

2007 Special Report: U.S. Banking Issues

Loan Margin Pressures Collide With Rising Credit Costs

The lending business of banks has been under pressure from thinning margins combined with rising credit costs, still another sign confirming the turning point of the U.S. banking industry cycle that A.M. Best believes began in early to mid 2006.¹ Prior to 2007, the sometimes flat, sometimes inverted yield curve had been an obvious factor in overall margin pressures experienced by U.S. banks. Though a recent shift toward a more traditional yield curve eventually should provide relief to the industry, for now, pressures remain on margins. Regulatory bank filings and earnings releases through the first quarter of 2007 indicate that the relationship of loan spreads to funding costs and loan provisioning has deteriorated to the point where it is threatening to get out of balance.

Generally, loan margin compression seems to affect large banks more than small banks. The underlying factors of scarce sources of earnings, heightened price competition among lenders and the excess supply of loan funds, however, all confront the majority of banks to some degree. In this research report, A.M. Best takes a closer look at the components of the industry's net interest margin (NIM)—defined as interest income minus interest expense, divided by earning assets—with a particular focus on loan margin compression and rising credit costs.

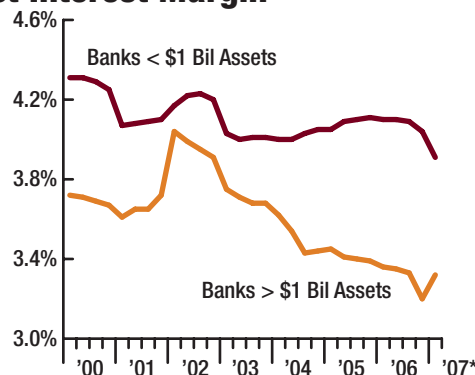
As shown in **Exhibit 1**, NIM for the industry declined gradually for some time, especially for the larger banks, where NIM dropped sharply and steadily from a 10-year peak of 4.04% in 2002, through the third quarter of 2006 at 3.33%, with a dramatic further drop in the fourth quarter to 3.20%. Preliminary data for March 2007 indicate that margins for the industry overall are down from the same quarter in 2006—though improved from the last quarter of 2006—caused by strong increases in funding costs set against only very modest increases in loan yields.

As of the first quarter of 2007, it appears that the NIM of smaller banks was declining at an intensifying pace, but larger institutions engineered an improvement in NIM. Smaller banks reported a NIM of 4.04% for the fourth quarter of 2006, which declined to 3.91% for the first quarter of 2007; larger banks reported a NIM of 3.20% in the fourth quarter, with an improvement to 3.32% in the first quarter.

The behavior of interest margins of larger banks relative to smaller banks ran more or less in tandem in the past. Those margins began to diverge, however, in 2002, with a widening gap seen between NIM for large and small institutions into 2006. Recently, NIM for smaller institutions typically ran about 50 basis points higher than for larger institutions. Interestingly, however, the gap that began to widen in 2002 apparently began to narrow in the first quarter of 2007.

For the first time since 2002, larger institutions in the first quarter of 2007 actually improved their NIM, while NIM at smaller institutions declined. The widening gap between smaller and larger institutions from 2002 through 2006 was partly because structural changes in the industry have had a disparate impact on large versus small banks, as have changes in the way each group

Exhibit 1
Net Interest Margin



*2007 first quarter only.
Source: FDIC.

This report was written by Khanh Vuong, assistant vice president, and Diane Goodheart, senior financial analyst, at the A.M. Best Co.

1. See *U.S. Banking Trends for 2005 – Signaling End of Peak Industry Cycle*. Feb. 27, 2006.



responds to fluctuations in the overall interest-rate environment.

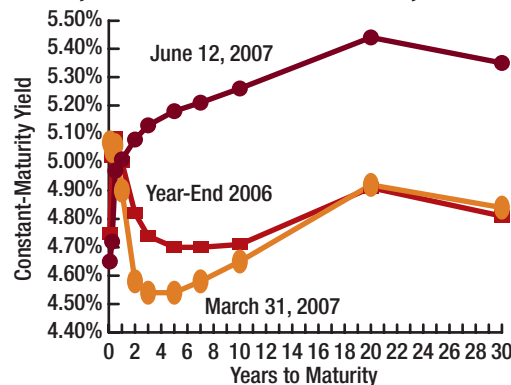
Increased funding costs—a factor in margin compression disproportionately affecting the larger banks from 2002 to 2006—stemmed not only from increases in overall interest rates, but also from structural changes in bank deposits. As shown in **Exhibit 2**, the gradual, structural shift in the industry away from demand deposits and other noninterest-bearing funds impacted the larger banks. Those banks historically fully tapped into their deposit bases and consequently were affected more by any slowing of growth in deposits.

