

U.S. Banking – Regulatory Review

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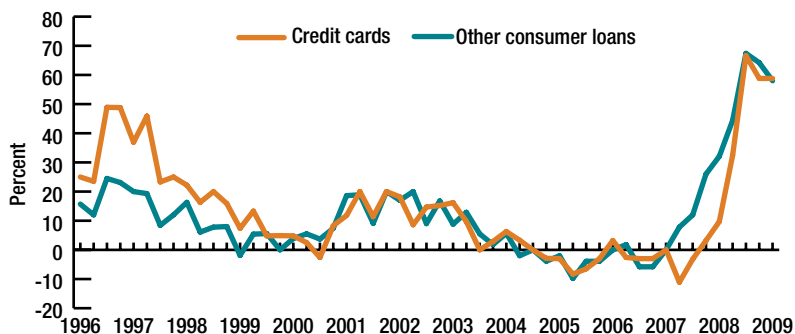
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Obama Administration, Treasury Revise Approach to Bank Bailout

The Treasury Department announced its Financial Stability Plan aimed at unlocking frozen credit markets and reviving the economy. It includes a public-private investment fund to help cleanse banks of their toxic assets. Other aspects of the plan seek to stabilize the housing market and inject more capital into banks through convertible preferred shares. Lawmakers, meanwhile, are working through their own reforms of last year's bailout program and other proposals that pertain to the respective deposit insurance funds of banks and credit unions.

- Through the Financial Stability Plan's consumer and business lending initiative, up to \$1 trillion in loans could be provided to support securitization markets by way of a Federal Reserve program.
- Banks that accept government funds face restrictions on dividends, share repurchases and acquisitions. They also will have to implement mortgage foreclosure mitigation programs.
- The Financial Stability Plan requires banks with more than \$100 billion in assets to undergo stress tests to determine whether they have enough capital to lend and absorb greater than projected losses.
- Under a plan to restore the federal fund that insures credit union deposits and guarantees uninsured shares of corporate credit unions, credit unions face a special assessment and will have to partially write off the 1% of their deposits that capitalize the insurance fund.
- Lawmakers are considering extending the restoration period for the FDIC's deposit insurance fund (DIF) to eight years from five years.
- Losses from bank failures to the DIF likely will be higher than last fall's estimate of \$40 billion for the 2008-2013 period, the FDIC's chief operating officer said in early February.
- The FDIC may consider extending its Temporary Liquidity Guarantee Program's maturity to 10 years from current limits through June 2012.

U.S. Banking – Net Percentage of Banks Tightening Standards for Consumer Loans (1996-January 2009)



Source: Federal Reserve Senior Loan Officer Survey



The Bailout's Next Phase

As the nation's banking system continues to suffer huge losses, the Obama administration announced in February another phase to the federal bailout of troubled institutions. Among the key policy changes to last October's bailout plan is an investment fund with participation by the federal government and the private sector that would buy banks' troubled assets and aid price discovery for illiquid securities.

Purchases of distressed and poorly performing assets from banks by the U.S. Treasury Department had been the original intent of the \$700 billion Troubled Asset Relief Program (TARP) that became law last October as part of the Emergency Economic Stabilization Act (EESA). The Treasury Department, however, switched gears less than two weeks after the EESA's passage in favor of direct injections of capital into banks through its \$250 billion Capital Purchase Program (CPP). But as banks continued to write down the value of loans and securities they held in recent months, more calls have come from regulators to rethink the original intent of the TARP.

A crucial stumbling block for purchasing banks' toxic assets has been pricing the securities. Paying too high a price would expose taxpayers, while paying "fire-sale" prices would reprice the market and potentially result in another round of severe write-downs for banks holding the bad debt. Under the Obama administration's Financial Stability Plan, unveiled on Feb. 10, a new "Public-Private Investment Fund" would use public financing to leverage private capital on an initial scale of as much as \$500 billion, potentially expanding to \$1 trillion. The fund would buy those toxic assets that are hampering lending and help in determining prices for these illiquid assets. Final terms of how the investment fund would be structured are expected over the next few weeks.

Other major pieces of the proposal include another round of capital injections into banks. The terms for accepting federal funds, though, would be more stringent than under the CPP – the TARP program under which the Treasury purchases preferred shares in the nation's banks. Banks would have to undergo examinations, or "stress tests," to determine that those in

need of government funds still would be healthy enough to lend and withstand economic downturns. Federal banking regulators also would institute uniform standards to help clean up and strengthen banks.

