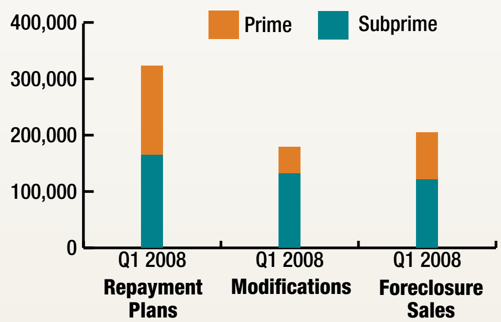
**U.S. Banking – Regulatory Review**

May 26, 2008

### Sector
Banking

### U.S. Banking – Mortgage Workout Plans and Foreclosure Sales (1Q2008)




Source: Hope Now Alliance

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# Credit Crisis Prompts Response From Lawmakers, Regulators

Lawmakers and regulators have confronted the housing slump and global credit crisis with a number of initiatives. In early May, the House of Representatives passed legislation aimed at reducing foreclosures, though the bill may face difficulty in becoming law. Global central bankers, meanwhile, will unveil guidance for stronger liquidity risk management, while the Securities and Exchange Commission (SEC) plans new disclosure requirements for the nation's top investment banks.

• The House bill would authorize the Federal Housing Administration (FHA) to insure as much as $300 billion of newly issued mortgages.

• The bill requires mortgage holders to agree to principal write-downs before borrowers receive new loans through FHA-approved lenders.

• Some regulators favor principal reductions to help prevent foreclosures since more borrowers face negative equity in which home prices fall below outstanding mortgage balances.

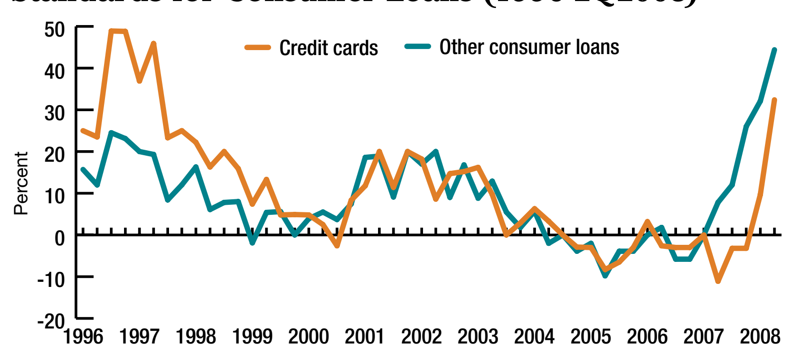
• The House legislation provides some incentives for second-lien holders to consent to more loan modifications.

• The Basel Committee on Banking Supervision plans guidance by July on more robust liquidity buffers – including contingent liquidity risk and management of intraday liquidity risk.

• The Basel Committee also plans to raise the capital treatment under Basel II of complex structured credit products, and enhance the capital treatment of liquidity facilities that support asset-backed commercial paper conduits and credit exposures held in a bank's trading book.

• The nation's four largest investment banks may need to diversify the source and duration of their funding because the SEC has added more extreme scenarios for determining liquidity pool requirements.

### U.S. Banking – Net Percentage of Banks Tightening Standards for Consumer Loans (1996-2Q2008)




Source: Federal Reserve Senior Loan Officer Survey

# Averting Foreclosures, Capital, Liquidity Rules Eyed

The ongoing housing slump in the United States and global banks' widespread losses tied to complex mortgage securities and other credit products have resulted in a number of initiatives from lawmakers and central bankers.

Congressional leaders have called for banks and lenders to increase the number of loan modifications they agree to with borrowers having trouble keeping pace with mortgage payments. These efforts are viewed as a way to stem price declines in the housing market and to help stabilize the broader economy.

The collapse in March of Bear Stearns Cos., meanwhile, has led to calls for tighter regulation of investment banks, particularly since they are now able to borrow directly from the Federal Reserve. The Securities and Exchange Commission, which has been criticized for its oversight, has said that investment banks would have additional capital and liquidity disclosure requirements later this year.

