

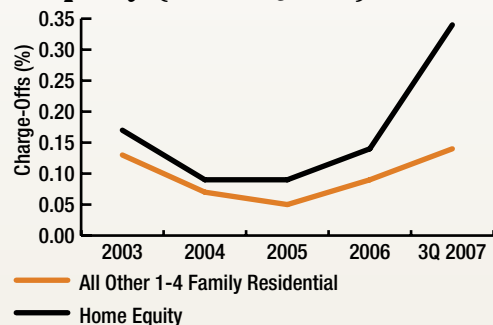
U.S. Banking – Regulatory Review

February 18, 2008

Sector

Banking

U.S. Banking – Net Charge-Offs On 1-4 Family Residential Property (2003-3Q2007)



Source: Federal Deposit Insurance Corp.

Related Reports

2007 Special Report:

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Methodology:

A.M. Best's Rating Methodology for Banks

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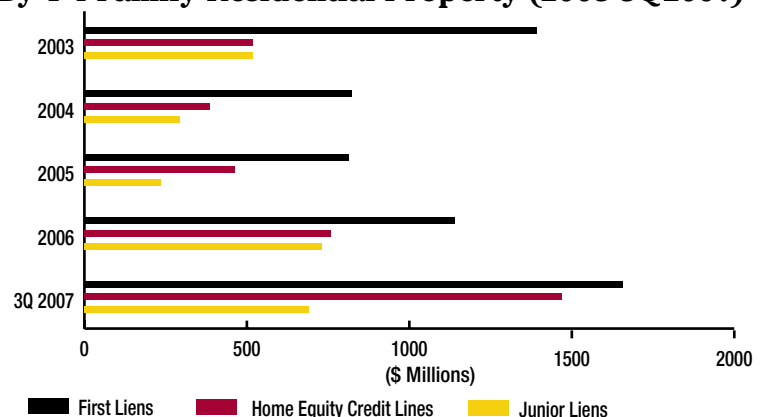
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Banks, Lenders Urged To Do More For Troubled Mortgage Loans

As more homeowners face foreclosure, regulators and lawmakers have urged banks and lenders to modify upwards of 1.8 million hybrid adjustable-rate mortgages (ARMs) made to subprime borrowers. These ARMs, with below-market introductory “teaser” rates typically for two or three years, will reset in 2008 and 2009 to interest rates that are substantially higher than market rates.

- Under guidelines unveiled in December and negotiated by the U.S. Treasury Department with the mortgage industry, potentially 1.2 million subprime borrowers with hybrid ARMs could qualify for affordable refinancings or loan modifications that freeze initial interest rates for five years.
- Another initiative launched in February to avert foreclosures targets homeowners with loans that are delinquent by 90 days or more. It includes subprime loans and other mortgage products.
- As more hybrid ARMs approach their initial interest-rate resets, more borrowers may find it difficult to refinance into affordable loans because of tighter lending standards and lower home prices.
- Lawmakers and regulators have pushed for rules that would compel lenders to make monthly disclosures on their efforts to help subprime borrowers modify the terms of their loans.
- Proposed federal legislation for new mortgages would require brokers and lenders to assess a borrower's ability to make payments over the life of the loan, rather than just the “initial” teaser rate period.
- The Securities and Exchange Commission provided interim guidance in January that the streamlined process for loan modifications met accounting guidelines for securitizations.

U.S. Banking – Net Charge-Offs for Loans Secured By 1-4 Family Residential Property (2003-3Q2007)



Source: Federal Deposit Insurance Corp.



Broader Efforts Seek To Avert Foreclosures

In the hopes of forestalling massive foreclosure filings in the nation's already troubled housing market, regulators and lawmakers have urged banks and mortgage lenders to modify millions of hybrid adjustable-rate mortgages that automatically will reset to higher interest rates in the next few years. As banks and lenders work to restructure these loans, they face greater disclosure requirements and the threat that balance sheet valuations might be negatively impacted depending on how the restructured loans are classified.

