

U.S. Banking Trends for 2005 — Signaling End of Peak Industry Cycle

In January 2006, AM Best initiated in-depth analysis and coverage of the U.S. banking industry. To this end, a new series of regular research papers and analytical methodologies will be published, focusing

on banking issues, trends and developments. This article is an annual review of highlights of U.S. commercial banking industry trends observed from regulatory filing data. www.ambest.com/banks

U.S. commercial and savings banks are on track to close out 2005 with continuing solid trends in operating performance and balance sheet strength, based on recent fourth-quarter earnings releases and third-quarter regulatory filings. At the same time, however, these 2005 trends are leveling off from past years' highs, and both larger economic indicators and industry conditions are showing underlying worrisome developments that strongly signal the turning of the cycle peak for the industry going into 2006.

2005 industry summary: The industry, in aggregate, exhibited robust growth combined with strong asset quality, solid profitability,

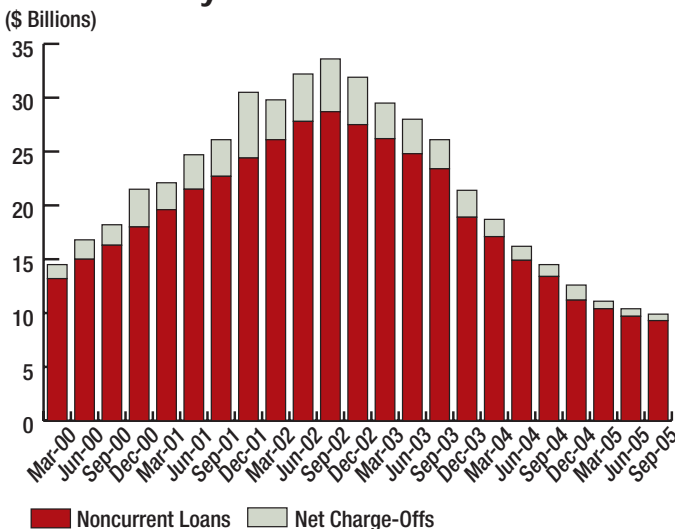
continuing improvement in capital positions and a 10-year record low number of problem banks for the quarter results ended Sept. 30, 2005 (Charts 1, 2, 3, and 4). The industry's liquidity is subject to longer-term, supply-related issues in relation to banks' asset growth, but it stands adequate at the present. U.S. banking assets grew at a rate of 8.3% at Sept. 30, 2005, as compared with the same period in 2004, while deposits grew at 9.2%, with short-term borrowings making up the difference. Earnings held up remarkably well through 2005, except for a spike in consumer credit charge-offs in the fourth quarter, which raised credit costs at some of the largest credit card-issuing banks. New, stricter bankruptcy laws went into effect in October 2005, and the rush of personal bankruptcy filings was

This report was written by Khanh Vuong, senior financial analyst with A.M. Best Co.

2005 was another banner year for U.S. commercial banks by most key measures:

Chart 1

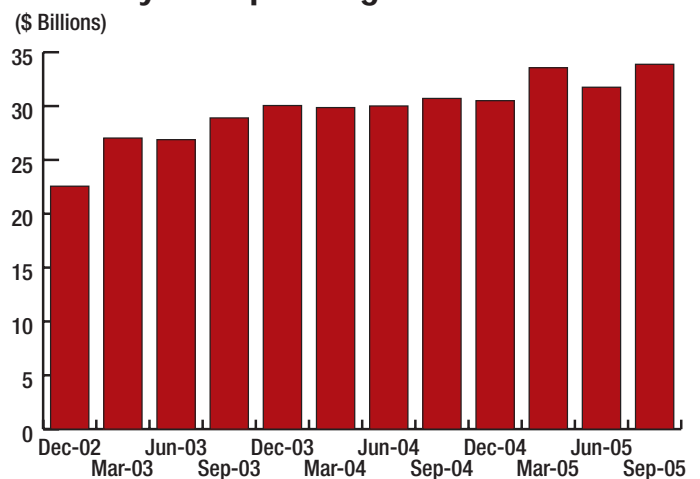
Credit Quality of C&I Loans



Source: FDIC

Chart 2

Quarterly Net Operating Income



Source: FDIC



at record levels during the last two months of 2005. It is expected that the elevated charge-offs will spill over to the first quarter of 2006 but then return to more normal levels closer to those prior to the new law.

