A.M. BEST

SPECIAL REPORT SEPTEMBER 2006

Loan Demand Helped Banks to Overcome Tighter Margins in Second Quarter

Synopsis of the Second-Quarter 2006 Industry Results

Margin compression pressures persisted through the second quarter of 2006 for U.S. banks, albeit without further declines in the industry's aggregate net interest margin as of the quarter ended June 30. The industry reported an unchanged net interest margin, as loan demand continued to trend upward, offering higher yield opportunities for banks and thereby offsetting the effects of a declining spread between short-term and long-term rates. The industry generated another quarter of record profits, largely on higher noninterest income. Of note is the lowest percentage of banks reporting earnings gains since September 2004. The different paths taken by banks in response to the persistent flat yield curve environment ranged from a boost in noninterest income to improved operating efficiency. At the same time, there are some signs of a higher degree of risk assumed by banks in some portfolios on their balance sheets in an effort to enhance yields. Asset-quality ratios showed some slight upward trends but nonetheless remained well within historical lows. These largely short-term effects on the banking industry from ongoing margin compression are discussed further below.

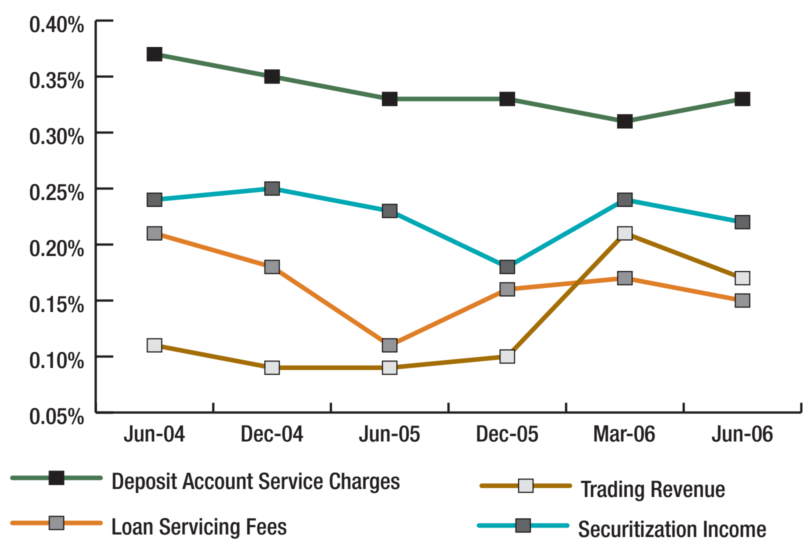
Industry Earnings Remain Strong – Noninterest Income Is Key

Although net interest margins remained under continued strain from the flat yield curve, overall earnings held up well during the second quarter of 2006, with net income reaching a quarterly record level at $38.0 billion. The strong earnings results were in part due to the continued strength of various sources of noninterest income, notably an improvement in trading account activity. The industry as a whole saw rising levels of noninterest income, which reached $62.4 billion as of June 30, 2006, compared with $55.6 billion at June 30, 2005.

Service charges from deposit accounts remained the largest single component of noninterest income, at $9.3 billion (0.33% of average assets) at June 30, 2006. As a percentage of assets, service charges compared favorably with the first quarter of 2006 when they represented 0.31% of average assets, but remained steady from one year ago, when they represented 0.33% of average assets. Trading account income improved significantly in the quarter ended June 30, 2006, rising to $4.7 billion (0.17% of average assets) from nearly $2.5 billion (0.10% of average assets) at June 30, 2005. Loan servicing fees also recorded relatively healthy growth, rising by nearly $1.4 billion to $4.3 billion (0.15% of average assets) during the same time period. Other components of noninterest income were generally flat (See chart).

Chart 1

Selected Non-Interest Income Sources As a Percentage of Average Assets



This report was written by Khanh Vuong, managing senior financial analyst; Steven Wollum, CFA, financial analyst; and James Barnes, CFA, financial analyst with A.M. Best Co.

Total noninterest income as a percentage of net operating income (net interest income plus noninterest income) stood at 42.1% at June 30, 2006, dipping slightly from 42.3% in the first quarter of 2006. In spite of this modest decline, noninterest income as a percentage of net operating income remained well above the 40.8% reported in the second quarter of 2005 (See chart).

