A.M. BEST

SPECIAL REPORT DECEMBER 18, 2006

Year-end Banking Summary for 2006

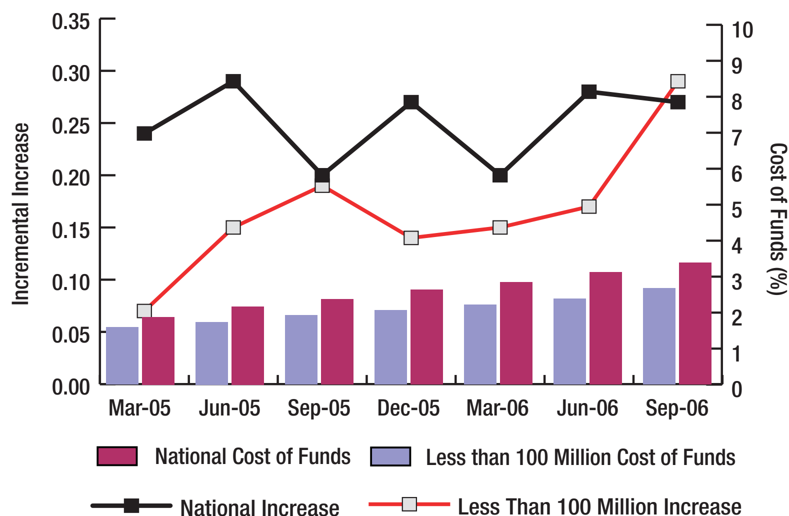
For the past couple of years, the U.S. banking industry has been managing successfully through margin-compression pressures, benefiting from fairly stable economic conditions combined with the banks' ability to draw down on loss reserves and to resort to fee income sources. Several notable developments occurring in the third quarter of 2006 and beyond that confirm A.M. Best's February 2006 commentary on the turning of the industry cycle: a new Federal Reserve policy holding the line on raising rates; upward creeping of loan losses in consumer credits, construction and land development (C&LD), commercial real estate (CRE), and Commercial and Industrial loans (C&I); a more erratic performance of trading income at large institutions; and increased competition for deposits and loans that has been driving up the cost of funds and driving down asset yields. As a result, while the industry continued to turn in strong earnings during the third quarter of this year, the number of institutions showing gains in earnings continued on a steady decline since its peak in June 2005. More important, other, underlying shifts in the balance-sheet mix and operating statements of U.S. banks suggest a trend toward higher levels of credit and interest rate risk in various segments in the industry.

Slower Loan Growth in the Consumer Sector

In 2006 the U.S. banking industry saw a continuation of the transition between consumer lending and commercial lending as a primary driver of growth in bank loans and operating results. Loan growth rates in both the C&LD (29.47%) and CRE (9.14%) segments exceeded the growth rate for 1-4 family residential property loans (6.83%) in the nine months ended Sept. 30, 2006. The strong growth in the C&LD and CRE segments continues a trend that began in 2003 when growth rates in these two loan categories eclipsed growth in 1-4 family residential lending. Loan growth in the commercial sector has risen steadily since 2002, when 1-4 family loans grew at a rate of 13.1%, compared with CRE and C&LD lending, which grew at rates of 10.2% and 5.8%, respectively.

The slowdown in the growth rate of 1-4 family residential loans has occurred in spite of the continuation of relatively low interest rates. One factor that may be limiting the growth in this sector is that consumer debt-service obligations are at record levels. As previously commented upon by A.M. Best, the Federal Reserve's Survey of Household Debt Service indicates that the ratio of debt payments to disposable personal income is at a record level. Combined with a negative savings rate, these factors suggest that the consumer's capacity to take on additional debt is limited and will further restrict growth in the sector.

