# I.

## Comptroller's Viewpoint

This year's *Annual Report* reflects the reach – and the strength – of the national banking system and the Office of the Comptroller of the Currency. I am pleased to report that the system remains safe and sound, and fully able to support the needs of its consumer and business customers.

FY 2007 was a year of challenge and accomplishment. Typically, late in an economic cycle, credit problems begin to appear as lenders compete for a smaller base of creditworthy borrowers, and loans made earlier in the cycle begin to show signs of wear. With the United States now in the sixth year of an economic expansion, it is not surprising that such trends became increasingly apparent in 2007.

One of the most significant supervisory issues this year was the continued decline in underwriting standards. Weakened underwriting is often a leading indicator of credit problems, and we are monitoring banks closely for any evidence that relaxed standards are translating into an undue growth in problem loans.

Problem loans did increase in national banks in FY 2007, but they remained very low by historical standards, and supervisory performance ratings remained strong. That's no small achievement, considering the number and severity of economic troubles that emerged during the year. The mortgage market experienced significant difficulties, especially in the subprime area, resulting in increased delinquencies and foreclosures. While the national bank share of problem subprime loans was proportionally smaller than at other lenders, it was significant nevertheless.

The OCC took a number of steps in response. We joined the other federal banking agencies in urging lenders to work with troubled borrowers to modify troubled loans where appropriate, rather than resorting to foreclosure. We also bolstered underwriting and consumer disclosure standards for nontraditional and subprime mortgage products; monitored compliance with regulatory guidance; and supported efforts to obtain flexibility under accounting standards for lenders to restructure mortgages sold to third-party investors. I was especially concerned that we address the widespread acceptance of unverified income in providing subprime credit. So-called "stated-income loans" have allowed too many subprime borrowers to assume more debt than they could afford, and in a market with rising rates and falling home prices, many are now facing foreclosure. I am very pleased that the final subprime guidance we issued provides that stated income should be the exception, not the rule, in underwriting subprime loans.

Commercial real estate concentrations continued to receive our attention. Along with the other agencies, we issued guidance that called on our banks to adopt appropriate risk management policies. The guidance did not set limits on commercial real estate lending, but it did reemphasize that banks with higher CRE concentrations have higher levels of risk, and that they need to have risk management practices and capital commensurate with this increased level of risk. Despite industry apprehension, our implementation of this guidance went smoothly, despite the fact that we began to observe increased CRE losses in the residential sector by the end of the year. This trend in the credit cycle will likely continue in the next year, and commercial real estate lending will very much remain a supervisory focus for the agency.

*Testifying before Congress.*

While commercial real estate lending concentration was primarily an issue for smaller banks, our larger institutions were challenged by leveraged lending. Banks active in this market experienced market liquidity problems in the second half of the year. Skeptical of underwriting standards that had relaxed significantly, investors shrank from purchasing leveraged loans in the quantities they had previously. This unexpectedly forced banks to hold on their balance sheets large volumes of such loans or loan commitments. It also forced them to mark down the values of the loans to reflect the declines in price caused by the lack of market liquidity, resulting in substantial charges to earnings.

We also published guidance – and conducted training – to help banks understand the rules on the Allowance for Loan and Lease Losses (ALLL) – one of the most significant buffers against credit risk. Some national banks have experienced issues with their auditors when they have tried to increase reserves to prudent levels. We have not hesitated to intervene in such cases where we believed the auditor was substituting its judgment for the bank's management in determining reserve adequacy – and we will continue to do so where we believe that is appropriate.

The OCC continues to embrace the concept of risk-based supervision. We spend more time on areas of greater risk to a bank, and conversely, less time on lower risk activities. One promising development has emerged in the area of money laundering and Bank Secrecy Act compliance that has been a great concern to all of us. The OCC developed a Money Laundering Risk (MLR) analysis system that provides more than 1,650 community banks with a concrete tool to help measure anti-money laundering risk. One of our goals is to use the results of the MLR analysis to help focus our BSA compliance resources on the relatively small number of banks where risk is higher, with less intrusive examinations for the vast majority of institutions where risk is low.

New capital requirements resulting from the Basel II accord will, with respect to the very largest national banks, significantly improve both the alignment of capital with risk and risk management practices. I was very pleased that we were able to issue a final interagency rule, implementing these so-called "advanced approaches" of Basel II, just after the end of the fiscal year. We also plan to issue, at the beginning of 2008, a proposed risk-based capital rule to implement the so-called "standardized approach" as an option for all but the very largest banks. This option is also intended to better align regulatory capital with risk, but in a less costly and complex way than the advanced approaches, for smaller institutions that do not have the complex risk profile of our very largest banks.

Of course, risk-based capital is not the only issue at the OCC that has an international focus. Few industries have been more affected by globalization than banking. As the supervisor of most of the nation's largest banks – including three that each hold over a trillion dollars in assets – the OCC has been heavily involved in international issues for years and has developed a number of approaches to examining banks' international activities. For example, our large bank exam teams regularly evaluate international activities and risk exposure, using specialists in such areas as capital markets, credit, and anti-money laundering compliance. Indeed, our London of-

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fice is fully staffed with such specialists, who are dedicated to evaluating key risks in national banks' European operations.