In addition to helping families stay in their homes by stabilizing payments, loan modifications are increasingly viewed by a growing number of regulators and lawmakers as a way to stem price declines in the housing market and potentially ward off further fallout to the broader economy. So far, though, efforts to modify around 1.2 million "teaser rate" adjustable-rate mortgages (ARMs) made to subprime borrowers under a plan announced in December with support from the U.S. Treasury Department appear not to have achieved the critical mass that regulators and lawmakers had hoped. Since then, more initiatives have been launched, such as Project Lifeline, which target more borrowers and mortgage products beyond subprime loans.

Since September 2007, the Federal Reserve has aggressively cut the federal funds rate – the short-term borrowing rate that banks charge each other for overnight loans – by 2.25 percentage points to 3.0%. The Fed has cut rates and injected liquidity into the banking system in the hopes of offsetting a credit crunch and a slowing economy. While lower rates are some help to ARM borrowers, loans having introductory, below-market "teaser" rates typically for two or three years will adjust upward regardless of trends in floating-rate benchmarks. Compounding these woes, more borrowers may find it difficult to refinance because price declines in many residential real estate markets have lowered the value of their homes, and because banks have tightened their

lending standards since the beginning of 2007 (see **Exhibit 1**).

With support of the Hope Now Alliance of banks, lenders, and mortgage servicers and the American Securitization Forum (ASF), the Bush administration and Treasury Department unveiled a private-sector plan in December to help ease the strain on borrowers whose mortgages will reset to higher interest rates. The plan, sometimes referred to as the Paulson Plan because of Treasury Secretary Henry Paulson's involvement in brokering a deal with the industry,

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freezes low introductory interest rates on subprime ARMs for up to five years for qualifying borrowers. Standards for subprime loans vary by financial institution but these loans generally are made to borrowers with FICO scores below 660.

The streamlined plan applies to subprime ARMs originated between Jan. 1, 2005 and July 31, 2007 that offered initially low “teaser” rates for 36 months or less. While introductory rates may make sense for borrowers expecting imminent salary increases, many subprime borrowers who received these loans would not be able to afford the sharp increases in monthly payments. To qualify, the first interest rate reset on these loans must be between Jan. 1, 2008 and July 31, 2010. There are additional criteria borrowers must meet to be eligible, according to framework established by the ASF (see **Exhibit 2**).

To avert more foreclosures, another push to broaden workout plans to more borrowers and mortgage products was announced on Feb. 12 by six banks within the Hope Now Alliance. The effort, known as “Project Lifeline,” targets homeowners who are 90 days or more behind on their mortgage payments. It is available for a wide range of mortgage loans beyond subprime ARMs. Qualifying borrowers would be eligible for a

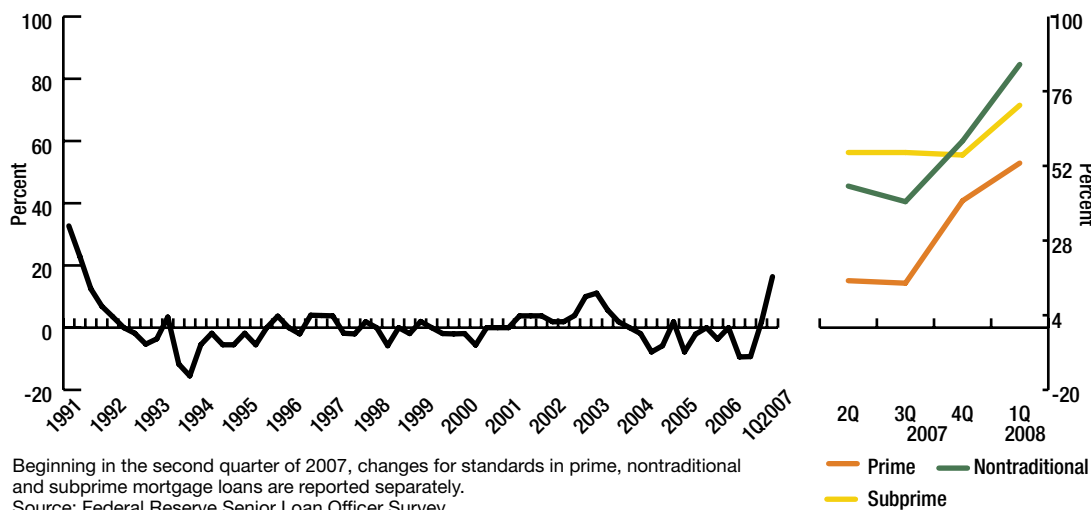
pause of up to 30 days for any pending foreclosure while a potential loan modification is evaluated.

