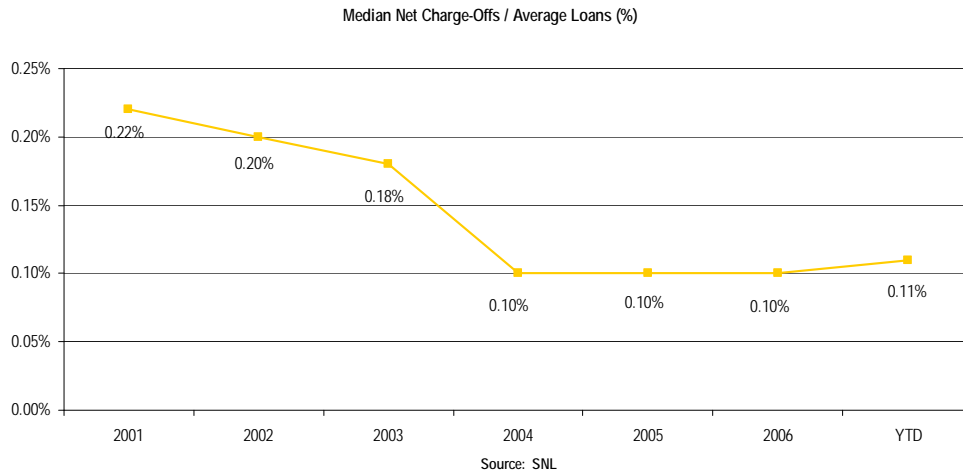


Today's AFS Market Overview

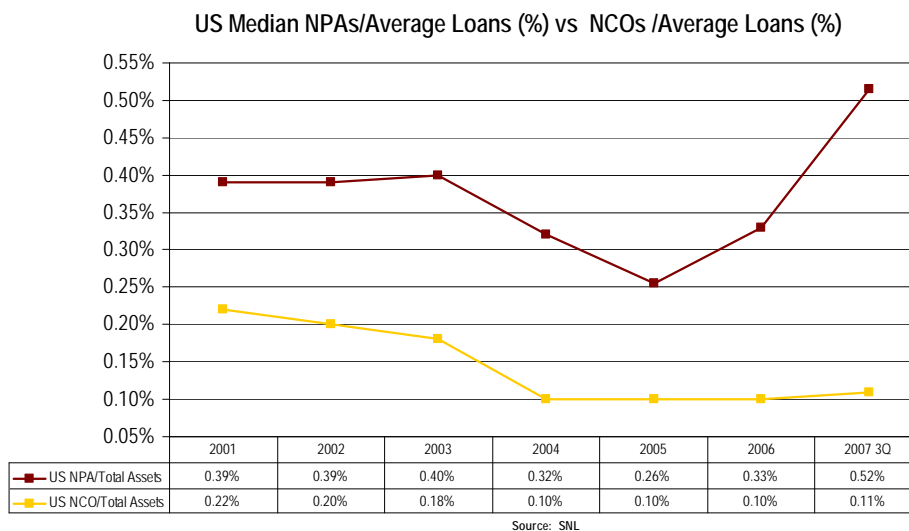
January 2008

WHAT IS WRONG WITH THIS PICTURE?



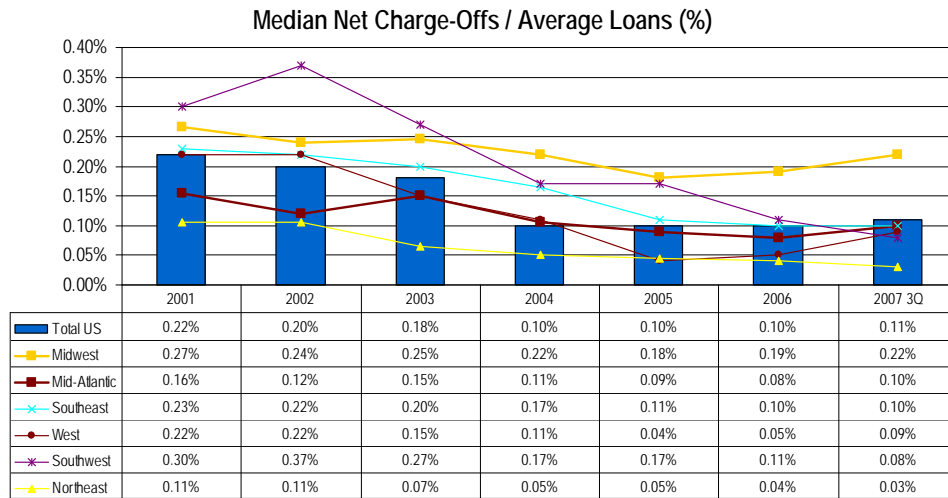
If you believe this chart, derived from SNL of publicly traded banks up to \$10 billion in asset size, the banking industry must be in pretty good shape. Net charge offs have been under control since 2004. In truth, the market is much more bleak --- bank stock prices have been under pressure, most financial news has not been good, and we all know somebody who has been impacted by the latest credit crunch.

