

U.S. Banks' Non-Interest Income Enjoyed Healthy Growth in the First Quarter of 2006

Despite multiple increases in short-term interest rates over the past two years, the U.S. banking industry reported record earnings in the quarter ended March 31, 2006, in part due to the strength of various sources of non-interest income. Although the Federal Reserve has boosted short-term rates by 425 basis points since June 30, 2004, the yield curve remains relatively flat. This situation has resulted in margin compression and increased pressure on banks to develop alternative sources of income. While the overall earnings and net interest margins of all banks potentially are affected by this situation, those banks whose earnings are most reliant on the spread between loan and deposit rates will be the most affected.

Typically, the largest banks have the greatest ability to diversify their revenue streams, while smaller banks generally rely more upon the spreads generated from real estate and other types of lending. As seen in the chart, non-interest income as a percentage of net operating income (defined as net interest income plus non-interest income) has been declining steadily for all but the largest U.S. banks. In recent years, smaller banks have focused their business strategies largely on real estate lending, leading to the drop in non-interest income as a percentage of net operating income. In contrast, the largest banks have been able to expand their revenue sources to better insulate themselves from shrinking margins.

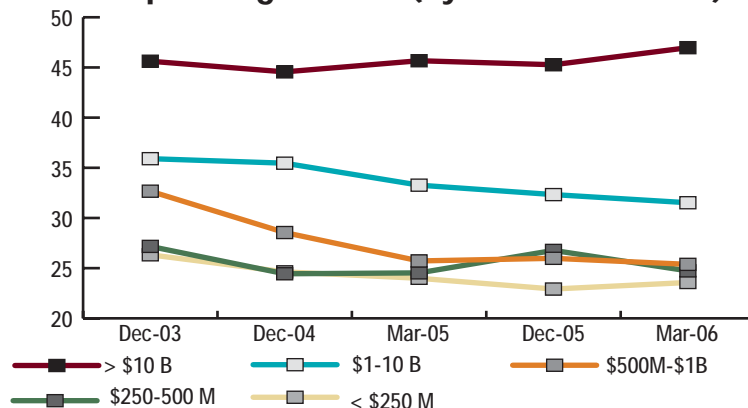
From the year ended Dec. 31, 2003 to Dec. 31, 2005, non-interest income rose by some 9.5% from \$202.7 billion to \$222.0 billion, in part due to increases in loan-servicing fees (\$3.3 billion), trading account gains (\$2.3 billion) and charges on deposit accounts (\$1.9 billion). Although trading account gains are generally a nonrecurring source of income, the steady increase in overall non-interest income for banks stems from loan-servicing fees generated by the solid growth in real estate mortgage activity prevalent during this time period. Non-interest income growth

remained healthy in the quarter ended March 31, 2006, as it rose by \$5.7 billion, or 10.3%, over the quarter ended March 31, 2005. Some of the most significant increases consisted of trading-account gains (\$1.5 billion) and higher securitization income (\$1.1 billion).

The ratio of non-interest income to net operating revenue for the industry reached 39.9% in 2002 and rose to 41.8% in 2003; however, for both 2004 and 2005, this figure did not surpass 41.1%. In the first quarter of 2006, the ratio of non-interest income to net operating income for the industry rebounded and reached 42.3%, compared with 41.4% in the first quarter of 2005, in part due to higher fee income from deposit accounts, increased securitization income, trading account gains, and fiduciary and capital market fees.

If the flat yield curve continues to persist, banks likely will remain focused on developing other sources of non-interest income in the short run, while also searching for higher-yielding lending opportunities. These shifts in asset and income mix by the industry will be reflected in the financial reports filed with the regulators. A.M. Best will continue to monitor the situation and will comment on the credit risk implications and other significant issues presented by these changes.

Non-interest Income as a Percentage Of Net Operating Income (By Total Asset Size)



Source: Federal Deposit Insurance Corp.

This report was written by Steven Wollum, CFA, financial analyst with A.M. Best Co.



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



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A.M. Best Company
Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
<http://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 5707 Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Phone: (852) 2827-3400
Fax: (852) 2824-1833
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