

## U.S. Banks' Earnings Reach Quarterly High On a Variety of Operating Tactics

### Synopsis of The First-Quarter 2006 Industry Results

U.S. banks ended the first quarter of 2006 with record earnings of \$37.3 billion in aggregate (from an average of \$33.9 billion in 2005), benefiting from higher fee income and lower loss provisions which offset a continuing trend of lower net interest margins. However, the industry's profitability is distributed less evenly, as a lower percentage of banks saw higher profits. Higher aggregate earnings contributed to a corresponding increase in the industry's aggregate capital base as of the first quarter of 2006. Both return on assets (ROA) and return on equity (ROE) increased slightly from their fourth-quarter 2005 levels, with ROA rising from 1.34% to 1.35% and ROE rising from 13.01% to 13.07%. Regional and large banks (of asset size exceeding \$1 billion) were better able to increase noninterest income, while community banks fared best in combating margin compression. The industry also saw a jump in insured deposits, aided by higher rates. The evolving asset mix of U.S. banks toward higher-yielding assets, combined with significantly higher trading activities in derivatives, was the primary driver of the industry's response during the first quarter of 2006, with the former seen more among the community banks while the latter was more prevalent among larger banks. Highlights of the primary issues for U.S. banks are discussed further below.

### Operating Performance—Strong Earnings Aided by Income

The effects of a rising rate environment on the industry are being felt on dual fronts: margin compression, on one hand, and slower growth in demand for consumer credit, historically the highest-margin asset class for banks, on the other. Most segments of consumer-credit assets grew at a flat or lower rate in the first quarter of 2006

(see Chart 1).

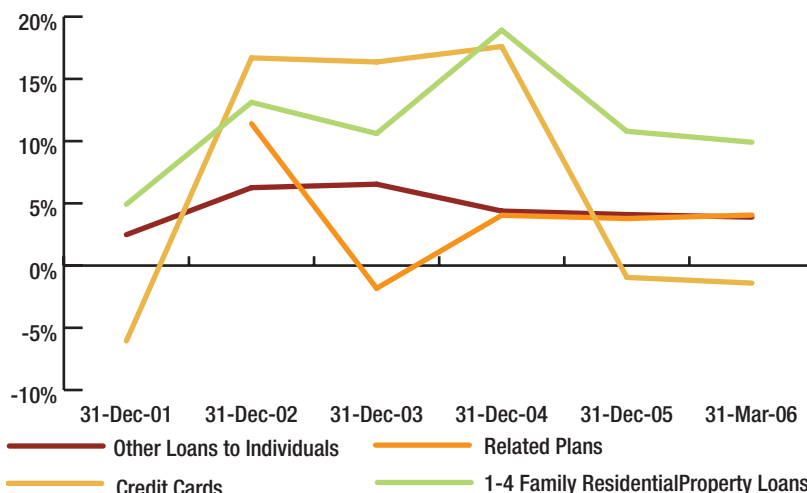
As a result, U.S. banks were challenged to enhance yields elsewhere besides consumer credit. Data for the first quarter of 2006 showed that banks were seeking higher yields in construction and land development loans (C&LD), commercial and industrial loans (C&I), trading activities and mortgage-backed securities (MBS) (see Chart 2).

Yields on earning assets increased significantly to 6.3% during the first quarter of 2006, from 5.8% in the fourth quarter of 2005 and 5.4% for the same period last year. However, with the cost of funds rising even faster, U.S. banks were only able to limit the decline in net interest margin to 6 basis points, with a resulting margin of 3.46% for the first quarter of 2006 (see Chart 3).

U.S. banks further boosted earnings during the first quarter of 2006 with fee income generated from derivative trading (service charges on deposit accounts were flat as a percentage of assets) and by lower loss provisions (see Chart 4). Taken together, the changing asset mix, with greater concentration in C&LD and C&I loans;

Chart 1

### Slower Growth Rates of Consumer Credit First Quarter 2006



Source: FDIC

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expanding noninterest income—especially trading activity; and the drawing down of loss reserves point to an incrementally higher risk profile for U.S. banks, albeit one that is mitigated by higher capital levels in

the industry (see Chart 5).

