

Regulators limit construction loans to 100% of total capital because of their high risk.



Source: FDIC

In Search of a Better ALLL Methodology

As the current delinquency crisis has shown, the Allowance for Loan and Lease Losses (ALLL) clearly is inadequate to cover sharply rising nonperforming loans. Its inability to keep up has renewed the interest of regulators, accountants and industry observers, some of whom are calling for a revised ALLL methodology. The issue is how to design a balanced ALLL methodology that on one hand discourages banks from using the ALLL as a means to smooth out earnings, and on the other mitigates a cyclical pattern of banks entering a downturn with inadequate ALLLs and racing to build them up.

The banking industry now is in such a race. It increased the ALLL this past quarter to an all-time high of 2.50% in a failing effort to keep up with charge-offs and nonperforming loans. The ALLL (informally known as the “loan loss reserve”) is a mechanism for estimating and recognizing losses on loans. In effect it acts as a buffer for portfolios against delinquent and nonperforming loans that are unlikely to be repaid completely. One measure of its adequacy is the “coverage ratio,” which shows how much ALLL is available to “cover” noncurrent loans representing potential losses. This coverage ratio fell below 100% during 2007 and continues falling relentlessly (see **Exhibit 1**). Despite enormous buildup in banks’ ALLLs, the coverage ratio dropped yet again at the end of March 2009 to 66.5%,

its lowest level in 17 years. The sharp and historic increase in noncurrent loans clearly is defeating the industry’s efforts to beef up the ALLL ahead of additional loan charge-offs.

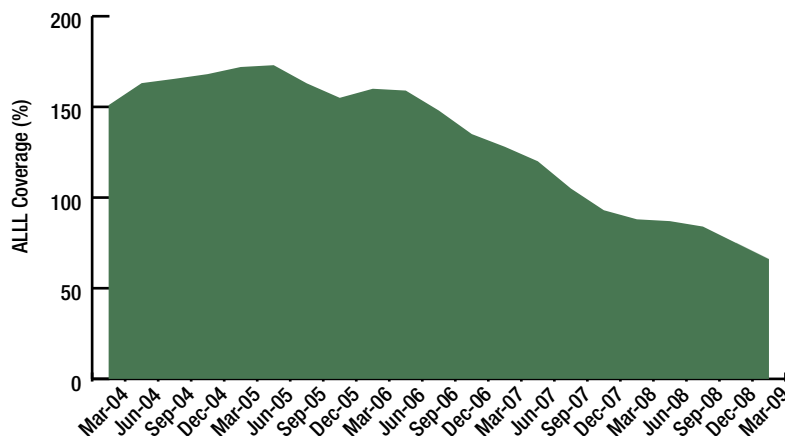
Industry observers are floating various explanations for the ALLL’s inadequacy and are suggesting a variety of potential changes to accounting rules. The limited ALLL at the onset of this downturn – and its subsequent inability to cover nonperforming loans as the downturn progressed – is spotlighting the fact that the ALLL often is at its lowest level precisely when its highest level is needed urgently – just before an economic downturn. In a speech earlier this year,¹ U.S. Comptroller of the Currency John Dugan called for a new look at the methodology behind the ALLL calculation, and last week the Treasury Department issued a white paper on financial regulatory reform that includes a recommendation that revisions to the ALLL methodology be completed by the end of this year. Meanwhile, the Financial Accounting Standards Board is preparing an exposure draft² about new loan risk disclosure rules. The current methodology for calculating the ALLL is inadequate in that banks are not able to set aside enough reserves to prepare for an impending downturn, for at least three reasons:

1. Economic cycles are exacerbated by human behavior – it’s just natural to become less cautious when times are good.
2. Accounting methods may have made it more difficult for banks to reserve adequately for losses during apparently strong industry conditions (e.g., 2005 and 2006). Most notably, standard-setters are reconsidering the elusive “incurred loss model,” which Dugan criticized in his speech.
3. Not enough attention has been paid to loan underwriting standards and the concentration of loans in higher risk products or industries, particularly with respect to commercial real estate loans. Bank regulatory reports need to capture more data, and the character of loan portfolios needs to play a larger role in determining appropriate reserves.

¹ Remarks by John C. Dugan, Comptroller of the Currency, before the Institute of International Banker, March 2, 2009, *Loan-Loss Provisioning and Pro-Cyclicality*.

² The Project Update on Loan Loss Disclosures can be located as follows: http://www.fasb.org/loan_disclosures.shtml#summary

Exhibit 1
**U.S. Banks – ALLL Coverage*
Of Seriously Delinquent Loans**



* ALLL Coverage = ALLL/Noncurrent Loans (90 days or more past due)
Source: FDIC

History Repeating Itself

This is not the first time a large real estate lending crisis caught the banking sector with low ALLLs right before noncurrent loans sharply increased. As shown in **Exhibit 2**, the ALLL is repeating a pattern from the mid 1980s, when a large number of savings and loans and a handful of banks failed.

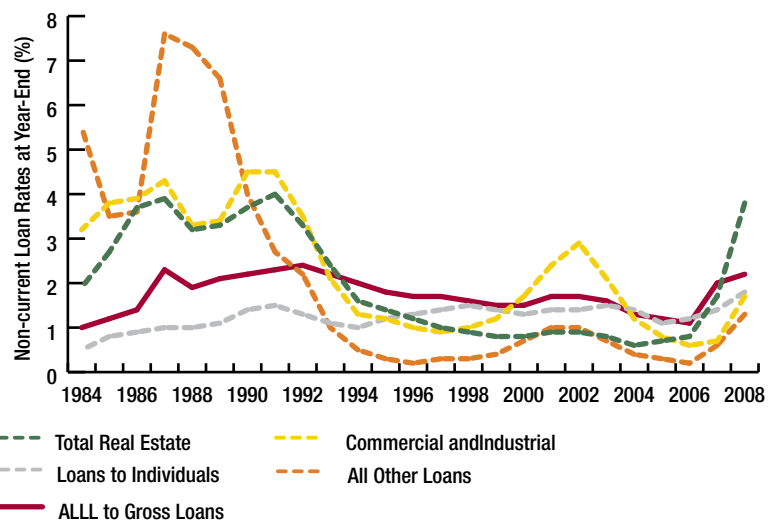
The ALLL reached historically low levels at the end of 2006 and in mid-1985. Both of these troughs occurred precisely before historic real estate crises. The scenario generally plays out repeatedly along the following lines:

