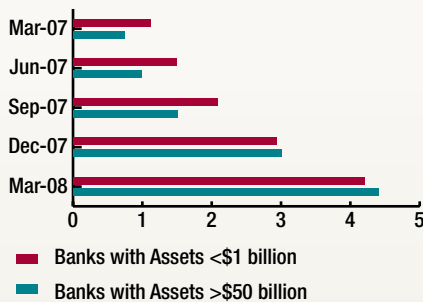


**U.S. Banking – 2008 Issue Review,
Construction Loans**

September 8, 2008

Sector
Banking

**Percent of Noncurrent
Construction and Land Loans**



Source: FDIC. A.M. Best

Related Reports

2008 Special Reports:

U.S. Banking – U.S. Banking Regulatory Review

U.S. Banking – U.S. Banking 2nd Quarter and July Interest Review

Rating Analysts

Rating Analysts

Diane Goodheart, Senior Financial Analyst
+1 (908) 439-2200 Ext. 5649
Diane.Goodheart@ambest.com

Kevin McFadden, Associate Financial Analyst
+1 (908) 439-2200 Ext. 5242
Kevin.McFadden@ambest.com

BestWeek subscribers have full access to all statistical studies and special reports at www.ambest.com/research. Spreadsheet files also are available.

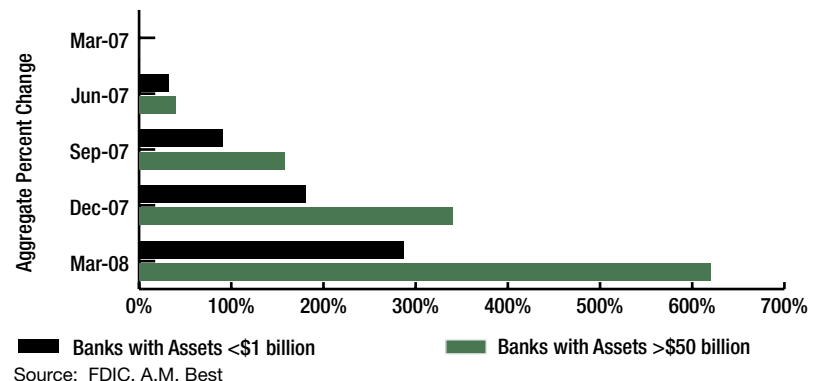
Small Banks Fare Better Than Larger Banks in Construction Loan Sector

The current real estate correction is likely to have the biggest impact on construction loan portfolios of banks with the most lenient underwriting standards and those whose construction loans are concentrated in geographic areas hardest-hit by construction industry declines. Given industry wide increases in construction loan noncurrent rates, charge-offs, and Real Estate Owned in the past two quarters, all sizes of banks are subjects of concern.

Some differences exist, however, between banks of various asset sizes' performance. While construction loans make up a larger percentage of smaller U.S. banks' total book of business, larger banks have seen the sharpest increases in charge-offs and nonperforming assets. This indicates small banks, under \$1 billion, may have better knowledge of borrowers or tighter underwriting standards and have positioned themselves more favorably to weather the storm.

- U.S. banks will continue to struggle to work through existing loans, while having limited opportunities to replenish construction portfolios with sound, newly-originated loans.
- In the first quarter of 2008, the smallest U.S. banks – those having assets under \$1 billion – had the lowest rate of construction charge-offs, the lowest construction loan noncurrent rate, and the lowest rate of loans emerging 30-89 days past due.
- Large banks, banks with assets more than \$50 billion, led the industry surge in delinquencies between the fourth quarter of 2007 and the first quarter of 2008 with a 191.4% six-month increase in noncurrent construction loan rates.
- U.S. banks' current capital is extended to the point where further lending expansion is in doubt given their troubled portfolios and declining loan demand.

