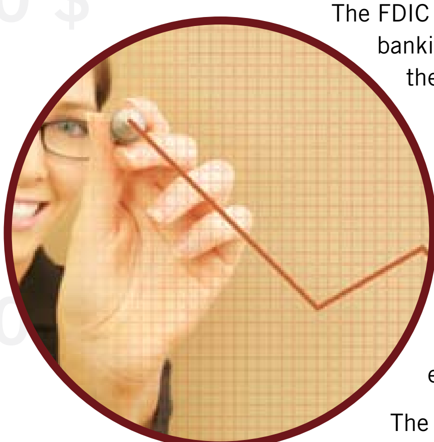
MOSS ADAMS LLP
BANKING VIEWPOINT
Fall 07

Nationwide Banking Trends

By Richard Sprayregen, Director of Financial Institution Services
Moss Adams LLP, Los Angeles



The FDIC publishes a quarterly newsletter that highlights significant nationwide banking trends. As of June 2007 here's a summary of some of the key items that they mentioned:

Higher Expenses Hold Down Earnings

Industry earnings remained strong in the second quarter of 2007, despite an operating environment that was decidedly less favorable than in earlier quarters.

Insured commercial banks and savings institutions reported $36.7 billion in net income for the quarter, a decline of $1.3 billion (3.4 percent) from the second quarter of 2006, but $772 million (2.1 percent) more than they earned in the first quarter of 2007.

The average return on assets (ROA) for the second quarter was 1.21 percent, down from 1.34 percent in the second quarter of 2006.

There were 824 institutions reporting net losses for the quarter, compared to 600 unprofitable institutions a year earlier. This is the largest year-over-year increase in unprofitable institutions since the third quarter of 1996. The increase in unprofitable institutions was greatest among institutions with less than $1 billion in assets, and among institutions with high levels of residential real estate and commercial loan exposures. The proportion of unprofitable institutions — 9.6 percent of all insured institutions — was the highest level for a second quarter since 1991. More than half of the unprofitable institutions (52.2 percent) were less than five years old.

Loss Provisions Rise Significantly

Insured institutions added $11.4 billion in provisions for loan losses to their reserves during the second quarter, the largest quarterly loss provision for the industry since the fourth quarter of 2002. This was $4.9 billion (75.3 percent) more than they set aside in the second quarter of 2006. At institutions with assets greater than $1 billion, loss provisions absorbed 7.7 percent of net operating revenue (net interest income plus total noninterest income); a year earlier, provisions siphoned off only 4.5 percent of revenue.

Charge-offs Continue to Rise

Net charge-offs totaled $9.2 billion in the second quarter, the highest quarterly total since the fourth quarter of 2005, and $3.1 billion (51.2 percent) more than in the second quarter of 2006. This was the second consecutive quarter that net charge-offs have had a year-over-year increase.

Continued on pg.4...

In this issue:

Dealing with Derivatives

By Richard Sprayregen, Director of Financial Institution Services
Moss Adams LLP, Los Angeles

The Office of the Comptroller of the Currency (OCC) publishes a booklet that provides a good listing of what national bank directors should be looking for in their periodic board reports. It also provides them with certain, "Red Flags"—ratios or trends—that will highlight existing or perhaps potential problems.

Although many risk areas are mentioned in the (OCC) booklet, one in particular— Financial Derivatives and Off Balance Sheet Activities (securitizations)—are of particular interest now because of recent changes in interest rates, and trends that have surfaced in mortgage banking. Bank directors should make certain that their board reports reflect enough information to permit them to deal with the complex issues discussed below.

Financial Derivatives

Banks are increasingly using financial derivatives and other off-balance-sheet transactions, such as securitization activities, to manage financial risk and increase income. The broad categories of risks that arise in these activities are no different than those that arise in other bank products and business lines. However, these risk categories, including credit, interest rate, transaction, compliance, liquidity and reputation, often arise in ways that are more difficult to measure. As a result, activities such as derivatives and securitization activities require stronger risk management programs and managerial expertise than more traditional bank risk-taking activities.

Financial derivatives derive their value from the performance of underlying interest rates, foreign exchange rates, equity prices, commodity prices, or credit quality. A bank can use derivatives to reduce business risks, expand product offerings to customers, trade for profit, manage capital and funding costs, and alter the risk-reward profile of a particular item or an entire balance sheet. As with all financial products, derivatives present risk, and directors should make sure that applicable risks are managed as part of the bank's overall risk management program. Because financial derivatives can be complicated instruments, directors must make sure that the bank has appropriate expertise to identify, measure, monitor and control the entire risk spectrum of all products used.