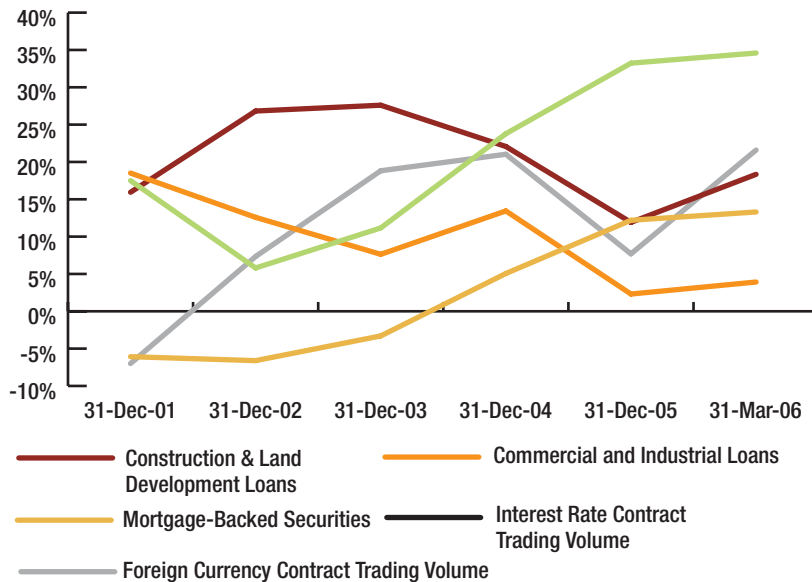
### Credit Risk—Strong Asset Quality Ratios but Higher-Risk Asset Mix

Although credit quality remained relatively strong throughout 2005 and into 2006, the credit cycle is likely at or past its peak. Moreover, despite the industry's strong credit-quality profile at March 31, 2006, it appears the overall risk profile of the industry has increased since March 31, 2005.

Banks have experienced relatively healthy loan demand over the past several years, as consumers took advantage of relatively low interest rates and rising home values to either take on new debt or refinance existing, high-interest-rate debt. In the first quarter of 2006, net loans grew by some \$147 billion to nearly \$6.8 trillion, while loan growth for the 12 months ended March 31, 2006, reached \$665 billion. Over the past year, net loans as a percentage of average assets also

Chart 2

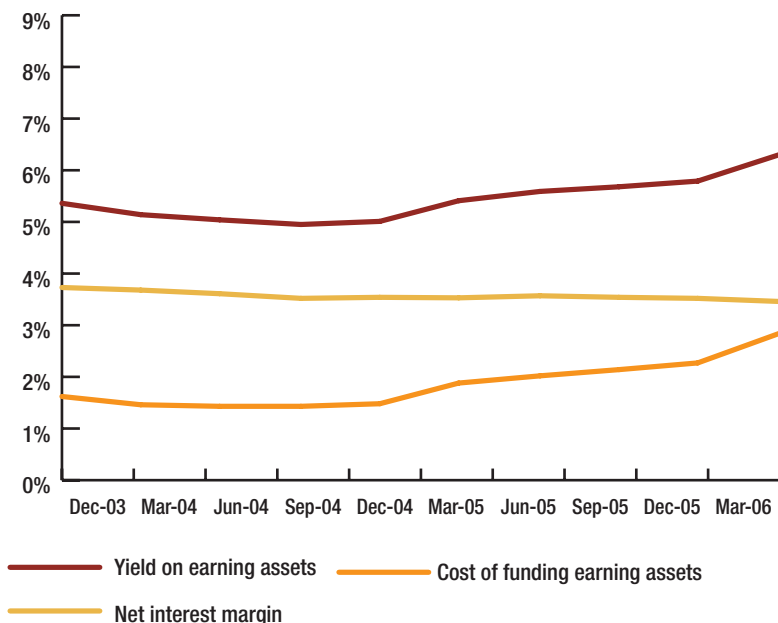
### Growth Rates Picked Up in Higher Yielding Derivatives



Source: FDIC

Chart 3

### Net Interest Margin Lower on Faster Rising Cost of Funds



Source: FDIC

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rose from 59.51% to 60.54%.

