

U.S. Banking – Regulatory Review August 18, 2008

Sector
Banking

U.S. Banking – Closings and Assistance Transactions (2008)

Institution	Failure Date	Total Deposits (000s)	Total Assets (000s)
IndyMac Bank FSB Pasadena, CA	7/11/2008	\$19,064,531	\$32,010,816
AMB Financial National Assoc. Bentonville, AR	5/9/2008	1,792,319	1,895,545
First National Bank of Nevada Reno, NV	7/25/2008	1,412,453	1,634,041
First Priority Bank Bradenton, FL	8/1/2008	227,000	259,000
First Heritage Bank, NA Newport Beach, CA	7/25/2008	135,867	158,701
First Integrity Bank, NA Staples, MN	5/30/2008	50,178	52,916
Douglass National Bank Kansas City, MO	1/25/2008	50,250	52,824
Hume Bank Hume, MO	3/7/2008	13,566	18,682

Source: Federal Deposit Insurance Corp.

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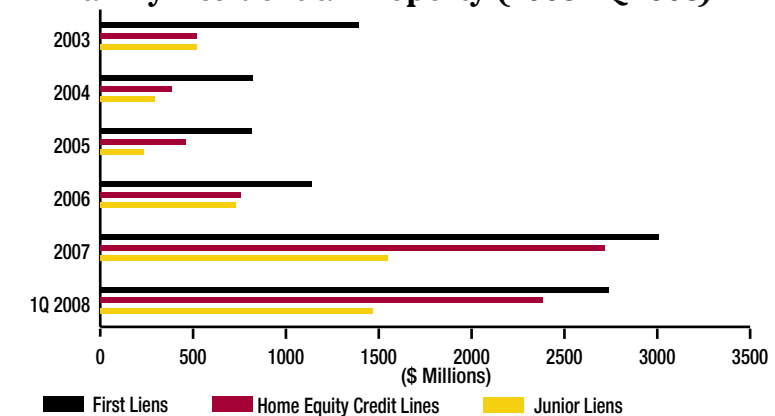
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More Bank Failures Expected As Real Estate Loans Turn Sour

The Federal Deposit Insurance Corp. (FDIC) has been called in as receiver for eight banks through Aug. 4, 2008, following the closure of four institutions in 2007. Prior to the recent closings, the FDIC had not been appointed as receiver for a failed bank since 2004. Regulators expect bank failures in the near term to increase, partly due to some banks' concentration in real estate loans and construction and development lending.

- In July, IndyMac Bank FSB was closed by the Office of Thrift Supervision, representing the nation's largest ever failure of a thrift institution.
- The closing of IndyMac Bank FSB, now known as IndyMac Federal Bank FSB, is expected to cost the FDIC's deposit insurance fund from \$4 billion to \$8 billion.
- IndyMac's failure also will likely reduce the deposit insurance fund's reserve ratio to less than 1.15%, necessitating a restoration plan for the fund by the FDIC.
- The number of institutions on the FDIC's problem list – 90 as of the first quarter 2008 – has risen for six straight quarters after hitting a low of 47 at the end of the third quarter of 2006.
- The banking industry's coverage ratio, or ratio of capital and loan loss reserves to problem assets, fell to 89 cents in reserves for every \$1 of noncurrent loans in the first quarter of 2008, its lowest level since the first quarter of 1993.
- The FDIC may consider advances from the Federal Home Loan Banks in the assessment base used to set premiums banks pay in to the deposit insurance fund.
- Regulators issued final guidance in July for covered bonds, clarifying how the bonds would be treated in the event the FDIC was appointed receiver of a failed bank.

U.S. Banking – Net Charge-Offs for Loans Secured by 1-4 Family Residential Property (2003-1Q2008)



Source: Federal Deposit Insurance Corp.



Real Estate Woes Pressure More Banks

Federal banking regulators expect more bank failures over the next several quarters as turmoil in the nation's housing and real estate markets erodes the capital bases of banks heavily concentrated in mortgage and construction lending.