Another factor impacting the consumer mortgage sector is the slowdown in appreciation of home prices. The Third Quarter 2006 Survey from the Office of Federal Housing Enterprise Oversight (OFHEO) indicated that although national home prices rose 7.73% in the 12 months ended Sept. 30, 2006, they rose only 0.86% in the third quarter. In addition, five states



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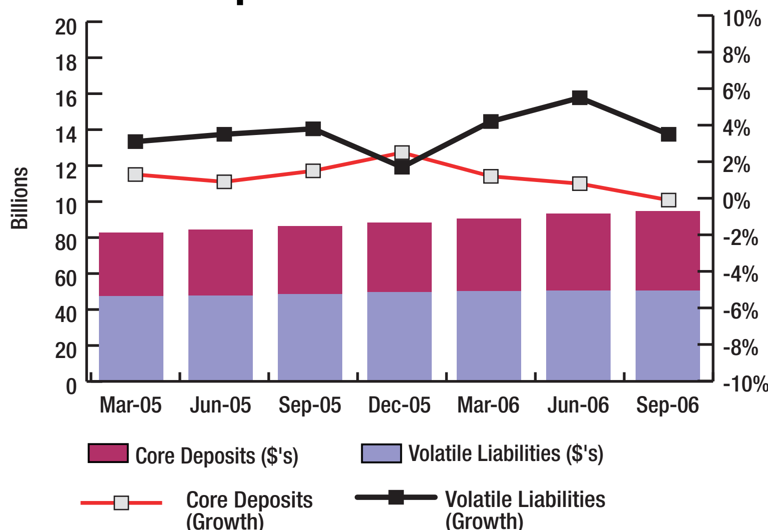
(New York, Rhode Island, Michigan, New Hampshire, and Massachusetts) saw price declines between the second and third quarters of 2006. Michigan also was the first state to show a year-over-year decline in more than six years.[1] As a result of the slowdown in appreciation rates, the capacity of homeowners to take on increased levels of debt appears limited.

In addition to the slowing growth in consumer mortgages, other types of consumer lending, such as credit cards, also have experienced lower rates of growth. Although some of the slowdown in credit card growth is attributable to changes in the bankruptcy regulations, which resulted in large charge-offs in the fourth quarter of 2005, outstanding credit card balances rose steadily through the first three quarters of 2006 to $383.1 billion; however, balances remained $12.1 billion below the year-end 2005 level of $395.2 billion.

Weakness in the consumer mortgage sector also has become evident in the form of rising delinquency levels. In the year ended Sept. 30, 2006, total delinquent 1-4 family residential loans rose by some $7.8 billion to $47.7 billion, representing an increase of nearly 20%. Notably, there have been increases of $5.1 billion in loans that are delinquent by 30 to 89 days and $3.1 billion in nonaccrual loans. Offsetting these increases was a modest drop of $0.4 billion in loans that were delinquent by more than 90 days.

Volatile Liabilities Growth Versus Core Deposit Growth



Source: FDIC

Changing Loan Portfolio Composition

In an effort to maintain loan growth and yields, banks have increasingly turned from the consumer mortgage sector to other products such as C&I, CRE, and C&LD loans. The fastest-growing loan segment has been C&LD, and throughout 2006 the composition of the industry's balance sheet reflected the shift toward higher levels of construction loans. At Sept. 30, 2006, construction loans totaled $541.5 billion and represented 4.6% of total assets, compared with $418.3 billion, or 3.9%, as of Sept. 30, 2005. During that same period, CRE loans dropped, as a percentage of total assets, by 5 basis points to 7.50%, while C&I loans rose by 30 basis points to 10.11%. The consumer-lending segment reflected declines in 1-4 family residential loans from 23.88% to 23.22%, while loans to individuals (credit card and related plans, and all other loans to individuals) also dropped from 8.72% to 8.12% of total assets.

