A DAY *with the* COMMISSIONER

The Current State of the Banking Industry

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The views expressed in this presentation are the views of Julie Stackhouse and not necessarily the views of the Federal Reserve Bank of St. Louis or the Federal Reserve System.

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A Quick Look Back

- The Financial Crisis
- The Spillover Effect on Community Banks

The Current State of the Industry

- A Look at the Performance Scorecard

Near-term Challenges

- Preparing for Rising Interest Rates
- Profitability

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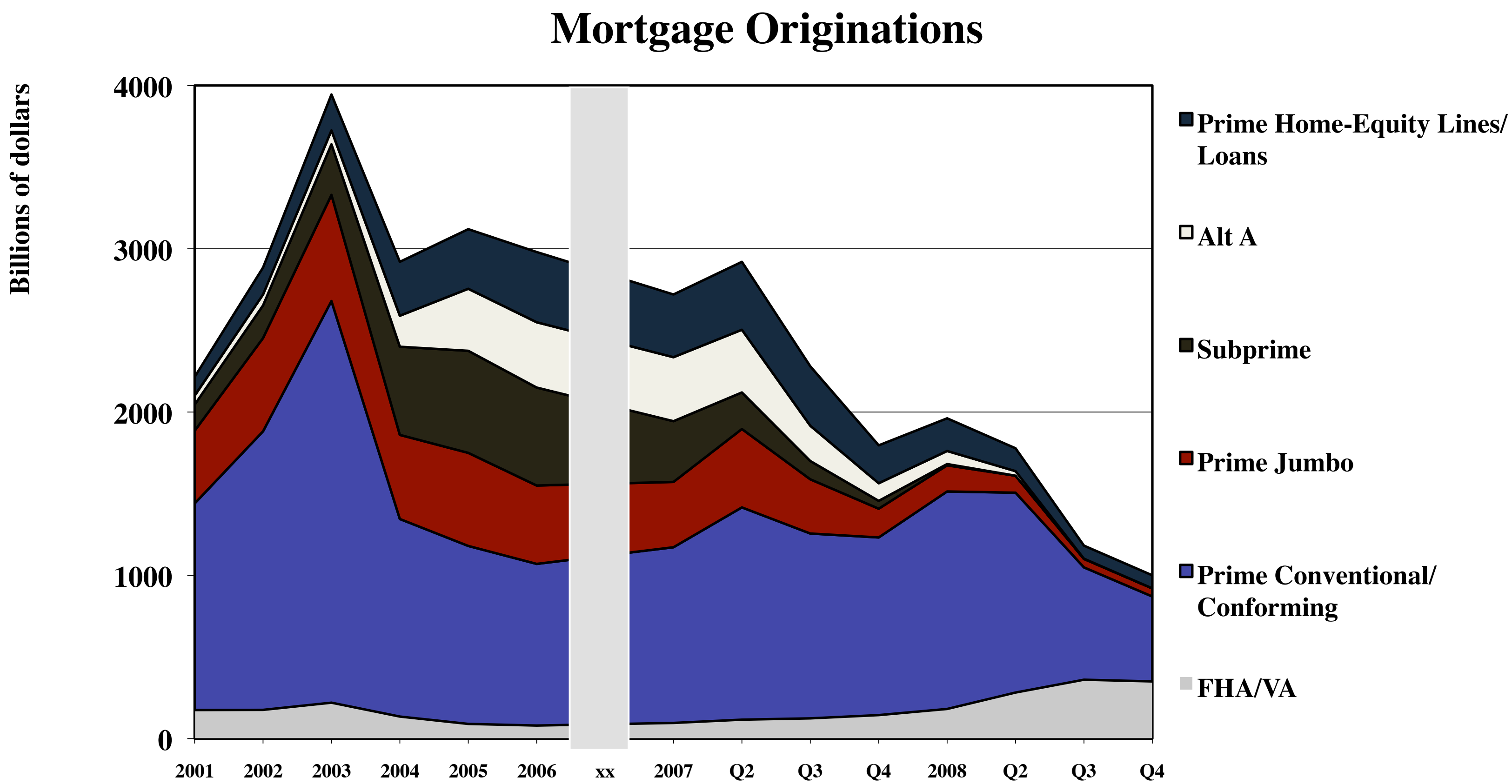
Looking back to the fall of 2009

The financial crisis that gripped the United States last fall was unprecedented in type and magnitude. It began with an asset bubble in housing, expanded into the subprime mortgage crisis, escalated into a severe freeze-up of the interbank lending market, and culminated in intervention by the United States and other industrialized countries to rescue their banking systems.

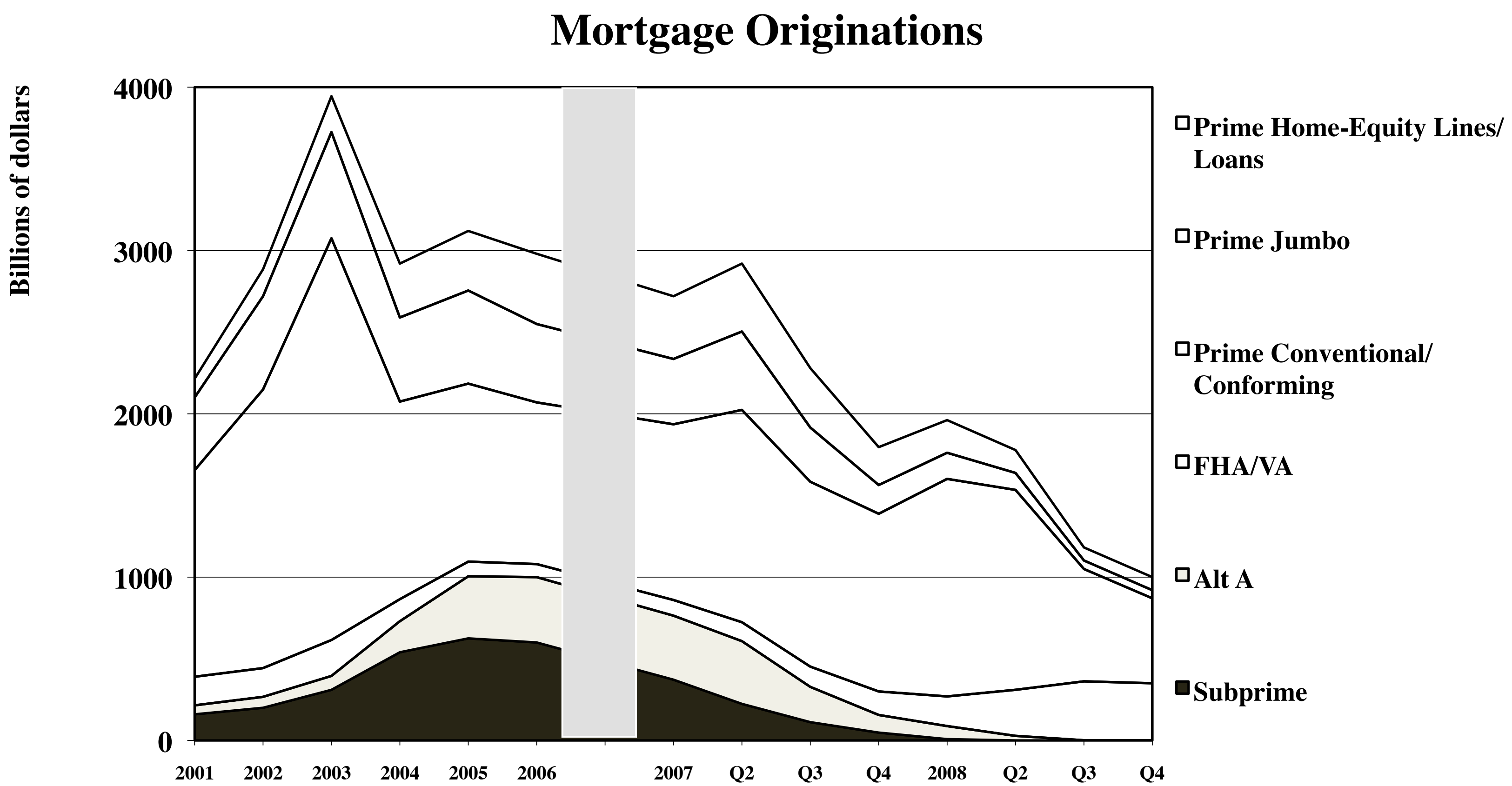
Congressional Oversight Report on the Troubled Asset Relief Program, December 9, 2009

What happened? Favorable mortgage rates and terms made it easier to purchase a home.



Quarterly figures for 2007 and 2008 expressed at an annual rate.
Source: *Inside Mortgage Finance*, Jan. 30, 2009.

And new nontraditional mortgage products made it easier for less creditworthy individuals to get a mortgage.



Quarterly figures for 2007 and 2008 expressed at an annual rate.
Source: *Inside Mortgage Finance*, Jan. 30, 2009.

Adding to the complexity, these "nontraditional" mortgage loans were taken by nonbank investment companies and transformed into securities.

The mortgages were pipelined through mortgage companies

- Mortgage companies specializing in these obligations originated volumes of mortgages for sale to investment banks.

Subprime mortgages were typically transformed into "mortgage-backed securities"

- The mortgages were grouped into payment and risk "tranches" and sold as "collateralized mortgage obligations."
- And sometimes, other assets or enhancements were added to the collateralized mortgage obligation to create a "collateralized debt obligation."

