

>>ANDREW GRAY

We'll get started in just a few minutes. Welcome to the 4th Quarter 2009 Quarterly Banking Profile press conference. The chairman should be in in just a minute. She will open with remarks and then take a few questions from the media. After that we will turn it over to the professional staff that is assembled here, let them introduce themselves with their names and titles. One thing I would ask, if you are going to ask a question, just make sure that you wait for the microphone so we can record the audio. And I think Chairman Bair should be in in just a moment and we will get started.

>>CHAIRMAN SHEILA BAIR

Good morning and welcome to our release of fourth-quarter results for the banking industry. Last year will be remembered as a challenging time for the industry. We witnessed the largest number of failures in 17 years. Consistent with the recovering economy we saw signs of improvement in industry performance. But as we have said before, recovery in the banking industry tends to lag behind the economy as industry works through its problem assets. This first chart shows quarterly earnings over the last five years. And as you can see, we are still bumping along at the bottom of the credit cycle. The industry earned less than \$1 billion in the fourth quarter essentially just breaking even. Usually a lack of profits is not considered a good result, but compared to the record loss the industry reported a year ago it represents significant improvement. Each quarter we present a chart that shows the major positive and negative factors that contributed to the year-over-year change in bank earnings. This quarter, the positives vastly outweigh the negatives. It's not that this is a strong quarter; it's simply that everything was so bad a year ago. The three largest contributors to the year-over-year improvement in earnings were: non-interest income, non-interest expenses, and loan loss provisions. All three were mostly concentrated among large institutions. While the industry totals are dominated by a partial rebound at large institutions from historic losses posted a year ago, you can see from the next chart that more institutions are showing improved earnings. Slightly more than half of all institutions reported year-over-year improvement in their quarterly net income. The highest share in three years. But for about one in five of these institutions, improvement was a smaller quarterly loss than a year ago. Overall almost one out of every three insured institutions reported a net loss for the fourth quarter. For all of 2009, the industry reported earnings of \$12.5 billion for a return on assets of .09 percent versus .03 percent in 2008. Reported earnings for 2009 were more than \$8 billion higher than in 2008 even though banks expensed \$15 billion more in deposit insurance assessments. However, 29 percent of institutions reported net losses for the year. This is the highest percentage in the 26 years the data for all institutions are available. Troubled loans continued to increase in the fourth quarter as this chart shows. Net charge-offs were higher than a year ago and the amount of non-current loans continues to increase. However, the pace of deteriorations, as you can see, slowed for the third quarter in a row. As we've said before, this trend suggests that non-current loans may peak in 2010. Banks and thrifts have three lines of defense against credit losses. The first line is current earnings, the second is loan loss reserves, and the final line of defense is capital. Credit losses for the past four quarters have absorbed most of the industry

earnings, but as this next chart shows, in 2009 insured institutions continue to grow their reserves and return to expanding their capital bases. Leveraged capital increased by 11 percent during the year and reserves grew by 31 percent. The next chart illustrates that while the industry has steadily built its loss reserves, this growth has not kept pace with the rising level of non-current loans. As a result, coverage ratio, that's reserves divided by non-current loans, has been falling throughout the time the non-current loans have increased. Although the decline in the coverage ratio is slowing, loss provisions should remain high in the near term. As you can see in this chart, 45 institutions failed during the fourth quarter bringing the total for the year to 140 failures. This is the highest annual total since 1992 when 181 insured institutions, but it is still far short of the record 531 failures recorded in 1989. The cost of banks failures continues to reduce the balance of the Deposit Insurance Fund as we have projected. The DIF balance or the net worth of the fund was negative in September and fell further to a negative \$20.9 billion, unaudited, as of December 31st. As we explained in previous quarters, the balance is negative because of the large amount that has been set aside in our contingent loss reserve to cover estimated losses. The total DIF reserves are a positive \$23.1 billion when the contingent loss reserve, which was \$44 billion as of December 31st, was added back to the fund balance. Many of the losses anticipated in the contingent loss reserve can be attributed to commercial real estate losses as we've said for sometime. Also it's important to note that the cash resources of the DIF, which differs from the fund balance, stood at \$66 billion as of December 31st. Cash increased by about \$46 billion at year end when insured institutions prepaid about three years worth of deposit insurance premiums. This requirement provided the FDIC the funds needed to continue to resolve failed institutions in 2010 and beyond, but without accelerating the effect of assessments on the industry's earnings and capital. The FDIC's resources to protect insured depositors are strong and our guarantee to protect insured depositors is absolute backed by the full faith and credit of the US government. Additional challenges do lie ahead for the industry. The continued rise in loan losses and troubled assets points to further pressure on earnings. The growth in the number and assets of institutions on our "problem list" points to a likely rise in the number of failures. As we have said, both the "problem list" and the bank failures tend to lag behind economic recovery. Unfortunately loan growth also tends to lag the economy. As this chart shows, all major loan categories had decline in balances in 2009. Total loans fell by 7.5 percent, the largest full year decline since 1942. The decline in lending is driven by a number of factors. Surveys indicate that credit demand has weakened as consumers and businesses have cut their spending. Banks have tightened their lending standards and a number of institutions have reduced their loan balances in order to deleverage and improve their capital ratios. Large banks were responsible for 90 percent of the decline in loan balances this quarter. These banks have been cutting back significantly on lines of credit to consumers and small businesses. Small and midsize institutions who tend to make business loans secured by residential and commercial properties are dealing with the effects of large declines in real estate values. Lower values reduce the collateral coverage of existing loans and make it more difficult for households and small businesses to qualify for new credit. The events surrounding the financial crisis of late 2008 continue to take a toll on our economy and the banking industry. The extraordinary policy responses to that crisis were effective in