Foreclosed Construction Real Estate Owned to Total Construction Real Estate Loans



Source: FDIC, A.M. Best



As Nonperforming Construction Loans Rose, Smallest Banks Fared Best

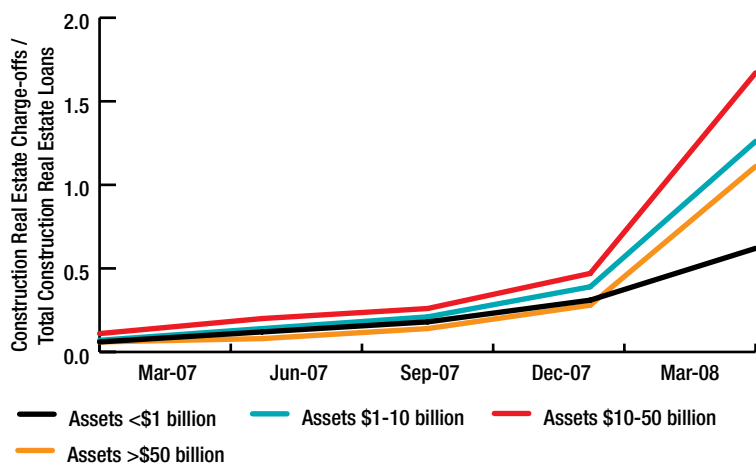
As the U.S. banking industry works its way through a difficult real estate downturn, banks are losing ground in the face of relentlessly rising noncurrent loans. The high noncurrent rate of construction loans is a particularly alarming trend given the risks they pose to earnings. The noncurrent rate for construction loans rose to 4.7% for U.S. banks as of March 31, 2008, after having been at 1.9% as recently as Sept. 30, 2007.

Construction loan performance has varied across bank asset-size groupings. In the first quarter of 2008, the smallest U.S. banks – those having assets under \$1 billion – had the lowest rate of construction charge-offs, the lowest construction loan noncurrent rate, and the lowest rate of emerging past due construction loans. However, they retained a greater percentage of real estate acquired from previously foreclosed construction loans than other banks.

The highest construction loan charge-offs and construction loan noncurrent rates were reported by banks having between \$10 billion and \$50 billion in assets. Across the board however, banks of all sizes together charged-off more construction loans and experienced sharp rises

in construction loan delinquencies in the first quarter of 2008 (see **Exhibit 1**). As leading economic indicators continue to signal reduced future construction activity, U.S. banks will continue to struggle to work through existing loans, while having limited opportunities to replenish construction portfolios with sound, newly-originated loans.

Exhibit 1
Construction Real Estate Loan Charge-Offs Worsen Mostly for Large Banks
 (Mar 2007-Mar 2008)



Sources: FDIC, A.M. Best

A.M. Best Company

Special Report

September 8, 2008

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

SENIOR VICE PRESIDENTS
Manfred Nowacki, Life/Health
Matthew Mosher, Property/Casualty
Rita L. Tedesco, Information Services

ANALYTICAL SERVICES GROUP
John Lafayette, Assistant Vice President
Carole Ann King, Assistant Manager
Stephen Brown Klinger, Senior Business Analyst
Carol Demyanovich, Senior Business Analyst
Joe Niedzielski, Senior Business Analyst
Brendan Noonan, Senior Business Analyst
Laura McArdle, Business Analyst
Jey Thanapal, Business Analyst
Thomas Dawson IV, Associate Editor

PRODUCTION
Angel Negron, Senior Designer

Copyright © 2008 by A.M. Best Company, Inc., Ambest Road, Oldwick, New Jersey 08858. ALL RIGHTS RESERVED. No part of this report or document may be distributed in any electronic form or by any means, or stored in a database or retrieval system, without the prior written permission of the A.M. Best Company. For additional details, see Terms of Use available at the A.M. Best Company Web site www.ambest.com.

Best's Ratings reflect the A.M. Best Company's opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. These ratings are not a warranty of an insurer's current or future ability to meet its contractual obligations, nor are they a recommendation to buy, sell or hold any security. Further, any and all information herein is provided "as is," without warranty of any kind, expressed or implied. A.M. Best is compensated for its interactive rating services. These rating fees can vary from US\$ 5,000 to US\$ 500,000. In addition, A.M. Best may receive compensation from rated entities for non-rating related services or products offered.