A significant component of that growth was the strong demand for construction loans, with the annual growth rate for construction loans approaching 35%. As a result, construction loans now represent 4.31% of average assets, compared with 3.49% one year ago. Construction loans also represented nearly 39% of equity capital and reserves at March 31, 2006, reflecting an increase from 31.6% at March 31, 2005. During that same time period, total commercial real estate loans, as a percentage of equity capital and reserves, also increased from 114.5% to 121.9% (see Chart 6).

In response to rising concentration levels within individual institutions, the regulatory agencies have issued proposed guidance on Concentrations in Commercial Real Estate Lending. The proposed guidance establishes thresholds that help determine whether a bank has a commercial real estate loan concentration. Using these thresholds, the FDIC indicated that at March 31, 2006, there were 2,029 institutions with a construction loan concentration, while there were 2,631 institutions with a commercial real estate loan concentration. The agencies are particularly concerned that concentration levels in some institutions are higher than those experienced during the banking crisis of the late 1980s and early 1990s. Although underwriting standards and policies are arguably stronger today, the relatively high concentration levels are a source of risk that should be monitored. If adopted, the guidance potentially could affect community banks the most, as construction and commercial real estate lending is an increasingly large part of their business.

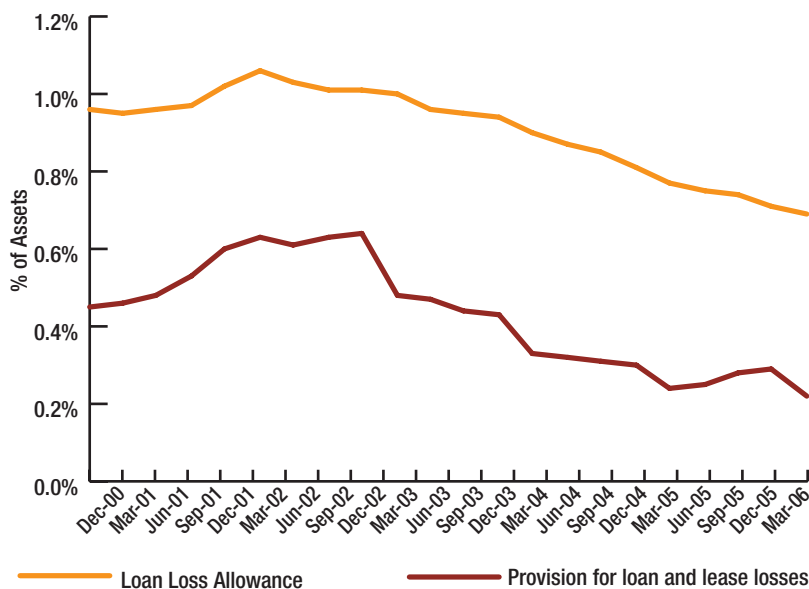
In past quarters, residential real estate loans were growing at a faster rate than commercial and commercial real estate loans, but it now appears that with rising interest rates and slowing rates of home price appreciation, some of this lending activity may be moderating. Growth in 1-4 family residential loans as a percentage of average assets has been minimal over the past year, increasing by only 0.2% to 23.48% of average assets at March 31, 2006. Within the 1-4 family loan segment, first-mortgage loan growth has been steady, but home equity lending has slowed. Given that home equity lines generally have a variable interest rate feature, the recent interest rate increases have made borrowing more costly for consumers. The higher borrowing costs, combined with slowing home price appreciation and higher energy costs, may limit the financial flexibility of consumers, especially those with lower

incomes. Any reduced flexibility also may result in higher delinquency and charge-off levels in the future.

Another sign that the consumer sector may be slowing is that loans to individuals, as a percentage of average assets, declined from 8.82% to

