

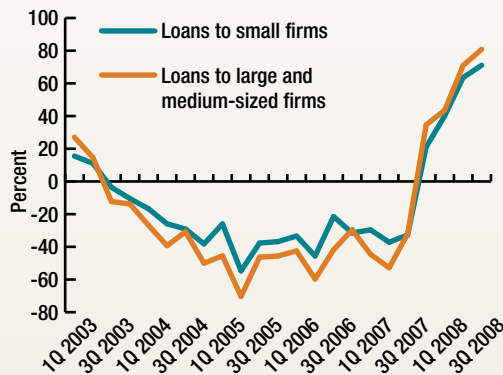
U.S. Banking – Regulatory Review

October 27, 2008

Sector

Banking

U.S. Banking – Net Percentage of Banks Increasing Spreads of Loan Rates over Costs of Funds (1Q 2002-3Q 2008)



Source: Federal Reserve Senior Loan Officer Survey

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Rating Analysts

Khanh Vuong, Vice President
+1 (908) 439-2200 Ext. 5633
Khanh.Vuong@ambest.com

Analytical Communications

Joe Niedzielski, Senior Business Analyst
+1 (908) 439-2200 Ext. 5549
Joe.Niedzielski@ambest.com

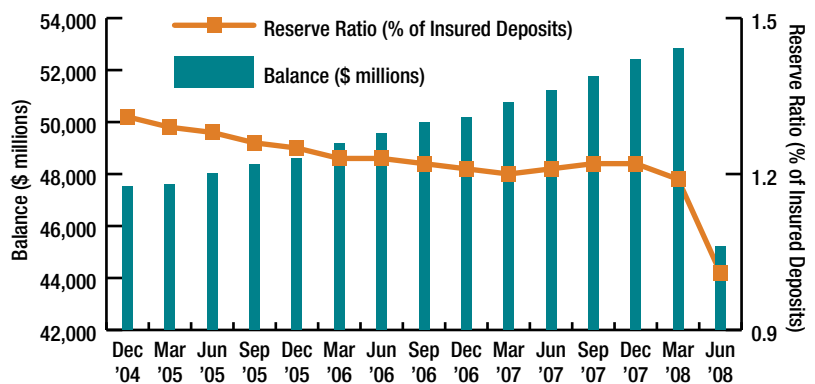
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Treasury Department, Regulators Respond to Global Financial Crisis

The Treasury Department and banking regulators unveiled several initiatives to unlock frozen credit markets and help restore confidence in the nation's banking system amid a growing global financial crisis. The Treasury Department will directly invest as much as \$250 billion in financial institutions as part of the \$700 billion authorized to buy troubled assets under the Emergency Economic Stabilization Act (EESA). The Federal Deposit Insurance Corp. (FDIC) also is offering temporary guarantees on senior unsecured debt issued by banks and non-interest bearing deposit accounts under a voluntary liquidity program.

- The EESA allows banks to record ordinary losses rather than capital losses on Fannie Mae and Freddie Mac preferred stock.
- The Treasury Department may consider whole loan purchases of mortgages under the \$700 billion Troubled Asset Relief Program.
- The EESA allows the Securities and Exchange Commission to suspend mark-to-market accounting if it is in the public interest.
- The FDIC proposed a restoration plan for its deposit insurance fund (DIF) that would more than double the average assessment rate that banks pay into the fund beginning in April 2009.
- The restoration plan introduces a risk-based assessment system in which banks with a greater dependence on secured liabilities and brokered deposits would face higher assessment rates.
- The restoration plan incorporates estimates that bank failures could cost the DIF about \$40 billion from 2008 to 2012.
- The DIF's reserve ratio stood at 1.01% as of June 30, 2008, its lowest level since March 31, 1995 when the ratio was 0.98%.

U.S. Banking – FDIC Deposit Insurance Fund Balance and Reserve Ratio (4Q 2004-2Q 2008)



Source: Federal Deposit Insurance Corp.



Bush Administration, Regulators Unveil Broad Plan to Combat Financial Crisis

The Bush administration and banking regulators plan to invest as much as \$250 billion in thousands of financial institutions to help rebuild capital and restore confidence in the nation's banking system.

