

Structural Changes in U.S. Banks' Financial Statements at Year-End 2005

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](#).

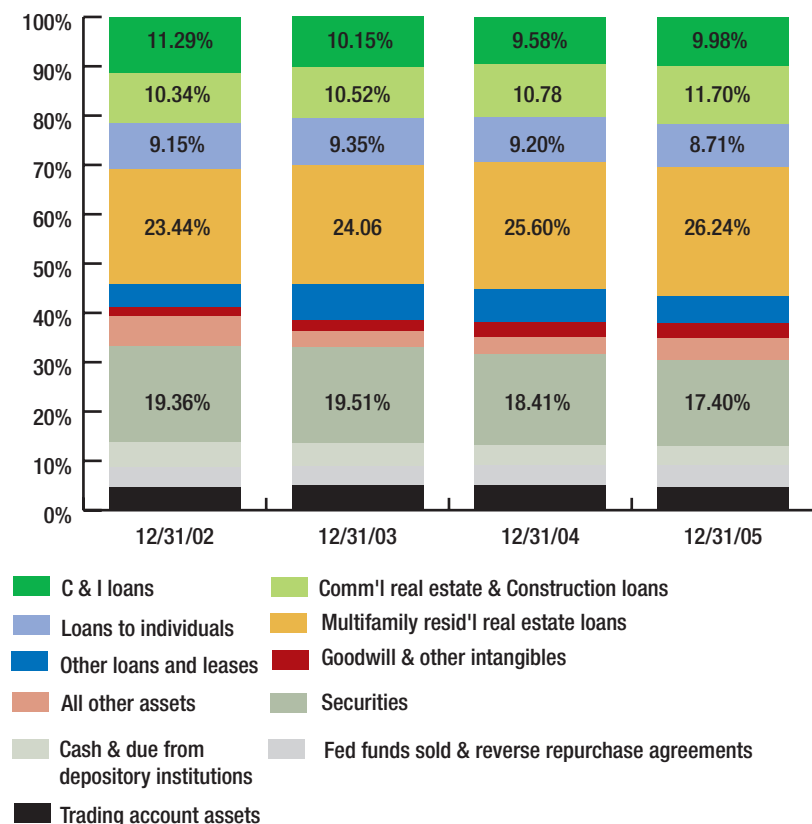
The fourth quarter ended Dec. 31, 2005, capped off a potential year of transition for the U.S. banking industry, as some of the key industry indicators turned less favorable. Driven primarily by a prolonged flattened yield curve, and exacerbated by cyclical and competitive forces, the industry's balance sheet and income statement composition shifted accordingly to reflect more defensive characteristics. At the same time, however, there also were some nondefensive elements in the industry's aggregate asset mix toward high-risk, high-return credits to combat margin pressures.

The industry's assets continued their path of robust growth during the last quarter of 2005, while asset mix shifted more toward higher-yielding assets, namely loan assets and, in particular, real estate loans. The industry's assets grew 1.7% during the fourth quarter of 2005 as compared with the third quarter, and 7.6% over the same quarter in 2004. The largest growth was in short-term interbank placements (federal funds and reverse repurchase agreements grew by 14.3% vs. the same quarter in 2004) as a way for banks to earn short-term interest income without locking into a longer-term position in anticipation of rising rates. Following this category of assets, loans and leases also grew at a high rate (9.9% over the same period in 2004). U.S. banks' securities portfolios and consumer credit assets increased marginally by 1.8% and 1.9%, respectively, over the same period in 2004. As a percentage of average assets, both categories decreased by around 1 percentage point. Commercial and industrial (C&I) loans and real estate loans—in all major classes of residential, commercial real estate, and construction and land

development—increased as a percentage of average assets.