The U.S. "spread the risk"

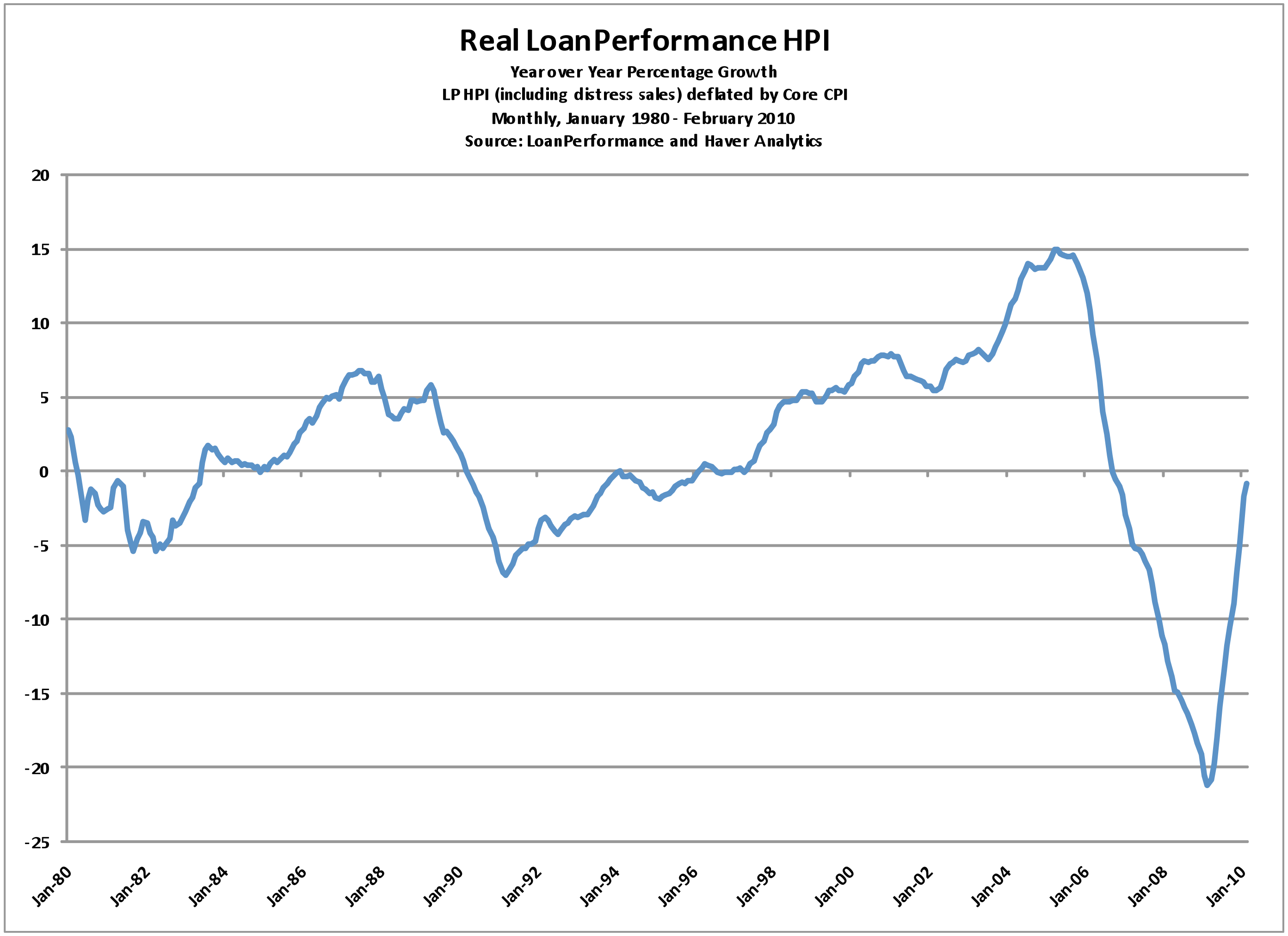
- The securities were sold to investors around the world or held in in the trading books of investment banks.

A lesson learned again: the perils of weak underwriting.

	Subprime Mortgages – 2005-2006 Vintages
> 78%	Subprime mortgages with adjustable rates (including hybrids)
40%	Subprime mortgages with reduced documentation
98%	Combined loan-to-value ratio
55%	Share of subprime mortgages that were cash-out refinances
90%	Share of subprime mortgages originated through broker or wholesale channel

Sources: Mortgage Bankers Association, Loan Performance Corp.

A lesson learned again: repayment reliant on increases in asset values.



Asset values have experienced the most significant decline in "sand states."

Geographic Area	Peak to Present Decline	When the Market Peaked
Boston	18.41	November 2005
Chicago	26.76	February 2007
Denver	11.11	March 2006
Los Angeles	40.92	April 2006
Las Vegas	51.85	April 2006
Miami	47.82	December 2006
New York City	20.87	May 2006
San Diego	42.21	March 2006
San Francisco	45.57	March 2006
Washington, D.C.	33.25	March 2006

Source: Case Schiller

The unexpected and rapid losses led to a "run" in financial markets.

Fear in the financial markets, which had been building, evolved into a full-blown panic in September 2008. During a remarkable 19-day stretch, the federal government took over the two largest players in the mortgage market, allowed a large investment bank to go bankrupt, bailed out one of the world's largest insurance companies, and steered a major financial institution through the largest bank failure in U.S. history.

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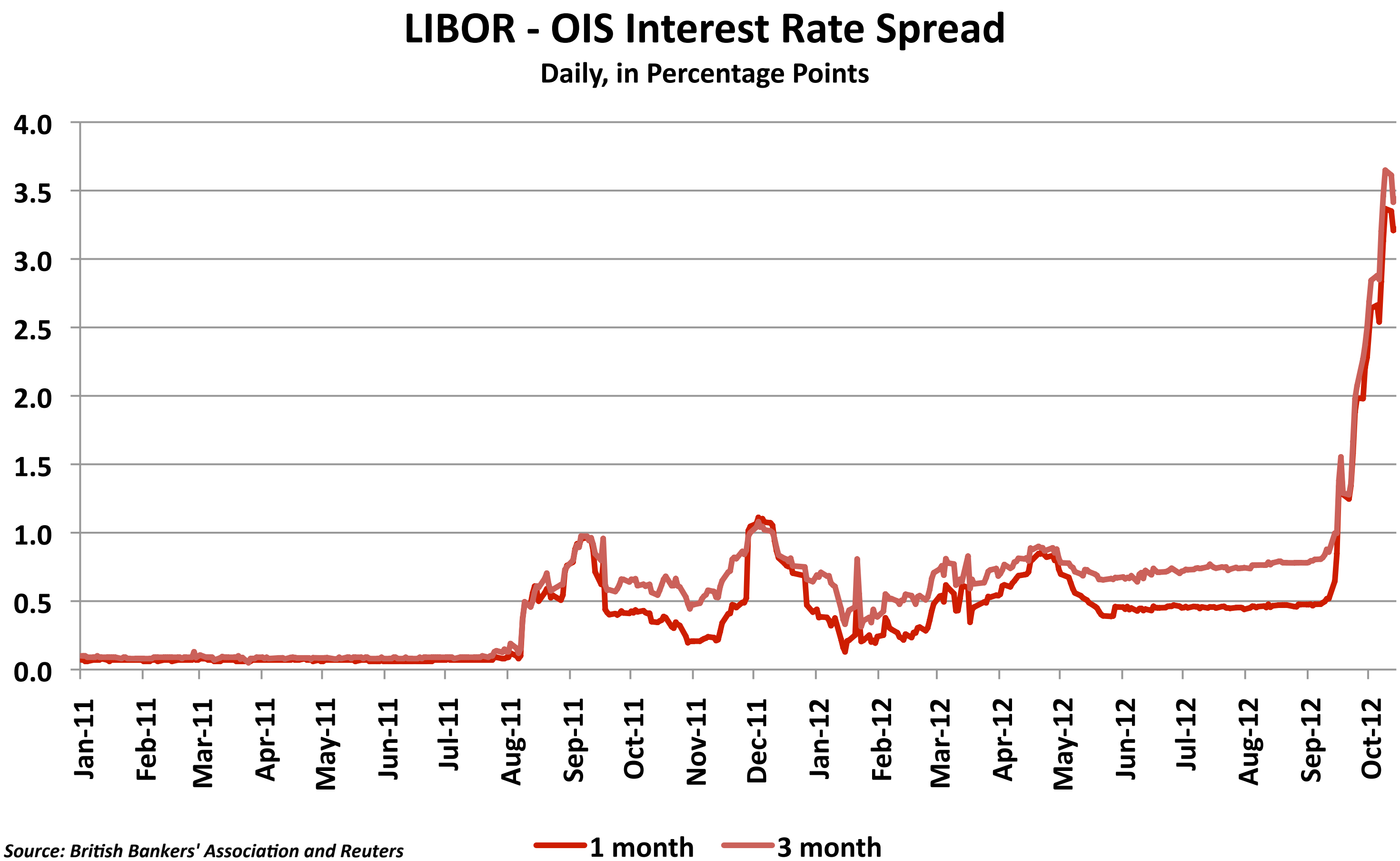
The country faced a financial crisis.



Source: British Bankers' Association and Reuters

The Federal Reserve, the U.S. Government, and the Federal Deposit Insurance Corporation all responded.

