

Regulatory Review

May 27, 2009

Sector

Banking

Rating Analyst

Khanh Vuong, Vice President
+1 (908) 439-2200 Ext. 5633
Khanh.Vuong@ambest.com

Analytical Communications

Brendan Noonan, Managing Senior Business
Analyst
+1 (908) 439-2200 Ext. 5570
Brendan.Noonan@ambest.com

BestWeek subscribers have full access to all statistical studies and special reports at www.ambest.com/research. Spreadsheet files also are available.

Bank Oversight in Crisis Is a High-Wire Act

Banks and their regulators face conflicting imperatives amid efforts to rebuild the global financial system and pull the economy from its deepest slump since the Great Depression. Borrowers are starved for credit even as banks seek to preserve capital and tighten lending standards that had become too lax. The Federal Deposit Insurance Corp. (FDIC) is bracing for impending claims, but tapping banks to strengthen the FDIC may put even more institutions at risk. Efforts to head off foreclosures could prove costly for banks. These and other issues shaped legislation and regulation in the early months of 2009.

- Banks dodged a potential blow to earnings and capital, especially for community banks, when a special assessment to help restore the Deposit Insurance Fund was reduced after legislation increased the FDIC's line of credit with the Treasury.
- Participants and observers in financial services are advocating a "systemic risk regulator" to monitor institutions that could jeopardize the financial system if they fail – and calling for efforts to keep single institutions from reaching such size and importance.
- Bankers lobbied feverishly – and with apparent success – against efforts in Congress to allow bankruptcy courts to adjust the terms of mortgages to help borrowers keep their homes – the so-called "cram-down" provision.
- Banks hailed moves by the Financial Accounting Standards Board to amend rules on mark-to-market valuations and the treatment of other-than-temporary impairments, which many say exacerbated the financial crisis by making banks look weaker than they actually were.
- Popular outrage over bonuses paid to some financial executives spurred swift congressional action to restrict "excessive" compensation for executives of institutions that received funds under the federal Troubled Asset Relief Program (TARP).
- Some institutions now are giving back or declining to take funds through TARP's Capital Purchase Program (CPP), citing shifting rules and tightening oversight attached to the CPP program, including limits on executive compensation.
- The Office of Thrift Supervision has proposed realigning regulation of the industry by line of business, with two separate regulators: one for consumer and community banking, and one for commercial banking.
- At April's Group of Twenty summit, leaders of the top industrialized nations embraced steps to stabilize the world's economy and financial system, including greater cross-border coordination.

Seeking the Right Balance

The global financial crisis has banks and their regulators struggling with conflicting imperatives amid efforts to shore up the financial system and pull the economy at large from its deepest slump since the Great Depression. The need to restart the flow of credit sits awkwardly with banks' need to preserve capital and renounce lax lending standards that contributed to the current crisis. The precarious position of some banks suggests a surge of impending claims for the Federal Deposit Insurance Corp. (FDIC), but banks lobbied successfully to curtail large FDIC assessments that they saw as a financial threat. And efforts to head off foreclosures raise potential costs for banks, which must be weighed against the cost of letting nature take its course in the reeling mortgage sector. These and other dilemmas shaped legislative and regulatory action, nationally and internationally, through the early months of 2009.

Change for the Better

Banks may have dodged a significant blow to their earnings and capital from a special assessment by the Federal Deposit Insurance Corp. to help restore the Deposit Insurance Fund (DIF). The impact would have been most severe on community banks, far exceeding the FDIC's own estimates, according to the Independent Community Bankers of America (ICBA). The American Bankers Association (ABA), meanwhile, had estimated the assessment would cost banks nearly \$27 billion in 2009. The ICBA had warned that the financial impact could put some banks in a precarious state, potentially posing further risk to the very fund the FDIC sought to strengthen through the assessment.

But legislation signed by President Obama on May 20 increased the FDIC's borrowing authority with the Treasury to \$100 billion from \$30 billion.