Through early August, the Federal Deposit Insurance Corp. (FDIC) has been appointed receiver for eight banks closed by regulators, following the failure of three institutions in 2007. The largest takeover occurred early in July when the Office of Thrift Supervision (OTS) shuttered Pasadena, Calif.-based IndyMac Bank FSB. With more than \$32 billion in assets at the time of its closing, IndyMac was the largest thrift ever to fail, according to the OTS, and the third-largest failure of a financial institution (when adjusted to 2007 dollars) since the 1984 collapse of Continental Illinois National Bank & Trust (see **Exhibit 1**).

The closure of IndyMac, now known as IndyMac Federal Bank FSB, is expected to cost the FDIC's deposit insurance fund anywhere from \$4 billion to \$8 billion. The FDIC currently is operating the bank to maximize its value for a future sale. IndyMac has 33 branches and also operates a mortgage servicing loan business and a reverse mortgage company. The FDIC retained Lehman Brothers Holdings Inc. to advise it on the sale of IndyMac's assets, which the FDIC hopes to complete within 60 to 90 days from the July 11 date when it was named as receiver.

July also saw the failure of two smaller banks – First National Bank of Nevada, based in Reno, and First Heritage Bank of Newport Beach, Calif. Both banks were units of First National Bank Holding Co. of Scottsdale, Ariz. The two banks' combined \$3.2 billion in deposits were transferred to Mutual of Omaha Bank, a subsidiary of Mutual of Omaha, the life insurer. Mutual of Omaha Bank also purchased about \$200 million of assets. The FDIC will retain the remainder of the failed banks' assets for later disposition. The FDIC said the transactions would cost its deposit insurance fund an estimated \$862 million.

In early August, the FDIC was appointed receiver of Bradenton, Fla.-based First Priority Bank after the Florida Office of Financial Regulation shut down the bank. As of June 30, First Priority had total assets of \$259 million and total deposits of \$227 million. SunTrust Bank of Atlanta agreed to assume First Priority's insured deposits and also will buy about \$42 million of the failed bank's assets. LNV Corp. of Plano, Texas will buy another \$14 million of First Priority's assets. The FDIC, which plans to retain the remainder of First Priority's assets for later sale, estimated the cost of

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the bank failure to the deposit insurance fund at \$72 million.

Before 2007, the FDIC hadn't been called in as receiver for a failed bank since 2004, when four institutions were closed. But the FDIC and other regulators have been gearing up for more bank failures, primarily because of concerns over the banking system's concentration in real estate loans and construction and development lending.

More Bank Failures Expected

During Senate testimony in early June, FDIC Chairman Sheila Bair noted that the number of bank failures in recent years has been "unusually low" by historic standards and that the FDIC expects bank failures in the near term to increase. Bair also warned that future failures could include banks of greater size than those that have failed in the recent past.

Apart from the eight institutions closed this year through early August, there are a rising number of institutions that the FDIC has under heightened regulatory scrutiny because of dwindling capital cushions. During the first quarter, there were 90 banks with total assets of \$26.3 billion on the FDIC's so-called "problem list," up from 76 banks with total assets of \$22.2 billion at the end of 2007 (see **Exhibit 2**).