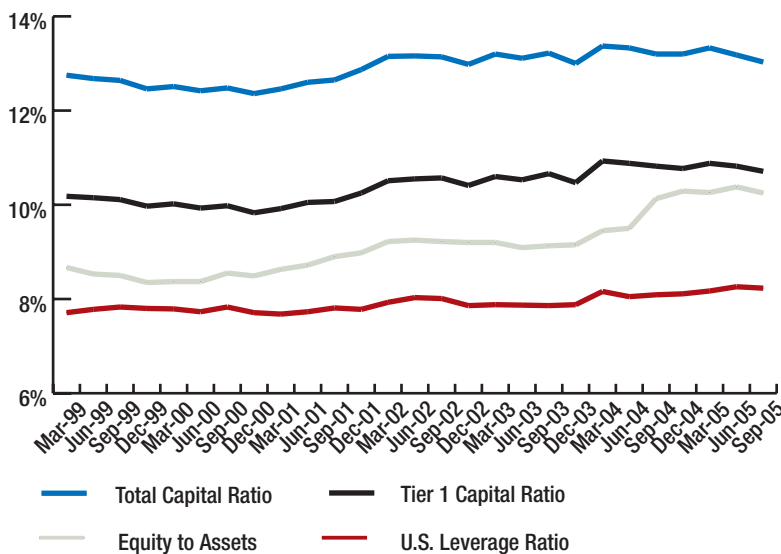
Net interest margins withstood pressures with a largely flat line in net interest margin trends during the year (Charts 5

and 6). The industry took advantage of opportunities to increase levels of higher-yielding assets while also minimizing loss of lower-cost deposit funds. While the industry momentum at year end 2005 is cooling off from prior years' record performance levels, there remains sufficient support for these trends to continue into 2006, but with a cautionary note. There are notable pressure points on the earnings and balance sheet condition of U.S. banks on many fronts at the start of 2006.

Net interest margin trends: In the near to intermediate term, the industry is expected to continue to experience pressures on its net interest margin. The industry has had to absorb a total of eight rate hikes in 2005, and inflationary pressures may linger still for the foreseeable future. Even with the possibility of the end of the Federal Reserve's rate hikes sometime in

