

U.S. Banking Issues
August 27, 2007

Sector
Banking

**Classification of
Bank-Held Securities**

	1994	2006
Available for Sale	49%	92%
Held to Maturity	51%	8%

Related Reports

2007 Special Reports:

Fed Pressured to Address Subprime ARMS

Inflation Concerns Push Yield Curve Toward Normal Slope

Methodology:

A.M. Best's Rating Methodology for Banks

Rating Analysts

James Barnes, CFA Financial Analyst
(908) 439-2200 Ext. 5433
James.Barnes@ambest.com

Tam Nguyen, Financial Analyst
(908) 439-2200 Ext. 5169
Tam.Nguyen@ambest.com

Full report and data available at
www.ambest.com/research

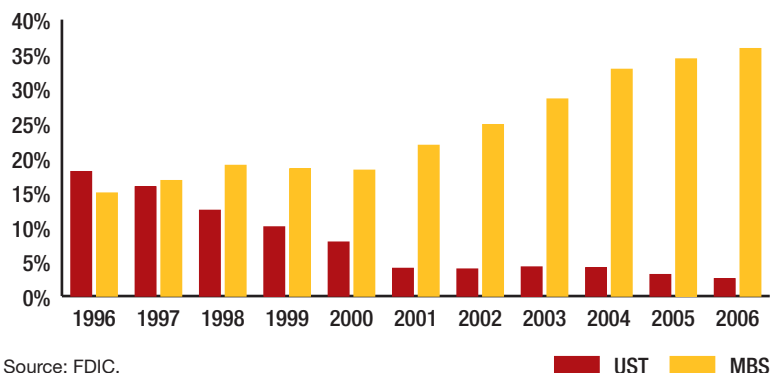
**Increased Bank Exposure to MBS
Contributing to Disorderly Markets**

Volatile interest rates, combined with the banking industry's increased exposure to mortgage-backed securities (MBS), may mean more volatile assets and lower asset valuations reflected on the balance sheets of U.S. banks. Anticipation of this has contributed to recent liquidity disruptions in the financial markets, which have forced the Federal Reserve to reassert its status as lender of last resort to assure stability in the U.S. banking system.

- Over the past decade, the industry has taken advantage of additional funding options, relying less on the securities portfolio for liquidity, which has led to a steady decline in highly liquid Treasury holdings.
- Banks have increased their exposure to MBS in an effort to enhance yield, which also has added risk to their balance sheets.
- The mortgage market also has experienced its own transformation, as innovative products, transparent pricing, sophisticated investors and enhanced technology increased the MBS market to more than \$6 trillion.
- Implementation of FAS 115 and the one-time reclassification of securities amnesty in late 1995 further exposed banks' balance sheets to volatile assets, with more than 90% of the securities portfolio now classified as available for sale.
- The banking industry experienced a steady decline in Treasury holdings as financial institutions restructured their portfolios and took advantage of other funding sources such as FHLB advances and brokered deposits. These additional funding options have allowed banks to invest in higher yielding assets, trading off to some extent liquidity for interest income.

Exhibit 1

**U.S. Treasuries and
Mortgage Backed Securities
As % of Total Securities Portfolio**



High Bank Exposure to MBS Increases Asset Valuation Volatility

The impact of higher and more volatile interest rates, combined with the banking industry's increased exposure to mortgage-backed securities (MBS), may lead to more volatile assets and lower asset valuations reflected on the balance sheets of U.S. banks. Anticipation of this has contributed to recent liquidity disruptions in the market place, which have forced the Federal Reserve to reassert its status as lender of last resort to assure stability in the U.S. banking system.

One issue facing banks is that over the past decade, the industry has taken advantage of additional funding options, relying less on the securities portfolio for liquidity, which has led to a steady decline in highly liquid Treasury holdings. During this time, banks have increased their exposure to MBS in an effort to enhance yield, which also added risk to their balance sheets.

The mortgage market also has experienced its own transformation, as innovative products, transparent pricing, sophisticated investors and enhanced technology increased the MBS market to more than \$6 trillion. Implementation of FAS 115 and the one-time reclassification of securities amnesty in late 1995 further exposed banks' balance sheets to volatile assets, with more than 90% of the securities portfolio now classified as available for sale and fluctuating market values reflected in the equity account.