The so-called capital purchase program would tap into the \$700 billion that Congress authorized the Treasury Department to spend under the Troubled Asset Relief Program (TARP) that is part of the Emergency Economic Stabilization Act (EESA) signed into law Oct. 3. The Treasury Department will invest in banks through preferred stock. As much as \$125 billion of the \$250 billion in available capital will go to nine of the nation's largest financial institutions that initially agreed to take part in the program: Citigroup Inc.; Bank of America Corp. (including Merrill Lynch & Co. which it is acquiring); JPMorgan Chase & Co.; Wells Fargo & Co.; Goldman Sachs Group Inc.; Morgan Stanley Group Inc.; Bank of New York Mellon Corp. and State Street Corp.

The Treasury Department also would receive warrants for common shares of those banks that decide to participate. In exchange, banks would have to accept

restrictions on executive pay, including no new contracts with "golden parachute" payments, and caps on the tax deductions they can take for executive compensation for some senior executives (see **Exhibit 1**).

The capital purchase program represents a shift from the Treasury Department's initial focus on purchasing distressed and poorly performing assets from banks

Exhibit 1

U.S. Banking – TARP Capital Purchase Program

- Treasury Department will purchase up to \$250 billion of senior preferred shares. Program available until Nov. 14, 2008.
- The senior preferreds qualify as Tier 1 capital and rank at the same level of the capital structure with existing preferred shares.
- Minimum subscription amount of 1% of risk-based assets. Maximum amount is the lesser of \$25 billion or 3% of risk-weighted assets.
- Banks pay a cumulative dividend rate of 5% annually on the senior preferreds for the first five years, with a reset to 9% annually after year five.
- The shares are callable at par after three years; banks may redeem the senior preferreds early through offerings of Tier 1 perpetual preferred stock or common stock that meets certain guidelines.
- Banks face restrictions on dividends for other securities in the capital structure and must get Treasury's consent to increase common stock dividends or engage in share buyback programs.
- Treasury retains the right to transfer the senior preferreds to third parties at any time.
- Treasury also may buy common shares of up to 15% of its investment by exercising warrants granted by banks taking part in the program. Treasury also can sell the warrants.

Source: Treasury Department

A.M. Best Company Special Report

October 27, 2008

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



SR-2008-124

under TARP. Rather, banking regulators have taken their cue from several rescue plans across Europe and other nations around the globe in which governments agreed to inject capital into their financial institutions, guarantee interbank lending and issue blanket guarantees for banking deposits.

As more governments outside of the United States took those actions, U.S. regulators feared the competitiveness of domestic financial institutions would be harmed. The Treasury Department also was keen to quickly deploy the \$700 billion authorized under TARP to help unlock frozen credit markets and help stabilize financial markets. And though it is still committed to buying a wide range of mortgage-backed securities under TARP, the Treasury Department also is considering whole loan purchases of residential mortgages, particularly those that are on the balance sheets of regional banks.

In addition to the Oct. 14 announcement of the capital purchase program, regulators unveiled a new liquidity program from the Federal Deposit Insurance Corp. (FDIC) and further details of a program from the Federal Reserve to lend directly to corporations in the commercial paper market (see **Fed Will Lend to Corporations Through Commercial Paper Program**). The FDIC's temporary liquidity guarantee program would backstop senior unsecured debt of banks, thrifts and other financial holding companies that are newly issued on or before June 30, 2009 for as long as three years. The FDIC also said it would temporarily provide full deposit insurance coverage for non-interest-bearing deposit transaction accounts – typically payment processing accounts that businesses use for payroll – through 2009 (see **Exhibit 2**).

About \$1.4 trillion would be eligible for coverage on the senior unsecured debt portion of the program, while \$400 billion to \$500 billion of non-interest bearing accounts would be eligible under the program's unlimited insurance coverage option. If the costs of the FDIC's temporary liquidity guarantee program exceed its fees, the agency would make up the

difference through a special assessment. Conversely, it is expected that any surplus generated by the liquidity program would be transferred to the FDIC's deposit insurance fund.

The EESA, meanwhile, has several other provisions designed to relieve stresses on banks' balance sheets. For example, banks will be able to record ordinary losses rather than capital losses on preferred stock issued by Fannie Mae and Freddie Mac, the two government-sponsored enterprises (GSEs) placed under conservatorship in early September by the Federal Housing Finance Agency. Losses on preferred securities issued by Fannie Mae and Freddie Mac have impacted scores of U.S. banks, particularly smaller institutions and community banks.