The FDIC board had voted in February to impose an emergency special assessment of 20 basis points on the industry, effective June 30 and due on Sept. 30. But on May 22, the board voted to reduce that assessment to 5 basis points and reallocate the burden away from smaller banks to larger ones.

The board also had approved an additional special assessment of as much as 10 basis points after June 30 if necessary to preserve public confidence in the federal deposit insurance system, but FDIC Chairman Sheila Bair reportedly said any assessment in the fourth quarter likely wouldn't exceed 5 points. This would come on top of a base assessment rate of 12-16 basis points for most banks in 2009, up from 5-7 basis points in 2008.

The higher base assessments are part of efforts to restore the DIF reserve ratio to 1.15%. The February vote extended that timeline to seven years from five, and the new legislation gave the FDIC still another year to recapitalize the DIF.

Failure Not an Option?

Among the questions raised by the current financial crisis is whether some financial institutions are "too big to fail" – and if so, should any bank or other financial company be allowed to reach and maintain that size. "Systemic risk" has been discussed widely in recent months amid efforts to bail out bank and nonbank institutions alike, including American International Group Inc., Bank of America Corp. and Citigroup Inc., among others.

A wide array of participants and observers in financial services have called for creation of a "systemic risk regulator" to monitor institutions that could jeopardize the financial system if they fail. Chief among them is U.S. Treasury Secretary Timothy Geithner. In testimony before the House Financial Services Committee on March 26, Geithner said that major financial institutions no longer should be allowed to choose their regulators in the hopes of gaining the most favorable treatment or minimizing scrutiny.

In his testimony, Geithner outlined criteria for identifying systemically important organizations, including:

- The financial system's interdependence with the company.
- The company's size, leverage and reliance on short-term funding.

- The company's importance as a lender and as a source of liquidity for the financial system.

Regulation of such institutions would have to be stricter than that imposed on other institutions in several ways, Geithner said:

- Capital requirements must be more conservative, geared to account for potential scenarios farther into the future and to "dampen rather than amplify financial cycles."
- Liquidity, counterparty and credit risk management must be more stringent.
- Oversight of the largest leveraged private investment funds, over-the-counter derivatives and money market funds must be more intensive, centralized and orderly.
- Corrective mechanisms must allow for prompt, protective regulatory action when needed.

While bankers and federal regulators at times have been at odds over the handling of the financial crisis, sentiment has been more uniform on the question of systemic risk. William R. Attridge, president, chief executive officer and chief operating officer of Connecticut River Community Bank, told the Senate Banking Committee that the government should be prepared to "aggressively regulate, assess, and eventually break up institutions posing a risk to our entire economy." Attridge, speaking for ICBA, noted that four banking companies control 40% of the nation's deposits and more than 50% of U.S. bank assets. He called for lowering the 10% nationwide cap on deposit concentration established under the Riegle-Neal Interstate Banking and Branching Efficiency act of 1994.

Simon Johnson of the Peterson Institute for International Economics testified recently before the Joint Economic Committee of the U.S. Congress. He argued that not only does the concentration of deposits threaten the financial system, but that very threat gives a handful of banks leverage to bend public policy according to their wishes – even if the resulting policies are unsound. And as

Federal Reserve Chairman Ben Bernanke noted in a recent speech, accepting the very notion of "too big to fail" encourages imprudent risk-taking by financial companies that are so labeled, and even encourages companies to seek such status through growth.

When All Else Fails

The prominent role of lax lending standards in the financial crisis is producing an array of real and potential consequences, one of which bankers lobbied feverishly to avoid. As a possible extension of the Obama administration's efforts to aid homeowners facing foreclosure, legislation in Congress proposed allowing bankruptcy courts to adjust the terms of mortgages to help borrowers keep their homes. This "cram-down" provision was contained in the Helping Families Save their Homes in Bankruptcy Act of 2009 (H.R. 200 and S. 61). Prospects for the measure remain unclear, but in a major victory for opponents, a related amendment failed to make it into the deposit insurance bill passed in May (S. 896).