A PDF copy of all full banking special reports plus all related spreadsheet files of the report data can be downloaded at no additional cost from our Web site at <http://www3.ambest.com/banks/>.

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



Largest U.S. Banks Saw Highest Rises in Noncurrent Construction Loans

Just prior to the fourth quarter of 2007, the best-performing construction loan portfolios were held by banks with more than \$50 billion in total assets. These larger banks' annualized quarterly charge-off rates were below 0.2% per quarter, while their noncurrent construction rate was less than 1%. However, the surge in delinquencies in the fourth quarter of 2007 and the first quarter of 2008 has had a dramatic impact on the loan performance of these larger banks, as banks with more than \$50 billion in assets led the industry with a 220.5% six-month increase in noncurrent construction loan rates. The smallest banks in the U.S. experienced the least, but still a dramatic, 104.2% increase in the same period. This pattern is consistent with 2002, another difficult year for banks, when banks with more than \$50 billion in assets reported the highest percentage increases in nonperforming construction loans in the industry (see **Exhibit 2**).

The surge in nonperforming construction loans for banks over \$50 billion occurred despite these banks raising net charge-off rates for construction loans. Had charge-off rates been consistent with historical standards, the number of nonperforming construction loans in banks' portfolios would have been much higher. The six-month increase in net charge-off rates was 99.9% for the industry. Banks over \$50 billion increased their net construction loan charge-offs by 183.1%, versus only 18.6% for banks having less than \$1 billion in assets. The first quarter of 2008 level was 13.9 times higher than the first quarter of 2007 for the total industry, yet 23.2 times - over two thousand percent - higher for banks having over \$50 billion in total assets.

Although banks with more than \$50 billion in assets saw larger percentage increases of nonperforming construction loans and net charge-offs, their construction loans make up a smaller percentage of their total loans and total assets than smaller banks (see **Table 1**).

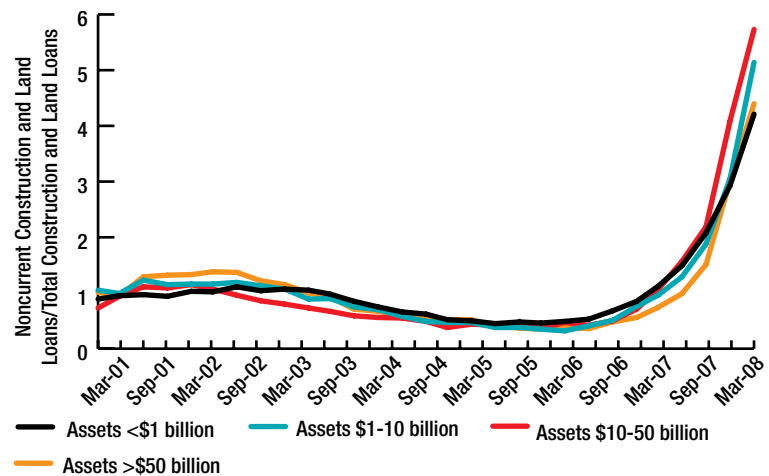
Additionally, the two middle groupings reported the highest overall levels of noncurrent loans as a percentage of their construction loan portfolios (see **Table 2**).

Banks in these asset ranges are of special concern because many of them also reported higher concentrations and thus have a higher overall exposure of construction lending.

Industry Concentrations in Construction Loans

Regulators have been concerned about commercial real estate and construction loan concentrations for some time. To heighten supervision of these institutions, banking regulators in 2006 issued calculations to track institutions having

Exhibit 2
Noncurrent Construction and Land Loans Skyrocket, Small Banks Fare Better
 (Mar 2001-Mar 2008)



Sources: FDIC, A.M. Best

Table 1
Relative Size of Construction Loan Portfolios

Bank Range By Total Assets	Construction Loans	Total Assets	% of Total Assets	Total Loans	% of Total Loans
<\$1 billion	\$158,563,680	\$1,512,358,643	10.49%	\$1,047,173,540	15.14%
\$1-10 billion	164,319,716	1,438,161,836	11.43	994,981,459	16.51
\$10-50 billion	79,299,728	1,669,229,127	4.75	1,066,652,893	7.43
>\$50 billion	229,634,562	8,749,745,977	2.62	4,859,079,369	4.73
All Banks	631,817,686	13,369,495,583	4.73	7,967,887,261	7.93

