

U.S. Banking – Issue Review

June 30, 2008

Sector

U.S. Banking

Outlook

Stable

U.S. Commercial Banks – Funding Composition (2007)

	Northeast	Midwest	South	West
Transaction Deposits	12.8%	18.3%	18.8%	15.1%
Time Deposits	26.7%	30.6%	24.5%	18.8%
Time Deposits over \$100K	15.3%	16.0%	22.0%	18.2%
Money Market Accounts	13.9%	15.0%	16.8%	25.1%
Other Savings	18.8%	11.1%	9.9%	14.0%
FHLB Advances	10.0%	5.9%	5.4%	5.7%
Repo	2.2%	2.8%	2.3%	2.3%
Other Borrowings	0.3%	0.2%	0.3%	0.7%

Source: FDIC and A.M. Best Co.

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Rating Analysts

Khanh Vuong, Vice President
+1 (908) 439-2200 Ext. 5633
Khanh.Vuong@ambest.com

Anthony McSwieney, Senior Financial Analyst
+1 (908) 439-2200 Ext. 5715
Anthony.McSwieney@ambest.com

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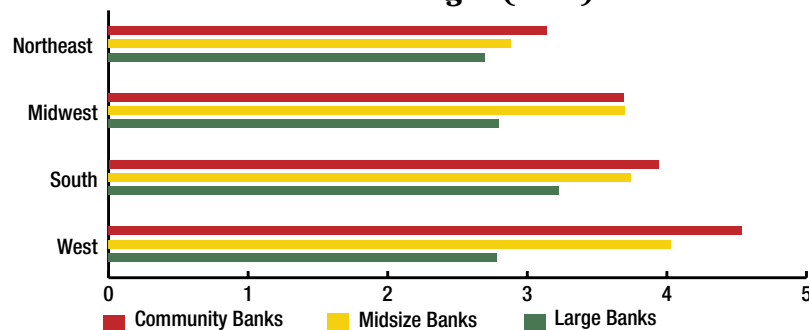
Some Regions Fare Better in Net Interest Rates Than Others

The nation's commercial banks have experienced persistent margin compression since the start of 2005 and well into the second quarter of 2008 for a host of different reasons. When the Federal Reserve Board first began raising the short-term target rate in mid-2004, the yield curve was trending toward a flat to inverted slope, which had a dampening effect on banks' margins. Then in August 2007, the Fed aggressively lowered its short-term target rate, which steepened the yield curve. However, U.S. banks continue to experience margin pressures for different reasons. This time, the combination of a weak economy and the troubled consumer sector leads to fierce price competition, both in funding and lending, among banks across the country. Yet, the degree to which U.S. banks experience margin compression is not regionally uniform.

Between 2005 and 2007, some important trends were observed:

- Banks in the Midwest and South are more insulated from margin pressures, while banks in the West and Northeast tend to be more prone to margin erosion.
- Large banks have seen dramatic changes in funding composition, from lower-cost transaction deposits to higher-cost wholesale funding.
- For the midsize banks, asset mix has less to do with margin pressures than the local economic conditions and banking market dynamics within each region.
- Community banks in the South reported a rise of 114 basis points in yield on assets, compared with a rise of fewer than 100 basis points for all other regions.
- Community banks in the Western region fared the worst in terms of margins, with an especially large decline of 25 basis points in 2007. Other regions reported declines close to 11 to 17 basis points.

U.S. Banks – Net Interest Margin (2007)



Source: FDIC and A.M. Best Co.



Net Interest Margins Tighten for Most Banks

A.M. Best Co. analyzed net interest margins (NIM) on U.S. banks that were in the Federal Deposit Insurance Corp.'s 2007 year-end database back to 2005. After making adjustments for state filing changes for a few large banks during the years analyzed, a NIM profile for the four census regions was created (**Exhibit 1**). Between 2005 and 2007, there was not only a significant local variation in NIM between banks within these regions, but also a distinct profile for community banks vs. midsize and large banks.

Generally, community banks are more protected from margin erosion than the midsize and large banks. By region, banks in heartland areas of the United States (Midwest and South) are more insulated from margin pressures, while banks in the West and Northeast tend to be more prone to margin erosion. Banks in the West, which historically have the widest net interest margins in the country even after experiencing the sharpest declines, still showed higher margins as of 2007, albeit not much more than those of the South (**Exhibit 2**). Apart from these broad observations, local trends are discussed further below.