Banks can execute derivative contracts either on an exchange or privately with a dealer. Exchange-traded contracts involve standardized terms; there is no negotiation of terms and conditions. Such contracts typically have excellent liquidity and readily observable market prices. The exchange is a counterparty to all contracts, which reduces credit risks. In contrast, banks can negotiate the terms and conditions on transactions with dealers, and therefore can customize contract details, such as contract size and maturity date. Derivative contracts with dealers are referred to as "over the counter" (OTC) transactions because they do not occur on an exchange. These contracts are generally less liquid than exchange-traded contracts, and they do not have readily observable market prices. Most significantly, OTC contracts with dealers create credit risk for each party. As a result, banks participating in the OTC derivatives market should identify creditworthy counterparties, analyze the potential credit exposures of derivative transactions, and establish appropriate credit facilities.

Similar to other financial instruments, a derivative contract can gain and lose value. As a result, prior to entering into a derivatives transaction, management should understand the sensitivity of the value of that contract to changes in market factors, such as interest rates, that will determine its value.

A derivative contract's "current credit exposure" refers to the amount of money a counterparty would owe the bank if the two parties terminated the contract today. However, this current credit exposure is not a complete measure of credit risk. "Potential future exposure" refers to a statistical estimate of how large the current credit exposure on a derivative contract (or a portfolio of such contracts) could become over the life of the contract. It represents the amount of money the counterparty could owe the bank. The sum of current credit exposure and potential future exposure is total credit exposure, the metric a bank should measure and manage.

Current credit exposure + Potential future exposure = Total credit exposure

When a bank enters into an OTC derivative transaction, the transaction should be priced so that it has no current credit exposure for either party. Such contracts are fairly priced. "Off market" contracts have initial value to one of the counterparties. They essentially represent an extension of credit. Off-market transactions deserve extra scrutiny because they are exceptions to normal business practices.

Parties to a derivatives contract often collateralize their exposures with high quality, liquid collateral to reduce credit exposures. Collateral reduces current credit exposure to a net current credit exposure, if the bank monitors the value of its derivative transactions and calls for the collateral when it needs to do so. Banks should establish policies that detail appropriate circumstances for pledging collateral to, and requiring it from, OTC counterparties.

Financial Accounting Standard 133 (FAS 133), "Accounting for Derivative Instruments and Hedging Activities," requires all derivative contracts to be on the balance sheet. The standard outlines broad categories of derivatives transactions: 1) fair value hedges; 2) cash flow hedges; 3) foreign exchange hedges; and 4) contracts not categorized as hedges.

Fair value hedges must be marked-to-market, with changes in value reflected in current earnings. Cash flow hedges must be marked-to-market, with changes in value reported directly in Other Comprehensive Income (OCI), the same category that includes unrealized gains and losses on available-for-sale securities. Foreign exchange hedges must be marked-to-market and treated as either a fair value or cash flow hedge, depending upon certain criteria. Derivative transactions that are not hedges must be marked-to-market, with any gain or loss reflected in current income.

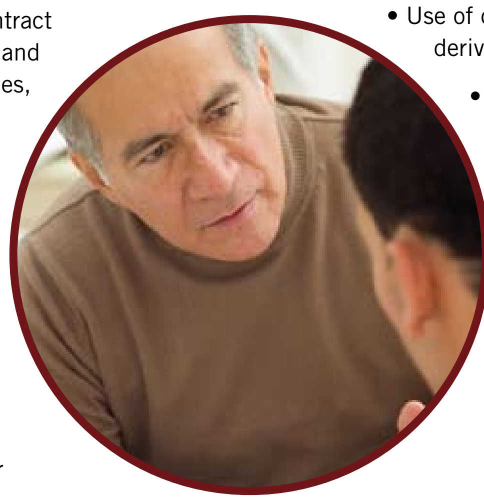
The safe and sound use of derivatives is contingent upon the board ensuring that the bank has the relevant management expertise and overseeing and reviewing management's activities.

Directors should use the following types of reports to assess financial derivatives activity:

- **Credit Risk Exposures**—identifies current credit exposure for each counterparty, which is the net value of all derivative contracts, assuming the bank has a legally enforceable netting agreement. The board should require management to obtain netting agreements since netting, like collateral, reduces credit risks. Such reports should also indicate credit limits and collateral requirements, as well as identify any credit concentrations.
- **Trends in derivatives usage** —tracks the notional amount of derivative contracts over time, by type of contract (futures, interest rate swaps, caps, floors, etc.) and by market risk factor (interest rates, equity prices, commodities, etc.).
- **Compliance with policies and risk limits**—details compliance with all board-approved derivative limits.
- **Results of stress testing**—augments the bank's risk measurement process by altering market variables to determine which scenarios may pose significant risk to the derivatives portfolio. Reports to the board should include the major assumptions used in each scenario. Stress testing is important for assessing both market and credit risk.
- **Impact on income from derivatives**—shows the accounting impact on the bank's income statement from its hedging and trading activities. In particular, such reports should assess whether the bank's hedging passes certain correlation requirements required by FAS 133 to measure hedge effectiveness and avoid having the entire contract marked-to-market through income.