Chart 3

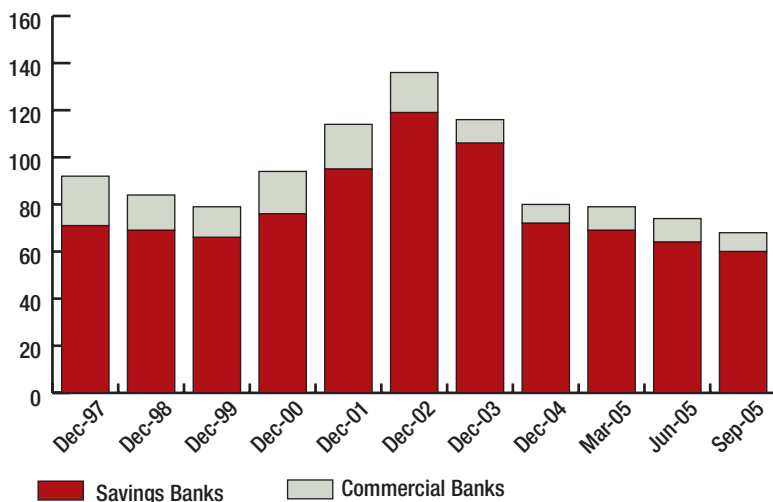
Capital Ratios 1999-2005



Source: FDIC

Chart 4

Number of FDIC-Insured "Problem" Institutions



Source: FDIC

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2006, net interest margins for banks are likely to continue to be pressured by the lack of lower-cost deposit funds in the industry. The degree of margin compression experienced by banks may vary depending on the shape of the yield curve, as well as the ability of banks to garner more of the higher-yielding assets relative to low-yielding assets. Large banks (with assets in excess of \$50 billion) historically seem to experience more margin compression than smaller banks, which traditionally have benefited from closer ties to their deposit and borrowing client bases (Chart 5). Adding to the effect of the rising rate environment will be higher funding costs for yet another reason, namely the slower growth of the deposit base in comparison with that of banking assets nationally (Chart 7). As a result of the faster rate of growth of banks' assets than of low-cost funding, banks have had to rely more on higher-cost, nondeposit as well as wholesale funding sources and short-term borrowings. Whether these factors will cause a significant deterioration of the industry's net interest margins depends on the ability of the banks to adroitly manage asset and liability mix in 2006 through a combination of increased holdings of high-yielding assets and of core deposits. Banks will also look to noninterest income to offset the effects of the declining net interest margins.

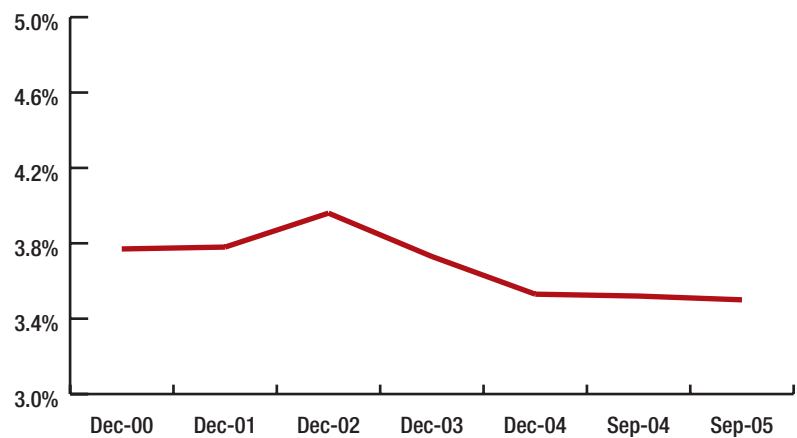
Credit cost trends: Concurrent with a net interest margin squeeze, banks' earnings will be subject to higher noninterest rate-related factors. Credit cost in terms of greater loan loss provisions will climb back up from recent years' record low levels for a number of reasons. U.S. banks will need to build their loan loss reserves back to nonpeak cycle levels, if only because the industry's reserves-to-loan ratio has been setting new record lows for the past four years (Chart 8). Moreover, loan loss and charge-off rates have been on the rise beginning in the third quarter of 2005 (Chart 9), possibly marking a new phase in the credit cycle past the peak conditions seen in the past several years. There has also been a notable reversal of the past decade-long decline in corporate borrowings, beginning in the second quarter of 2004 (Chart 10), which may or may not continue into the foreseeable future. A

greater weighting of loan assets to other earning assets by U.S. banks will generate higher credit expenses. Within the consumer banking segment, delinquency and charge-off rates probably are bound for still faster increases. According to the recent Senior Loan Officer Opinion Survey by the Federal Reserve, the industry has exhibited laxer underwriting standards during 2005, especially in the high-risk consumer mortgage loan products.