## House Plan Seeks Fewer Foreclosures

Efforts to avert the escalating number of foreclosures across the country intensified in early May with passage of key legislation in the House of Representatives. Lawmakers hope the bill will spur mortgage banks and servicers to step up their own efforts to help borrowers refinance into lower cost mortgages.

The Congressional Budget Office (CBO) estimated that the bill could help as many as 500,000 borrowers. Since the loans would receive an average estimated subsidy credit of 2% of the loan principal, the FHA loan-guarantee program would cost about $1.7 billion, according to the CBO. The bill establishes the program for a four-year period and could cost a total of about $2.7 billion, assuming other future appropriations, the CBO said. The Bush administration has threatened to veto the legislation, mostly because of the cost.

Since the rate of foreclosures around the nation began rising last year, regulators and lawmakers have been urging lenders and mortgage servicers – firms that collect and process mortgage payments and pass the proceeds to investors – to modify millions of adjustable-rate mortgages (ARMs) that have been resetting to higher interest rates. Hybrid ARMs made to subprime borrowers with low credit scores or spotty credit histories have been among the targets of industry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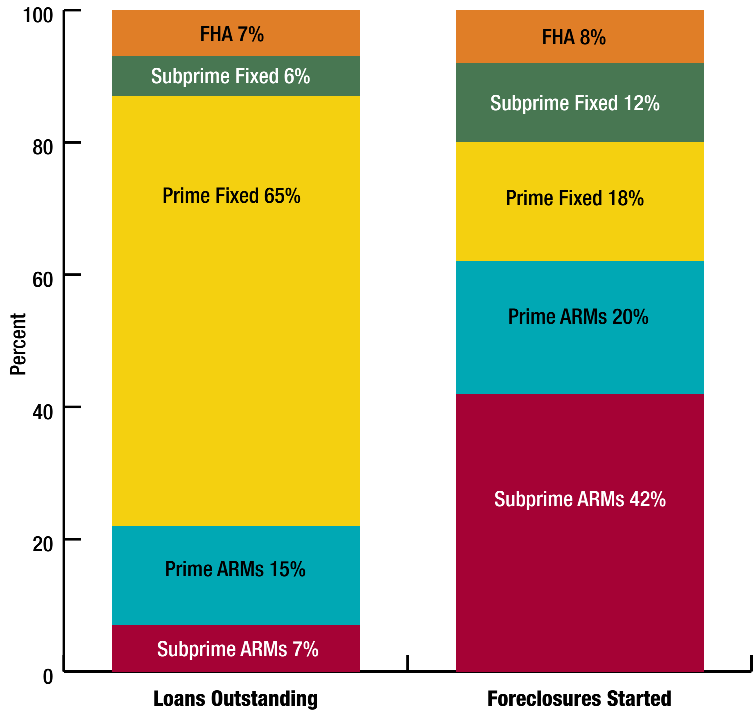
led efforts announced in 2007.

Meanwhile, borrowers beyond the subprime realm are having trouble keeping up with mortgage payments. The rate of foreclosures started in the fourth quarter of 2007 for prime ARMs rose to 1.06%, up from 0.41% in 2006, according to the Mortgage Bankers Association (MBA). Subprime ARMs still represent the bulk of foreclosure activity (see **Exhibit 1**).

Exhibit 1

**U.S. Banking – Foreclosures Started By Loan Type (4Q2007)**




Source: Mortgage Bankers Association

According to Irvine, Calif.-based RealtyTrac, foreclosure filings surged by 112% in the first quarter of 2008, compared with the same period in 2007. That was the seventh straight quarter in which foreclosure filings advanced. The 649,917 properties in the first quarter that were in some phase of foreclosure – default notice, auction sale notice or bank repossession – represented a 23% jump from the fourth quarter of 2007, RealtyTrac said.