stabilizing global financial markets. However, the large dislocations that have taken place in real estate and credit markets are slowing the pace of emerging economic recovery and contributing to persistent high unemployment and slow growth in consumer and business spending. Resolving these credit market dislocations will take time. One thing that can help is a balanced approach to lending as outlined in the recent interagency policy statements on improving CRE loan workouts and on meeting the credit needs of small business borrowers. Institutions must effectively manage concentration risk in their portfolios. However, they should neither over rely on models to identify and manage concentration risk nor automatically refuse credit to sound borrowers because of the borrower's particular industry or geographic location. Obviously these policy statements alone won't make the problem go away. But they do get to the root of the matter by giving lenders a roadmap for working out problem loans and making new credit available to qualified consumers and businesses. Thank you very much. And I will be happy to take your questions now.

>>QUESTION

Hi, Chairman Bair. You said previously that 2010 is expected to be a peak year for bank failures. Why have we not seen more bank failures so far this year?

>>CHAIRMAN SHEILA BAIR

Well, bank failures can be cyclical and I think as we have said, the pace is probably going to pick up this year. For the total year it will exceed where we were last year. I think this year the losses will be heavily driven by CRE. We have known for some time we have been projecting that. It does take CRE losses sometime to work through the system because frequently the borrower may have cash reserves to continue the payment for a while. Also tenants may be longer-term leases so you don't really start seeing the problems until those leases come due and they don't renew or can only renew at a significantly reduced rental rate. So CRE takes a little longer to work through the system but again we think it will peak in 2010. Yeah, David.

>>QUESTION

Chairman with nearly like one in 11 banks now on the "problem list" or one in 12, is it -- it is obviously harder for these banks to make new loans. Are you worried about that? You know, the credit to the economy and how can that be fixed?

>>CHAIRMAN SHEILA BAIR

I do think that is an issue. I think the smaller banks are a disproportionate share of small business lending. Many of them are capital constrained right now because of the losses they are suffering on their CRE portfolios. So we are trying to work with them and take a balanced supervisory approach and within a prudent risk management -- bolster to the extent we can their ability to continue lending. But it is a real issue. I'm going to say the large banks I think need to step up to the plate here too. The loan

decline balances have been heavily driven by large bank cutbacks, not only on loan balances, but in their credit lines have been dramatically reduced. So I do think small business lending has been disproportionately impacted by the capital constraints on the smaller community banks, but I do think that larger banks do need to do a better job of stepping up to the plate here. Yeah.

>>QUESTION

How confident are you in the steps taken to replenish the DIF? Are there going to be additional steps needed or --?

>>CHAIRMAN SHEILA BAIR

Not based on our current projections. We have some pretty severe stress scenarios. Even with those we think the cash balances should be -- position us well to get through this. So no, I don't think -- I think the DIF balance will also trough this year based on our current projections. Again, so much of this is about the economy, which is beyond our control. But assuming we don't have a significantly more adverse scenario than most people think, I think we will be in good shape this year and we will start seeing the DIF balance go back up towards the end of the year.

>>QUESTION

What do you attribute -- there was a difference in non-currents for mortgages, which went up, and non-currents for commercial loans that went down. Is there any reason for that that you see?

>>CHAIRMAN SHEILA BAIR

You know, I am not sure. I think the -- again the CRE performance is just different because it takes -- it takes -- the performance characteristics frequently take longer to work through the system. So I am not sure I would read too much into that. Okay, great. One more. He didn't hear the question. Last one. Yes. [laughing] Yeah, I can hear him.