Those banks undergoing stress tests would have access to a capital buffer from the

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Treasury in the form of contingent equity through the new Capital Assistance Program. Unlike the CPP, companies participating in the Capital Assistance Program would receive an investment in preferred shares that could convert into common equity if needed. Dividend rates for the convertible preferred shares were not provided, though the Treasury Department said the conversion price would be set at a “modest discount” from the prevailing level of the bank’s stock price as of Feb. 9. Financial institutions accepting capital from the government would face restrictions on dividends, stock repurchases and acquisitions. The banks also would be required to demonstrate how government assistance would expand lending.

The plan also would pump more money into efforts to modify mortgage loans. Banks that accept government funds would be obligated to participate. The plan commits \$50 billion to reduce monthly payments and sets standards for modifications for government and private programs.

The Obama administration’s Financial Stability Plan envisions an expanded role for a Federal Reserve lending program announced last November but that has yet to begin operations. The facility known as the Term Asset-Backed Securities Loan Facility (TALF) initially was to have a capacity of \$200 billion to aid liquidity in the market for securities backed by new and recently originated consumer and small business loans. The facility, though, could be expanded to as much as \$1 trillion in financing and include other assets such as securities backed by commercial real estate loans and private-label mortgages. The lending facility’s term already has been extended to three years from one year.

TARP Reform Advances in House

Meanwhile, provisions within TARP itself are under scrutiny with reform legislation that passed in the House of Representatives in late January. Among the legislation’s provisions is a requirement that the treasury secretary formalize a foreclosure prevention and mitigation plan. The bill also allocates from \$60 billion to \$100 billion of the second \$350 billion of TARP funds to foreclosure relief.

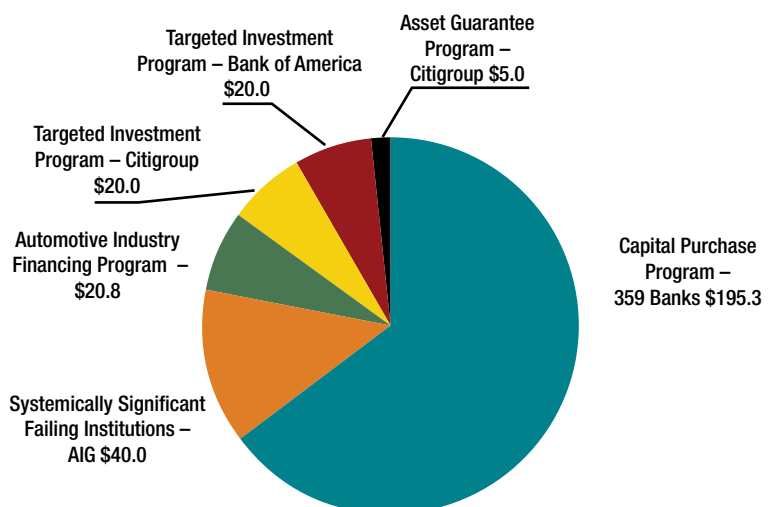
Through January, more than \$301 billion had been allocated under the first \$350 billion installment of TARP, according to figures from the Treasury Department. However, much of that – about \$195.3 billion – represented investments in nearly 360 financial institutions through the CPP (see **Exhibit 1**).

The legislation known as the TARP Reform and Accountability Act would require banks that receive TARP aid to report on how those funds are being used. The bill also would expand available funds under the program to aid consumer lending and municipalities struggling because of the ailing economy. A section of the bill, for example, gives the Treasury secretary explicit powers to invest TARP funds in consumer loans, municipal securities and even commercial real estate loans. The emphasis on increasing the flow of credit is one of several areas where the Obama administration plans to allocate TARP funds.

Lawmakers and regulators have been keen to reignite lending in the wake of the nation’s severe economic downturn. Recent data from the Federal Reserve’s Senior Loan Officer Survey demonstrate that banks have severely tightened their lending standards for both mortgage and consumer loans (see **Exhibit 2**).

The Federal Reserve already put programs in place late last year to support the mortgage market and consumer lending. In late November, the Fed said it would purchase

Exhibit 1
Funds Allocated Under TARP
(\$ Billions)



Source: Treasury Department, through January 2009

as much as \$600 billion in mortgage-backed securities and debt issued by Fannie Mae and Freddie Mac to reduce costs and increase the availability of credit in the housing market. The Financial Stability Plan discussed above envisions a commitment to expand those efforts if needed to keep mortgage rates low.

