

2007 U.S. Banking Issues

Are Loss Reserves Adequate in Light of Rising Delinquencies?

A prominent feature of the U.S. banking industry's fourth-quarter 2006 results were noticeable increases from the prior quarter in other real estate owned (OREO) and real estate charge-offs of 9% and 33%, respectively, and in emerging past-due real estate loans, which increased by 21%. This leads to the question of whether loan loss reserves are sufficient for the industry. The question is even more pertinent for the smaller banks, which exhibit concentrations in higher-risk commercial real estate and construction loans: 25% and 14% of total loan and leases, respectively.

While the banking industry's absolute capital levels are high, and improvements have been seen in credit card portfolios and fixed-rate mortgages, these positive developments have been more than offset by sharply declining quality in adjustable-rate mortgages (ARMs) and other real estate loan classes, such as commercial real estate. The low delinquency and charge-off rates of the past several years may have encouraged the assumption of additional risks without additional loss provisions. Of note is that loan loss reserves are down to levels not seen since 1985, while past dues are ticking upward. The historical context of past downturns in the economic cycle, as well as the forward-looking credit quality indicator of 30- to 89-day past-due loans for the industry, provide an interesting perspective on the adequacy of the industry's current reserve levels.

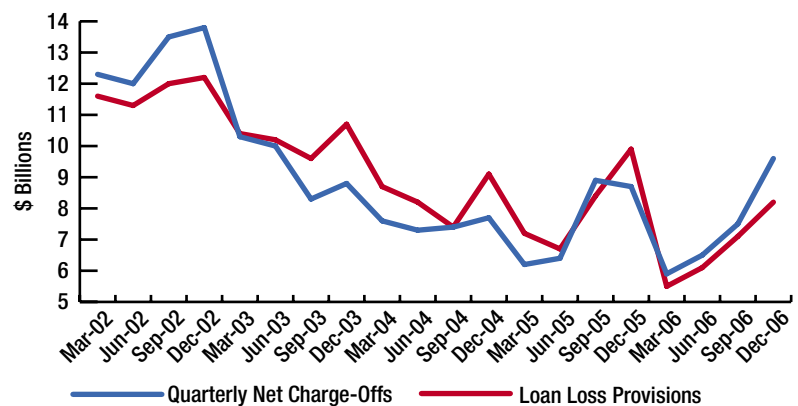
Does History Repeat Itself?

Looking back historically, the last time loan loss reserves declined to these levels was 1985. Interestingly, that time period preceded a real estate downturn for which banks were not prepared. As indicated in **Exhibit 3**, the confluence of the industry's low reserves in the mid-1980s and the onslaught of one of the most severe real

estate market corrections had all the ingredients of a perfect storm that wreaked havoc on U.S. banks for more than a decade later. Whether or

Exhibit 1

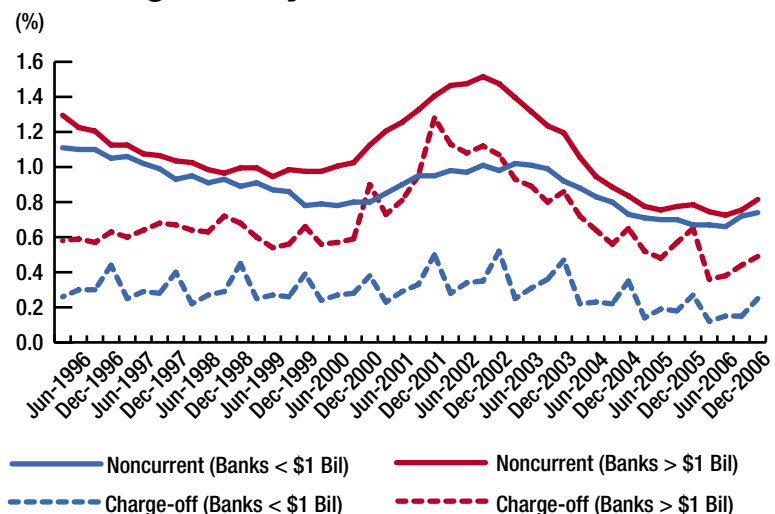
Quarterly Net Charge-Offs vs. Loan Loss Provisions



Source: FDIC.

Exhibit 2

Noncurrent Loan Rates vs. Net Charge-Offs by Bank Asset Size



Source: FDIC.

This report was written by Khanh Vuong, assistant vice president, and Diane Goodheart, senior financial analyst, of A.M. Best Co.



not higher reserve levels back in 1985 might have made any difference in the state of the U.S. banking industry during the real estate market correction is another matter. The historical context of cyclical patterns for real estate loans and the industry's exposures to this asset class is seen by the peaks of noncurrent loan rates at the time of or shortly following the 1985/1986 slowdown, the 1990/1991 recession and the 2000 recession as seen in **Exhibit 3**. Indications that the economy may be slowing, once again, beg the question of how adequate are current levels of bank loss reserves.