>>QUESTION

It's Aaron Girsh with Nightly Business Report. I am just wondering, somebody who is sitting at home and hearing that banks barely broke even, the "problem list" went up, loans seem to be still going bad but maybe not as fast. What should they make of all this? Does this mean the banking system is healing and the worst of the crisis is over? How should people --

>>CHAIRMAN SHEILA BAIR

I think there is incremental improvement. We are seeing some encouraging signs. It

will take a year to work through, but it is also important to put in context, 140 bank failures, 700 on the "problem bank list," sounds scary but there are about 8,000 banks out there and 95 percent of them exceed regulatory standards for being well capitalized. So I think overall the banking system is challenged but stable. It is performing its credit extension role. Again we would like to see more of that within the framework of prudent risk management, but again particularly with the large institutions, their declines in their loan balances and their cutbacks in the credit lines have been significant. So hopefully we will see some turning of that this year. Okay, great. Thank you very much.

>>ANDREW GRAY

We will turn it over to the second panel now for your more technical questions.

>>QUESTION

Can you explain how the \$45 billion fits into the \$20.9 billion deficit in the DIF?

>>KAREN HUGHES

Are you talking about the \$44 billion contingent liability?

>>QUESTION

The \$45 billion collected in December.

>>KAREN HUGHES

Okay, the prepaids, okay --.

>>QUESTION

How that affected the fund balance.

>>KAREN HUGHES

The FDIC received cash from the institutions for the about \$46 billion paid for the prepaid assessment, but we did not recognize that as revenue at the time. Because it had not yet been earned. So that is established as a deferred liability and it will be recognized as revenue in the DIF as the quarters pass. So just as the institutions will take a charge on their books for their insurance expense, the Deposit Insurance Fund will recognize corresponding revenue. So we will see that over the next three years.

>>QUESTION

Also just wondering if you made any change to your projection on the cost of bank

failures from 2009-2013. I think last it was at \$100 billion.

>>DIANE ELLIS

That's right. \$100 billion over five years. The period 2009-2013. And no, we have not made any change to those projections based upon the data we have currently. There is nothing that would lead us to change that either up or down. I will say that later in the first half of this year, staff will be going back to the Board of Directors to report on our progress in meeting the requirements of the restoration plan and we will officially update those numbers at that time.

>>QUESTION

I'm sorry, what was the timing?

>>DIANE ELLIS

Later in the first half of this year. Sometime before the end of the first half of this year.

>>QUESTION

I'm just wondering is your outlook consistent with the sluggish recovery -- with the sluggish recovery in the industry? What does this say about where -- what the economy might look like over the next couple of years?

>>RICH BROWN

The signs of the economic recovery are pretty robust right now. The recovery is moving pace, but it is a jobless recovery. Part of it is the impairment of balance sheets by consumers and by financial institutions. Lending has been weak and spending by businesses and consumers has also been weak. While the economy though is moving ahead, banking results tend to lag behind. The problem loans and the earnings of the industry will improve somewhat after the economy improves. Of course, the expansion -- it appears that the economy -- that the recession ended sometime in the middle of last year. Again we expect the banking results to lag that somewhat.

>>QUESTION

Rich, sort of a follow up on that, do you -- I mean do you see that unemployment impacting the industry over the next few quarters perhaps in a more elevated asset deterioration or has that peaked -- has the asset losses as a result of unemployment peaked?

>>RICH BROWN

Unemployment certainly affects the asset losses that we have seen in virtually every

portfolio that you can name. So that effect has been going on for sometime now. If unemployment remains elevated, will those portfolios get better? Well only time will tell. We have seen tighter lending standards as well, that will play a factor. And really what happens with unemployment depends on a number of factors as well. Someone mentioned have we seen a peak in non-currents for CNI. We will continue to monitor that. The mortgage situation as well is worth monitoring. There has been a stabilization in home prices and that has been good news. The Case-Schiller numbers just came out today. But at the same time, I think there is still certainly room for credit distress out there. We see a lot of underwater mortgages, we see the resets on the option ARMS. There is still potential for more credit distress in the mortgage portfolios.

>>QUESTION

Can you guys talk a little bit about what you are doing for the CRE market and if there are maybe other steps or programs that you could see in the future that could help as things get worse.

>>JOHN CORSTON

We have guidance right now out there both for the industry and for examiners for our side to ensure that we have consistency in approach and a balanced approach. And for the industry to understand really our concerns from a supervisory standpoint so they can go about lending in really a difficult market. I think for the most part it's going to come down to the condition of particular institutions and the market they are in and the demand in the particular market they are in.

>>QUESTION

Do you anticipate any further openings of satellite offices to deal with failures? There have been three so far that have been opened. But as these loss provisions for the agency increase, do you anticipate there will be more of these regional --

>>JOHN CORSTON

I'm sure none of us here actually directly work with resolutions, but I think that's probably more based on -- it will be based on the amount of failures and where they take place. But we probably can't get a more --

>>DIANE ELLIS

You probably ought to find somebody else to get back to you on that. None of us are familiar enough with those plans.