Chart 5

Net Interest Margins, Annualized 2000-2005

Net Interest Margin (%)

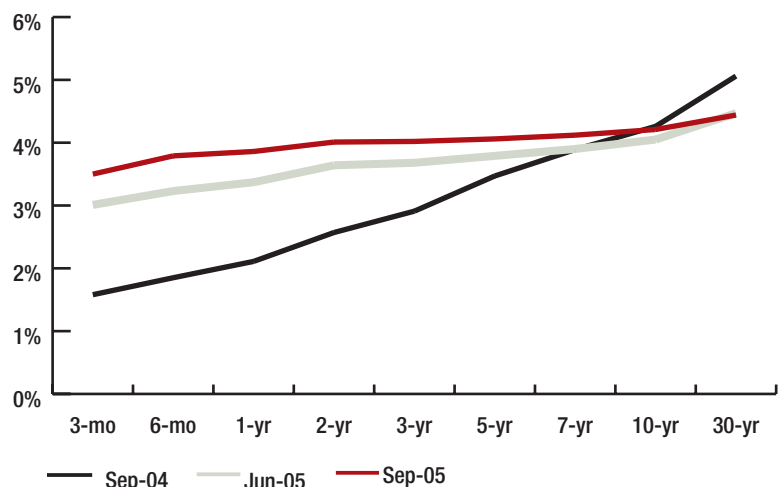


Source: FDIC

Chart 6

U.S. Treasury Yield Curves

Sept. 30, 2004 - Sept. 30, 2005



Source: Federal Reserve H.15 Statistical Release; 30-year T-Bond

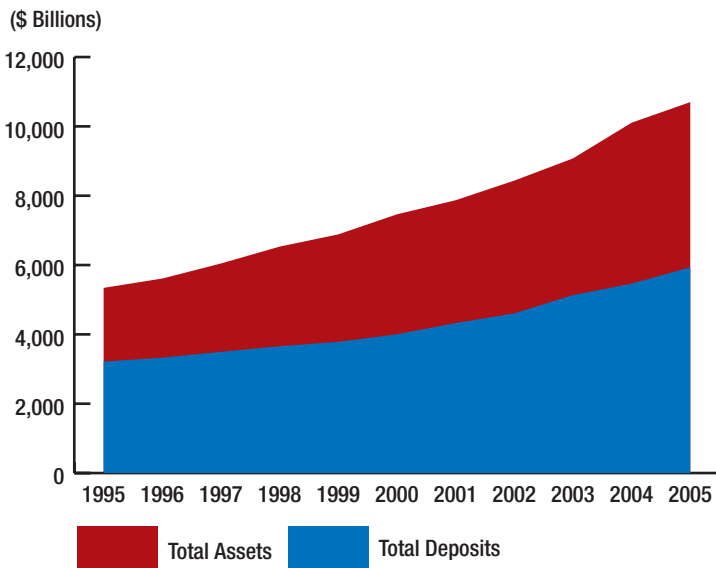
These high-risk credit assets are fertile grounds for high loss rates for this segment, as the consumer sector is heading into a challenging phase. In combination with weakening consumer income and confidence levels, these conditions are exerting pressures on the quality of banks' consumer credit portfolios and associated credit costs.

Operating cost trends: Adding to the pressures on the industry's earnings are

signs of declining economic returns of its retail branch networks. Retail branches' expenses have started to creep up, while their economic benefits in gathering deposits and generating fee revenue are slowing. U.S. banks have been opening new offices and retail branches at a steady rate since the 1980s, despite long-term consolidation in the industry. Both 2004 and 2005 marked the recent highest growth of offices and branches (Chart 11), as consumer and retail banking provided the industry with strong earnings. However, as market and economic conditions are cooling off, the high number of branches is beginning to affect the economic return of these networks for banks. Although growth in total deposits remained strong in 2005, it has leveled off from the peak in 2003, while core deposits in particular actually have been declining (Chart 15). Furthermore, combined with a generally improving equity market, the industry is expected to experience some effects of disintermediation of consumer savings away from banks into mutual funds and equity investments. As a consequence, the competition among banks for deposit funds is intensifying. In turn, this will exert pressure on banks' operating expenses. On the other hand, banks historically have been successful in cutting cost to improve margins when revenues are pressured. The overhead ratio (operating expenses as a percentage of operating income) of the industry is one of the key metrics to monitor for the coming year.