Many of the nation’s banks and mortgage servicers – firms that collect and process mortgage payments and pass on the proceeds to investors – had already stepped up their efforts to restructure troubled mortgage loans earlier in 2007. But a lower percentage of these restructurings represented modifications in which borrowers receive new loans or changes to the loans’ terms that are more affordable.

A greater share of the industry’s efforts resulted in repayment plans that typically add past-due amounts on to monthly payments or the unpaid loan principal without modifying the terms of the loan. An additional danger of this practice, is that true delinquencies are understated when payments are merely rescheduled rather than being recorded and reported as late. Foreclosures, meanwhile, continued to rise in 2007 at alarming rates, prompting scrutiny from congressional leaders and several state legislatures, as well as lawsuits filed by mayors on behalf of U.S. cities, such as Baltimore and Cleveland, which have been impacted negatively by the large numbers of foreclosures.

Numbers released in mid-January 2008

**Exhibit 1
U.S. Banking – Net Percentage of Banks
Tightening Standards for Residential Mortgages (1991-1Q2008)**



by the Mortgage Bankers Association (MBA) showed that the industry modified 53,573 loans and established repayment plans on another 182,702 loans in the third quarter of 2007. Subprime ARMs represented 12,741 of the modified loans. Foreclosure proceedings, though, were initiated on 384,388 loans.¹

The MBA notes that foreclosures should be assessed by a measure known as “net foreclosures started” which it says excludes borrowers who may not be helped by a payment modification plan. These include investor-owned properties, borrowers who don’t respond to lenders’ attempts to contact them and borrowers who have defaulted despite already being on repayment plans or loan modification plans. On that basis, net foreclosures started represented 148,785 of the 384,388 proceedings initiated in the third quarter, the MBA figures show.

According to figures released in February by Hope Now, an estimated 652,000 repayment plans and 217,000 loan modifications were initiated in the second half of 2007 for borrowers with prime and subprime loans. Of the 545,000 subprime loans in which servicers within the Hope Now Alliance initiated a loss mitigation solution, 27.5% represented modifications. In the fourth quarter alone, 34.8% of subprime borrowers received loan modifications, Hope Now says.

Exhibit 2 U.S. Banking – Loan Modification Framework For Adjustable-Rate Subprime Mortgages

- Loans must have been originated between Jan. 1, 2005 and July 31, 2007; be included in pools of mortgages that have been securitized; and have their initial interest-rate resets between Jan. 1, 2008 and July 31, 2010.
- The loans may not be more than 30 or 60 days delinquent, depending on whether the servicer classifies delinquencies based on standards from the Office of Thrift Supervision or the Mortgage Bankers Association.
- Loans eligible for modification also must not have been more than 60 or 90 days delinquent more than once in the past 12 months, again, depending on the delinquency standards used by the servicer.
- The servicer determines that the borrower’s payments would rise by more than 10% at the upcoming reset.
- The property is the borrower’s primary residence.
- The borrower is unable to qualify for a refinancing through the Federal Housing Administration (FHA).
- The borrower’s current FICO score has to be less than 660 and less than 10% higher than the FICO score when the loan was originated.
- If the FICO score is too high, servicers may further assess if the borrower is eligible by reviewing current income and debt obligations, among other factors.

Source: American Securitization Forum

Although industry figures indicate that the number of modifications is rising, the escalating rate of foreclosures around the nation has prompted calls for stronger industry efforts and even legislation. Foreclosure filings jumped 75% to more than 2.2 million in 2007, according to RealtyTrac, the Irvine, Calif.-based online marketplace for foreclosure properties. The 2.2 million filings represent documents related to all phases of foreclosure on nearly 1.3 million properties, according to RealtyTrac.