According to a survey released by the American Bankers Association in late September, 27% of banks hold preferred stock in the two GSEs, with total industry exposure estimated at \$10 billion to \$15 billion. The survey found that 85% of banks that reported holdings of securities issued by the two GSEs were community banks with less than \$1 billion in assets, and 65% were banks with less than \$500 million in assets.

Since these institutions may not generate significant capital gains, they would not have been able to deduct those capital

Exhibit 2 U.S. Banking – FDIC Temporary Liquidity Guarantee Program

New Senior Unsecured Debt

- Voluntary program guarantees this debt issued by any bank, thrift or holding company on or before June 30, 2009.
- Fees waived for the first 30 days. Participating issuers then pay annualized fees equal to 75 basis points multiplied by the amount of debt issued.
- Debt covered by the guarantee may not exceed 125% of an institution's outstanding debt as of Sept. 30, 2008 that was scheduled to mature before June 30, 2009.
- Coverage limited to June 30, 2012 even if the debt maturity exceeds that date.

Non-Interest Bearing Deposit Transaction Accounts

- Unlimited insurance coverage for these accounts held by FDIC-insured banks until Dec. 31, 2009.
- Fees waived for the first 30 days. A 10-basis point surcharge is then applied to participating institutions' FDIC insurance assessments for accounts above the existing \$250,000 deposit insurance limit.

Source: Federal Deposit Insurance Corp.

losses against capital gains before the legislation passed. The result would have been a substantial reduction in their capital and even insolvency in some cases. The tax provision in the legislation, then, provides a tax benefit to help reduce these banks' losses.

Fair Value Reassessed

The new legislation authorizes the Securities and Exchange Commission (SEC) to suspend mark-to-market accounting if the SEC deems it to be in the public interest. The law also requires the SEC, in consultation with the Federal Reserve and the Treasury, to study the effects of Financial Accounting Standard (FAS) 157, an accounting rule that sets standards for measuring the fair value of financial assets. The study, due within 90 days of enactment of the EESA, should examine the accounting standard's impact on financial institutions' balance sheets and on bank failures in 2008, among other issues.

Critics of FAS 157 claim that it has exacerbated the current financial crisis. Among the primary concerns voiced by financial institutions is that the standard doesn't provide a clear framework for valuing assets in illiquid markets. Rather, market prices in this environment are more a function of distressed sellers in thinly traded markets and don't reflect the intrinsic or economic value of these assets.

The SEC and the Financial Accounting Standards Board (FASB) did address some of these concerns by clarifying certain aspects of measuring fair value on Sept. 30, which FASB further amplified in early October. They said that management can use estimates of future cash flows in determining fair value when active markets for particular securities don't exist. They added that the results of distressed sales are not "determinative" when measuring fair value. Also, less reliance should be placed on using broker quotes that aren't the result of market transactions as inputs for fair value.

Broader Role for FDIC

Throughout the evolving financial crisis, the FDIC has assumed a more active role. The new law, for example, provides

unlimited borrowing powers to the FDIC from the Treasury Department. Prior to the legislation, the FDIC had access to a \$30 billion line of credit with the Treasury, which it never had used. The legislation also temporarily raises the cap on deposit insurance coverage to \$250,000 through December 2009, up from \$100,000.

In recent months, the FDIC also has sought quick resolution for banks it has identified as the most troubled. In late September, the FDIC facilitated JPMorgan Chase & Co.'s acquisition of Washington Mutual. With \$188.3 billion in total deposits, the collapse of Washington Mutual represents by far the largest bank failure in U.S. history. But the transaction with JPMorgan Chase resulted in no cost to the FDIC's deposit insurance fund, which the agency uses to insure customers' deposits.

Also in September, the FDIC demonstrated other broad powers it has by using what's known as the "systemic risk" exemption to facilitate an open bank assistance transaction to sell Wachovia Corp. to Citigroup Inc. Wachovia subsequently agreed to be purchased by Wells Fargo in a transaction that does not involve FDIC assistance. The Federal Reserve Board approved the sale on Oct. 12.