Asset Yield vs. Funding Cost

Between 2005 and 2007, excluding the South, community banks with assets of less than \$1 billion experienced margin compression across the country (**Exhibit 2**). Banks in the South bucked the declining margin trend in 2006, with an actual growth of 6 basis points, and showed only 11 basis points in margin decline during the two-year period from 2005 to 2007, which is about half of the decline in other regions. A look at the interest cost vs. interest income reveals that the South had the same rise in cost of funds as the other regions but was able to pass on that cost to customers, as shown by rising asset yields, well above all other regions.

Community banks in the South reported a rise of 114 basis points in yield on assets, compared with a rise of fewer than 100 basis points for all other regions. Community banks in the Western region fared the worst in terms of margins, with an especially large

decline of 25 basis points in 2007. Other regions reported declines close to 11 to 17 basis points.

As indicated in **Exhibit 2**, midsize banks (assets between \$1 billion and \$20 billion) experienced significant margin compression in 2006, followed by improved or milder compression in 2007. **Exhibit 2** shows margins for banks in the Western region were down as much as 77 basis points in

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



2006, while other regions experienced a 3 basis point improvement to an 18 basis point compression in margin. The meager rise in asset yield for banks in the West of 44 basis points from 2005 to 2007, or about half the growth in other regions (ranging from 92 to 119 basis points), is attributable directly to the significant margin compression. With funding costs rising at the same pace as midsize banks in all other regions, banks in the West experienced a precipitous 79 basis point decline in margins for the two-year period, ten times the pace for all other regions.

The picture for large banks (asset size more than \$20 billion) is entirely different than for community banks or midsize banks. On both coasts, large banks experienced significant drops in their respective margins; the Northeast in 2006 and the West in 2007 (**Exhibit 2**). For large banks in the Northeast, margin pressures arose primarily from a much slower rise in asset yields than the rising cost of funds as compared with other regions. Large Northeastern banks with assets greater than \$20

billion had one-quarter the rate of increase in asset yields of other regions in 2006. These pressures amounted to large Northeast banks losing 63 basis points of margin in 2006. On the other hand, large banks in the West experienced margin pressures on both fronts: slower rises in asset yields combined with larger rises in funding costs relative to other parts of the country. In 2007 large banks in the West experienced margin erosion of 72 basis points, compared with 12 to 14 basis points in other regions. Over the two-year period, large banks in the West and Northeast had dramatic margin declines of 69 and 54 basis points respectively, while large banks in the Midwest and South had mild declines in margins on a relative basis.

Asset Mix

The differences in asset mix between banks regionally and by asset size partially explain variances in NIM profiles. Among community banks, total asset yields remained stable during the period 2005 to 2007 (**Exhibit 4**). The Northeast had a higher concentration in residential

Exhibit 1

U.S. Banks – Components of Net Interest Income (2005-2007)

Community Banks (Assets < \$1 Billion)

	FY 2007			FY 2006			FY 2005		
	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin
Northeast	6.14%	3.00%	3.14%	5.90%	2.60%	3.30%	5.29%	1.88%	3.41%
Midwest	6.90%	3.21%	3.69%	6.63%	2.83%	3.80%	5.92%	2.03%	3.89%
South	7.05%	3.11%	3.94%	6.80%	2.69%	4.11%	5.91%	1.86%	4.05%
West	7.38%	2.84%	4.54%	7.17%	2.38%	4.79%	6.40%	1.59%	4.82%

Midsize Banks (Assets \$1 Billion - \$20 Billion)

	FY 2007			FY 2006			FY 2005		
	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin
Northeast	5.84%	2.96%	2.88%	5.81%	2.95%	2.87%	4.92%	1.99%	2.93%
Midwest	7.03%	3.33%	3.70%	6.45%	2.87%	3.58%	5.95%	2.19%	3.76%
South	6.92%	3.18%	3.74%	6.54%	2.72%	3.82%	5.72%	1.94%	3.79%
West	7.09%	3.06%	4.03%	6.64%	2.59%	4.05%	6.65%	1.83%	4.82%