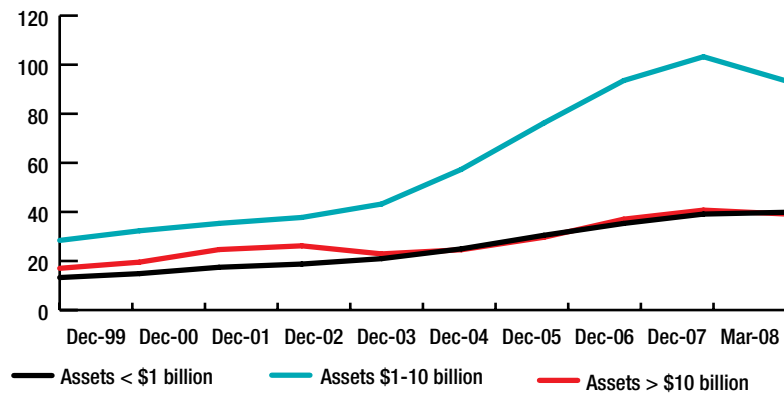
Sources: FDIC, A.M. Best

Table 2
Recent Noncurrent Construction Loan Rates

Bank Range By Total Assets	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08
<\$1 billion	1.12%	1.49%	2.08%	2.93%	4.21%
\$1-10 billion	0.96	1.29	1.88	3.05	5.14
\$10-50 billion	1.06	1.57	2.19	4.09	5.73
>\$50 billion	0.74	0.99	1.51	3.01	4.40

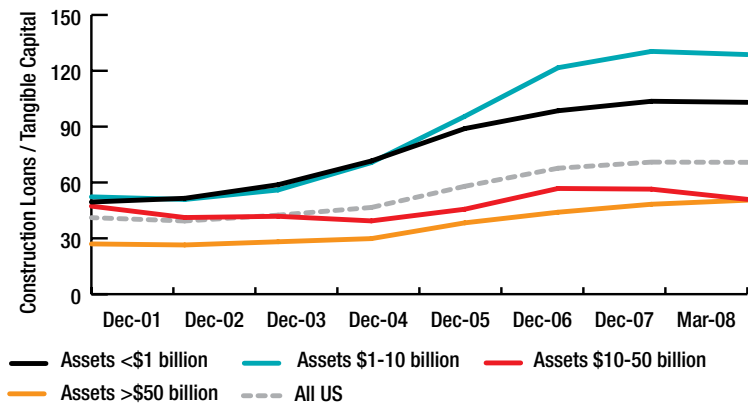
Sources: FDIC, A.M. Best

Exhibit 3
Construction and Development Loan Concentrations
 (1999-Mar 2008)



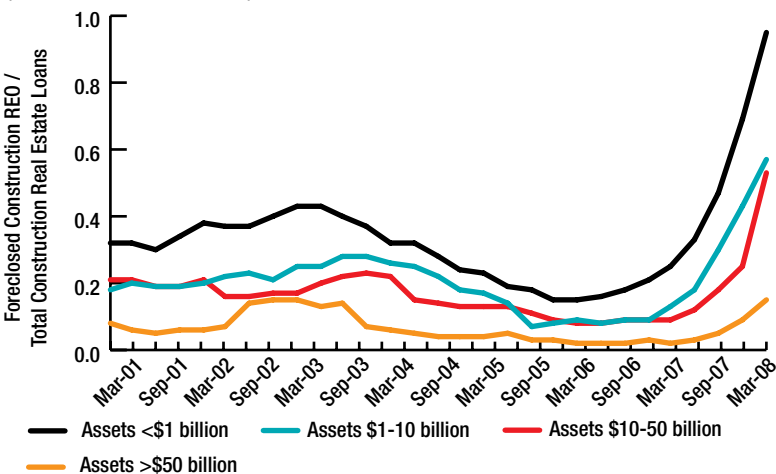
Sources: FDIC, A.M. Best

Exhibit 4
Leverage of Construction Loans in Banks' Portfolios
 (Dec 2001-Mar 2008)