Of the industry's aggregate loan composition, real estate loans registered the largest growth, especially construction and land development loans as well as commercial real estate (CRE) loans. Real estate loans increased 12.4%, while construction and development loans jumped 33.2% and CRE loans rose by 9.5%, as compared with the same period last year. As mentioned, the rotation into real estate assets was a way for U.S. banks to enhance yield in a flat yield curve environment. Annual

U.S. Banks' Asset Composition (As a % of Assets)*



* Data labels shown only for significant asset classes. Source: FDIC

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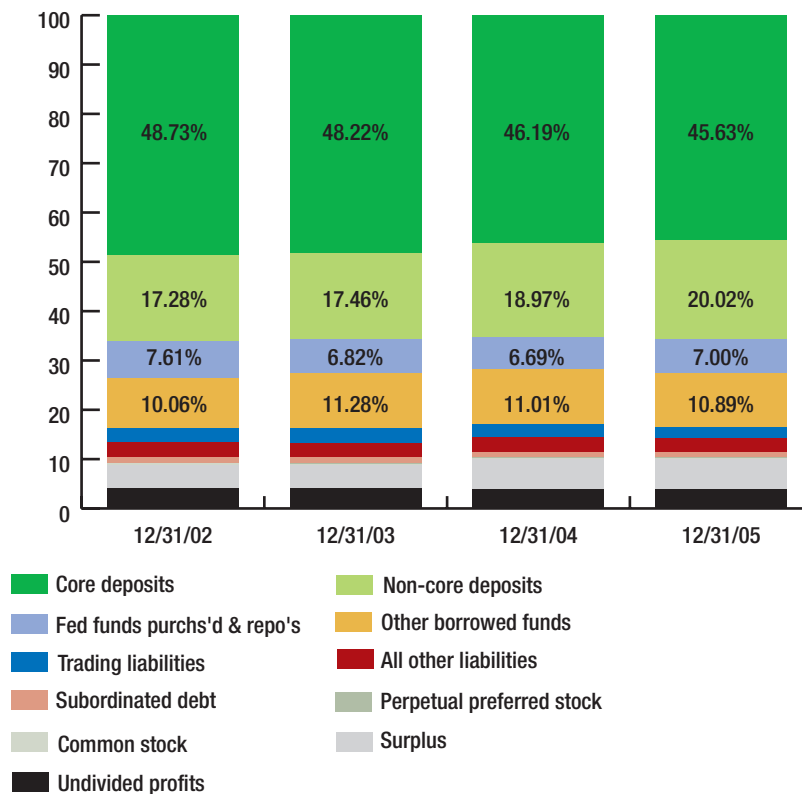
yields on loan assets, real estate assets and C&I loans stood at 7.4%, 7.1% and 7.7%, respectively in 2005 — all up from 2004 levels. In comparison,

yields on securities averaged 3.9% in 2005. This trend leaves banks susceptible to the softening real estate market conditions through potential declines in earnings and impairment of assets. U.S. bank regulators have taken note of the increased levels of CRE exposure and issued in January 2006 new proposed interagency guidance on CRE concentrations in an effort to address the rising levels of exposure in the industry to this sector.

Consumer credit yields were high, at 8.2% in 2005, but did not increase significantly as a result of large credit card charge-offs in the fourth quarter. It is expected that U.S. banks will look to build up their credit card portfolios aggressively in 2006.

