A.M. BEST

SPECIAL REPORT FEBRUARY 2006

Net Interest Margins Remained Stable In the Third Quarter of 2005

Beginning in 2006, AM Best is initiating 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. This article is part of a regular series of statistical studies and highlights trends in the U.S. banking industry.

In spite of rising short-term interest rates, the net interest margin for the U.S. banking industry in the third quarter of 2005 was relatively stable when compared with the prior quarter, dropping by only 1 basis point from 3.51% at June 30, 2005, to 3.50% as of Sept. 30, 2005.[1] Although margins have been under increasing pressure from a combination of rising short-term interest rates and a relatively flat yield curve, the industry has been able to maintain its margins through shifts in the asset composition of the balance sheet and by trying to lock in lower-cost sources of funding.

As a result of rising short-term rates, the industry's total interest expense in the third quarter of 2005 was 67% higher than in the third quarter of 2004 at $55.2 billion, while total interest income was 24% higher at $136.1 billion.[2] Even with the significant percentage increase in the overall cost of funds, the net interest margin has experienced only modest shrinkage. The limited shrinkage is largely due to the gradual, but noticeable shift in the industry's asset composition in an effort to boost asset yields. The shift, which intensified after the Federal Reserve began raising short-term rates in June 2004, continued into the third quarter as cash and securities, as a percentage of total assets, dropped from 22.0% as of June 30, 2005, to 21.6% as of Sept. 30, 2005, while total loans rose from 61.1% to 61.4% of total assets. The shift toward higher-yielding loans, in particular commercial real estate and construction loans, helped push earning asset yields to 5.62% at Sept. 30, 2005, an increase of 12 basis points from June 30, 2005. In the quarter ended Sept. 30, 2005, the cost of funds rose by 13 basis points, reaching 2.12%.[3]

The net interest margin for small banks (less than $100 million in total assets) stood at 4.25% at Sept. 30, 2005, an increase of 3 basis points from June 30, 2005. Net interest margins for large banks (more than $100 million in total assets), which generally have trended downward since Dec. 31, 2003, rose by 1 basis point to 3.49%. Larger institutions generally are more reliant on wholesale funding sources than their smaller counterparts are, and as a result, their margins are more sensitive to changes in market interest rates.

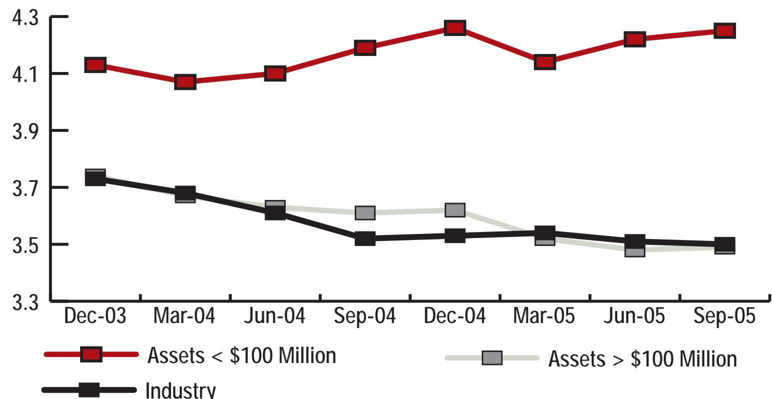
In the short term, bank margins are likely to remain under pressure, given the 75-basis-point increase in the federal funds rate since Sept. 30, 2005, and the continued potential for future rate increases. The future direction of short-term rates is clouded by the uncertainty presented by the installation of Ben Bernanke as the new chairman of the Board of Governors of the Federal Reserve in February 2006. Analyst opinion is divided as to whether the new chairman will feel compelled to demonstrate his inflation-fighting capabilities, or whether the January 2006 rate hike will be the last in this most recent series of rate increases.

This report was written by Steven Wollum, CFA, a financial analyst with the A.M. Best Co.

Footnotes

[1, 2, 3] Federal Deposit Insurance Corp.

Net Interest Margin (%)



Source: Federal Deposit Insurance Corp.

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.

A.M. Best Co.
Special Report
February 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
Angel Negron, 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 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: +44-207-626-6264
Fax: +44-207-626-6265
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