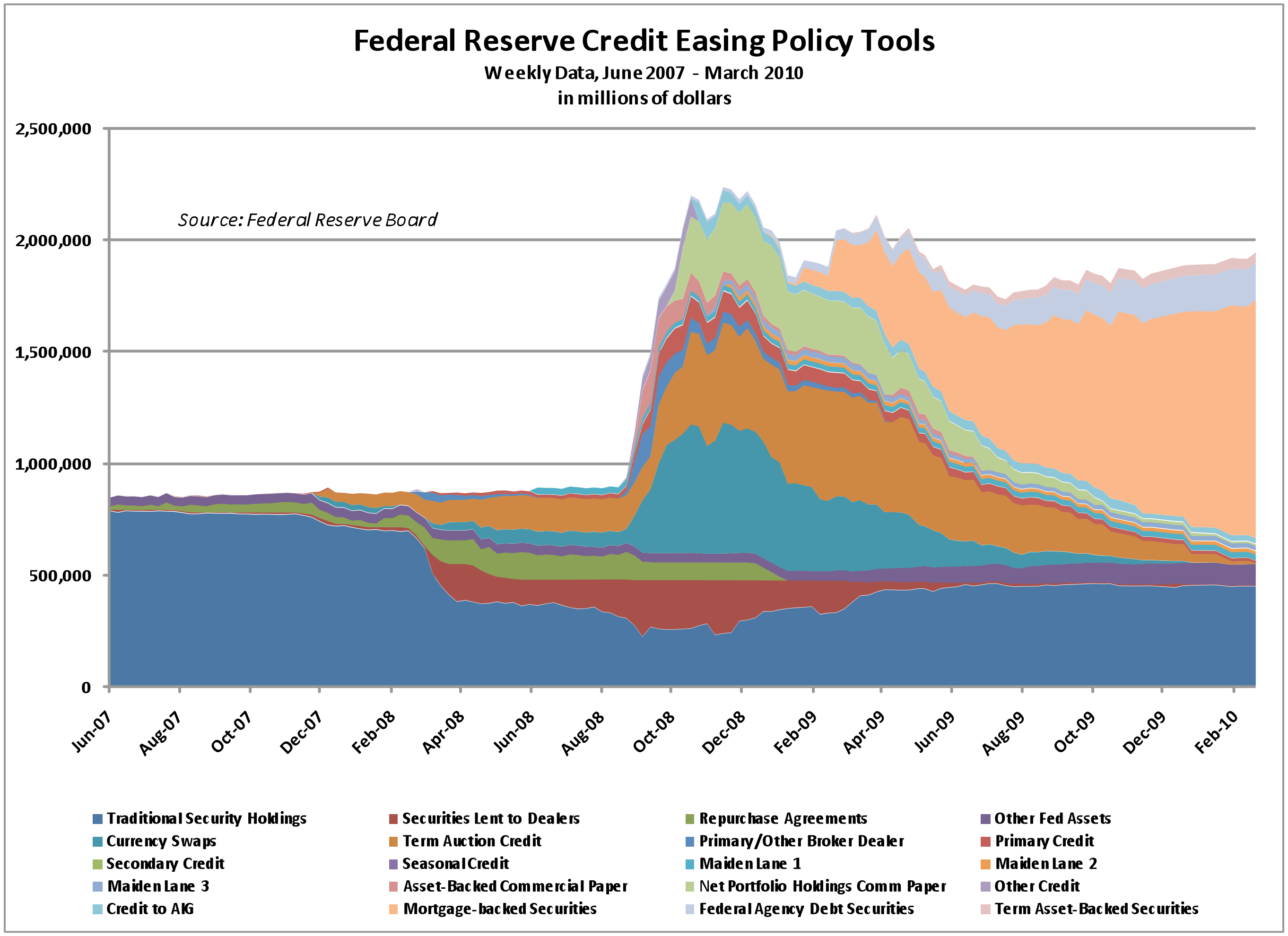
“First Responders” to the financial crisis

- **Federal Reserve**
  - Provided funds (liquidity) to stabilize financial markets
- **United States Government**
  - Funded the Troubled Asset Relief Program and the $800 billion economic stimulus
- **Federal Deposit Insurance Corporation**
  - Raised bank deposit insurance limits and provided other bank debt guarantees

The Federal Reserve provided funds to keep financial markets functioning. That's our job.

Financial Institution Facilities	Lender	Current Rate
Primary Credit	District Reserve Banks	Federal Funds plus 25 basis points
Secondary Credit	District Reserve Banks	Primary Credit rate plus 50 basis points
Seasonal Credit	District Reserve Banks	Published
Term Auction Facility	District Reserve Banks	Set at auction
Section 13(3) Facilities	***Lender***	***Date of Facility***
JPMC/Bear Stearns	FRB New York	March 16, 2008
Primary Dealer Credit Facility	FRB New York	March 17, 2008
AIG	FRB New York	September 16, 2008/November 10, 2008
AIG– Residential Mortgage-Backed Securities Facility	FRB New York	November 10, 2008
AIG- Collateralized Debt Obligations Facility	FRB New York	November 10, 2008
AMLF - Asset-Backed Commercial Paper Money Market Mutual Fund Lending Facility	FRB Boston	September 19, 2008
CPFF- Commercial Paper Funding Facility	FRB New York	October 7, 2008
MMIFF – Money Market Investor Funding Facility	FRB New York	October 21, 2008
TALF – Term Asset-Backed Securities Loan Facility	FRB New York	November 25, 2008

A picture of the Fed's actions.



Congress responded with the Troubled Asset Relief Program and a stimulus package.

Utilization of TARP Funds	**May 3, 2010**
Capital Purchase Program (CPP) - $204.9 billion less $137.3 billion repaid less $4.7 billion in warrant proceeds (690 institutions initially)	$65.3 billion
Capital Assistance Program (CAP)	$0
Consumer and Business Lending Initiative (Super TALF)	$20.0 billion in TALF LLC
Public-Private Investment Program (S-PPIP) – Legacy Securities	$30.4 billion (less $368.2 million repaid)
Targeted Investment Program (TIP) – Citi, BofA	$40.0 billion invested $40.0 billion repaid $1.3 billion in warrant proceeds
Asset Guarantee Program - Citi	$5 billion; agreement terminated on 12/23/09
Auto Industry/Auto Supplier Program – GM, GMAC, and Chrysler	$84.8 billion invested $8.9 billion repaid
AIG Investment Program (formerly referred to as Systemically Significant Failing Institutions)	$69.8 billion
Home Affordable Modification Program (HAMP)	109 servicers; incentive caps of $39.9 billion

Source: www.financialstability.gov

The Federal Deposit Insurance Corporation responded with higher levels of insurance.

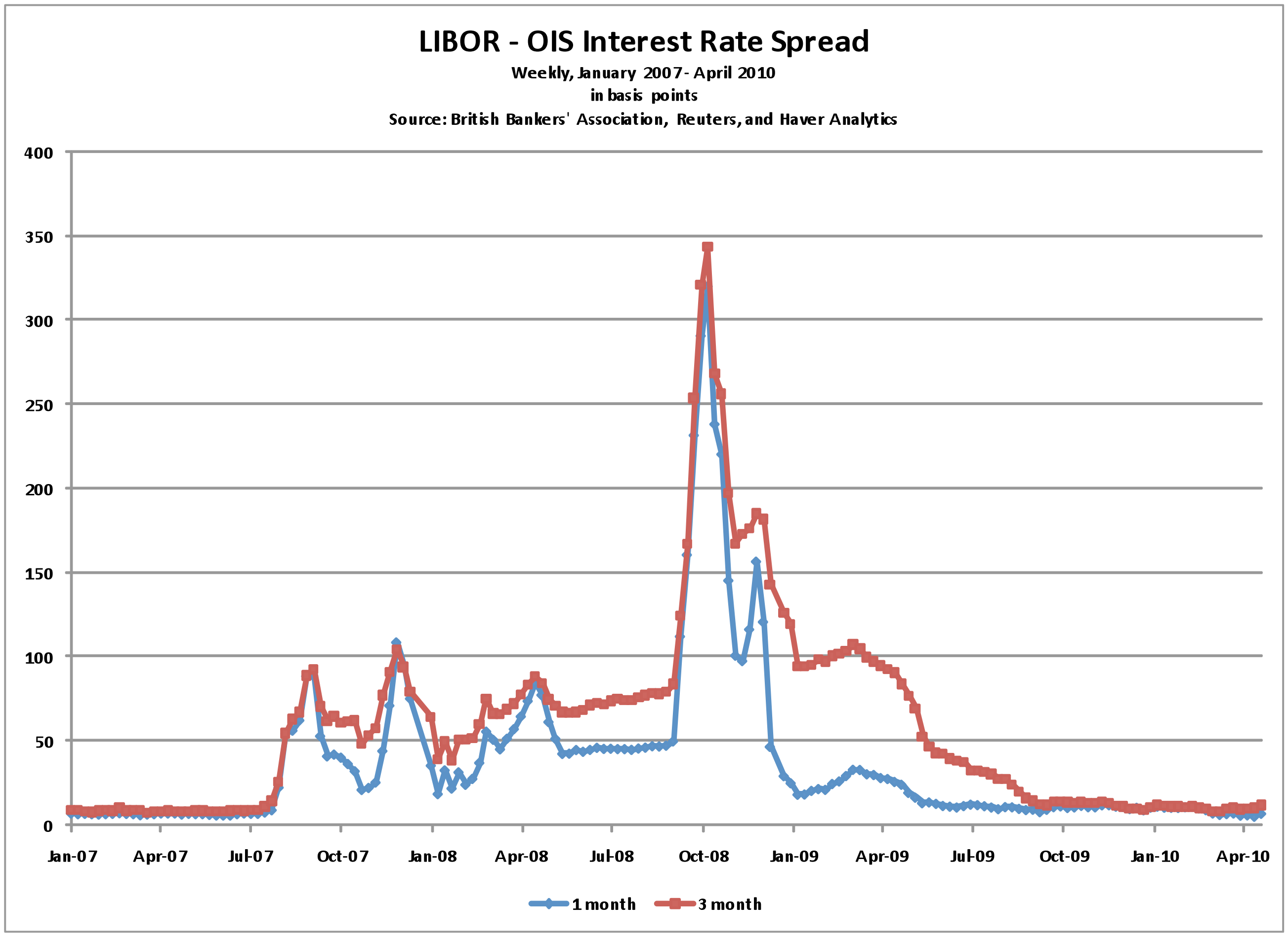
Federal Deposit Insurance coverage increased to $250,000 per owner through December 31, 2013 (Beginning May 2008)

