“The Year in Review”

17th Annual Capital Markets Conference
Federal Reserve Bank of Chicago
November 7, 2011

Kurt Wilhelm
Director Financial Markets Group
Office of the Comptroller of the Currency
(202) 874-4660

All quotes courtesy of Lawrence Peter "Yogi" Berra

What a Difference a Year Makes!

- Last year, although there were lingering problems from the financial crisis, we focused on the healing that had occurred in financial markets during 2010
- This year, those lingering problems have intensified, and some new problems/risks have emerged
  - Sovereign credit risk
  - Absence of loan demand
  - Weak economic growth in developed countries
  - Foreclosure practices in the US
  - Liability for reps and warrants
  - Revenue pressures
  - Stubbornly high unemployment and weak consumer confidence
- So, have we turned the corner, or is it “déjà vu all over again?”

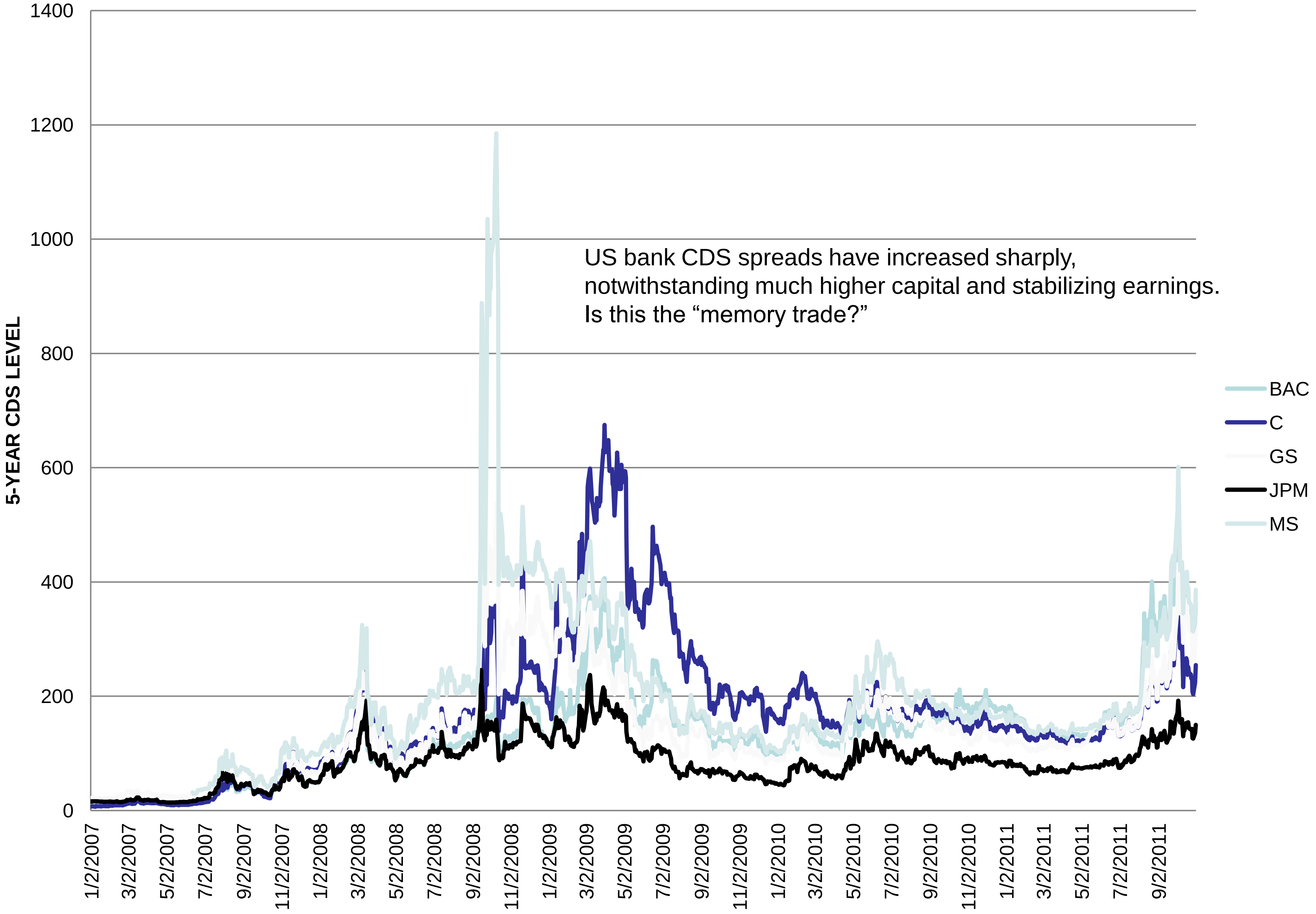
Parallels to the Financial Crisis

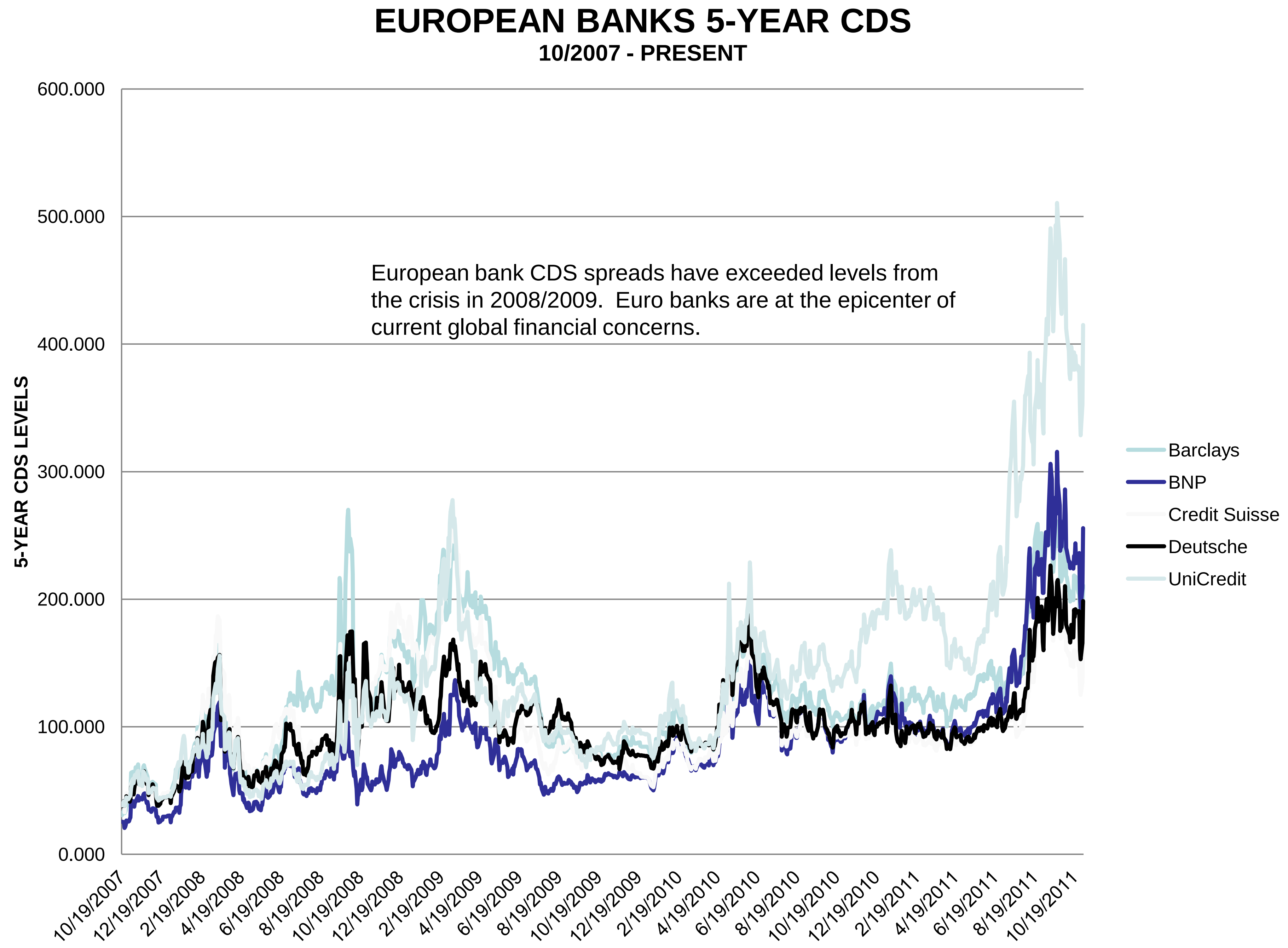
- Rising bank CDS spreads
- Low price/book ratios for banks
- Bank solvency concerns (Europe)
- Expanding central bank balance sheets
- Very low interest rates
- Broker/dealer failures
- Dollar funding difficulties
- CVA/DVA “noise” in trading results
- Depressed real estate markets

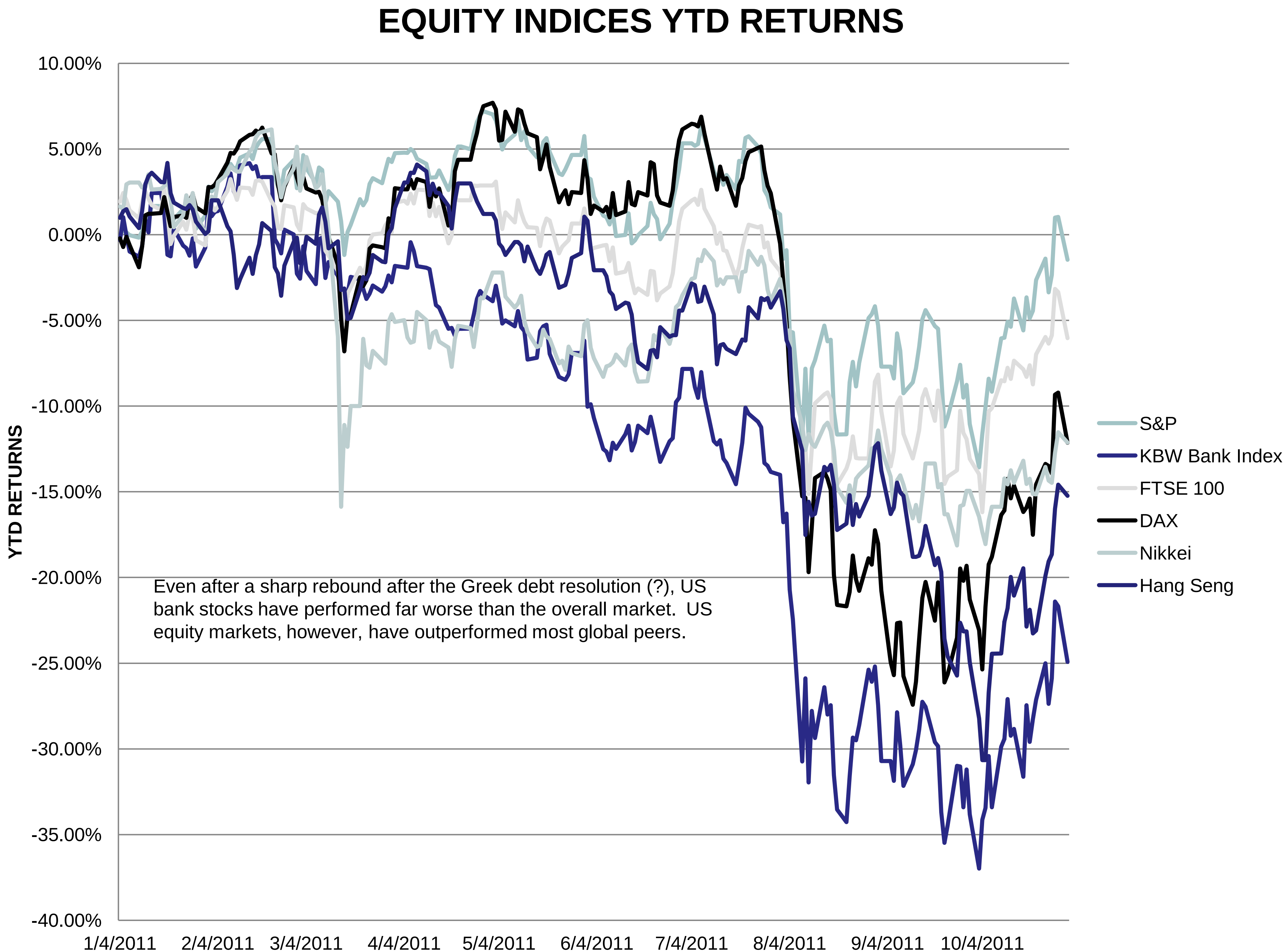
"Yeah, but we're making great time!" -- In reply to "Hey Yogi, I think we're lost."