Chart 4

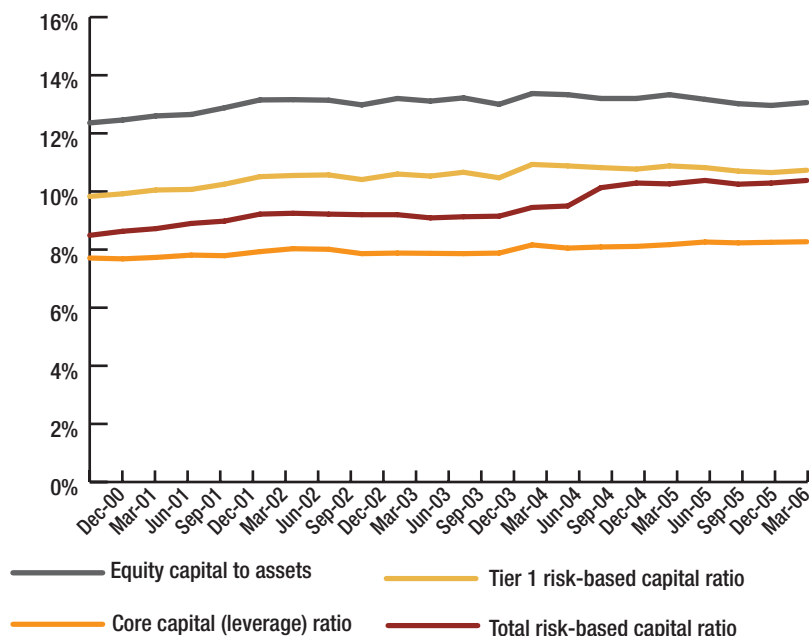
### U.S. Banks Continued Drawing Down Loss Reserves in Benign Credit Environment



Source: FDIC

Chart 5

### U.S. Banks' Capital Rose



Source: FDIC

8.24% in the year ended March 31, 2006. Although there were significant charge-offs of credit-card balances in the fourth quarter of 2005, largely in response to changes in the bankruptcy laws, outstanding balances reached 3.63% of average assets at Dec. 31, 2005, but declined in the first quarter of 2006 to 3.20%, compared with 3.54% a year earlier. It is unclear whether the drop was due to some spillover from the fourth

quarter, or whether in fact consumers are retrenching a bit. The Federal Reserve's seasonally adjusted delinquency statistics for all banks also show a somewhat mixed signal, as the fourth-quarter 2005 credit-card delinquency rate dropped nearly 50 basis points to 3.48%. However, this decline was likely an aberration caused by the changes in the bankruptcy laws, as the delinquency rate for credit cards rebounded in the first quarter of 2006 to 3.89%. Although the first-quarter rate is only nominally lower than the third quarter of 2005 (3.91%), it is higher than in the first and second quarters of 2005, when the delinquency rates stood at 3.71% and 3.70%, respectively.

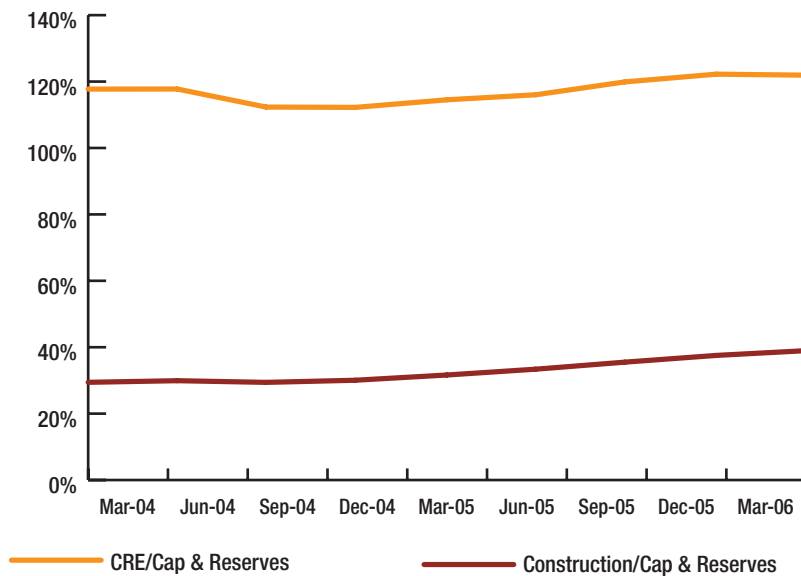
Still another signal that the consumer sector may be weakening is the recent uptick in certain delinquency statistics for 1-4 family residential real estate loans. Noncurrent 1-4 family residential loans, as a percentage of total loans, rose from 0.58% as of March 31, 2005, to 0.79% as of March 31, 2006. During that time, total delinquent (loans that are 30-89 days and 90-plus days past due) and nonaccrual one-to-four family residential loans also rose from 1.32% to 1.60% (see Chart 7).