1 Office of Federal Housing Enterprise Oversight (OFHEO) Press Release, Nov. 30, 2006.

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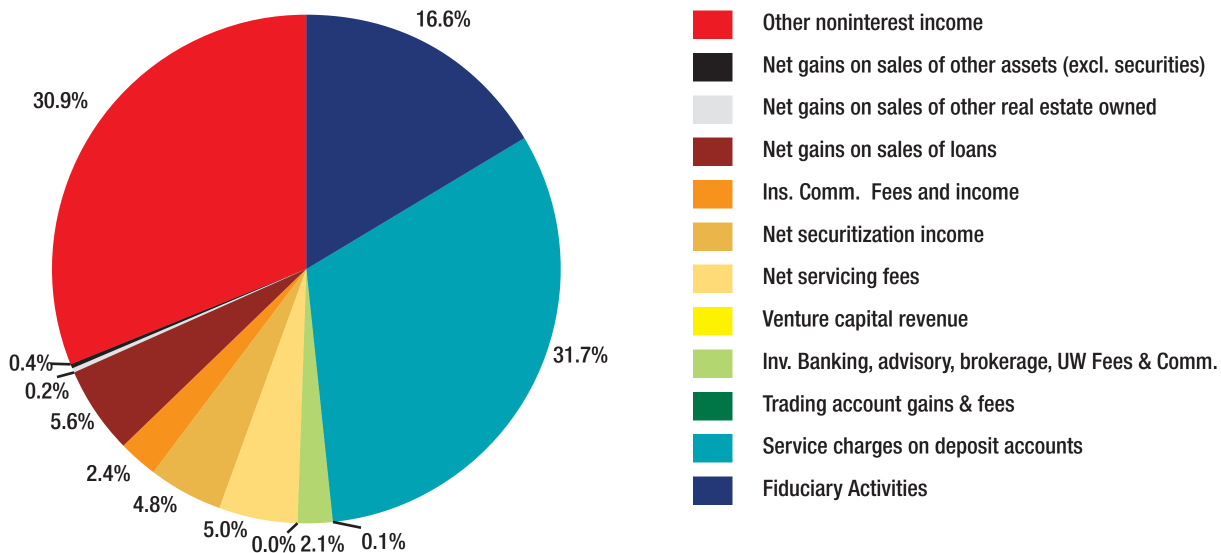
The Insurance Information Source

There is also evidence of increased competitive pressure in the commercial lending sector. The most recent Federal Reserve Survey of Senior Loan Officers from October 2006 reflects a modest decline in loan demand and an easing of loan terms, most notably for C&I loans. Survey respondents most often noted cuts in spreads for loan rates, reduced costs for credit lines and an easing of loan covenants. The easing of terms may help banks maintain growth targets but also may lead to a deterioration in overall credit quality should economic conditions weaken in 2007.

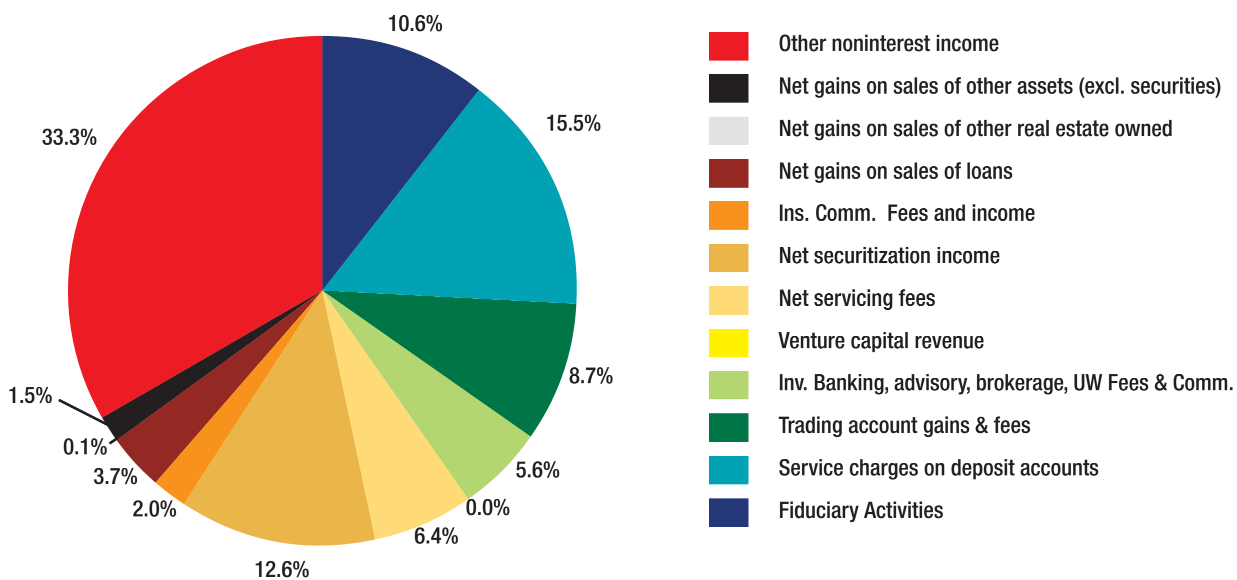
Nonperforming Asset Ratios Are Rising

The benign credit environment showed a definitive, albeit modest, deterioration in the third quarter of 2006, with noncurrent loans (90-day plus past due and nonaccruals)

