OCC Supervisory Efforts in Face of 2008 Market Turmoil

Before the damage spread throughout the U.S. financial system, OCC examiners were focused on the emerging fault lines in the credit markets. In 2005, for example, at a time when bank profitability was strong and house prices were still appreciating, the agency instructed examiners to address the risk of loan products with the potential for payment shock, such as hybrid mortgages that start with low monthly payments followed by payments that are much higher. Although national banks largely avoided subprime lending, nonbank lenders made large numbers of these loans, and the consequences eventually spilled over into the broader credit markets.

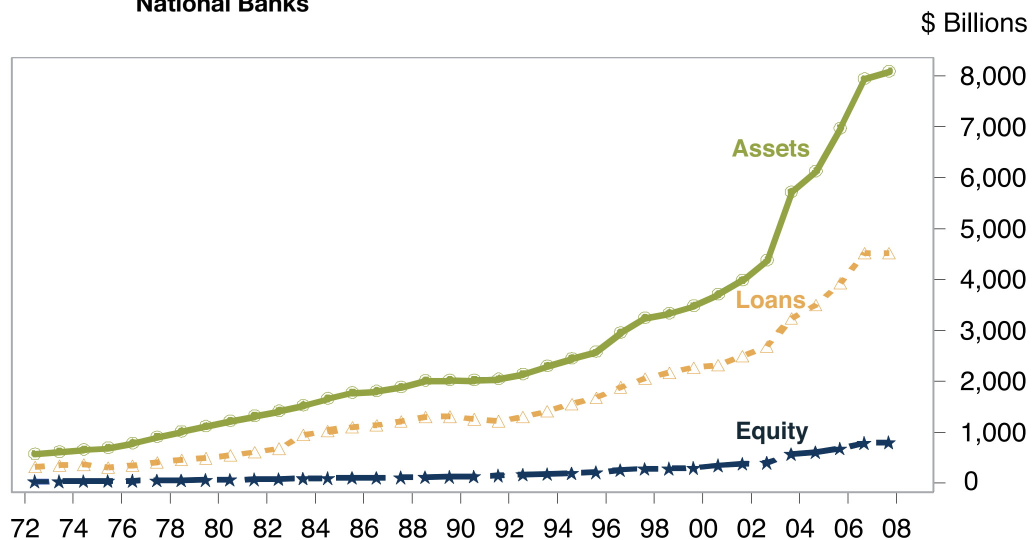
By 2008, as Comptroller Dugan noted in congressional testimony, the national banking system was being tested by two powerful and related forces that were exerting pressure on banks of all sizes in many parts of the country. "One is the large and unprecedented series of credit market disruptions, still unfolding, that was precipitated by declining house prices and severe problems with subprime mortgages," he told the Senate Banking Committee. The other was the slowdown in the economy, which had begun to affect credit quality adversely for a number of asset classes.

"The combination of these forces has strained the resources of many of the national banks we regulate," Mr. Dugan said at that hearing on March 4, 2008.

While the national banking system remains fundamentally sound, the effects of these complex market dislocations are still working through the financial system. At the height of the market turmoil, banks showed increasing reluctance to lend to each other out of concern over credit quality and a desire to maintain liquidity in the face of market uncertainty. The contraction of market liquidity required some large national banks to fund and hold additional assets on their balance sheets. The rapid deterioration in credit quality of subprime mortgages led to substantial write-downs in certain structured investment products.