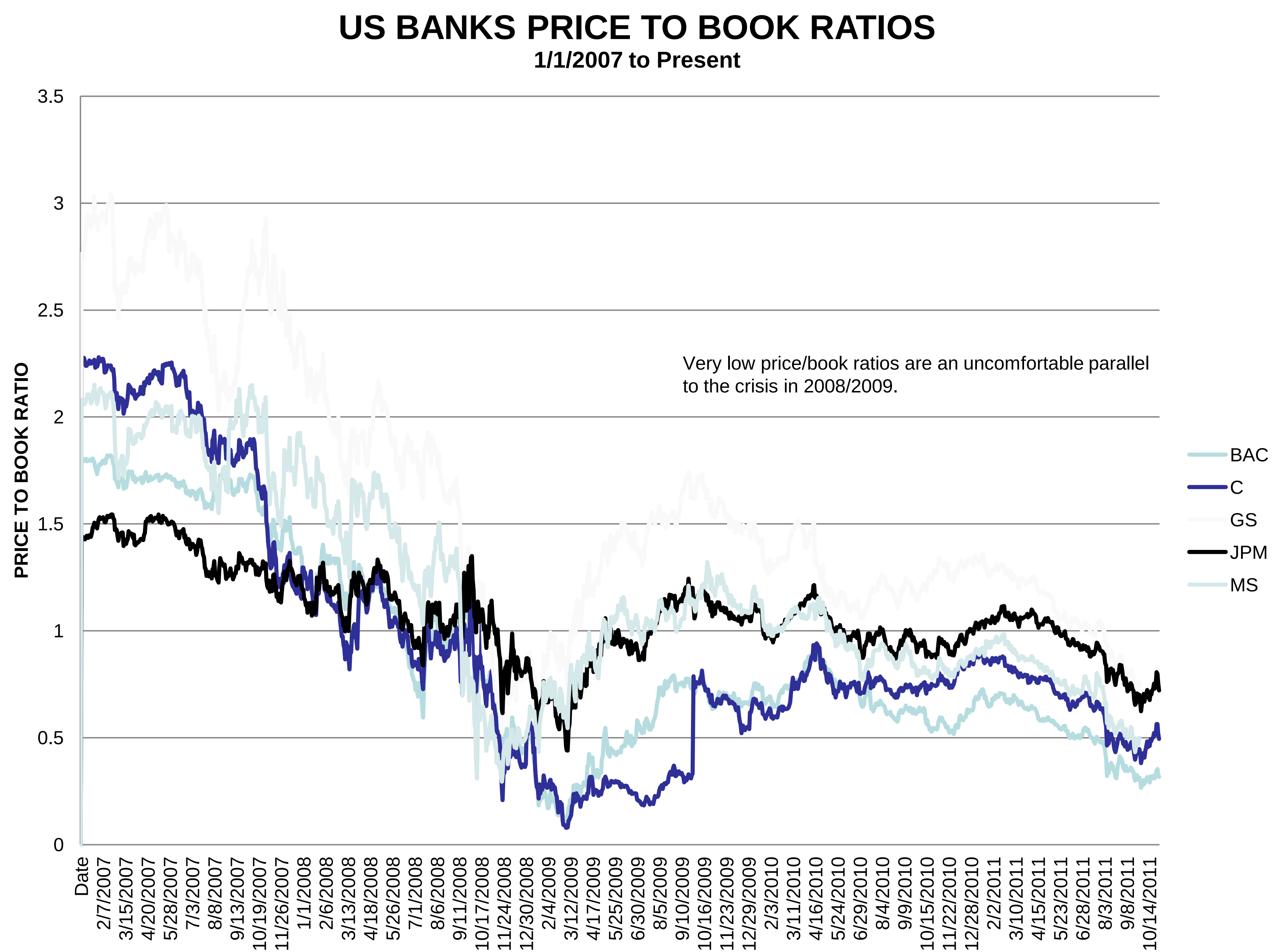
US BANKS 5-YEAR CDS

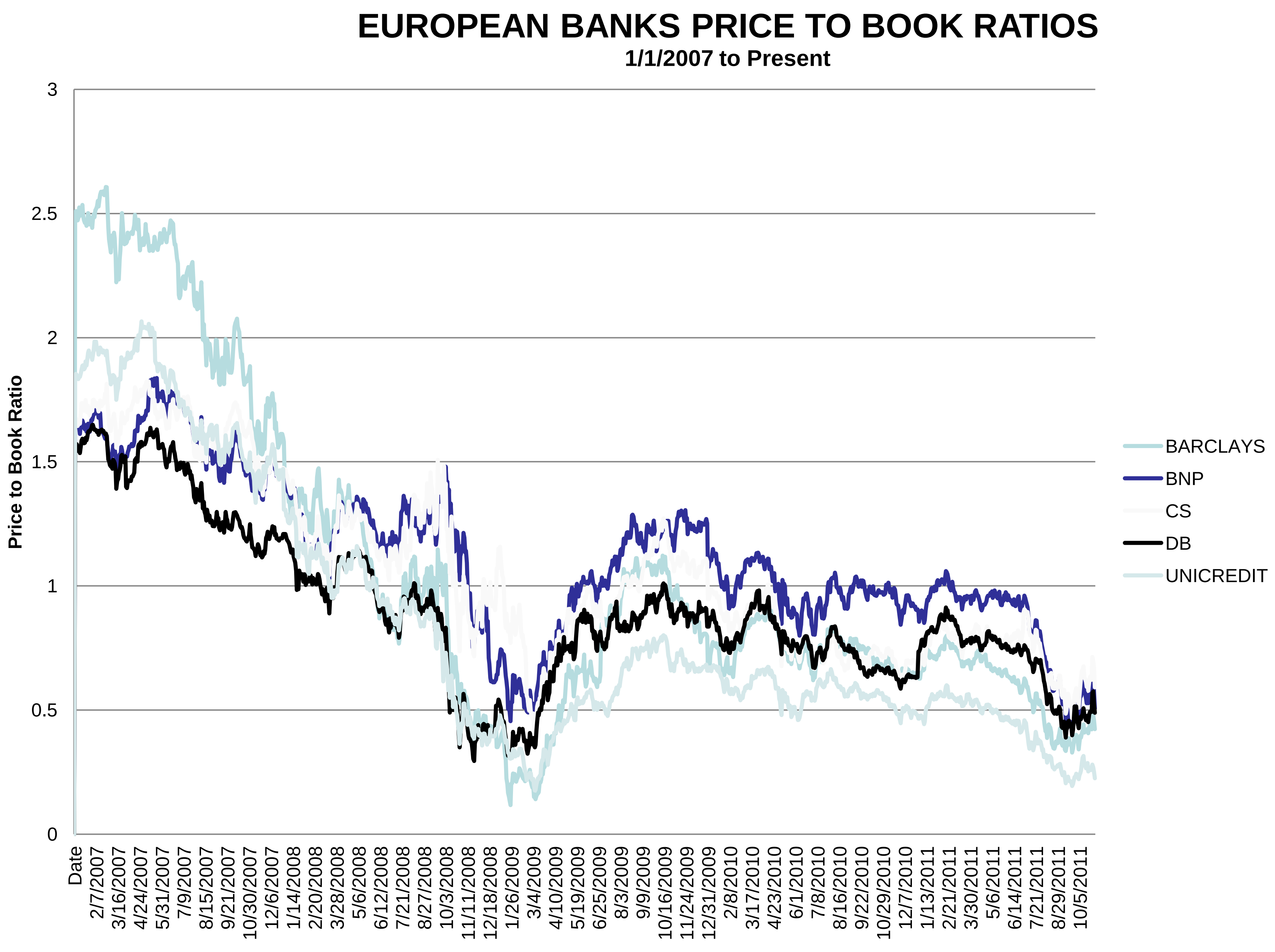
1/2007-PRESENT




EUROPEAN BANKS 5-YEAR CDS
10/2007 - PRESENT
5-YEAR CDS LEVELS
600.000
500.000
400.000
300.000
200.000
100.000
0.000
European bank CDS spreads have exceeded levels from the crisis in 2008/2009. Euro banks are at the epicenter of current global financial concerns.
10/19/2007
12/19/2007
2/19/2008
4/19/2008
6/19/2008
8/19/2008
10/19/2008
12/19/2008
2/19/2009
4/19/2009
6/19/2009
8/19/2009
10/19/2009
12/19/2009
2/19/2010
4/19/2010
6/19/2010
8/19/2010
10/19/2010
12/19/2010
2/19/2011
4/19/2011
6/19/2011
8/19/2011
10/19/2011
Barclays
BNP
Credit Suisse
Deutsche
UniCredit


EQUITY INDICES YTD RETURNS
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
-20.00%
-25.00%
-30.00%
-35.00%
-40.00%
YTD RETURNS
1/4/2011
2/4/2011
3/4/2011
4/4/2011
5/4/2011
6/4/2011
7/4/2011
8/4/2011
9/4/2011
10/4/2011
S&P
KBW Bank Index
FTSE 100
DAX
Nikkei
Hang Seng
Even after a sharp rebound after the Greek debt resolution (?), US bank stocks have performed far worse than the overall market. US equity markets, however, have outperformed most global peers.


US BANKS PRICE TO BOOK RATIOS
1/1/2007 to Present
PRICE TO BOOK RATIO
3.5
3
2.5
2
1.5
1
0.5
0
Very low price/book ratios are an uncomfortable parallel to the crisis in 2008/2009.
BAC
C
GS
JPM
MS
Date
2/7/2007
3/15/2007
4/20/2007
5/28/2007
7/3/2007
8/8/2007
9/13/2007
10/19/2007
11/26/2007
1/1/2008
2/6/2008
3/13/2008
4/18/2008
5/26/2008
7/1/2008
8/6/2008
9/11/2008
10/17/2008
11/24/2008
12/30/2008
2/4/2009
3/12/2009
4/17/2009
5/25/2009
6/30/2009
8/5/2009
9/10/2009
10/16/2009
11/23/2009
12/29/2009
2/3/2010
3/11/2010
4/16/2010
5/24/2010
6/29/2010
8/4/2010
9/9/2010
10/15/2010
11/22/2010
12/28/2010
2/2/2011
3/10/2011
4/15/2011
5/23/2011
6/28/2011
8/3/2011
9/8/2011
10/14/2011



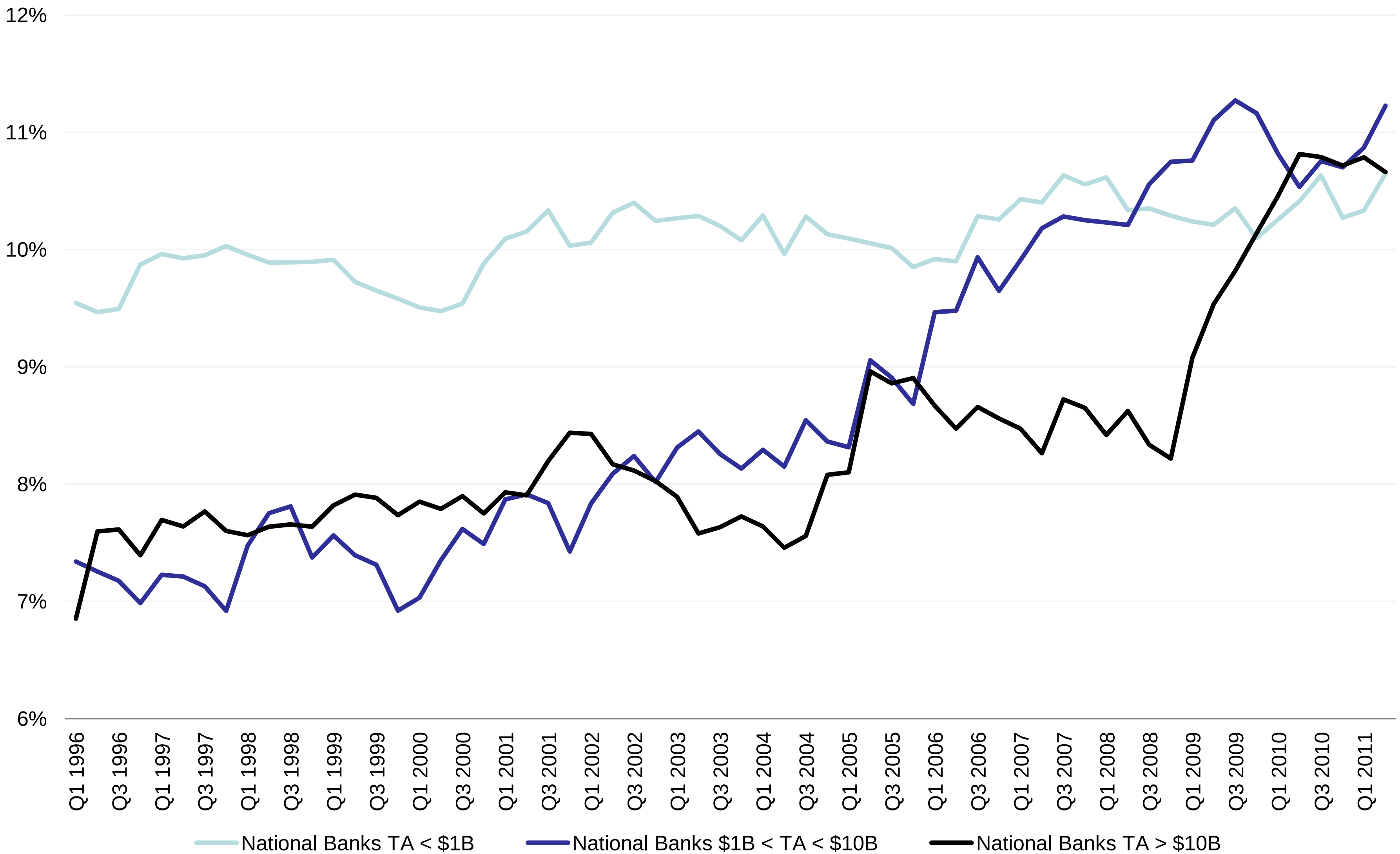
EUROPEAN BANKS PRICE TO BOOK RATIOS
1/1/2007 to Present
Price to Book Ratio
3
2.5
2
1.5
1
0.5
0
Date
2/7/2007
3/16/2007
4/24/2007
5/31/2007
7/9/2007
8/15/2007
9/21/2007
10/30/2007
12/6/2007
1/14/2008
2/20/2008
3/28/2008
5/6/2008
6/12/2008
7/21/2008
8/27/2008
10/3/2008
11/11/2008
12/18/2008
1/26/2009
3/4/2009
4/10/2009
5/19/2009
6/25/2009
8/3/2009
9/9/2009
10/16/2009
11/24/2009
12/31/2009
2/8/2010
3/17/2010
4/23/2010
6/1/2010
7/8/2010
8/16/2010
9/22/2010
10/29/2010
12/7/2010
1/13/2011
2/21/2011
3/30/2011
5/6/2011
6/14/2011
7/21/2011
8/29/2011
10/5/2011
BARCLAYS
BNP
CS
DB
UNICREDIT

Major Differences from the Crisis

- US banks in much better shape
  - Earnings recovering
  - Record levels of bank capital and liquidity
  - Improving asset quality
- Euro-centric vs. US-centric
- Push for central clearing of derivatives to reduce counterparty credit risk of derivatives
- Much stronger leveraged loan prices

"When you come to a fork in the road, take it."