*Examining a community bank.*

Reflecting our increased international focus, I agreed in September to serve as chairman of the Joint Forum, an organization that consists of banking, securities, and insurance regulators from many countries around the world. As the lines between these industries have continued to blur, cross-cutting regulatory issues have emerged with more frequency and salience. The Joint Forum provides a unique opportunity to study and address these issues with an exceptionally broad perspective. On behalf of the OCC, I am honored to serve in this new role.

In other international developments, I welcomed the opportunity to visit China last March to strengthen the OCC's longstanding relationship with China's banking supervisor, the China Banking Regulatory Commission, as well as to meet with bankers from our two countries. I observed first hand the remarkable progress that China has made in creating a modern financial system, and I sought to provide useful insight to our Chinese colleagues based on the OCC's considerable experience in supervising both complex and smaller banks.

**One of our primary goals this year was not only to expand the store of information available to the consumer, but also to make it more accessible and user-friendly.**

While many large national banks have increased their global operations, community banking is still at the heart of the OCC's mission. This year we expanded our outreach efforts to improve our communications with community bankers and directors, assess the effectiveness of our examination process, and identify areas where we can reduce regulatory burden. Our goal is to help community banks devote more of their time and resources to doing what they do best – serving their customers and their communities.

The increased retail orientation of national banks has created a significant shift in the nature of the banking business – and in the OCC's supervisory priorities. Consumer protection is a key element of our mission, and we devote considerable resources to examining national banks for compliance with consumer protection laws, promoting transparency and improved disclosure of customer information, and helping to resolve consumer complaints.

One of our primary goals this year was not only to expand the store of information available to the consumer, but also to make it more accessible and user-friendly. To that end, we launched a Web site, called HelpWithMyBank.gov, that provides a single reference point for the questions and answers we hear most frequently from consumers about the issues that concern them. It also provides a contact point to file a formal complaint with the OCC's Customer Assistance Group.

Because of the jurisdictional complexities of the U.S. banking system, consumers don't always know which agency supervises their bank, and often complain or pose questions to the wrong supervisor. This customer confusion has cropped up frequently between the OCC and state banking supervisors, and as a result, during this past year the OCC and the Conference of State Bank Supervisors jointly developed a mechanism for expediting the exchange of consumer complaint information between our agency and state banking departments. At the end of fiscal 2007, we had signed agreements with 28 states, which we think will significantly reduce response times for consumers. I am pleased with this progress, but I think we can do more along these lines to make it easier for consumers to get

*With the Tuskegee Airmen, Congressman Charles Rangel and OCC Ombudsman Sam Golden.*

answers from banking regulators. For that reason, the OCC has asked the Federal Financial Institutions Examination Council, consisting of all the federal banking regulators and representative state banking agencies, to consider additional proposals that would coordinate agency efforts for consumers in other areas, for example, by using a single Web site or call center to route questions and complaints to the appropriate agency.

*Meeting with bankers.*

Regarding the national bank charter, the Supreme Court issued a seminal decision last year confirming that the banking activities of national banks and their operating subsidiaries are subject to uniform laws established by Congress, not the states. In *Watters* v. *Wachovia,* the court reaffirmed the separate roles of the states and the OCC in regulating the banks that each charters. It also reaffirmed the principle, established earlier by the court in its *Barnett Bank* decision, that states may not significantly burden, curtail, or hinder a national bank's exercise of its powers under the National Bank Act. The *Watters* decision, which ratified the OCC's longstanding position that operating subsidiaries of national banks should not be treated differently from the banks themselves, helped clarify that it is the OCC's responsibility to regulate a national bank's interaction with consumers – a responsibility we take very seriously.

The OCC must be a strong organization if it is to continue to safeguard the interests of a safe and sound national banking system. We continue to invest heavily in technology, training, and development of our people – the OCC's most important resource. But, like all agencies of the federal government – and, indeed, like much of the private sector – the OCC faces demographic challenges that require us to look to the needs of the future. We are continuing to attract large classes of talented college graduates, as well as mid-career industry professionals with specific skills, and we took several important steps this year to improve recruitment, retention, and leadership development. Prominent among them was LeaderTRACK, a management succession development program for senior examiners.

Independent surveys continue to recognize the OCC as an outstanding place to work. In fiscal 2006, *BusinessWeek* included the agency on its list of the 50 best places in the private or public sector to start a career, and last year, the Partnership for Public Service ranked the OCC 4th out of 222 peer agencies in its rankings of best places to work in the federal government. None of this surprises me. As a veteran of just two years at the agency – really just a rookie by OCC standards – I can firmly attest to the exceptionally strong sense of purpose, professionalism, and culture that pervades this organization. What we do and how we do it is a source of great pride to the OCC employees I talk to all around the nation – and it certainly is to me as well. That bodes very well indeed for the future of our agency, and even more important, for the effective regulation of national banks, the financial engines of our economy.