Large banks (Assets Greater Than \$20 Billion)

	FY 2007			FY 2006			FY 2005		
	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin
Northeast	6.06%	3.36%	2.70%	5.79%	3.18%	2.62%	5.56%	2.32%	3.25%
Midwest	5.91%	3.11%	2.80%	6.05%	3.11%	2.94%	5.16%	2.17%	2.99%
South	6.52%	3.29%	3.23%	6.49%	3.14%	3.35%	5.63%	2.19%	3.44%
West	5.85%	3.07%	2.78%	6.05%	2.55%	3.50%	5.03%	1.56%	3.47%

Source: FDIC and A.M. Best Co.

loans and securities, for community and midsize banks, than the riskier loan assets of consumer and industrial (C&I), commercial real estate (CRE) or construction and development financing. In contrast, the community banks in the West showed higher concentrations in the construction and development and lower exposures to C&I. This explains the Western banks' high level of NIM, even after the highest degree of margin squeeze effects. It is interesting to note that the South had a similar risk level in their asset mix as the West, but had the most robust rise in asset yields among all the regions (**Exhibit 1**).

For midsize banks, the Northeast had notably lower concentrations of more risky loans such as: CRE, C&I loans and construction and development loans (**Exhibit 4**). Asset yields for the West increased the least of the four regions during the two-year period (**Exhibit 2**). Given this, it can be concluded that asset mix has less to do with margin pressures than the local economic conditions and banking market

dynamics within each region for the midsize banks.

Finally, for large banks, regional differences in asset mix between 2005 and 2007 offer strong explanations for the Northeast banks' reported weak gain in asset yields. Similar to midsize and small banks in the Northeast, the asset mix of large banks in the region showed lower components of all types of loans and a higher preference for trading assets and other earning assets, such as repurchase agreements and federal fund placements (**Exhibit 4**). Surprisingly, the Midwest asset mix consisted of the lowest concentration in real estate construction among all size banks for 2007, while the South and Western regions showed more robust rises in asset yields on account of higher concentrations in construction and development loans and in CRE loans (**Exhibit 2**).

Liability Mix

Margin compression over the past three years has resulted more from rising funding costs than from declining asset yields.

Exhibit 2

U.S. Banks – Year-Over-Year Change in Components of Net Interest Income (2005-2007)

Community Banks (Assets < \$1 Billion)

	FY 2007 - 2006			FY 2006 - 2005			FY 2007 - 2005		
	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin
Northeast	0.24%	0.40%	-0.15%	0.61%	0.72%	-0.11%	0.85%	1.12%	-0.27%
Midwest	0.27%	0.38%	-0.11%	0.71%	0.80%	-0.09%	0.98%	1.18%	-0.20%
South	0.25%	0.42%	-0.17%	0.89%	0.83%	0.06%	1.14%	1.25%	-0.11%
West	0.21%	0.46%	-0.25%	0.76%	0.79%	-0.03%	0.98%	1.25%	-0.28%

Midsize Banks (Assets \$1 Billion - \$20 Billion)

	FY 2007 - 2006			FY 2006 - 2005			FY 2007 - 2005		
	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin
Northeast	0.03%	0.02%	0.01%	0.89%	0.96%	-0.07%	0.92%	0.97%	-0.05%
Midwest	0.58%	0.47%	0.12%	0.50%	0.68%	-0.18%	1.08%	1.14%	-0.07%
South	0.38%	0.45%	-0.08%	0.82%	0.78%	0.03%	1.19%	1.24%	-0.04%
West	0.46%	0.47%	-0.01%	-0.01%	0.76%	-0.77%	0.44%	1.23%	-0.79%

Large banks (Assets > \$20 Billion)

	FY 2007 - 2006			FY 2006 - 2005			FY 2007 - 2005		
	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin	Int. Income/ Earning Assets	Int. Expense/ Earning Assets	Net Interest Margin
Northeast	0.27%	0.18%	0.09%	0.23%	0.86%	-0.63%	0.50%	1.04%	-0.54%
Midwest	-0.14%	0.00%	-0.14%	0.89%	0.94%	-0.05%	0.75%	0.94%	-0.19%
South	0.03%	0.15%	-0.12%	0.86%	0.95%	-0.09%	0.89%	1.10%	-0.21%
West	-0.20%	0.52%	-0.72%	1.02%	0.99%	0.03%	0.82%	1.51%	-0.69%

Source: FDIC and A.M. Best Co.

