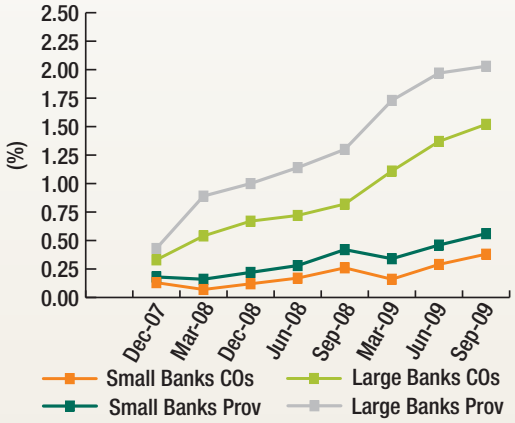
Issue Review

December 28, 2009

Sector
Banking

U.S. Banking – Median Total Charge-Offs, Provisions to Average Total Loans (2007-3Q 2009)
Large banks (assets of $5 billion or more) vs. small banks.



Source: FDIC

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Community Bank Advantages Challenge Historical Assumptions

A bank's size alone can have less to do with its performance, safety and soundness than would be expected, based on A.M. Best's analysis of data from the Federal Deposit Insurance Corp. and other, qualitative factors. Various operating models carry key advantages and disadvantages, as best delineated by a threshold of $5 billion in assets between small and large banks.

• Despite common industry perceptions that large commercial banks have greater safety and earnings power than community banks, a bank's assets don't necessarily equate to economies of scale, diversification of risk and market power.

• Small community banks generally have smaller scale and less diversification, but their local owner-managers provide stability, and they draw strength from focusing on their local communities and limiting risk.

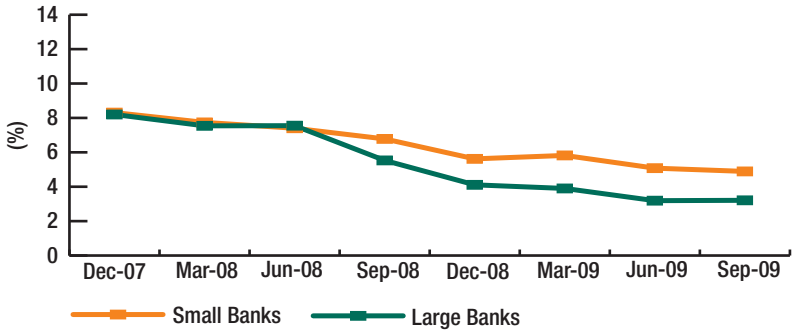
• Larger institutions historically have tended to take on more leverage and complex risk exposures, and they also may forego diversification to assume concentrated risk in certain regions or in certain products, such as subprime mortgages.

• Relative risk aside, community banks are better capitalized according to certain regulatory capital ratios, including the Tier 1 risk based capital and tangible common equity.

• Community banks are less susceptible to downswings in banking cycles, as shown by more gradual declines in median return on assets and return on equity compared with larger banks.

• The diverse operating models in U.S. banks – from the traditional, relationship-based business of community banks to the more market- and transaction-based models of large banks – mean that when one segment falters, another is better able to survive.

U.S. Banking – Median Return on Average Equity (2007-3Q 2009)
Large banks (assets of $5 billion or more) vs. small banks.



Source: FDIC

Small, but Measuring Up

The U.S. banking industry traditionally has been bifurcated into two distinct segments: large commercial banks and small community banks. This industry structure is so designed by the myriad banking regulations that keep large banks from crowding out small ones while also ensuring the viability of the small banks' economic model. Yet the bifurcation is more than regulatory and is reflected further in the diverse operating models of traditional, relationship-based business of community banks versus more market- and transaction-based models of large banks. Diversity provides some degree of counteracting and offsetting effects in that when one segment falters, another is better able to survive.

A.M. Best observes key advantages and disadvantages of various operating models, as best delineated between banks with less than $5 billion in assets and banks with $5 billion or more. Data from the Federal Deposit Insurance Corp. (FDIC) and qualitative factors together highlight the fact that asset size alone does not ultimately determine a bank's performance and safety and soundness. It is important to note that the relationship between size and credit ratings is a different subject not covered in this report, as credit ratings go beyond a specific bank's operations to consider also its parent bank holding company and other affiliates within its banking group, among other factors.

Basis for Pros and Cons Of Large and Small Segments

Common industry perception holds that large commercial banks have an inherent advantage over community banks for their higher earnings power and a higher degree of safety and soundness. However, there is not an immediate link or a guar-

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antee that a bank's assets equate with the advantages associated with size, namely economies of scale, diversification of risk and market power. When large banks clearly exhibit benefits from those size advantages, their financial standing will reflect a correspondingly stronger profile. Small, community banks generally do lack scale and diversification compared with large banks; however, those disadvantages often are offset in part by the stability that local owner-managers provide, and by their primary focus on their local communities and on limiting risk in ways that contribute to strong business profiles. There is evidence that these benefits of community banks' relationships with local borrowers, depositors, investors and various constituents somewhat help to insulate many such banks from the vagaries of financial markets.