Notably, loans that are more than 90 days past due doubled from \$4.6 billion to \$9.2 billion. Within this segment, the bulk of the growth (nearly \$4.4 billion) was from loans that are secured by first liens. Net charge-offs for 1-4 family residential loans in the first quarter of 2006 were also up by nearly \$96 million at \$451.6 million, an increase of 27.0% from one year ago. This increase was largely centered in home equity lines of credit, which rose by more than \$61 million, or 59%, to \$164.4 million. While the overall measures of the industry's credit quality remain favorable, they do not fully capture pockets of potential weakness within individual segments. In addition, while delinquency levels are not at excessive levels, the recent increase may be a precursor for future asset-quality issues. Given that the industry appears to be near the peak of the cycle, there is likely to be some deterioration.

Despite weaker credit quality measures in certain loan segments, loan loss allowance levels continue to drop to new lows. As of March 31, 2006, loss allowances stood at only 1.13% of loans and leases, compared with 1.29% at March 31, 2005. In spite of this decline, coverage ratios of noncurrent loans remained at acceptable levels, as the industry's overall credit-quality profile continues to be strong. At the end of the first quarter, the coverage ratio of noncurrent loans

Chart 6

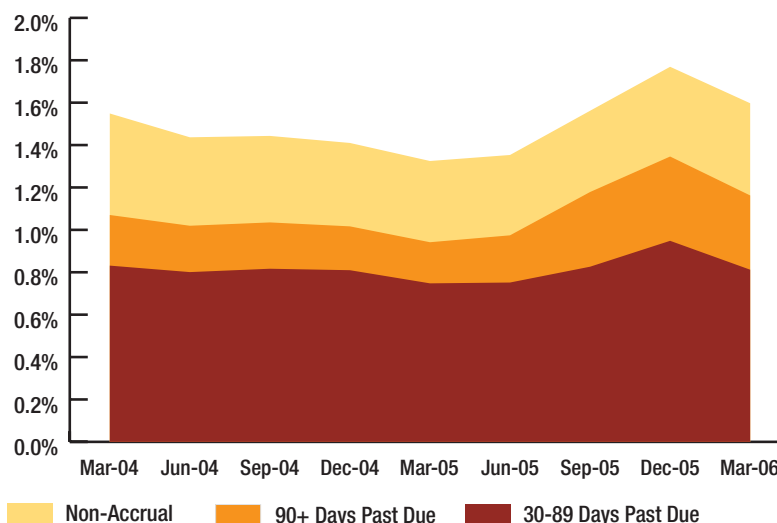
### Commercial Real Estate Lending Concentrations



Source: FDIC

Chart 7

### Delinquency — Percentage 1-4 Family Loans



Source: FDIC

stood at 160%; however, while the coverage ratio was higher than at the end of the fourth quarter of 2005 (155%), it fell below the level from a year ago, when the coverage ratio reached 172%.