Among the more vocal critics and a long-time advocate of a streamlined approach to loan modifications has been Sheila Bair, chairman of the Federal Deposit Insurance Corp. (FDIC). In a Jan. 31 hearing of the Senate Committee on Banking, Housing and Urban Affairs, Bair said the peak of monthly resets on subprime ARMs is approaching and that servicers must make an aggressive effort to dramatically increase the pace of loan modifications. More than 350,000 loans are estimated for initial resets in the third quarter of 2008, compared with about 270,000 loans in the first quarter of 2008. Bair said foreclosures are at an “unacceptably” high level, while loan modifications are lagging. “It is important that servicers demonstrate and document progress soon or they invite regulatory and legislative action to supplement the industry’s actions.”²

Bair has pushed for guidelines that would force lenders to make monthly disclosures to their regulators on their efforts to help subprime borrowers modify the terms of their loans. That is similar to several legislative measures making the rounds in Congress and state legislatures. Meanwhile, broader-based initiatives on the federal level and in several states, seek to establish more standards for newly issued mortgages. Senate Banking Committee Chairman Christopher J. Dodd, D-Conn., introduced legislation in December 2007 that would require mortgage brokers and lenders to assess a

¹ Mortgage Bankers Association, “An Examination of Mortgage Foreclosures, Modifications, Repayment Plans and Other Loss Mitigation Activities in the Third Quarter of 2007,” January 2008.

² “Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Strengthening the Economy: Foreclosure Prevention and Neighborhood Preservation; before the Committee on Banking, Housing and Urban Affairs,” Jan. 31, 2008 (press release available at <http://www.fdic.gov/news/news/speeches/chairman/spjan3108.html>).

borrower's ability to make payments over the life of the loan, rather than just the initial "teaser" rate period (see **Exhibit 3**). However, this measure would not address the millions of mortgages that already have been issued using underwriting standards that, contrary to underwriting standards that lenders adhered to in the past, did not consider the borrower's ability to repay the mortgage.

Dodd also has proposed the creation of a government-backed entity that would purchase troubled loans from trusts in the mortgage-backed securities market and then work directly with borrowers to restructure the terms of these loans. The entity, known as the Home Ownership Preservation Corp., could potentially add liquidity to the mortgage market. Liquidity, or ease of trading, has seized up in some corners of the mortgage market because of tighter lending standards, an increase in the number of abandoned properties and real estate price declines.

Other proposals, some of which are included in the economic stimulus package passed in the House and Senate, would raise the caps on mortgages that the Federal Housing Administration (FHA) would be able to insure. Temporarily increasing the size of mortgages available for purchase by Fannie Mae and Freddie Mac – the two government-sponsored enterprises that aid liquidity in the mortgage market – also is included in the stimulus package.

Because another fairly large pool of so-called "nontraditional" mortgage products such as payment-option and interest-only ARMs is expected to begin resetting to higher rates in 2009, the plan brokered by the Treasury Department last December may have to be broadened.

In a Jan. 7 speech before the New York Society of Securities Analysts, Paulson said all servicers need to report results on modifications to the Hope Now coalition to be able to measure the plan's effectiveness and make adjustments if needed. "This may include using elements of a systematic approach for

adjustable-rate mortgages other than subprime if it will benefit homeowners and investors," Paulson said.³

Under Project Lifeline, the initiative announced on Feb. 12, borrowers with subprime loans, Alt-A mortgages, prime loans, second lien loans and home equity loans could potentially qualify for loan modifications. Bank of America Corp., Citigroup Inc., Countrywide Financial Corp., J.P. Morgan Chase & Co., Washington Mutual Inc. and Wells Fargo & Co., the six lenders within the Hope Now Alliance that are leading the initiative, service about 50% of mortgages.

As discussed above, qualifying borrowers with loans that are delinquent by 90 days or more would be eligible for a pause of up to 30 days for any pending foreclosure

³ "Remarks by Treasury Secretary Henry M. Paulson, Jr. on Housing and Capital Markets before the New York Society of Securities Analysts," Jan. 7, 2008 (press release available at <http://www.treasury.gov/press/releases/hp757.htm>).

Exhibit 3 U.S. Banking – Recent and Proposed Federal Housing-Related Legislation

Helping Families Save Their Homes in Bankruptcy Act (S. 2136)

Status: Introduced Oct. 3, 2007 and referred to the Senate Judiciary Committee.

Summary: Amends federal bankruptcy law for Chapter 13 filings to allow courts to modify loans for the debtor's principle residence and provide for payment of the loan at a fixed interest rate over a 30-year period. Bankruptcy laws previously permitted loan modifications on primary residences from 1978 through 1993.