- Beginning at a low point in the cycle, lessons have just been learned. Regulators and legislators have developed new frameworks based on the previous crisis. Capital requirements and ALLLs have been increased. The appetite for risk is low.
- Due in part to more astute risk-taking, the economy and financial sector perform much better for a long time.
- Nearing the top of an economic cycle, loan underwriting standards loosen in response to benign risk expectations and competitive pressures. These lead to mispricing of loans relative to their inherent risks. (Former Federal Reserve Chairman Alan Greenspan noted that the worst loans are issued during the best economy.)
- Real estate prices inflate, and concentrations of loans (e.g., by region, category of borrower or type of loan) increase, compounding risk and potentially calling for a higher ALLL.
- Regulators, noticing a compounding of risk, may publicly suggest that a certain risk should be curtailed or relative capital levels increased. The industry objects, claiming that attempts to curtail the risky activity will precipitate a downturn in the economy.
- Emerging delinquencies or historical loan losses, which are very low during good economic times, generally are used to calculate targeted ALLL levels. Lower “loan loss provision expenses” reflect low ALLL targets at the very top of a cycle. Earnings are high, and ALLL levels drift downward.

- The ALLL sinks to a bottom as risk is highest, and right before the economy turns downward. (See the red line in **Exhibit 2**.)
- As the economy first begins to weaken, banks may increase loan loss provision expenses, which build the ALLL slightly, but the very low initial level of the ALLL renders increased provisioning only partially effective.
- Banks also may be reluctant to provision aggressively early in a downturn – provisions reduce earnings and erode capital – as they compete to appear strong before increasingly skittish investors.
- Once the downturn takes hold, and loan delinquencies and charge-offs begin to increase dramatically, it becomes almost impossible to catch up, because the charging off of ever-increasing bad loans only reduces the ALLL further.
- As the overall economy deteriorates, other losses may further weaken thrifts’ and banks’ earnings and capital.

In the most recent downturn, extremely high trading and market-risk losses – particularly at the largest organizations – left little or no earnings available to provide for emerging loan losses or to rebuild the ALLL. ALLLs were partially built back up, but only by reporting

**Exhibit 2
U.S. Banks – Historical Composition
Of Noncurrent Loans (1984-2008)**



Source: FDIC

even larger losses – because of the unusually high loan loss provision expenses.

This pattern raises the question of how the ALLL gets to be so low just when risk levels peak. To some extent, it is a deeper question about human behavior and economic cycles. Part of the answer, however, lies in the reasoning behind the ALLL calculation.

Inner Workings of the ALLL

The plummeting coverage ratio, caused by sharply rising nonperforming loans relative to reserve levels, is drawing attention to the once obscure theoretical underpinnings of the ALLL. The issue is how to design an ALLL methodology that discourages banks from using loss provisions to smooth earnings, but at the same time mitigates a recurring cycle of banks entering a downturn with inadequate ALLLs, as shown in **Exhibit 2**.

A number of goals guide accounting standard-setters. One is to be theoretically consistent. Another is to prevent earnings management, whereby an entity might voluntarily recognize some expenses when earnings are strong and hold off when earnings are weak, thereby smoothing earnings results over time. Matching revenue with related expenses is a similar goal. Yet another relates to the overall, theoretical framework – such as FASB’s directional change, more than a decade ago, away from historical cost accounting and toward fair value. At times, standard-setters’ goals may be difficult to implement, or they may conflict with other goals, such as regulators’ efforts to maintain the soundness of the banking industry. There has been tension between these objectives. During a truce in December 2006, bank regulators issued the “Interagency Policy Statement on the Allowance For Loan and Lease Losses”³ that clarifies GAAP from their perspective.

First, some background on ALLL accounting is needed. According to U.S. generally accepted accounting principles (GAAP), the ALLL has two parts. The first, FAS 114, “Accounting by Creditors for Impairment of a Loan,” is a fairly helpful tool that emerged shortly after the savings and loan crisis. The other portion, FAS 5, “Accounting for Contingencies,” is older and more problematic when applied to loans.

Two Segments, Two Steps of the ALLL
Current U.S. GAAP stipulates that the ALLL consists of 1) a portion determined by reviewing individual loans, via FAS 114, and 2) a portion determined by reviewing groups of homogenous loans separated into loan “pools,” via FAS 5.

1) Step One: Individual Loans (FAS 114)

According to FAS 114, certain loans, generally large loans, are reviewed individually for impairment. FAS 114 contains three methods to measure impairment as of the evaluation date: 1) the present value of expected future cash flows discounted at the loan’s effective interest rate; 2) the loan’s observable market price; or 3) the fair value of the collateral if the loan is collateral dependent.

Officially, FAS 114 is based on FAS 5, yet bankers and regulators prefer the methodology used in calculating the FAS 114 portion of the ALLL. They cite many reasons, including claims that it has tracked loan losses more accurately; involves the credit officer’s input; states loans at levels closer to fair value; and is a simpler and easier way to recognize losses promptly.

2) Step Two: Pools or groups of loans (FAS 5)

Once the individual loan portion of the analysis has been completed, the remaining loans are aggregated in groups or “pools” based on common risk characteristics. The primary risk characteristic is the type of loan – e.g., commercial loans, mortgages, credit cards, etc. Loans having additional risk characteristics, such as a common geographic location, may be grouped when that characteristic is believed to be relevant to credit quality. This is the “FAS 5” portion of the ALLL.

FAS 5 is an older and more generalized standard FASB issued in 1975. It encompasses virtually all kinds of loss contingencies, including lawsuits, natural disasters, etc. FAS 5 is the primary focus of the controversy over the ALLL methodology – and of this discussion.

Contingent losses under FAS 5 must meet two critical criteria to be recorded on the balance sheet:

³ *Interagency Policy Statement on the Allowance For Loan and Lease Losses*, jointly issued by the Office of the Comptroller of the Currency, Federal Deposit Insurance Corp., Federal Reserve Board and Office of Thrift Supervision, December 2006.