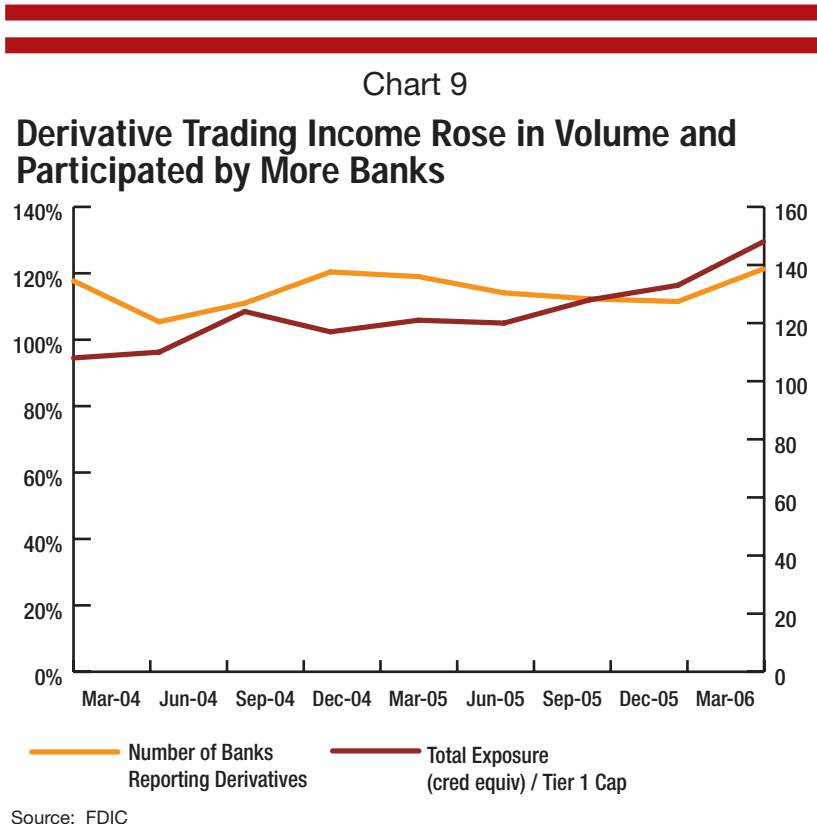
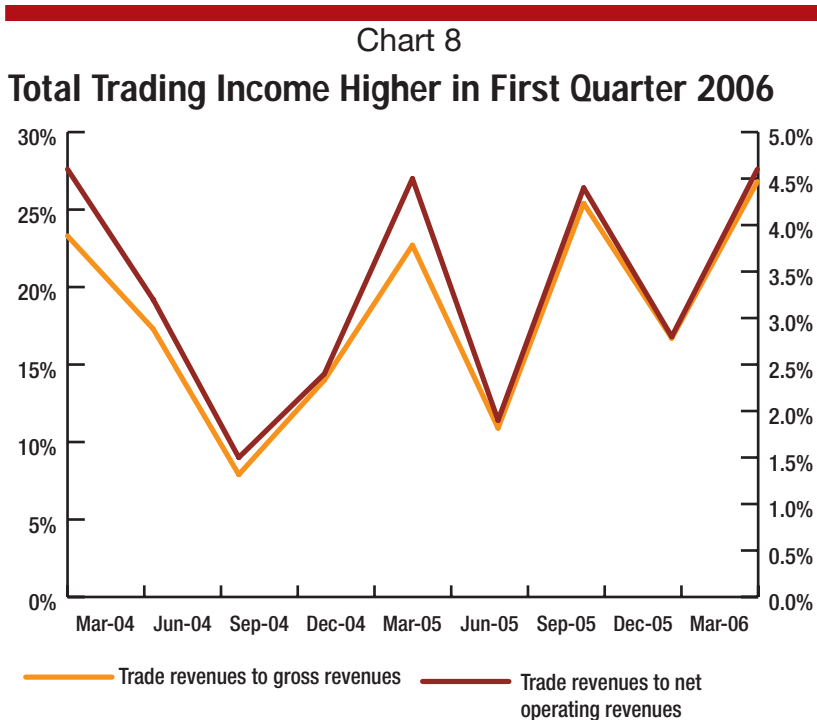
### Market-Risk Exposure Rose From Higher Trading Activity

Primarily for the large banks, fee income from trading activity provided yield enhancement and much of the earnings boost in the first quarter of 2006. Trading income in aggregate rose dramatically at the end of March 2006, with an increase of 32.4% over the same quarter in 2005, while the volume of derivative trading also surged. Although securitization and investment-banking income also increased (19.4% and 16.3% respectively), trading income rose proportionately more. Most of the trading activity was concentrated in a small number of institutions, 148, but was up from 133 in the fourth quarter of 2005, and was at the highest level in the past two years (see Chart 8).

The increased reliance on trading as a source of fee income by large banks, which alleviated the margin pressure from the flat yield curve environment, also posed a higher dependence on market conditions and exposure to market risks. Unlike the more desirable fee revenue sources such as service charges on deposit accounts, fiduciary services or other services, trading revenues are inherently more volatile and are not considered as a recurring source of income.