Chart 7

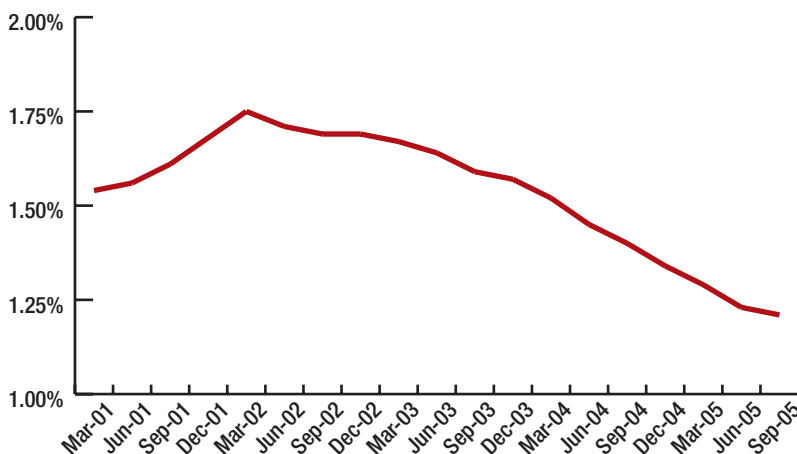
Total Assets and Deposits Of FDIC-Insured Institutions



Source: FDIC. Year-end 2005 data are annualized based on third-quarter filings.

Chart 8

Loss Allowance to Loans and Leases



Source: FDIC

Balance sheet trends: Similar to the operating performance issues, U.S. banks' balance sheet condition in 2006 will be prone to the above-mentioned adverse effects of scarcer cheap funding sources; higher-risk underwriting activities; weaker economic factors—especially within the consumer sector; and an overexposure to real estate risk. The industry's loan loss rates stand at historically low levels as of year-end 2005, but noncurrent loans, which provide a forward-looking picture of asset quality, registered an increase in the third quarter of 2005 (again as shown in Chart 9) and are expected to be on a continuing trend of further increases. The loss reserve to total loans wore thinner by historical standards for the industry, standing at

1.21% as of Sept. 30, 2005, vs. 1.40% for the same period in 2004. The loss reserve to noncurrent loan ratio receded from record levels beginning in the third quarter of 2005 back to the early 2004 level of 1.6 times (Chart 12). With added credit risk as well as lower asset-quality trends, banks will need to adjust their loan loss reserve and/or improve their Tier 1 capital and capital ratios. Yet, with the cost attached to holding capital in an environment of increasing competition, the industry's capital cushion relative to actual risk levels is at risk of declining, especially for the smaller banks, during some quarters in 2006. The 50 largest U.S. banks have been building up their capital levels, perhaps partly in anticipation of the perceived change of industry conditions and partly in preparation for the new Basel II capital requirement for operational risk.

Real estate risk: The overarching factor for the industry may well be the risk of a downturn in the real estate market that has the potential of becoming more severe sometime in 2006. Even a continued mild downturn in real estate conditions would be certain to amplify any asset-quality issues that should materialize for the industry. In spite of slower growth of real estate-related assets, banks currently are heavily exposed to real estate risk, whether in the form of loan assets, mortgage securities or other forms of indirect investments such as securitized mortgage instruments (Chart 13).

At the end of 2005, there are signs that the real estate market may be slowing. The seasonally adjusted annual rate of existing home sales was down in November 2005 by 4.4% from September 2005, while the inventory of existing homes available for sale has been steadily climbing since January 2005 (Chart 14). The rising inventory levels are likely to create downward pressure on prices. As of late 2005 there was already some evidence of a slowdown in housing price appreciation in several parts of the country. Although the price appreciation rates are dropping from what are arguably historic levels, the recent slowing, combined with higher interest rates, has caused a decline in home equity lending at U.S. banks.