Unlike the different dynamics on the asset side of the balance sheet, increases in funding costs have run parallel among all regions (**Exhibit 2**). This is better understood by looking at how the funding composition of banks in different parts of the United States has changed over the past few years. Competi-

tion among larger and nontraditional banks has made it increasingly difficult for banks to depend on traditional deposits and has driven them to tap into more non-core deposits.

All banks, with the exception of the larger banks with assets exceeding \$20 billion,

Exhibit 3 U.S. Banks – Funding Composition (2007 vs. 2005)

	2007					2005			
	Banks < \$1B in Assets					Banks < \$1B in Assets			
	Northeast	Midwest	South	West		Northeast	Midwest	South	West
Transaction Deposits	12.8%	18.3%	18.8%	15.1%	Transaction Deposits	15.9%	20.9%	24.8%	20.6%
Time Deposits	26.7%	30.6%	24.5%	18.8%	Time Deposits	24.7%	27.4%	21.8%	14.9%
Time Deposits over \$100K	15.3%	16.0%	22.0%	18.2%	Time Deposits over \$100K	12.8%	16.4%	19.4%	17.4%
Money Market Accounts	13.9%	15.0%	16.8%	25.1%	Money Market Accounts	14.0%	14.6%	16.1%	23.7%
Other Savings	18.8%	11.1%	9.9%	14.0%	Other Savings	20.6%	12.0%	10.3%	16.3%
Federal Home Loan Bank Advances	10.0%	5.9%	5.4%	5.7%	Federal Home Loan Bank Advances	9.3%	5.9%	5.1%	4.4%
Repurchase Agreements (Repo)	2.2%	2.8%	2.3%	2.3%	Repurchase Agreements (Repo)	2.5%	2.7%	2.2%	2.3%
Other Borrowings	0.3%	0.2%	0.3%	0.7%	Other Borrowings	0.3%	0.2%	0.3%	0.4%

	2007					2005			
	Banks \$1Billion - \$20 Billion in Assets					Banks \$1Billion - \$20 Billion in Assets			
	Northeast	Midwest	South	West		Northeast	Midwest	South	West
Transaction Deposits	8.6%	9.7%	11.0%	7.7%	Transaction Deposits	9.1%	12.0%	14.2%	14.2%
Time Deposits	17.7%	23.5%	18.1%	15.4%	Time Deposits	15.3%	19.8%	15.0%	15.0%
Time Deposits over \$100K	12.7%	13.2%	16.0%	14.2%	Time Deposits over \$100K	11.7%	14.3%	14.8%	14.8%
Money Market Accounts	29.5%	23.8%	27.2%	27.5%	Money Market Accounts	25.5%	22.8%	27.3%	27.3%
Other Savings	15.3%	11.3%	10.2%	11.4%	Other Savings	17.8%	11.6%	11.4%	11.4%
Federal Home Loan Bank Advances	9.4%	6.8%	6.1%	12.6%	Federal Home Loan Bank Advances	10.8%	7.0%	6.1%	6.1%
Repurchase Agreements (Repo)	5.7%	10.3%	8.8%	8.4%	Repurchase Agreements (Repo)	8.7%	9.4%	8.5%	8.5%
Other Borrowings	1.1%	1.3%	2.6%	2.8%	Other Borrowings	1.0%	3.1%	2.7%	2.7%