The Mortgage Bankers Association and other industry groups have warned of unintended consequences from any cram-down legislation, including:

- More costly credit.
- Further markdowns in lenders' mortgage portfolios to reflect their exposure to the cram-down provision.
- Further instability in the market for consumers and financial institutions.

The MBA also contends that homeowners who cannot be helped by other forms of relief are unlikely to succeed in bankruptcy. Rather, they will lose their homes anyway while adding the stigma of bankruptcy to their credit records.

ICBA pointed to more modest bankruptcy provisions suggested by the White House as a model for Congress to follow, making the cram-down option a true last resort. The association warned of fraud and abuse in the bankruptcy system if the bill passes as proposed.

Supporters of the measure say that mortgages' long-standing exemption from restructuring in bankruptcy is a relic of an era when most mortgages were fixed-rate, 30-year loans – far from today's complex products that have become a principal factor in many bankruptcies.

The Valuation Conundrum

As the mortgage crisis has unfolded, some financial institutions argued that their condition was made to appear worse than it really was because of accounting rules that were too aggressive in forcing write-downs on the value of certain securities. Banks have hailed moves by the Financial Accounting Standards Board (FASB) to address these concerns through amendments to rules on mark-to-market valuations and the treatment of other-than-temporary impairments (OTTI).

Community bankers were most focused on the amended OTTI rules. Under amendments to FAS 115 and FAS 124 and EITF 99-20, FASB proposed to separate OTTI losses on debt securities into two components: those due to credit losses and those due to other factors. The credit component is to be recognized in earnings, as is done with impaired loans, while the remainder is to be recognized in other comprehensive income. ICBA welcomed this change, as well as a clarification regarding management's intention to hold or sell a security. The focus under the new rules is shifted from the bank's ability to hold a security, instead emphasizing management's intentions and thereby clarifying how likely it is that a bank might sell the security at a loss.

The ABA expressed some reservations on FASB's guidance regarding securities classified as "held to maturity." The ABA noted that market losses still would have to be recorded on such instruments.

FASB also tackled issues with FAS 157 on fair valuation of securities, clarifying criteria that determine whether the market for a particular instrument is inactive. The revisions also clarify how to determine that a transaction used to measure fair value is not distressed, i.e. the sale followed a normal marketing process with multiple bidders.

FASB met on April 2 and directed its staff to make some adjustments to the proposals based on public comments received. FASB's staff issued additional guidance on April 9.

Banking groups said that the rules in general would provide investors with a clearer and more accurate picture of companies' financial condition and of gains and losses in their portfolios.

Breathing Room on Bonuses

Popular outrage over bonuses paid to some financial executives, particularly those leading troubled institutions, spurred swift congressional action during March and April. Echoes of the furor reached the international stage, where leaders of the Group of Twenty (G20) industrialized nations pledged to implement new principles on pay and compensation developed by the Financial Stability Forum.

The U.S. House passed legislation to restrict "excessive" compensation for executives of institutions that received TARP funds. The measure now awaits action in the Senate. Community bankers scored a victory, however, with an amendment to the bill that exempted institutions receiving \$250 million or less in TARP funds. ICBA hailed this as recognition that community banks did not engage in the bonus practices that were targeted by the bill.

The bill would prohibit financial institutions holding TARP funds from paying their executives any compensation, other than for longevity or in the form of restricted stock, that the Treasury Secretary deems "unreasonable or excessive." It also would require bonuses to be based on performance as measured by:

- The institution's stability and ability to at least begin repayment of TARP funds.
- The individual employee's performance.
- Adherence to risk management requirements.
- Other standards of accountability to shareholders and the public.

The bill also would establish an Executive Compensation Commission to study and

recommend legislative action as needed on pay for performance; what factors influence executive pay; and how that pay in turn influences executives' behavior. The commission also would examine the effects of giving shareholders a greater voice in executive compensation.

