A.M. BEST

STATISTICAL STUDY MAY 2006

Consumer Credit Sector May Start Slowdown for U.S. Banks in 2006

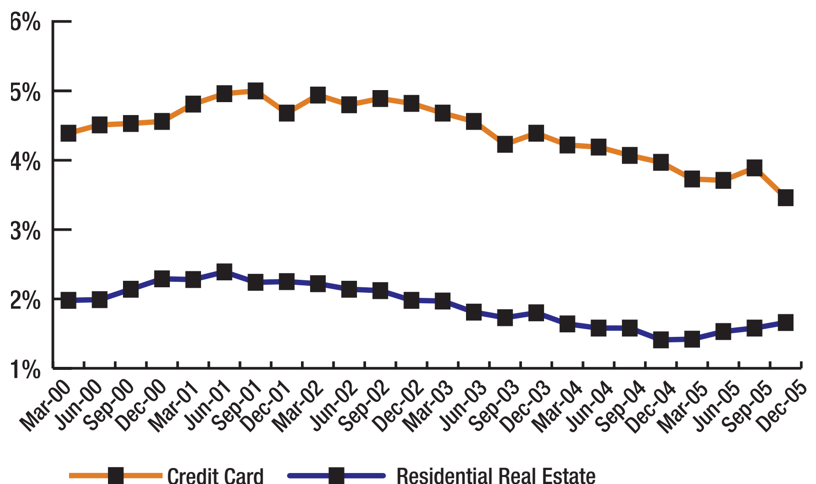
The U.S. banking industry has achieved record earnings over the past several years, in part due to the strength of consumer borrowing activity. Fueled by relatively low interest rates and strong price appreciation in residential real estate, the levels of mortgage and consumer debt have risen significantly, as consumers have tapped increasing levels of home equity. However, if interest rates continue to rise and the pace of home price appreciation slows significantly, the strength of the consumer sector may be curtailed.

Loan growth in the consumer sector (defined as 1-4 family residential mortgages, home equity loans, and loans to individuals – including credit card loans) was relatively benign in the fourth quarter of 2005 at 1.1% and was markedly lower than in the fourth quarter of 2004, during which consumer borrowing grew by 3.8%. Within the sector, the fourth-quarter growth rates of residential mortgages (1.34%), home equity loans (-0.73%) and loans to individuals (1.89%) all slowed in comparison with the third quarter (3.42%, 0.82% and 2.77%, respectively). Despite record numbers of fourth-quarter personal bankruptcy filings, in response to changes in the bankruptcy laws, credit card balances at FDIC-insured banks actually grew at a rate of 7.25%, likely due in part to seasonal holiday shopping. Although credit card balances grew steadily in the fourth quarter of 2005, growth rates in the fourth quarter of 2004 were stronger at nearly 10%. In addition, card balances at Dec. 31, 2005, were modestly lower at $395.2 billion, compared with $399.2 billion at Dec. 31, 2004.[1]

Consumer borrowing patterns, particularly in the home equity and credit card segments, appear to be impacted by the effect of increases in short-term rates, which the Federal Reserve raised by 325 basis points between June 2004 and December 2005. Since that time, short-term rates have gone even higher, as the Federal Reserve has raised short-term rates by an additional 75 basis points through May 10, 2006. Given that many home equity lines of credit and credit cards have variable interest rate features, the continued rate increases ultimately translate into higher borrowing costs. Notably, statistics compiled by the Federal Reserve indicate that after reaching a low point at Dec. 31, 2004, residential real estate loan delinquencies rose throughout 2005 (see chart). These same statistics also showed that credit card delinquencies reached their lowest levels since 1994; however, some of the fourth-quarter improvement is likely due to the elimination of credit card debt through the increase in bankruptcy filings. In addition to a rising interest rate environment, consumers also have weathered the impact of increases in both energy prices and the minimum monthly required payments on their credit cards, which in some cases have doubled.

The report was written by Khanh Vuong and Steve Wollum of A.M. Best Co.

Consumer Delinquency Rates — Percentage of Loans



Source: Federal Reserve Board. Seasonally Adjusted Delinquency Rates for All Commercial Banks.