Banks also had the option to pay a fee to participate in two other temporary programs beginning November 2008:

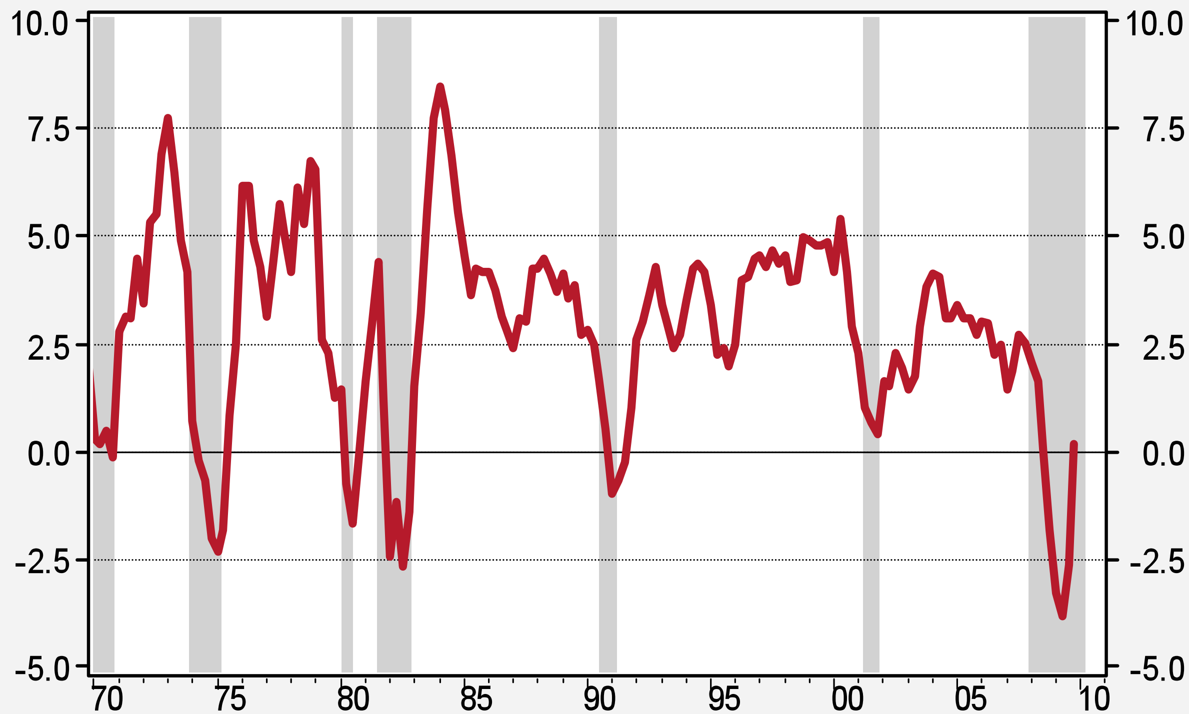
- Temporary full insurance of noninterest demand accounts in excess of $250,000
- Guarantee of certain newly-issued senior unsecured debt of banking organizations (no longer offered)

Separate from the FDIC program, the Treasury temporarily guaranteed participating money market mutual funds until September 19, 2009

A collapse of the financial system was avoided.

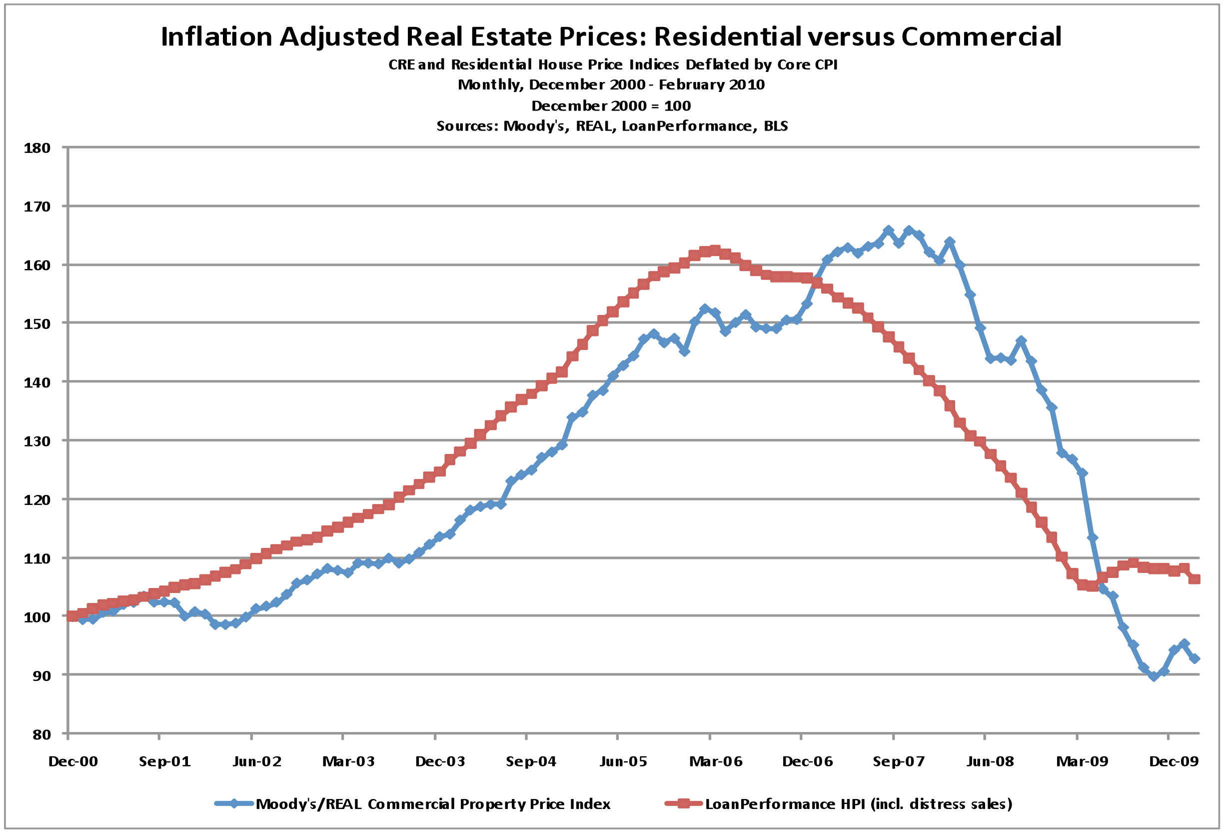


However, we did not avoid the "Great Recession."

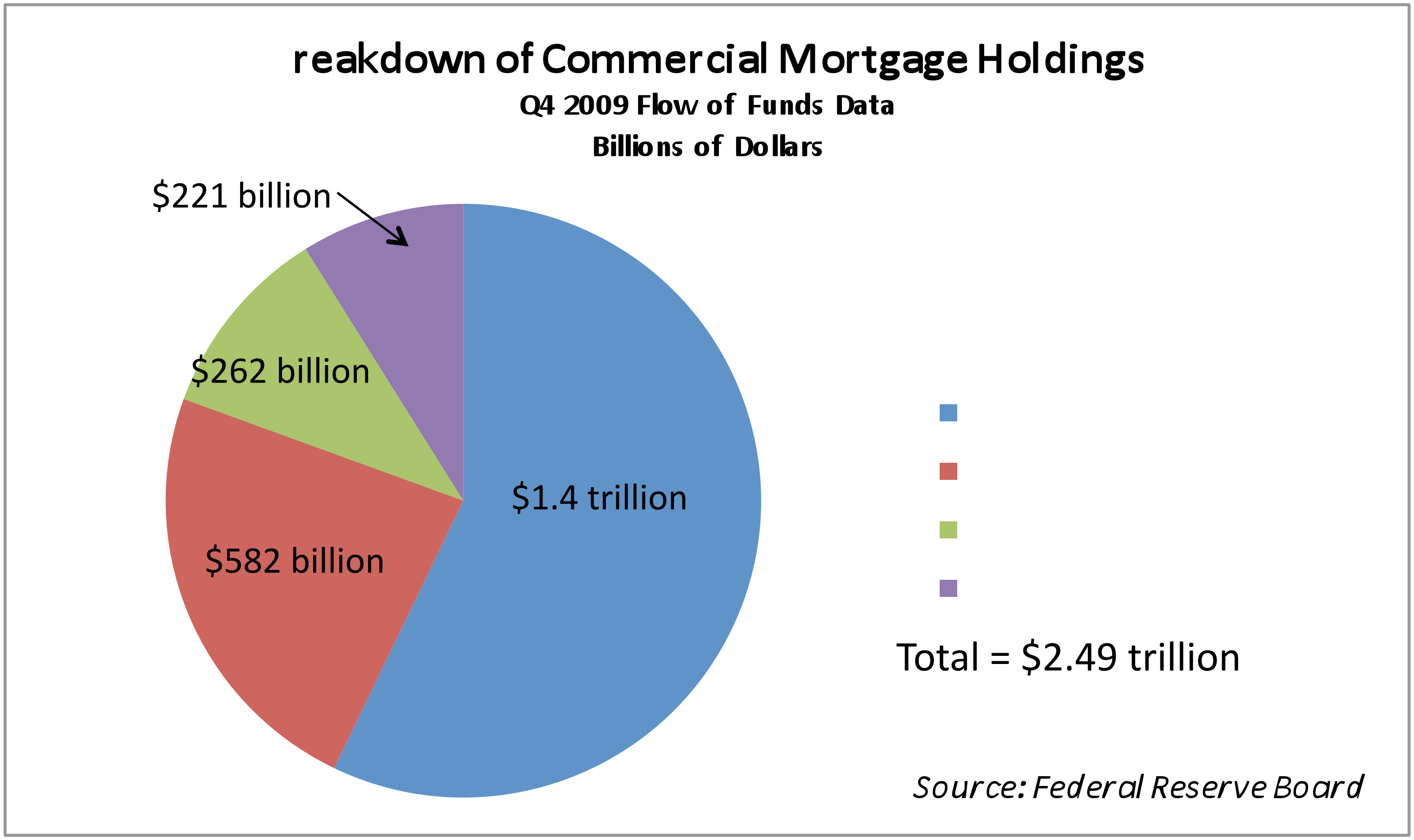


Source: Bureau of Economic Analysis /Haver Analytics

Commercial real estate declines lagged residential declines but dropped off more severely.