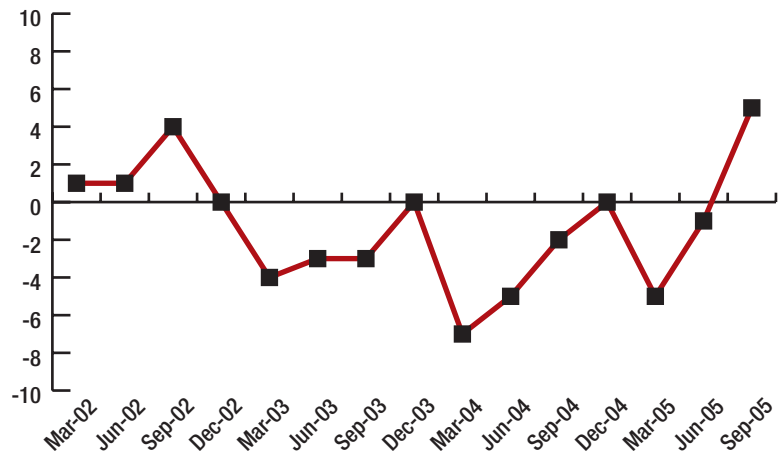
Should the delinquency and losses on

mortgages and other real estate credit products begin to rise more rapidly, the high real estate exposure at the U.S. banks may present widespread credit and liquidity issues, which may be a harder hit on the banks' balance sheets than fully anticipated by the industry based on the current level of loss reserves. The embedded optionality in mortgage assets also poses interest rate risk and potential earnings volatility for banks.

Chart 9

Quarterly Change in Noncurrent Loans & Net Charge-Offs

(\$ Billions)

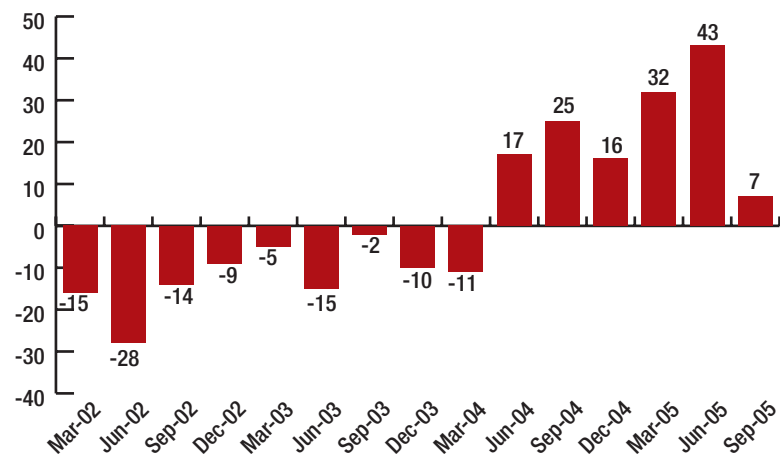


Source: FDIC

Chart 10

Quarterly Changes in C&I Loans — 2002-2005

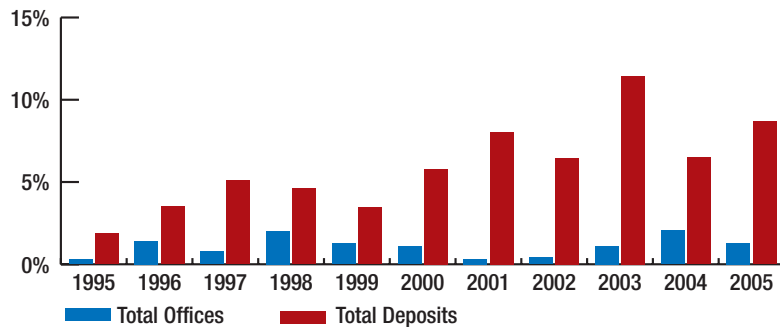
(\$ Billions)