Exhibit 1 U.S. Banking – Largest Failures by Asset Size

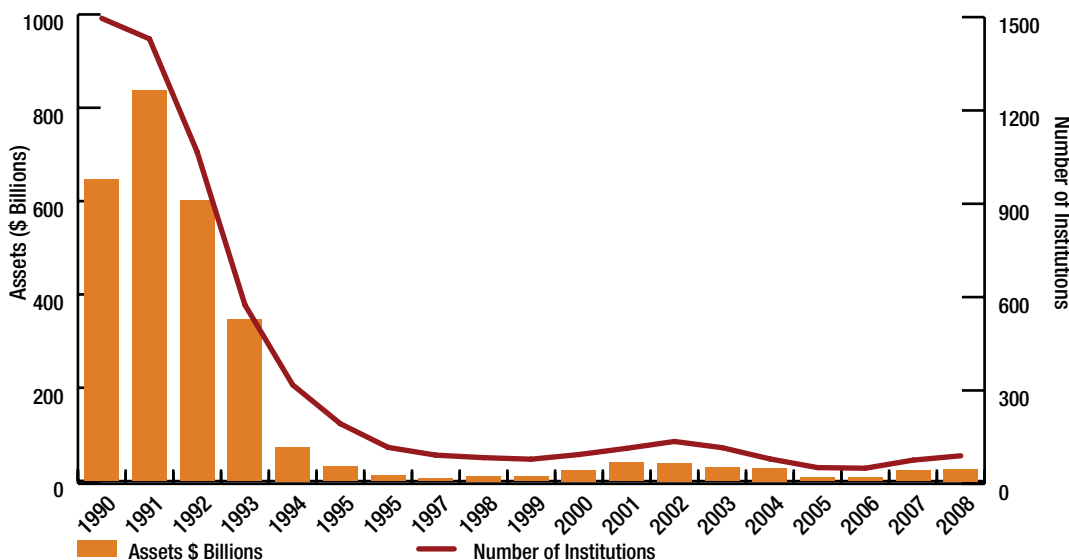
Institution	Failure Date	Total Deposits (000s)	Total Assets (000s)
Continental Illinois National Bank & Trust Chicago, IL	5/17/1984	\$28,590,214	\$39,956,956
IndyMac Bank FSB Pasadena, CA	7/11/2008	19,064,531	32,010,816
American S&LA Stockton, CA	9/7/1988	15,411,331	30,162,228
First Republic Bank Dallas, NA Dallas, TX	7/29/1988	7,680,063	17,085,655
Bank of New England, NA Boston, MA	1/6/1991	9,406,853	13,428,614
Gibraltar Savings, FA Simi Valley, CA	3/31/1989	7,575,392	13,382,327
HomeFed Bank, FA San Diego, CA	7/6/1992	8,903,571	12,175,590
Southeast Bank, NA Miami, FL	9/19/1991	8,908,637	11,026,691
Goldome Buffalo, NY	5/31/1991	6,525,085	9,890,866
City Savings, FSB Somerset, NJ	12/8/1989	7,322,665	9,813,776

Source: Federal Deposit Insurance Corp.

Twenty institutions were added to the problem list during the first quarter, and six were removed. About 75% of the institutions added to the list in the first quarter had concentrations in commercial real estate lending or construction and development lending, or both, according to the FDIC.

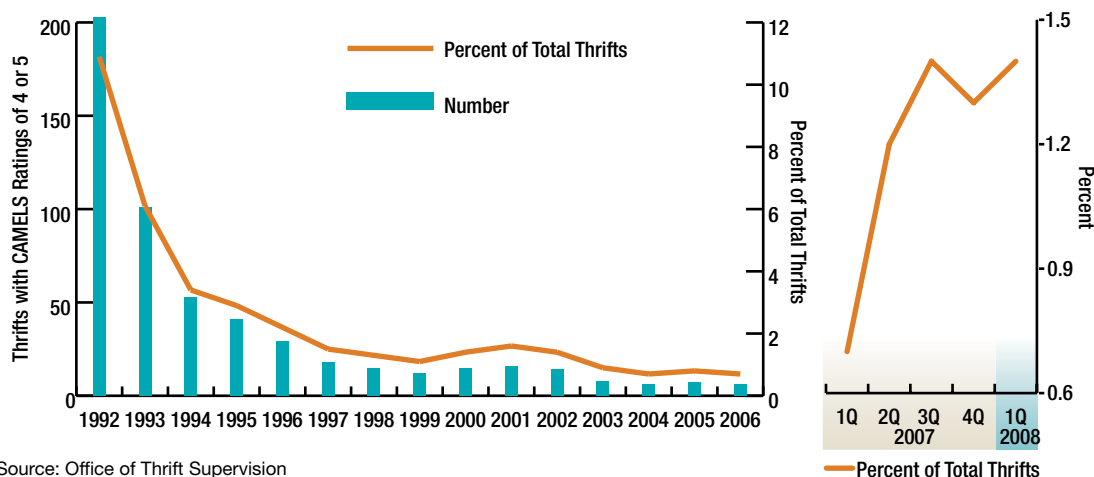
The FDIC doesn't make public the names

Exhibit 2 U.S. Banking – Problem Institutions (1990-1Q2008)



Source: Federal Deposit Insurance Corp.