Noninterest Income Breakdown: Banks with Total Assets < $1 Billion



Noninterest Income Breakdown: Banks with Total Assets > $1 Billion



* Percentages may not sum to 100% due to rounding.

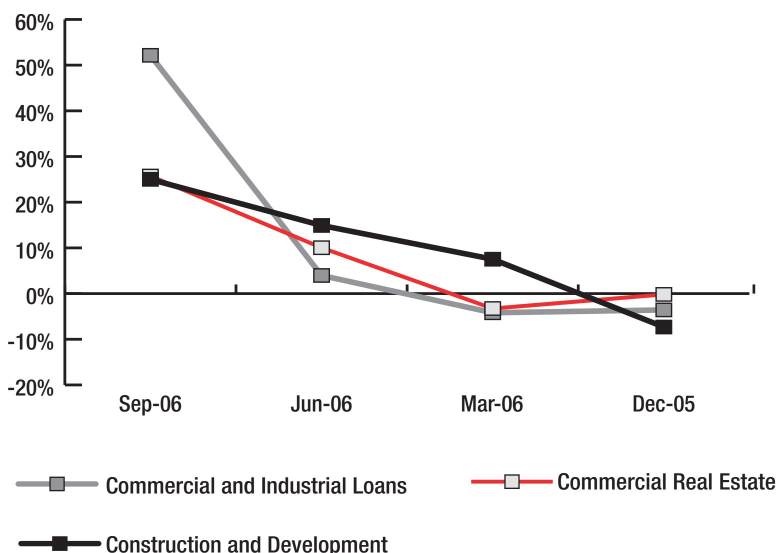
Source: FDIC

increased for the second straight quarter. Noncurrent loans grew by 6.61%, or $3.3 billion, in the third quarter following a 0.95% or $363 million increase from the previous quarter. Noncurrent loans as a percentage of total loans and leases still remained very low at 0.73%, but C&LD, CRE and C&I loans all showed signs of credit deterioration. The coverage ratio (loan-loss reserves as a percentage of noncurrent loans) and the ratio of reserves to total loans and leases together present a mixed picture of where banks stand in terms of their reserve adequacy.

The 90-day plus past-due category for banks, an indication of potential future nonaccruals, has experienced very high growth during the past two quarters. CRE and C&I loans experienced their first increase this year during the second quarter, 10.04% and 3.96%, while C&LD loans increased 7.52% in the first quarter in 2006. A trend may be developing within these loan categories, as each registered steeper rises this quarter from the previous quarter. C&LD increased 25%, or $102 million; CRE increased 25.73%, or $157 million; and C&I loans increased 52.15%, or $612 million, during the third quarter of 2006.

The coverage ratio continued its third consecutive quarter of declines, from 159% in the second quarter to 148% in the third quarter, which was the lowest level since December 2003. As noncurrent loans continued to trend higher, banks have modestly adjusted their reserves, leading to a declining coverage ratio during this period. Noncurrent loans increased 6.9% this quarter, and loan-loss reserves remained roughly the same at $77.9 billion.

The banking industry may be heading into a dilemma between setting up too much loan-loss reserves and not having enough in anticipation of the turning of the credit cycle. Some regulators, such as the Federal Deposit Insurance Corp., would like to see more reserves as a precautionary measure by banks, while others, such as the Securities and Exchange Commission, maintain a different perspective of preferring truer financial reporting by banks on their loss reserves. The allowance for loan and lease losses reserve (ALLL) to total loans ratio decreased during the third quarter from 1.10% to 1.09%, the lowest level in the past 20 years. With delinquencies on the rise, these coverage levels should begin to adjust, but it remains to be seen how the industry as a whole will resolve the standing issue on ALLL.