Source: FDIC

Chart 11

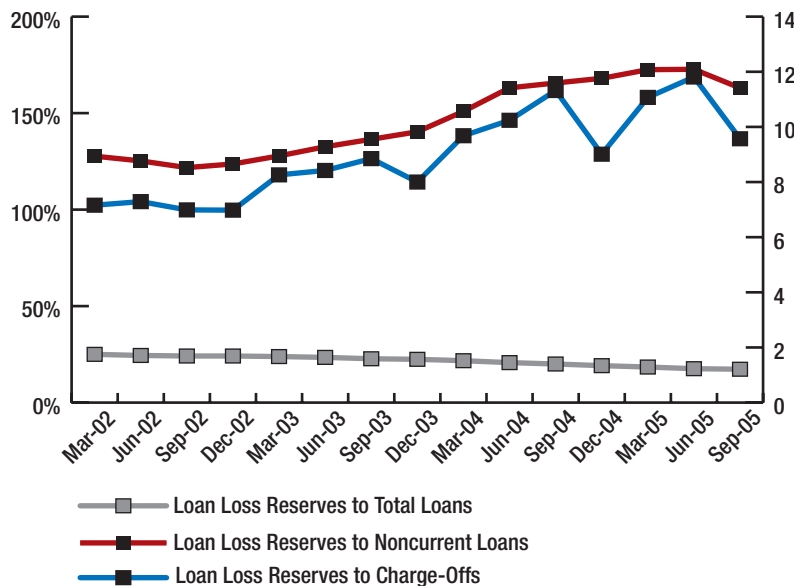
Growth Rates of Bank Offices vs. Domestic Deposits



Source: FDIC. Year-end 2005 data are annualized based on third-quarter filings.