	2007					2005			
	Banks > \$20 Billion in Assets					Banks > \$20 Billion in Assets			
	Northeast	Midwest	South	West		Northeast	Midwest	South	West
Transaction Deposits	44.9%	25.4%	17.2%	6.8%	Transaction Deposits	46.4%	19.5%	17.0%	9.5%
Time Deposits	3.7%	6.3%	10.9%	6.9%	Time Deposits	3.7%	5.4%	8.8%	4.1%
Time Deposits over \$100K	7.0%	7.4%	11.7%	9.6%	Time Deposits over \$100K	7.2%	9.6%	10.5%	7.7%
Money Market Accounts	15.1%	27.9%	26.2%	52.4%	Money Market Accounts	19.2%	28.2%	28.7%	65.7%
Other Savings	3.2%	6.6%	7.4%	1.4%	Other Savings	5.0%	9.9%	9.5%	3.5%
Federal Home Loan Bank Advances	8.8%	2.5%	1.7%	11.5%	Federal Home Loan Bank Advances	1.8%	1.9%	2.8%	6.0%
Repurchase Agreements (Repo)	5.3%	8.5%	11.2%	4.8%	Repurchase Agreements (Repo)	7.3%	9.1%	11.6%	2.9%
Other Borrowings	12.0%	15.4%	13.8%	6.6%	Other Borrowings	9.4%	16.4%	11.2%	0.6%

Source: FDIC and A.M. Best Co.

have seen dramatic changes in funding composition from lower-cost transaction deposits to higher-cost time deposits (**Exhibit 3**). For example, community banks in the Midwest, South and West all had more than 20% of their funding in transaction accounts in 2005, compared with reduced 2007 levels, all below 18.8%. In the Midwest, this is demonstrated by the jump in higher-cost time deposits, from 27.4% of total funding in 2005 to 30.6% in 2007. Furthermore, time deposits exceeding \$100,000, representing more volatile funds, also have increased. As would be expected, the transient nature of these volatile funds and non-core deposits lead to a greater

likelihood of these funds leaving the banks during periods of heavy pricing competition, heightening the risk of future margin compression.

This similar pattern of change in funding mix is seen to a lesser extent for the mid-size banks. By growing their money market accounts, these banks have been more effective in stemming the shift of customers' preference out of transaction accounts into time deposits. In 2007 more than 23% of the funding for midsize banks across the country came from money market accounts (**Exhibit 3**). In comparison, only community banks in the Western region had a

Exhibit 4 U.S. Banks – Asset Composition (2007 vs. 2005)

Community Banks (Assets < \$1 Billion) Asset Composition 2007

	Loans							Residential	Securities	Other Interest Earning Assets
	Consumer and Industrial	Commercial Real Estate - Secure/Unsecure	Consumer	Agriculture/Other	Residential Construction					
Northeast	8.0%	18.8%	2.6%	0.4%	5.6%	36.4%	24.4%	3.9%		
Mid-West	13.3%	19.2%	4.3%	5.2%	8.5%	21.4%	20.2%	7.8%		
South	11.6%	20.9%	4.9%	2.3%	15.3%	19.4%	20.9%	4.6%		
West	14.9%	25.6%	4.0%	4.4%	17.4%	13.1%	17.5%	3.0%		

Midsize Banks (Assets Between \$1Billion - \$20 Billion) Asset Composition 2007

	Loans							Residential	Securities	Other Interest Earning Assets
	Consumer and Industrial	Commercial Real Estate - Secure/Unsecure	Consumer	Agriculture/Other	Residential Construction					
Northeast	14.9%	14.6%	3.8%	0.3%	4.3%	26.5%	30.0%	5.5%		
Mid-West	18.3%	18.5%	6.9%	2.1%	11.7%	21.9%	18.7%	1.9%		
South	16.0%	18.5%	7.4%	0.8%	17.1%	18.6%	18.9%	2.7%		
West	15.7%	20.8%	7.9%	4.2%	14.0%	19.6%	15.2%	2.6%		

Large Banks (Assets > \$20 Billion) Asset Composition 2007

	Loans							Residential	Securities	Other Interest Earning Assets
	Consumer and Industrial	Commercial Real Estate - Secure/Unsecure	Consumer	Agriculture/Other	Residential Construction					
Northeast	23.3%	6.5%	9.6%	0.2%	3.8%	21.5%	10.4%	24.7%		
Mid-West	22.9%	3.5%	10.4%	2.9%	1.0%	21.3%	20.5%	17.6%		
South	22.6%	7.5%	17.7%	1.2%	2.3%	18.7%	14.5%	15.5%		
West	20.1%	7.1%	13.2%	0.6%	4.9%	26.4%	16.1%	11.6%		

similarly large concentration of funds (25%) coming from money market accounts. An interesting note is that while midsize banks have performed better than community banks in terms of savings account deposits in almost all regions, community banks have higher levels of transaction deposits