Thanks, But...

TARP's Capital Purchase Program (CPP), has drawn an evolving response from banks as the program itself has evolved, and some institutions now are giving the money back or declining to take it, even if they qualify. The program was intended to encourage lending in the midst of the credit crunch by providing capital through federal investments in various banking and savings institutions. Through March 31, the Treasury had invested \$198.8 billion in 532 financial institutions' senior preferred shares or other senior securities. But 14 organizations had repaid about \$1.26 billion of CPP capital through May 15, (see **Exhibit 1**), and more than 250 had withdrawn applications that already had preliminary approval, according to a report from the Financial Stability Oversight Board, which oversees the Treasury Dept.'s implementation of TARP.

Some bankers complained of shifting rules and tightening oversight attached to the CPP program, including limits on executive compensation. The federal loans also carried risk for banks in the form of an interest rate that would increase after five years. In addition, spreads would be very tight between the rates on the government loans and the available returns in a mortgage market where federal policy currently favors low rates to jump-start the housing market.

Typical were the remarks of Thomas X. Geisel, president and chief executive officer of New Jersey-based Sun Bancorp Inc.: "When the Capital Purchase Program became available to well capitalized and healthy financial institutions like Sun, it was a positive partnership between the government and business to stimulate the economy through additional lending and community support," Geisel said in a statement in March. "The partnership then became politicized, the rules and regulations changed, and the dynamics of the partnership substantially shifted. These changes significantly restricted the way we support our customers and communities, as well as the way we run our business."

Exhibit 1

U.S. Banks – Capital Purchase Program Funds Repaid (2009)

Through May 15, 2009. (\$ Thousands)

Name of Institution	City/State	Investment in Pref. Stock w/ Warrants	Capital Repayment Date	Capital Repayment Amount ⁴	Remaining Investment Description	Final Disposition Date	Disposition Investment Description	Final Disposition Proceeds
TCF Financial Corporation	Wayzata, MN	\$361,172	4/22/2009 ²	\$361,172	Warrants			
Iberiabank Corporation	Lafayette, LA	90,000	3/31/2009 ³	90,000	Warrants			
Bank of Marin Bancorp	Novato, CA	28,000	3/31/2009 ²	28,000	Warrants			
Old National Bancorp	Evansville, IN	100,000	3/31/2009 ²	100,000	Warrants			
Signature Bank	New York, NY	120,000	3/31/2009 ²	120,000	Warrants			
Sterling Bancshares Inc.	Houston, TX	125,198	5/5/2009 ²	125,198	Warrants			
Alliance Financial Corporation	Syracuse, NY	26,918	5/13/2009 ²	26,918	Warrants			
FirstMerit Corporation	Akron, OH	125,000	4/22/2009 ²	125,000	Warrants			
Sun Bancorp, Inc.	Vineland, NJ	89,310	4/8/2009 ²	89,310	Warrants			
Independent Bank Corp.	Rockland, MA	78,158	4/22/2009 ²	78,158	Warrants			
Shore Bancshares, Inc.	Easton, MD	25,000	4/15/2009 ²	25,000	Warrants			
Texas Capital Bancshares Inc.	Dallas, TX	75,000	5/13/2009 ²	75,000	Warrants			
Centra Financial Holdings, Inc./Centra Bank, Inc. ¹	Morgantown, WV	15,000	3/31/2009 ²	15,000	Preferred Stock ¹	4/15/2009	Preferred Stock ^{1,5}	750
First ULB Corp.	Oakland, CA	4,900	4/22/2009 ²	4,900	Preferred Stock ¹	4/22/2009	Preferred Stock ^{1,5}	245
Total		\$1,263,656		\$1,263,656				\$995

¹ Privately held qualified financial institution; Treasury immediately exercised warrant to purchase additional shares of preferred stock.