Copyright © 2006 by A.M. Best Company, Inc.
All rights reserved. No part of this report may be reproduced, stored in a retrieval system or transmitted in any form or by any means; electronic, mechanical, photocopying, recording or otherwise.

Overall, the annual loan growth rate in the consumer sector slowed from 16.1% in 2004 to 8.3% in 2005, with the slowdown being most visible in the home equity and credit card segments. In 2004, the fastest-growing component of bank loan portfolios was home equity lending, which grew at nearly 42%; however, growth rates dropped significantly to roughly 9% in 2005. In addition, credit card balances grew by nearly 18% in 2004 but contracted by 1% in 2005. In spite of this slowdown, loans to consumers still represented 53% of total U.S. bank loan portfolios at Dec. 31, 2005.[2] As a result, U.S. bank loan portfolios remain somewhat vulnerable to any weakness in the consumer sector.

There are a number of emerging issues in the consumer sector that bear watching beyond the fourth quarter of 2005. Although there was a spike in the number of bankruptcy filings in the fourth quarter, those consumers actually may represent a new market for credit card lending, as they now have significant new borrowing capacity. In addition, as banks increasingly are faced with a search for higher yields to maintain their margins, subprime lending may see renewed interest. Also, with consumer debt-service levels, as a percentage of disposable income, at or near all-time highs[3], the recent run-up in energy prices, rising interest rates and a slowing in home price appreciation may reduce the financial flexibility of some consumers, particularly those individuals whose adjustable-rate mortgages are approaching their reset dates. Finally, it is unclear whether the consumer merely took a "breather" in the fourth quarter or whether the slowdown in consumer borrowing activity portends further weakness in coming quarters.

1 Consumer sector-related data was provided by the Federal Deposit Insurance Corp. (FDIC)
2 FDIC
3 Federal Reserve Survey of Household Debt Service and Financial Obligations, prepared as of Dec. 31, 2005

A.M. Best Co.
Special Report
May 2006

PUBLISHER, PRESIDENT AND CHAIRMAN
Arthur Snyder

EXECUTIVE VICE PRESIDENT/CHIEF OPERATING OFFICER
Arthur Snyder III

EXECUTIVE VICE PRESIDENT/CHIEF RATING OFFICER
Larry G. Mayewski

EXECUTIVE VICE PRESIDENT/CHIEF INFORMATION OFFICER
Paul C. Tinnirello

MANAGING DIRECTOR
Shaun Flynn, International

GROUP VICE PRESIDENTS
Manfred Nowacki, Life/Health
Matthew Mosher, Property/Casualty

PRODUCTION
Thomas Dawson IV, Associate Editor
Andrew Crespo, Designer

Copyright © 2006 by A.M. Best Company, Inc., Ambest Road, Oldwick, New Jersey 08858. ALL RIGHTS RESERVED. No part of this report or document may be distributed in any electronic form or by any means, or stored in a database or retrieval system, without the prior written permission of the A.M. Best Company. For additional details, see Terms of Use available at the A.M. Best Company Web site *http://www.ambest.com.*

Best's Ratings reflect the A.M. Best Company's opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. These ratings are not a warranty of an insurer's current or future ability to meet its contractual obligations, nor are they a recommendation to buy, sell or hold any security. Further, any and all information herein is provided "as is," without warranty of any kind, expressed or implied. A.M. Best Company receives compensation for its interactive financial strength ratings, from the insurance companies it rates. In compliance with the Securities Act of 1933, A.M. Best also discloses that it receives rating fees from most issuers of the debt securities it rates. Those fees fall within a range of $ 7,500 to $ 500,000.

Online Availability: This study is available electronically from the A.M. Best Co. Web site at www.ambest.com/banks. Call customer service for more information, (908) 439-2200, ext. 5742.

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

The Insurance Information Source

A.M. Best has initiated analysis and coverage of the U.S. banking industry. This article is the latest installment in a regular series of research papers and analytical methodologies that highlight trends in the U.S. banking industry.

A.M. Best Co., established in 1899, is the world's oldest and most authoritative source of insurance company ratings. Best's Ratings are the definitive symbol signifying the financial strength and operating performance of insurance companies worldwide. For more information, visit A.M. Best's Web site at *http://www.ambest.com*, or contact one of our offices:

A.M. Best Company
Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
http://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