On the flip side of the size-factor argument, larger institutions have the potential operating advantages of scale and diversification but also historically have been shown to take on more leverage and complex risk exposures. Recent market performance, for example, clearly has demonstrated the perils of believing that scale automatically equals diversification of risk. Despite the opportunity to diversify, managements may opt to assume risk concentrations in certain geographic regions or in certain products, such as subprime mortgages. Under greater short-term pressure from public investors to perform, large banks tend to leverage up balance sheets and assume complex risks to generate higher returns on assets and equity. In contrast, community banks tend to focus on objectives that include longer term goals of service to customers. It also can be argued that community banks have more stringent oversight and higher regulatory burdens relative to their size. While these may be considered generalized perceptions, the operating model of large banks and community banks clearly are completely different. A particular bank's trade-offs between various advantages and disadvantages of size versus local relationships, along with a plethora of other factors, combine to form the unique profile of each bank.

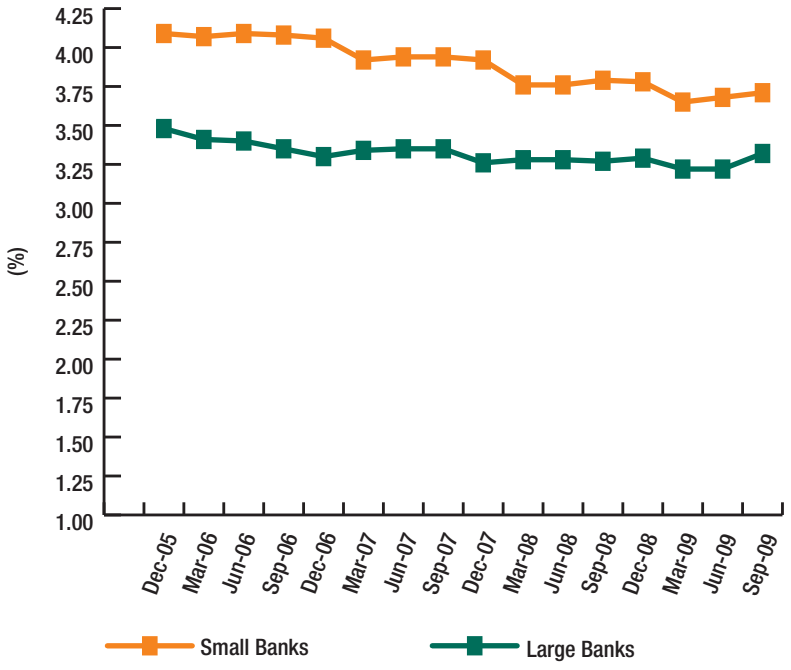
Historical Evidence Supporting Community Banks' Advantages

Both FDIC data and anecdotal evidence show that community banks' close ties to local depositors, borrowers, investors and other community constituents provide meaningful economic benefits that translate into financial performance. Furthermore, equally noteworthy is their simpler and more traditional banking model, which tends to incorporate more conservative balance sheet strategies. Thus, as a group, community banks historically have shown stable, robust margins and account service fees; less reliance on income derived from financial markets; higher capital levels; and minimal exposures to exotic financial investments and off-balance sheet derivatives. There is a presumption here that community banks' intimate knowledge of local markets and higher levels of customer service effectively provide them with a stronghold in their territories and a strategic barrier against new competitors. It also should be acknowledged that community banks are subject to higher concentrations of risk (geographic and otherwise) and have relatively less

Exhibit 1

U.S. Banking – Median Net Interest Margin (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.

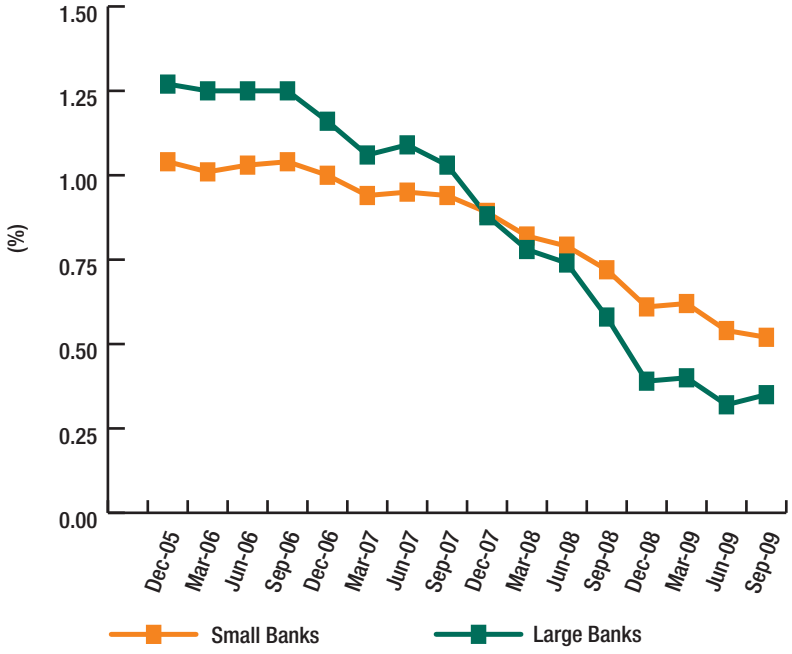


Source: FDIC

Exhibit 2

U.S. Banking – Median Return on Average Assets (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.