The banking industry experienced a steady decline in Treasury holdings as financial

institutions restructured their portfolios and took advantage of other funding sources such as FHLB advances and brokered deposits. These additional funding options have allowed banks to invest in higher yielding assets, trading off to some extent liquidity for interest income. In 1996, on average, Treasuries made up more than 18% of a bank's investment portfolio, compared with only 2.53% on average in 2006. The MBS market benefited from the banks' rotation out of Treasuries. MBS holdings accounted for 17.71% of a bank's investment portfolio in 1996, compared with more than 35% on average in 2006, as shown in **Exhibit 1**.

A.M. Best Company Special Report

August 27, 2007

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

Rita L. Tedesco, Information Services

ANALYTICAL SERVICES GROUP

John Lafayette, Assistant Vice President

Carole Ann King, Assistant Manager

Brendan Noonan, Senior Business Analyst

John Williams, Senior Business Analyst

Laura McArdle, Business Analyst

Jey Thanapal, Business Analyst

Thomas Dawson IV, Associate Editor

PRODUCTION

Jenica Thomas, Designer

Copyright © 2007 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.

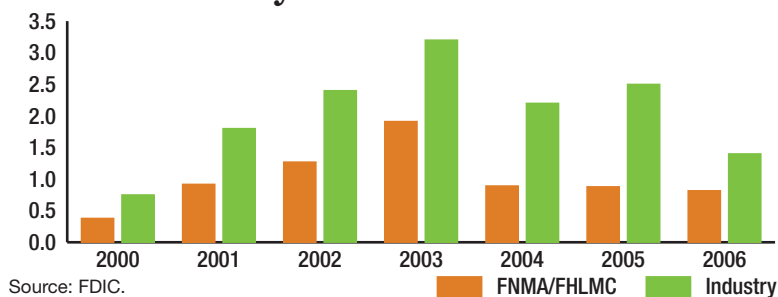
Best's Ratings reflect the A.M. Best Company's opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. These ratings are 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 Company receives compensation for its interactive financial strength ratings, from the insurance companies it rates. In compliance with the Securities Act of 1933, A.M. Best also discloses that it receives rating fees from most issuers of the debt securities it rates. Those fees fall within a range of \$ 7,500 to \$ 500,000.

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



Exhibit 2

FNMA/FHLMC MBS Issuance Versus Industry 2000-2006



A large part of the shift by banks was due to growth of the MBS market itself, which led to higher yielding assets in their securities portfolio. The MBS market today has grown to more than \$6 trillion, compared with the Treasury market at less than \$5 trillion in tradable government securities outstanding. The MBS market's expansion is due in part to the explosion of the housing market and investors' appetite for mortgage-backed securities over the past decade. As home buyers took advantage of the benign interest rate environment, securitization allowed banks to increase their liquidity and keep up with demand for loans. Banks have relied on the secondary mortgage market as a way to release cash by selling mortgage loans in the open market, which later were securitized and packaged into mortgage-backed securities. The cash from these loan sales then was used to make additional mortgage loans, increasing liquidity and further increasing the size of the MBS market. Total mortgage securitization issuance doubled to \$2 trillion in 2001 versus 2000, peaked in 2003 at slightly less than \$3.2 trillion, then lowered to about \$2.5 trillion in 2005 and \$1.4 trillion for 2006.

As part of the banks' reallocation of investments out of Treasuries, the majority of MBS holdings consists of issuances by the large, government-sponsored agencies of Freddie Mac (FHLMC) and Fannie Mae (FNMA), which offered relatively higher yield than Treasuries without adding significant risk because of the U.S. government's implicit support of these government-sponsored entities (GSEs).

On an industrywide basis, these agencies' securities and MBS amounted to about 68% of banks' available-for-sale securities at year-end 2006, versus 44% in 1996. For community banks with asset size ranging from \$100 million to \$300 million, agencies and MBS totaled 64% at year-end 2006 versus 39% in 1996. Issuance from FNMA and FHLMC in 2003 accounted for 60%, or \$1.9 trillion, with the 2006 level at 59%, or \$816 billion (see **Exhibit 2**).

