MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the First Defiance Third Quarter 2009 Conference Call. All participants will be in listen-only mode. [Operator Instructions]. After today's presentation, there will be an opportunity to ask questions. [Operator Instructions]. Please note this event is being recorded.

I would now like to turn the conference over to Carol Merry. Please go ahead.

Carol Merry, Vice President, Fahlgren Mortine Public Relations

Thank you. Good morning, everyone and thank you for joining us for today's third quarter 2009 conference call. This call is also being webcast and the audio replay will be available at the First Defiance website at fdef.com.

Providing commentary this morning will be Bill Small, Chairman, President and CEO of First Defiance and Don Hileman, Executive Vice President and Chief Financial Officer. Following their prepared comments on the company's strategy and performance, they will be available to take your questions.

Before we begi0n, I'd like to remind you that during the conference call today, including during the question and answer period, you may hear forward-looking statements related to future financial results and business operations for First Defiance Financial Corp. Actual results may differ materially from current management forecast and projections as a result of factors over which the company has no control. Information on these risk factors and additional information on forward-looking statements are included in the news release and in the company's reports on file with the Securities and Exchange Commission.

And now, I'll turn the call over to Mr. Small for his comments.

William J. Small, Chairman, President and Chief Executive Officer

Thank you, Carol. Good morning and thank you for joining us for the First Defiance Financial Corp conference call to review the 2009 third quarter results. Last night, we issued our earnings release for the quarter and this morning we would like to discuss that release and look forward to the balance of 2009. At the conclusion of our presentation, we will answer any questions you might have.

Don Hileman, our CFO will be joining me on the call this morning to give you more financial details on the quarter. Also present this morning for the question and answer session is Jim Rohrs, President and CEO of First Federal Bank.

Third quarter 2009 net income on a GAAP basis was $329,000 or a negative $0.02 per diluted common share compared to $322,000 and $0.04 per diluted share in the 2008 third quarter. For the nine month period ended September 30, 2009, First Defiance earned 6.6 million or $0.63 per diluted common share, compared to 6.5 million or $0.83 per diluted share for the nine month period ended September 30, 2008. Excluding the after-tax impact of acquisition-related charges in 2008, First Defiance had earnings of 7.1 million or $0.91 per diluted share for the nine months ended September 30, 2008.

2009 continues to present many challenges to the banking industry with the current economic conditions and for our market area in particular. These challenges are certainly reflected in our results for the quarter. While most core operating metrics were against dollar, we felt the negative impact of higher provision expense, additional expenses for OREO and collections, other than temporary impairment charges and lower mortgage servicing rights valuation.

To offset these charges, we had an improved net interest margin coupled with a larger loan base resulting in an increased net interest income of over $1.2 million and $1.4 million increase in total non-interest income and over $400,000 reduction in non-interest expense compared to third quarter of 2008.

All of this netted out to basically flat net income compared to the prior-year period. Credit quality remains the biggest challenge as it has been for the past several quarters. We did see some improvements in lower delinquency numbers and net charge-offs this quarter compared to the last quarter. And non-accrual loans were flat compared with the linked quarter.

We also have not seen any significant new deterioration in the loan portfolio. These are certainly signs of encouragement, but we need to see this improvement on a sustained basis to really identify it as a trend.

The primary factor behind the provision expense this quarter is not specific to any particular loans or relationships, but a general valuation allowance to insulate the portfolio. Even with the positive signs I just noted, property values continue to show weakness and some collateral kind of loans no longer have enough collateral value to support the outstanding balance.

Based on this and the economic forecast calling for a slow recovery, we thought it was necessary to build our general reserves as we work through this tough economy.

Despite the disappointing net income results for the quarter, there were several strong performance indicators. One of the significant positive stories in our third quarter was the strong net interest margin.

Net interest margin at the end of the quarter was 3.88%, a 27 basis point improvement over the second quarter 2009 margin. Also our strong performance in generating non-interest income continued during the third quarter, even though the record-setting residential mortgage production experienced in the first half of 2009 had subsided.

Mortgage originations did drop off in the third quarter compared to the first six months of the year, but we're still running significantly ahead of the same period last year.

Annualized average balance loan growth was a little over 5% compared to second quarter as borrowers continued to be cautious in taking on new debt. Most of the growth was coming from new relationships where these customers are refinancing existing debts with our banks. These new loan customers bring along deposit relationships and as a result non-interest bearing deposits were up at quarter end over 10% compared to end of third quarter 2008.

Period end total deposits were up about 7.5% over the September 30, 2008 period ending now. Total non-interest expense First Defiance decreased year-over-year and linked quarter due to expense control initiatives and reduced compensation expense.

I'll now ask Don Hileman to give you additional financial details for the quarter before I wrap up with an overview and look at what we see developing for the balance of 2009. Don?