- The loss must be believed to have “already occurred” as of the balance sheet date, and
- The extent of the loss must be knowable to the point that it can be “reasonably estimated.”

These two key FAS 5 principles often are referred to as “the incurred loss model” in discussions about ALLL accounting. They were established when GAAP was more clearly under an amortized-historical-cost framework. This FAS 5 portion of the ALLL, has been found not to be timed well in matching revenue with expenses pertaining to loans that generate losses. In addition, the standard predates FASB’s more recent shift in favor of standards that more closely reflect fair value. FASB issued FAS 114 shortly before FAS 115, a landmark step toward fair value in accounting for investment securities portfolios.

To complicate matters further, the theoretical landscape for developing accounting standards is changing yet again. The International Accounting Standards Board (IASB) and FASB signed an agreement in 2006 to work jointly on accounting standards. Representatives from the IASB and FASB met in London in March 2009 to discuss ALLL accounting. In preparation for the meeting they issued several agenda papers.⁴

The comparable existing IFRS standard is IAS 39, “Accounting for Financial Instruments.” IASB/FASB agenda papers from the joint ALLL discussion meetings indicate that objections to the “incurred loss model” are being considered, though at a very theoretical level.

“Incurred Loss” Versus “Expected Loss”

To attempt to define “incurred loss” and “expected loss” may be to wander into a quagmire, because the terms and especially their applicability to actual loan portfolios seem to be in the process of being defined. (FAS 114 is a matter of dispute, for example, with some claiming it uses expected loss.) One passage in an IASB/FASB meeting agenda document, however, ventures a definition as follows:

a. Credit losses are caused by [triggering] events, and until loss-creating events occur, there is no loss inherent in a loan or portfolio. IAS 39, Financial Instruments: Recognition and Measurement, is based

on this concept, often referred to as an incurred loss concept.

b. Credit losses are an integral part of lending. Different expectations about losses are reflected in different contractual interest rates. Thus there are always future defaults inherent in a portfolio. This is often referred to as an expected loss concept.

Agenda papers also differ in whether expected or incurred losses are considered GAAP, and whether it is possible to distinguish “incurred” from “future” losses on a pool of loans. At the heart of the discussion is the question of when a credit loss occurs or is possible to determine or quantify. Intuitively, and in practice, this is difficult for loan portfolios.

Standard-setters’ theoretical discussions regarding the ALLL imply both a desire for theoretical consistency with other amortized cost principles, and an earnest effort to prevent earnings management. Lately, most of the IASB/FASB discussion has centered on determining when and how to recognize emerging loan losses. The Interagency Policy Statement attempts to assuage concerns about potential earnings management by stipulating that changes in ALLL should be “directionally consistent” with changes in credit quality. In other words, if risk is increasing or quality (as measured, for example, by delinquencies) deteriorates, provisions to the ALLL should be increasing rather than declining.

Difficulties of Determining a “Triggering Event”

At the heart of this debate as it pertains to loans is the relative difficulty of determining a “triggering event” within loan portfolios. A triggering event is something that happens to drive the loss, which is followed by a “loss confirmation period.” A popular factory example, adapted for this text, illustrates the point.

1) Factory Example

A factory, such as an auto plant, has a major impact on commercial and consumer borrowers in a particular region. Pools of commercial loans from suppliers and consumer loans from employees in that region have risk correlations to the factory. First, rumors circulate that the factory may close. Second,

⁴ Four Agenda Papers are as follows:

1) Information For Observers, IASB/FASB Meeting: March 2009, London, Project: Loan Loss Accounting, Subject: Cover Paper (Agenda Paper 7); 2) Information For Observers, IASB/FASB Meeting: March 2009, London, Project: Loan Loss Accounting, Subject: Analysis of Alternatives (Agenda Paper 7A); 3) Information For Observers, IASB/FASB Meeting: March 2009, London, Project: Loan Loss Accounting, Subject: Impairment, Incurred Loss Model (Agenda Paper 7B); 4) Information For Observers, IASB/FASB Meeting: March 2009, London, Project: Spanish Provisions under IFRS (Agenda Paper 7C)

the factory makes a formal announcement that it actually will close.

According to incurred loss, only the formal announcement is a “triggering event” of the factory closing. The triggering event is followed by a “loss confirmation period,” when previously estimated losses at the time of the triggering event can be adjusted according to actual results. It is important whether the actual announcement has occurred by the financial statement date, because the incurred loss model makes a distinction between incurred losses and possible “future” losses, which are not recognized.

2) Loan Approval Example

An inexperienced or eager loan officer originates a number of poorly underwritten loans at a highly competitive rate. The loans make their way through the financial institution’s approval process without their weaknesses being detected. The day after the funds have been disbursed, the error is caught. Due to the same information asymmetry that existed inside the financial institution, the external market price of the loans has not been impacted.

This second situation illustrates one of the many practical difficulties of accounting theory with respect to loans. Even under some “expected loss model” constructs, no loss may be recognized when a loan is originated, because loans are assumed to be perfectly priced at origination. The risk is assumed to be incorporated accurately into the interest rate. A similar example is that of start-up banks. Many theoretical accountants claim that new banks do not need to record ALLLs because losses have not yet been “incurred.” However, practically, start-up banks are attempting to penetrate new markets. They may not be able to run profitably or to issue loans at “perfect” pricing, especially in the initial years.

3) Borrower’s gradual decline example (individual loan for illustrative purposes)

An individual borrower is fully employed and current on his loan. At some point, the borrower hears rumors of layoffs at work, and it doesn’t occur to him to inform his bank. Then, an announcement confirms the rumors, but the borrower doesn’t know whether he will be among those laid off.

Then he receives a pink slip. He continues paying his loan for some time, based on unemployment, severance and, finally, savings. Then, unable to find work, he stops making payments on his loan. The bank calls him and discovers his predicament.

At what point did the bank “incur” a loss? The bank wasn’t aware of these circumstances until contacting the borrower, but a number of possible “triggering events” occurred before then. When this example is multiplied across a pool of loans, the problem with trying to determine “triggering events” with precision becomes apparent.