Larger banks exhibited a different funding profile due to geographic diversification and scope of operation. Transaction accounts represented a major composition of funding for the larger banks in the Northeast (44.9%), the Midwest (25.4%) and the South (17.2%), but not so much in the West (6.8%) (**Exhibit 3**). The reduced level of

transaction deposits for large banks in the West is attributable to the large number of industrial banks, which are prohibited from taking Demand Deposit Accounts. As such, the West showed a much higher concentration of money market accounts than that of its peers (at 52.4%, as of 2007).

Conclusions

Margin pressures have affected, and will continue to affect, U.S. banks in common ways that run across all regions, but also in distinctive ways in different parts of the United States. All banks have shifted their asset mix more toward higher yielding assets that carry incrementally

Community Banks (Assets < \$1 Billion) Asset Composition 2005

	Loans								Residential	Securities	Other Interest Earning Assets
	Consumer and Industrial	Commercial Real Estate - Secure/Unsecure	Consumer	Agriculture/Other	Residential Construction	Residential	Securities	Other Interest Earning Assets			
Northeast	7.6%	17.3%	2.9%	0.3%	4.9%	34.1%	30.1%	2.7%			
Mid-West	13.3%	18.7%	5.0%	4.7%	7.3%	21.8%	22.0%	7.1%			
South	11.3%	20.4%	5.8%	2.1%	12.1%	20.1%	22.9%	5.3%			
West	13.9%	24.9%	4.5%	1.7%	15.1%	12.9%	19.7%	7.3%			

Midsize Banks (Assets Between \$1Billion - \$20 Billion) Asset Composition 2005

	Loans								Residential	Securities	Other Interest Earning Assets
	Consumer and Industrial	Commercial Real Estate - Secure/Unsecure	Consumer	Agriculture/Other	Residential Construction	Residential	Securities	Other Interest Earning Assets			
Northeast	11.7%	11.6%	5.1%	0.2%	3.0%	28.7%	34.4%	5.2%			
Mid-West	18.2%	17.0%	7.6%	1.4%	9.6%	23.5%	21.0%	1.7%			
South	17.1%	17.8%	6.3%	0.7%	12.2%	20.8%	21.0%	4.1%			
West	15.8%	17.9%	15.1%	0.9%	8.4%	18.9%	17.2%	5.8%			

Large Banks (Assets > \$20 Billion) Asset Composition 2005

	Loans								Residential	Securities	Other Interest Earning Assets
	Consumer and Industrial	Commercial Real Estate - Secure/Unsecure	Consumer	Agriculture/Other	Residential Construction	Residential	Securities	Other Interest Earning Assets			
Northeast	27.5%	4.1%	13.9%	3.6%	0.8%	11.3%	28.0%	10.8%			
Mid-West	21.3%	6.8%	10.2%	0.2%	3.3%	25.9%	11.0%	21.3%			
South	17.9%	6.8%	13.4%	0.6%	4.3%	28.0%	21.0%	8.1%			
West	27.5%	10.9%	10.5%	0.3%	3.3%	24.4%	18.8%	4.3%			

higher risk, such as commercial real estate, construction and land and development loans. Banks have also been competing harder for the lowest-cost funding sources of deposits, thereby forcing banks to grow their higher-rate deposit products such as time deposits and larger, non-core, deposits. More interestingly, the regional differences in local economies and banking market conditions have had different effects on banks' NIM in various regions.

Margin pressures also have depended on the asset size category of the banks. Community banks always have fared better than midsize banks, and in turn, these are more protected than the large banks in

combating margin compression. Among the various regions, A.M. Best observed that the South has performed the best in minimizing margin erosion, with the West being the worst. The Midwest more consistently has occupied the middle ground in NIM compression among all the regions. The shift toward higher asset risk classes also has put a greater degree of capital at risk, the one common denominator shared among all regions and banking segments. These events bring to question how the banking sectors will manage tightening NIM in the future and how well prepared their Asset/Liability Management Committees (ALCO) is in forecasting and developing balance sheet strategies to mitigate future earnings risks.



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