At the Asset Finance Services division of Howe Barnes Hoefler & Arnett we have been actively trying to get our arms around the current situation. While pundits pundit, AFS advises and addresses real issues that banks are facing every day. In this issue of *Today's AFS Market Overview* we will use both SNL data and the compilation of hundreds of calls with bankers, investors, and interested parties to sort through the current situation and share our findings. So what is wrong with this picture? Let's take a deeper look.



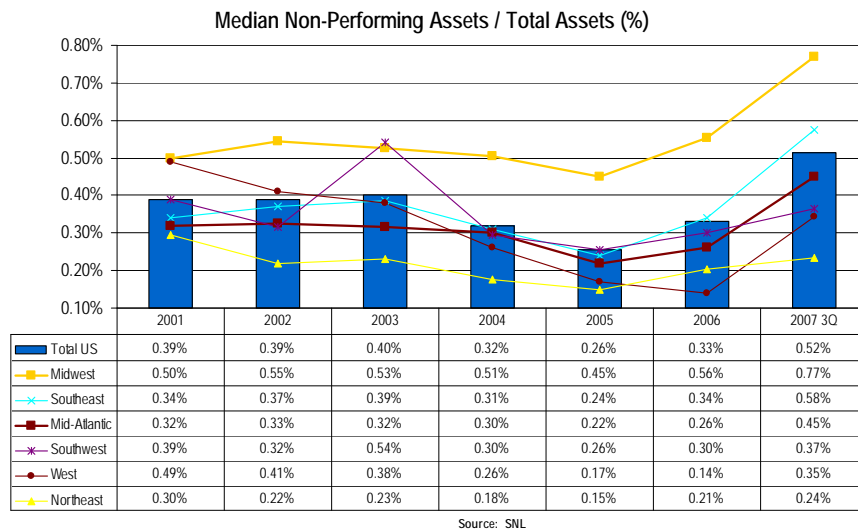
While net charge offs (“NCOs”) may be flat, reported levels of Non Performing Assets (“NPAs”) are rapidly increasing. Similar to pumping a balloon, NPAs have to go somewhere. NPAs can get worked out in-house, can continue to grow, can be periodically sold, and can ultimately be reflected as an NCO. In any event, it is clear that NCOs and NPAs are being carefully watched within the industry.

On a regional basis, the story is more clear.

