

Market Review—U.S. Banking Issues

## Shifting Balance Sheet Trends Heighten 2007 Banking Industry Risk Profile

A significant trend set by U.S. banking operations that stood out from other developments in 2006 was the sharp growth in commercial real estate lending — in particular construction and land development loans — funded increasingly by noncore sources. In a softening consumer credit market, U.S. banks have turned most heavily to commercial real estate (CRE)\* loans for growth to offset the slowdown in demand for consumer credit. Concurrently, the banks have relied more on noncore funding sources during 2006 to fund growth than they did in 2005. The competition among banks for low-cost deposits heated up during 2006 and

drove up the cost of funding for the industry as a consequence. Together, these developments pose heightened risks to the industry on multiple fronts.

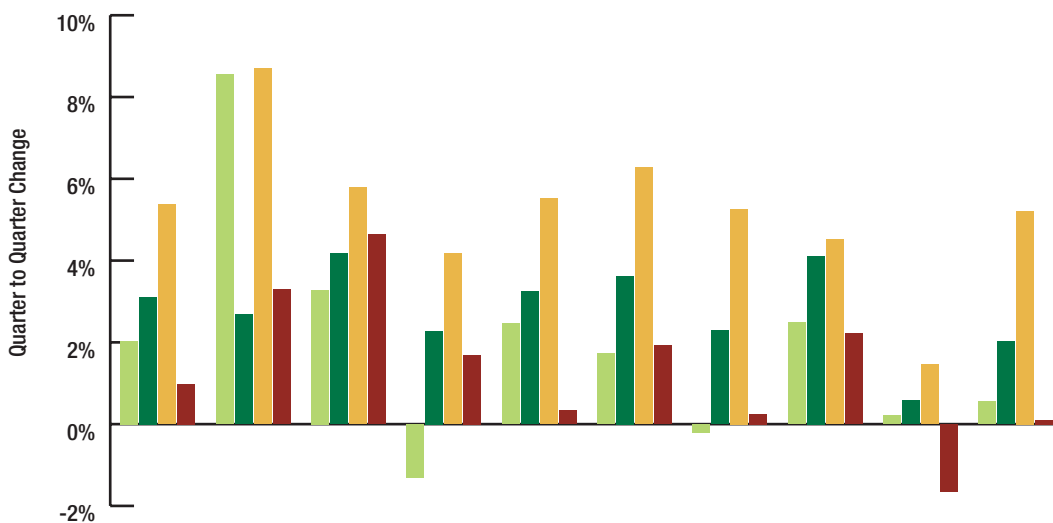
The U.S. banking industry's assets grew twice as fast as deposits, as shown in the table and chart below, based on third-quarter 2006 regulatory data. CRE loans grew three times faster, while construction and land development loans grew at more than five times the rate of growth for deposits. As of the end of the third quarter, CRE stood at a record 14.2% of total assets, which makes these trends particularly distressing.

Regionally, these trends were more pronounced in the active banking regions along

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\*CRE is as calculated in the regulators' thresholds used in identifying banks with high CRE concentrations.

### U.S. Banks' Growth: 3Q06 vs. 2Q06



Region	Asset Growth	CRE Loan Growth	Constr & Dev Loan Growth	Deposit Growth
Total U.S.	2.03%	3.11%	5.38%	0.98%
Pacific-West	8.55%	2.68%	8.70%	3.30%
Mountain-West	3.28%	4.17%	5.78%	4.64%
West North Central	-1.31%	2.28%	4.18%	1.69%
East North Central	2.47%	3.24%	5.51%	0.33%
West South Central	1.72%	3.62%	6.27%	1.92%
East South Central	-0.20%	2.29%	5.26%	0.25%
South Atlantic	2.48%	4.11%	4.51%	2.22%
New England	0.21%	0.57%	1.45%	-1.64%
Mid-Atlantic	0.55%	2.02%	5.21%	0.10%

Source: FDIC



the East and West coasts. Across all regions, however, construction and land development loans grew at a uniformly rapid pace. Growth in assets was high in most regions in the third quarter of 2006, except for New England and the Mid-Atlantic regions, and it actually contracted during the quarter in the East South Central and West North Central regions. New England also was the only region where deposits contracted from the prior quarter.

Similar growth trends were observed during the second quarter of 2006. Growth in construction and land development loans stood out as the fastest among other loan categories, across the nation and in all regions. Deposit growth relative to asset growth was slightly stronger in more regions than not (Mountain-West, New England and some of the Central states).

Fast growth concentrated in an asset class that historically is cyclical (e.g., commercial real estate), combined with a funding mix that reflects a shrinking percentage of core deposits, can lead to a heightened risk profile for the industry. Circumstances, however, are different now than during the last banking crisis. Mitigating factors during this cycle include the historically higher capital levels in the industry and the stronger underwriting discipline and risk-management systems at individual banks. How 2007 may be shaped by these trends depends on how banks next respond to competitive and market forces, particularly in this phase of the industry cycle, which is changing. Going forward, A.M. Best will observe the industry for signs of rising levels

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of risk appetite and/or competition-driven pricing. Those factors may determine whether the observed trends will be at manageable risk levels or a source of problems for U.S. banks.



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