A compromise version of a similar bill in the House – the Emergency Home Ownership and Mortgage Equity Protection Act (H.R. 3609) – was reported out of the House Judiciary Committee on Dec. 12, 2007. Language was tightened to limit the legislation to debtors unable to make mortgage payments and where foreclosure is imminent, and to subprime and non-traditional loan products such as payment-option and interest-only ARMs.

Home Ownership Preservation and Protection Act (S. 2452)

Status: Introduced Dec. 12, 2007 and referred to the Senate Banking, Housing and Urban Affairs Committee.

Summary: Would amend the Truth in Lending Act to provide new protections for consumers from more expensive subprime mortgage loans and would require an analysis of borrowers' ability to repay loans based on factors such as credit history and debt-to-income ratios. Also prohibits prepayment penalties and "yield spread premiums" – commissions brokers receive from lenders for steering borrowers into higher-cost loans than what borrowers qualify for.

Mortgage Forgiveness Debt Relief Act

Status: Signed by President George W. Bush on Dec. 20, 2007.

Summary: Creates a "three-year window" for homeowners to refinance their mortgages and pay no taxes on any debt forgiveness they receive. Previously, amounts forgiven by banks or lenders from home sales, refinancings, or other loans to construct or improve a taxpayer's residence were considered as gross income. Also extends a deduction through Dec. 31, 2010 that allows taxpayers to deduct premiums paid or accrued for mortgage insurance in connection with amounts forgiven on these loans.

Sources: Library of Congress, White House, Congressional Budget Office, Center for Responsible Lending

while a potential loan modification is evaluated by the servicer. Project Lifeline does not apply to loans on investment or vacation properties. It also does not apply if the loan is in active bankruptcy or active foreclosure with a sale date of less than 30 days.

Other efforts continue from government agencies. The FHA said on Feb. 8 that it would mail letters to up to 850,000 homeowners with high-cost mortgages that have already faced or are experiencing the first reset on their ARMs. The outreach effort focuses on options borrowers may have such as refinancing into a loan through the FHA or the FHASecure program. FHASecure, announced last August, allows eligible homeowners to refinance into a fixed-rate FHA loan as long as they were current on their mortgages prior to the expiration of the teaser rate.

Another set of products regulators believe could exacerbate the currently high rate of mortgage defaults and foreclosures are payment-option and interest-only ARMs. These products became popular, particularly after 2003, when surging home prices over several years contributed to substantially lower rates of affordability in the nation's major housing markets. These loans also were popular among investors buying homes to speculate on real estate prices or to profit from rental income and home price appreciation.

Payment-option ARMs allow borrowers to make monthly payments below the interest amount. If the borrower chooses that option, any unpaid interest is tacked on to the mortgage resulting in "negative amortization," in which the loan's balance rises above that at origination. Interest-only ARMs allow borrowers to make only the interest portion on their monthly payments. Although the principal balance isn't being amortized, interest-only loans don't offer the prospect of negative amortization. The risks with these products are that payments can rise sharply after the introductory period, which is typically five years.

Regulators had already issued finalized guidance for "nontraditional mortgages" in March 2007, urging lenders and financial institutions to consider a borrower's ability to make higher payments on these loans when considering the borrower's creditworthiness. The guidance also sought to raise

awareness of "risk layering" – in which lenders might combine nontraditional mortgages with second lien loans (loans in addition to first mortgages that generally help borrowers make down payments), while assessing creditworthiness without documentation of income.

Overcoming Accounting Hurdles

As lenders and mortgage servicers grapple with the new streamlined process for loan modifications, they've also had to turn to regulators for accounting guidance. The ASF guidelines apply only to mortgages that have been bundled together into trusts that issue mortgage-backed securities purchased by investors, a process known as securitization. Since the issuing trusts are off balance-sheet vehicles, in which the banks and lenders originating the loans have transferred the loans to the trusts and given up control of the assets, a range of legal and accounting issues apply under an accounting rule known as Financial Accounting Standard (FAS) 140.

One major concern has been that by modifying loans under the streamlined process prior to a delinquency or default, mortgage servicers could be invalidating the status of these trusts as so-called qualifying special-purpose entities (QSPEs). That would mean banks and lenders originating the loans would have to account for the trusts on their balance sheets under FAS 140. Documents governing these trusts generally require mortgage servicers to perform a more comprehensive analysis and collect more data than the ASF guidelines, such as information on borrowers' income and expenses, prior to agreeing to a loan modification or other loss-mitigation options.