Donald Hileman, Chief Financial Officer

Thank you, Bill and good morning everyone. The third quarter continued to be difficult as we saw a continuation of high unemployment and weak economic activity in our market. This has been especially true in the Southern Michigan and the extreme Northwest corner of Ohio where most of the counties are well into double-digit unemployment. We anticipate overall weak economic activity throughout the remainder of the year in our market area.

While we did not have a direct concentration of auto related commercial lending, we do have retail customers whose livelihood depends on the automotive and related industries. We anticipate more stabilization in these segments as the auto industry improves. As we review our financial performance, credit quality remains a key component. Well, we also had several other additional significant items that contributed to the flat year-over-year third quarter core income.

I will begin with a discussion on credit quality. This quarter, we had a large loan loss provision with the corresponding build in the allowance for the loan losses. In light of the continued environment of high unemployment, declining real estate values and sustained economic weakness in the Midwest, as well as our current regulatory environment, we believe it is prudent to build our general loan loss reserves.

Our provision expense totaled 8.1 million, up from 4.9 million in the third quarter of 2008 and 4 million in the second quarter of 2009. Our allowance for loan loss increased to 31.2 million or 1.92% of total allowance as September 30, 2009 and from 25.8 million and 1.6 % on June 30, 2009 and 23.4 million and 1.47% on September 30, 2008. The third quarter provision exceed the net charge-offs by 5.5 million. Annualized net charge-offs were 66 basis points of loans for the third quarter of 2009, down from 96 basis points in the second quarter and up from 55 basis points in the third quarter of 2008.

Of the total net charge-offs, 57% or 1.6 million were related to four credit relationships. Of the commercial real estate total charge-offs of 1.2 million, 763,000 or 66% related to two of those relationships and 611,000 and 92% of the total commercial charge-offs of 658,000 related to one credit relationship. We maintain a continuous process of analysis and review of our loan portfolio and had made decisions to reallocate resources to work with past due clients to determine a course of action that we hope will mitigate potential losses on client relationships.

We have two experienced individuals dedicated to handling problem commercial credits and developing action plans to move the credit to the workout process. We've also been actively working with residential borrowers to determine qualification for loan modifications. We have modified approximately 93 residential mortgage loans in 2009. We calculate our allowance for loan losses by analyzing all loans on our classified and special mention list and making judgments about the risk of loss based on the cash flow of the borrower, the value of any collateral, the financial strength of any guarantors.

Based on those judgments, we record a specific amount of loan loss against each loan that we analyze. The provision for loan losses is the adjustment we make to the allowance for loan losses necessary for the allowance to be adequate based on the losses we estimate to be in the portfolio. In our review, we have determined that it is appropriate to increase the economic, environmental and regulatory factors we use in determining the general portion of the reserve for loan loss, while determining the adequacy of the reserve.

We believe this is consistent with the operating environment we foresee for the remainder of 2009 and into 2010. At September 30th, our allowance for the loan losses represented 1.92% of the total loans outstanding, an increase of 32 basis points over the last quarter and 78% of our non-performing loans, which was up from 64% of non-performing loans at June 30, 2009.

Non-performing assets ended the quarter at 49.4 million or 2.45% of total assets, up from 48.9 million last quarter, which was 2.42% of total assets. Total non-performing loans remained basically flat from last quarter at 40.1 million on September 30th. The non-accrual loans basically remained flat as well as for the quarter compared to June 30, 2009 and restructured loans decreased 271,000 from last quarter.

Restructured loans are considered non-performing because of the changes in the original terms granted to borrowers. These loans are still accruing interest. This is a way we can work with the borrowers who have the ability to repay to mitigate the loss potential.

The delinquency rate for loans 90 days past due and or on non-accrual decreased slightly to 2.15% this quarter from 2.19% in the second quarter of 2009. The slight decline in the level of 90 plus days past due from the last quarter was due to a decrease in commercial real estate past dues of 2.4 million and an increase in commercial 90 days past due of 2 million and an increase in the one-to-four family residential of 400,000 with home equity and home improvements going down slightly.

The total delinquency rate increased to 2.77% at December – increased from 2.77% at December 31st, 2008 to 3.49% at September 2009, but was down from 3.78% at June 30, 2009. The composition of the 90 plus days past due non-accrual totals at the end of third quarter breaks down into certain sectors. With a comparison on a linked quarter basis, commercial real estate 2.90, down from 3.34, one-to-four family residential 2.50, up from 2.33, commercial 1.50, up from 0.94, home equity 0.38, down from 0.41, construction 0.36, up from 0.13 and consumer 0.13, up from 0.10.

We believe that our portfolio continues to be well positioned with the diversified portfolio and low average loan size, very little presence in problematic segments such as big-box retailers and large office buildings, and credits are generally underwritten on a cash flow basis and require meaningful equity and personal guarantees. We've also strengthened our credit review process and increased the overall scope of loans we individually view on a quarterly basis.