The FDIC is mandated to choose the least costly resolution for ailing banks to protect depositors' assets. But in the case of Wachovia, the FDIC for the first time used its authority, granted in 1991, to exercise broader powers to resolve a large, complex bank failure.

Regulators left open the possibility of using the systemic risk exemption again. In an Oct. 6 statement, the President's Working Group on Financial Markets said the FDIC would use its "authority and its resources" when systemic risk determinations are necessary and appropriate in the future. Indeed, Treasury Secretary Henry M. Paulson signed the systemic risk exception that enabled the FDIC to offer the temporary liquidity program discussed above.

Including Washington Mutual, 15 institutions have failed this year through Oct. 12. In the

second quarter, there were 117 institutions on the FDIC's "problem list" of banks under heightened regulatory scrutiny, with total assets of \$78.3 billion. That was up from 90 banks with total assets of \$26.3 billion in the first quarter (see **Exhibit 3**).

The FDIC said the number of banks on the problem list would increase in the third quarter. On average, 13% of institutions on the FDIC's problem list fail, with the average higher during the savings and loan cri-

sis and lower during other periods.

FDIC Proposes Higher Assessments

The growing number of bank failures thus far in 2008 has reduced the FDIC's deposit insurance fund, leading to a broad proposal to raise the assessments banks pay into the fund. In early October, the FDIC's board adopted a restoration plan for the deposit insurance fund (DIF), which, under a 2005 law, the agency is required to do once the insurance fund's

Fed Will Lend to Corporations Through Commercial Paper Program

After unveiling a series of measures over the past year that have included extending overnight discount window borrowing privileges to investment banks, the Federal Reserve now plans to lend directly to corporations for the first time since the Great Depression.

The Fed's so-called Commercial Paper Funding Facility (CPFF) is the latest in a series of initiatives announced since September 2008 following further strains in the credit markets marked by the federal government's takeover of Fannie Mae and Freddie Mac and the bankruptcy of Lehman Brothers Holdings Inc. Term funds auctioned under lending programs put in place last December to alleviate pressures in global money markets have increased substantially. Meanwhile, collateral the Fed accepts in other secured lending facilities has vastly expanded beyond relatively risk-free securities.

With the CPFF, the Fed plans to provide a liquidity backstop in the \$1.6 trillion commercial paper market. The commercial paper market – in which companies borrow funds overnight to as long as 270 days – represents the lifeblood of day-to-day financing for many U.S. corporations.

But because money market funds – the main investors for this debt – have had their own liquidity pressures, they have been reluctant to purchase commercial paper, particularly with longer maturities. The Fed's program to buy commercial paper aims, then, at eliminating the risk that issuers won't be able to repay investors by rolling over their maturing obligations as they come due.

Money market funds have faced their own bank run of sorts following the "breaking of the buck" in mid-September by the Reserve Primary Fund managed by Reserve Management Company Inc.

The Primary Fund's shares fell below \$1 following losses on debt issued by Lehman Brothers – the first time in 14 years that a money market fund had allowed the net asset value of its shares to fall below \$1.

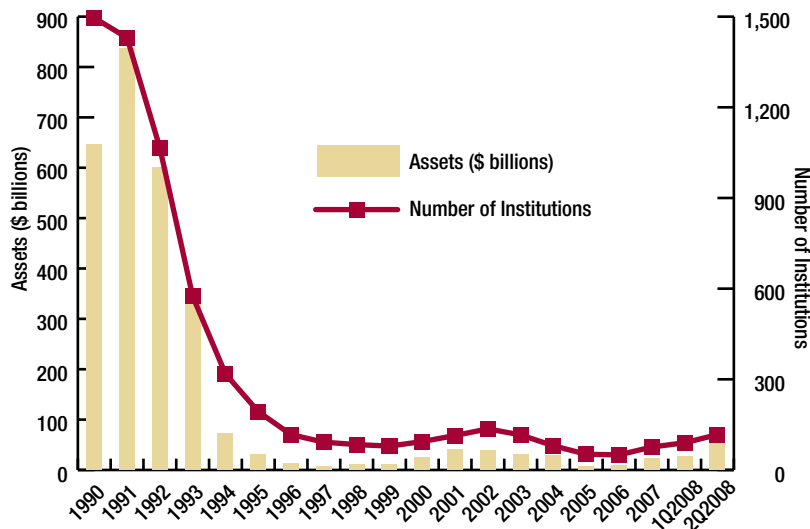
That sparked an exodus from money funds that invest in a broader array of commercial paper to funds that invest in safer government securities. Partly as a result of these significant redemptions from investors, the Fed also initiated a program in September that allows money market mutual funds to borrow from a new facility to purchase asset-backed commercial paper, a market that has been relatively illiquid in recent weeks. In addition, the Treasury Department rolled out a \$50 billion temporary guarantee program of its own for money market funds.