Exhibit 3 U.S. Banking – Number of Problem Thrifts (1992-1Q2008)



Source: Office of Thrift Supervision

of banks on its problem list for fear of setting off a withdrawal run on these banks' deposits. IndyMac was placed on the FDIC's problem list in June, an FDIC official confirmed. The number of institutions on the problem list is expected to rise when the FDIC releases an updated problem list in August.

The number of problem institutions has risen for six straight quarters after hitting a historic low of 47 at the end of the third quarter of 2006. The current number of institutions on the problem list is at its highest point since the third quarter of 2004, when there were 95 problem institutions, FDIC figures show. The growing list is still well short of peak levels hit in the midst of the savings and loan crisis, when 1,430 institutions with combined assets of \$837 billion were listed at year-end 1991, according to the FDIC.

The number of problem thrifts regulated by the Office of Thrift Supervision also has been rising in recent quarters (see **Exhibit 3**).

For several quarters, deteriorating asset quality, particularly in real estate loan portfolios, has hampered earnings at many of the nation's financial institutions. As banks have had to set aside more capital for souring loans, returns and margins have suffered. Banks, though, haven't added to their reserves fast enough to keep pace with the number of delinquent or nonperforming loans on their books.

Figures from the FDIC show that the banking industry's "coverage ratio" – or the ratio of capital and loan loss reserves to problem assets – fell to 89 cents in reserves for every \$1 of noncurrent loans, the lowest level for the coverage ratio since the first quarter of 1993. The coverage ratio, which declined from 93 cents at the end of 2007, has fallen for eight consecutive quarters, according to the FDIC.

There are other signs that banks could face further write-offs over the next several quarters. Since home prices in many major metropolitan areas have been declining, the loan to value ratios for banks' home-equity loan portfolios may be rising to the point where there is little collateral left to back the loan. In other words, more of these loans that were secured by a borrower's home may now be unsecured due to the fall in home prices.

Nonperforming Assets Cloud Performance

A concentration in real estate has been a common theme among some of the bank failures in 2008. In the case of First National Bank Holding Co., its two subsidiaries closed by the OCC had been struggling with poor loan performance. The holding company, for example, recorded a first-quarter provision of \$115.5 million for loan and lease losses. That contributed to the bank swinging to a \$140.4 million net loss, compared with net income of \$9.1 million in the first quarter of 2007, according to FDIC figures.

Nearly 9.5% of loans at First National Bank Holding’s subsidiaries were 90 days or more past due in the first quarter. That compared with 1.5% in the first quarter of 2007. Noncurrent loans as a percentage of all loans and leases in the construction and development category hit 14.62% in the first quarter of 2008.

IndyMac, which operated as a hybrid thrift and mortgage banking company, focused on originating and securitizing Alt-A mortgages. These loans are made to borrowers with credit scores higher than those considered subprime but not high enough to qualify for prime mortgages eligible for purchase by government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac.

IndyMac’s Alt-A mortgages generally were jumbo loans outside the conforming limits allowable for purchase by the GSEs. The bank’s underwriting standards also typically relied on borrowers’ stated-income rather than full documentation of income, according to the OTS.

But IndyMac’s originate to securitize model hit a snag with the onslaught of the credit crunch in the second half of 2007. It wasn’t able to sell a large portion of its Alt-A portfolio, prompting it to reclassify \$10.7 billion of loans intended for sale to “held for investment” in the fourth quarter of 2007, the OTS said. Concerns from the OTS had

prompted IndyMac to change its business plan in November 2007 to focus on originating mortgages that qualified for purchase by the GSEs. The OTS said it deemed IndyMac to be in “troubled condition” in January 2008.

IndyMac Bancorp, the parent of the bank unit that failed, posted a \$184.2 million loss in the first quarter of 2008, the most recent financial data available. That compared with net income of \$52.4 million for the first quarter of 2007. Total nonperforming assets as a percentage of total assets were 6.51% as of March 31, 2008, compared with 1.09% at March 31, 2007.

In mid-June, the OTS sent IndyMac an enforcement order known as a memorandum of understanding, agreed to by the bank on June 20. Noting that IndyMac already was in distress, the OTS said the immediate cause of its closing was a deposit run that began with the release of a June 26 letter by Sen. Charles Schumer, D-N.Y., to the OTS and FDIC. The letter expressed concern about IndyMac’s viability. In the next 11 business days, depositors withdrew more than \$1.3 billion from the bank.