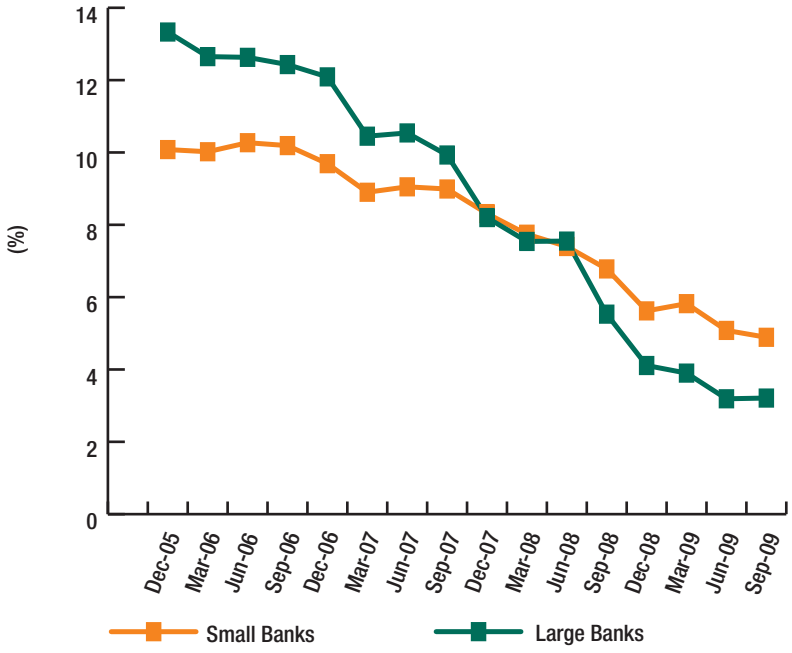


Source: FDIC

Exhibit 3

U.S. Banking – Median Return on Average Equity (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.



Source: FDIC

access to capital and funding, among other resources, compared with larger banks. Nevertheless, FDIC data clearly show the advantages of smaller banks in many respects, as discussed below.

The disparity of median net interest margin between large and small banks (ranging between 43 and 76 basis points since 2005) (see **Exhibit 1**) demonstrates the ability of community banks to charge higher rates on earning assets, presumably due to their closer relationships with borrowers and depositors than their larger counterparts have. When combined with fees and other loan income, the median differences in the spreads of total yield on loans and leases for community banks has widened from a low of 58 basis points in the first quarter of 2007 to 94 basis points in the second quarter of 2009.

Another advantage of community banks is lower susceptibility to the downswings of banking cycles, as evidenced by the gradual decline of median return on assets (ROA) and return on equity (ROE) for community banks, compared with a steeper decline for larger banks (see **Exhibits 2** and **3**). Larger banks have experienced steeper declines in returns since the end of 2007, due in part to their dependence on trading and other income derived from capital markets.

Even setting aside questions of relative risk, community banks are better capitalized, according to a number of regulatory capital ratios, including Tier 1 risk based capital and tangible common equity (see **Exhibits 4** and **5**). Community banks historically have a median Tier 1 RBC ratio of 2.17% to 3.67% more than large banks since 2005. Another measure that speaks to the quality of community banks' equity position is retained earnings to average total equity, which began to favor community banks in the third quarter of 2006 and, as of the latest quarter, sits at 2.35% compared with 1.03% for large banks. While traditionally, larger banks are assumed to be more highly leveraged compared with community banks, the differences in median values of these two groups has remained within 1x since 2005. Recent market and regulatory conditions

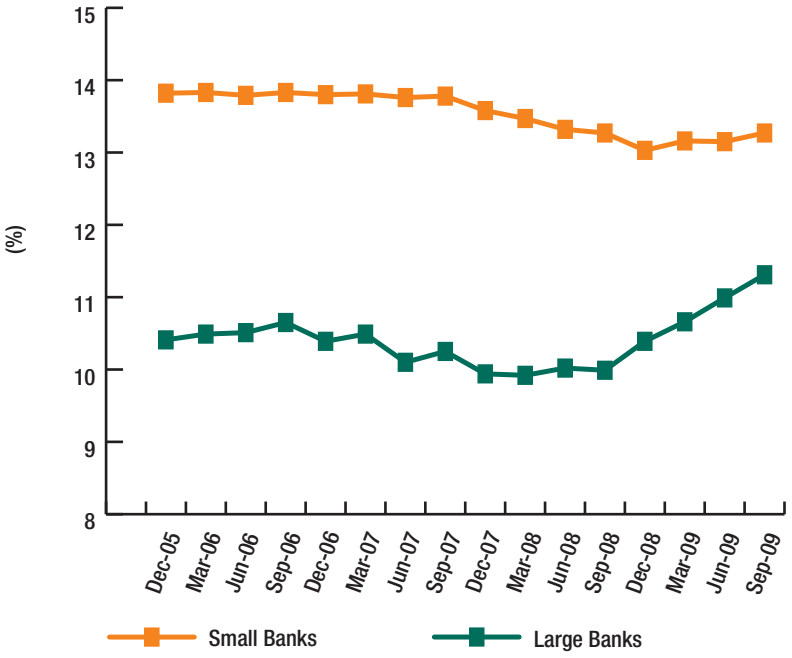
that encouraged the deleveraging of large banks and maintenance of more capital at the operating entity level actually caused community banks' median leverage multipliers to be slightly greater than those of large banks (10.1× vs. 10.04×) in the second quarter of 2009. During 2009, large banks also may have temporarily built capital in anticipation of accounting changes that will increase their on-balance sheet assets in 2010. While this trend of large banks deleveraging balance sheets raises their capital ratios somewhat, it does not necessarily signal a fundamental, permanent change in their business model of utilizing high leverage. It also does not consider leverage and capital at other levels of the organization or the overall quality of capital (common versus mezzanine).