The mechanics of the CPFF involve setting up a special-purpose vehicle, or SPV. The SPV will be financed by the Federal Reserve Bank of New York and will begin direct purchases on Oct. 27 of three-month unsecured commercial paper and asset-backed commercial paper (ABCP). ABCP is short-term debt backed by a wide range of collateral including mortgages, car loans and credit card receivables. It typically is issued by off-balance sheet bank conduits and other nonbank financial institutions.

The SPV that the New York Fed plans to use for direct commercial paper purchases will hold the paper until maturity and will repay its loan from the New York Fed as its commercial paper holdings mature. The SPV will buy commercial paper at a discount and those issuers selling unsecured commercial paper to the SPV also will have to pay a credit surcharge.

The program is authorized until April 30, though the Federal Reserve could extend it.

**Exhibit 3
U.S. Banking – Problem Institutions (1990-2Q 2008)**



Source: Federal Deposit Insurance Corp.

reserve ratio of insured deposits falls below 1.15%.

Under the plan unveiled Oct. 7, assessment rates would be raised for all banks by seven basis points in the first quarter of 2009. That would change in the second quarter, however, as the FDIC would incorporate a risk-based assessment system. Banks with a greater dependence on secured liabilities and brokered deposits would face higher assessment rates. The FDIC’s proposal is open for a 30-day comment period. The agency expects to issue a finalized plan by the end of the year.

Currently, banks pay between five and 43 basis points for deposit insurance. The average assessment rate was 6.3 basis points as of June 30, 2008. The FDIC expects the overall average assessment rate would more than double to 13.5 basis points of insured deposits beginning in April 2009. A basis point represents one cent for every \$100 of domestic deposits.

In addition to being mandated to develop a restoration plan, the deposit insurance fund needs to be replenished because of expectations of more bank failures over the next several quarters. The added assessments, though, come at a time when arguably the industry can least afford them, because more banks face strained capital levels

stemming from the evolving financial crisis.

The FDIC estimates that the failure of IndyMac Bank FSB in early July – the second-largest thrift failure ever – will cost the fund \$9 billion. Even before IndyMac’s takeover, the fund’s reserve ratio was at its lowest level in more than a decade.

As of June 30, 2008, the reserve ratio stood at 1.01%, down from 1.19% as of March 31, 2008. The second-quarter figure was the lowest for the reserve ratio for a combined bank and thrift insurance fund since March 31, 1995, when the ratio stood at 0.98%, according to the FDIC. And the FDIC projects the ratio will continue to fall during 2008 and into early 2009 to a low of 0.65% to 0.70% because of an anticipated increase in bank failures.

The FDIC’s current plan seeks to restore the deposit insurance fund’s reserve ratio to 1.25% by 2013. The plan also incorporates estimates that bank failures could cost the deposit insurance fund about \$40 billion from 2008 to 2012. About \$13 billion of that total represents actual and projected costs incurred from bank failures in 2008. The deposit fund stood at \$45.2 billion as of June 30, backing total deposits eligible for insurance of \$4.5 trillion.

Although the industry’s average assessment is expected to double to 13.5 basis points beginning next April, banks would pay from as little as eight basis points to as much as 77.5 basis points, depending on their risk profile. That range includes the potential for a downward adjustment of as much as two basis points from an initial base assessment rate, depending on a bank’s ratio of long-term unsecured debt to domestic deposits.

Notwithstanding the temporary liquidity guarantee program, when a bank fails, unsecured debtholders aren’t paid off until secured claims, administrative claims and deposit claims have been paid in full, according to the FDIC. Greater amounts of long-term unsecured claims, then, provide a cushion that can reduce the FDIC’s loss in the event of a failure, the agency said. Naturally, under

the temporary liquidity guarantee program, unsecured debtholders have been allowed the same protection as depositors for up to three years on new debt issued on or before June 30, 2009. Smaller institutions also would be eligible for the downward adjustment for unsecured debt based on a ratio of certain amounts of Tier 1 capital to domestic deposits, according to the FDIC.