More than half of the exposure to commercial real estate is in banks.



The components of the commercial real estate portfolio (CRE) are reasonably similar for banks across the country.

CRE Exposure: CRE Components as a Percentage of Total CRE				
In %, Source: Call Reports				
Q4 2009	All US Bks	US Community Bks	All TN Bks	TN Community Bks
Construction and Land Development	26.7	24.5	32.1	30.6
Multi-Family Residential	10.1	6.6	4.4	3.8
Owner Occupied Non-Farm Non-Residential	28.5	34.5	32.8	31.8
Non-Owner Occupied Non-Farm Non-Residential	34.3	33.5	29.8	33.1
Other Loans to Finance CRE	.4	.9	.9	.7
Note: Does not include CMBS held on bank balance sheets				

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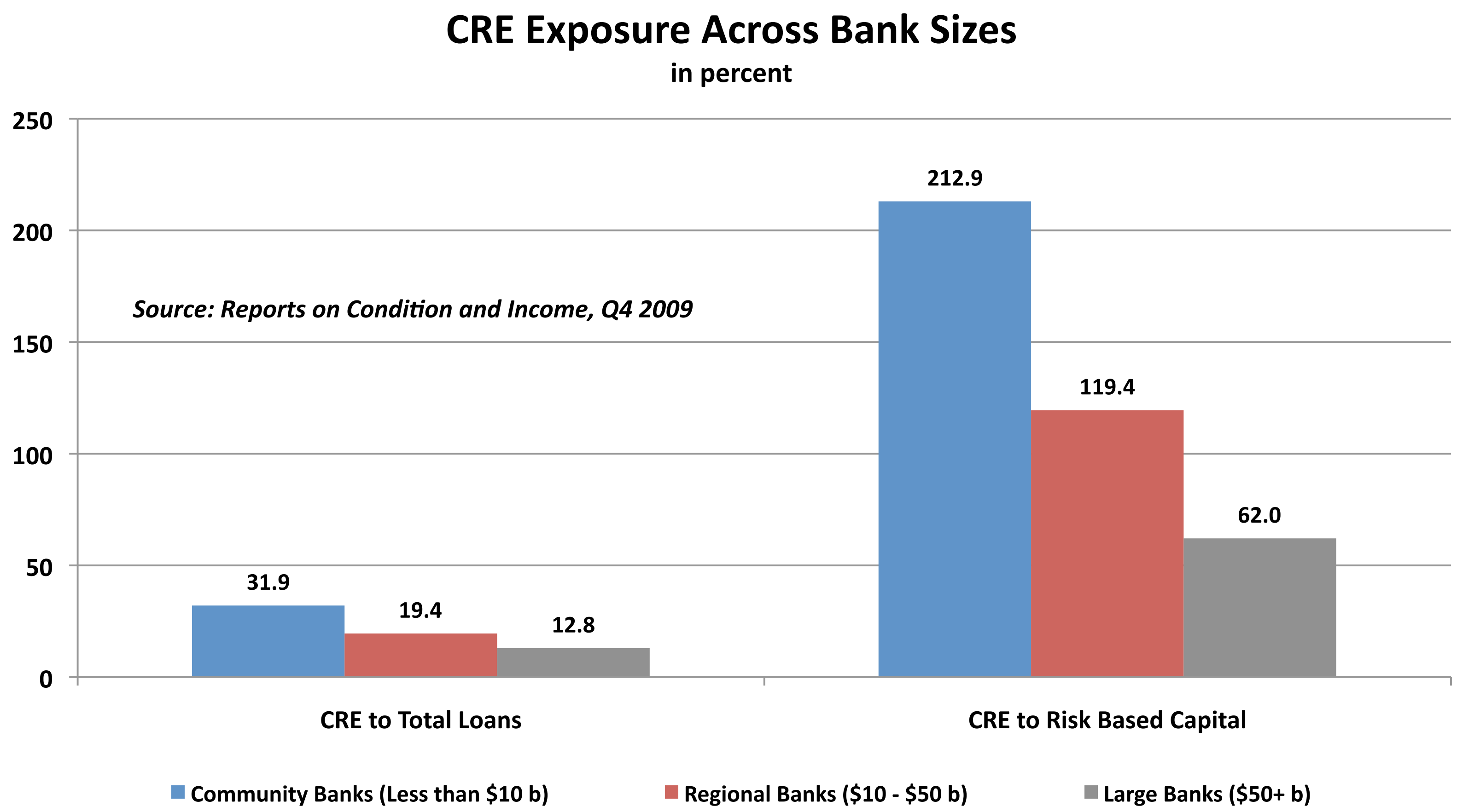
However, relative to size, smaller community and regional banks are more exposed to commercial real estate.



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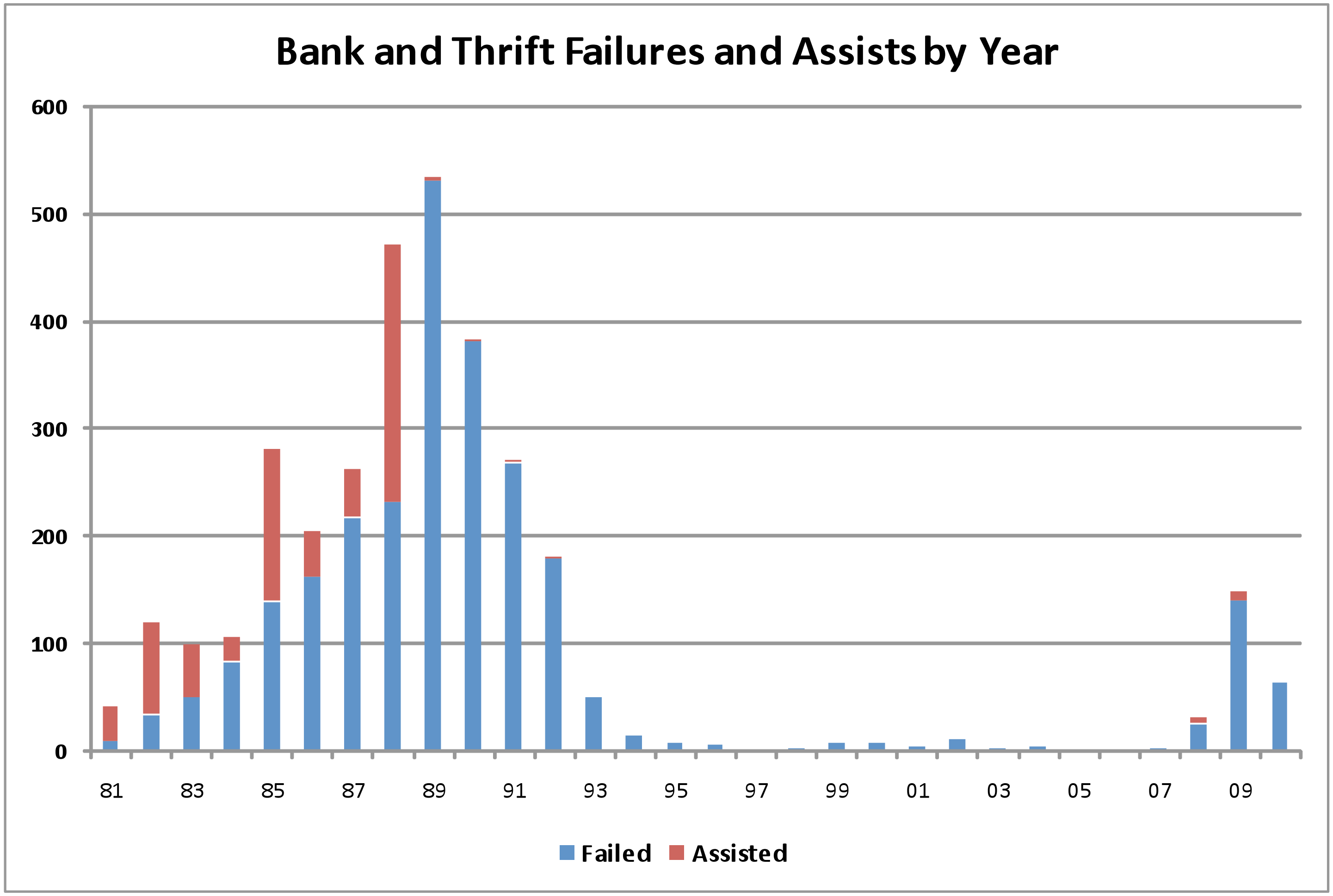
The impact on bank performance has been significant.

