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MAIN STREET BANKS LEAD WAY THROUGH RECESSION (SO FAR)
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VERIBANC'S analysis of recent filings for 7,495 commercial and savings banks show that smaller is better – for financial health, ability to lend and independence from the government's reach. Year end 2008 data indicate that many small banks have not sunk as far, nor have curtailed new lending to the extent seen at money center and large regional institutions. Not surprisingly, the smaller banks have also led in rejecting the government's Temporary Liquidity Guarantee Program (TLGP). Under TLGP, the FDIC guarantees a participant's business deposits without limit ("transaction accounts") as well as certain bank debt obligations.

At the other extreme, 19 banking companies now undergoing U.S. Treasury Department "stress tests" because of worries they are too big to fail ("TBTf") highlight the industry's current problems. A snapshot of these four groups of institutions' recent performance is presented below.

SMALL vs. LARGE BANKS – PENALTIES OF SCALE IN A DOWN ECONOMY
 (Source: Federal filings of bank Call Reports)

Data is as of 12/31/08 unless stated otherwise	Banks with Assets ≤ \$100 Million	Banks that Rejected Government's TLGP*	Banks with Assets > \$100 Million	TBTf Stress Test Banks†
# of Institutions	2,878	3,733	4,617	55
Assets (\$ Trillions)	0.16	0.81	12.5	8.3
Equity Capital (% of Assets)	12.6%	10.9%	9.4%	8.9%
Equity Capital (% of Assets) - 12/07	13.4%	11.1%	10.2%	9.8%
ROA‡	0.33%	<u>0.62%</u>	0.19%	0.31%
ROA – 12/07	0.76%	1.03%	0.89%	0.91%
Accorded VERIBANC's Highest Rating (#/% of group)**	1,659/57.6%	2,163/65.5%	2,564/55.5%	15/27.3%
Accorded VERIBANC's Lowest Rating (#/% of group) ††	61/2.1%	45/1.4%	152/3.3%	7/12.7%

* Institutions that have opted out of TLGP as of 2/12/09 - Source: FDIC

† Bank members of 19 holding companies identified by VERIBANC as most likely to be undergoing U.S. Treasury stress tests (omits 6 OTS-regulated federal savings banks).

‡ Return on Assets (ROA) – Net Income for the indicated year as a % of yearend assets

** Green with Three Stars; institutions receiving this rating have had an annual failure rate of 0.0001 since 1991.

†† Red with No Stars; institutions receiving this rating have had an annual failure rate of 0.32 (about one in three) since 1991. (Source: <http://www.veribanc.com/TrackRecord.html>)

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While it is clear that all classes of banks have suffered, the first two columns of the table provide a quick glimpse of the relative advantage enjoyed by the smaller institutions. By almost all measures, banks with assets of \$100 million or less and those that rejected TLGP have held onto their capital and earnings better than their larger counterparts. VERIBANC's ratings – which also consider problem loans, distressed securities holdings, regulatory sanctions and other risk indicators – bear out this distinction. Particularly interesting is the strong showing of banks that chose not to accept liquidity guarantees from the government. Their confidence to go-it-alone appears to be supported by their performance data. For example, this group, with an ROA of 0.62%, is almost twice as profitable as banks with assets of \$100 million or less. Moreover, along with the small bank group, the set of non-TLGP banks enjoys a double digit equity capital ratio.

LENDING LEADERSHIP

While the smaller institutions, with their stronger earnings and better capital positions, are clearly in a better position to support the economy's need for increased lending, banks taking the most new credit initiatives are the opt-outs from TLGP. The following table shows this group's heightened lending activity despite problems with nonperforming assets near levels suffered by the rest of the industry.