Large banks continued to be the best able to develop various sources of noninterest income. In contrast, smaller banks have not experienced the same improvement in noninterest income results, choosing instead to focus on real estate lending, which has generated relatively healthy spreads and yields over the past several years.

Chart 2

Noninterest Income as a Percentage Of Noninterest Income + Net Interest Income

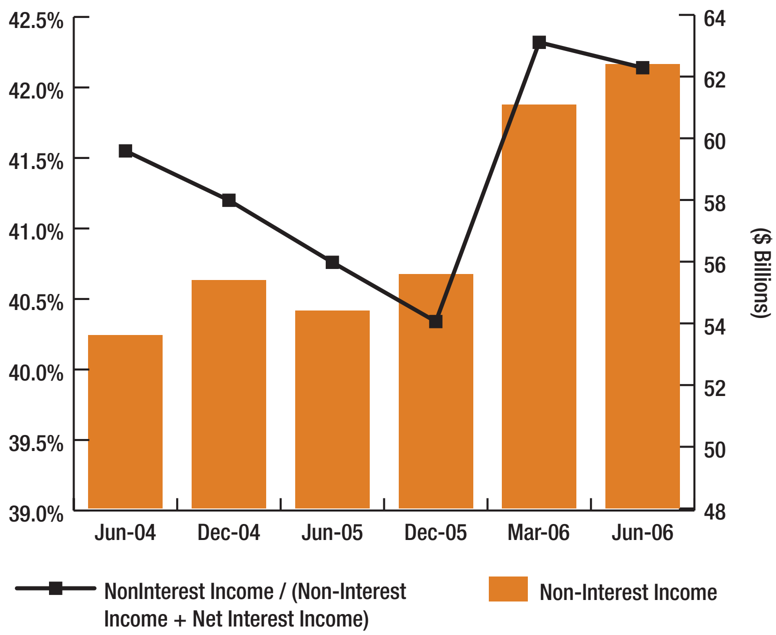
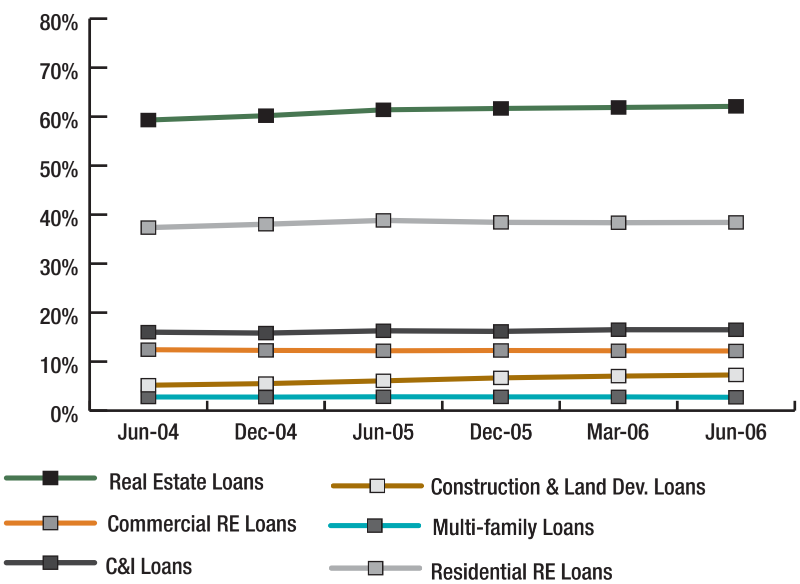


Chart 3

Selected Loan Categories As a Percentage of Total Loans



Loan Growth and Healthy Asset Quality Mitigate Margin Pressures

U.S. banks also have been able to mitigate the effects of the prolonged flat yield curve environment by underwriting potentially higher-yielding assets, such as commercial real estate (CRE), construction and land development (C&LD), and commercial and industrial

A.M. Best Co.