Traditional relationship-based banking is another important attribute that helps community banks better manage their problem loans and, in turn, perform better on asset-quality measures. From anecdotal evidence, community banks have a better understanding of credit risk because of a more intimate knowledge of customers' individual circumstances as well as their local markets. Also, community banks encourage long-term customer loyalty through business practices such as an inclination to structure loans in terms more favorable to the borrower and to work out troubled loans rather than write them off. Observing the "Texas ratio" of nonperforming assets to tangible equity plus loan loss reserves, during the recent period of industrywide increases in nonperforming loans, the median Texas ratio for large banks increasingly exceeded that for community banks, having grown from a difference of 65 basis points in the first quarter of 2007 to 998 basis points in the second quarter of 2009 (see **Exhibit 6**). Community banks also fared better in terms of charge-offs to nonperforming assets, with a median well below the charge-off levels of larger banks (ranging from 24.52% in the fourth quarter of 2005 to 37.51% in the first quarter of 2008). When viewed in combination with the historically stronger margins and capital ratios, the charge-off numbers are even more favorable to community banks.

Exhibit 4

U.S. Banking – Median Tier 1 Risk-Based Capital Ratio (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.

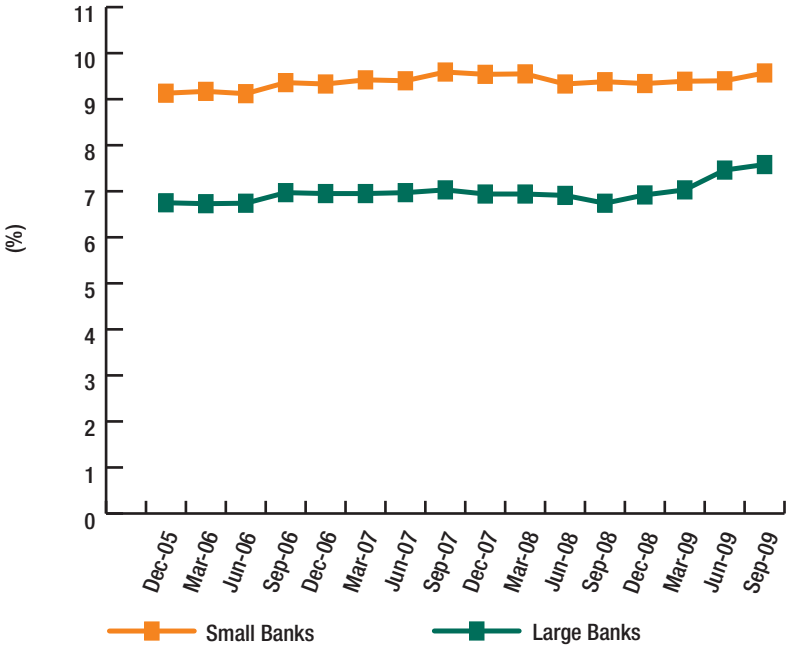


Source: FDIC

Exhibit 5

U.S. Banking – Median Tangible Equity to Assets Plus Securitized Assets (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.

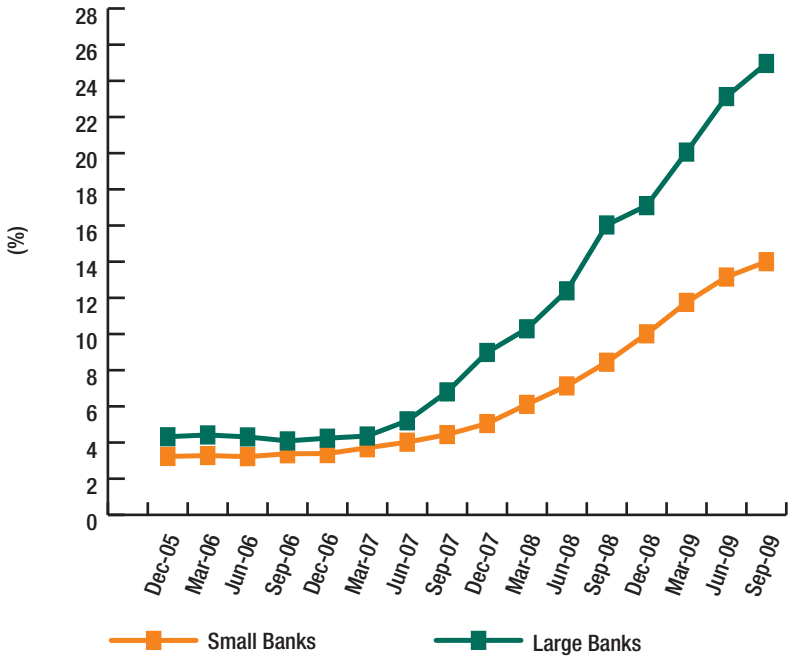


Source: FDIC

Exhibit 6

U.S. Banking – Median Texas Ratio[1] (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.