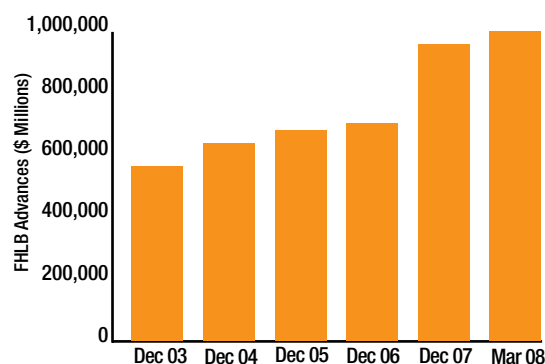
Schumer, in turn, said the bank’s failure was due to its long-standing practices, including its emphasis on originating riskier mortgages. He also said the OTS was lax in its regulatory oversight of the bank.

Higher FDIC Premiums Likely

The failure of IndyMac also highlights the reliance of some thrifts and community banks on advances from the Federal Home Loan Bank system (FHLB), another GSE, as a viable funding source. FHLB advances to the nation’s banks rose nearly 36.6% in 2007 and were up another 4.3% in the first quarter of 2008 (see **Exhibit 4**).

With turmoil in the capital markets, FHLB advances have provided banks with a cheaper source of funds. The advances also have been more cost effective than funding through deposits for some banks. Although the Federal Reserve has cut the federal funds rate by 3.25 percentage points since September 2007, some banks have not lowered their deposit rates at a similar pace.

Exhibit 4
U.S. Banking – FHLBank Advances
(2003-1Q2008)



Source: Federal Home Loan Banks

Regulators, Banks Throw Weight Behind U.S. Covered Bond Market

Amid turmoil in the mortgage market and the broader credit crunch, regulators and the Bush administration have put their weight behind covered bonds in an attempt to increase mortgage financing and provide banks with a new and diversified funding source.

Covered bonds are a popular financing vehicle in Europe, where issuance is estimated at \$3.3 trillion. However, only two U.S.-based institutions – Bank of America Corp. and Washington Mutual Inc. – have issued these securities, partly because of uncertainty over the regulatory environment and investors' concerns over how covered bonds would be treated in the event of a bank failure.

Covered bonds are a somewhat more restrictive form of securitization in that banks continue to hold the mortgage pools that back covered bonds on their books. That is in contrast to the typical mortgage securitization in which bonds backed by a mortgage pool are issued through a bankruptcy-remote, off-balance sheet trust.

The mortgages in a covered bond transaction represent separate obligations of the bank that can be liquidated in the event of insolvency. But until the Federal Deposit Insurance Corp. (FDIC) issued a final policy statement in July, bond investors would have had to wait as long as 90 days to take control of the collateral in the event of an FDIC receivership of a failed institution. The new guidance now reduces that time to 10 days.

The push for clarification for U.S.-issued covered bonds, particularly from the U.S. Treasury Department, marked another in a growing number of policy initiatives to address the market stress in the residential mortgage market. In late July, conventional fixed-rate, 30-year mortgages hit their highest level in the past year (see **Exhibit 5**).

Concerns, meanwhile, over capital levels and the viability of Fannie Mae and Freddie Mac, two government-sponsored enterprises (GSEs), drove passage in late July of a broad housing package in Congress. A key piece of that legislation provides the Treasury secretary with temporary authority to buy an unlimited amount of GSE obligations and securities through 2009. (Obligations issued by the Federal Home Loan Banks, another GSE, also are eligible for purchase under the legislation.) Previously, debt issued by Fannie Mae and Freddie Mac was not explicitly guar-

anteed by the federal government, although the Treasury secretary had the authority to purchase up to \$2.25 billion each in the debt of the two GSEs.

Covered bonds have been pitched as a potential new source of financing, since banks have found it difficult to securitize their mortgage loans from off-balance-sheet vehicles because of rising losses and delinquencies in the current environment. In late July, Bank of America, Citigroup Inc., JPMorgan Chase & Co. and Wells Fargo & Co. said they would begin issuing covered bonds. The four banks announced their support for the FDIC's guidance and a set of best practices prepared by the Treasury Department.