Special Report

September 2006

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

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

(C&I) loans. Given that demand for consumer products such as mortgages, equity loans and consumer loans has moderated, banks increasingly have focused on the commercial segment to fill the gap. The July 2006 Federal Reserve Senior Loan Officer Opinion Survey indicated that the commercial segment remains highly competitive, and there are signs of a further easing of lending standards and terms, most notably for C&I loans.

For the year ended June 30, 2005, C&LD loans registered the fastest rate of growth of any loan category, rising by nearly 32% to 4.46% of average assets. During the same time period, C&I loans also experienced a solid growth rate of 11.7%, reaching 10.11% of average assets at June 30, 2006. Although CRE loans remained steady at 7.46% of average assets, their one-year growth rate approached 10%.

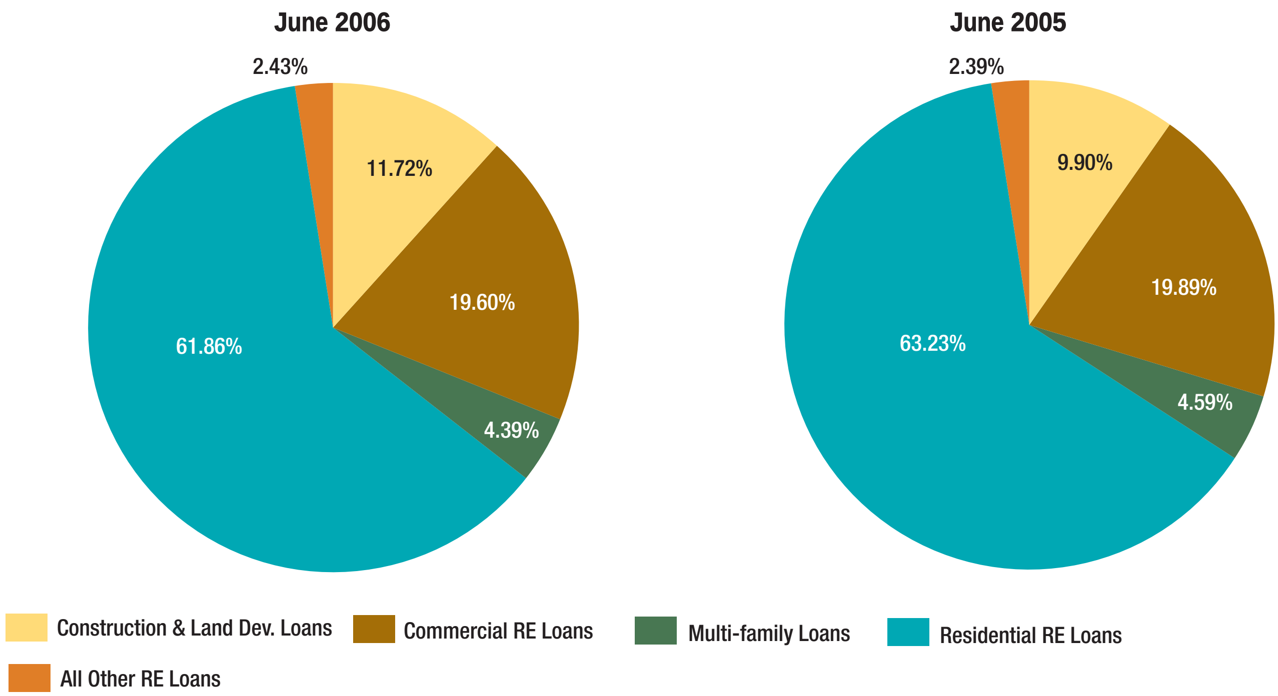
Within the loan portfolio, C&LD loans represent an increasing percentage of the overall portfolio, rising from 6.08% of total loans as of June 30, 2005 to 7.28% of total loans as of June 30, 2006. During the same period, C&I loans increased modestly as a percentage of total loans, rising from 16.29% to 16.50%, while CRE, multifamily and residential real estate loans dropped slightly (See chart).

Real estate loans, as a percentage of the overall loan portfolio, continue to rise, reaching 62.10% of total loans at June 30, 2006 as compared with 61.39% one year ago. Within the real estate loan segment, the strength in the commercial segment has offset a softening in the consumer mortgage sector. Notably, commercial real estate loans (CL&D, CRE, and multifamily) reached 35.7% of total real estate loans, an increase of nearly 1.4 percentage points from June 30, 2005. The growth in commercial real estate lending has been centered largely in C&LD loans (See chart).