**II.**

# The Comptroller and the Executive Committee

**John C. Dugan**

*29th Comptroller of the Currency*

Director of the Federal Deposit Insurance Corporation, Federal Financial Institutions Examination Council, and Neighborhood Reinvestment Corporation. Chairman, Joint Forum. Former Partner, Covington & Burling law firm. Former Assistant Secretary for Domestic Finance, U.S. Department of the Treasury. Former Counsel and Minority General Counsel, U.S. Senate Committee on Banking, Housing, and Urban Affairs.

## The Executive Committee

(Front row, left to right) *Senior Deputy Comptroller Douglas W. Roeder, Large Bank Supervision; Chief of Staff and Public Affairs John G. Walsh; Comptroller of the Currency John C. Dugan; Chief Information Officer Jackie Fletcher; Senior Deputy Comptroller Timothy W. Long, Mid-size/Community Bank Supervision.*

(Back row, left to right) *Ombudsman Samuel P. Golden; Senior Deputy Comptroller Mark Levonian, International and Economic Affairs; First Senior Deputy Comptroller and Chief Counsel Julie L. Williams; Senior Deputy Comptroller and Chief Financial Officer Thomas R. Bloom, Office of Management; Senior Deputy Comptroller and Chief National Bank Examiner Emory Wayne Rushton.*

III.

# History of the Office of the Comptroller of the Currency

In February 1863, President Lincoln signed the National Currency Act into law, creating a national banking system and "a separate bureau in the Treasury Department," headed by the Comptroller of the Currency, to administer it.

The law was designed to address the country's longstanding need for a uniform national currency and a nationwide system of banks operating under uniform rules, uniform supervision and regulation, and uniformly high standards.

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For most of the pre-1863 period, thousands of different bank note varieties were in circulation—some good as gold, some not worth the paper they were printed on. This diverse and irregular paper was a source of inflation and uncertainty, and a barrier to trade and economic growth.

Under the National Currency Act (revised in June 1864 as the National Bank Act), organizers were required to raise substantial capital (previously, many banks had little or no capital) and to invest a portion of that capital in U.S. government bonds, sales of which were lagging at the time. The bonds would be deposited with the Comptroller, who would deliver a proportionate quantity of bank notes of uniform design imprinted with the bank's name. The bonds served as security for the notes; if a national bank was unable to meet its obligations, the bonds were liquidated and the note holders repaid. This ingenious system served the country for many years until national currency was phased out in favor of Federal Reserve notes.

The first Comptroller of the Currency was Hugh McCulloch, a respected Indiana banker. McCulloch staffed the office, developed policies and procedures, promulgated standards of professional conduct for bankers and bank examiners, and worked to refine the legal framework under which national banks still operate today.

Charter number one was issued to the First National Bank of Philadelphia. The First National Bank of Davenport, charter number fifteen, was first to open for business, on June 29, 1863. By 1870, more than 1,600 institutions, including hundreds of former state-chartered banks, had joined the national system, holding well over 50 percent of the country's total bank assets.

The National Bank Act provided extensive enumerated powers and such "incidental powers as shall be necessary to carry on the business of banking." The law required the Comptroller to report directly to Congress on needed improvements in the law, and modifications undertaken over the years have provided national banks with the flexibility to meet changing conditions in the financial marketplace.

The National Currency Act and subsequent laws endowed the Comptroller's Office with considerable operational independence. The Comptroller is appointed by the President to a five-year term. Throughout its history, OCC has been funded by assessments paid by the banks it supervises.


BANK

# IV.

# Profile

## The National Banking System*

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|---|---|
| National Banks:[1] | 1,677 |
| Percentage of Total Number of Commercial Banks: | 23 |
| Uninsured National Trust Companies: | 78 |
| Federal Branches of Foreign Banks: | 49 |
| Assets of National Banks (excluding federal branches): | $7.062 trillion |
| Percentage of Total U.S. Commercial Banking Assets: | 68 |
| Total Insured Deposits: | $4.397 trillion |
| Employees of National Banks: | 1,232,243 |
| Total Investments by National Banks under 12 CFR 24, Community Reinvestment Act: | $4.82 billion |

## The Office of the Comptroller of the Currency

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|---|---|
| Total Employees: | 3,066 |
| National Bank Examiners: | 2,061 |
| Safety and Soundness Examinations Conducted: | 1,287 |
| Specialty Examinations Conducted: | 897 |
| Consumer Assistance Personnel: | 35 |
| Consumer Complaints Processed: | 26,967 |
| Total Budget Authority: | $671.2 million |
| Total Revenue: | $695.4 million |
| Percentage of Revenue Derived from Assessments: | 95.8 |

* Based on June 30, 2007, call report data.

[1] National banks are examined every 12 to 18 months, depending on their complexity and risk profile.