Earnings

As a result of the shift in the loan-portfolio composition, quarterly yields on earning assets have risen steadily from 5.87% in the quarter ended Sept. 30, 2005 to 6.76% in the quarter ended Sept. 30, 2006. However, in spite of the increase in yields on earning assets, the industry's overall return on assets (ROA) continues to experience pressure from a corresponding increase in interest expense. The ROA was stable in the first half of 2006 at 1.34% but dropped 5 basis points in the third quarter to 1.29%. Heading into 2007, banks are likely to continue to experience pressure on earnings, as there are increased signs of weakening credit quality, albeit from historically low levels. Such a drop in credit quality would require additional provisions to the allowance for loan losses and would translate into lower ROAs in 2007.

The ROAs of smaller institutions remain lower than those for the largest institutions, given that the larger banks have a greater capacity to diversify their sources of earnings. In the third quarter of 2006, ROAs ranged from 1.01% for banks with total assets of less than $100 million to 1.36% for banks with total assets of more than $10 billion. Although larger institutions generated stronger ROAs, their Net Interest Margins (NIM) lagged those of smaller institutions, likely because the liability structure of larger banks is tied more closely to market rates. In the third quarter of 2006, NIMs ranged from 3.26% for banks with total assets of more than $10 billion to 4.15% for banks with total assets of less than $100 million. Continued margin pressures are

anticipated for 2007 as banks continue to face a flat to inverted yield curve. In addition, smaller institutions may not be able to continue lagging their pricing on term deposits if consumers anticipate that the Federal Reserve will cut short-term interest rates in 2007.

In an inverted yield curve environment where banks continue to seek out sources of noninterest income, upward pressure on noninterest expenses magnifies the importance of operating efficiency. Although FDIC-insured banks reported their second-highest net income ever in the third quarter of 2006, the efficiency ratio for the banks worsened by 53 basis points from the third quarter of 2005 to 56.65%. As banks become less efficient, they generally become less profitable—as only 53.9% of insured institutions reported earnings gains in the third quarter of 2006, the lowest percentage since year end 2003. Although the industry has seen the number of problem institutions dwindle to the lowest quarterly total ever, the percentage of unprofitable institutions at year end will be at its highest level since 2001. This is another indication that the banks, though enjoying a profitable period by historical standards, are seeing a decline in their operating efficiency.

Rising Overhead Relative to Revenues

The continued rise of overhead expenses (at a faster pace than noninterest income) is an important problem facing banks, as the latest FDIC data indicate. Salary and employee benefits increased by almost 9.5% over year-earlier levels. Premises and fixed-asset expenses saw a 2.2% rise from the previous year. Impairment losses and other amortization expenses on goodwill and other intangibles increased 12.5%. All other noninterest expenses saw a 4.2% increase over year-earlier levels. Although some of these increased costs are relatively modest and consistent with historical industry figures, the recent compression of net interest margins and slower growth in noninterest income amplify them significantly. Looking ahead, the recent reinstatement of FDIC deposit insurance assessments will increase noninterest expense for a significant number of banks.

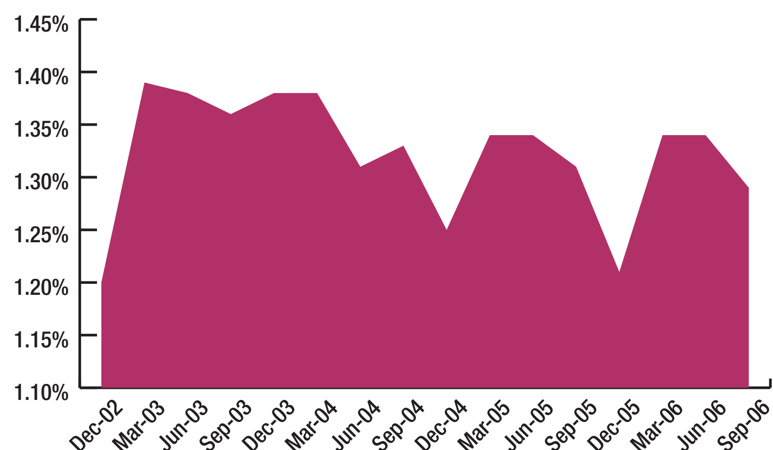
Scaling back these operating expenses and boosting profits could prove difficult for many banks in the current banking environment. Noninterest expense grew at a greater rate than noninterest income (7.2% versus 6.6%) from the third-quarter of 2005 to the third-quarter of 2006. Total interest expense increased by 56.9%, while total interest income grew by 26.4% over the same period. To complicate matters, net interest margins have been declining steadily since 2002, especially for banks with total assets of more than $100 million. One measure banks have used to alleviate pressure on their bottom line is to decrease the provision for loan and lease losses, which has declined 14.6% since third-quarter of 2005. Banks have been able to do so because net charge-offs have declined as well over the past year; however, this measure can be viewed only as a temporary solution, as there are some indications that overall credit quality is beginning to slip.