There also has been decreased dependence on residential real estate loans, as 1-4 family residential real estate loans dipped from 63.23% of total loans (23.74% of average assets) at June 30, 2005 to 61.86% of total loans (23.53% of average assets) at June 30, 2006. Within this asset class, the composition also has shifted somewhat over the past year. In response to rising interest rates, first mortgage loans have slipped from 17.35% to 16.99% of average assets. During the same period, home

Chart 4

Selected Real Estate Loan Categories as a Percentage of Real Estate Loans



equity lines of credit, which generally carry a variable rate feature, have dropped from 5.10% to 4.82% of average assets, in favor of fixed-rate home equity loans, which grew from 1.27% to 1.72% of average assets. Although equity lines still represent a larger asset class than fixed-rate equity loans, consumers increasingly have been turning to the fixed-rate product as increases in short-term interest rates persisted through the second quarter. These increases eventually translate to higher borrowing costs for those consumers with variable interest rate lines of credit.

The consumer segment is likely to experience some continued softness in light of both the ongoing slowing in the housing market and higher energy costs. In response to these developments, some banks are considering an expansion into higher-yielding products such as subprime and alternative or "nontraditional" mortgages.

Chart 5

Trends in the Allowance for Loan Losses

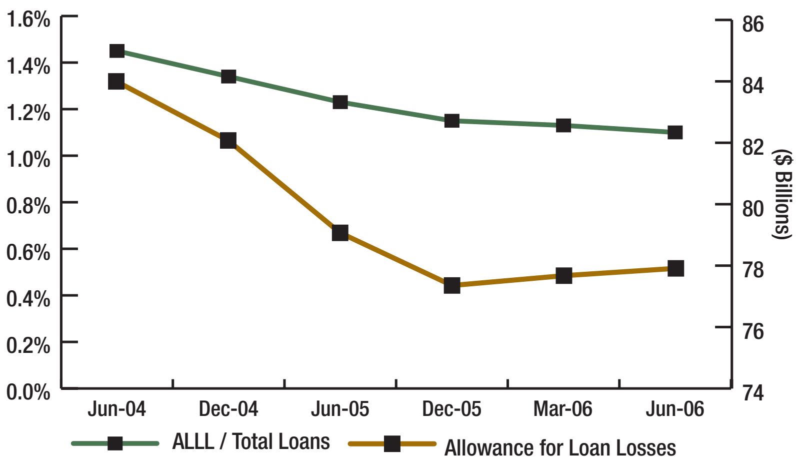
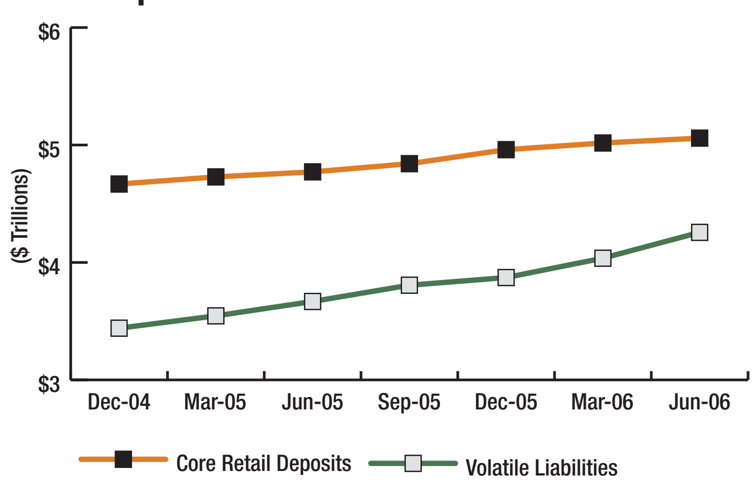