Mortgage banking was still strong in the third quarter, continuing the momentum from earlier in the year. We had a gain on sale income of 1.5 million in the third quarter of 2009, compared with 2.9 million in the second quarter of 2009 and 624,000 in the third quarter of 2008. We also recorded a negative valuation adjustment in mortgage servicing rights of 772,000 in the third quarter, compared with a negative adjustment of 36,000 in the third quarter of 2008.

At September 31, First Defiance had 1.2 billion in loan service for others. The mortgage servicing rights associated with those loans had a fair value of 8.4 million or 70 basis points of the outstanding loan balances serviced.

Total impairment reserves, which are available for recapture in future periods, totaled 1.9 million at the end of the quarter. While we are pleased with the mortgage loan activity in the first nine months of the year, we have seen signs of slowing refinance activity with a slight increase in purchase activity.

The economic environment continues to add stress on our investments in Trust Preferred Collateralized Debt Obligations or CDOs, and required additional Other-Than-Temporary Impairment write-downs in the third quarter.

The CDOs are made up of pooled investments in Trust Preferred securities issued primarily by commercial banks and thrifts.

As the issuing institution experienced financial difficulties, they can defer payments and in many cases, we have seen these institutions default on their issue, which is a negative impact on the collateral supporting the pooled investments. The Other-Than-Temporary charge recognized in the third quarter of 2009 totaled 994,000.

The Other-Than-Temporary charge for the quarter related to one security with a book value of a 163,000 at June 30, 2009, which was written down to zero in the third quarter and four other Trust Preferred Collateralized Debt Obligations with a remaining book value of 2.2 million.

First Defiance also has another CDO investment that had an Other-Than-Temporary charge in the first quarter of 2009, which has a remaining book value of 243,000 and a market value of 170,000 at September 30, 2009, which has seen positive upper movement in the discounted cash flows resulted in no additional OTTI charge for the quarter, current quarter and previous quarter.

Other-Than-Temporary charges are due to the deterioration of the underlying collateral and relate to the credit component of the security. The rest of the Trust Preferred CDO investments in the portfolio have a total book value of 2.9 million and market value of some 1.2 million at September 30, 2009. The decline in the value of those investments is primarily due to continued lack of liquidity in the CDO market. These investments continue to pay principal and interest in accordance with contractual terms of the securities.

Management has not deemed the impairment in value of these CDO investments to be Other-Than-Temporary and therefore has not recognized a reduction in value of those investments and earnings. The Other-Than-Temporary charge was partially offset by $154,000 gain on the sale of securities.

Turning to other operating results, our net interest income of 17.6 million for the quarter was an increase of 1.4 million on a linked quarter basis and up from 16.4 in the third quarter of 2008. For the quarter, our margin was 3.88%, which was a seven basis point increase from the third quarter of 2008 and a 27 basis point increase on a linked quarter basis. Falling interest rates continue to impact us on both the asset and liability side. We've been successful in continuing to lower our cost of funds. This remains challenging when we feel that we have hit the floor on some products. There are still some opportunities on term accounts.

Fee income continues to be strong but declined slightly to 3.6 million in the third quarter of 2009 from 3.7 million last year. Insurance revenue was 1.1 million in the third quarter of 2009, basically flat with the third quarter of 2008.

Overall non-interest expense decreased to 14.8 million this quarter compared with 15.2 million the third quarter of 2008 and 16.1 million on a linked quarter basis. The third quarter compensation and benefit expenses were down primarily due to reversal of variable compensation based on the overall corporate performance as well as a reduction in FTEs.

FDIC insurance expense increased to 649,000 in the third quarter of 2009 from 327,000 in the same period of 2008 as a result of the FDIC rate increases and higher insured deposit balances. It was down on a linked quarter basis from 1.5 million, which had a 5 basis point special assessment of 900,000. We're still waiting for the final determination of any future special assessments.

Other non-interest expense increased to 3.7 million in the third quarter from 2.8 million in the third quarter of 2008. Increase in expenses of 778,000 for credit, collection and OREO; 462,000 related to deferred compensation valuation, which was partially offset by cost reductions in various areas, such as advertising and loan-related expenses. We saw balance sheet growth with total assets growing 95.4 million from September 2008, 2.02 billion, but shrinking 6.1 million on a linked quarter basis.

Total deposits grew 107.3 million from September 2008, but decreased 10.1 million on a linked quarter basis. This is somewhat reflective of our pricing decisions and efforts to reduce our cost of funds. Loan balances increased $13.2 million on a linked quarter basis while cash and equivalents decreased 11.5 million.

We are pleased with the loan growth and the new activity during the quarter. We have been able to develop strong new relationships with good commercial clients. We believe that controlled growth is reflective of the environment and we are well positioned for future growth.