These circumstances illustrate the main problem with applying “incurred loss” to loans, as compared with a natural disaster (also covered under FAS 5), because with loan portfolios, “triggering events” can be very unclear. Opponents of the incurred loss model see a major problem in trying to impose a theoretical science of “triggering events” that may not be scientific. The Interagency Policy Statement took a stand on this point by stating clearly that estimating the ALLL involves a great deal of judgment.

Qualitative and Environmental Factors

Prior to the IASB/FASB agenda papers mentioned above, U.S. bank regulators attempted to clarify and reconcile some of the problematic aspects of GAAP with practical considerations that arise in implementation. In the Interagency Policy Statement, regulators explained that in estimating ALLL levels on loan pools, historical loss rates should be adjusted to reflect current internal and external “qualitative and environmental factors” including:

- Current economic activity both nationally and locally.
- The financial institution’s lending policies, practices and underwriting standards.
- The experience, turnover and depth of the lending staff.
- Volume of past-due loans, nonaccruals and adversely classified loans.
- Changes in the mix of the loan portfolio and levels of risk concentration.

- The quality of the institution's loan risk rating system.
- Changes in the collateral value of collateral-dependent loans.
- Impact of competition and the regulatory environment.

When trying to explain how the ALLL reached a trough at the end of 2006, proponents of the current method of ALLL accounting point out that proper consideration of these additional factors would have resulted in more appropriate levels of ALLLs. Proponents of expected loss claim that the “qualitative and environmental factors” are consistent with an expected loss model and not with an incurred loss model. They continue these discussions.

What Happens When ALLLs Decline Relative to Risk Throughout the Financial Sector?

Now to return to the original question: how to design an ALLL methodology, or even an application of the current methodology, that would result in more appropriate ALLLs being recorded. The time frames singled out in this paper are mid-1985 and year-end 2006, because at these points two things happened: 1) risks reached historic highs, and 2) ALLLs reached historic lows, even before considering risk.

A.M. Best believes risk is the key to this problem. Whatever the theoretical construct, whether incurred loss or expected loss, somehow risk is not being properly accounted for in the ALLL estimate. In practice, it seems that the ALLL is computed with an emphasis on historical loss rates, emerging delinquencies and economic trends. While these are useful, none of these necessarily capture shifts in loan risk at origination that occur in different phases of an economic cycle.

Most of the IASB/FASB agenda papers, whether discussing the “incurred loss” or “expected loss” viewpoint, seem to indicate that loans at origination should not have an ALLL. Most of these theorists seem to assume that loans are priced perfectly, as though part of a rational expectations hypothesis, at origination. Data and anecdotal experience, however, indicate that competitive pressures, particularly at the peak of an economic cycle, play a part in loan pricing. This is a key problem. If loans, due to high levels of risk being assumed for the yield, are not being priced at par value, there seems

to be a strong case that ALLLs should be adjusted accordingly, even ALLLs pertaining to recently originated loans. One explanation of the mid-1985 and year-end 2006 troughs is that loans were underpriced on a massive scale, and higher ALLLs were not established for those loans.

The potential for mispricing of loans during highs and lows of economic cycles deserves more attention from theoretical accountants, because the textbook assumptions regarding loan pricing may have an impact on the development of accounting standards. This may be one explanation for tensions among accountants having different kinds of experience, whether from academic, auditing, bank or bank regulatory environments.

Theory or Application?

Those who are more supportive of the current system of ALLL accounting point out that the ALLL reached bottom in 2006 partly because the correct ALLL methodology, including consideration of the “qualitative and environmental factors” described above, was not applied. If these factors had been applied more rigorously, ALLLs would have been built up more, even if still not enough, before the recent surge in loan delinquencies.

In practice, it appears that the primary “qualitative and environmental factors” considered in establishing ALLL levels are historical loss rates, emerging delinquencies and economic trends. Anecdotal evidence indicates that coordination between the accounting and the credit function, which may differ from institution to institution, nonetheless typically features the accounting function playing a greater role than the credit management function in establishing the FAS 5 portion of the ALLL. If this is correct, it may partially explain the higher emphasis on the three factors mentioned above.

Even considering economic data, it is a matter of dispute as to what information was known that should have led banks to increase ALLLs before the current ballooning of delinquencies. At the beginning of 2006, signs of a turn in the banking cycle already were evident to many in the banking industry. (A.M. Best published an article, *U.S. Banking Trends for 2005 – Signaling End of Peak Industry Cycle*, in February 2006.) However, others might have believed the economic data and industry

trends were not yet clear enough to justify raising loss provisions.

Despite these signs, the ALLL continued to decline through 2006 until it reached a historic low at the end of that year. (In March 2007, A.M. Best published an article, *Are Loan Loss Reserves Adequate in Light of Rising Delinquencies?*) Warning indicators continued to develop, but ALLLs were not increased sufficiently to cover the delinquency bath that is now under way. As mentioned earlier, coverage ratios continue dropping relentlessly through the most recent quarter.

Although the “qualitative and environmental factors” are listed in the Interagency Policy Statement, without a fully developed accounting standard, there is little clarity regarding how to consider each of these factors when making loan loss provisions. It is especially difficult to determine the magnitude of change in loss provisions. The emphasis in practice on economic and delinquency trends does not, in A.M. Best’s view, sufficiently capture changes in risk – or pricing – in the loan portfolio.

While there is merit in the arguments of those who support the current ALLL methodology with a greater emphasis on the “qualitative and environmental factors,” it is important that some of the “qualitative” factors be “quantified” for bankers to have data available when considering how much they should increase or decrease ALLLs. They also may need more specific guidance regarding how to incorporate the information into ALLL estimates. Clearly, risk appetites increased before the downturn, and the heightened portfolio risks were not reflected in ALLLs, which actually declined.

Finally, it could be argued that the level of delinquencies during this downturn was unexpected by most and of extraordinary and historic proportions. It was accompanied by an almost unprecedented decline in real estate prices, which is a key factor in the decline in loan quality. Should the ALLL even be expected to be sufficient during such an extreme downturn?

Is Higher Capital the Answer?