Equity Capital to Total Assets

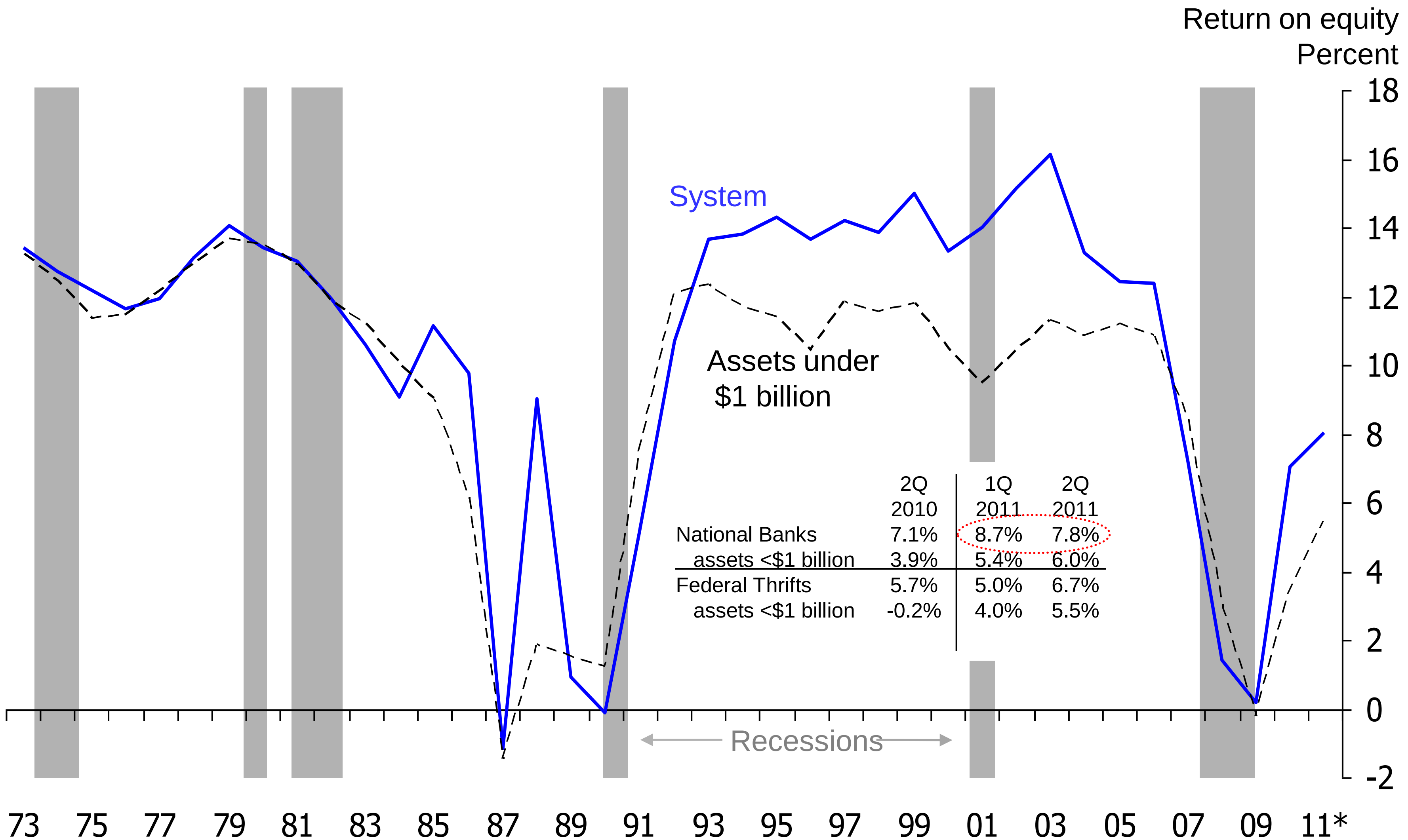


Source: Reports of Condition and Income

Condition of the Banking System

Profitability still weak

National banks and federal thrifts



	2Q 2010	1Q 2011	2Q 2011
National Banks	7.1%	8.7%	7.8%
assets <$1 billion	3.9%	5.4%	6.0%
Federal Thrifts	5.7%	5.0%	6.7%
assets <$1 billion	-0.2%	4.0%	5.5%

Source: Integrated Banking Information System (OCC)

* Data as of June 30, 2011 (annualized); all other data as of year-end. Thrift data not available (not included in chart) prior to 1984.

Revenue and expense trends remain drag on system earnings; quarterly provisions stabilizing

National banks and federal thrifts

$ billions	System				Assets <$1 billion			
	1Q:10	2Q:10	1Q:11	2Q:11	1Q:10	2Q:10	1Q:11	2Q:11
Revenues								
Net interest income	78.4	76.5	74.1	73.5	3.16	3.20	3.19	3.23
Noninterest income	46.5	44.5	43.5	43.2	1.35	1.41	1.37	1.34
Realized Sec. G/L	1.1	1.7	-0.5	0.1	.01	.03	.02	.05
Expenses								
Provisioning	39.0	29.0	14.3	13.4	0.60	0.66	0.43	0.41
Noninterest expense	66.7	68.5	71.9	73.4	3.31	3.53	3.40	3.33
Income taxes	5.9	7.9	9.4	10.0	0.16	0.12	0.19	0.24
Net income	14.2	17.0	21.4	19.9*	0.52	0.35	0.55	0.64

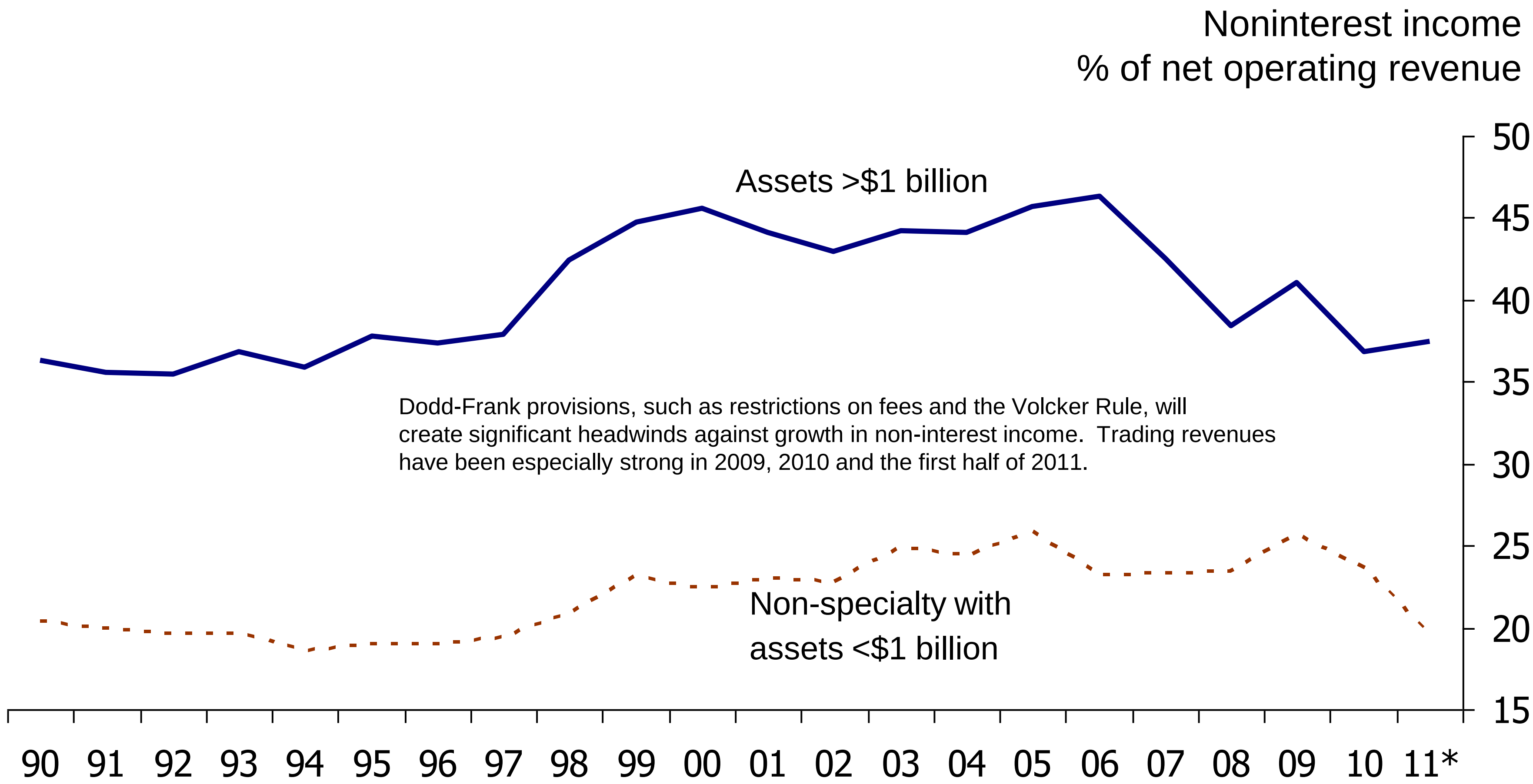
*NOTE: BAC combined OCC charters reported 2Q:11 net *income* of $3.5 billion, but Y9C HC showed a net *loss* of $8.8 billion

Source: Integrated Banking Information System (OCC)

Data are merger-adjusted and held constant for institutions in continuous operation from 1Q:06 to 2Q:11.
* BAC 2Q:11 settlement costs mostly reflected in non-bank mortgage subsidiary of holding company.

Erosion of noninterest income has contributed to pressure on earnings at big and small lenders

National banks and federal thrifts



Source: Integrated Banking Information System (OCC)

*2011 data as of June.
Net operating revenue = net interest income + noninterest income

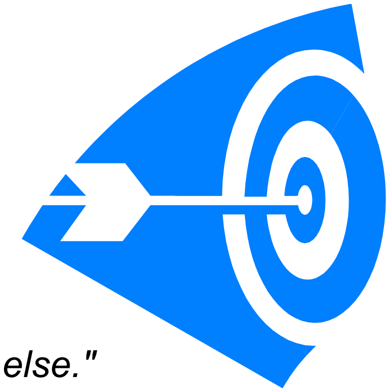
Asset Quality

Asset Quality Continues to Improve

- Delinquencies and charge-offs continue to decline, but remain elevated for some loan classes

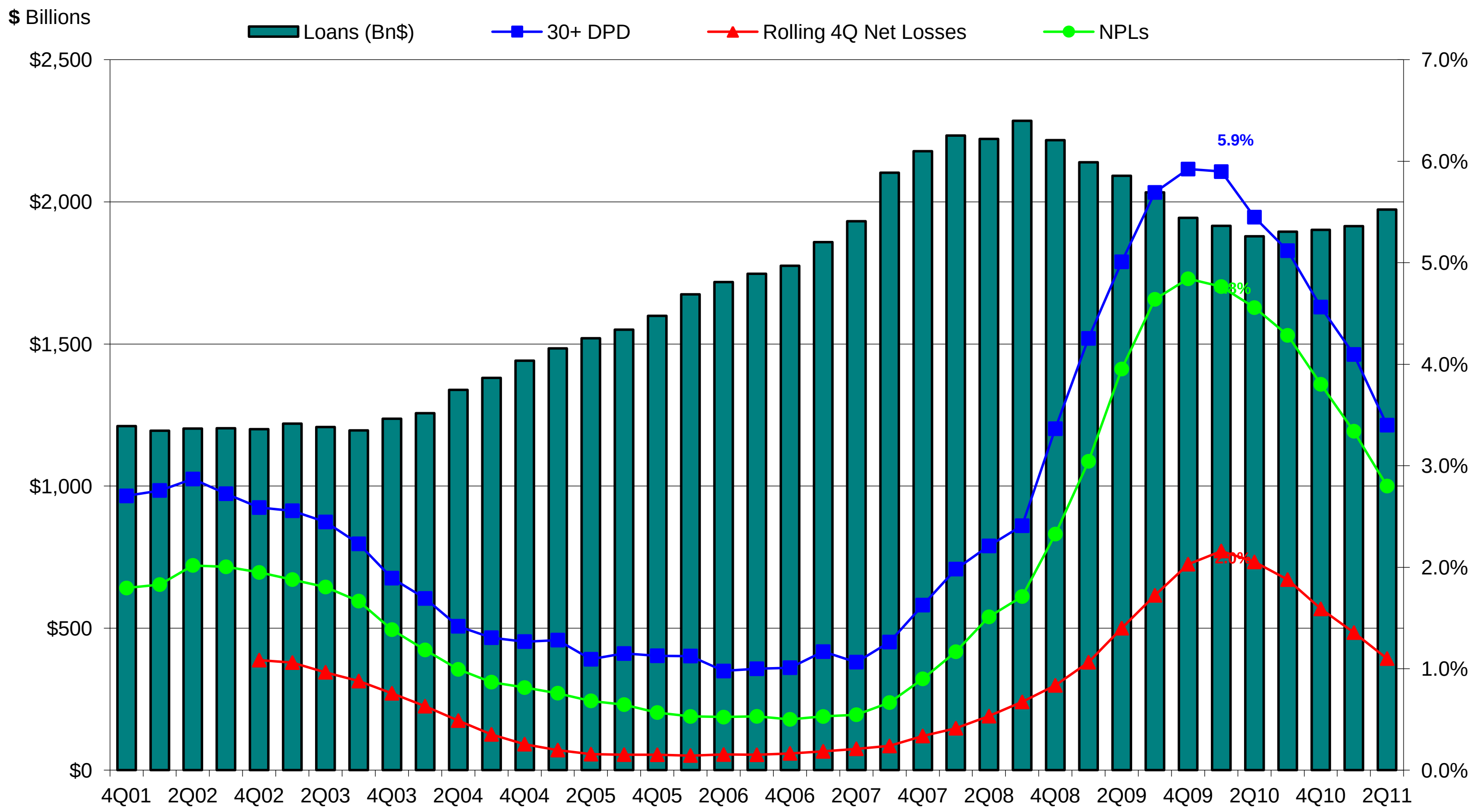
- Improving credit quality driving lower provision expense

- SNC exam showed continued improvement in classified and criticized levels



“If you don't know where you are going, you will wind up somewhere else."

Commercial loan performance

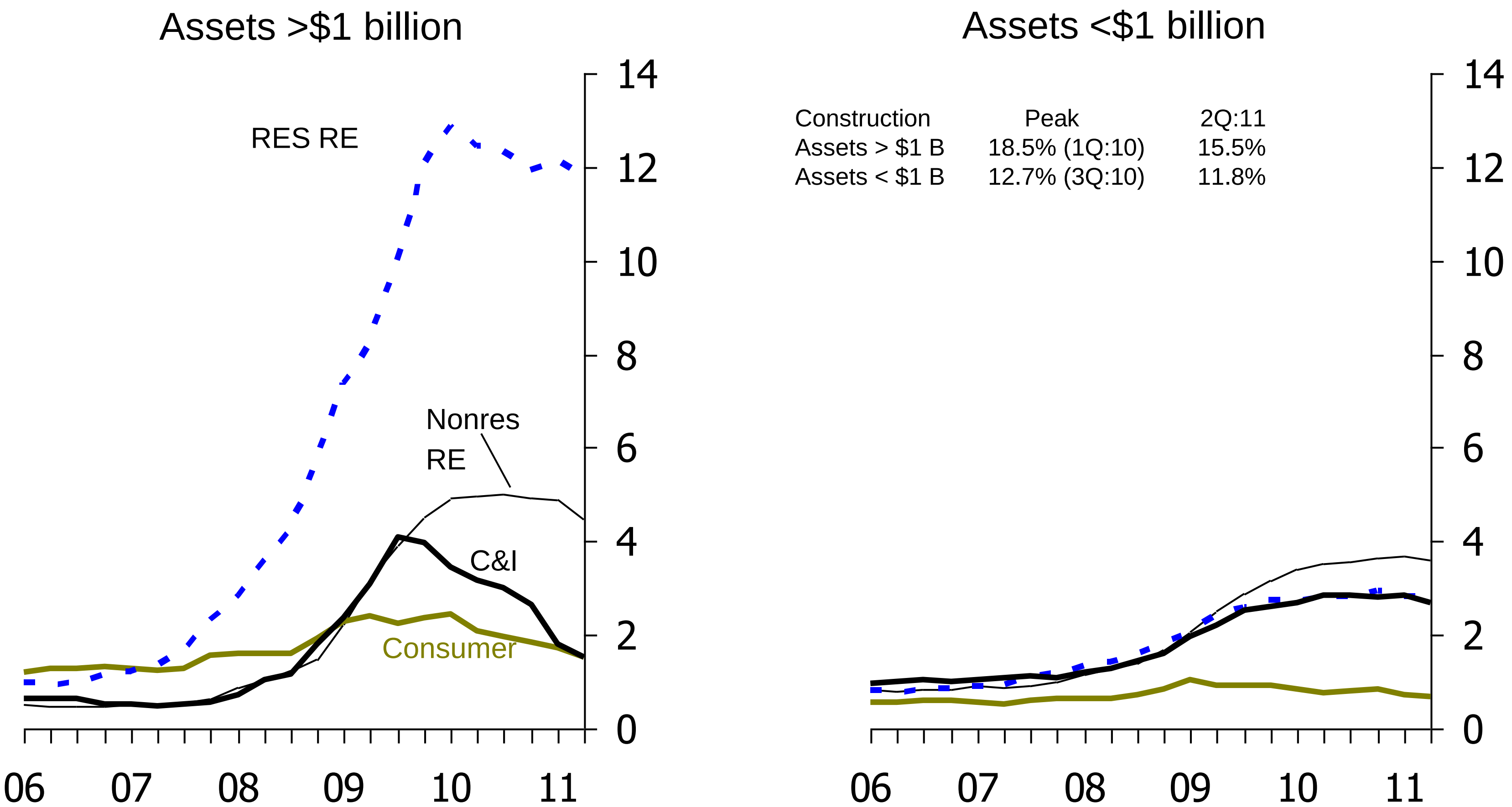


National banks. C&I, CRE, loans to depositories, government, agricultural, and all other commercial loans and leases.
Source: Consolidated Reports of Condition and Income