Sources: FDIC, A.M. Best

Exhibit 5
Foreclosed Construction REO
 (Mar 2001-Mar 2008)



Sources: FDIC, A.M. Best

commercial real estate concentrations (A.M. Best released two special reports about Commercial Real Estate Concentrations in January and April of 2006). Despite regulators' efforts, however, construction and development loan concentrations continued to climb and reached an all-time peak as of year-end 2007 (see **Exhibit 3**).

The most pronounced concentrations of construction loans measured as a percentage of risk based capital were within the category of banks with \$1 billion to \$10 billion in assets.

Poor performance of real estate loans and construction and development lending have pressured more banks' capital cushions. During the first quarter, there were 90 banks on the so-called "problem list" compiled by the Federal Deposit Insurance Corp. (FDIC), up from 76 in the fourth quarter. Twenty institutions were added to the problem list during the first quarter and six were removed.

During Senate testimony in early June, FDIC Chairman Sheila Bair said 75% of the new problem institutions had concentrations in commercial real estate lending or construction and development lending, or both.

Levels of construction loans as a percentage of tangible capital increased in banks across the U.S., rising from 39.3% in 2002 to 70.8% as of March 31, 2008 (see **Exhibit 4**). U.S. banks with assets between \$1-10 billion had the highest increase of any bank size range, from 52.3% to 128.7%, during the same period. Banks over \$50 billion are the only asset-size group whose concentrations continued to increase through the first quarter of 2008.

Smallest U.S. Banks Have Highest Levels of Real Estate Owned Properties

Until recently, large banks have fared best in their ability to avoid accumulating larger portfolios of construction related real estate owned properties from foreclosed loans, relative to their total construction loan portfolios. However, from the fourth-quarter of 2007 to the first-quarter of 2008 the highest rate of increase in foreclosed

construction REO was by banks over \$50 billion, tripling from 0.05% to 0.15% (see Exhibit 5).

Despite leading the industry in the rate of increase, the actual levels of construction REO remain lowest for these larger banks. Banks under \$1 billion reported at the end of the first quarter 2008 that their level of REOs as a percentage of their construction loan portfolio was more than six times higher than the percentage reported by large banks.

The higher levels of construction related REO being carried by small banks, combined with significant increases in construction related charge-offs and noncurrent assets is cause for concern. In many cases, their REO problems involve halted construction projects. As banks fund these assets, they continue to accrue interest expenses while facing additional non-interest expenses related to managing all types of REO properties.

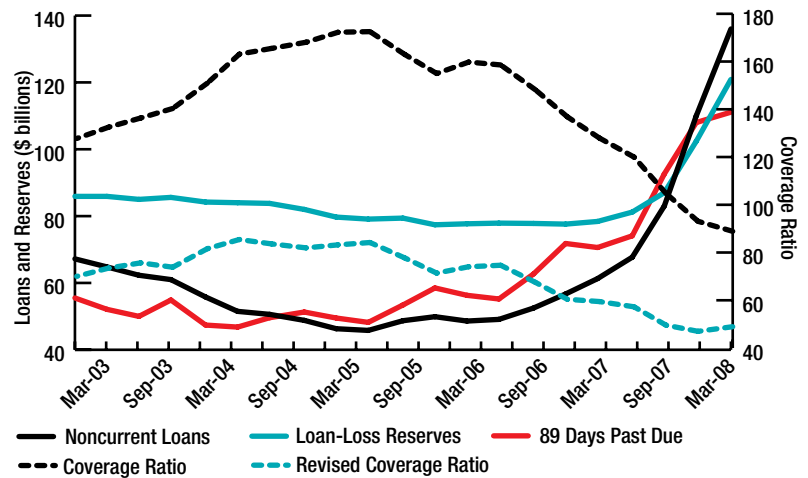
Capital and Loan Loss Allowance Levels – “Coverage” Ratio

As the banking industry copes with rising nonperforming assets, first quarter 2008 earnings were dampened significantly by \$37.1 billion, or 24% of net operating revenue, in loan loss provisions. Yet, despite high provisions and charge-offs, the Allowance For Loan and Lease Losses (ALLL) lost ground against rising levels of noncurrent loans.