>>KAREN HUGHES

I just think to generally answer the question, we have the three that are anticipated and I

think from an expectation perspective that's what we see as necessary for now.

>>QUESTION

Is this to some degree a large bank/small bank story with the results? It seems that the large banks have largely healed and when you see the problem bank list, that's a real eye-popping number, but it's mostly smaller institutions and commercial real estate also concentrated in smaller institutions. So going through and looking through all these results that are released today, is it a large bank/small bank story? A contrast?

>>RICH BROWN

Probably Ross and I can both answer that.

>>ROSS WALDROP

Yeah, I think obviously we made observations that the magnitude of the year-over-year improvement was driven by the large banks. They had the biggest losses a year ago so they had the biggest improvements. In a lot of cases that improvement meant smaller losses. Again when the industry is right at the break-even point, I don't think you can state that a recovery is completed or anything. I do think the large banks probably were in a deeper hole a year ago. I think they probably went into difficulty sooner than smaller institutions and I think that reflects more their areas of concentration in lending. They have a bigger proportion of mortgage loans, other consumer loans in their portfolios than medium and smaller banks, which tend to focus more on commercial credits. I think the retail loans probably lead the industry into this downturn in the credit cycle. All things being equal you would like to think those things -- what led you and will lead you out as well. That remains to be seen. I don't think we are at a point yet where we would be announcing that as a given, but certainly in terms of the overall improvement. That said, if you look at some of the broader indicators, the number of institutions reporting year-over-year improvement, over half -- slightly over half reported year-over-year improvement for the first time in three years. That speaks to a broader trend in the industry. About 90 percent of all the banks we ensure have less than \$1 billion in assets, what we call community banks. If over half of the number of banks is improving, that's a lot of community banks that are at least doing better. We saw a slightly smaller proportion of the industry losing money, reporting net losses for the fourth-quarter compared to a year ago. That was just over one-third of all institutions a year ago. This fourth quarter was just under one-third. So there are some incremental signs of progress. The more dramatic improvements from the sizable losses have been concentrated among the large banks.

>>JOHN CORSTON

The other thing I would add is the smaller institutions tend to have natural concentrations and in general that is in commercial real estate. That is an area obviously that is under stress. It became under stress a little bit after the residential

stress, but the ability to withstand that stress when you do have a concentration is lessened and that results in higher failures.

>>QUESTION

One other thing too, as far as -- what do you see as the looming risks still out there, commercial real estate, also Chairman Bair has been recently sounding the alarm on interest rate risk and to try to minimize that. What other risks are you most closely watching?

>>JOHN CORSTON

The ones -- I spend more time dealing with the larger institutions, but certainly the rate risk is one we are looking at and we still are monitoring liquidity. For the markets to come back at this point, it has been fairly encouraged. But it is certainly an area we continue to watch as institutions carry still a reasonable amount of credit risk and as long as the credit risk is embedded in their balance sheets, they will be a little bit more sensitive to liquidity markets so we do watch that area.

>>RICH BROWN

I think the two areas you mentioned are certainly the two that are front and center for us. With regard to commercial real estate, it's important to point out that that construction and development portion of that portfolio; the problems are already evident in the non-current rates and the charge-off rates. Those are already elevated. As Chairman Bair pointed out, it takes a longer period of time generally for income producing properties, things of that sort, the permanent commercial real estate portfolios to experience problems. That is an area we are watching very closely right now.

>>QUESTION

[off mic comment]

>>RICH BROWN

The sense is that the challenges that are out there will be experienced fairly gradually over the next couple of years.

>>QUESTION

Could you just help me understand, why is the cash balance on the DIF so much higher than the reserve balance?

>>KAREN HUGHES

That is getting back to the question about the pre-paids. We collected the \$46 billion from the industry for the prepaid assessments at the end of 2009. While that improved the Deposit Insurance Fund's cash balance or liquidity position, it did not impact the fund so much because we did not take that to revenue. We will be taking that to revenue in the fund over the next three years and so it will take a while for the fund balance to reflect that prepaid activity. But again the liquidity position immediately was benefited by that.

>>QUESTION

[off mic comment].

>>KAREN HUGHES

We take it to revenue quarterly as we passed the insurance -- we look at the insurance period as a quarter. So as we pass that insurance period, then we will reflect revenue for that coverage period.

>>DIANE ELLIS

If I could just add one thing, the fund balance is the net worth of the Deposit Insurance Fund. So it is assets minus liabilities and the cash is just one kind of asset on our balance sheet.

>>GREG HERNANDEZ

Any other questions? Alright, thank you very much.