Noncurrents continue to improve; mortgage loans and small lenders still lagging

National banks and federal thrifts

Noncurrent loans, Percent

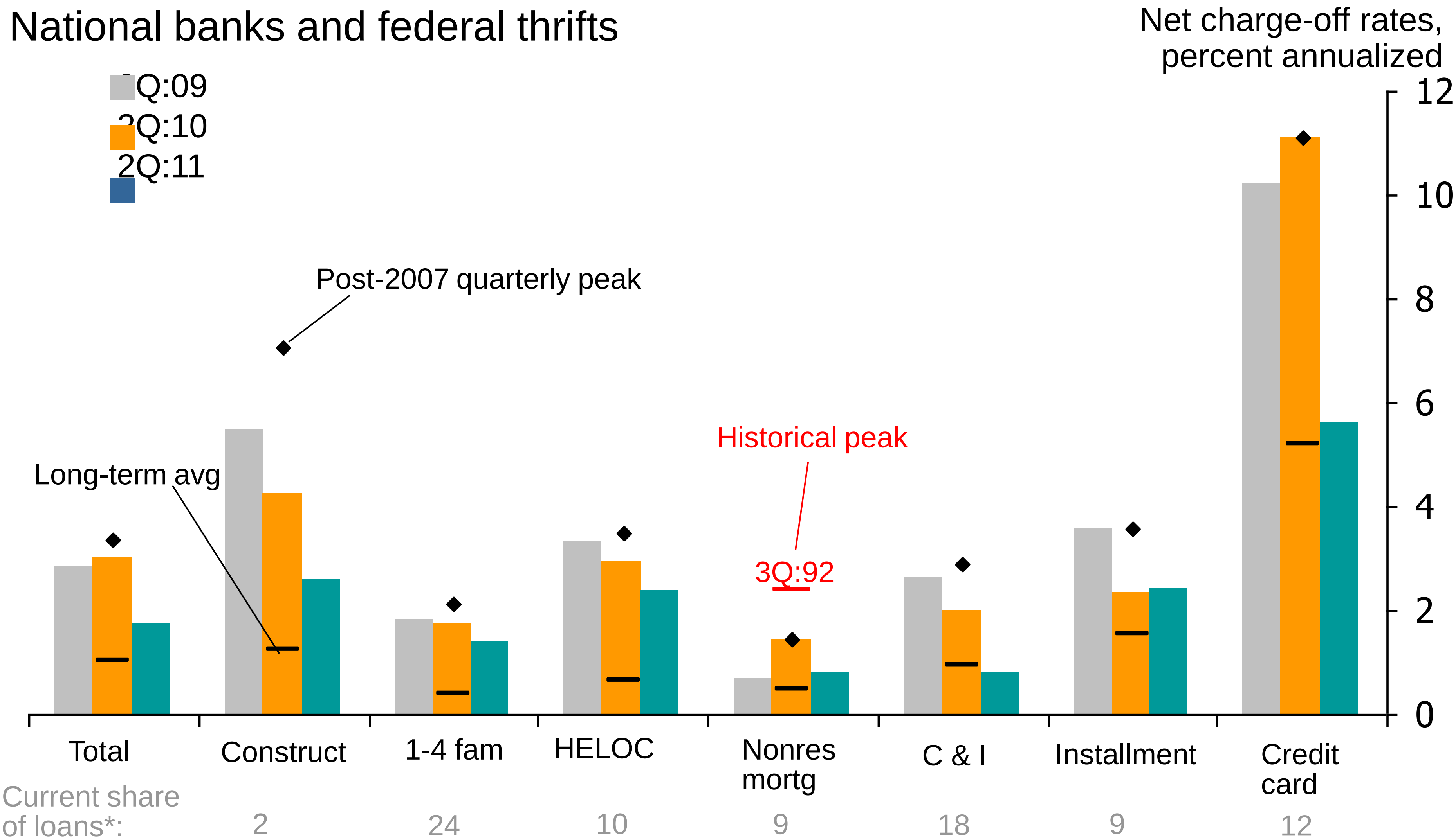


Source: Integrated Banking Information System (OCC)

Data are merger-adjusted and held constant for institutions in continuous operation from 1Q:06 to 2Q:11.

System charge-off rates down from year-ago levels but still high; RES RE decline lags

National banks and federal thrifts

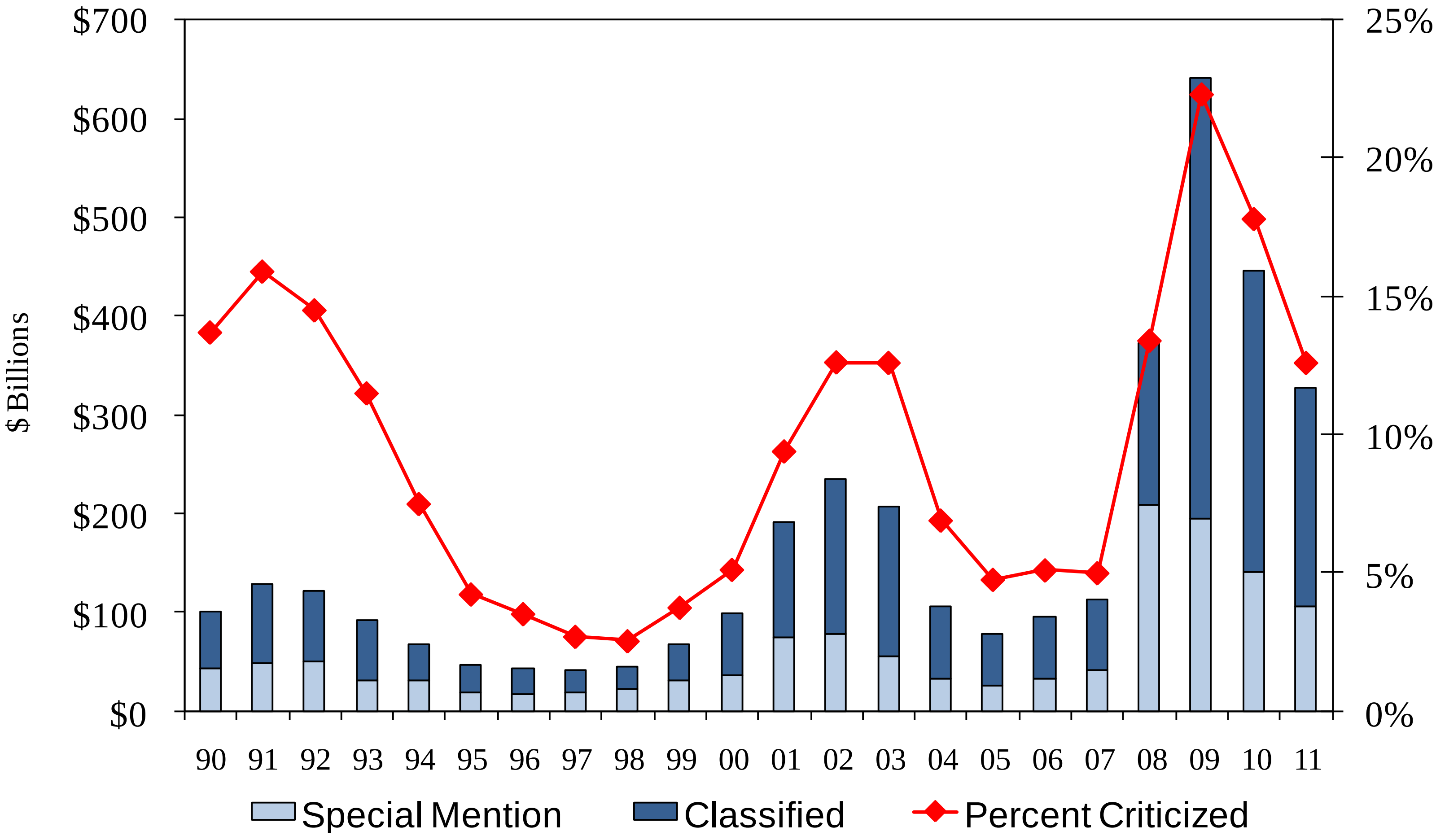


Source: Integrated Banking Information System (OCC)

Net charge-offs as a percent of loans in respective category. Not all detail loan categories are shown.

2011 SNC Summary

Criticized and classified commitments and percentages continue to decline but are still at historically high levels.



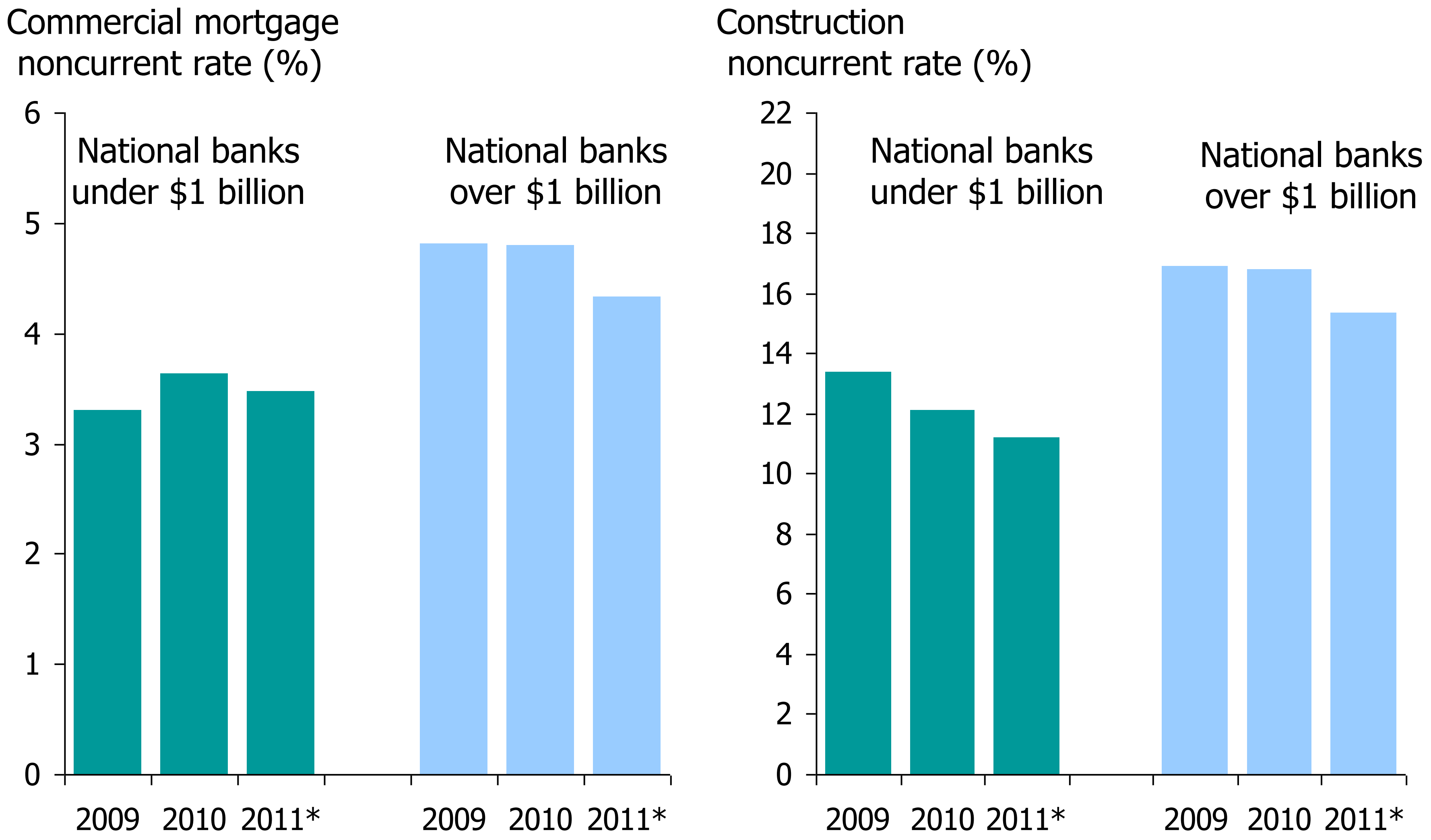
Commercial Real Estate

CRE Improving but Challenges Remain

- Delinquencies and losses improving
- Construction & development remain problematic for some banks
- Concentrations down, but remain worrisome for some small banks
- Slower economic growth likely means slower improvement in vacancy rates

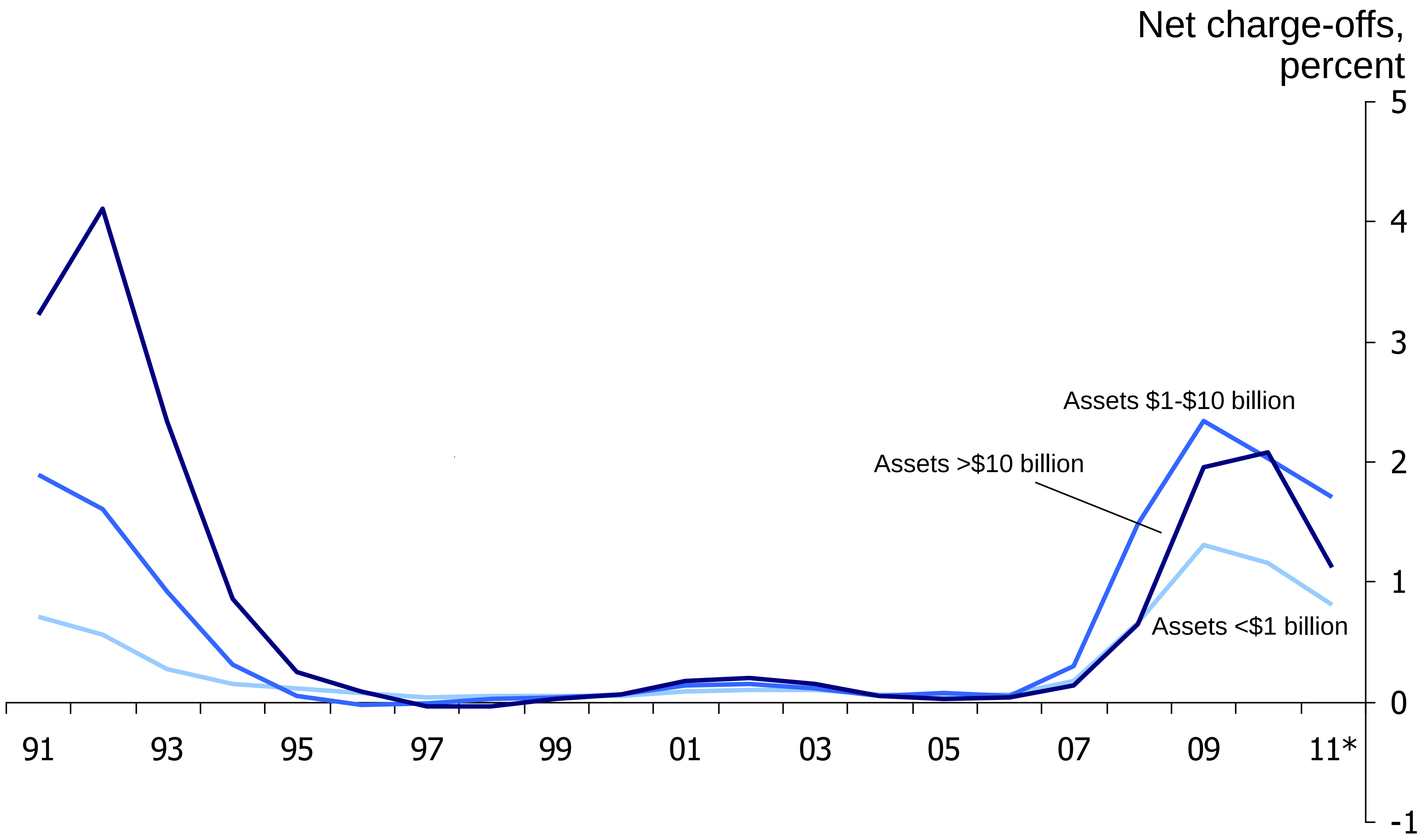
“You can observe a lot just by watching.”