The TARP reform package has several other provisions affecting the nation's banking sector. It would make permanent the \$250,000 limit on deposit insurance coverage from the Federal Deposit Insurance Corp. (FDIC). That limit was increased from \$100,000 in October 2008 but was set to expire in December 2009. Separate legislation has been introduced that includes several FDIC-related provisions, which are discussed below in this report.

Credit Unions Seek TARP Funds

Until recently, the CPP was limited to public and private financial institutions. In January, however, guidelines for S Corporations (S Corps) – banks that choose that tax election – were released to allow them to access TARP funds through the CPP. The Treasury Department has yet to issue a term sheet for mutual institutions to participate in the CPP. Meanwhile, credit unions – cooperatives owned by their members – have been unable to access any TARP funds, even though they were

included in the EESA's definition of a financial institution.

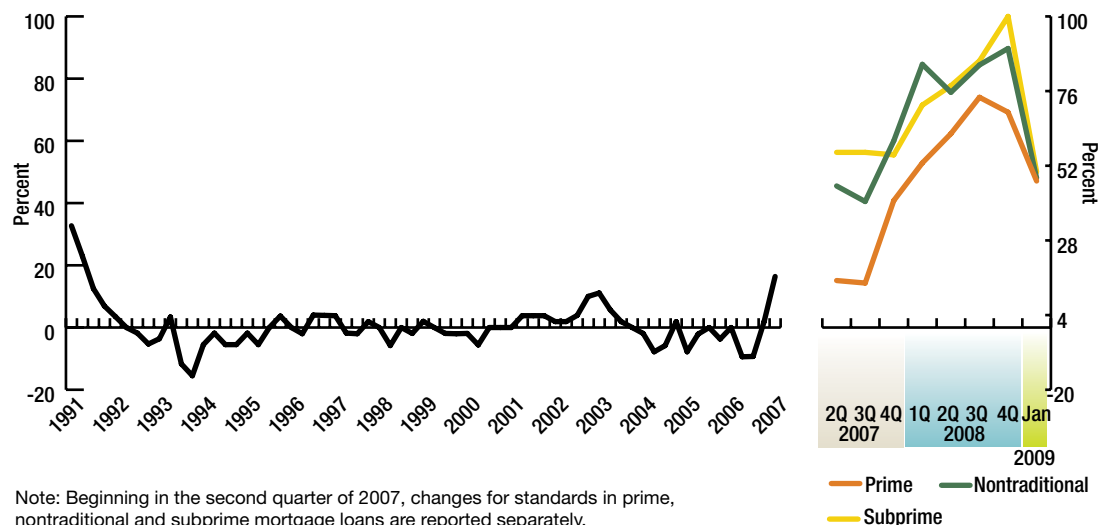
Credit unions would be able to access TARP funds under an amendment included in the House's TARP reform bill, though it is not known whether the Senate would agree to the provision. The amendment would revise the statutory definition of a credit union's net worth. That change would allow the calculation of a credit union's net worth to include any "donated equity," or government assistance such as funds from TARP, guarantees of loans from the Small Business Administration and any emergency funds from the National Credit Union Administration (NCUA), the agency that regulates federal credit unions.

Credit unions, it was thought, would benefit from the Treasury Department's original intent of TARP – the purchase of poorly performing mortgage securities and other troubled assets. But former Treasury Secretary Henry Paulson said in a speech in mid-November that purchasing illiquid mortgage-related assets would not be the most effective way to use TARP funds at the time.

Relief for credit unions has become more important in recent months, particularly as large corporate credit unions that provide payment and clearing services to other credit unions have suffered liquidity problems. There are 28 corporate credit unions

Exhibit 2

U.S. Banking – Net Percentage of Banks Tightening Standards For Residential Mortgages (1991-January 2009)



Note: Beginning in the second quarter of 2007, changes for standards in prime, nontraditional and subprime mortgage loans are reported separately.
Source: Federal Reserve Senior Loan Officer Survey

around the country servicing roughly 7,900 credit unions.

Over the past year, though, many corporate credit unions have experienced a reduction in the value of their investment portfolios. In addition, a “virtual freeze-up” for trading in some types of securities has undermined the stability of the corporate credit union system, according to the NCUA. The system holds about \$64 billion of investments in mortgage- and asset-backed securities, but corporate credit unions reported about \$18 billion in unrealized losses on securities through November, the NCUA said.