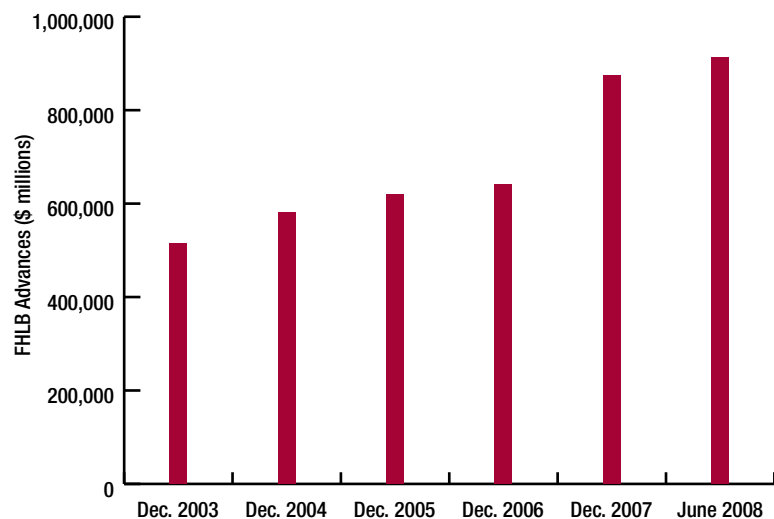
Conversely, under one of the new risk measures the FDIC introduced, banks could be assessed as much as 22.5 basis points above initial base assessment rates after adjustments for secured liabilities. These liabilities include advances from the Federal Home Loan Bank system (FHLB), securities sold under repurchase agreements and other secured borrowings.

The assessment for FHLB advances has not been received favorably by the industry. Borrowing from the FHLB system has become an increasingly important source of funding for banks because of the credit crunch and a decline in deposits (see **Exhibit 4**). These advances, however, are collateralized by assets that the FDIC isn't able to sell to help maximize a recovery in the event of a bank failure. IndyMac, for example, had \$10.1 billion in FHLB advances as of June 30.

Some banks also could be assessed higher rates – as much as 10 basis points – if their ratio of brokered deposits to domestic deposits exceeds 10%. Brokered deposits represent funds that banks solicit through brokers from third parties. They typically offer higher rates than certificates of deposit offered directly by a bank and can help spur growth in deposits. But they also are not considered a stable source of funds, since investors tend to pull their funds once the brokered deposits have matured.

A number of “costly” bank failures, including some recent failures, have been tied to rapid growth in assets funded through brokered deposits, the FDIC said. There also is a “significant correlation” between such growth and the probability of an institution with higher bank ratings being downgraded within a year, according to the FDIC.

Exhibit 4 U.S. Banking – FHLB Advances (2003-2Q 2008)



Source: Federal Home Loan Banks

In the case of IndyMac, brokered deposits comprised nearly \$6 billion, or roughly 32%, of total deposits as of June 30, according to the Office of Thrift Supervision (OTS). Similarly, Bentonville, Ark.-based AMB Financial NA had \$1.6 billion in brokered deposits in addition to the \$1.8 billion in total deposits at the time of its failure in early May 2008.

Lower Risk Charge for Fannie Mae, Freddie Mac Debt

The FDIC's board also approved an interim rule that would reduce the risk weighting for credit exposures and securities issued by Fannie Mae and Freddie Mac to 10% from 20%. The change reflects the federal takeover of the two GSEs in early September. The change in risk charge doesn't include common and preferred stock issued by the two GSEs.

A lower risk charge for the FHLB system also was not included in the interim rule, though it may be part of a final rule. At the FDIC's board meeting Oct. 7, Comptroller of the Currency John C. Dugan proposed that debt issued by the FHLB be added to the final rule.

A lower risk weighting for debt issued by Fannie Mae and Freddie Mac, but not for the FHLB, could put FHLB debt at a disadvantage to that of the other GSEs and potentially impact the FHLB's funding costs.



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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