Some believe that ALLLs cannot be expected to be adequate to protect banks before

an unusually sharp downturn. They argue that the real backstop protecting banks is capital. This argument has some merit. Two important problems, however, are that 1) efforts to increase capital before a downturn seem to meet obstacles analogous to those that hinder efforts to bolster the ALLL; and 2) capital has a far wider range of risk-bearing responsibility than it did when banks were more focused on lending.

Capital requirements are not immune to unfortunate, procyclical forces. Financial institutions are able to argue persuasively and lobby successfully for lower capital levels at the top of an economic cycle. Just before the recent downturn, many considered capital levels to be high – even too high. A few articles written in 2007 featured calls to return capital via dividends to investors. In 2004, the SEC loosened constraints on investment banks’ leverage relative to their capital. Now, virtually the entire investment banking industry is gone. Basel II, developed during more benign economic times, now has been much more sharply criticized based on what has been revealed about risk, including model risk, since the time it was developed.

Large banks especially need capital to protect against losses other than loan losses, as long as they continue to be permitted to engage in high-risk activities other than lending. Emphasizing capital without addressing a problematic ALLL methodology poses a danger of making capital a first resort for loan losses, rather than a last resort.

In addition, during times of economic stress, plunging stock prices make it difficult to raise capital. If capital is found to be inadequate and cannot be raised in open markets, an organization has limited options. Recently, the sometimes murky distinction between operating entities and holding companies (particularly thrift holding companies) has complicated the capital issue. If other entities in the structure bear high levels of risk, the operating entity’s capital might not suffice. With thrifts, consolidated capital at the holding company level has not been monitored as closely as that at banks, though this has been addressed through recent proposals, including the Treasury Department’s white paper.

The ALLL remains a critical safety measure on banks' balance sheets, because it pertains to a leading risk exposure. Assuming credit risk is at the very heart of both the operations and the function of the typical commercial bank in the broader economy. It is critical that banks manage and estimate this risk properly. Successful management of credit risk usually correlates with a bank's viability. A slight turn in loan loss levels poses the biggest opportunity for gain – or the biggest threat to survival – for most banks.

Most important, it is currently difficult to recognize when extraordinary levels of ALLL or capital are needed, because measures of risk in bank data are very primitive. Levels of capital needed at investment banks certainly were seriously and fatally misjudged, as mentioned above. Similarly, when commercial banks' loan portfolio risk reaches historic highs, while simultaneously ALLLs reach historic lows, as happened in 1985 and 2006, it is hard not to be skeptical of the process by which banks measure and incorporate risk into calculating either the loan loss reserve or the capital they need.

Transparency: Capturing Risk Data

Now to reach the heart of the cyclical ALLL problem: the need to incorporate changes in risk that occur through economic cycles. When ALLL levels have failed to keep pace with changes in loan risks during speculative booms, the fault seems to lie with two variables in loan portfolio quality – loan risk concentrations and loan underwriting standards. These two factors also happen to be largely absent in otherwise excellent public data on commercial banks.

A.M. Best believes risk is the heart of the issue with respect to the ALLL shortfalls noted in 1985 and 2006. Risk should be better captured on the standardized bank regulatory filings, especially those filed by larger and more complex banks. Greater transparency with respect to loan origination, loan underwriting and loan concentrations – most notably in commercial real estate – would have had the potential to address shortfalls in ALLLs and capital relative to risk during those two periods. Banks need the information not just on their own institutions, but on other banks, especially large ones, to properly understand

and incorporate overall, industrywide lending trends when assessing risks in their own portfolios.

Inner Workings of Regulatory Data

Once more, some background. The ALLL might offer a small illustration of a wider concern in the financial services industry: the need to capture risk in standardized, publicly-available regulatory data for each type of financial institution, especially those presenting the greatest systemic risks. The quality and transparency of regulatory data varies widely, and the types of institutions that were the least transparent have shown themselves – perhaps not coincidentally – to be most problematic in the current financial crisis.

The most transparent and useful regulatory reports have at least four characteristics:

- 1) Where applicable, the financial information is produced in accordance with GAAP.
- 2) The financial information is comparable across institutions because it is filed in standardized formats, then compiled into aggregated reports by individual institution, industry segment and the entire industry
- 3) The standardized reports capture risk – if necessary through memoranda items – and are useful to independent industry analysts whose work complements government analysis and assists shareholders, depositors and others
- 4) The financial statement instructions, as well as the finalized data, are transparent and publicly-available

A good example is the Uniform Performance Report, which already is being produced for both commercial banks and their holding companies. This segment of the financial services industry has performed better than similar but less transparent financial institutions – such as thrifts and especially thrift holding companies – whose regulator does not create public Uniform Performance Reports.

Uniform Performance Reports

Uniform Performance Reports are valuable sources of data collected and compiled by commercial bank regulators. The FDIC creates the Uniform Bank Performance Report, and the Federal Reserve creates the Uniform

Bank Holding Company Performance Report. These quarterly statements are available free on these regulators' Web sites, pertaining to each depository institution as well as aggregated versions on industry segments and the entire industry. The data are extremely useful to bankers, economists, industry analysts, finance professors, bank examiners and investors in considering risks and trends in the banking industry, and with respect to a particular commercial bank.

The data in these reports are helpful in setting ALLL levels or broadly judging their reasonableness. For example, at the end of 2006, loan delinquency data in Uniform Bank Performance Reports made it clear that ALLL levels were inadequate. The question is how to improve banking data so that it would be possible to make that determination earlier in the cycle – based, for example, on increases in loan risk concentrations and declines in loan underwriting standards, the two factors cited above.

Difficulties When Loan Risk Data Are Not Captured Adequately

In contrast to the Performance Reports, other regulatory reports generated without the needed loan data are impaired, though still somewhat useful. For example, when the general press discusses the well-known residential mortgage problem, the focus is on loan underwriting and origination. Was the loan issued by a mortgage broker? Is it an adjustable rate? What was the loan-to-value? What is the loan to value now? Is the borrower “upside-down” in the mortgage? Does the loan have a teaser rate? How many years remain in the mortgage term? Is it a “pay-option” mortgage or perhaps a “negative amortization” mortgage? Since the focus is on the mortgage underwriting terms and origination procedures – which have been shown to affect credit quality– the general press seldom uses the term “subprime” any longer.