The rate of mortgage delinquencies and foreclosures is being exacerbated by the decline in home prices in many metropolitan areas around the country. Millions of borrowers face negative equity because their homes are worth less than the amount outstanding on their mortgages. This has made it difficult for borrowers to refinance and has added to the difficult sales environment for new and existing homes. Banks continue to tighten their lending standards for mortgages, particularly for subprime and Alt-A loans (see **Exhibit 2**).

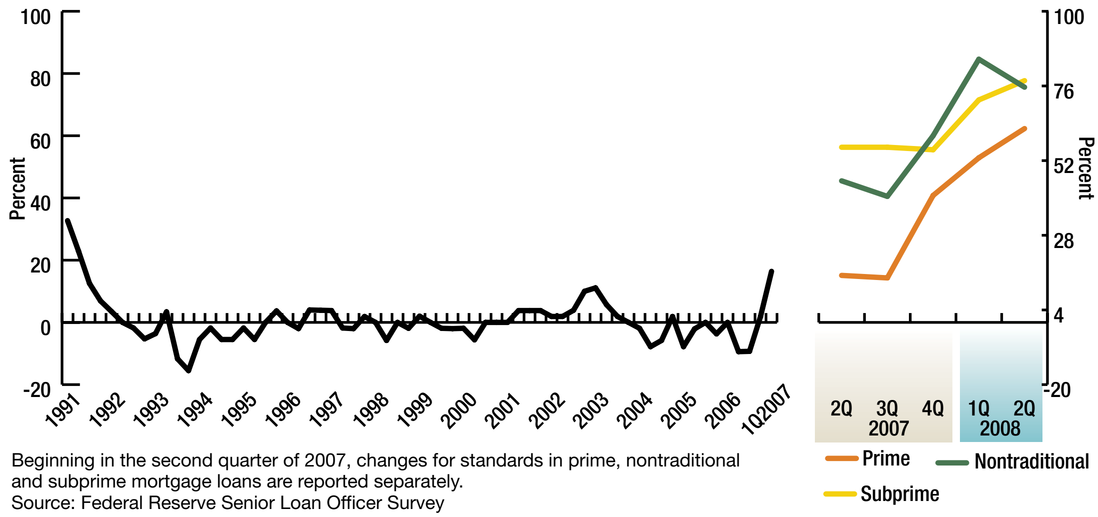
Some lawmakers, regulators and housing groups have said that private industry efforts to stem the rising tide of foreclosures haven't been robust enough. The nation's largest servicers and lenders banded together in late 2007 through the Hope Now Alliance to fast-track loan modifications after agreeing to a plan with the Treasury Department. But lenders, critics say, appear to have resisted making modifications that are more affordable than repayment plans that may tack on past-due amounts.

In speeches this year, Federal Reserve Chairman Ben Bernanke has come out in favor of principal reductions as an effective way to help prevent foreclosures, primarily because of the negative equity that many borrowers face. Meanwhile, House Financial Services Committee Chairman Barney Frank, D-Mass., author of the FHA bill, alluded to further legislation that would put "real restrictions on the role of servicers and give many more rights to borrowers" if there is little participation by servicers to reduce foreclosures.

Foreclosure sales outpaced modifications in the first quarter of 2008, according to figures from Hope Now. Modifications for subprime borrowers, however, represented 44% of subprime loan workouts – double the 2007 rate, Hope Now said (see **Exhibit 3**).

Hampering servicers' efforts to modify more loans has been the prevalence of second-lien loans used by borrowers to help make down payments. These loans, which are subordinate to first-lien mortgages, were prevalent for subprime and Alt-A mortgages; the CBO estimates that 40% of those mortgages carry second liens, citing information from loan servicers.