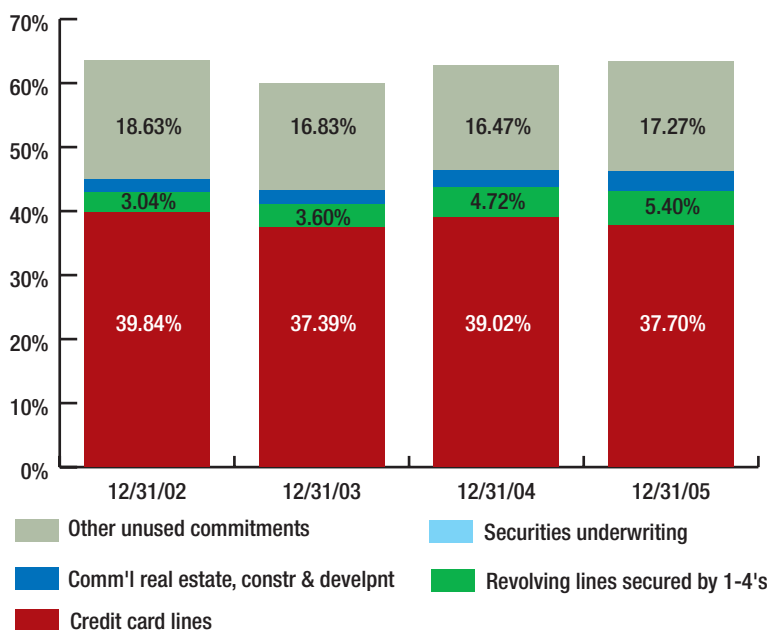
The liability structure of the industry at Dec. 31, 2005, continued the prior years' trend of increasing reliance on noncore deposits and short-term borrowings, while the industry's equity capital kept pace with asset growth. Core

U.S. Banks' Liability Composition (As a % of Assets)



Source: FDIC

U.S. Banks' Unused Commitments (As a % of Assets)



Source: FDIC

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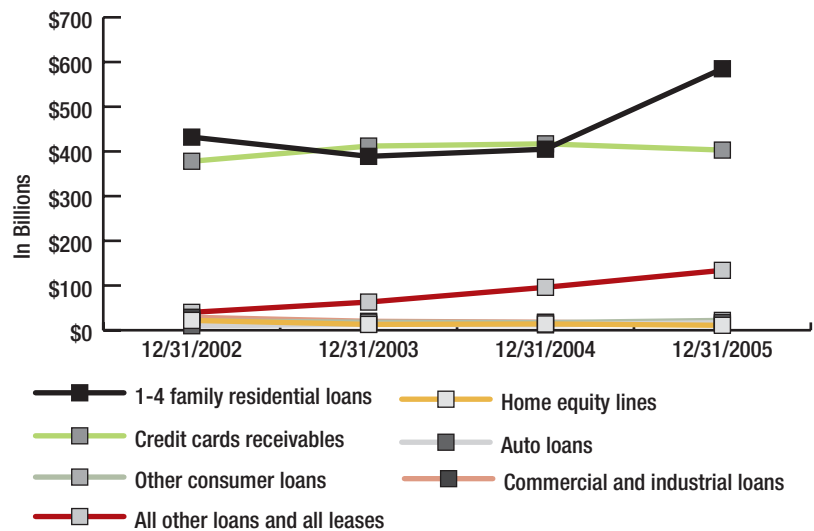
deposits as a percentage of average assets declined by half a percentage point, to 45.6% at Dec. 31, 2005, from 46.2% at Dec. 31, 2004. Non-core deposits, such as uninsured customer deposits, brokered deposits and trading accounts as a percentage of average assets, rose consistently in the past several years (see chart above), offsetting the lower levels of core deposits. Bank borrowings such as federal funds and repurchase agreements also followed the past several years' trend of steadily increasing as a way of funding asset growth. Other borrowed funds, which consist primarily of Federal Home Loan Bank advances, continued to grow, albeit at a slower rate of 6.5% during 2005. As a percentage of average assets, these advances have remained in a range from 10.1% in 2002 to 11.0% in 2004, standing at 10.9% in 2005. Long-term borrowings, in terms of subordinated debt as a percentage of average assets, stood at 20.0% in 2005, up from 18.9% in 2004 and 17.5% in 2003. As the industry becomes increasingly dependent on rate-sensitive funding sources (noncore and wholesale sources), banks are becoming more subject to volatility in funding cost. Equity capital remained steady as a percentage of average assets, standing at 10.3% as of both periods ending Dec. 31 in 2005 and 2004. It should be noted that the industry's equity kept pace with asset growth but not with the higher risk associated with higher concentration in CREs.