Yet, due in part to an apparent lack of 2004-2006 mortgage loan underwriting data, the OTS and OCC issue a report called *Quarterly Mortgage Metrics* on the quality of mortgages within the financial institutions they supervise. It provides information on mortgage loans and delinquency trends, but it does so without grouping the loans via the crucial underwriting terms mentioned above. The report simply divides mortgages by borrow-

ers' FICO scores into “prime” and “subprime,” while remaining almost silent on loan terms and origination procedures. Even “Alt A,” which originally referred to limited loan documentation, is given as a FICO score range. Another example of an attempt to address loan underwriting without quantitative data is the Federal Reserve's quarterly *Senior Loan Officer Opinion Survey on Bank Lending Practices*, which is qualitative.

The lack of quantitative loan underwriting data makes it difficult to use the report. Without dollar balances of loans originated online or through mortgage brokers (which adversely impacts credit quality); repricing dates; loan-to-values; or dollar balances of fixed-rate versus adjustable-rate mortgages, bankers were not as able to judge the depth of residential real estate problems when establish ALLL levels for residential real estate loan portfolios.

Incorporating Risk Into ALLL Estimates

The Treasury Department's recently issued white paper, titled *Financial Regulatory Reform*, commented on both the ALLL and the quality of financial regulatory data. Along with numerous other recommendations, the report suggests:

- The need for financial firms to be able to identify risk concentrations.
- Enhanced public disclosures for large FHCs, with supervisory expectations relative to size.
- Requiring firms to “internalize” public costs of systemic risks.

Requiring public transparency is among the best ways to accomplish the Treasury's goal of internalizing public costs of systemic risks, and it would have the added benefit of reducing systemic risk. Treasury's white paper specifically mentions investment banks and AIG as examples of financial institutions that may have avoided registration as BHCs to circumvent stricter regulation. An additional explanation for riskier firms avoiding BHC status might be avoidance of public transparency requirements.

Regarding Treasury's recommendation to vary public disclosures relative to an organization's size, the report filings used to generate Uniform Performance Reports varied by

an institution's size in the past. As the degree of difference in size and scope increased, the difference in reporting requirements also was gradually phased out. Now, banks having \$100 million, \$10 billion, or \$1 trillion in total assets file virtually the same format. This has significantly increased the regulatory burden of smaller institutions relative to larger institutions, while simultaneously reducing the transparency of larger institutions relative to their growth in complexity and systemic risk.

The Treasury department's white paper most notably included the following recommendation:

The accounting standard-setters...should review accounting standards to determine how financial firms should...employ more forward-looking loan loss provisioning practices that incorporate a broader range of available credit information.

To employ a broader range of available credit information, banks will need to be able to establish loan loss reserves based on credit risk. The bank's management has the best information regarding these two items with respect to itself. Regarding important risk factors in the industry generally, banks need at least general public loan risk data.

With the background presented here, the discussion turns to what may be the most important causes of the inadequate ALLLs noted in 1985 and 2006: failure to adequately adjust the ALLL for growing concentrations in high-risk loans and a weakening – across the entire financial services industry – in loan underwriting standards. General, external economic forces, such as employment levels and interest rates, definitely played a role in these two real estate crises, but the *loans* themselves played a major and overlooked role as well.

Loan Risk Concentrations

Increases in concentrations, especially in commercial real estate, play a major role in banking downturns – and this downturn is no different. At the top of an economic cycle, heightened competition for borrowers and loan yield leads banks to assume greater levels of exposure to a single risk factor. Loan risk concentration is the opposite of diversification. A concentration can be a high level of exposure to a single borrower, a geographic area or an industry (as described by NAIC

code, for example). In terms of banking and the ALLL troughs of 1985 and 2006, the most important concentration is in commercial real estate (CRE), particularly construction loans.

The role of CRE concentrations in the 1980s is legendary in banking and widely understood by bank regulators. Leading up to the current crisis, a few years ago bank regulators noticed sharply increasing CRE concentrations and established capital thresholds (see sidebar, Commercial Real Estate Concentrations). This came with greater regulatory oversight and higher expectations of risk management.

Despite regulators' efforts, CRE concentrations continued to increase. Now, CRE delinquencies are increasing rapidly. From the peak concentration level at Dec. 31, 2007 to March 31, 2009, respectively, seriously delinquent commercial real estate loans increased from 0.81% of the loans in that category to 2.25%. During the same period, seriously delinquent construction loans, the highest risk category, increased from an already alarming 3.22% to a staggering 10.92%. Seriously delinquent commercial real estate loans, especially construction loans, are a major threat to the continued viability of many banks (see sidebar for information regarding Georgia.)

Deteriorating CRE loans play a part in most banking crises, especially at the largest banks, usually thought to reflect large banks' lack of local knowledge of borrowers and different ways of structuring credits, such as not obtaining as many personal guarantees. Regional and community banks are not immune, however, as they tend to have higher levels of concentrations in these high-risk loans. The exact risk exposure in a CRE concentration often is unclear until delinquencies emerge, which generally is much later in the life of loans.

The Interagency Policy Statement stipulates that a bank consider its risk via concentrations of credit when setting ALLL levels, and that changes in ALLL levels be "directionally consistent" with changes in the loan portfolio's credit quality. Yet while these concentrations increased, ALLL levels actually declined. Incorporating quantitative information on individual institutions' *and industrywide* loan concentrations into the ALLL methodology might help to produce a directionally consistent movement in the loan loss reserve.

Loan Concentration Data

Regulators have an opportunity to improve loan detail in filing formats. Currently, regulatory reports contain little detail on traditionally riskier CRE loans. For example, “nonfarm nonresidential properties” is an all-encompassing, large-balance line item. It contains many kinds of CRE loans having widely varying levels of risk. The addition of subcategories of office, retail, hotel and industrial, for example, would help to reveal the extent of an actual concentration⁵ in commercial real estate.