The “coverage ratio,” a measure of loan loss reserves as a percentage of noncurrent loans, fell from 172.5% to 88.9% between June 2005 and March 2008, with aggregates for the smallest bank ranges all falling below the industry average (see Table 3). While banks with more than \$50 billion in assets generally have higher coverage ratios, across all asset sizes

Exhibit 6 Troubled Loans and Reserves Increase as Reserve Coverage Ratios Decline

(Mar 2001-Mar 2008)



Sources: FDIC, A.M. Best

Table 3
ALLL Coverage Ratio (Mar 2008)

Industry	Assets <\$1 billion	Assets \$1-10 billion	Assets \$10-50 billion	Assets >\$50 billion
88.88%	79.77%	75.63%	76.98%	96.37%

Sources: FDIC, A.M. Best

Table 4
Emerging 30-89 Day Past Due Construction Loans

Bank Range	March 31, 2008	March 31, 2007
Assets <\$1 billion	2.31%	1.19%
Assets \$1-10 billion	2.52	1.03
Assets \$10-50 billion	2.77	1.15
Assets >\$50 billion	2.45	0.99
All Banks	2.47	1.08

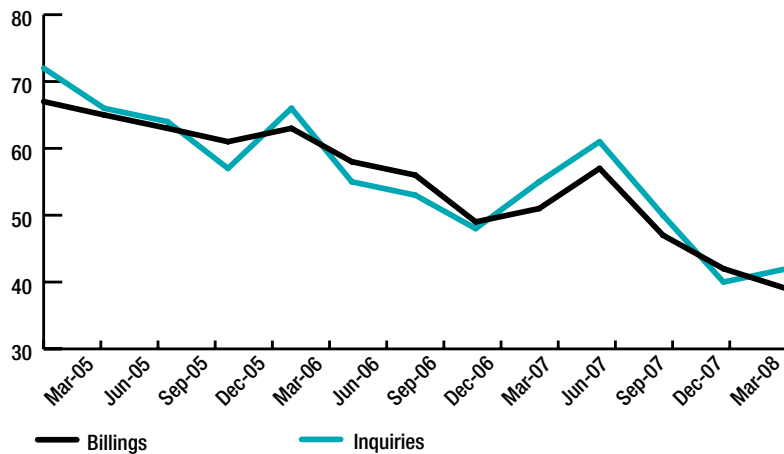
Sources: FDIC, A.M. Best

Table 5
Construction Loan Performance by Asset Size (Mar 2008)

Bank Range By Total Assets	Troubled Construction Loans				Total Troubled	Total Troubled as % of Tangible Equity
	Real Estate Owned	Net Charge-offs	Nonperforming Assets	30-89 Past Due		
<\$1 billion	0.95%	0.16%	4.21%	2.31%	8.09%	8.34%
\$1-10 billion	0.57	0.32	5.14	2.52	9.49	12.21
\$10-50 billion	0.53	0.42	5.73	2.77	10.70	5.45
>\$50 billion	0.15	0.28	4.40	2.45	8.11	4.10
All Banks	0.51	0.27	4.71	2.47	8.79	6.23

Sources: FDIC, A.M. Best

Exhibit 7
American Institute of Architects Residential
Diffusion Index
 (2005-Mar 2008)



Sources: FDIC, A.M. Best

Table 6
American Institute of Architects
Forecast for Construction

	Forecast (% change)	
	2008	2009
Nonresidential Total	-1.20%	-6.70%
Commercial Total	-4.50	-11.10
Office	-3.70	-12.30
Retail/Other Comm	-8.30	-9.90
Hotel	6.60	-9.90
Industrial Total	4.60	-5.50
Institutional Total	1.50	-0.20
Health	0.20	1.10
Education	2.70	-1.10
Religious	-11.70	-1.20
Public Safety	5.90	-1.90
Amusement/Recreation	3.60	-8.50

Sources: FDIC, A.M. Best

the ratio dropped below 100%, indicating that loan loss reserves are limited relative to nonperforming loans.