Although actual losses could be less in a more liquid market, the total capital in the corporate credit union system is about \$8.7 billion, which forced the NCUA to unveil a series of actions to stabilize the system. In late January, the NCUA had to inject \$1.0 billion into Lenexa, Kan.-based U.S. Central Federal Credit Union. The NCUA made the infusion after U.S. Central said it expected a \$1.1 billion net loss for 2008 due to \$1.2 billion of write-downs on residential mortgage-backed securities.

The NCUA also issued a guarantee of uninsured shares at corporate credit unions through February 2009 and established a voluntary guarantee program through December 2010. The guarantee results in a liability initially estimated to be \$3.7 billion for the National Credit Union Share Insurance Fund (NCUSIF). The NCUSIF is the federal fund that insures members’ deposits in credit unions – currently to a limit of \$250,000.

The NCUA based its liability estimate on participation of all corporate credit unions in the guarantee program; potential credit losses within their securities portfolios; and other factors that could impact guarantee payments. The NCUA said the figure could change significantly, depending on credit loss estimates and other factors. The NCUA’s capital infusion into U.S. Central will require federally insured credit unions to partially write off the 1% of their deposits that help capitalize the NCUSIF. They also will face a premium assessment as part of the NCUA’s plan to restore the NCUSIF’s equity ratio of insured deposits to 1.30%.

The projected cost for the average credit union from the share guarantee and the capital infusion to U.S. Central would be a 62-basis-point decline in return on assets and a 56-basis-point reduction in the net worth ratio, the NCUA said. The impact for some credit unions could be more substantial, according to the National Association of Federal Credit Unions (NAFCU), a trade group.

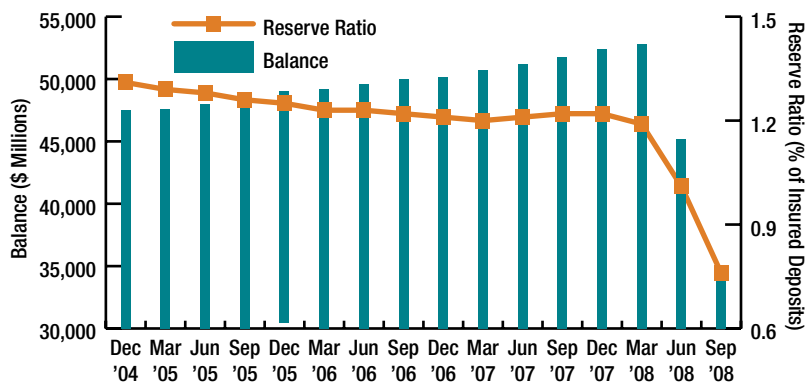
NAFCU estimated that the NCUA’s plan would result in about 151 federally insured credit unions experiencing a decline in the regulatory measure of their net worth ratio, known as a prompt corrective action (PCA) code. NAFCU has urged the NCUA to consider adding money to the deposit insurance fund by borrowing from the central liquidity facility (CLF), the NCUA’s facility that lends to credit unions experiencing shortfalls in liquidity. The trade group also proposed that the CLF be used temporarily to infuse capital into the corporate credit unions, and that the NCUA ask the Federal Reserve to grant corporate credit unions access to the discount window – overnight loans directly from the Fed.

Deposit Insurance, Bank Liquidity Bills Advance

To help offset the strain on credit unions and the NCUSIF, the House Financial Services Committee in February approved a provision in a series of banking liquidity and lending bills that would lengthen the time that credit unions have to restore or recapitalize the NCUSIF. The provision would let

Exhibit 3

U.S. Banking – FDIC Deposit Insurance Fund Balance & Reserve Ratio (4Q 2004-3Q 2008)



Source: Federal Deposit Insurance Corp.

credit unions pay the estimated \$5 billion premium charge needed to recapitalize the NCUSIF over five years rather than in one payment, according to NAFCU's analysis.

For the FDIC, meanwhile, the 25 bank failures in 2008 and another six failures that occurred in January 2009 continue to reduce the FDIC's deposit insurance fund, or DIF (see **Exhibit 3**). In addition, the DIF's reserve ratio would face an immediate dilutive effect under proposed legislation to permanently increase deposit insurance coverage to \$250,000, the FDIC says. Lawmakers are considering additional proposals to extend the DIF's restoration period; increase the FDIC's borrowing capacity from the Treasury Department; and enable the FDIC to assess bank holding companies (see **Exhibit 4**).