Chart 6

Core Deposits vs. Volatile Liabilities



Asset-quality measures remained healthy in the second quarter of 2006. The ratio of past-due loans to total loans rose only two basis points in the year ended June 30, 2006 to 1.48%. In addition, the ratio of noncurrent loans to total loans improved from 0.72% at June 30, 2005 to 0.70% at June 30, 2006, in part due to the overall loan growth in the industry. In spite of this improvement on a percentage basis, the total dollar volume of non-current loans rose from $46.4 billion to $49.3 billion during this period. Noncurrent loans secured by 1-4 family properties rose significantly in the year ended June 30, 2006, from nearly $15.0 billion (32.3% of noncurrent loans) to $20.2 billion (40.9% of noncurrent loans). Although the level of noncurrent loans secured by 1-4 family properties is higher than in June 2005, second-quarter figures reflect a modest decline from the end of the first quarter of 2006, when noncurrent loans secured by 1-4 family properties stood at $20.7 billion. The improvement in this category reflects a roughly $550 million decline in loans that were 90 days or more past due, while nonaccrual residential loans increased by only $6 million.

Loan-loss reserve levels as a percentage of total loans continued to drop, declining from 1.13% at March 31, 2006, to 1.10% at June 30, 2006. Although the ratio of the loan-loss reserve to total loans continues to slide, the total dollar amount of reserves has risen in each of the past two quarters and now stands at $77.9 billion as of June 30, 2006. In spite of these recent increases, reserve levels are lower than one year ago, when they stood at $79.1 billion (See chart).

In addition, over the past year the coverage ratio of noncurrent loans has dropped from 172.5% to 158.7%. Of concern is the continued trend of lower coverage and reserve ratios, coupled with the potentially higher levels of credit risk resulting from the continued strong demand in the commercial sector.

Limited Supply of Deposits Spurs Alternative Funding, Higher Costs

On the liability side of the balance sheet, the competition for core deposits continued to intensify, as banks' asset growth surged while core deposits failed to keep pace. As a percentage of average assets, core deposits continued their decline in the second quarter of 2006 to 43.90% from 44.76% in the previous quarter and 45.55% this quarter one year ago.

As a result, banks were forced to rely on alternative funding sources. Brokered deposits and foreign office deposits were the highest-growing components of total funding, rising 8.79% and 8.12% during the second quarter of 2006 respectively. Foreign office deposits have been showing fast growth over the past two quarters for the industry, concentrated mostly in the Midwest region of the United States and the South (mostly due to Bank of America, which is based in North Carolina) (See charts in later section). Fed funds and repurchase agreements also rose significantly by 6.26%, rounding out the remaining sources of funding for banks.

Net interest expense rose at a slower pace in the second quarter of this year as compared with the first quarter. U.S. banks have been able to moderate the increase in deposit offering rates, with the average rate on interest-bearing deposits rising only by 16 basis points (at 2.91% for the second quarter of 2006 compared with 2.75% the previous quarter). This occurred in spite of the Federal Reserve having raised the federal funds rate by 50 basis points from 4.75% to 5.25% during this period. Other sources of nondeposit funds contributing to the net interest expense all increased at a faster rate.

It should be noted that FHLB advances remained, as historically is the pattern, a popular source of funding for banks during this quarter after leveling off in the first quarter of 2006. The recent proposal by the Federal Housing Finance Board that would limit the amount of excess funds FHLB could lend to its member banks has yet to have a noticeable impact on the banking industry. This quarter FHLB had outstanding advances of $623 billion, an increase of $25 billion, or 4.2%, from the previous quarter's $598 billion.

Asset and Cost Efficiencies Targeted to Increase Earnings

Banks overall were more efficient in managing their expenses and asset mix during the second quarter of 2006 in an effort to further boost earnings under the existing margin-compression condition. Earning assets as a percentage of total assets increased during the second quarter of 2006 versus the prior quarter, indicating greater earning ability by the banks. Average assets per employee were at $5.24 million in the second quarter of 2006, compared with $5.16 million in the previous quarter and $4.92 million in the second quarter last year. Banks have been able to generate more assets per employee on average, which in turn would generate higher revenues relative to operating expenses. Large banks are better able to generate more assets per employee than smaller banks, benefiting from the economies of scale of the large