For the short term, there is little relief in the credit picture, shown by the continued increase in the 30-89 days past due loans category. Historically, these delinquencies are a precursor to more serious delinquencies. In contrast to the same period one year earlier, banks having total assets under \$1 billion reported the lowest levels of emerging past due construction loans, a possible indication of better knowledge of their borrowers. Across the industry, however, emerging past due construction loans remain sharply higher than years past,

indicating continuing increases of nonperforming construction loans in the quarters to come.

A look at REO, charge-offs, noncurrent rates, and emerging past dues (see **Table 5**) provides a snapshot view of division by asset size, indicating the greatest credit quality concerns are for institutions having between \$10-50 billion in total assets. The small banks continue to look better than other assets size groupings, yet their concentration levels are almost as high as the banks between \$1-10 billion in assets. Banks having over \$50 billion in total assets, which have almost \$230 billion in construction loans – far more than any other group of banks – have seen the sharpest deterioration in their portfolios.

Evidence suggests that one of the industry’s responses to nonperforming asset increases is capital preservation. When faced with the impact of high loan-loss provisions on earnings, many banks have responded by cutting dividend payments or suspending them entirely. Despite these actions, the amount of earnings retained totaled \$5.3 billion for the first quarter of 2008, down from \$9.4 billion in the same period in 2007. Capital ratios also decreased slightly. As banks have been boosting provisions and cutting dividends to preserve capital, loan growth rates have begun to slow. This has raised questions as to whether U.S. banks’ current capital is taxed to the point where further lending expansion is in doubt because of their troubled portfolios and declining loan demand.

Loan Growth and Construction Lending

Given these conditions, it is not surprising that overall loan growth for all types of lending slowed during the first quarter, though loan growth remained positive. However, the high rate of charge-offs and provisions, swelling of nonperforming assets, attempts by banks to preserve capital and depressed economic factors raise the possibility of negative overall aggregated loan growth in the future.

Augmenting these expectations, data and consensus forecasts suggest construction activities will continue to decline for some

time. As would be expected given well-publicized residential real estate woes, billings and inquiries at residential architecture firms have been falling. Index measurements of business levels at architecture firms have been below 50 for five consecutive months, according to the Architecture Billings Index (see **Exhibit 7**). The index is a nine-to-twelve month leading economic indicator of construction activity. It measures activity in billings with any score above 50 indicating an increase in billings, while an index reading below 50 indicates a contraction in billings.

The most recent reading in June was 46.1. The March index reading of 39 was the lowest since the American Institute of Architects (AIA) began the index in 1995.

The AIA also issues forecasts of total non-residential construction. The group forecasts that total nonresidential construction will contract by 1.2% in 2008 and by 6.7% in 2009. (see **Table 6**).

As leading indicators suggest continuing declining construction loan demand, banks may find it increasingly difficult to

strengthen their portfolios by originating sound new loans. As existing portfolios see higher noncurrent rates despite higher charge-offs, construction loan portfolios may see negative growth in the quarters ahead.

A decline in real estate prices along with a general loosening of underwriting standards has greatly compounded industry difficulties. The recent seizure of IndyMac by the FDIC is indication that it is not just the smaller banking organizations that have concentrations exposing them to increased risks. Though a number of factors played into its seizure, 34.3% of IndyMac's nonaccrual assets were construction loans as of March 31, 2008. Since the current real estate correction is having biggest impact on construction loan portfolios of banks with the most lenient underwriting standards and those whose construction loans are concentrated in geographic areas hardest-hit by construction industry declines, it appears smaller banks are better positioned to weather the storm, but banks of all sizes fitting this description are at high risk.



Founded in 1899, A.M. Best Company is a global full-service credit rating organization dedicated to serving the financial and health care service industries, including insurance companies, banks, hospitals and health care system providers. For more information, visit 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
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