Aside from the shift in liabilities, U.S. banks also reduced their interest rate risk exposure further in 2005 by shortening their aggregate funding mismatch. The net one-year-and-over position, calculated as loans plus securities over one year net of liabilities over one year in maturity or next repricing date, decreased to 36.8% as a percentage of average assets in 2005, compared with 38.8% in 2004. The net three-year position, which captures the mismatch gap further out in the maturity scale, similarly declined to 25.7% of average assets, compared with 28.7% the year prior. Given the continued increases in interest rates, the reduction in the funding mismatch may suggest some repositioning of U.S. banks' balance sheets toward a more measured level of interest rate risk.

The industry's off-balance-sheet growth paralleled that of its on-balance-sheet activity in 2005, with the fastest growth exhibited in real estate commitments and securitization,

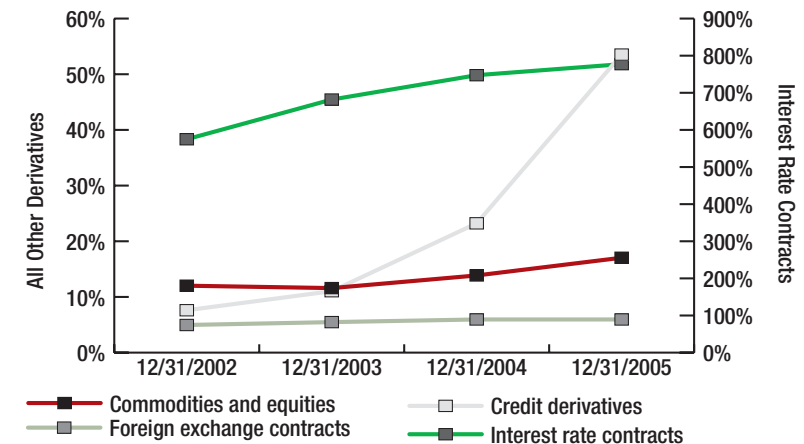
and a surge in credit derivative transactions. Total unused commitments grew 9.3% in 2005, to 65.9% of total assets, with real estate unused commitments having grown the fastest among all asset classes. Specifically, unused commercial real estate and construction and development commitments rose 28.9% in 2005, while unused residential equity lines of credit increased by 23.0%. In contrast, unused credit card lines increased by only 3.9%. As a percentage of assets, unused credit card lines still remained as the largest component of off-balance-sheet exposure, at 37.7%, albeit down from 39.0% in 2004. Similarly, off-balance-sheet activity through securitization and asset sales of U.S. banks in 2005

U.S. Banks' Securitization & Asset Sales



Source: FDIC

U.S. Banks' Derivative Portfolio (As a % of Assets)



Source: FDIC

showed a marked increase, most notably in 1-to-4 family residential loans.

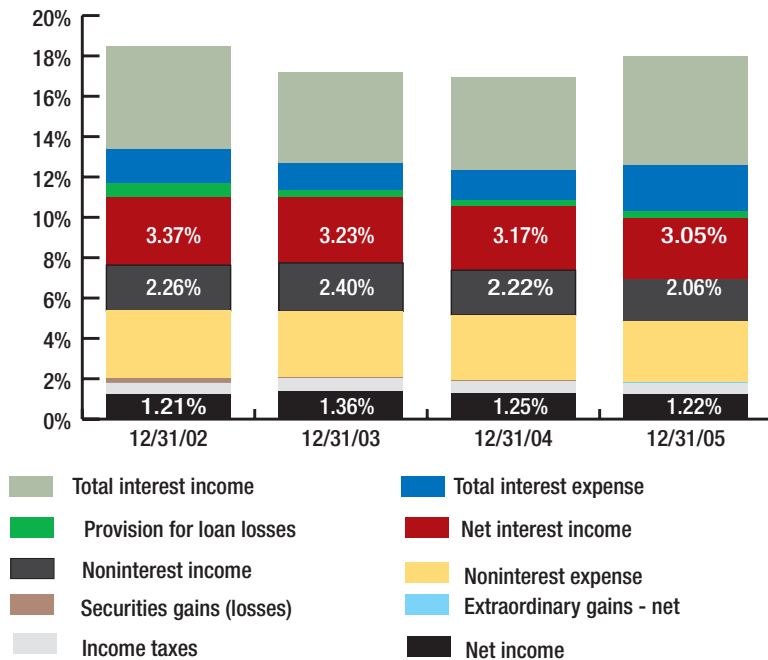
The notional amount of derivative transactions by U.S. banks grew at a slightly lower