## Exhibit 2
### U.S. Banking – Net Percentage of Banks Tightening Standards for Residential Mortgages (1991-2Q2008)



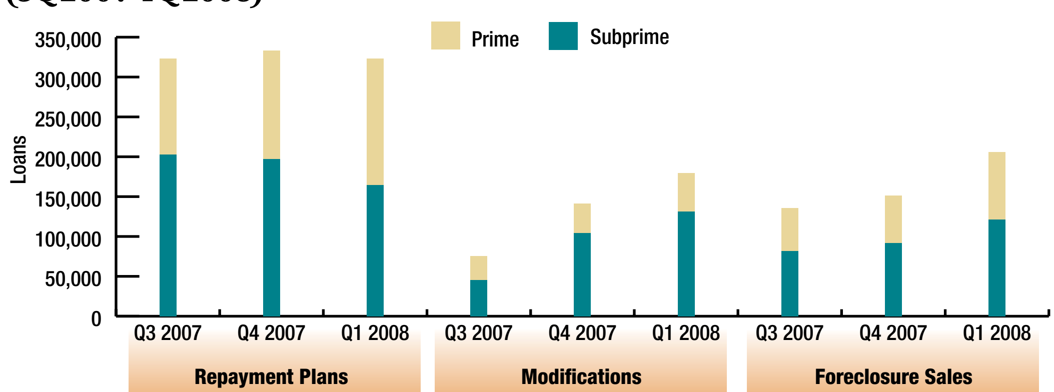

Beginning in the second quarter of 2007, changes for standards in prime, nontraditional and subprime mortgage loans are reported separately.
Source: Federal Reserve Senior Loan Officer Survey

Second-lien holders have to agree for modifications to take place, but getting their consent has been difficult, even though modifications may not pay off first-lien holders if the workout includes a write-down of the principal. Second-lien holders, then, would rather hold onto their loans in the hopes that borrowers would make higher payments in the future, or until home prices begin appreciating rapidly enough for a refinancing or sale to generate more cash.

The bill passed by the House would provide some incentives to entice second-lien holders to voluntarily release their liens, according to the CBO analysis. A new oversight board in charge of the FHA loan-guarantee program would have the authority to develop a compensation formula for second-lien holders for loans that could be refinanced under the FHA program.

### Broader Role Seen For the Fed
Economic officials and banking regulators across the globe have had to be creative to respond to the financial turmoil caused by the credit crunch. Banking regulators worldwide are revisiting the Basel II framework to ensure that liquidity risks are factored into the new regulatory capital system.

## Exhibit 3
### U.S. Banking – Mortgage Workout Plans and Foreclosure Sales (3Q2007-1Q2008)




Source: Hope Now Alliance

For U.S. financial institutions, including commercial banks and brokerage firms, that has meant more liquidity and easier access to funds from the Federal Reserve. The eventual trade-off for this liquidity support to the banks, though, may be broad changes in the way these financial institutions beyond commercial banks are regulated.

The Treasury Department already had been working on a plan to streamline the nation's financial regulatory system before the Federal Reserve in mid-March loaned $29 billion to Bear Stearns Cos. The loan facilitated the crippled investment bank's sale to JPMorgan Chase & Co. The Fed's further move to open emergency lending to investment banks through its discount window has prompted calls for tighter regulation of investment banks. Previously, only commercial banks were able to tap funds directly from the Fed.

The Securities and Exchange Commission (SEC) currently regulates investment banks. But the agency has been criticized for its oversight prior to the collapse of Bear Stearns, though others have noted that the agency may have been constrained in terms of resources, the scope of its mandate and assets held by the institutions it oversees.

The Fed already has assumed broader oversight of investment banks. Fed examiners are on site at several Wall Street firms to assist the SEC in assessing their capital and liquidity, partly because the Fed now lends directly to investment banks through its primary dealer credit facility (see **Changes to the Federal Reserve's Liquidity Provisions**).

For its part, the SEC said in May that it was drafting a formal memorandum of understanding with the Federal Reserve Board to outline the scope and process of information sharing for the credit facility program and other overlapping supervisory areas. SEC staff added that investment banks would have additional capital and liquidity disclosure requirements later this year.