There are a number of similarities between the circumstances of the mid-1980s and 2006, as well as some differences. Most notably, the tax and bank regulatory environments have changed dramatically. The Post-Economic Recovery Tax Act of 1981 had encouraged a more speculative posture among real estate investors by effectively increasing rates of return. Banking regulations were undergoing a period of dramatic changes, and banking supervisors did not have access to the modern information systems that are available today. Two similarities between the periods ring a cautionary note for U.S. banks: 1) that the banking sector had been apparently healthy for a long time and 2) that loan loss reserves were at historic lows. In keeping with the apparent healthy environment, loan loss reserves were at levels lower than have been seen since—until now.

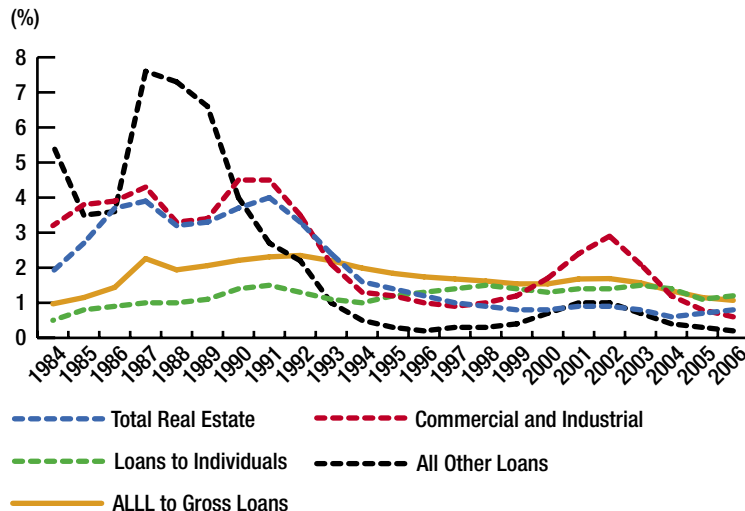
A difference between the mid-1980s and the present is that concentrations in real estate loans are more pronounced today. In particular, com-

mercial real estate and construction financing are at an all-time peak. The percentages of commercial real estate and construction loans stood at 4.76% and 7.62% of average assets, respectively, at year-end 2006, the highest levels ever. While speculative loan underwriting by banks was probably more prevalent in the 1980s than it is now, even with stronger underwriting standards, real estate loans still carry significant risks of cyclical downturns. Some signs of such cyclical turns are already evident in the current subprime residential real estate segment, exacerbated in part by the underwriting of nontraditional mortgage products.

Most important are the current conditions and fundamentals of the real estate market. Signs of weakness are becoming evident in both consumer—mainly adjustable-rate mortgages—and commercial sectors. In addition to the increase in delinquencies already mentioned above, general market conditions are showing some signs of weakness. Certain local residential markets have seen sharp price declines, such as the Cape Coral-Fort Myers,

Exhibit 3

Noncurrent Loan Rates at Year-End



Source: FDIC.

A.M. Best Co. Special Report

March 26, 2007

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



Fla. market, which saw an annual drop in real estate prices of 11.1% in 2006.¹ A new factor in the current market—not reflected in the 1980s—is the widespread use of ARMs and other nontraditional mortgages, many of which are newly issued and still under temporary, initial fixed-rate terms. With more than \$1 trillion of these mortgages set to reprice in 2007,² borrowers, especially subprime borrowers, are expected to remain under significant pressure. Fixed-rate mortgages, however, even in the subprime category, are performing relatively well in comparison with the ARM sector.

These comparisons raise interesting questions regarding the adequacy of loan loss reserves as measured by the allowance for loan and lease losses (ALLL). When calculating average loss rates to compute the ALLL, one factor for consideration is the relevance of recent experience to the current point in the credit cycle.³ If the credit cycle today is echoing some of the characteristics of 1985, it is possible that using recent, low historical loss rates for establishing reserves may be losing relevance.

The 30- to 89-Day Past-Due Pipeline

As yet another indicator of the potential for the U.S. banking industry's 2006 year-end reserve levels to prove inadequate for deteriorating credit risk profiles, the fourth-quarter rise in delinquencies included a troubling increase in the emerging 30- to 89-day past-due category. Historically, these delinquencies are a precursor to more serious delinquencies, which ultimately may lead to loan losses. Another way of stating it: regard the 30- to 89-day past dues as the pipeline that ultimately feeds into the 90+ past dues and the non-accruals (albeit perhaps not dollar for dollar). With a groundswell of the 30- to 89-day past dues underpinning the 90+ day-past dues and non-accruals, the industry reasonably can be expected to face ever-rising delinquencies in the latter category in the coming months and quarters.

The trends of rising delinquencies and deteriorating asset quality across the board in all asset-quality indicators, including OREO, charge-offs, 90+ past dues and non-accruals, and the 30- to 89-day past-due increases, lends further credence to the troubling aspect of the reserve levels being the lowest since 1985.