rate of 15.4% in 2005, as compared with 23.7% and 26.5% in the prior two years. Nearly all of the derivative contracts, across all types of instruments, are attributable to large U.S. banks with assets in excess of \$10 billion. Of special mention, the volume of credit derivative transactions in notional amounts jumped by 148.1% in 2005, after an increase of 134.5% and 56.0% in 2004 and 2003 respectively. Slightly more than half of the credit derivatives undertaken by U.S. banks (53.9% in 2005) were to lay off credit risk (i.e., with the banks being the beneficiaries), while 46.1% consisted of contracts with the banks acting as guarantors. On a fair market value basis, credit derivative contracts in aggregate between banks acting as guarantors vs. beneficiaries netted out perfectly to yield very slight residual risk. While the factors influencing these large increases in credit derivatives of U.S. banks are varied, it is certain that the banks were more actively managing credit risk through the derivative market in 2005 — both in assuming certain credit risks and transferring other credit risks. Interest rate derivatives, mostly interest rate swaps, remained as the largest volume of derivative transactions for the industry, up to 82.9% of the total 2005 volume and around the same level for several years. Derivative contracts involving commodities and equities also ticked up in 2005, perhaps as a way of generating trading income and other revenues.

The changes in U.S. banks' operating performance during the fourth quarter of 2005 reflected current market conditions of a flattened yield curve and lower credit cost for the industry. Compared with the same period for the three prior years, the fourth quarter of 2005 showed further declines in the industry's ratio of net interest income as a percentage of assets to 3.05% as cost of funds (interest expense) surged to 2.3%. Cost of funds was significantly lower in 2004 and 2003, at 1.5% and 1.3% respectively. However, U.S. banks' average yields on earning assets also rose accordingly, at 6.1%, helping keep net interest margin above the 3.0% level. In dollar terms, net interest income was aided additionally by a larger base of earning assets, which grew by 8.1% at the end of the fourth quarter of 2005. U.S. banks can expect to continue to aggressively manage their net interest margin in 2006, based on industry trends.

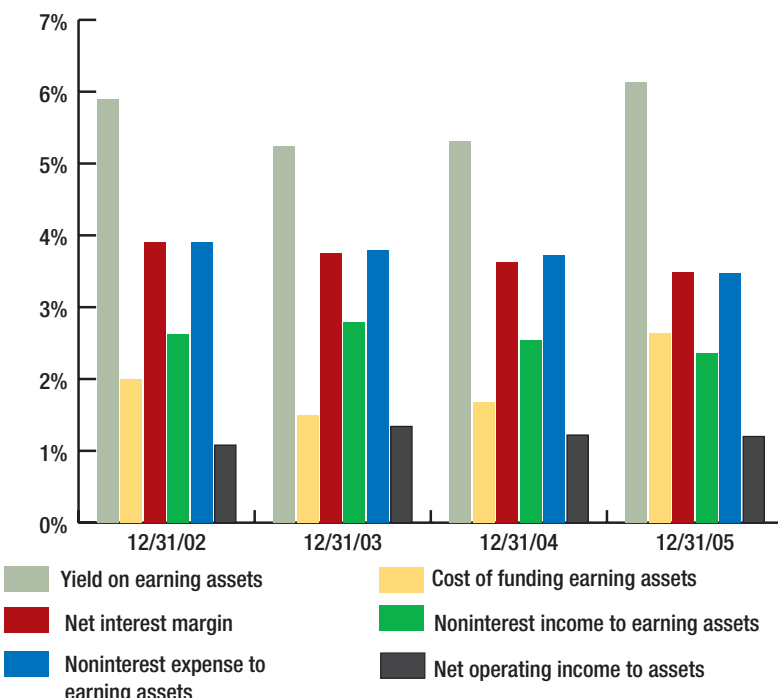
Noninterest income also was lower for the