Noninterest Income Slowing

The banking industry was less successful in combating the impact of a declining NIM with increases in noninterest income in the third quarter of 2006. Total noninterest income had a very slight increase of 0.3% this quarter compared with a 2.2% increase last quarter and a 10.12% increase the first quarter of this year. Trading revenue, after posting a 102.2% increase in the first quarter of 2006, has recorded two straight quarters of declines, -16.1% in the second quarter and -2.1% this past quarter. Fiduciary activities experienced their first quarterly decline this year, -4.1%, after increasing 3% in June 2006 and 3.3% in March 2006. Service charges on deposit accounts, at 15.2% the largest component of noninterest income this quarter, increased 2.3% in the third quarter of 2006 and 7.6% in June 2006.

Securitization remained a very profitable

Quarterly Return on Assets (ROA), Annualized



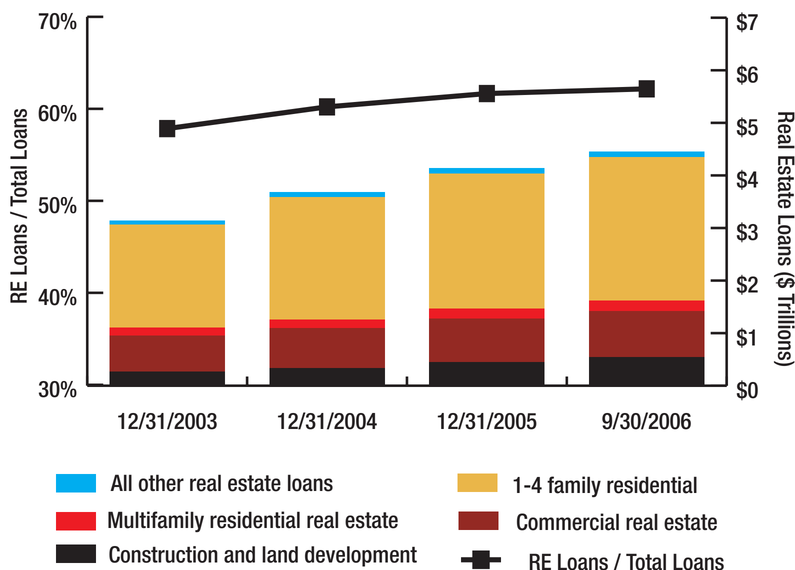
Source: FDIC

component for banks, as servicing fees continued their downward trend for the year. Banks have relied on securitization not only as a tool for managing credit risk and liquidity but also for fee income as a service provided to third parties. Securitization income, the second-largest component of noninterest income at 10.9% this quarter, increased 8.6% from last quarter and has grown 15.5% in the past four quarters.

Mortgage and other servicing fees, on the contrary, have decreased consistently as a percentage of noninterest income during this time frame. Servicing fees fell 20.6% in the third quarter, contributing to a smaller share of noninterest income at 5.4% compared with 8.6% for the same quarter last year. The 10-year Treasury bond decreased 51 basis points, from 5.14% to 4.63% during the quarter, which led to an increase in refinancing and mortgage prepayments. The impact was a reduction of servicing rights for banks and a large decrease in servicing income.