[1] Texas Ratio = (Nonperforming Assets/Tangible Equity + Allowance for Loan and Lease Losses)
Source: FDIC

Exhibit 7

U.S. Banking – Median Number of Branches (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.

	Large Banks	Small Banks
December 2005	82	3
March 2006	82	3
June 2006	83	3
September 2006	80	3
December 2006	75	3
March 2007	78	3
June 2007	80	3
September 2007	74	3
December 2007	72	3
March 2008	73	3
June 2008	73	3
September 2008	74	3
December 2008	70	3
March 2009	71	3
June 2009	70	3
September 2009	74	3

Source: FDIC

All these attributes of community banks taken together contribute to the fundamental franchise strength of community banks, but they still may be subject to other risk factors particular to smaller banks. Thus, when a community bank is able to address the corresponding small-bank issues of higher risk concentration and relatively more limited access to resources within the context of its obligations to depositors and creditors, then it will have a correspondingly strong profile.

Historical Evidence Supporting Advantages of Large Banks

For banks with assets of $5.0 billion or more, the advantages of scale can be seen through the median number of branches totaling 70 for large banks versus three for small banks with less than $5.0 billion in assets (see **Exhibit 7**). Looking at the median assets per branch for large versus small banks, large banks' branch assets amounted to about four times the size and more than double the number of employees per branch dating back to 2005. Assets per employee at larger institutions were more sizable, averaging about two times larger, with the median level slightly less (see **Exhibit 8**). The sheer number of branches allows for better market diversity and coverage to support overall funding needs.

With extensive branch networks and market diversification as well as operational resources and synergies, large banks are able to maintain efficiency ratios (the level of operational expenses to net interest income plus non-interest income) well below those of their smaller peers, both currently and on a historical level dating back to fiscal year-end 2005 (see **Exhibit 9**). The one exception was during the fourth quarter of 2008 and first quarter of 2009, at the peak of the market downturn, when larger banks experienced significant deterioration in efficiency levels due to lower operating income. The median efficiency ratio (on a quarterly basis) for large banks was maintained consistently around the mid 50th percentile, with the more recent two quarters trending upward in the upper 50th percentile range. By comparison, the median efficiency ratio for small banks ranged from the mid 60th percentile to a more recent level slightly below the 74th percentile.

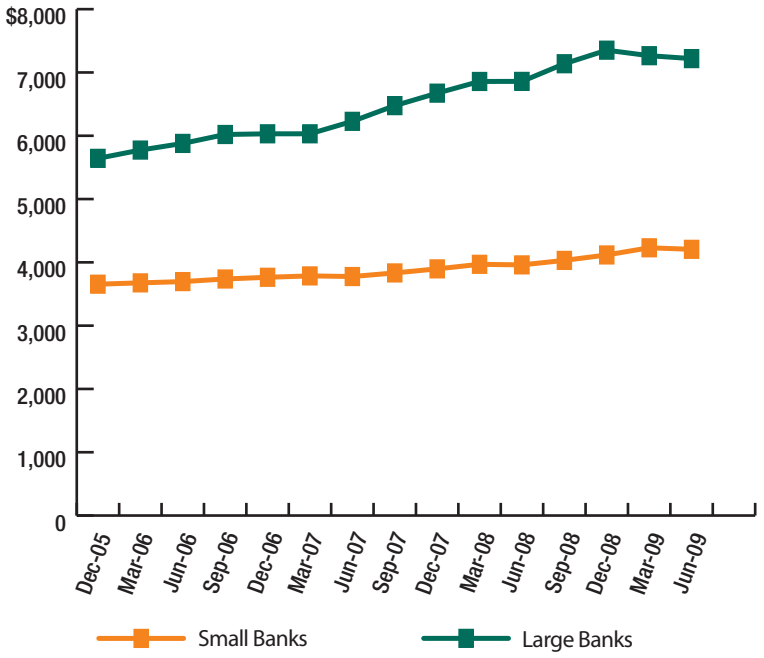
Diversification in large banks' earnings can be seen through the level of non-interest income as a percentage of net operating income (see **Exhibit 10**). Before year-end 2008, the median non-interest income ratio well exceeded 60%, reaching as much as 84%. Since the third quarter of 2008, reflecting the volatile market environment, the ratio dropped to 60% by year-end 2008, with the second quarter of 2009 level at 39%. For small banks, the ratio was fairly stable, ranging in the low to mid 40s and reflecting mainly core banking-related non-interest sources of income. The volatility or wide range in large banks' ratios is a good indication of other non-interest sources of income derived from trading and underwriting fees from investment-banking activities – all of which are outside the traditional banking model and much more volatile. Trading income for large banks before the recession (year-end 2007) comprised on average 5% to 11% of net operating income, while this figure for small banks was less than 1%.