CRE Delinquencies Declining, but Remain High



Sources: Reports of Condition and Income
Note: 2011* data as of 2011Q2. Commercial mortgage includes multi-family mortgages.

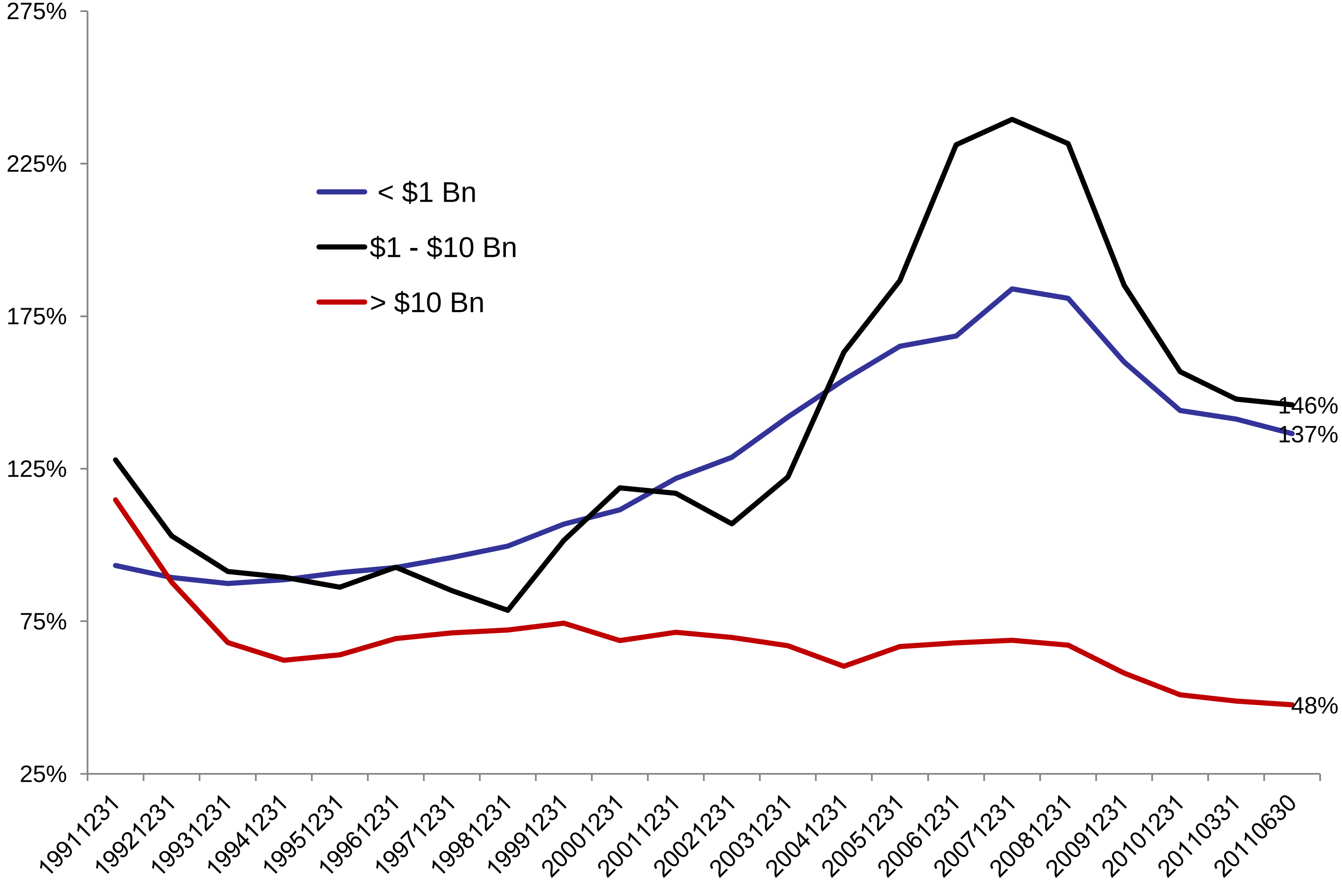
CRE Charge-off Rates Continue to Decline



Source: Integrated Banking Information System (OCC)

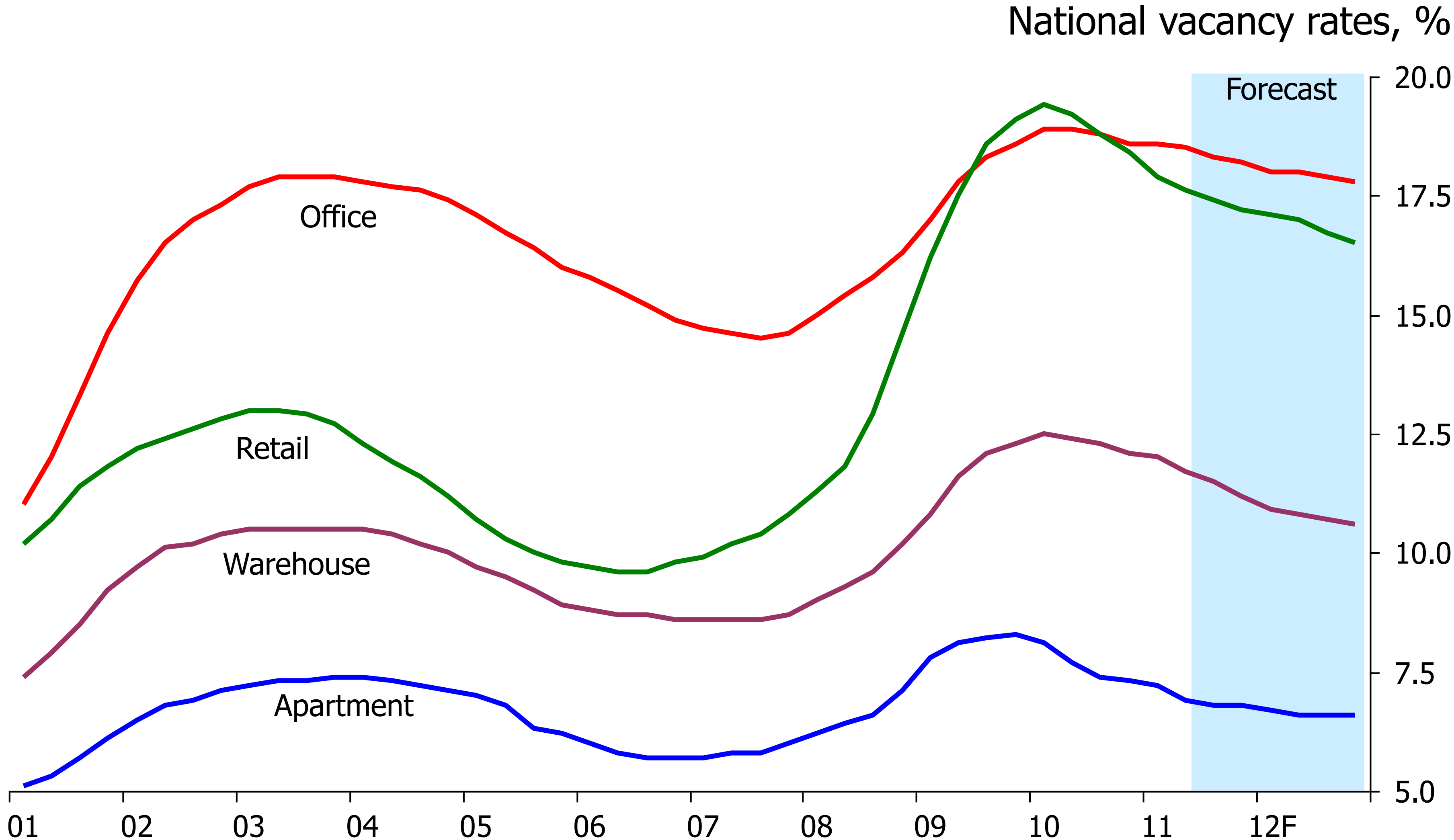
* 2011 data as of June 30, 2011 (year-to-date annualized): all other data as of year-end. Commercial real estate includes nonresidential, multifamily and construction.

CRE Concentrations Remain Elevated for National Banks with Assets < $10B



Source: Integrated Banking Information System (OCC)

Down-shift in economic forecast implies slower improvement in CRE vacancy rates

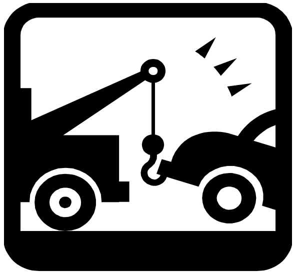


Source: Property & Portfolio Research; 2011Q2 original baseline and sluggish recovery forecast

Residential Mortgage Risk

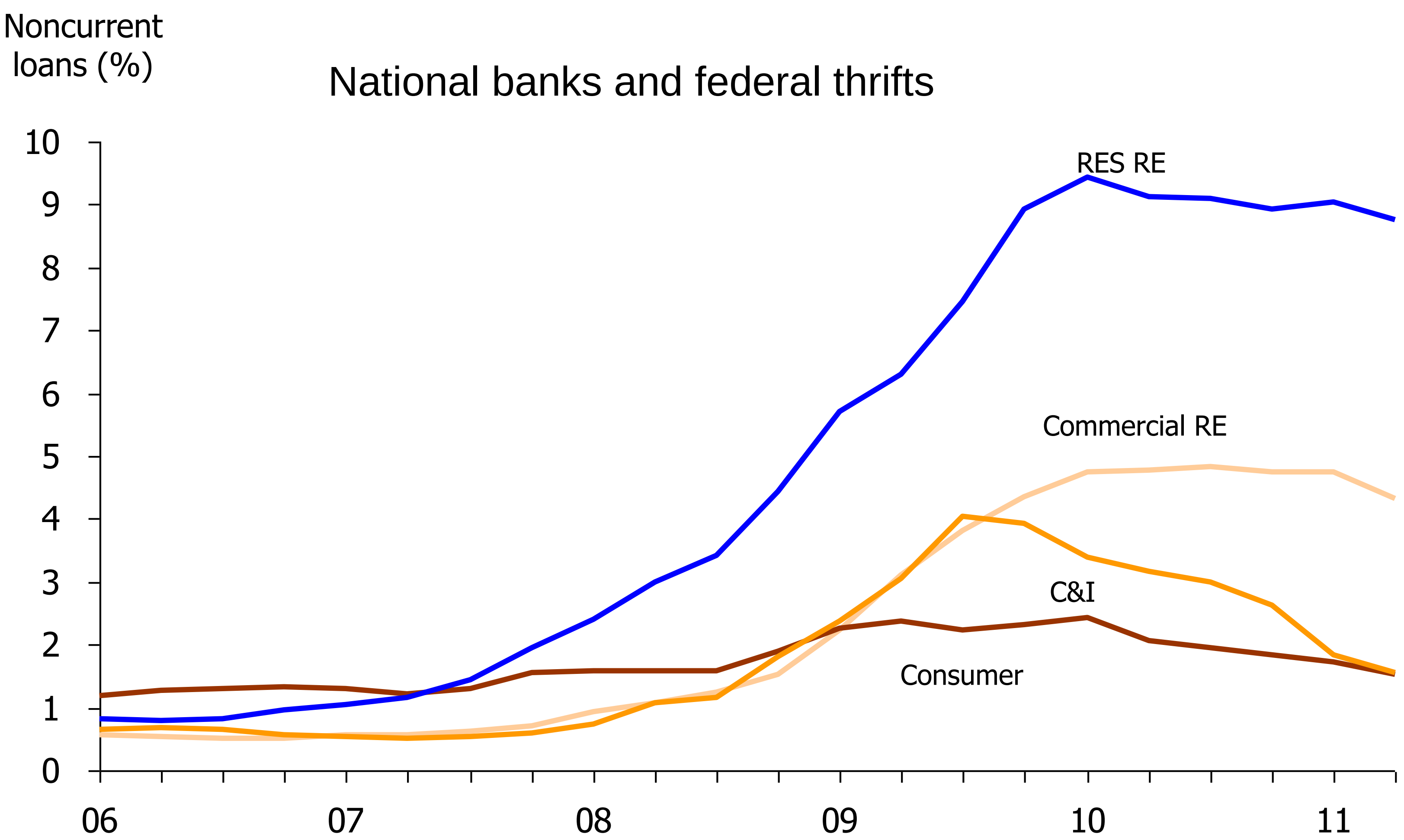
Residential RE Slow to Recover

- Residential mortgages lag behind other loan types in credit improvement
- Record-high levels of foreclosure still weigh on the market
- Mortgage resolution costs continue to build
  - Contingent liabilities for mortgage settlements a big unknown; could be one year of earnings
    - GSE put-backs
    - Robo-signing
    - Reps/warrants on private label deals