As overall rates have rebounded, the trend away from noninterest-bearing accounts has accelerated even further, as have rates needed to be paid to attract and keep large-bank deposit customers. As of the first quarter of 2007, it appears that community banks are beginning to feel cost-of-funds pressures as well, as interest expense increased a dramatic 15% from the fourth quarter of 2006, even exceeding the 14% increase that continued trends experienced by the larger banks. Those larger banks, during the first quarter of 2007, appeared finally to be seeing a leveling off of the almost exponential growth in interest-bearing deposits that began in 1992.

Also contributing to the NIM compression forces above, the prolonged flat yield curve environment that periodically tipped into an inverted slope over the past couple of years has caused a great deal of uncertainty, thwarting the ability of many banks to enhance margins. The rate environment has been particularly difficult over the past two to three years for banks in their attempts to predict or estimate the direction of relative rates. As a result, most banks have not been able to effectively position their balance

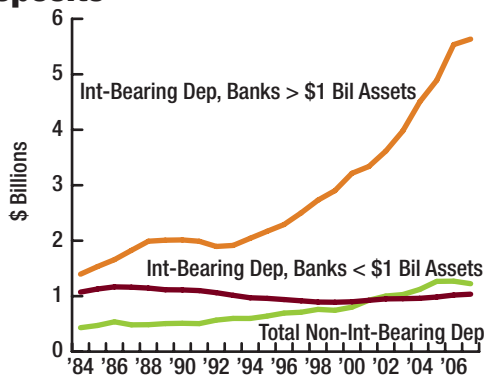
sheets to generate additional earnings from funding mismatches in either direction: asset sensitive or liability sensitive. A potentially favorable development is that as of this printing, the yield

Exhibit 3
Treasury Yield Curve Year-End 2006, March 31 & June 12, 2007



Source: Federal Reserve Board.

Exhibit 2
Deposits



Source: FDIC.

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curve has turned positive, as shown in **Exhibit 3**, below. This development, discussed in the *2007 Special Report: U.S. Banking—2nd-Quarter Interest Review*, may provide some relief to banks as they attempt to reverse recent trends.

For the most part, based on recent past regulatory filings, the industry has maintained a relatively narrow funding mismatch gap in response to yield-curve uncertainties. The industry operated in a very restrained manner, rather than assuming greater interest-rate risk in hopes of enhancing NIM. The elevated and rising absolute level of interest rates in the past couple of years also increased the cost of bank borrowings. Large banks traditionally rely more on Fed Funds and other borrowings as a source of lendable funds, and therefore generally have been affected more.

An additional factor pressuring loan margins, which reflects the current stage of the credit cycle that the industry faces, is that banks have not been able to take full advantage of overall rate increases on the loan side. While one factor was the yield curve mentioned above, another factor has been higher competition for loans and an excess supply of loan funds that has led to lower yields. While larger banks have seen higher funding costs, smaller banks have seen increased competition for loan business and have been forced to reduce prices. Smaller banks also have had a disproportionate share of loans in lower-yielding classes, while larger banks have focused on credit card and other higher-yielding loans (though yields on credit cards have been contracting sharply as well).

As seen in **Exhibit 4**, LIBOR rates have increased dramatically from 2003, while loan yields have failed to keep pace. **Exhibit 5** shows the corresponding compression in loan spreads that has occurred for the industry across all loan types, resulting in spreads coming down to a new, six-year low in 2006. For March 2007, this trend began to reverse, especially for the larger banks, which were able to increase interest income by more than 10% to 6.66% of earning assets. Smaller banks increased their interest income only by more than 6%, to 7.00% of earning assets.

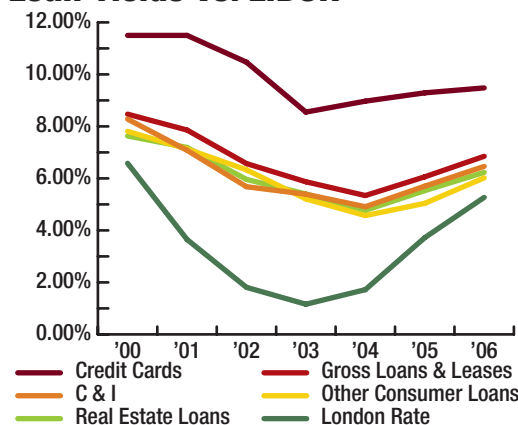
Adding to the mix of factors pressuring loan margins, clear signs of weakening asset quality, particularly in real estate loans, began to emerge during 2005 and accelerated during the fourth quarter of 2006. Delinquencies and charge offs, as well as Other Real Estate Owned (OREO), all

rose sharply. The industry's asset quality continued to decline in the first quarter of 2007, when slight improvements in loans to individuals—whether credit cards, mortgages or other categories—were not enough to offset continued asset-quality declines in all other loan classes; where 30-89 past dues, 90+ and nonaccrual loans have continued across-the-board increases.