One feature of covered bonds could make them more palatable to investors hit by losses from other mortgage-backed securitizations. The issuing bank is able to change the loans in the pool if its credit quality deteriorates so that the bonds continue to receive interest payments. The FDIC's guidance also allows banks to substitute cash, U.S. Treasury securities and agency securities for the initial collateral to "prudently manage" the cover pool.

Other elements of the FDIC's guidance included revising the term limit for covered bonds to 30 years, up from 10 years initially proposed. In addition, mortgages that comprise the collateral pool for covered bonds must be underwritten conservatively. On that score, the FDIC resisted comments from banks and industry groups that sought to expand eligible mortgages for covered bonds to second-lien home equity loans and home equity lines of credit, among other assets.

Although the covered bond market has been viewed as a liquidity aid for banks and the troubled mortgage market, it is not expected to overtake the broader mortgage-backed securities market any time soon. That is partly because a bank's issuance of covered bonds may not exceed 4% of its total liabilities, according to the FDIC's guidance.

Covered bonds also are not immune to turmoil in credit markets. In November 2007, inter-dealer trading of European covered bonds was shut down for about a week because of an extreme widening of spreads for outstanding bonds. At the time, liquidity across many fixed-income markets had declined because dealers were concerned about trading with each other, higher funding costs and the need for cash to close their books with the approaching year end.

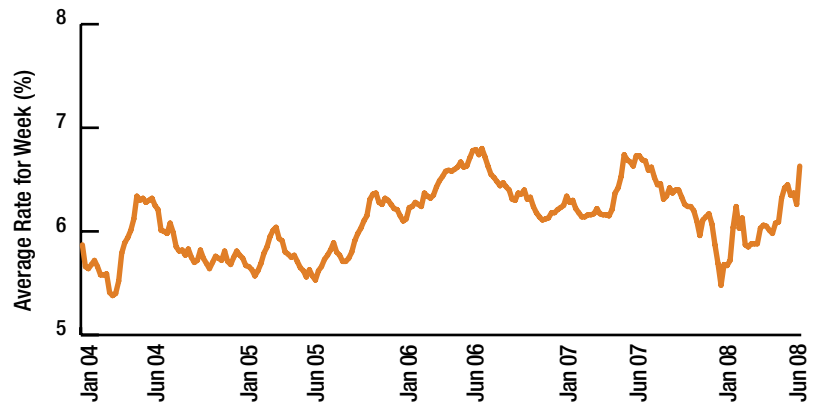
IndyMac had \$10.1 billion in FHLB advances as of June 30. Those advances are collateralized by assets the FDIC isn't able to sell to help maximize IndyMac's recovery and reduce the FDIC's insurance costs. That is partly why the FDIC may consider including FHLB advances in the assessment base used to set FDIC premiums, primarily for institutions with a significant level of advances.

IndyMac's failure is expected to reduce the FDIC's designated reserve ratio for its deposit insurance fund to less than 1.15%. The reserve ratio of insured deposits was 1.19% as of March 31. Under a law passed in 2005, the FDIC is required to submit a restoration plan once the reserve ratio falls below 1.15% that restores the designated reserve ratio to a target of 1.25% of insured deposits. The FDIC is expected to release that plan in September.

The FDIC also is moving forward with a plan requiring the nation's largest banks to establish standard practices for determining deposit and other account balances that would be used by banking regulators in the event of a bank failure. The rules take effect Aug. 18 and also require large banks to have mechanisms in place to allow for holds and releases on certain accounts.

The FDIC also proposed new rules for

Exhibit 5 U.S. Banking – 30-Year Fixed-Rate Mortgage Rates



Source: Freddie Mac

sweep transactions that automatically move funds from deposit accounts to other accounts internally within a bank or to external accounts. Where sweep arrangements transfer funds from insured deposit accounts to nondeposit investment vehicles or accounts, the FDIC said the swept funds wouldn't be eligible for deposit insurance coverage. The FDIC also would require banks to disclose to customers whether the swept funds are deposits and the status of the swept funds if the institution failed. The rules won't take effect until July 1, 2009 so the FDIC can consider industry comments.



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