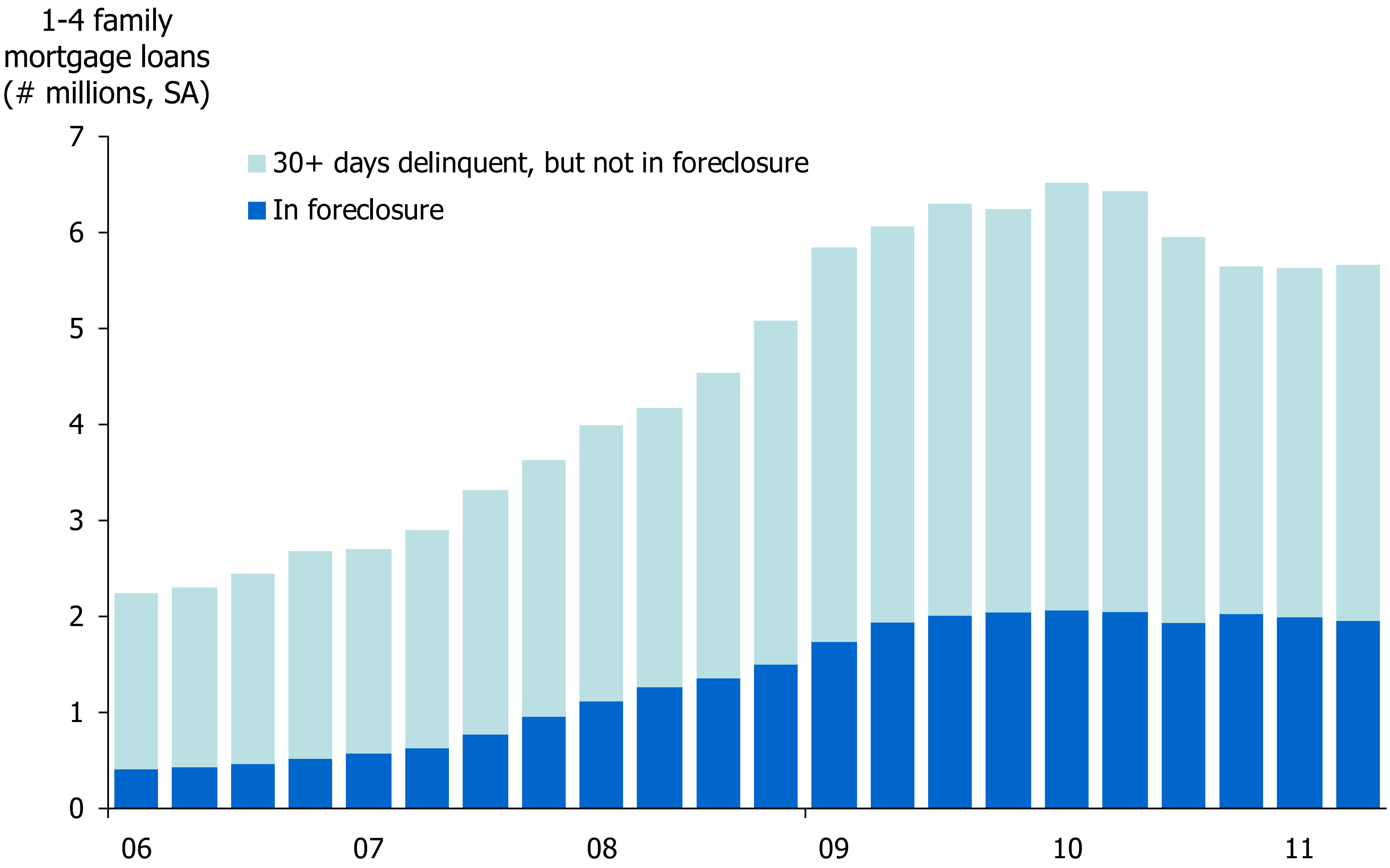
"We made too many wrong mistakes."

Noncurrents continue to improve, mortgage loans still lagging



Sources: IBIS (Call Report)
Note: Data are merger adjusted and population is held constant.

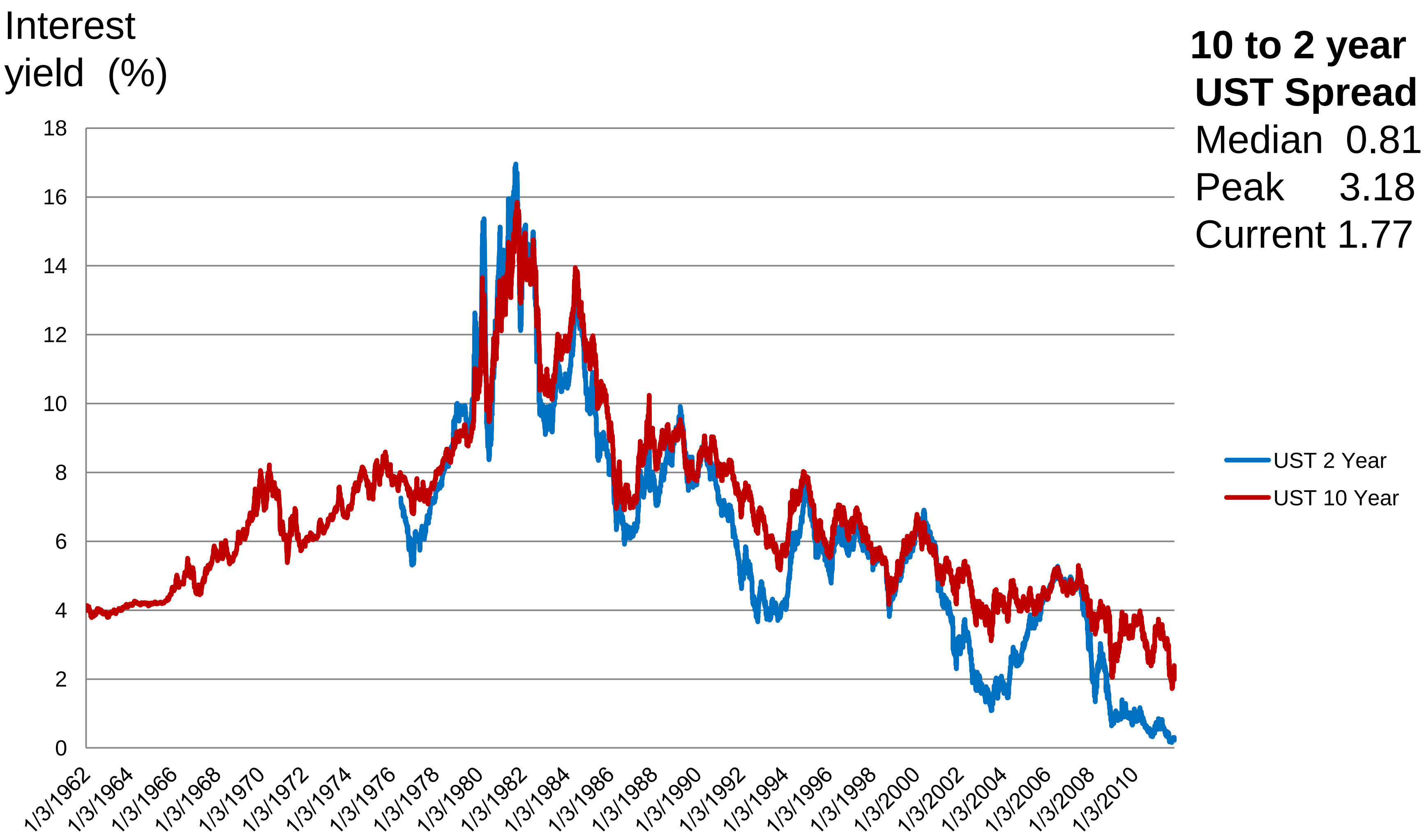
Distressed properties still loom over housing market



Source: Mortgage Bankers Association

Interest Rate & Liquidity Risks

Treasury yields at historic lows



10 to 2 year UST Spread

Median 0.81

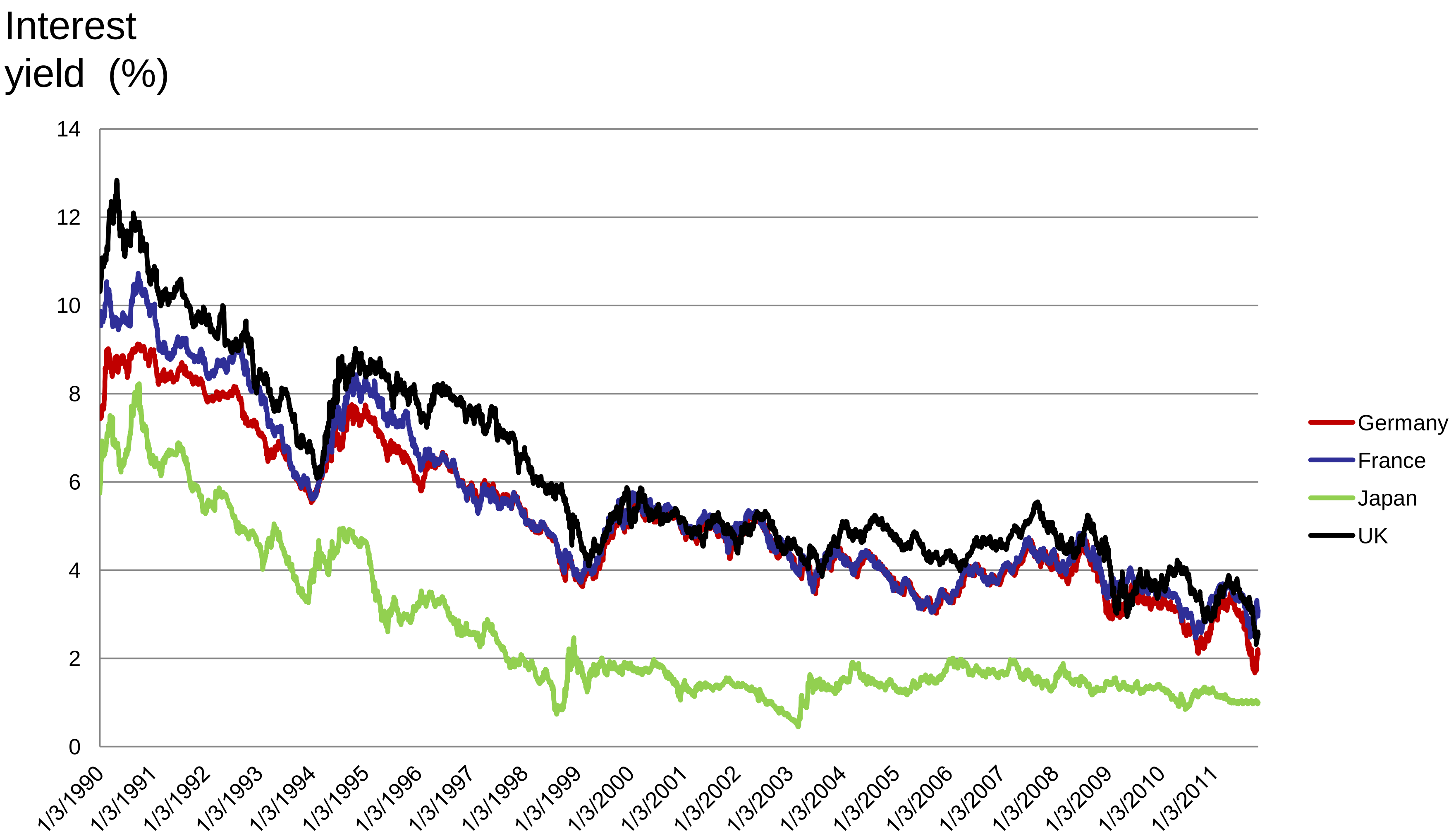
Peak 3.18

Current 1.77

Sources: Bloomberg

Treasury yield curve estimates, coupon equivalent par-yields.
Updated as of October 31, 2011.

Sovereign 10 Year Yields

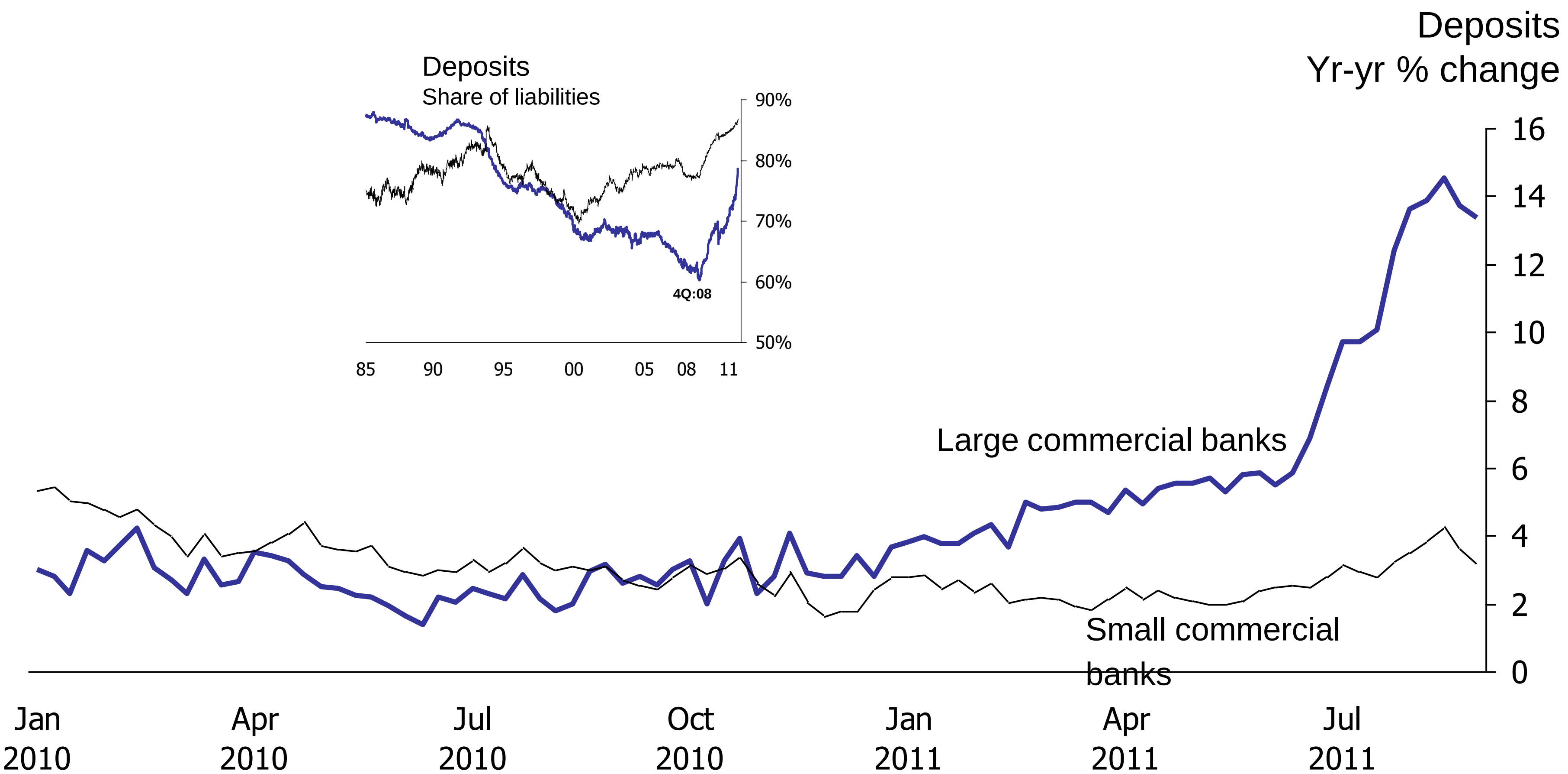


Sources: Bloomberg

Updated as of October 31, 2011.

