

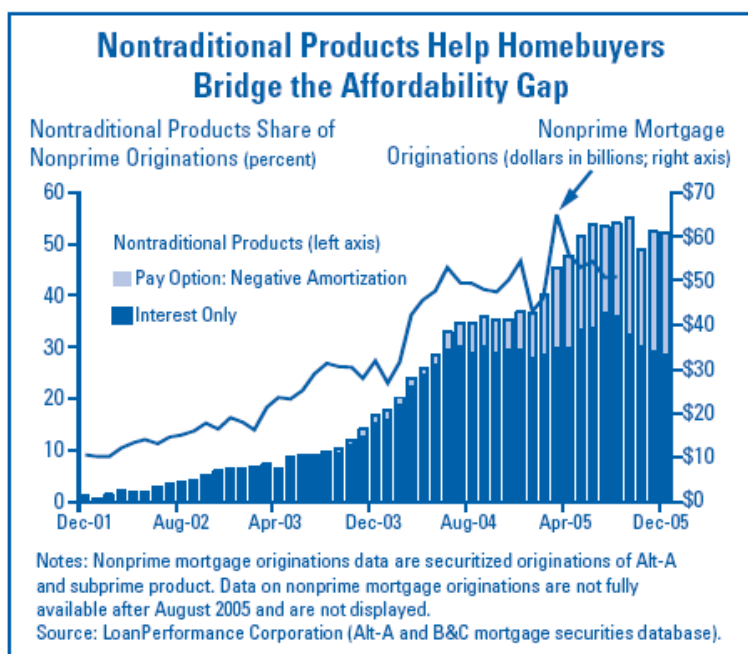
## FDIC expects declining loan performance

Earlier this week the Federal Deposit Insurance Corporation (FDIC) released its outlook on the performance of Commercial & Industrial (C&I) loans, Commercial Real Estate (CRE) loans, and Residential Mortgage loans (<http://www.fdic.gov/bank/analytical/regional/ro20062q/na/t2q2006.pdf>). The FDIC expects a gradual weakening of the credit cycle, which will lead to higher losses and charge-offs. However, they believe banks are well positioned financially to withstand higher losses from this downturn. The FDIC attributes most of this expected decline in the performance of outstanding loans to loosening underwriting standards across different types of loans, slowing economic growth, higher interest rates, and weakening real estate markets. We highlight some key aspects of the FDIC's report below.

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### I. Residential Mortgages

In their outlook of residential mortgage performance, the FDIC attributed the rise in nontraditional mortgage products to the reduced affordability of housing in many parts of the country as a result of rapid home price appreciation and increased risk-appetite from investors. In order to meet borrowers demand, originators have merely extended loan terms to non-prime borrowers that were typically offered only to super-prime and prime borrowers (see chart below).



Source: FDIC

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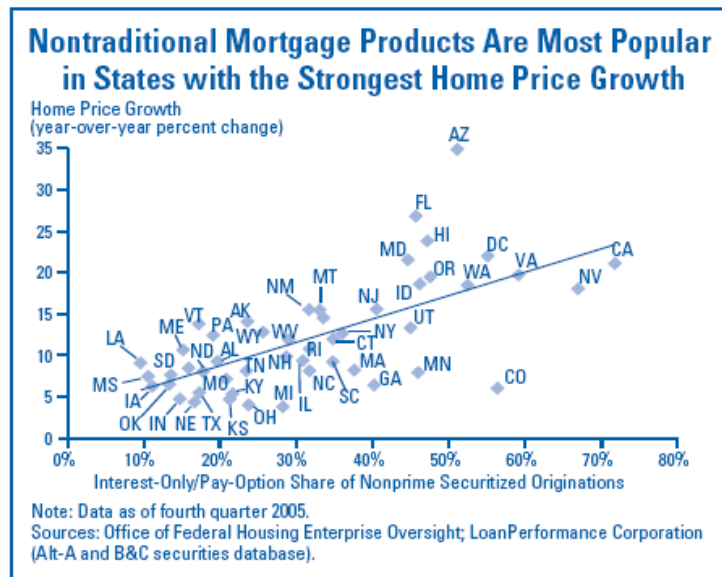
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The FDIC also believes that by extending nontraditional loans to non-prime borrowers, risk layering has become problematic. The chart below, from the FDIC report, illustrates that affordability products are most prevalent in the states that have experienced the highest appreciation of home prices. Therefore, they conclude that borrowers are using these products to buy homes they normally would not be able to afford with traditional mortgages. Another sign of risk layering is the growing number of interest-only and option-ARMs that are underwritten to borrowers with limited or no documentation.