In the fourth quarter, the more advanced-stage 90+ nonaccrual category already had increased by 14% for all real estate projects and a whopping 31% for the highest-risk construction and development loans. If even half of the emerging 30- to 89-day delinquencies were to move through the pipeline to be included with these loans, the result would be 90+ days non-accrual loans of \$92.7 billion, overwhelming an industry loan loss reserve of \$77.6 billion.

This concern is mitigated somewhat when overall capital levels are considered, as it would be equivalent to approximately 11.1% of tangible equity capital.⁴ While current industry capital levels are reassuring, the question of future capital levels is beginning to emerge, given margin pressures that banks are under; the dramatic signs of recent deterioration that include widely publicized problems with subprime loans; and the yield-seeking that seems to have led to the assumption of greater asset-quality risk. A.M. Best is monitoring the capital levels in the banking industry in light of these risks and may comment further in the future.

A perception may exist that recent efforts to improve the application of generally accepted accounting principles to the ALLL necessarily results in lower reserves. A number of interagency policy statements have been issued clarifying the process for establishing the ALLL, including a reference to a statement indicating the Securities and Exchange Commission does not have a policy of seeking reductions in financial institutions' ALLL.⁵ Furthermore, consideration of national and local economic trends and conditions, changes in credit concentration, shifts in portfolio composition, and levels and trends of delinquencies and impaired loans all are recommended parts of the calculation of the loan loss reserve.⁶ Finally, according to methodologies for calculating the reserve, "Credit-loss and recovery experience may vary significantly depending upon the business cycle. For example, an overreliance on recent credit-loss experience during a period of economic growth will not result in realistic

¹ National Association of Realtors, Existing Home Prices, Single Family, Fourth Quarter 2006.

² Mortgage Bankers Association estimate.

³ Interagency Policy Statement on the Allowance for Loan and Lease Losses, Dec. 13, 2006.

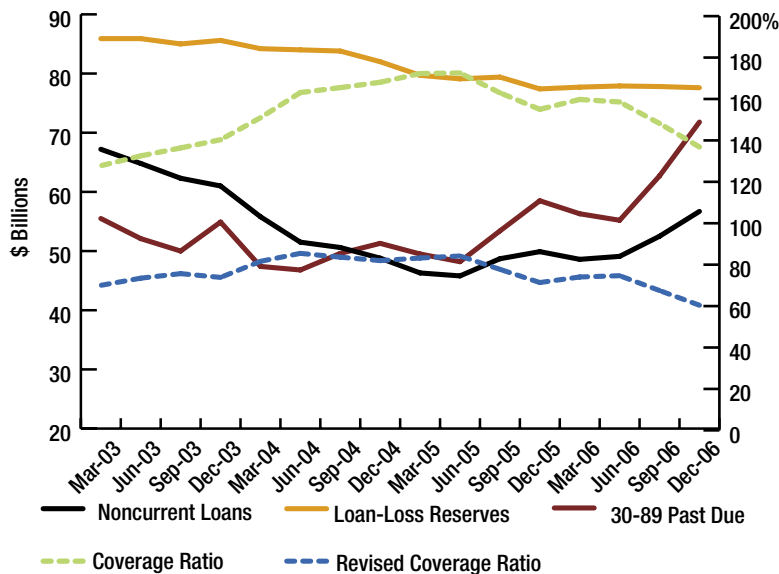
⁴ FDIC Statistics on Depository Institutions.

⁵ Joint Interagency Letter to Financial Institutions, July 12, 1999.

⁶ Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions, July 2, 2001.

Exhibit 4

Reserve Coverage Ratio



Source: FDIC.

estimates of credit losses during a period of economic downturn.”⁷ Although the loan-loss-reserve calculation is not based on a “life of the loan” or “future loss” concept, consider-

ation should be given to the proper context for estimating credit-loss experience.

U.S. banks already appear to be responding to the deteriorating real estate loan quality and low reserve levels, as can be seen in the decreases in loan risk exposure and increases in provisioning during the fourth quarter of 2006. The pace of these responses, however, is lagging the rapidly rising delinquencies across all categories. Given the all-time high risk exposure, the cyclical nature of real estate assets, the current point in the credit and business cycles, and the further signs of rapidly rising credit risks in these portfolios, there is a strong likelihood of further strains on earnings coming from the need to boost the loss-reserve accounts of U.S. banks. Although capital levels are reassuringly high, the question remains whether capital levels will begin to weaken from these earnings pressures and if loan portfolios deteriorate further. A.M. Best will monitor the industry for these developments in further research reports on a quarterly basis.

⁷ Interagency Policy Statement on the Allowance for Loan and Lease Losses, Dec. 13, 2006.



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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)-7-626-6265
www.ambest.co.uk

A.M. Best Asia-Pacific Ltd.
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 18 Harbour Road
 Wanchai, Hong Kong
 Phone: (852)-2827-3400
 Fax: (852)-2824-1833
www.ambest.com.hk