NEW LENDING AND USE OF CAPITAL IN THE FACE OF CLIMBING ASSET PROBLEMS
 (Source: Federal filings of bank Call Reports)

Data is as of 12/31/08 unless stated otherwise	Banks with Assets ≤ \$100 Million	Banks that Rejected Government's TLGP	Banks with Assets > \$100 Million	TBTF Stress Test Banks
Total Loans (\$ Billions)	101	521	6,940	4,098
Total Loans (\$ Billions) – 12/07	106	473	6,715	3,983
New Lending* (\$ Billions / % increase)	-5/-4.7%	48/10.2%	223/3.4%	115/2.9%
New Loans - (% of Equity Capital)	-25.7%	<u>54.7%</u>	19.5%	15.5%
Noncurrent Assets[†] and REO (\$ Billions / % of Equity and Loss Reserves)	2.68 /12.6%	13/13.3%	211/15.8%	141/16.6%
Noncurrent Assets and REO (\$ Billions / % of Equity and Loss Reserves) – 12/07	1.6 / 6.7%	6.3/7.3%	87/ 7.0%	56/7.4%

* Net of new loans less old loans paid off

† Loans, securities and derivatives contracts 90 days or more past due, or in nonaccrual status

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Two observations are particularly noteworthy:

1. Despite published claims to the contrary, most banks are continuing to make new loans. In fact, the data supporting columns two and four of the foregoing table show that, between year ends 2007 and 2008, total bank lending increased by \$218 billion (3.2%).
2. Banks in the TLGP opt-out group appear to have the highest propensity to underwrite new loans. During 2008, these institutions lent nearly 55¢ for each dollar of their equity capital. In contrast, banks larger than \$100 million and TBTF banks, as a group, established new credits amounting to less than 20¢ for each dollar of their equity capital. Since lending by the smallest banks declined, capital conservation rather than new lending dominated their business strategies.

OUTLOOK FOR COMING QUARTERS

The recession-driven asset quality slide continues for all classes of financial institutions. Until a clear bottom in loan defaults, securities illiquidity and overall economic distress is established, volatility of banks' income and balance sheets will persist or increase. Significant new FDIC levies for deposit insurance, scheduled to take effect later this year, will contribute additional drag on institutions' 2009 performance. Another illustration of the turbulent environment facing banks of all sizes is the increasing pace of ratings downgrades. During the fourth quarter of 2008, 1,571 institutions (21.0% of all banks) had their VERIBANC ratings lowered by one or more levels. In contrast, the fourth quarter of 2007 saw VERIBANC ratings declines for only 876 banks (11.4%). If the past quarter's trend continues, more than half of all banks could be downgraded during the remainder of 2009.*

So far, this year, 23 banks have failed. Based on VERIBANC's ratings performance over the past 18 years, the expected number of bank failures in 2009 is 97. As of yearend 2008, there were 252 institutions on the FDIC's problem bank list (vs. 76 at the end of 2007). Bank failures in 2008 (25) represented almost one third of the number of FDIC-designated problem banks at yearend 2007. Should the same relationship hold in 2009, the FDIC will encounter 83 bank closures.

* This estimate represents an upper bound insofar as some banks report atypically lower earnings in the fourth quarter due to managements' over optimism earlier in the year; as a result more ratings downgrades usually occur in the last quarter than in the other three. However, worsening recession or significantly counterproductive government policies over the course of the next several months could lead to realization of the worst case scenario indicated above.

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VERIBANC'S CREED – DATA DRIVEN RATINGS UNCOMPROMISED BY CONFLICT OF INTEREST

VERIBANC believes that the recent financial sector meltdown is less a failure of capitalism than a failure of transparency in the bond and debt sectors. In the United States' widely respected equity markets, with their SEC-enforced disclosure practices, millions of investors take calculated risks with assured access to accurate, timely and relevant financial data. As a result, from the mid 1930s until last year, U.S. equity markets have been one of the greatest engines of wealth generation the world has ever known. We believe that, if transparent public data for all debt and derivative securities were available, not only would the current crisis have been minimized (or even avoided), but such information would also forestall future crises. Specifically, we propose broad application of the ratings practices we have engaged since our incorporation in 1981.

1. Timely public disclosure of relevant financial data for all debt instruments, including derivative instruments, sold to the public, to state or local government agencies or to federally regulated or sponsored entities. (Current Call Report and Edgar data could provide models.)
2. Prohibition of monetary or other material consideration to ratings agencies from sellers and originators of instruments being rated, i.e., no conflict of interest.
3. Use of data-driven ratings models based on actual default, loss and failure events.
4. Minimal or negligible reliance on "management input" or "analyst judgment."
5. Back testing and public disclosure of ratings agencies' track records.

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