Based on the industry's total credit equivalent exposure amount of only \$1.1 trillion out of the notional amount of derivative contacts volume of \$104.7 trillion, the risk seems to be mostly for customer accounts (however, there is no regulatory filing data to distinguish between bank and customer trading account activity). Trading activities for customer accounts would not be of great risk to the banks since the customers bear the risk for the outcomes of the trades. Nevertheless, the exposure amount is 121.3% of the industry's Tier 1 capital; 100% of total Risk-Based Capital; and higher in the first quarter of 2006 than in any other quarters in the past two years. Even with fee revenues derived from trading for customer accounts, the quality of this revenue stream depends on volatile market performance. Market swings typically characterize the derivative trading market to a larger degree than the cash markets. Derivative trading is additionally risky due to the growing size of this market (see Chart 10), which carries potential operational risk for banks actively participating in derivatives.

Clearly, trading is more of a short-term measure for banks to combat earnings pressure due to margin compression. Until the long bond rates move even higher, banks may continue to resort to these short-term



measures from quarter to quarter.

### Deposits Grew, but Funding Issues Remained as Volatile Liabilities Rose

Deposit growth remained steady between the

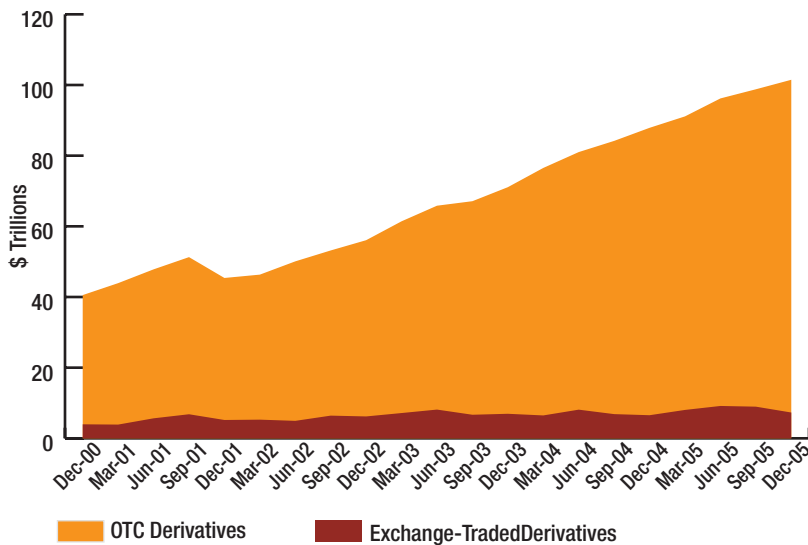
first quarters of 2005 and 2006, with domestic insured deposits in the first quarter of 2006 growing at a rate that was 175% faster than in the first quarter of 2005. In the 12 months ended March 31, 2006, total deposits grew by 9.0% or \$610 billion, with \$503 million of the new deposits being held in domestic offices. Of the new domestic deposits, 62% consisted of insured deposits, while the remaining 38% were uninsured deposits. Given the recent weakness in the equity markets, insured deposits may be viewed as an acceptable alternative. Although deposit growth was healthy, deposits as a percentage of total assets were little changed at 65.29%. While funding sources remained relatively stable, the industry is becoming more reliant on volatile liabilities, which grew from 34.47% to 36.02% in the 12 months ended March 31, 2006 (see Chart 11). In addition, while interest rates have been rising, smaller banks have been better able to maintain their margins by effectively managing their deposit rate structure.

Another potential issue that could affect the industry's funding structure is a recent proposal from the regulator of the Federal Home Loan Banks (FHLB), the Federal Housing Finance Board. In general, this proposal would, among other things, limit the amount of excess FHLB stock that could be issued to member banks and also establish a minimum level of retained earnings for each FHLB. For those FHLBs that do not meet the required minimum level of retained earnings, there would be restrictions on the level of dividends that could be paid to the member banks. In addition, if the level of excess FHLB stock exceeds the proposed amount, the individual FHLB would be required to repurchase the excess stock. In both cases, the amount of funds available to member banks potentially could be reduced. This proposal, if enacted, also could force member banks to pursue alternative sources of funds at potentially higher interest rates than those available on FHLB advances. These rates are likely to be more market-based and potentially could further increase the industry's cost of funds, which in turn would place additional stress on bank margins and overall operating performance.