During stable market environments, the diversity of non-interest sources of income helps large banks to mitigate volatility in interest income, which was reflected in their performance ratios. On a quarterly basis from 2005 to the third quarter of 2007, large banks outperformed their smaller peers in both ROA and ROE ratios. As the market deteriorated starting in the fourth quarter of 2007, large banks showed a steeper declining trend in ROA and ROE ratios versus smaller banks. In terms of average net operating income to average earning assets ratio, before the fourth quarter of 2007 there was a much wider spread, a good indication that the large banks benefited from diversified earnings, which helped offset sharper declines from their less conservative lending practices (see **Exhibit 11**). As the market environment weakened, the spreads declined to negative levels from the third quarter of 2008 to the present. Taken in context, large banks' advantages in scale and diversification of earnings also could lead to more market and credit risk exposures that would offset the benefits of size.

Exhibit 8

U.S. Banking – Assets per Employee (2005-2Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.
($ Thousands)

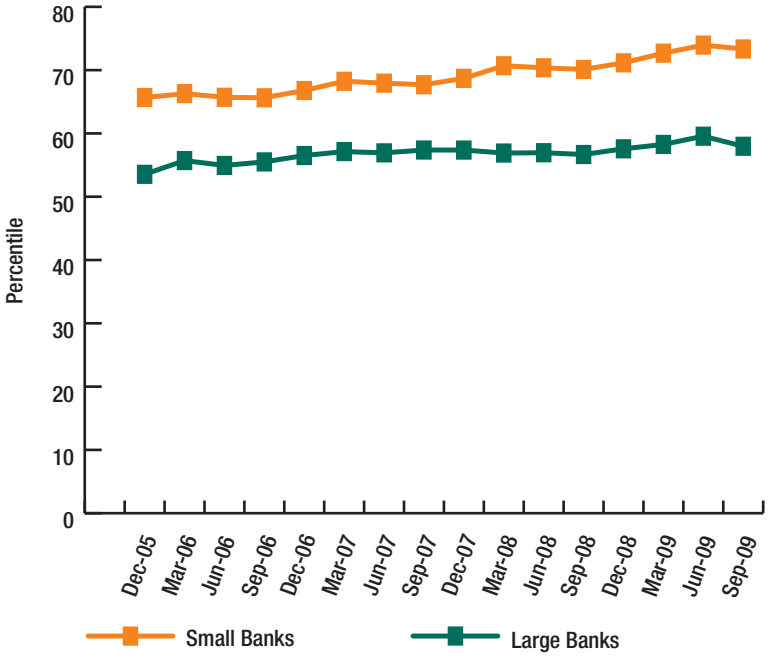


Source: FDIC

Exhibit 9

U.S. Banking – Median Efficiency Ratio (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.

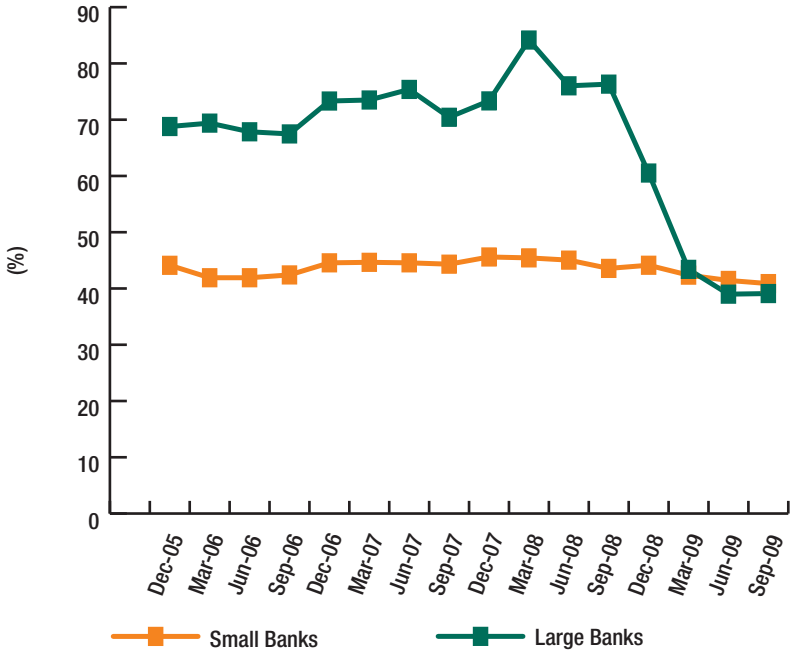


Source: FDIC

Exhibit 10

U.S. Banking – Median Non-Interest Income/Net Operating Income (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.

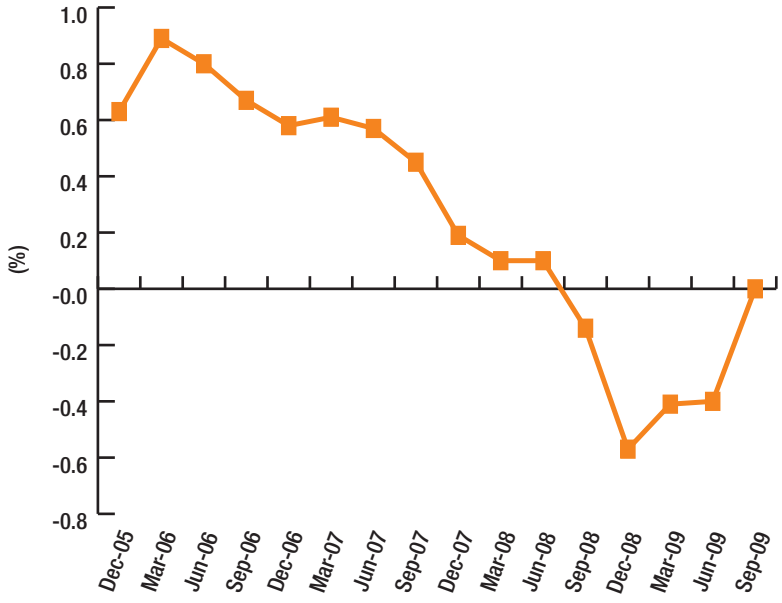


Source: FDIC

Exhibit 11

U.S. Banking – Net Operating Income to Average Assets bps Spreads (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.