Large banks have seen further surge in deposits since June

Commercial banks



Weekly data through Aug 31ST, 2011

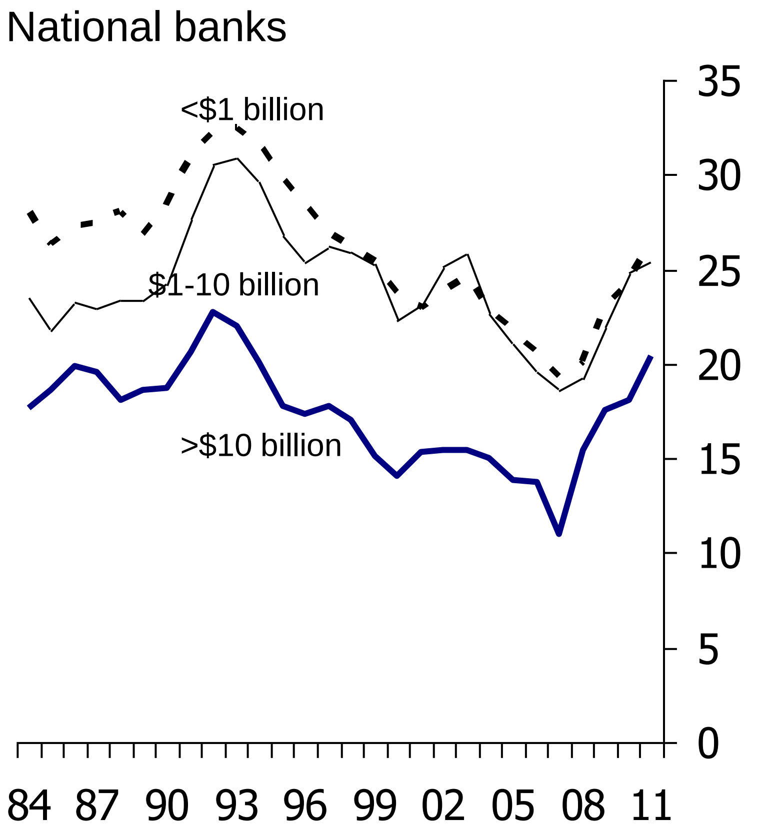
Source: Federal Reserve weekly H.8 data (domestically chartered institutions)

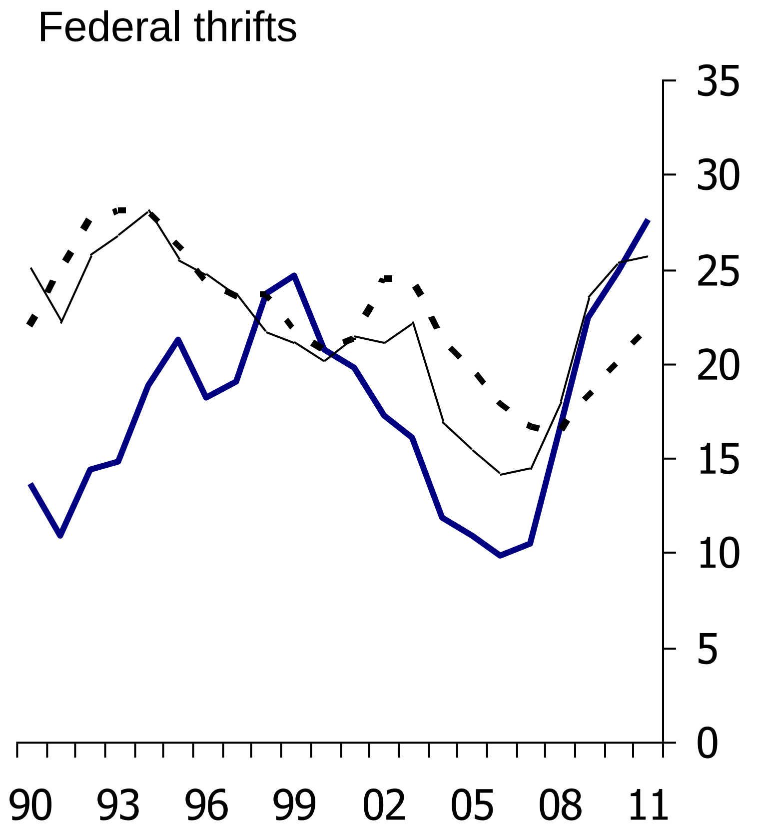
Weekly data as of Wednesdays. Large domestically chartered commercial banks are defined as the top 25 domestically chartered commercial banks, ranked by domestic assets in most recently available Call Report. All others are placed in sample for small domestically chartered commercial banks. Data are adjusted to remove the estimated effects of mergers and panel shifts between these two groups.

Liquid asset share is already at historically high levels at largest banks and thrifts

National bank and federal thrifts

Cash and U.S. govt. securities, % of assets





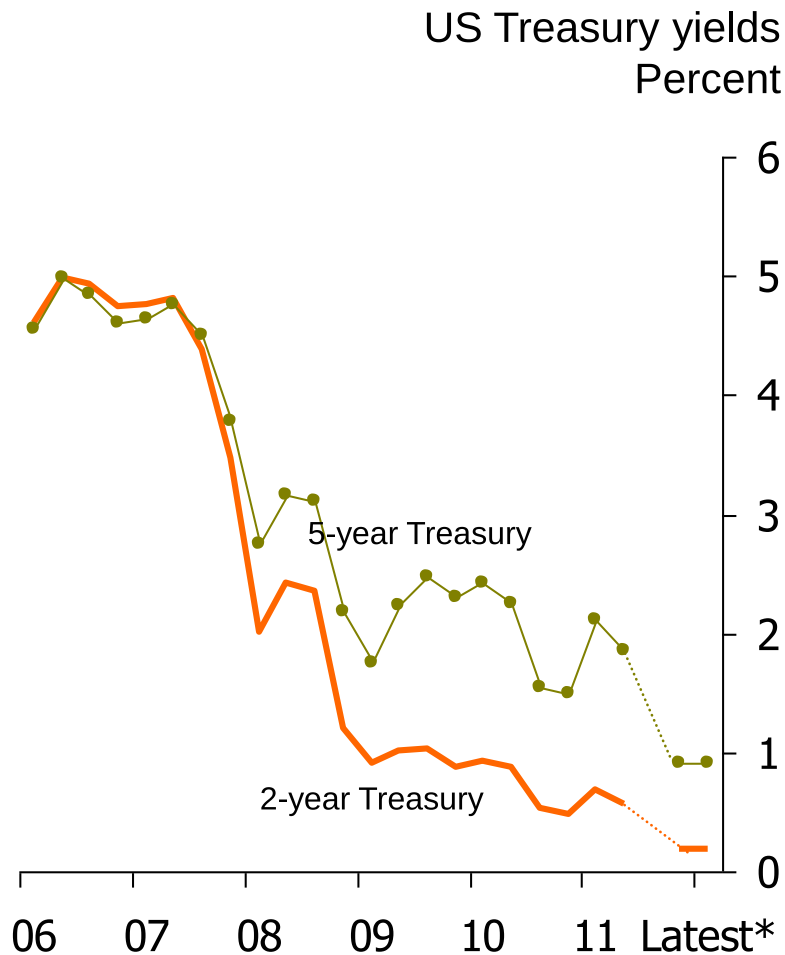
NOTE: cash data for thrifts not comparable prior to 1990

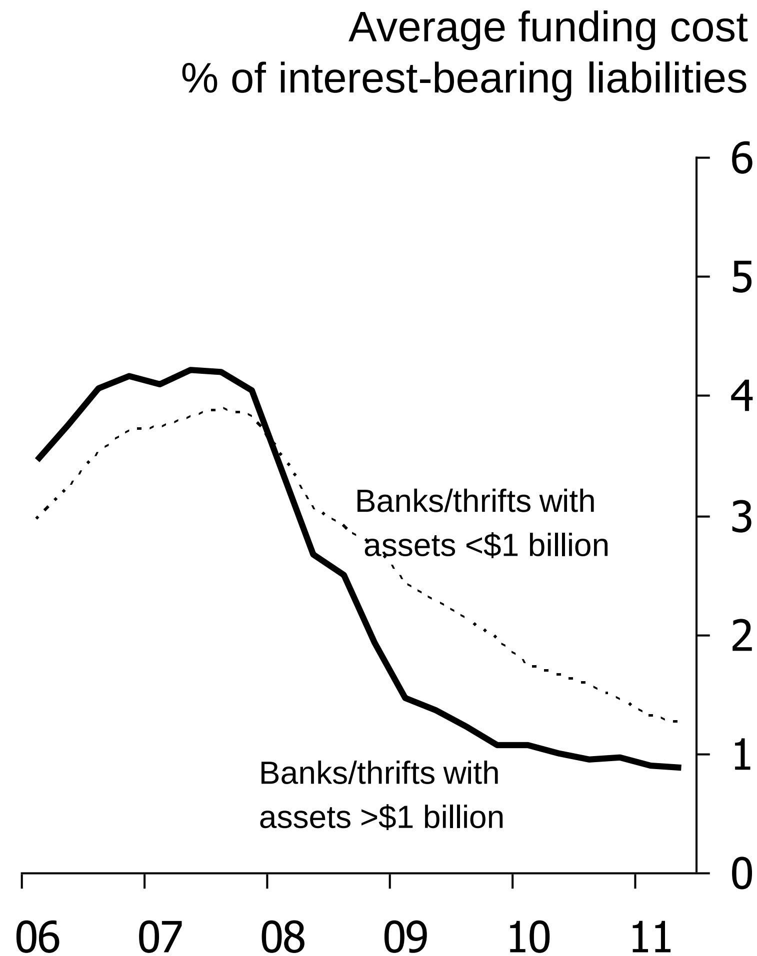
Source: Integrated Banking Information System (OCC)

Data are for combined charters where holding company present. Mixed holding company underlying charters are assigned to either bank or thrift group based on majority of assets.

Decline in safe asset yields and flatter yield curve further pressure margins

National banks and federal thrifts

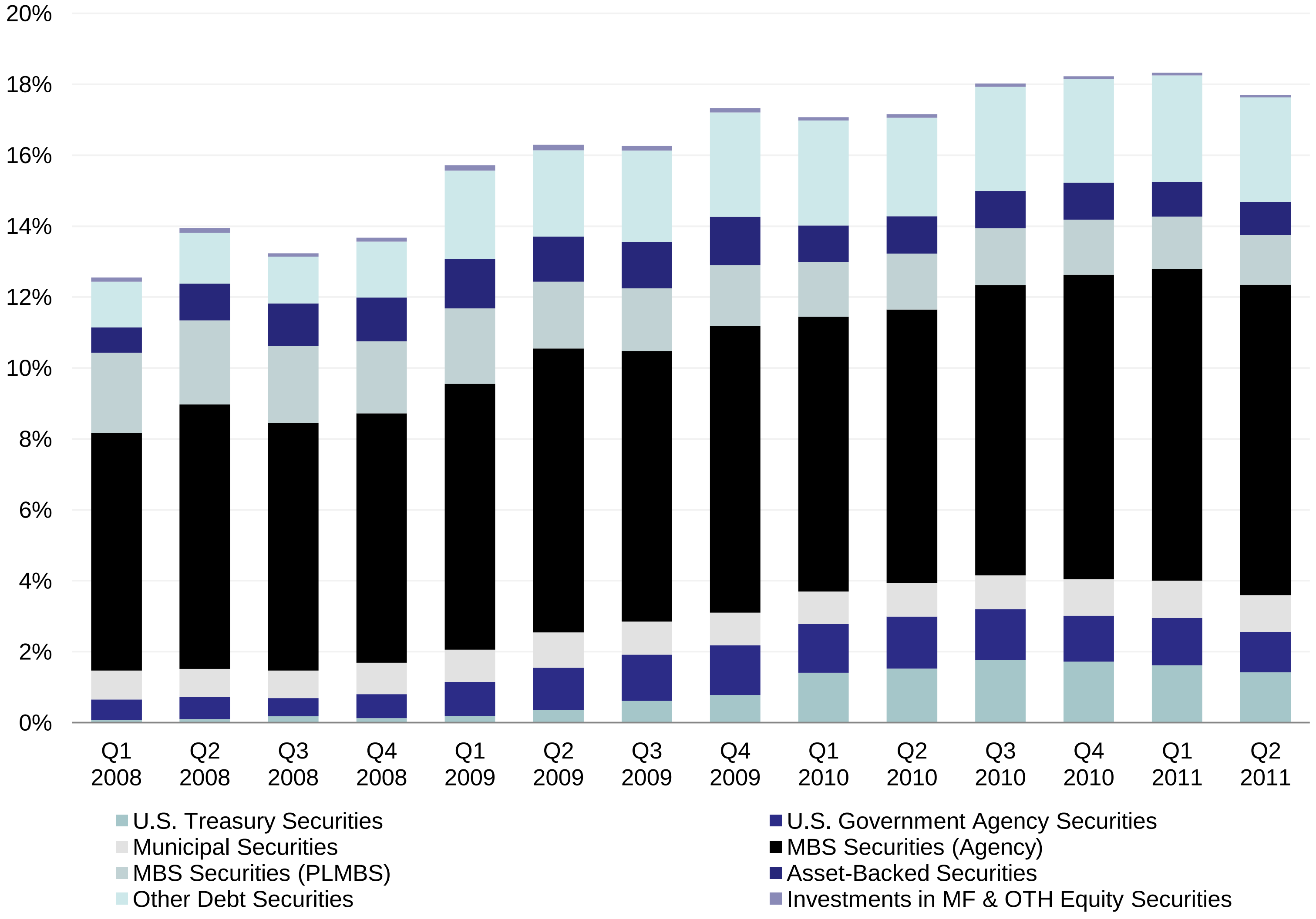




Source: Integrated Banking Information System (OCC)

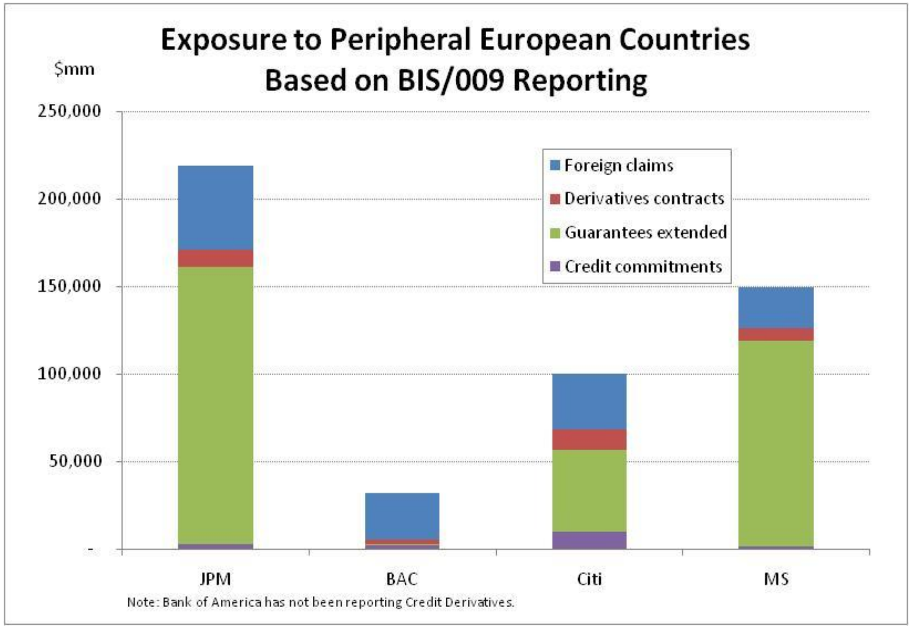
* UST yields as of 9/14/2011. Bank/thrift data are merger-adjusted and held constant for institutions in continuous operation from 1Q:06 to 2Q:11.