One development that may provide banks with a new source of deposits stems from the recent changes to the federal deposit insurance rules. As of April 1, 2006, these rules were modified to increase the insurance limit for deposits in retirement accounts from \$100,000 to \$250,000. In addition, under the new rules, retirement

Chart 10

### Derivative Market Grows as OTC Derivative Popularity Increases



Source: FDIC

Chart 11

### Volatile liabilities — Percentage of Average Assets



Source: FDIC

accounts are separated from nonretirement accounts when calculating insurance coverage for nonretirement accounts. Nonretirement accounts will continue to be insured up to \$100,000, but the insurance limit on such accounts will now be adjusted for inflation every five years. While the increased insurance limits may translate to a new, more stable source of funding for the banks, it is unclear what the ultimate impact on the industry will be.

### Off-Balance Sheet Activity Was Subdued

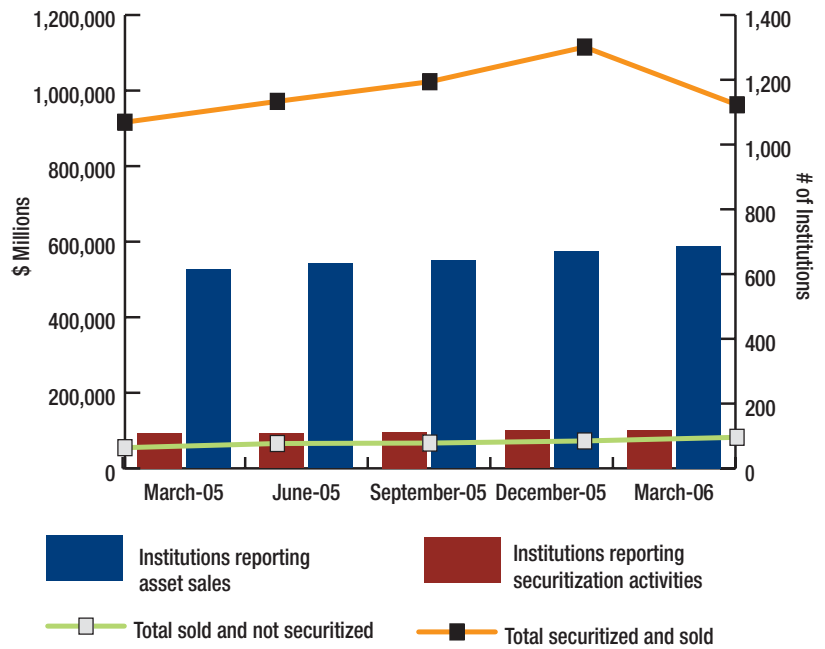
In addition to the surging levels of derivatives held for trading and other uses (especially interest rate and foreign currency contracts), the regulatory data for the first quarter of 2006 also showed a greater number of U.S. banks participating in asset sales and securitization activities than ever before (see Chart 12).

Moreover, the figures of asset sales by banks (mostly 1-4 residential family real estate loans) showed a rising level, while securitization activity slowed down. A possible explanation for this may be that banks are actively reshuffling their residential mortgage assets in light of the continuing flattened yield curve. Other areas of off-balance sheet activities are subdued, with unused commitments remaining stable.

### Summary

U.S. banks faced largely the same set of factors as late last year: a benign credit environment, continuing margin compression, and a slowdown in consumer credit, offset by higher activity in commercial and industrial loans, construction and land development loans, and in fee-income generating trading accounts. As A.M. Best had anticipated in its 2005 year-end research report, the U.S. banking industry is fac-

Chart 12  
Asset Sales and Securitization Activities



Source: FDIC

ing some challenges beginning in 2006. In response to the tougher operating environment, banks seem to be taking on more risk in their operations. Some segments of banking will be subject to a declining credit profile earlier, such as the mortgage banks. Among the commercial banks, savings banks and thrifts, earnings remain strong, but with a divergence in operating strategies by various subsegments leading to different risk issues. As the second quarter of 2006 is ending, certain trends (such as the continuing decline in consumer credit) will build up more momentum, and it remains to be seen how U.S. banks manage through these developments.



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