That completes my overview for the quarter and I'll turn the call back to Bill.

William J. Small, Chairman, President and Chief Executive Officer

Thank you, Don. As we progress through 2009, we will continue to address the challenges that face us. The overall economic climate throughout our market area continues to be tentative, but we have seen some signs of improvement.

Unemployment numbers continue to run higher in this region compared to national numbers, but seem to have at least leveled off. Some manufacturing entities and automotive-related industries had recalled employees in recent weeks. And agriculturally, the harvest season is facing weather challenges following a good growing season, so crops that have been harvested have produced good yield. So there are some positive indicators out there.

However, we remain cautious in this economic environment and have expanded our credit monitoring function even beyond our traditionally focused approach. Additional asset review functions and more delinquent loan reporting requirements have been added to assist in this monitoring. Detailed action plans are being utilized on all watch list credits and are updated monthly to chart the progress.

We continually review credit concentrations by industry and have placed limitations on lending within certain industry spectrums. The large provision expenses this quarter positions us to work out the problem credits and dispose of OREO properties.

We are seeing more interest from buyers of these properties and we hope to continue working on getting these non-performing assets off the books.

We've worked hard to execute our strategy in this challenging environment and to adapt to the fluctuations in the business cycles. This was a disappointing quarter from an earnings performance perspective and certainly not acceptable to us, but I believe it is a time of opportunity for community banks like ours.

We remain well capitalized and First Federal Bank and First Defiance are positioned to be able to attract new relationships and grow by following the business plan that has prepared us for times like this.

Our core fundamentals remained strong, and the underlying strengths will keep us on course for the future. In addition to working to improve our asset quality, we are focused on finding and growing revenues sources, as well as focusing on operating efficiently to step up and meet today's challenges. There are certainly better environments to operate in, but we will continue to work with our customers and offer the best in products and services as we look forward to better times.

We thank you for joining us this morning, and now we will be happy to take your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions]. Our first question comes from Eileen Rooney at KBW.

<Q – Eileen Rooney>: Good morning, guys.

<A – William Small>: Good morning, Eileen.

<A – Donald Hileman>: Good morning.

<Q – Eileen Rooney>: I was just wondering if you could give us the amount of that comp reversal that was in the compensation line?

<A – Donald Hileman>: It was approximately 100,000.

<Q – Eileen Rooney>: I'm sorry, 800?

<A – Donald Hileman>: Yes.

<Q – Eileen Rooney>: Okay. And what was the inflows into non-performing this quarter?

<A – William Small>: Trying to remember offhand.

<A – Donald Hileman>: I really can't give you the specific credits that went into that.

<Q – Eileen Rooney>: Okay. Yes, no, I was just kind of wondering the dollar amount, if you took out like charge-offs and all, if you backed that stuff out.

<A – Donald Hileman>: Well, the non-performings were essentially flat and we had charge-offs of about $2.5 million, right?

<A – William Small>: Right.

<A – Donald Hileman>: So I would say that if they were flat, then we've added inflows of about 2.5 million into the non-performing.

<Q – Eileen Rooney>: Okay. Yes, I just wasn't sure if there were things that paid down or moved to OREO.

<A – Donald Hileman>: Some of it, so it's probably a little north of that, but not a lot, Eileen.

<Q – Eileen Rooney>: Right. Okay. And then just a question on the loan growth this quarter. I'm sorry if I missed this in your comments, but the commercial real estate categories seem to have quite a bit of growth. I was just wondering where that was coming from, what types of credits, any particular region?

<A – William Small>: The commercial real estate loans that we're booking now are – primarily are multi-family residential apartment complexes. That's a category that has performed well for us. There is a major real estate developer and owner in the Toledo area that passed away and literally put about 30 million of apartment complexes on the market. So we've financed a few of those for good borrowers. But that's a category that has performed well for us.

<A – Donald Hileman>: We have looked at how we underwrite those credits over the course of this year in line with the economic environment we are in and we've improved and required a little bit more down payment. We have required more collateral, a little stronger guarantors on some of those credits. So, I think we – the newer credits are underwritten a little bit stronger than they were in prior periods.

<Q – Eileen Rooney>: And what would be like a typical loan-to-value now?

<A – William Small>: Maximum 80, in more cases 75%, and in cases where it's a property that needs improvements, we are requiring that cash to be put in upfront. We will hold that cash until the improvements are made.

<Q – Eileen Rooney>: All right. That's great. Thanks, guys.

<A – William Small>: Thank you, Eileen

<A – Donald Hileman>: Thanks.

Operator: [Operator Instructions]. It seems we have no further questions.

Carol Merry, Vice President, Fahlgren Mortine Public Relations

All right. If we have no other further questions, we'll thank you for joining us today and this will conclude our conference call. You can now disconnect.

Operator: Thank you very much.