Data also could be improved by including geographic information on properties serving as collateral for loans, perhaps by county code. Banks, regulators and users of financial statements would be able to determine the level of risk concentrated in a particular area that may be subject to wider economic swings or natural disasters, for example. This information would be extremely valuable in estimating ALLLs that would more accurately reflect actual levels of risk.

Loan Underwriting Standards

The residential mortgage underwriting crisis of 2004-2006 noted above brought about a much greater understanding of the importance of underwriting with respect to credit quality in residential mortgages. What currently is less well understood by the general public is the importance of commercial loan underwriting terms. Bank regulators understand that commercial loan underwriting standards decline dramatically at the top of a banking cycle. Widespread reports of “covenant lite” (referring to banks lightening up on loan covenants with commercial borrowers) and certain highly leveraged loans provide anecdotal evidence of weakening commercial loan underwriting standards. Underwriting data are not available, aside from some pockets available from securitized commercial real estate loan pools.

Loan Underwriting Data

Collection of basic loan underwriting data would help banks establish ALLLs. Even a few simple measures would help, such as regulators revising report formats to include a distribution of a few loan-to-value (LTV) range-level groupings. As relative balances within these distributions move over time, such data would provide useful, high-level information regarding industrywide levels of risk. Other

factors typically stated as ratios, such as debt service coverage, similarly could be provided in ratio buckets. If CRE loans are to be listed by CRE class type (as indicated in “loan concentrations” above), it would facilitate capture even of broad underwriting criteria appropriate for loans in each category.

Industrywide loan underwriting information is relevant to the ALLL calculation for many reasons. As discussed above, assumption of additional risk by virtually all of the largest institutions in the financial services industry has more significant implications than assumption of greater risk by a small, individual financial institution. For example, an individual institution choosing to increase its risk profile can substantially increase its ALLL and capital levels as part of its risk management. This decision will not substantially impact another, conservative community bank that has not actively changed its risk profile. But if an increase in risk occurs on a massive scale by large institutions, that information has implications for the small, conservative bank establishing its ALLL. This is due to the economic implications of widespread increases in risk. Underwriting data also are relevant because they enable banks to compare their own risk profile and corresponding ALLL levels with those of the industry to determine their reasonableness.

FASB called attention to residential mortgage loan underwriting standards in 2005 when it issued FSP SOP 94-6-1, “Terms of Loan Products That May Give Rise to a Concentration of Credit Risk.” This FSP is incorporated by reference in FASB’s project outline for loan risk disclosure rules. While FASB’s loan risk disclosure recommendations may help if implemented, some cautions should be noted. FASB’s project advocates that banks disclose their *internal* means of measuring credit risk. Some banks may be motivated to modify internal loan risk capture systems, knowing those systems’ data will be disclosed publicly. Also, because banks follow a variety of internal systems, comparisons might not be possible. For these and many other important reasons, capture of underwriting data on regulatory filings offers the greatest opportunity for positive impact on the assessment of appropriate ALLL and capital levels.

⁵ A Portfolio Stress Test Approach to Measuring Commercial Real Estate Risk in Arkansas Banks, May 2007, Timothy J. Yeager, University of Arkansas. Similarly, Eide Bailly, LLP, a CPA firm, developed a template (*Working with FAS 114 and FAS 5*) to assist small banks in calculating ALLLs, which allows for additional categories given the limits of the regulatory format.

It should be noted that FASB emphasized residential mortgage examples within “terms of loan products” in the FSP; while admittedly very prescient in 2005, the examples do not address commercial loan underwriting standards. Fallout from previously lax commercial loan underwriting is the next emerging issue and generally plays a major role in real estate crises.

Double Whammy

The combination of increased concentrations in higher risk loans with decreased loan

underwriting standards can multiply risk. Individually, these two factors frequently are cited as reasons for bank failures. Quantitative data on both underwriting standards and concentrations in high-risk loans would help to identify times when this combination has increased risk exponentially, generating a need for extraordinary levels of ALLLs and capital. In fact, a requirement to set aside additional reserves and proportionally higher capital levels when a financial institution assumes risk of this magnitude might be a deterrent from pursuing this strategy.

⁶ Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, jointly issued by the Office of the Comptroller of the Currency, Federal Deposit Insurance Corp., and Federal Reserve Board, Dec. 6, 2006

Commercial Real Estate Concentrations

One characteristic in common between the two ALLL troughs of 1985 and 2006 is that they coincided with historic commercial real estate (CRE) concentrations. CRE concentrations played a major role in the crisis of the late 1980s and early 1990s, when a large number of S&Ls and a handful of banks failed.

When CRE concentrations recently emerged again, regulators sounded the alarm, and in December 2006, they issued an interagency statement⁶. The statement announced that regulators would use regulatory data to track CRE concentrations, particularly construction loans. Those institutions whose construction loans exceeded 100% of capital, or whose total CRE loans exceeded 300% of capital and had increased by 50% over the preceding 36 months, would be placed on a list for heightened scrutiny.

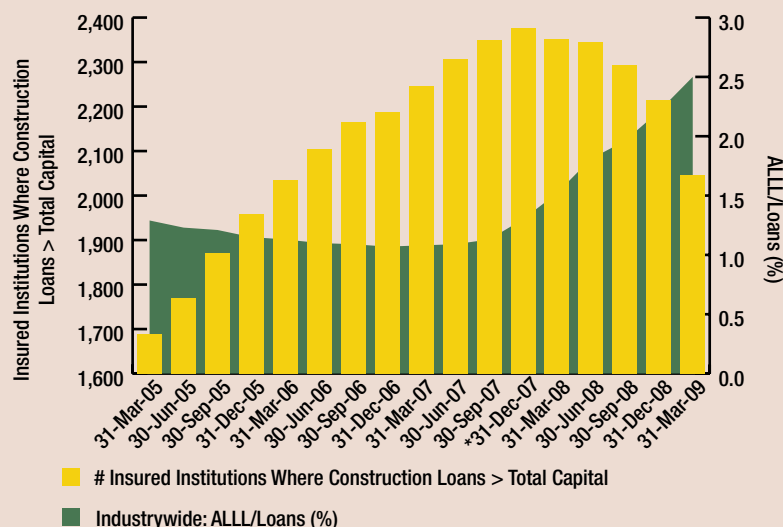
The statement also reminded banks of the importance of maintaining and increasing capital and ALLL levels when assuming additional risk (but did not provide specifics on how to consider concentrations when setting ALLL levels). Despite these regulatory actions, industry-wide CRE concentrations continued to increase until they peaked at the end of 2007. Although ALLLs were rebuilt slightly during 2007, this appeared to be in response to rising nonperforming assets and falling coverage ratios, rather than in response to risk.