Chart 7

Volatile Sources of Funds — Growth Trends

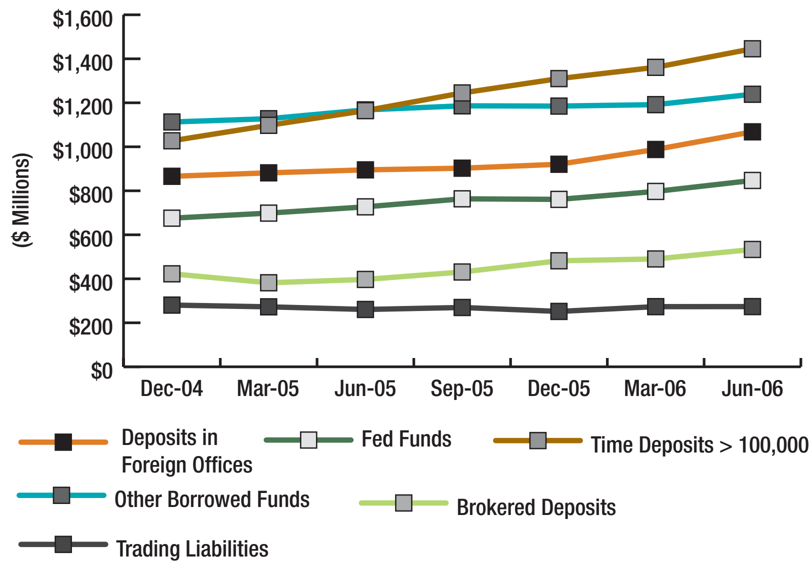
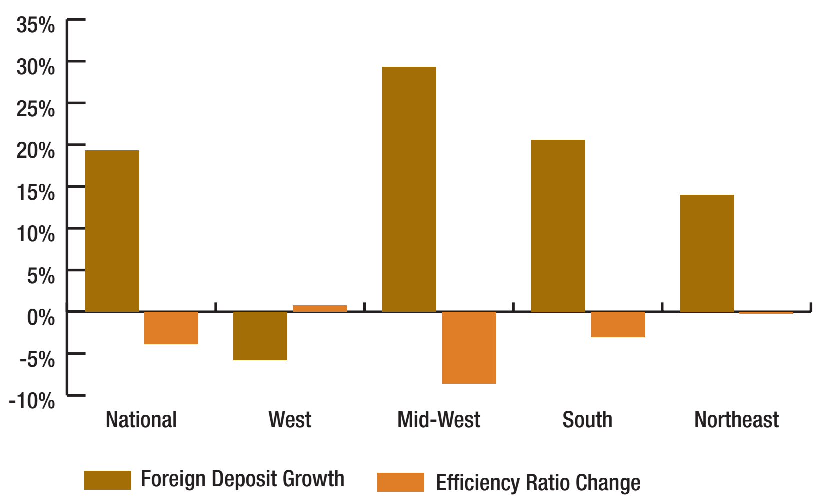


Chart 8

Foreign Deposit Growth & Changes In Efficiency Ratio June 2005-June 2006



banks. The Midwest region fared the best in efficiency based on asset dollars per employee, with an 8.4% increase over the same quarter last year, while the South was next with a 7.7% increase (see chart).

The efficiency ratio, which measures overhead costs to total interest and noninterest income, further demonstrated the great extent to which banks aggressively managed their overhead expenses. The ratio decreased to 56.45% this quarter from 56.93% last quarter and 57.41% this quarter a year ago. Total overhead expenses rose modestly by a mere 0.93% over the prior quarter, even as revenues increased by 2.59%. Interestingly, this is a continuation of the industry's improved efficiency during the first quarter of 2006, marking the first half of the year as an overall more efficient operation by U.S. banks in aggregate.

Both small and large banks exhibited similar improvement in their respective efficiency ratios during the second quarter of 2006 (see chart). Regionally, the Midwest again showed the highest improvement of 5.6 percentage points in its banks' efficiency ratio over the same quarter last year, followed by the South, which saw a 1.7 percentage point improvement. Among the contributing factors to these regions' greater improvement in their efficiency ratios than other regions, as compared with the same period last year, may be related to the same regions' ability to gather foreign deposits to supplement the limited supply of domestic deposits. Banks in these regions benefited from the lower cost of deposit funds overall.