Financial Derivatives Red Flags:

- Participation in transactions without appropriate knowledge of derivatives or experience in the market.
- Substantial exposure to a counterparty whose ongoing ability to meet its obligations is uncertain.
- Rapid growth in the notional amount of derivative contracts.
- A large ratio of derivative notional amounts to total assets.
- Written options on derivatives, such as interest rate caps or floors.
- Concentration of credit risks (total credit exposure) with a derivatives counterparty.
- Use of complex or illiquid derivative contracts.
- Derivatives embedded in cash market securities.
- "Off market" derivative contracts (e.g., a loan to or from a counterparty).
- Derivative contracts executed without an assessment of interest rate and/or credit risks.
- Large net payments or receipts of cash.
- Unilateral collateral posting (collateral arrangements should be bilateral).
- Use of only one firm for all, or nearly all, derivative transactions.
- Activity in new derivative products without subjecting the product to a new product review.
- Insufficient understanding of accounting rules for derivatives (FAS 133).
- Insufficient understanding of rules for derivative transactions with affiliates (12 CFR 223).
- Absence of legally enforceable netting agreements.



Nationwide Banking Trends (cont'd)

Real Estate Leads the Growth in Non-current Loans

The amount of loans and leases that were noncurrent (loans 90 days or more past due or in nonaccrual status) grew by $6.4 billion (10.6 percent) during the quarter. This is the largest quarterly increase in noncurrent loans since the fourth quarter of 1990, and marks the fifth consecutive quarter that the industry's inventory of noncurrent loans has grown. Almost half of the increase (48.1 percent) consisted of residential mortgage loans.

Pace of Reserve Growth Picks Up

Banks and thrifts grew their loss reserves by $2.6 billion (3.2 percent) during the quarter, as loss provisions of $11.4 billion surpassed net charge-offs of $9.2 billion. The $2.6-billion rise in loss reserves was the largest quarterly increase since the first quarter of 2002, but it barely kept pace with growth in the industry's loans and leases. The ratio of reserves to total loans increased from 1.08 percent to 1.09 percent during the quarter, but remains near the 32-year low of 1.07 percent reached at the end of 2006. For the fifth quarter in a row, reserves failed to keep pace with the increase in noncurrent loans. As a result, the industry's "coverage ratio" of reserves to noncurrent loans fell from $1.30 in reserves for every $1.00 of noncurrent loans to $1.21 during the quarter. This is the lowest level for the coverage ratio since the third quarter of 2002.

What's the Effect on Community Banks?

1. It appears that the lingering flat yield curve, coupled with declines in real estate values is eroding earnings at accelerated levels. Younger, smaller banks appear to be much more susceptible to these factors than larger institutions.

2. The provision for loan losses is increasing. For younger banks, that are both growing their loan portfolios and also encountering increased credit risk it cuts down profits—almost a double hit!

3. Loan delinquencies are on the rise, reducing interest income levels. Stiff (non-earning) loans use up capital resources. In a smaller bank, with more limited capital this can reduce the ability to grow the loan portfolio.

4. Reduced real estate values adversely impacts original loan to value underwriting guidelines. Many smaller banks have significant amounts of "owner occupied commercial real estate loans" in their loan portfolios. These loans have a duel underwriting criteria since the borrower is also the principal tenant of the commercial building. Thus when cash flow of the tenant's business declines because of prevailing overall economic downturns, the value of the real estate declines. Moreover, when vacancy levels of other similar like buildings increase, the likelihood of "re-renting" the commercial building declines. These factors can also create a "double impact" effect.

As bankers approach year end, it is advisable to consider these trends insofar as they may impact loan portfolio quality, adequacy of the allowance for loan losses, and new loan origination policy revisions.

Contacting Our Team

For information about Audit, Tax and Business Consulting services provided by the Financial Institutions Group at Moss Adams LLP please contact:

DENESE CAHILL
Partner, Northern California
Financial Institutions Group
T 209.955.6100
denese.cahill@mossadams.com

KAVEH VARJAVAND
Partner, Southern California
Financial Institutions Group
T 310.477.0450
kaveh.varjavand@mossadams.com