## Basel II Changes Expected

Global banking regulators and economic officials, meanwhile, are exploring a host of measures aimed at banks in light of the current credit crisis. Based on estimates made in March, the International Monetary Fund estimates financial institutions will realize as much as $945 billion in write-downs and losses over the next two years, more than half of that from U.S. mortgage-related securities and loans (see **Exhibit 4**). The Organization for Economic Cooperation and Development has said the cost of the financial crisis would be lower, estimating a range of $350 billion to $420 billion.

In April, the Basel Committee on Banking Supervision, a group of central banks, outlined plans to strengthen aspects of an updated banking capital framework known as Basel II. The proposals had been put forth earlier that month by the Financial Stability Forum, an international group of regulators and central bankers.

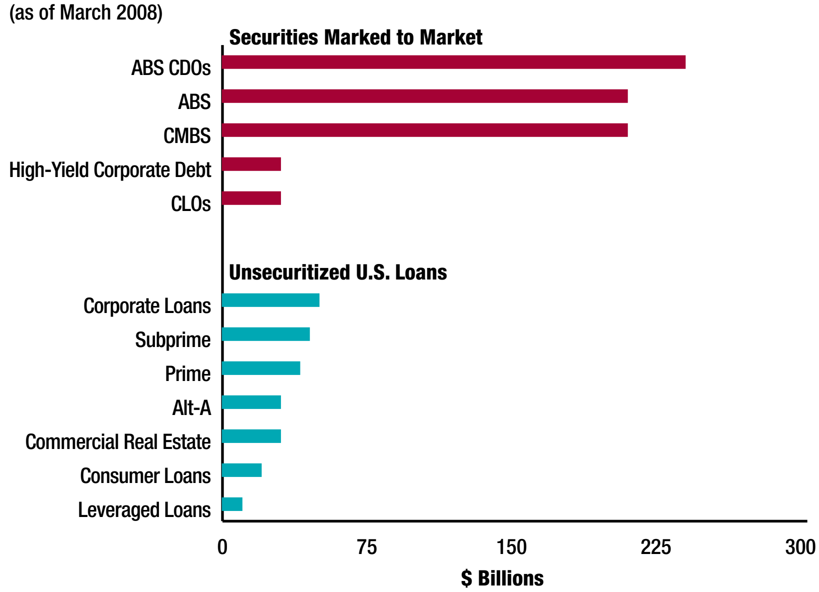
The proposals include raising capital requirements for complex structured credit products such as collateralized debt obligations (CDOs) composed of other asset-backed securities. CDOs with underlying pools of subprime mortgage-backed securities have been the main contributor to the spate of write-downs taken by global financial institutions in recent months.

The Basel Committee added that it would issue guidance by July that reflects the

Exhibit 4

**U.S. Banking – Forecasts of Global Financial Sector Credit Losses**

(as of March 2008)




Source: International Monetary Fund

# Changes to the Federal Reserve's Liquidity Provisions

Ongoing liquidity pressures and turmoil in the credit markets, which kicked into full gear in August, have forced the Federal Reserve to be creative in its efforts to reduce the risks to financial stability. To help keep markets functioning, the Fed has introduced a series of new lending facilities, culminating in March 2008 with its decision to let investment banks borrow directly from the Fed's discount window in the wake of the collapse of Bear Stearns & Cos.

Until last August, the discount window was seen as the last resort for banks if they needed cash in a pinch. Previously, eligible depository institutions could get overnight loans directly from the Fed via the discount window at the Federal Reserve Bank of New York. These loans, though, carried both a stigma and a penalty interest rate of 100 basis points over the target federal funds rate – the rate the Fed sets for overnight loans between banks.

On Aug. 17, however, the central bank extended the term of these loans to 30 days and cut the spread over the fed funds rate to 50 basis points. The Fed again extended the term for discount window loans to 90 days on March 16 (the Sunday that JPMorgan Chase & Co. agreed to buy Bear Stearns) and reduced the spread over fed funds to 25 basis points. As of April 30, the discount rate was 2.25%, still 25 basis points over the 2.00% fed funds rate, following the Fed's decision to lower both rates by a quarter point.