	Return on Assets		Non Performing Loans/ Total Loans		Loan Loss Reserve/Non Performing Loans		Tier 1 Leverage Ratio	
	12/31/2009	12/31/2008	12/31/2009	12/31/2008	12/31/2009	12/31/2008	12/312009	12/31/2008
US Banks > $100 billion	0.23	0.24	6.60	3.14	55.27	80.10	7.72	6.50
US Banks $10 - $100 billion	(0.17)	(0.05)	4.26	2.63	86.90	88.27	10.64	8.65
US Banks < $10 billion	(0.20)	0.05	4.04	2.78	51.09	60.86	9.18	9.24
Banks Headquartered in Tennessee	(0.54)	(0.30)	3.82	3.06	72.96	75.01	10.52	10.40

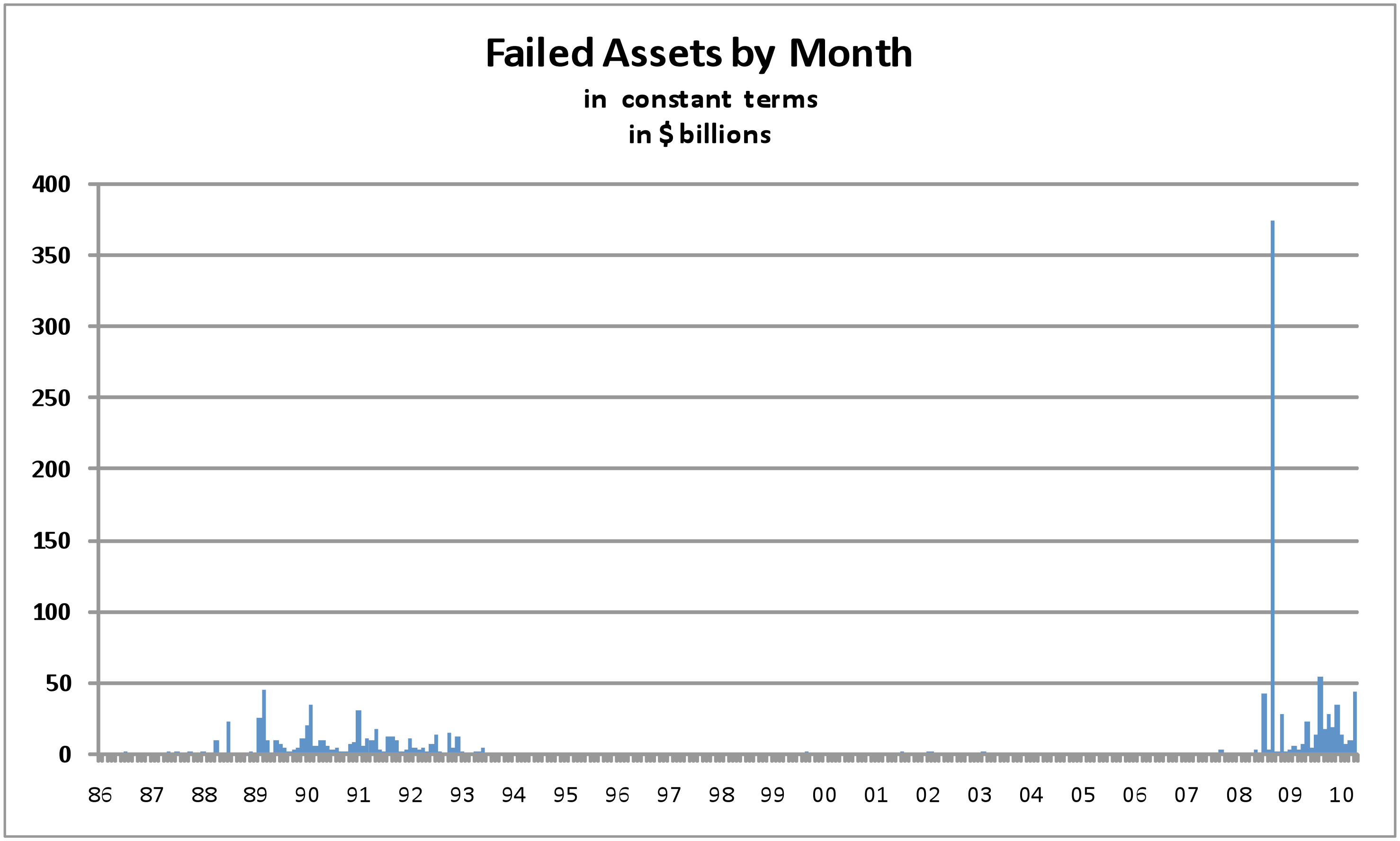
Source: Reports of Condition and Income

And in turn, bank failures are increasing.



Source: FDIC (64 failures as of April 30, 2010)

When put into constant terms, it appears that assets of failed banks will exceed the 1980s.



Source: FDIC (current as of April 30, 2010)

Assets deflated by Core CPI, January 2000 billions of dollars

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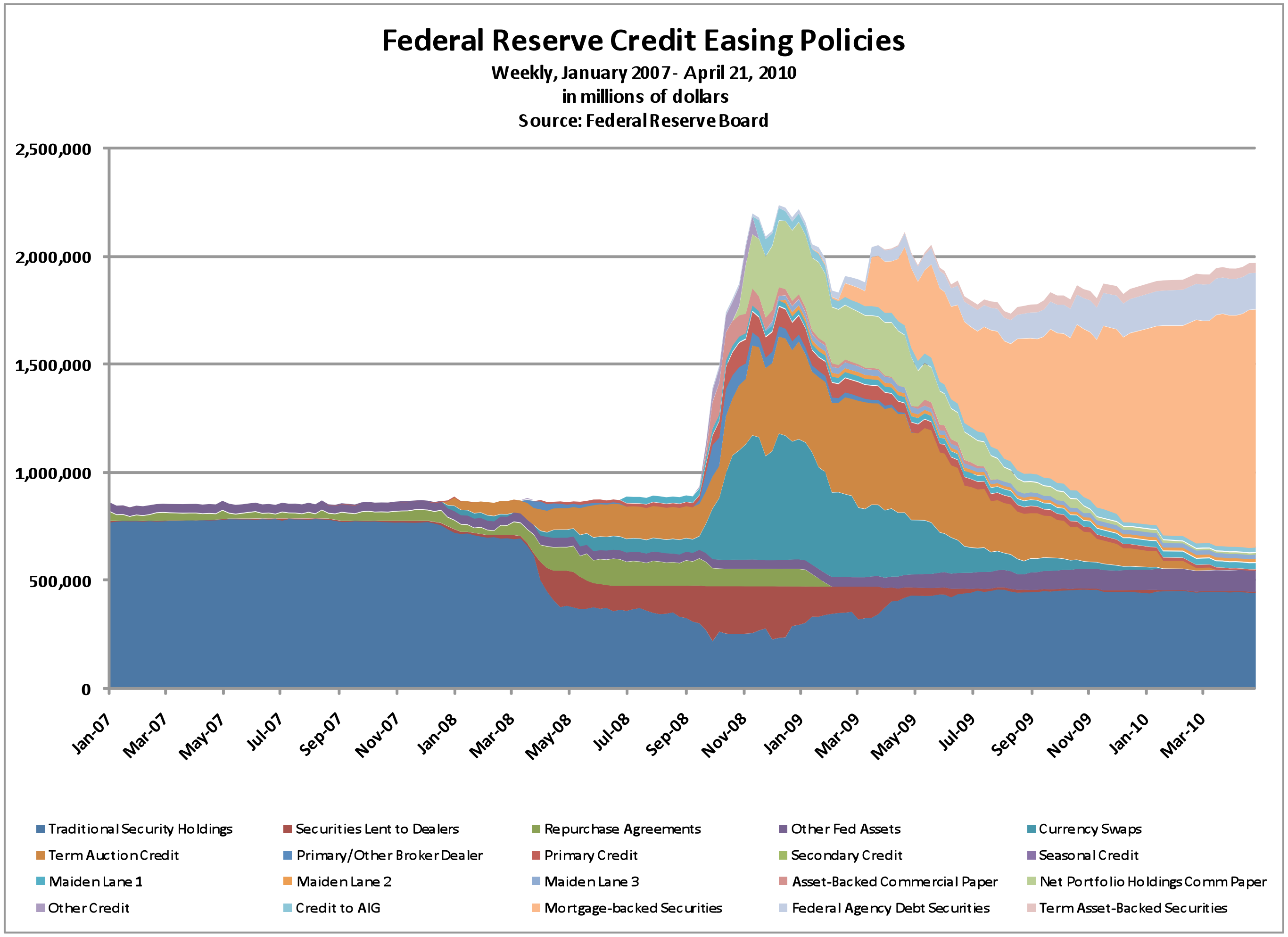
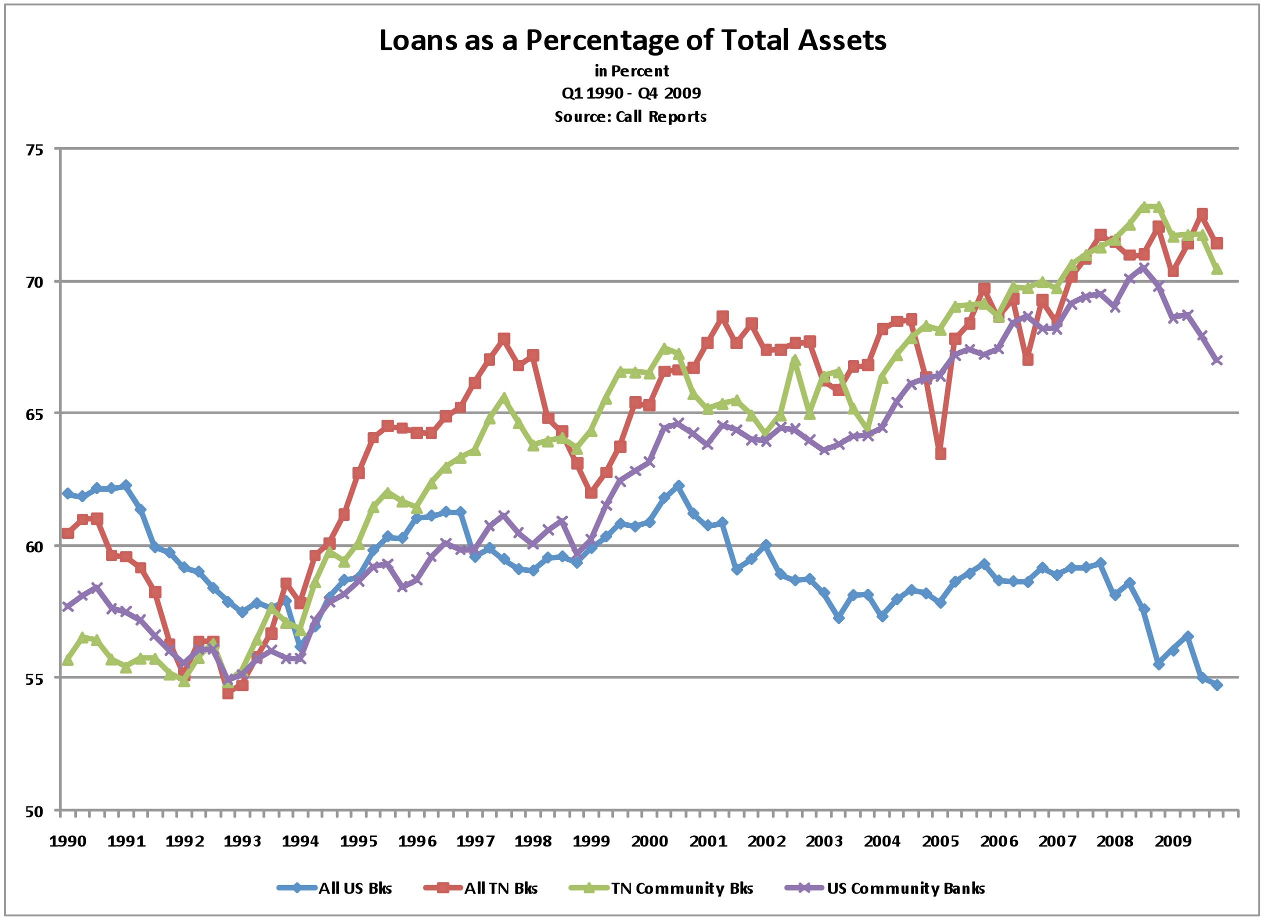
At some point, the Fed's easy will be reversed, resulting in rising interest rates.