U.S. Banks' 4th-Quarter Income Statement Composition (As a % of Assets)



Source: FDIC

U.S. Banks' 4th-Quarter Key Performance Ratios



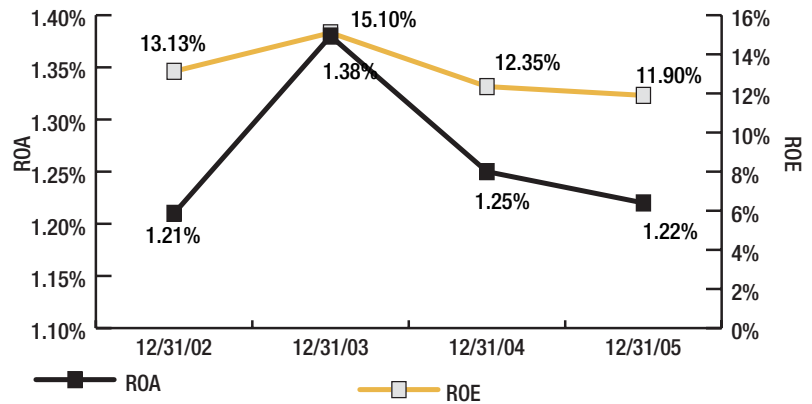
Source: FDIC

fourth quarter of 2005 as compared with the same quarters of prior years; however, it was offset by lower noninterest expenses. Gains from securities fell to almost half of the prior year's level, as higher interest rates had eroded the values of banks' securities portfolios. The industry's aggregate efficiency ratio, which is noninterest expenses as a percentage of total interest and noninterest revenues, improved to 58.0% from 58.8% for the fourth quarters of 2005 and 2004 respectively.

Also aiding U.S. banks' operating performance during the fourth quarter of 2005 was the continued decline in credit cost. Loan loss provisions as a percentage of assets were at the same low level of 0.3% for the fourth quarters of 2005 and 2004 respectively. For the full year, the loan loss provision to asset ratio was at the lowest level historically, at 0.28% in 2005, down from 0.3% in 2004 and 0.39% in 2003. As a result, for the fourth quarter of 2005, U.S. banks on aggregate realized net income to assets, or return on assets of 1.22% in 2005, slightly off from the 2004 level of 1.25%. Return on equity ratios also declined to 11.9% at 2005 quarter end from 12.4% for the same period in 2004.

During the last quarter of 2005, U.S. banks adjusted their aggregate financial profile toward a more defensive mix of assets and liabilities to compensate for compressed margins, better manage interest rate risk, and at the same time, grow their aggregate asset

U.S. Banks' 4th-Quarter Profitability Ratios



Source: FDIC

base to realize higher net interest income. The pace of adjustments may change or take another direction depending on market and industry developments in 2006. While government policies and regulatory authorities will want to aim for more gradual adjustments in the banks' financial profile, competitive forces and the equity market's expectations on the industry may drive it toward higher-risk activities such as subprime lending and construction financing in the short term. A.M. Best will continue to monitor the industry on a quarterly basis and gauge both the level and direction of any changes and their impact on the overall risk level in the industry.



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