Discussed below are other facilities the Fed has launched to improve market liquidity.

**The Term Auction Facility (TAF)** was announced on Dec. 12 after several weeks of intense funding pressures in global money markets. Banks were reticent to lend to each other – evident in high London Interbank Offered Rates (LIBOR), benchmark rates that banks charge each other for loans. The Fed sought to ease these liquidity constraints by offering term funds for up to 28 days, with the rate set by a competitive bidding process.

In early March, the Fed said it would continue TAF auctions for another six months because of continued strains in term funding markets. The Fed followed in May with the announcement that it would raise the amounts it auctions on a biweekly basis to $75 billion from $50 billion.

**The Term Securities Lending Facility (TSLF)** was announced on March 11. Its aim, again, was to provide more liquidity to financial markets. Through this facility, the primary dealers the Fed conducts open-market operations with are able to exchange a broad range of relatively illiquid collateral in exchange for Treasury securities. TSLF loans are provided through weekly auctions, and the term of the loans is 28 days.

Collateral accepted by the Fed in exchange for Treasurys includes triple-A-rated mortgage-backed securities issued by private institutions; commercial mortgage-backed securities; and collateralized mortgage obligations issued by Fannie Mae and Freddie Mac. The Fed accepts this collateral so long as the securities are not on review for a possible downgrade from credit rating agencies. In May, the Fed extended the range of collateral it accepts for TSLF loans to triple-A-rated asset-backed securities.

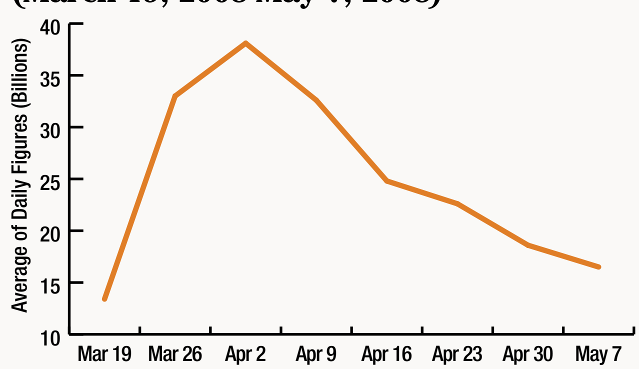
**The Primary Dealer Credit Facility** was established on March 16 because of what the Federal Reserve Board said were "exigent circumstances," including a severe lack of liquidity that threatened to impair the functioning of a broad range of financial markets. The Fed wanted to ensure that other investment banks wouldn't face the same funding pressures in overnight lending markets that Bear Stearns had experienced. At the time, the Fed said the facility would be in place for at least six months, though it left open the option of extending it.

The facility allows investment banks to borrow overnight directly from the discount window in exchange for a broad range of collateral. Borrowers also are able to roll over the loans daily. Previously, borrowing directly from the Fed through the discount window was only for depository institutions.

As **Exhibit 5** demonstrates, investment banks were eager to use the Fed's balance sheet to fund their securities holdings in the weeks immediately following the collapse of Bear Stearns. Since then, though, borrowing under the facility has fallen somewhat.

Exhibit 5

**U.S. Banking – Borrowing Under the Primary Dealer Credit Facility (March 19, 2008-May 7, 2008)**




Source: Federal Reserve

need for larger, more robust liquidity buffers. The guidance will focus on areas such as contingent liquidity risk associated with off-balance sheet vehicles that banks sponsor, as well as the management of intraday liquidity risks associated with payment and settlement obligations.

The importance of liquidity management was evident in the wake of the Bear Stearns collapse. According to the SEC, the investment bank was well capitalized even though its pool of available liquidity declined from $12.4 billion on March 12 to $2 billion on March 13. That was the day before Bear Stearns had to receive temporary funding from the Fed through JPMorgan to avoid bankruptcy.