Chart 12

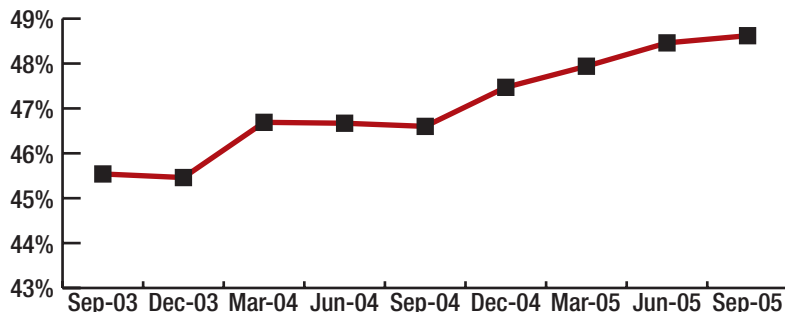
Loan Loss Reserve to Charge-Offs Ratio



Source: FDIC

Chart 13

Banks' Real Estate Exposure As a Percentage of Total Assets



Source: FDIC

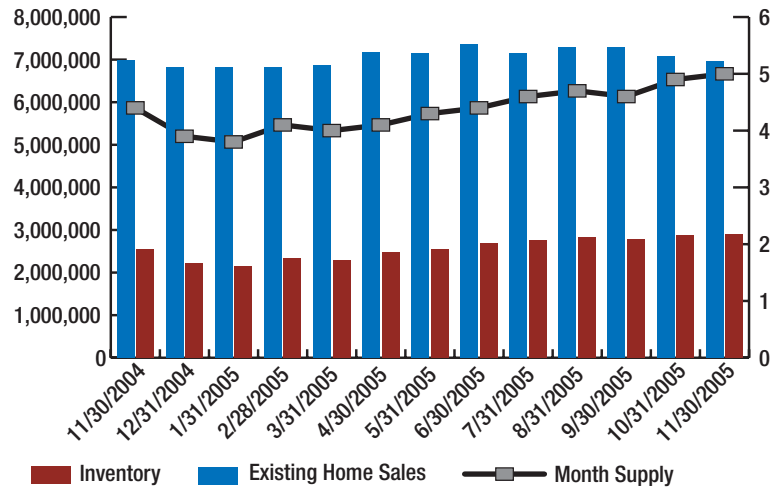
Liquidity trends: In terms of liquidity measures, U.S. banks' liquidity is adequate at year-end 2005, but sourcing funds at competitive rates may be an issue for the industry at some point in the future. While this has been a growing trend for U.S. banks for at least the past decade, the problem may be more pronounced under less favorable industry conditions. The composition of banks' funding sources as a percentage of total assets has shifted toward more of the higher-cost deposits and short-term borrowings. Low-cost core deposits (defined as demand, time and other customer deposits of \$100,000 or less) as of quarter end Sept. 30, 2005, made up 35.8% of total assets, as compared with 38.0% three years ago and 49.88% 10 years ago. At the same time, banks' core deposits are becoming more transient as a source of funding. Banks already have had to spend more effort and costs to attract deposits. As a result, wholesale funding sources (institutional and brokered deposits) and borrowed funds (interbank funds and Federal Home Loan Bank advances) are being tapped on a more regular basis (Chart 15). Consequently, the industry increasingly is operating with tighter net interest spreads and potentially more volatile earnings than in the past.

Outlook for 2006: The U.S. banking industry is entering 2006 in a relatively healthy condition. However, a rise in loan delinquency and loss rates already has been observed, and other issues underpinning the industry are exerting pressures on the earnings and balance sheet condition of the banks. There remains sufficient support for positive industry trends to continue into 2006, but with a cautionary note. Faced with new challenges, there is likely to be a divergence in performance between the stronger and the weaker or unprepared banks. Even among banks that traditionally are regarded as having strong profiles, a defensive repositioning of their asset and funding mix, a proactive bolstering of loss reserves, and a combination of more prudent credit underwriting and/or laying off of credit exposures in areas of high concentration would be viewed favorably by analysts. If the all-critical flattened yield curve condition should persist throughout much of 2006, those banks better able to control operating

expenses in a rising cost environment (in terms of cost of funds and credit costs) would correspondingly fare better. Finally, banks with strong, diversified franchises should benefit from a resilient net interest margin and a strong base of fee and other noninterest income sources to provide a buffer against a potentially tougher environment for U.S. banks in 2006.

Chart 14

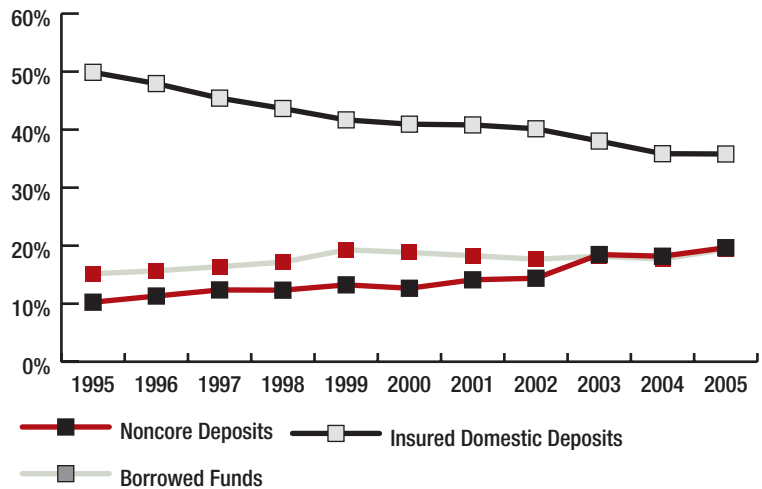
Home Sales and Inventory vs. Month Supply



Source: National Association of Realtors

Chart 15

Banks' Major Funding Sources As a Percentage of Total Assets



Source: FDIC



The Insurance Information Source

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