The declines in asset quality have caught the industry with very low loan-loss reserves, otherwise known as Allowances For Loan and Lease Losses (ALLL), indicating that additional potential expenses may be on the sidelines threatening future earnings that already have been under pressure from declining margins.² As can be seen in **Exhibits 6a** and **6b**, for some time the emerging nonperforming assets have not been met with the expected response in bolstering reserves. For small banks in particular, nonperforming assets have continued to increase.

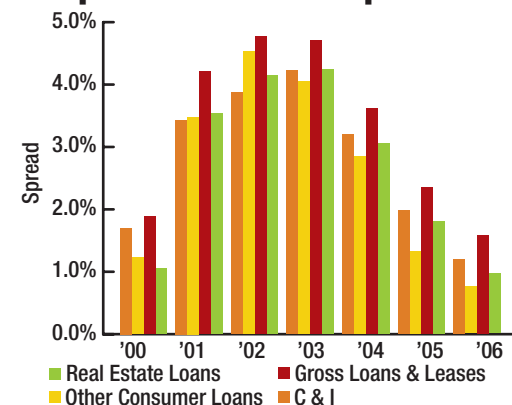
The larger banks very recently have begun to

**Exhibit 4
Loan Yields vs. LIBOR**



Source: FDIC.

**Exhibit 5
Compression of Loan Spread**



Source: FDIC.

2. See A.M. Best Special Report *Are Loss Reserves Adequate in Light of Rising Delinquencies?* March 20, 2007.

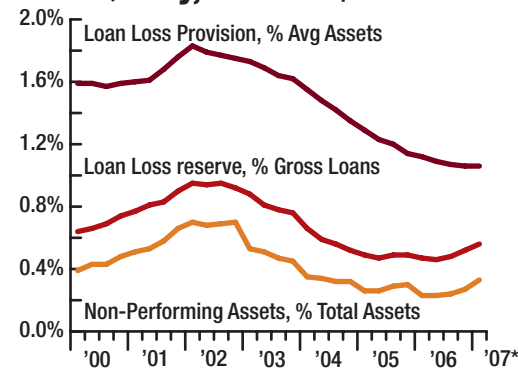
regain some ground and reverse the low ALLL trend by increasing provisions in the first quarter of 2007. Loan provisions to date in 2007 for smaller banks, however, have increased at a slower rate than the increases in delinquencies, resulting in noncurrent loans that are overshadowing corresponding loan-loss reserves. Increased provisioning by larger banks has helped the industry overall barely to keep up with rising delinquencies. Starting from a point of loan-loss reserves being at historic lows, provisions would need to be made at a rate faster than rising delinquencies for loan-loss reserves to keep up with chargeoffs. Setting aside for a moment the rising funding costs the banking industry has faced, the relation of loan spreads to delinquencies alone indicates very little room for appropriate risk premiums on the income side.

Data for the past few years indicate that a confluence of all these factors has been putting pressure on the lending business of the banking industry. For the first quarter of 2007, increased competition for deposits and continued increases

in interest rates combined to raise funding costs, while lower incremental increases in yields did not keep pace. Banks then found that they had not been paid for the apparently increased risk indicated by rising delinquencies. The net effect of all of these factors—impacting the NIM as well as asset quality—has been pressure on lending operations from all sides. It will be interesting to see how much impact one factor—the recent normalization of the yield curve—will have on NIMs within the banking industry.

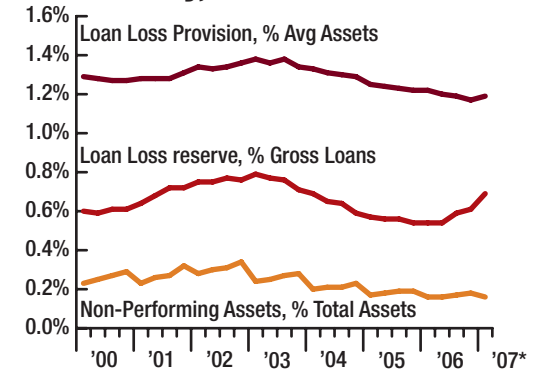
Loans historically have been the mainstay of commercial banks, and especially for community banks. If recent trends pressuring lending do not reverse, banks will be forced to navigate some tricky waters, having to choose when to walk away from some transactions. As is always the case, the more disciplined banks will fare better in the long run. The individual circumstances and the approach of each bank are important factors considered by A.M. Best in evaluating an individual bank's strength in this or any stage of the industry cycle.

Exhibit 6a
Asset Quality, Banks > \$1 Bil Assets



*2007, first quarter only.
Source: FDIC.

Exhibit 6b
Asset Quality, Banks < \$1 Bil Assets



*2007, first quarter only.
Source: FDIC.



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