² Repayment pursuant to Title VII, Section 7001(g) of the American Recovery and Reinvestment Act of 2009.

³ Redemption pursuant to a qualified equity offering.

⁴ This amount does not include accrued and unpaid dividends, which must be paid at the time of capital repayment.

⁵ The proceeds associated with the disposition of this investment do not include accrued and unpaid dividends

Beyond the measurable financial implications, many banks also feared that participation in the program would mark them in the marketplace as troubled, regardless of their actual soundness. Ultimately, long-term participation in the CPP program may be skewed heavily toward banks that truly need it – those with no choice but to accept thin margins on lending, heightened government control and potentially negative public perception.

A New Blueprint

While much has been made of the relative size of financial institutions and the attendant implications for systemic risk, the Office of Thrift Supervision has proposed slicing the banking industry a different way as it considers how regulation may be restructured in the wake of the financial crisis. In testimony before the Senate Banking Committee, the agency's acting director, Scott M. Polakoff, outlined a plan to divide regulation by line of business.

The OTS proposal calls for two federal banking regulators: one to focus on banks engaged primarily in consumer and community banking, including lending, and the other to focus on banks that mainly provide commercial products and services.

The consumer and community banking regulator would fill the regulatory gap that allowed a "shadow banking system" of inconsistently regulated mortgage companies, brokers and lenders to help sow the seeds of the current financial crisis, Polakoff said. Working in collaboration with state regulators, its would supervise state and federally chartered banks and all entities engaged in lending, overseeing safety, soundness and consumer protection.

The commercial banking regulator would house expertise in the complex products provided to business customers, and it would supervise issuers of derivative products, both bank and nonbank. This regulator also would be versed in the risk factors unique to commercial mortgages, such as income streams from rents and occupancy rates.

Given that most banks serve both consumers and commercial markets, the assignment of the regulator would depend on

what percentage of a bank's business is in each sector. A sustained shift from one to the other would trigger a switch in regulatory responsibility for a given bank.

Eyes of the World

The steps taken to date and those yet to come in addressing the financial crisis, have global implications – and are drawing global attention. At the G20 summit in April, heads of state from the leading industrialized nations agreed on an array of measures to stabilize the world's economy. The G20 declaration, "Strengthening the Financial System," included the following steps:

- A new, more powerful Financial Stability Board (FSB) as successor to the Financial Stability Forum (FSF), including the G20 countries, FSF members, Spain and the European Commission.
- Collaboration between the FSB and the International Monetary Fund to warn of macroeconomic and financial risks and the necessary response.
- An overhaul of regulatory structures to better equip them to identify large-scale risks.
- Expanded regulation and oversight of systemically important components of the financial system, including certain hedge funds.
- Implementing the FSF's new principles on pay and compensation, as well as corporate social responsibility.
- Strengthening capital and controlling the level of leverage in the banking system.
- Moving against "non-cooperative jurisdictions" and tax havens to increase transparency throughout the banking system.
- Urging standard-setters to work with governments on improved valuation, provisioning and accounting standards.
- Tightening oversight and registration of credit rating agencies.

Among the measures specific to banks, the G20 leaders agreed that minimum capital

standards should be maintained, with buffers in excess of that level to be built up in good times, then drawn down as necessary to facilitate lending in downturns. Also agreed to was development of a supplement

to risk-based capital requirements: a simple, clear, non-risk-based standard that accounts for off-balance-sheet exposures and helps to keep leverage in check within the banking system.