Source: FDIC

As mentioned before, one important measure of profitability favoring large banks over their community counterparts is their superior access to more varied sources of funding, which results in a lower cost of funds compared with community banks. While large banks are far too large for their deposit customer base and are fully tapped out with their deposit funding, they have an economic advantage in their access to public and wholesale funding because of their size. Cost of funds, as measured by interest expense to total liabilities, previously favored smaller banks as recently as the fourth quarter of 2007 (26 basis points), but declines in interest rates since then have caused the cost of funds for community banks to be higher (with a median difference of 48 basis points in the second quarter of 2009).

Historical trends for large banks' off-balance sheet exposures tend to be much more complex, mainly because of loan securitizations. At year-end 2005, near the peak of the real-estate market bubble, the large banks' median off-balance sheet exposures amounted to 32.6% of total assets, compared with 11.9% for community banks (see **Exhibit 12**). On an average basis, the figures were more significant, with large banks amounting to 134.1%, versus 33.3% for community banks. From year-end 2005 to 2007, banks experienced a very moderate declining trend in off-balance sheet exposures, with a more significant decline during 2008 through the third quarter of 2009, especially for larger institutions. As of the third quarter of 2009, the median off-balance sheet exposures for large banks totaled 22.3%, compared with 8.5% for small banks (on an average basis, 70.8% and 25.7%, respectively). The steeper decline in off-balance sheet exposures since year-end 2007 reflected the drop in market demand due to the subprime crisis, lower securities valuations and higher write-offs. Off-balance sheet exposures could decline further for larger institutions as they adopt new accounting standards that result in previously deconsolidated assets being added to balance sheets in 2010. This accounting change was included in Supervisory Capital Assessment Program tests for high systemic-risk banks, and large banks already

have been building capital and allowances for loan and lease losses (ALLLs) in anticipation of this upcoming change.

Before year-end 2006, the charge-off spreads between large banks and community banks were relatively small, ranging from 10 to 15 basis points. The spread started to widen during 2007 and increased sharply for large banks that were experiencing greater asset-quality deterioration going into early 2008, while community banks experienced a relatively moderate rise. From year-end 2008 to the third quarter of 2009, the increase in charge-offs was much more significant for larger banks. Charge-off levels for large banks increased more than six times since 2005, from 0.23% to 1.52%, compared with an increase from 0.12% to 0.38% for small banks. The rise in charge-offs for small banks generally reflected relatively modest credit risks in their loan portfolios; larger institutions experienced a greater degree of both kinds of asset-quality deterioration, having higher loan charge-offs than small banks and additional charge-offs from trading assets.

Provision levels also increased across the board, due to a variety of factors. These included widespread retrenching regarding ALLL methodologies among accountants. as well as market conditions that included increased nonperforming assets, charge-offs and negative economic indicators. As indicated by **Exhibit 13**, large banks experienced significantly greater deterioration in loan quality since year-end 2007. During 2009, large banks also have been temporarily increasing provisioning relative to on-balance sheet loans in anticipation of the off-balance sheet loans coming onto balance sheets in 2010 (see **Exhibit 14**). ALLLs relative to loans at large likely will drop when this occurs. The impact on performance ratios for large banks is reflected clearly in their performance ratios, as noted above. The charge-offs and provisions trends reflected for community banks are a clear indication of their market knowledge and deep local relationships, supporting overall asset-quality ratios.

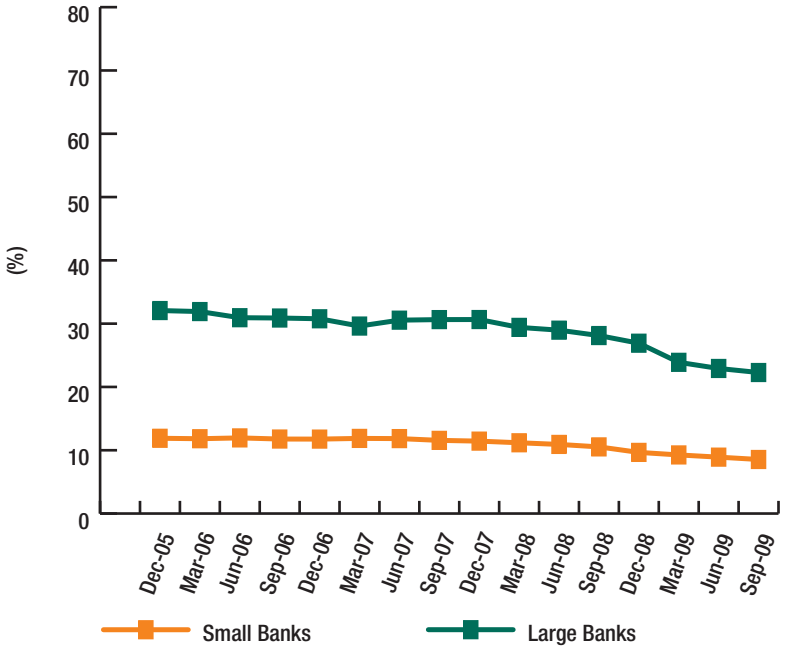
Conclusion

Recent financial-market disruptions have challenged and tested standard thinking

Exhibit 12

U.S. Banking – Median Off-Balance Sheet Exposures to Total Assets (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.