The larger the institution, the more dependent the income statement is on noninterest income. In the third quarter of 2006, banks with less than $1 billion in assets recorded noninterest income as a percentage of total assets of 1.25%. This compares with 1.61% and 2.45%, for banks of total assets between $1 billion to $10 billion and banks with assets greater than $10 billion, respectively. Securitization income and trading activities traditionally have been two components of noninterest income for which the larger banks are able to leverage their size and capital to generate additional income.

Smaller institutions, with assets of $100 million or less, relied on service charges on deposit accounts as their main driver of noninterest income. This is a result of the smaller banks obtaining 94% of their funding through deposits, 22% more than the banking industry. Furthermore, service charges on deposit accounts made up 38.1% of the smaller banks' noninterest income, 22.9% more than the banking industry. As total deposits moved in different directions this quarter for each segment—a decrease of 2.9% for the smaller banks compared with a 1% increase for the banking industry—so too did the service charges on deposit accounts. The disparity has led to a 1% decline in the service charges on deposit accounts for smaller banks, compared with the banking industry's 2.3% increase.



Rising Reliance on Volatile Funding Sources

The banking industry continued to rely on noncore deposits, as core deposits posted their first quarterly decline in three years. Volatile liabilities made up 41.9% of total liabilities this quarter, compared with 41.2% last quarter and 39.6% this quarter last year. Banking customers are taking advantage of the higher-yielding CDs as well as putting their funds in nonbanking products. Time deposits of less than $100,000 increased 3.1% this quarter compared with the second quarter of 2006 and have increased 14.6% over the past year. Time deposits greater than $100,000 increased 4.2% this quarter compared with the second quarter of 2006 and have increased 21.1% over the past year.

Total deposit growth has not kept pace with the banks' asset growth, thereby increasing their dependence on wholesale market funding sources. Total assets grew by 2.0% this quarter, compared with a 1% increase in total bank deposits. Banks relied particularly heavily on the federal funds market to close this gap, with borrowings increasing 6.9% from the previous quarter. As a percentage of total liabilities, federal funds purchased made up 8.6% this quarter compared with 8.2% last quarter, and are at their

highest level in the past year. Banks also relied this quarter more on higher–cost, volatile sources of funding, which led to an increase in interest expense of 27 basis points, 3.39% overall compared with 3.12% last quarter and 2.37% this quarter last year. Time deposits greater than $100,000 and federal funds purchased were the two volatile funding sources that saw the most growth this past year.

Although the banking industry experienced a 27-basis-point increase in funding costs this quarter, smaller banks with an asset size less than $100 million experienced above-average marginal costs of 29 basis points. This is a reversal of the results for the small banks during the first and second quarter of this year, when banks in this asset group enjoyed average funding costs that were 18 basis points and 11 basis points cheaper in their respective quarters. Typically, the smaller community banks are able to reap the benefits of a loyal customer base, which is reflected in below industry average cost of funds. As competition continued for deposits and banking customers continued seeking higher yields for their money this quarter, smaller banks were forced to raise deposit rates at the same pace as the banking industry. Given that total deposits make up 94% of total liabilities for the smaller banks, compared with 72% for the banking industry, smaller banks were harder hit in the third quarter of 2006.

Summary

The past three consecutive quarters have shown a progressive, gradual leveling off from the industry cycle peak in a number of financial indicators for U.S. banks. Net interest margin compression, which began in early 2005, as of December 2006 has been compounded by signs of more challenges: A slowing housing market and a rising consumer-debt burden have raised delinquency rates on loans; greater competition among banks for both deposits and loans exerted continued margin pressures despite the pause in rate hikes by the Federal Reserve; and the weaker ability of banks lately in generating noninterest income to counteract lower net interest margins led to fewer banks with earnings gains. Based on these industry developments, A.M. Best foresees U.S. banks in 2007 adopting selective risks on their balance sheets. While all banks undoubtedly will focus on leveraging their competitive strengths, the decision facing various institutions increasingly has been which risk areas to venture into in garnering better yield. The counterbalance to higher risk factors assumed by U.S. banks likely will come from higher earning streams to support potential loss events, appropriate risk management, and lastly, increased capital holdings. A.M. Best will monitor industry developments closely to report on any significant trends among U.S. banks.

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