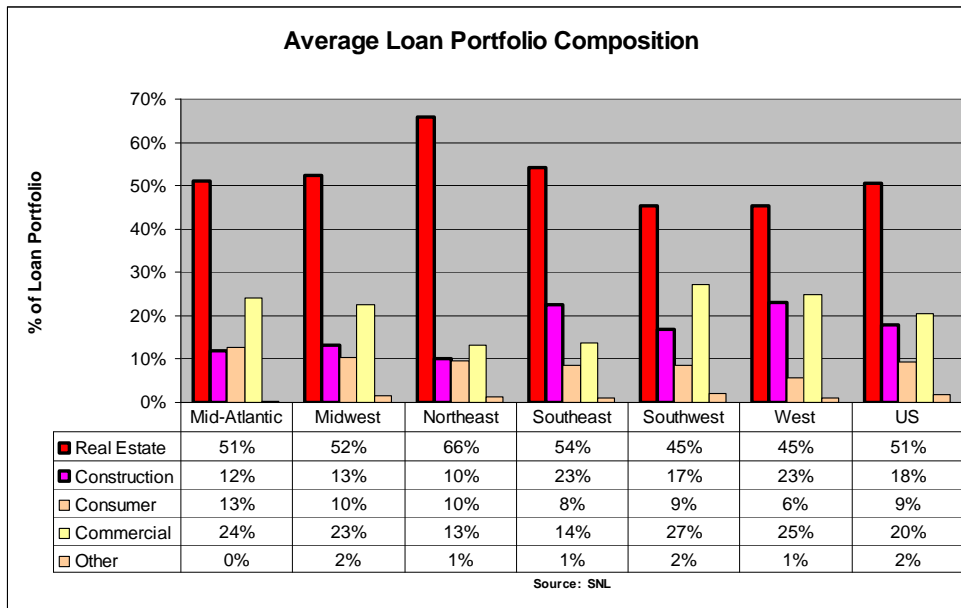


With NCOs, regions like the Mid-Atlantic, Southeast, the West, and Southwest appear to be generally tracking with the median US results. Given the ongoing woes in the Midwest, we should not be surprised that NCOs are relatively higher in this region. So why is the Northeast so far below the US median? As suggested below, it may have to do with this region's relatively lower levels of construction activity.

The next level of analysis takes us to NPAs, as NPAs should be our best analytical bridge between originations and charge offs. While the US median has showed a steady increase since 2005, a regional breakdown offers additional insight.



So what is causing the spike in NPAs? Mark Twain said, "Buy land, they're not making it anymore". While buying land may be a good decision, lending against land is potentially fraught with peril. Interestingly, the rough rankings by region generally track with the NCO chart above. To confirm what we are reading in the papers, the Midwest and the Southeast are reporting NPAs that trend above the levels of their US median and peer groups. Does this suggest that other regions are out of the woods and on the path to a soft recovery? Can we blame the banking downturn on slow car sales and a few too many condo projects? Unfortunately, the answer is probably not.



The apparent driver for much of today’s credit quality lies around real estate. How can our peer group of banks be impacted by the sub-prime mortgage collapse when they were not aggressive lenders within that sector? When you look at the US median for loan composition, those regions with higher concentrations in real estate, may be more vulnerable than those with relatively less exposure. Does this mean that the next economic shoe may drop in the Northeast, Southeast, and the Midwest? Perhaps. However, while real estate may be a driver, this sector typically includes relatively stable, post construction risks.

The risk factor that may be driving the current banking predicament may lie within those regions with a disproportionate exposure to construction. Nationwide, residential real estate developments have come under pressure. While lenders expect to lend to the best developers in the best locales, the evaporation of easy mortgages has made us all more aware of the term “absorption”. How long will it take for my construction project (residential and commercial) to generate sufficient cash flows to service debt? Can I really rely upon the appraisal that reported a loan-to-value of 75%? Am I getting a debt return for taking equity risk?

If we were to assume that relative construction exposure may be driving the spike in current and potentially future NPAs, which regions may be potentially vulnerable? According to the chart above, those regions with a relatively higher exposure to construction include the West and Southeast. And those regions with a relatively lower exposure to construction include the Midwest, Mid-Atlantic, and the Northeast. This suggests that while the worst may be behind the Midwest, it may be just ahead for the West and Southeast.

Rather than dwelling in the past, it is critical to get your arms around your portfolio’s credit risk and critically assess where your potential issues arise both today and in the near term. While not a banker to my knowledge, Ziggy Marley may have said it best, “*No matter the bad things that happened in past time, let’s try to live the best we can now.*”

While the markets remain in flux, the good news is that banks are still selling loans to the secondary markets. Liquidity may be tight and sale economics are not as predictable as in the past, however, AFS remains successfully diligent in serving our clients in a host of asset classes. From selling portfolios for gains to advising on the best strategies for NPA divestitures, AFS remains committed to creating successful, market-driven solutions for our clients. Any thoughts or comments? Please let us know at ksegal@howebarnes.com. We will be sure to share the most interesting feedback (anonymously) in future issues.

The Asset Finance Services division of Howe Barnes Hoefler & Arnett provides loan portfolio assessment, advisory and brokerage services as well as expertise in valuing and trading an array of consumer and commercial loan assets for community banks.

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