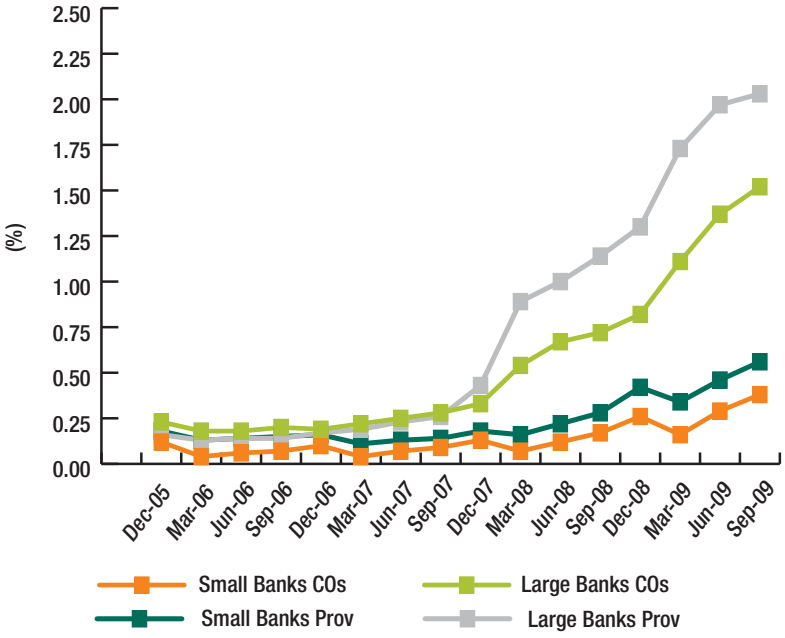


Source: FDIC

Exhibit 13

U.S. Banking – Median Total Charge-Offs, Provisions to Average Total Loans (2005-3Q 2009)

Large banks (assets of $5 billion or more) vs. small banks.

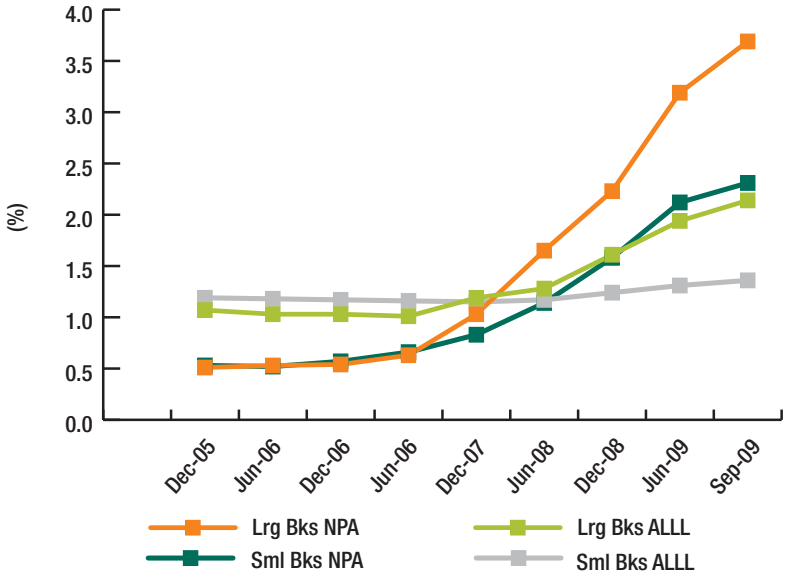


Source: FDIC

Exhibit 14

U.S. Banking – Median ALLL[1] and NPA[2] to Gross Loans plus OREO[3]

Large banks (assets of $5 billion or more) vs. small banks.



[1] Allowance for Loan and Lease Losses
[2] Nonperforming Assets
[3] Other Real Estate Owned
Source: FDIC

about relative risk among banks of various sizes. Large banks have not been immune to risk concentrations and issues with diversification of earnings, despite the advantages of scale. A significant number of community banks also strayed from their conservative stances and did not benefit from their intimate relationships with borrowers. A strong banking operation reflects the totality of consistent operating fundamentals; favorable external conditions; and effective risk management with adequate safeguards protecting a bank's ongoing capacity to pay on its debt. Asset size or any other presumed, single overriding factor cannot capture the totality of all characteristics contributing to a strong profile. Thus, when comparing large versus small community banks, there are advantages and disadvantages within both segments that may tip the scales in either direction. The uniqueness of the U.S. banking system in having a diverse mix of business models means that when market or economic circumstances are unfavorable to one model, the alternate segment seems to hold its own.

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