A.M. Best Company

Special Report

May 27, 2009

PUBLISHER, PRESIDENT AND CHAIRMAN
Arthur Snyder

EXECUTIVE VICE PRESIDENT/CHIEF OPERATING OFFICER
Arthur Snyder III

EXECUTIVE VICE PRESIDENT/CHIEF RATING OFFICER
Larry G. Mayewski

EXECUTIVE VICE PRESIDENT/CHIEF INFORMATION OFFICER
Paul C. Tinnirello

SENIOR VICE PRESIDENTS
Manfred Nowacki, Life/Health
Matthew Mosher, Property/Casualty
Rita L. Tedesco, Information Services

ANALYTICAL SERVICES
Carole Ann King, Managing Senior Business Analyst
Brendan Noonan, Managing Senior Business Analyst
Stephen Brown Klinger, Senior Business Analyst
Carol Demyanovich, Senior Business Analyst
Joe Niedzielski, Senior Business Analyst
Laura McArdle, Business Analyst
Thomas Dawson IV, Associate Editor

PRODUCTION
Shannon E. Wallace, Designer

Copyright © 2009 by A.M. Best Company, Inc., Ambest Road, Oldwick, New Jersey 08858. ALL RIGHTS RESERVED. No part of this report or document may be distributed in any electronic form or by any means, or stored in a database or retrieval system, without the prior written permission of the A.M. Best Company. For additional details, see Terms of Use available at the A.M. Best Company Web site www.ambest.com.

Any and all ratings, opinions and information contained herein are provided "as is," without any expressed or implied warranty. A rating may be changed, suspended or withdrawn at any time for any reason at the sole discretion of A.M. Best.

A Best's Financial Strength Rating is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. The Financial Strength Rating opinion addresses the relative ability of an insurer to meet its ongoing insurance policy and contract obligations. These ratings are not a warranty of an insurer's current or future ability to meet contractual obligations. The rating is not assigned to specific insurance policies or contracts and does not address any

other risk, including, but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. A Financial Strength Rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser.

A Best's Debt/Issuer Credit Rating is an opinion regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. These credit ratings do not address any other risk, including but not limited to liquidity risk, market value risk or price volatility of rated securities. The rating is not a recommendation to buy, sell or hold any securities, insurance policies, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

A Best's Bank Deposit Rating is an opinion of the relative ability of a bank to meet its ongoing financial obligations to depositors. It is based on a comprehensive quantitative and qualitative evaluation of a company's capitalization, asset quality, management, earnings, liquidity and sensitivity to market risk. The ratings are not assigned to specific deposit accounts or contracts and do not address the ability of the bank to repay any other financial obligation issued by the bank. A Bank Deposit Rating is not a recommendation to buy, sell or hold financial obligations of a bank, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

In arriving at a rating decision, A.M. Best relies on third-party audited financial data and/or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information.

A.M. Best does not offer consulting or advisory services. A.M. Best is not an Investment Adviser and does not offer investment advice of any kind, nor does the company or its Rating Analysts offer any form of structuring or financial advice. A.M. Best does not sell securities. A.M. Best is compensated for its interactive rating services. These rating fees can vary from US\$ 5,000 to US\$ 500,000. In addition, A.M. Best may receive compensation from rated entities for non-rating related services or products offered.

Price: BestWeek subscribers BestWeek subscribers can download a PDF copy of all full special reports at no additional cost or a combination of the PDF copies plus all related spreadsheet files of the report data at no additional cost from our Web site at www.ambest.com/research.

Nonsubscribers can access an excerpt of each special report and purchase individual reports and spreadsheet data from our Web site at www.ambest.com/research. Call customer service for more information, (908) 439-2200, ext. 5742.

For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.

SR-2009-10



Founded in 1899, A.M. Best Company is a global full-service credit rating organization dedicated to serving the financial and health care service industries, including insurance companies, banks, hospitals and health care system providers. For more information, visit www.ambest.com or contact one of our offices.

A.M. Best Company

Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
www.ambest.com

A.M. Best Europe Ltd.

12 Arthur Street, 6th Floor
London, UK EC4R 9AB
Phone: (44) 20 7626 6264
Fax: (44) 20 7626 6265
www.ambest.co.uk

A.M. Best Asia-Pacific Ltd.

Unit 4004 Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Phone: (852) 2827-3400
Fax: (852) 2824-1833
www.ambest.com.hk