A.M. BEST

SPECIAL REPORT JANUARY 8, 2007

Federal Regulatory Changes Loom for Banking

Though it remains unclear what the Senate Banking Committee and the House Financial Services Committee may have in store for the banking industry in 2007, the federal regulatory agencies that oversee it are already on the way to ushering in several significant changes to how banks do business.

"This is going to be a very interesting year, because you're going to have changes in regulation that affect the fundamentals of banking, and some other changes that could mess up the whole system if they're not done right," said Wayne Abernathy, executive director for financial institutions policy for the American Bankers Association and former assistant secretary at the U.S. Treasury Department.

For the first time in years, many banks will have to pay deposit insurance, and the Federal Deposit Insurance Corp. is now figuring out precisely how those insurance premiums will be assessed. U.S. banks are rated under what's called the CAMELS system, which are scores used by banking supervisors to assess a bank's soundness; the ratings range from one for the least risky, to five for the most risky. About 95% of all banks are in a single insurance category, the 1A, or least risky category, meaning that, for years, they have paid no federal deposit insurance premiums at all.

That will change under the new system, approved late last year, which will affect about 8,800 banks, credit unions, and savings and loans, according to the FDIC. All banks will be charged, at a minimum, two to four basis points — or 0.02% to 0.04% — for every $100 of their deposits, with adjustments for net income, charge-offs, bad loans and other factors.

Figuring out precisely how much each bank will be assessed will happen this year.

"The scores that a regulator determines could very well mean a difference to your deposit insurance costs," Abernathy said. "We're hoping there can be an appeals process ... We raised this issue verbally and in letters to the FDIC, and we said that, after they finalized the deposit insurance (issue), their next order of business should be entering into review and appeals processes. We're hopeful we can enter into a dialog this year."

Also on the table are proposed rules for Basel II, the name given to the banking standards set up by the 13 member countries in the Basel Committee. Those standards, years in the making, are intended to allow consistent measurement of banks' capital adequacy across national borders, as well as help set up consistent regulatory approaches to risk management from country to country. Though the international Basel group adopted a comprehensive version of the standard in July 2006 — the drafting process began in 2001 — U.S. banking regulators are still deliberating the best way to implement them.

"It's looking like we're shooting with real bullets in Basel capital accords," Abernathy said. "That's going to be a real reform."

Rather than one standard for all banks, U.S. regulators are leaning toward one standard for the largest and most-complex banks, and another for smaller banks. "For smaller, less-complex banks, they can basically just be left alone," he said. "It looks like we're getting to a better and more comfortable place. The thinking is, rather than just one standard, there should be a regime of standards ... Having that kind of approach will get us to a place where you can balance the complexity of your operations and get more or less the same kind of capital treatment" from regulators, Abernathy said.

Another major issue is the so-called Talent amendment that was tacked onto the defense authorization bill late last year. The provision, named for its sponsor, former Sen. Jim Talent, R-Mo., was intended to prevent

This report was written by Chris Grier, Washington correspondent for A.M. Best Co.

Copyright © 2007 by A.M. Best Company, Inc.
All rights reserved. No part of this report may be reproduced, stored in a retrieval system or transmitted in any form or by any means; electronic, mechanical, photocopying, recording or otherwise.

unscrupulous lenders from offering "payday loans" — which often have usurious rates — to military families. The problem, Abernathy said, is the bill language is vague, and the bill could put legitimate banks in hot water.

"Unfortunately, this was drafted in haste ... There are a lot of undefined terms and weaknesses that could drive banks away from doing any sort of business with military families at all," Abernathy said.

The bill provides for revocation of all interest payments, and potentially the principal of the loan, and some violations of the bill's provisions are criminal felonies. "Banks are going to go nowhere near that," Abernathy said. "Who's covered by this? It isn't as though someone walks in looking for a loan and they have a hat on saying, 'I'm military.' "

Banking industry representatives are now entering into conversations with Department of Defense officials, as they are the ones who are putting the bill's provisions into effect. "They have the pen, they wield the authority, but finance is not their forte, so we're encouraging them to work with Treasury and the regulators," Abernathy said. "We're going to highlight what we see as the concerns."

Bankers also are advocating on behalf of an anti-money laundering scheme that would significantly reduce the burden to banks. As it stands, the current approach of collecting currency transaction reports, doesn't work very well, Abernathy said. "The process is essentially, let's just collect a whole bunch of reports on transactions without any thought as to whether it actually does anything." Some 13 million such reports, called CTRs, were collected last year; Abernathy estimates that this year, about 14 million will be collected. "And Treasury can't show us where they've ever gotten any good information from them."

Bankers instead advocate use of new regulations enabled under Section 314(a) of the Patriot Act, which lets regulators and law enforcement authorities contact banks with names of customers suspected of being involved in money-laundering activities.

In contrast to the zero cases Abernathy said had been developed from CTR filings, FinCEN, the Treasury's financial crimes network, said in a Jan. 2 report it had developed 387 money laundering cases and 211 terrorist or terrorist financing cases from 314(a) reports from November 2002 to Jan. 2, 2007. Those cases resulted in more than 3,200 suspect transactions being identified, along with 108 indictments and nine convictions.

"That approach, we think, is much more productive," Abernathy said. "If you focus on the information that's useful, you can have a much more useful money-laundering approach."

Bankers also advocate doing away with collecting CTRs from regular business customers. The House last year passed a bill that would have eliminated CTRs for seasoned business customers, which was supported by both banks and regulators, but it ultimately did not pass. "We're hoping to be able to turn the corner on that this year," Abernathy said.

Regulators also are implementing guidelines this year for the amount of commercial real estate holdings a bank can have before

A.M. Best Co.

Special Report

January 8, 2007

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

GROUP VICE PRESIDENTS
Manfred Nowacki, Life/Health
Matthew Mosher, Property/Casualty

PRODUCTION
Thomas Dawson IV, Associate Editor
Angel Negron Designer

Copyright © 2006 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 *http://www.ambest.com*.

Best's Ratings reflect the A.M. Best Company's opinion 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. These ratings are not a warranty of an insurer's current or future ability to meet its contractual obligations, nor are they a recommendation to buy, sell or hold any security. Further, any and all information herein is provided "as is," without warranty of any kind, expressed or implied. A.M. Best Company receives compensation for its interactive financial strength ratings, from the insurance companies it rates. In compliance with the Securities Act of 1933, A.M. Best also discloses that it receives rating fees from most issuers of the debt securities it rates. Those fees fall within a range of $ 7,500 to $ 500,000.

Online Availability: This study is available electronically from the A.M. Best Co. Web site at www.ambest.com/banks. 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.

The Insurance Information Source

it triggers more intense regulatory scrutiny. Those guidelines, Abernathy said, have been widely interpreted as quotas or limits on commercial real estate holdings.

"The regulators have basically said, no, these aren't limits, these are quotas, but if you pass a certain threshold, we're going to look closer at the bank's risk-management processes. That's fine, if that's actually how it plays out. What we need to see this year is whether that's actually going to be applied — do those numbers in the field, in practice, become hard targets, or do they preserve flexibility?"

A.M. Best Co., established in 1899, is the world's oldest and most authoritative source of insurance company ratings. Best's Ratings are the definitive symbol signifying the financial strength and operating performance of insurance companies worldwide. For more information, visit A.M. Best's Web site at *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: +44-207-626-6264
Fax: +44-207-626-6265
www.ambest.co.uk

A.M. Best Asia-Pacific Ltd.
Unit 5707 Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Phone: +852-2827-3400
Fax: +852-2824-1833
www.ambest.com.hk