Chart 9

Efficiency Ratio — Overhead Costs to Total Revenues

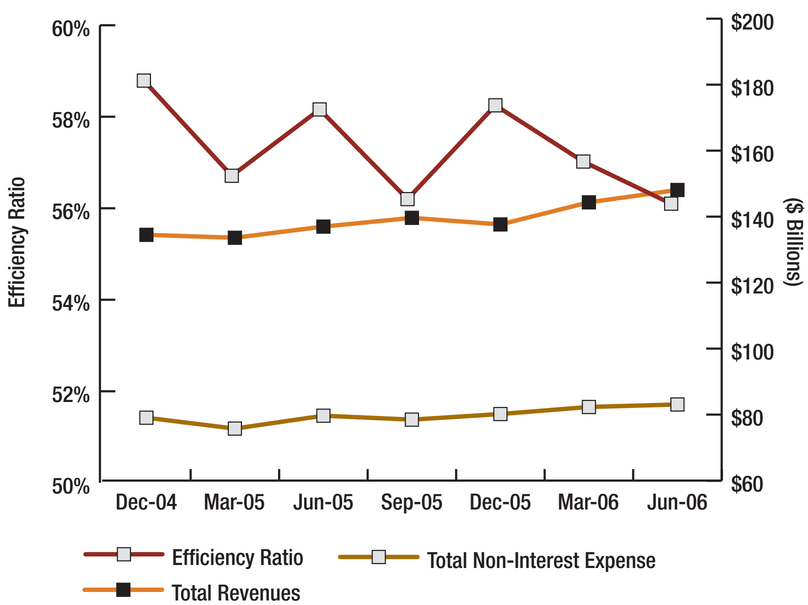
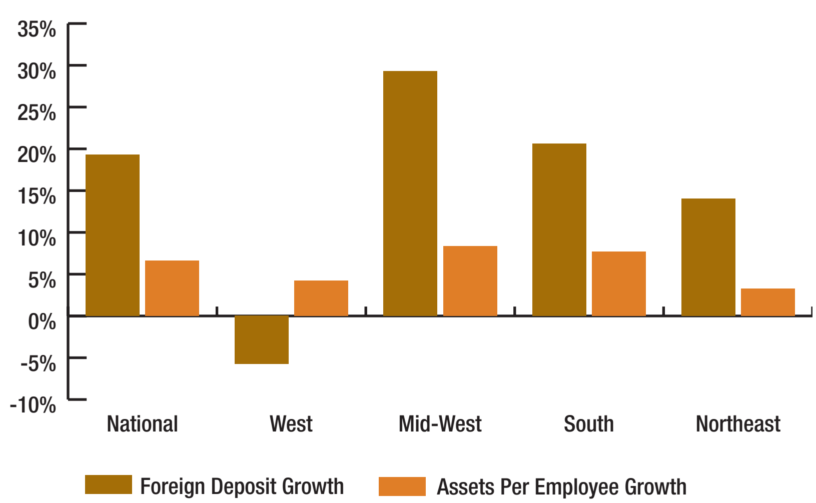


Chart 10

Foreign Deposit Growth & Assets Per Employee Growth, June 2005-June 2006



Summary

The Federal Reserve took a pause in its rate hikes in August of this year. While this would halt the rise in short-term rates, it remains to be seen whether the banking industry's net interest margin will reverse its decline as a result. The demand and supply for credit are just as powerful market forces as market interest rates in driving rates charged by banks on loans (or paid out by banks to gather funds on the other end). As noted in the latest July 2006 Senior Loan Officer Opinion Survey on Lending Practices, some banks are trimming spreads on loan rates over their cost of funds and reducing the cost of credit lines. The decline in underwriting standards by the industry and a continuing, strong demand for bank loans provided some relief in the industry's margin compression in the second quarter of 2006. For the second half of 2006, A.M. Best expects to see a larger shift in asset mix toward loan assets; ever-higher dependence on wholesale funding to fund the asset growth; and further erosion of asset quality — albeit from very favorable levels with ample wiggle room for the industry.

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 *http://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
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
www.ambest.com.hk