Good quality loans will be the answer for banks.



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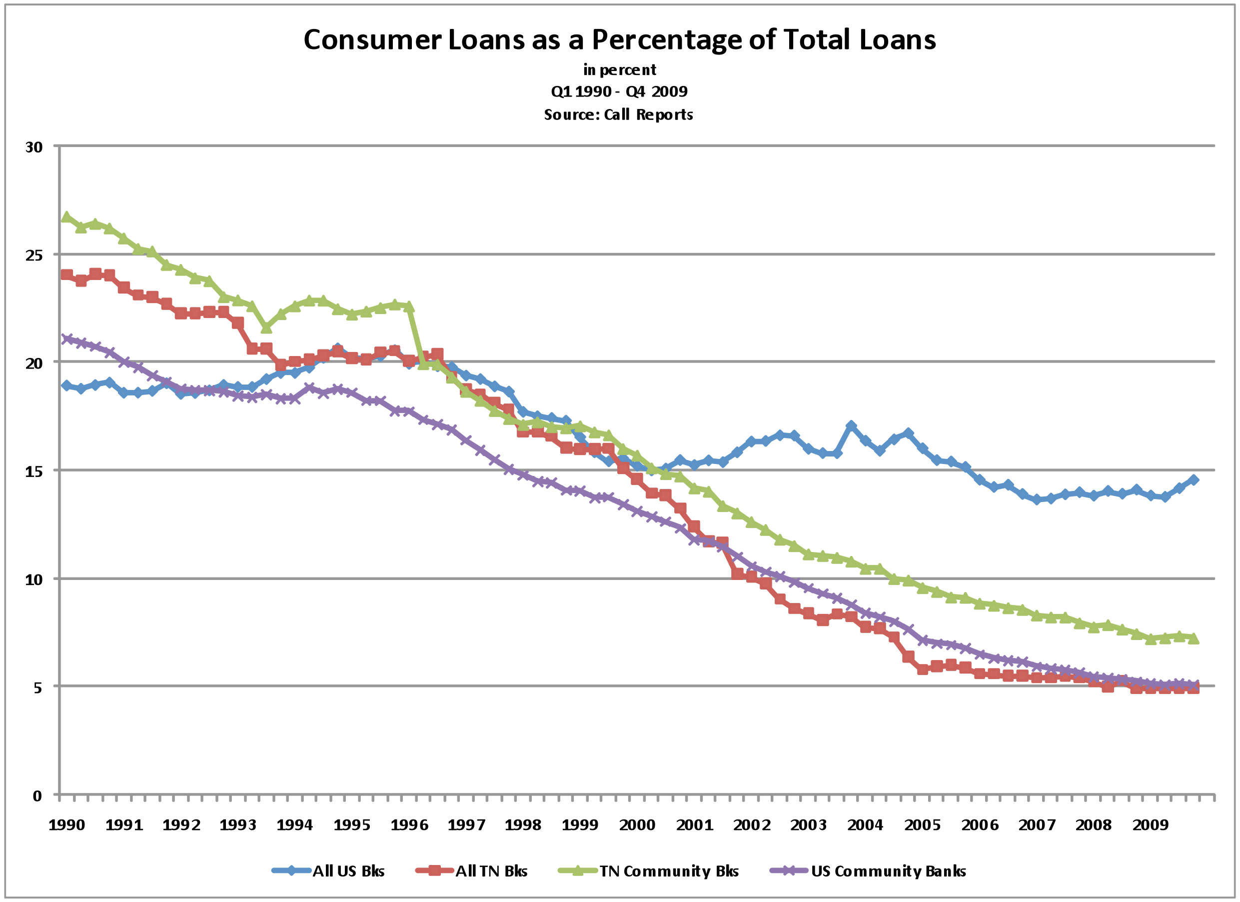
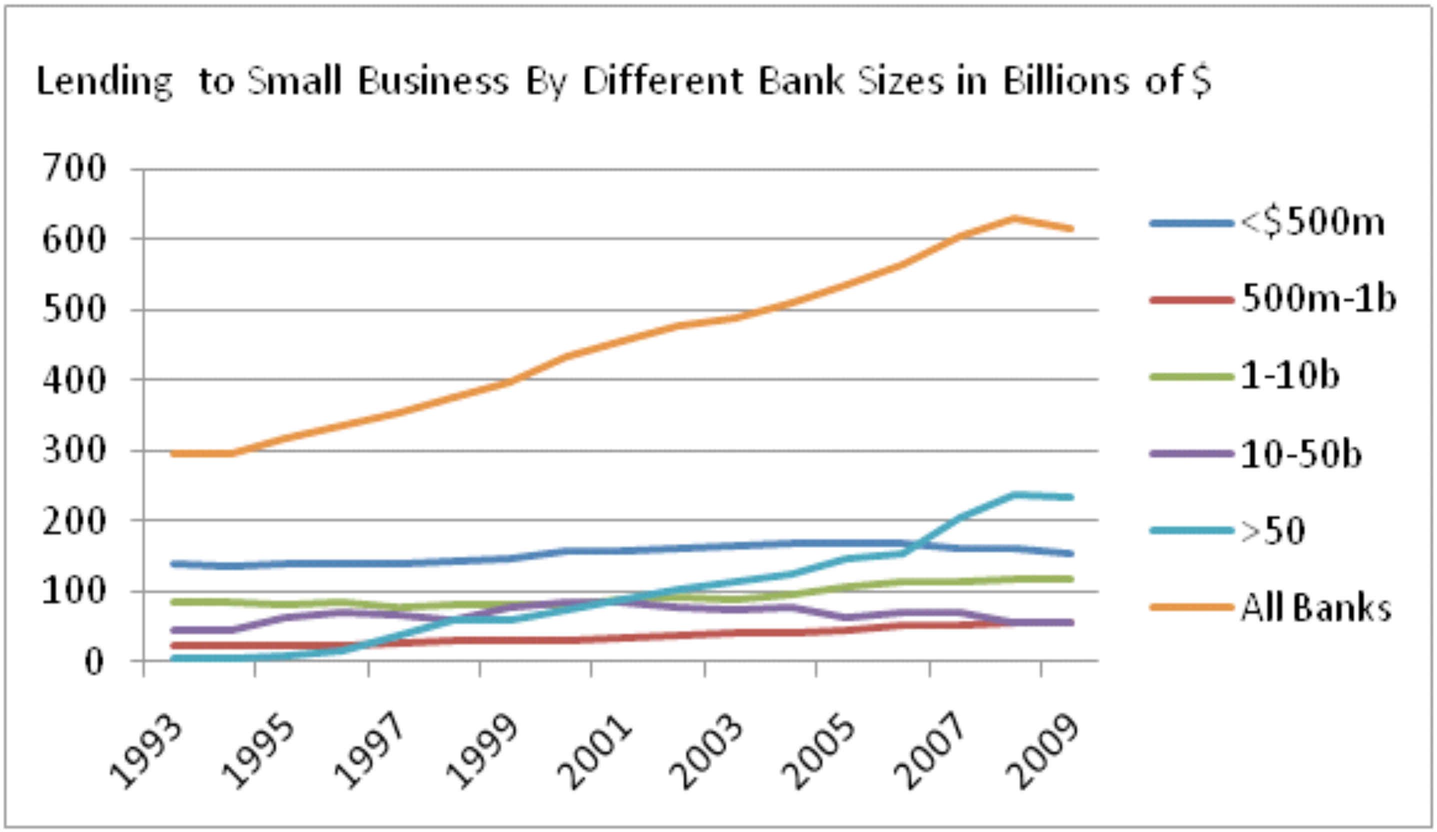
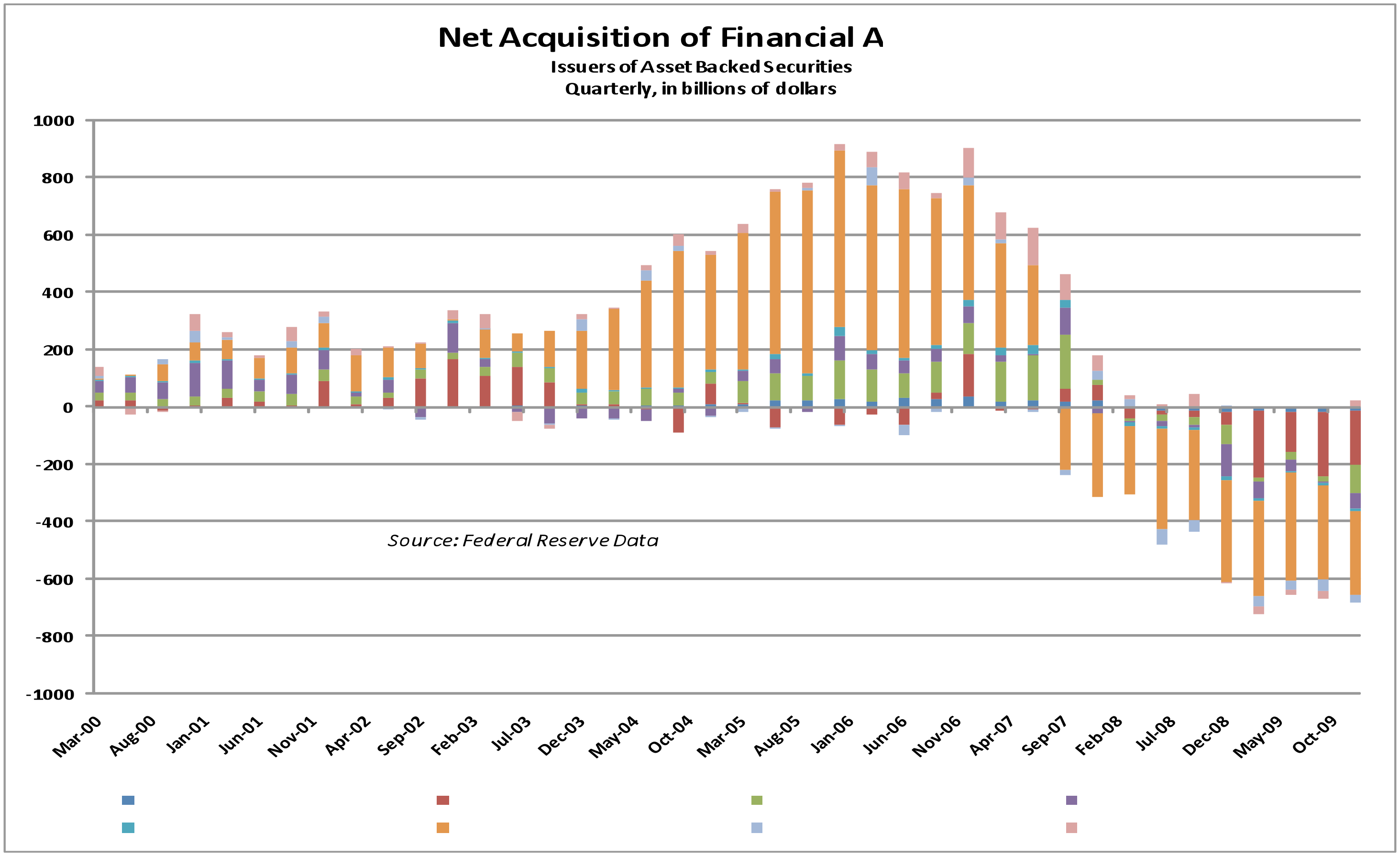
Consumer and small business loans will remain an option for some banks, although they are increasingly moving elsewhere.