Georgia Banks

Georgia has a history of both high CRE concentrations and high rates of bank failures relative to other states. More than its share of banks failed in the 1980s crisis, and Georgia currently leads the nation in the rate of banks being seized by the FDIC. Exceeding some far more populous states, it experienced five

Exhibit 3
U.S. Banks – Construction Loan Concentrations Vs. ALLLs (2005-1Q 2009)

Regulators limit construction loans to 100% of total capital because of their high risk.



* Historic high reached in December 2007.
Source: FDIC

of the 25 failures in 2008 and nine of the 45 to date in 2009. Although a well-known cause is the large number of new banks in Georgia, it is less well known that at the time regulators were developing the guidance mentioned above, in most measures, Georgia led the nation in the number of banks that exceeded the limits on CRE concentrations that regulators were establishing. Of the 2,593 banks exceeding the 300% CRE loan threshold at Dec. 31, 2005, Georgia led with 200 banks (compared with 196 and 192, respectively, in more populous Florida and California). Regarding the 100% threshold for construction loans, more than 24 institutions at the time had exposure exceeding 500% of total capital. Nine of the 24 banks were in Georgia, more than in any other state.

Another double hit is that the same shortfalls in risk data collection impact *both* ALLLs and capital. Thus, a misjudgment about risk can lead to deficiencies in both of these buffers simultaneously. Regulatory risk-based capital calculations currently in use generally do not consider changes in underwriting standards and high-risk loan concentrations. Types of loans are grouped very broadly and given the same risk weighting, regardless of potentially vast differences in quality due to specific types of loans within the class, as well as differences in underwriting standards across banks. Insufficient detail with respect to commercial loan categories and corresponding underwriting not only can lead to insufficient capital and ALLL relative to risks; it even can encourage relaxed underwriting standards or concentrations in riskier subcategories, because loans within the same broad class receive the same capital penalty, regardless of the level of risk within the class.

Finally, it should be noted that many significant differences exist among types of institutions, particularly among large, midsize and small commercial banks. Differences in the nature and scope of their lending are relevant considerations when developing an ALLL accounting standard for loan portfolios. The smallest banks usually have greater diversification in their underwriting and better knowledge of local borrowers, but also higher geographical concentrations in local real estate. The largest banks tend to have more standardized loan products with the same risk features magnified across large numbers of loans. They also therefore are better able to segment their portfolios according to underwriting features for reporting and risk monitoring. It easily could be argued that larger banks should have a much more complex and detailed regulatory financial statement format to file.

Accountants, Regulators Develop Their Views

When the repeated pattern of the economy reaches the final stage in the long-term cycle described earlier (see “History Repeating Itself,” page 3), the first piece in the pattern for the next cycle is the new legislation, accounting and regulation developed from the bitter lessons of the preceding crisis. This time around, these proposals seem to be arriving early, even as loan delinquencies, including

commercial real estate loan delinquencies, continue to rise, and ALLL coverage ratios continue to drop.

The Financial Stability Board (formerly the Financial Stability Forum) has made a number of recommendations, some of which have been incorporated into other plans. Discussion papers regarding the ALLL and capital, including reducing procyclicality, are ongoing, as are suggestions for regulatory change. In the white paper issued last month, the Treasury Department incorporated suggestions on several topics, including elimination of the thrift charter and reconsideration of regulatory capital standards, especially for large banks. The white paper, titled “Financial Regulatory Reform,” also includes a recommendation that by the end of the year, standard-setters improve the accounting standards to make the ALLL more forward-looking.

As mentioned earlier, participants in a joint group formed out of collaboration between the IASB and FASB have issued several Agenda Papers in connection with joint meetings. They have identified four possible known ALLL accounting options. The exact definitions of some of these options are being clarified, but very generally, they are as follows: 1) Fair Value; 2) Incurred Loss; 3) Expected Loss, as discussed earlier (“Inner Workings of the ALLL”); and 4) Dynamic or “Spanish” Provisioning.

Discussions of dynamic or “Spanish” provisioning have been very theoretical to date, but this model seems similar to expected loss in that it is based on historical loss rates via loan categories. The differences between it and expected loss appear to be that 1) most descriptions indicate it is based on regulatory data collection, which, as discussed above, is not fine-tuned enough to capture even dramatic gradations in risk, and 2) the portion of the ALLL determined by this method might be recorded as set-aside capital, possibly at the direction of regulators, rather than as ALLLs.

Many accountants in the banking or bank regulatory realm would prefer an expected loss model with an accounting standard designed specifically for loan pools, with ALLLs to be established by banks themselves and reviewed by bank examiners. Previous congressional testimony of bank regulators on the ALLL does indicate that

examiners were strongly in favor of a methodology that would have resulted in much higher reserves. It also does seem that quantitative data regarding loan quality at origination, though it would be very helpful, would yield meaningful detail only at the bank level, and as fully understood by a particular bank's management. Further, the recommendations for capture of quantitative underwriting quality and loan concentration data mentioned above, even if implemented, would yield only very general results at best and, in any event, currently are not collected on bank filings.

Conclusion

Fighting against behavior in economic cycles is a daunting task. With respect to

the ALLL, it is hard to escape the limitations of the "incurred loss model" when applied to bank loan pools, and how at the peak of an economic cycle, using historical loss rates apart from industrywide underwriting and concentration data can work against banks' attempts to report loan pool balances at something close to fair value. It may be time to reconsider whether loans should be kept within the scope of FAS 5, an older standard that wasn't designed with bank loan pools in mind. FASB's increased disclosure proposal is interesting, because the real issue is risk. No reasonable amount of ALLL or capital is adequate when risks reach untenable levels. That's why capturing data about risk is so important.

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