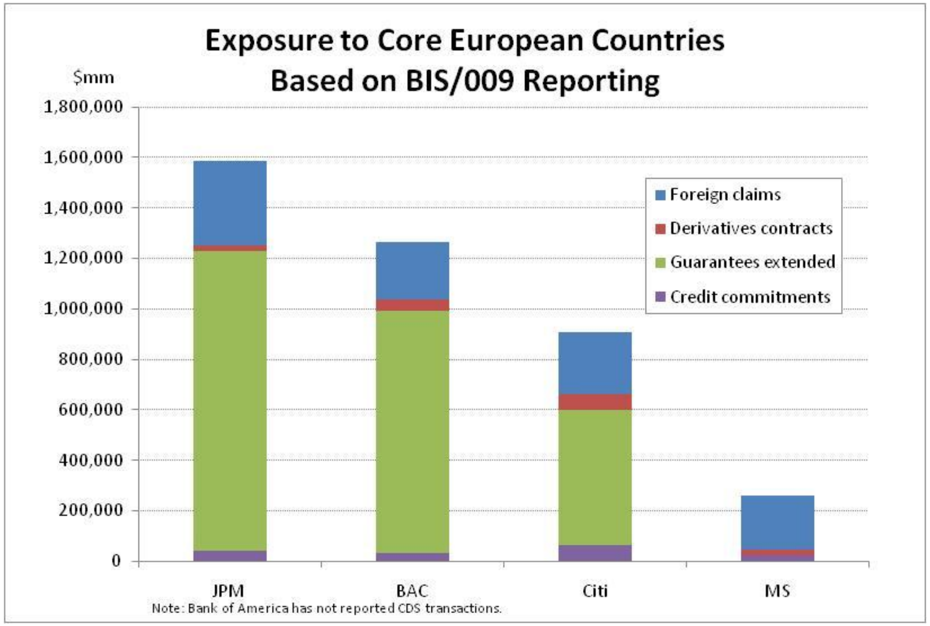
Excess Liquidity Feeds Growth in Investment Securities Centered in MBS

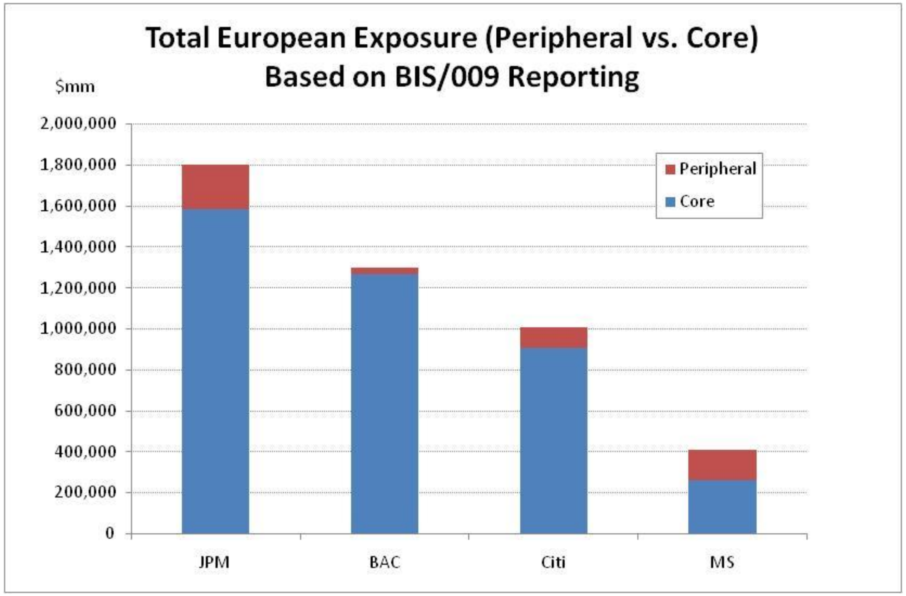


Source: Reports of Condition and Income

European Sovereign Debt Crisis

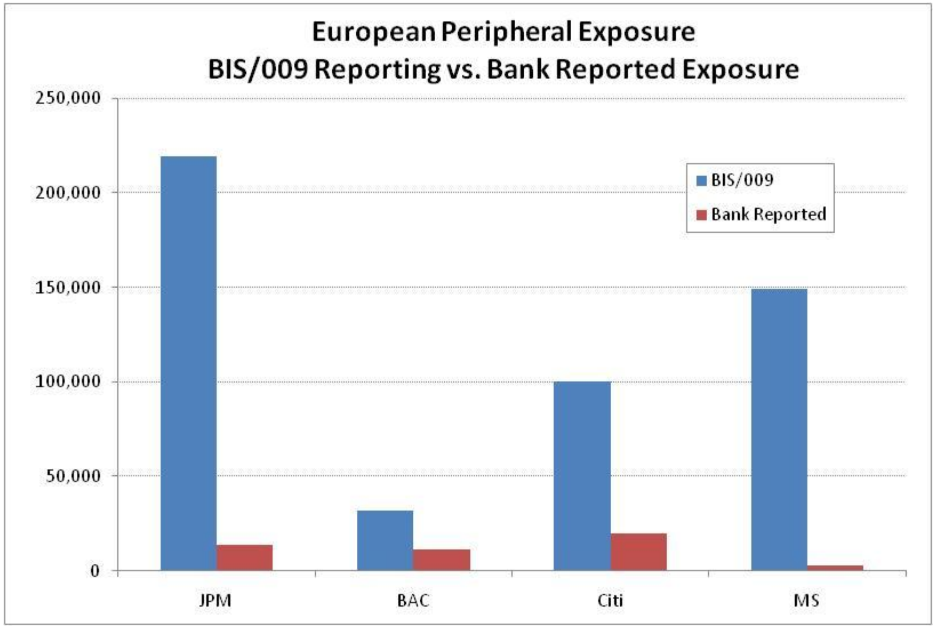


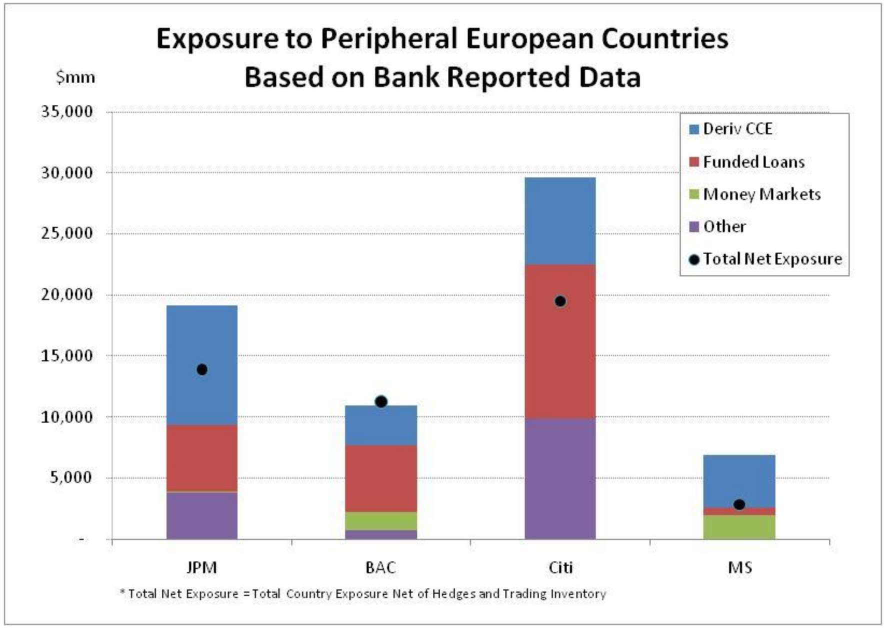


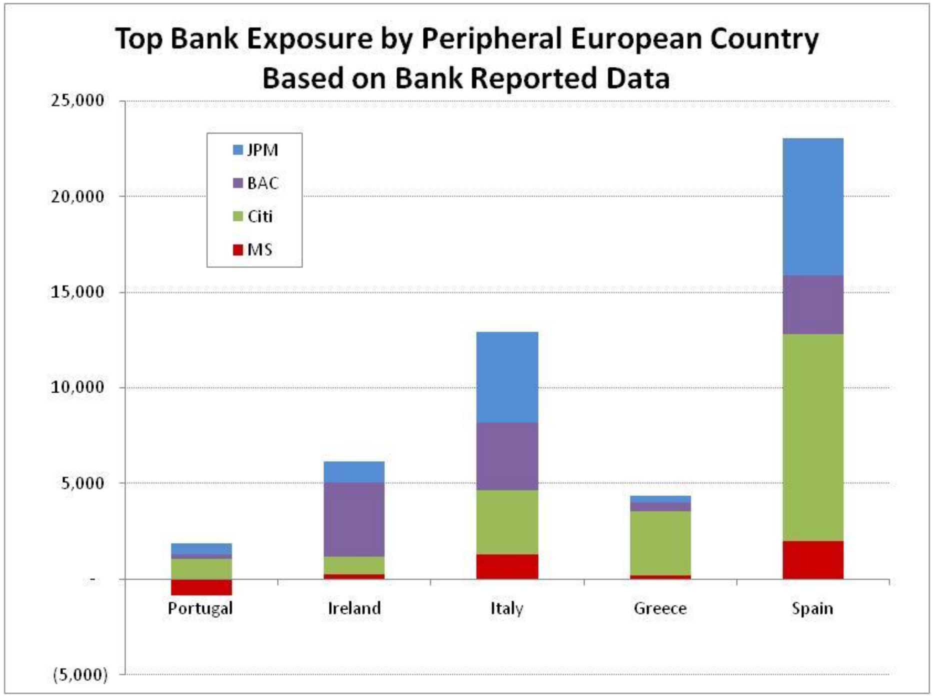


- U.S. banks and BHCs report cross-border exposures via form FFIEC 009, which feeds the widely-cited BIS cross-border banking statistics
- FFIEC 009 data show that “Guarantees extended” is the major component of country exposure
- CDS protection sold is the dominant component of guarantees extended
- “Foreign claims” includes loans, securities, repo activity, etc.
- Peripheral exposures are a very small part of total country exposures

“Half the lies they tell about me aren’t true.”







- Credit exposure from bank submissions is less than 10% of CE from the 009 data
- Major differences are treatment of credit derivatives, repurchase agreements and securities trading
- Our measure of bank risk considers hedging, CVA and short positions in securities
- Some banks are net “short” in various countries
- Peripheral exposure manageable with Italy and Spain a modest concern

Regulatory Reform

Dodd-Frank Act – Key Provisions for OCC

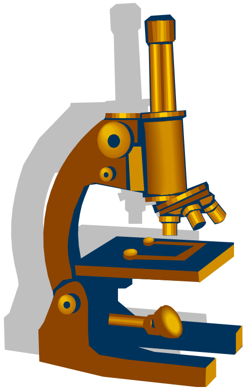
- Volcker Rule
- OTC Margin Rules
- Systemically Important Financial Institutions
- Securitization
- CFPB
- Orderly liquidation authority
- Heightened prudential standards
- Financial Stability Oversight Commission
- Removing Use of Credit Ratings in Regulations

"It gets late early out there."

Volcker Rule

- Bans proprietary trading
- Statute provides regulators significant flexibility
- Banks have already shut down “pure prop trading” desks
  - Separate unit
  - No client contact
  - Covered by “the street”
  - Price takers, not price makers
- Many exemptions – weakens scope of the rule
- Key area of focus is degree to which prop trading activities are buried within permitted market making function

"It was impossible to get a conversation going; everybody was talking too much."



Swap Margin Rules

- US prudential supervisors proposed swap margin rules that fundamentally change current business practice for dealers
  - Initial margin required, segregated at independent third parties
    - Potentially significant liquidity impact
  - Proposed application creates competitiveness issues due to extraterritoriality concerns

"A nickel isn't worth a dime today."

Emerging Risks

CDS Effectiveness

- Most major banks use credit default swaps to hedge their “tall tree” credit exposures
- Greek “voluntary” debt exchange will not constitute a credit event, so no CDS payout
- If politicians can invalidate CDS protection, what is the value of CDS?
- Are bank exposures correctly stated?

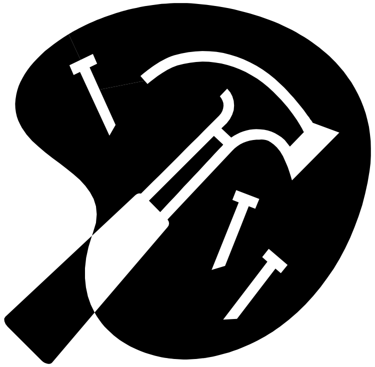
"Nobody goes there anymore; it's too crowded."

Transfers from AFS to HTM

- A number of banks have made large transfers from AFS portfolios to HTM
  - Basel capital rules will require OTI to be part of regulatory capital
- Absence of loan demand has led to large purchases of negatively convex MBS, at the lowest yields ever
- Rates have been low for a long time
- Central bank policy has encouraged maturity extensions
- A contrarian might say we’re due for an unpleasant surprise
- Interest rate risk, usually a lower order risk for banks, is increasing sharply

“If you don’t know where you’re going, you might end up some place else.”

Alternative Termination Events Valuation Adjustment (“ATEVA”)



- Also known as Replacement Valuation Adjustment, or “RVA”
- Banks are attempting to model RVA as an adjustment to the derivative MTM
    - This is in addition to CVA and DVA
        - CVA and DVA account for default probabilities
        - RVA accounts for the impact of rating downgrades
    - RVA arises from “Alternative Termination Events” (ATE) clause in ISDA-governed confirmations
    - Typically requested by counterparty as protection against a deterioration in the bank’s credit rating
    - Allows counterparty to terminate a trade against a bank if the bank’s credit rating falls below a pre-defined threshold
    - Bank would be responsible for any replacement costs incurred by the counterparty upon the decision to unwind
        - Typically, the replacement costs would be the MTM plus transactions costs
            - Transactions costs = bid/offer
- ATE clauses have always existed, but heightened awareness of counterparty risks are leading banks to attempt to measure its value

"I didn't really say everything I said."