Credit scoring models have made small business loans a profitable operation for larger banks.

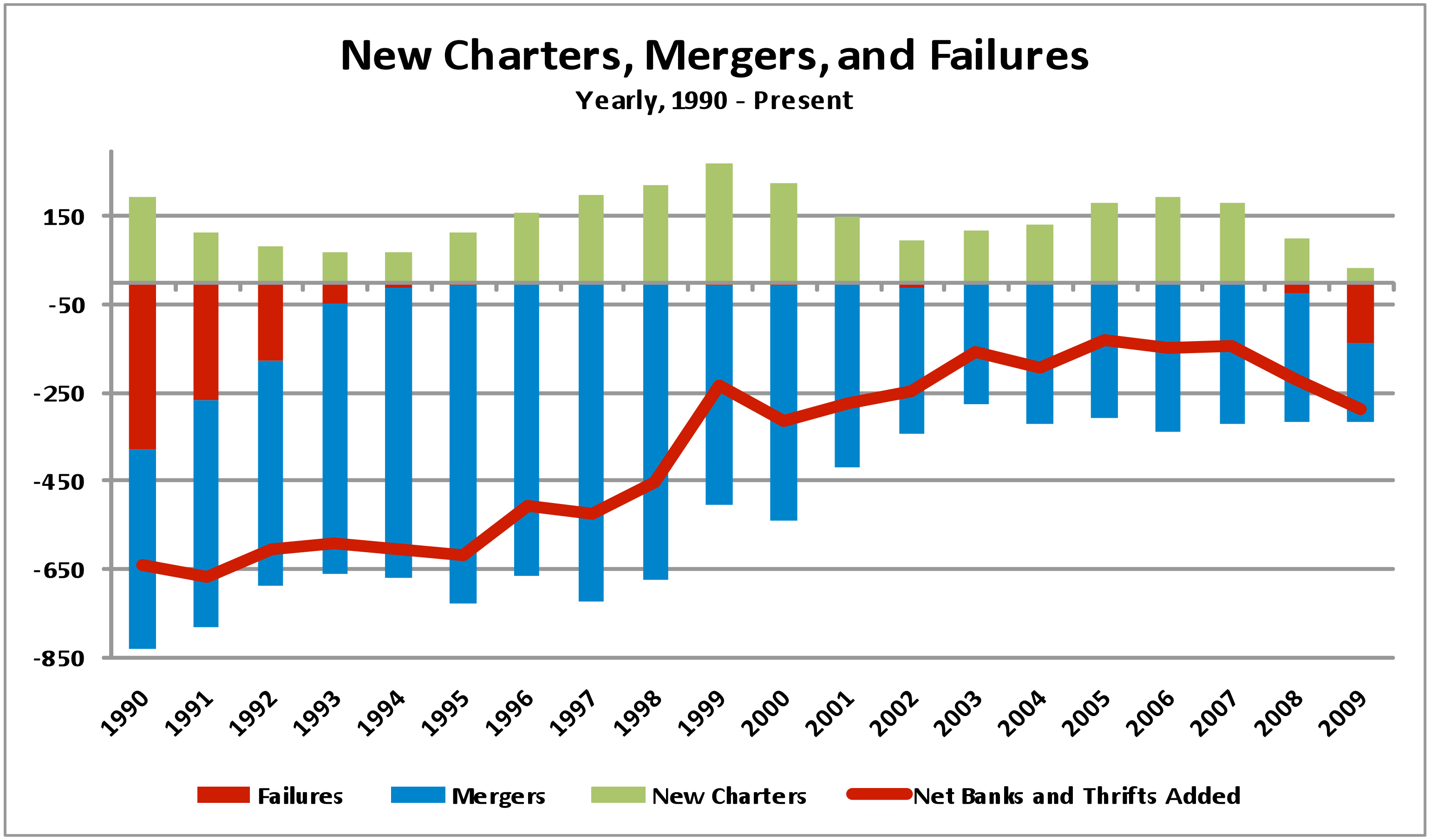


The shadow banking system has securitized other commodity loan products.



Source: Federal Reserve *Flow of Funds Accounts*, Fourth Quarter 2009.

Given the business model of community banking, it would not be surprising to see an acceleration in consolidation.



In fact, the numbers of banks/thrifts per capita suggest that certain states may be "overbanked."

Number of Citizens Per Head Office and Branch Located in Each State

What are the implications?

- Scale may be needed to absorb growing fixed costs, such as the cost of additional regulation or need for augmented internal controls.
- Community organizations may find it beneficial to diversify areas of concentration – on both the asset and liability sides of the balance sheet.
- Organizations with compatible cultures and business plans may choose to strategically merge.

Questions?