Source: FDIC

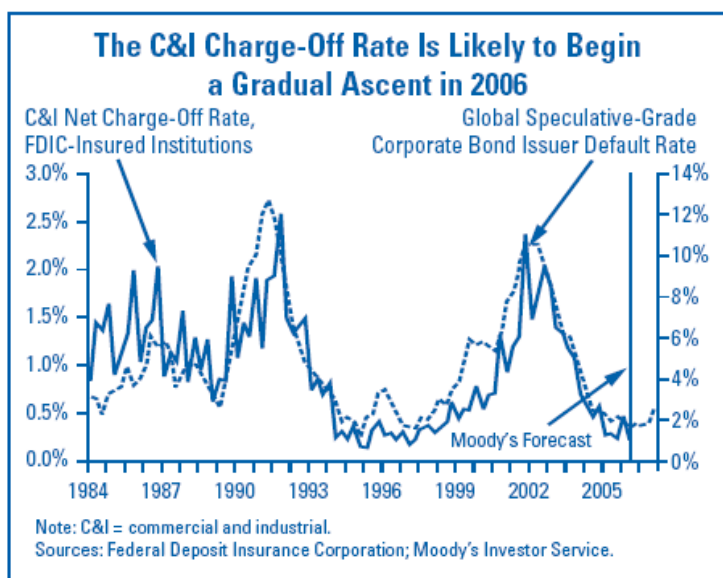
Currently, charge-off rates remain well below their historical average, but they have recently edged up slightly. The FDIC predicts that charge-offs will continue to rise gradually as they expect delinquencies and foreclosures to increase. As mortgage rates reset with higher interest rates some borrowers will be unable to cope with the higher payments. While unlikely, the FDIC also concludes that if home prices fell due to either a recession or economic shock, mortgages losses could be significantly higher.

## II. C&I Credit Outlook

After shrinking following the recession earlier this decade, the amount of C&I loans outstanding has risen back to record levels. Since 2001, non-bank lenders have increased their share of outstanding C&I loans to 13% from 8%. According to the FDIC, non-bank lenders have targeted riskier borrowers that commercial banks in order to increase their market share. Increased competition from non-bank lenders and the relatively strong performance of these loans driven by a resilient economy and benign corporate environment has led to looser underwriting standards.

The FDIC notes that charge-offs typically tend to rise during periods of loosening credit standards. However, the advent of the credit default market and the growing secondary market for commercial loans has provided a very effective mechanism for banks to diversify and transfer these risks. Therefore, if loan performance declines, banks will likely have less concentrated risk than they have in the past, which could lead to less severe credit cycles.

In the chart below, the FDIC ties the performance of C&I loans with the speculative-grade corporate default rate. They predict that charge-offs are at the lows of the current cycle and are likely to gradually decline, which is commensurate with Moody's prediction of a rising corporate default rate. In spite of this gradual decline in loan performance, the FDIC does not believe the full effects of lax underwriting recently will be felt until the next economic downturn.



Source: FDIC

### III. CRE Loans

While commercial real estate cycles in the past have tended to be longer-lasting and more severe than other credit cycles, the FDIC believes that the volatility of these cycles could be reduced in the future by the growth of both CMBS and REITs, which have provided greater information to market participants and have standardized underwriting of CRE loans. Between 1994 and 2004, the CMBS share of outstanding CRE loans increased from 5% to 18%, while the market capitalization of REITs has increased from \$44.3 billion in 2004 to \$330.7 billion at the end of 2005.

In spite of this, the FDIC points to declining underwriting standards and high CRE loan concentrations among FDIC-insured institutions as their biggest concerns, which may ultimately lead to rising losses. Since 2004, DSCRs and Cap Rates have been falling, LTVs have been rising, and according to the Federal Reserve's Survey of Senior Loan Officers underwriting standards have been easing. The FDIC suggests that this will lead to weaker loan performance of CRE loans going forward.

Finally, the Condo market is highlighted by the FDIC as particularly problematic. Condo conversions have been particularly popular among speculators, who have flipped properties quickly for a profit over the past few years. The FDIC believes this has created a supply imbalance. Florida, San Diego, and Washington, DC are identified as markets which have seen the largest degree of over-supply. Condo sales have dropped dramatically in the first half of the year as investors have withdrawn due to reduced profitability and higher interest rates.

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