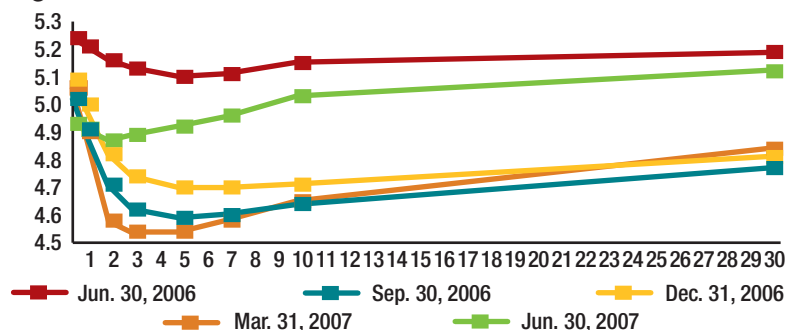
Shifting the balance sheet to higher yielding assets, however, did not come without additional risks for U.S. banks, with the interest rate environment becoming less

certain of late (see **Exhibit 3**). Higher interest rates and volatility have the potential for a negative impact on valuations of mortgage-backed securities through extension, interest rate and optionality risk. On average, more than 90% of a bank's investment portfolio consists of available-for-sale securities, which are marked to market with unrealized gains/losses flowing through the equity account on the balance sheet. An MBS investor effectively is taking the positions of being long straight bonds and short embedded options. These options theoretically have been sold to homeowners, who may exercise their options by prepayment of principal, either in part or in full. As interest rates increase, the value of the straight bond decreases. As volatility increases, the embedded options are worth more, which also leads to a lower valuation for the MBS bond.

Accounting changes in 1995 also led to higher exposure as banks were given a one-time amnesty to restructure their investment portfolios. The Financial Accounting Standards Board implemented FAS No. 115 at the beginning of 1994, requiring banks to classify securities within their investment portfolios as either available for sale (AFS) or held to maturity (HTM). The classification determined whether the asset would be recorded at historical cost adjusted for amortization, or at market value with the changes in valuations recorded in the equity account on the balance sheet.

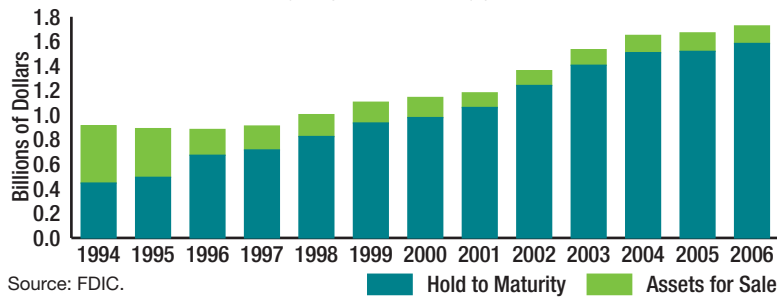
As shown in **Exhibit 4**, on average, at the end of 1994, banks classified 49% of securities as AFS and 51% as HTM. Moving securities freely between AFS and HTM without

Exhibit 3
Treasury Yield Curve, Quarters-Ended June 2006 to June 2007



Source: Federal Reserve Board.

Exhibit 4
**Available-for-Sale versus
 Held-to-Maturity (Industry)**



penalty was constrained, limiting banks' portfolios as a source of liquidity. In November 1995, FASB issued A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities, giving banks a one-time amnesty to restructure their investment portfolios without enduring consequences from the FASB for the reclassification. Many banks took advantage of this amnesty for liquidity purposes. At the end of 1996, banks on average had more than 75% of the securities portfolio listed as AFS, and the upward trend has continued, with more than 90% of the portfolios classified as AFS at the end of 2006. These reclassifications now have exposed banks to volatility on their balance sheets, as changes in valuation for the mortgage-backed securities listed as AFS will flow through the equity account.

Through these various historical shifts in investment decisions, banks today

are invested significantly in a variety of mortgage-backed securities. In light of the recent ongoing crisis in the adjustable-rate mortgage sector impacting collateralized debt obligations securities (CDOs) and potentially spilling into the MBS market, banks' investment portfolios may be exposed to heightened valuation risks. Current estimates indicate that approximately \$500 billion of adjustable-rate mortgages are scheduled to reset at higher rates this year by an average of more than 200 basis points, with the 2008 level reaching \$700 billion.

Investors' negative sentiment could widen spreads in the MBS market versus Treasuries, demanding higher yield for additional risk, even if it is just market perception. Investors' perception also could change with the regulatory and ethical issues impacting FNMA. FNMA has been limiting the size of its mortgage holdings under an agreement with its federal regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), while the company works through accounting and financial reporting problems. An agreement was reached in May 2007 for FNMA to pay \$400 million in fines as part of the settlement. A.M. Best will continue to monitor this risk exposure in U.S. banks' investment portfolios and will present, in upcoming articles, more research and analytical reports related to banks' potential risk exposures through their investment portfolios.



Founded in 1899, A.M. Best Company is a full-service credit rating organization dedicated to serving the financial services industries, including the banking and insurance sectors. 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