The SEC, too, is strengthening the liquidity requirements for the four largest investment banks it supervises on a groupwide basis under the SEC's consolidated supervisory entities (CSEs) program. The CSE program, which took effect in 2004, came about as a result of European Union rules requiring multinational companies to be regulated on a consolidated basis. Previously, investment bank holding companies had broker-dealer subsidiaries regulated by the SEC, but the firms weren't being supervised on a consolidated basis by one regulator.

## SEC Adds Disclosure Rules

In exchange for voluntarily consenting to consolidated oversight, CSEs also were able to apply for exemptions from the SEC's net capital rule. Instead, Goldman Sachs Group Inc., Lehman Brothers Holdings Inc., Merrill Lynch & Co., Morgan Stanley and Bear Stearns were allowed to apply their own value-at-risk calculations based on their in-house models to calculate their net capital requirements for market risk and derivatives-related credit risk.

Now, the SEC wants CSEs to find secured funding over a longer term and to diversify their sources of funding, because it is adding additional scenarios that determine CSEs' liquidity pool requirements. The SEC said in May that the additional scenarios for risk management focus on market shocks of shorter duration and more extreme events that entail a substantial loss of secured funding.

The SEC also envisions more disclosure of CSEs' actual capital and liquidity positions, and that the firms will institute public disclosure of their capital ratios later this year. Additional disclosure related to concentration of exposures will be phased in, the SEC said.

# GUIDE TO BEST'S BANK DEPOSIT RATINGS

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## Bank Deposit Ratings

A **Best's Bank Deposit Rating** (BDR) is an opinion as to the company's ability to meet its ongoing financial obligations to depositors.

| | Rating | Descriptor | Definition |
|---|---|---|---|
| Secure | aaa | Exceptional | Assigned to companies that have, in our opinion, an exceptional ability to meet their ongoing obligations to depositors. |
| | aa | Very Strong | Assigned to companies that have, in our opinion, a very strong ability to meet their ongoing obligations to depositors. |
| | a | Strong | Assigned to companies that have, in our opinion, a strong ability to meet their ongoing obligations to depositors. |
| | bbb | Adequate | Assigned to companies that have, in our opinion, an adequate ability to meet their ongoing obligations to depositors; however, the company is more susceptible to changes in economic or other conditions. |
| Vulnerable | bb | Speculative | Assigned to companies that have, in our opinion, speculative credit characteristics and are vulnerable to changes in economic or other conditions. |
| | b | Very Speculative | Assigned to companies that have, in our opinion, very speculative credit characteristics and extreme vulnerability to changes in economic or other conditions. |
| | ccc, cc, c | Extremely Speculative | Assigned to companies that have, in our opinion, extremely speculative credit characteristics and/or limited ability to withstand adverse changes in economic or other conditions. |
| | rs | Regulatory Supervision | Assigned to companies (and possibly their subsidiaries/affiliates) that have been placed by a regulatory authority under a significant form of supervision, control or restraint whereby they are no longer allowed to conduct normal ongoing operations. This would include rehabilitation and liquidation. It may also be assigned to companies issued cease and desist orders by regulators. |

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| Modifier | Descriptor | Definition |
|---|---|---|
| u | Under Review | A modifier that generally is event-driven (positive, negative or developing) and is assigned to a company whose Best's Rating opinion is under review and may be subject to change in the near term, generally defined as six months. |

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| | |
|---|---|
| Positive | Indicates a company's financial/market trends are favorable, relative to its current rating level, and if continued, the company has a good possibility of having its rating upgraded. |
| Negative | Indicates a company is experiencing unfavorable financial/market trends, relative to its current rating level, and if continued, the company has a good possibility of having its rating downgraded. |
| Stable | Indicates a company is experiencing stable financial/market trends and that there is a low likelihood its rating will change in the near term. |

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