The Financial Accounting Standards Board (FASB), the nation's accounting rulemaking body, for several years has had a project on its agenda to simplify guidance for FAS 140 and issued an exposure draft in 2005. The FASB expects to issue an amended exposure draft, which includes servicer discretion and permitted activities of QSPEs, in the second quarter of 2008, according to its Web site.⁴

In early January, the chief accountant of the Securities and Exchange Commission (SEC) provided interim guidance that didn't object

⁴ For more on the FASB's timetable and project updates for FAS 140, see http://www.fasb.org/project/transfers_of_financial_assets.shtml.

to the continued status of QSPEs regarding modifications of subprime ARMs under the ASF guidelines. The guidance was consistent with the view provided to the House Financial Services Committee in July 2007.⁵

Many banks and lenders also are seeking relief from an accounting rule for another set of mortgage loans they own but haven't securitized. These loans are still on their balance sheets, partly because of declining home prices and tepid investor appetite for bonds backed by riskier mortgages, such as hybrid ARMs.

Under FAS 114, which dates back to 1993, financial institutions are required to record loan impairments once they deem it "probable" that all of the payments won't be collected. Groups of consumer loans such as mortgages, credit card loans and consumer installment loans that lenders collectively evaluate for impairment are generally covered under FAS 5 rather than FAS 114. But FAS 114

does apply if the terms of these so-called "smaller-balance homogeneous loans" are modified in a "troubled debt restructuring," according to FAS 114.

Since more banks and lenders have been modifying mortgages over the past year, some have decided to reclassify the modifications as troubled debt restructurings, adding to the percentage of nonperforming assets on their balance sheets. For its part, the MBA has written to the FASB requesting relief from the standard. In correspondence with the accounting body, the MBA has argued that the vast majority of its members lack the systems capability to evaluate volumes of modified loans for impairments under FAS 114. The FASB is currently reviewing the MBA's request for possible addition as a future project.

⁵ See letter of Jan. 8, 2008 from Conrad Hewitt, Chief Accountant, Securities and Exchange Commission (available at <http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf>).

GUIDE TO BEST'S BANK DEPOSIT RATINGS

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Bank Deposit Ratings

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	Rating	Descriptor	Definition
Secure	aaa	Exceptional	Assigned to companies that have, in our opinion, an exceptional ability to meet their ongoing obligations to depositors.
	aa	Very Strong	Assigned to companies that have, in our opinion, a very strong ability to meet their ongoing obligations to depositors.
	a	Strong	Assigned to companies that have, in our opinion, a strong ability to meet their ongoing obligations to depositors.
	bbb	Adequate	Assigned to companies that have, in our opinion, an adequate ability to meet their ongoing obligations to depositors; however, the company is more susceptible to changes in economic or other conditions.
Vulnerable	bb	Speculative	Assigned to companies that have, in our opinion, speculative credit characteristics and are vulnerable to changes in economic or other conditions.
	b	Very Speculative	Assigned to companies that have, in our opinion, very speculative credit characteristics and extreme vulnerability to changes in economic or other conditions.
	ccc, cc, c	Extremely Speculative	Assigned to companies that have, in our opinion, extremely speculative credit characteristics and/or limited ability to withstand adverse changes in economic or other conditions.
	rs	Regulatory Supervision	Assigned to companies (and possibly their subsidiaries/affiliates) that have been placed by a regulatory authority under a significant form of supervision, control or restraint whereby they are no longer allowed to conduct normal ongoing operations. This would include rehabilitation and liquidation. It may also be assigned to companies issued cease and desist orders by regulators.

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u	Under Review	A modifier that generally is event-driven (positive, negative or developing) and is assigned to a company whose Best's Rating opinion is under review and may be subject to change in the near term, generally defined as six months.

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Negative	Indicates a company is experiencing unfavorable financial/market trends, relative to its current rating level, and if continued, the company has a good possibility of having its rating downgraded.
Stable	Indicates a company is experiencing stable financial/market trends and that there is a low likelihood its rating will change in the near term.

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