Adjusting the FDIC's line of credit with the Treasury Department would ensure the public has no confusion or doubt about the government's commitment to insured depositors, FDIC Chief Operating Officer John Bovenzi said in testimony before the House Financial Services Committee in early February. Bovenzi also said losses to the deposit insurance fund from bank failures probably would be higher than the FDIC's previous estimate last fall that bank failures could cost \$40 billion in the 2008-2013 period. Bovenzi cited additional data on the industry's performance and the deteriorating conditions in the economy and the industry.

Special assessments under the FDIC's systemic risk exception that include bank holding companies would help pay for the FDIC's Temporary Liquidity Guarantee Program (TLGP) if it incurred losses. The voluntary program, unveiled in October, guarantees new senior unsecured debt issued by banks, thrifts or

holding companies on or before June 30, 2009 until June 30, 2012. Issuers pay annualized fees based on the amount of debt issued. Outstanding debt covered by a TLGP guarantee totaled about \$221 billion as of Jan. 28, according to the FDIC.

In supporting the ability to assess bank holding companies, the FDIC noted that the benefits of the TLGP accrue more broadly to bank holding companies, even though it is only authorized to assess insured depository institutions. Amending current law would give the FDIC the ability to implement rulemaking on assessments in a manner that isn't procyclical and does not exacerbate problems in the financial industry, Bovenzi said in his congressional testimony.

Separately, the FDIC said in January that it plans to propose changes to the TLGP that would extend the maturity of the guarantee to as long as 10 years. The debt would have to be collateralized and the issuance supportive of new consumer lending.

CPP Guidelines Released for S Corps

Smaller banks that were excluded from the Treasury Department's Capital Purchase Program (CPP) now are able to apply for capital injections from the government following guidelines issued in January for so-called "S Corporations."

Subchapter S Corporations (S Corps) – meaning institutions that chose that tax election under the Internal Revenue Code – weren't able to participate in the CPP when it was unveiled in October. The program's terms at that time would have jeopardized S Corps' tax status, as these institutions can have only one class of equity and wouldn't have been able to issue preferred shares to the Treasury. S Corps also aren't able to issue securities to institutions.

To overcome those hurdles, the Treasury will make its investment in S Corps through subordinated debt rather than preferred shares. S Corps can sell anywhere from 1% to 3% of their risk-based assets, to a maximum of \$25 billion of the debt, to the Treasury. That amount is the same as other banks that already have sold preferred shares under the CPP. The Treasury also plans to immediately exercise warrants granted under the agreement of up to 5% of

Exhibit 4

U.S. Banking – Proposed Amendments to FDIC Act, Federal Credit Union Act

- Makes permanent the \$250,000 deposit insurance limit for FDIC-insured banks, federally insured credit unions.
- Raises the FDIC's line of credit with the Treasury Department to \$100 billion from \$30 billion.
- Extends the restoration period for the FDIC's deposit insurance fund to eight years from five years.
- Expands the FDIC's systemic risk special assessments to bank holding companies.

Source: House Financial Services Committee

its purchase of subordinated debt. The warrants pay an interest rate of 13.8% annually.

Some of the terms for S Corps differ from those of other financial institutions that have participated in the CPP. S Corps, for example, will pay an annual interest rate of 7.7% on the subordinated debt. That rate steps up to 13.8% after year five. Those interest rates exceed the 5% annual dividend rate banks pay on preferred shares issued to the Treasury, along with the 9% annual reset after the fifth year.

S Corps are paying higher rates because the Treasury's investment is through debt, which can be deducted from taxes. But dividend payments on preferred shares aren't tax deductible. To equalize the effect on all institutions participating in the CPP, then, Treasury applied a 35%

effective tax rate to the S Corp senior securities. That equates to after-tax effective rates of 5% and 9%, respectively, the same rates as for preferred securities issued by banks under the CPP.

The subordinated debt issued to the Treasury qualifies as Tier 1 capital for S Corps structured as bank holding companies. Federal banking regulators, though, will have to issue an interim rule designating the securities as Tier 1 capital before the Treasury's investment. The Treasury's term sheet for S Corps also had to include the ability for bank holding companies to defer interest payments for debt securities of the banks to qualify as Tier 1 capital. Holding companies, then, are able to defer interest for as long as 20 quarters, though unpaid interest is cumulative and compounds at the applicable interest rate at the time.



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