Figure 3: **Assets, Total Loans, and Equity from 1972 to 2008**

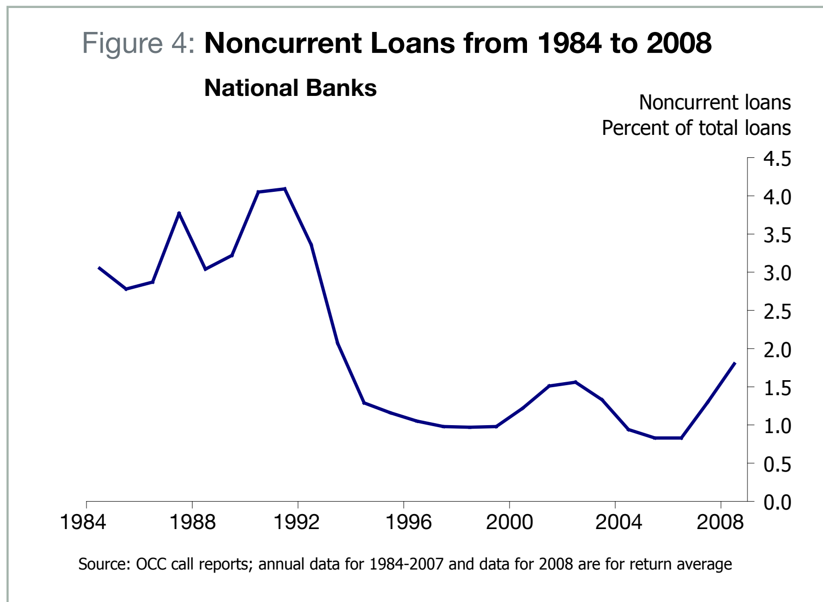
National Banks



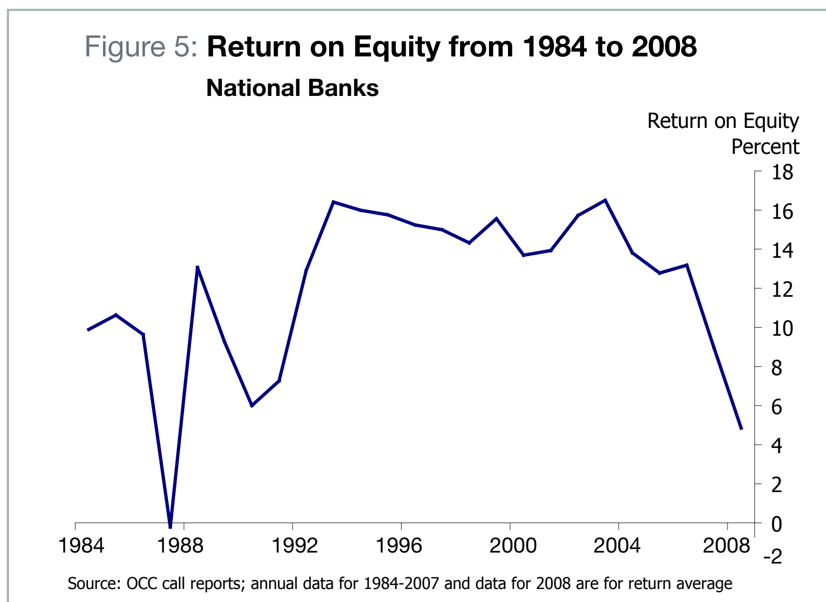
Source: Integrated Banking Information System (OCC)

Note: 2008 data as of June 30, 2008. All other data as of year-end.

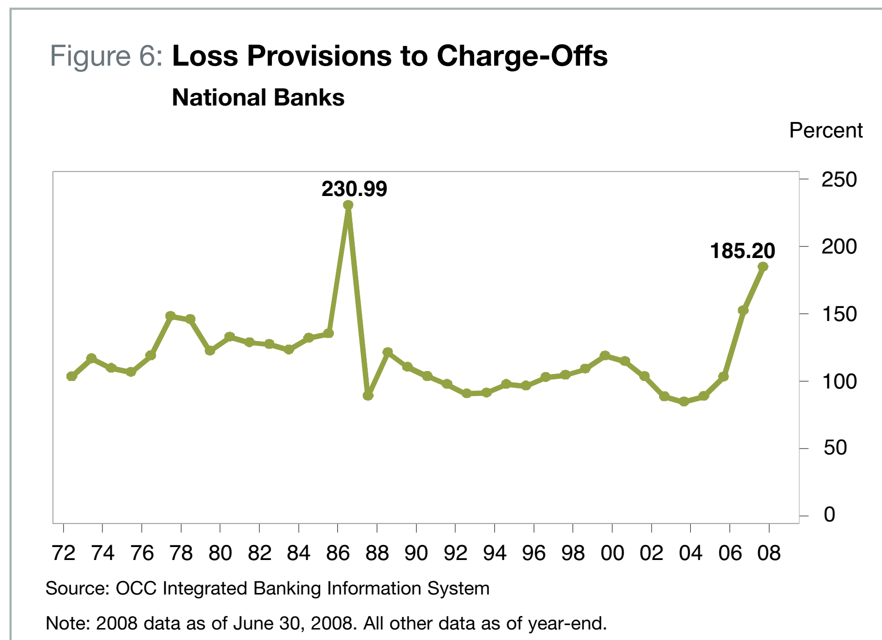
The downturn in housing and the broader economy affected national banks' loan portfolios adversely, increasing the level of nonperforming and past-due loans. Noncurrent loans—the percentage of bank loans that are 90 days or more past due and on nonaccrual—rose to 1.80 percent at the end of June 2008, up from 0.86 percent a year earlier, as Figure 4 shows, and then rose again, to 2.19 at the end of September 2008. Even at that level, noncurrent loans were low by historic standards. Deterioration in loans tied to the real estate sector, however, was more pronounced. Losses from housing loans rose to new highs, and losses on other retail credits were up sharply. Credit stress was complicated by elevated liquidity risk and, in the latter part of the year, by heightened concern about the safety of retail deposits in the wake of publicized bank failures. All of these events were reflected in lower earnings for the national banking industry.



National bank net income in 2008 declined to one-third of its level a year earlier. National banks recorded income of $6.9 billion in 2008's second quarter, down from $21.5 billion a year earlier. Return on equity, a key measure of bank profitability, was 3.5 percent in the second quarter of 2008 versus 12.8 percent a year earlier. As Figure 5 shows, 2008 return on equity year-to-date is averaging 4.4 percent, substantially below the level seen before the market turmoil began.



Over the last year, weak noninterest income and higher provisions were the main drags on earnings. Large banks benefited from improved profit margins, while the margins of smaller banks deteriorated. Despite poor earnings, banks were able to increase capital and reserves over 2007 levels.



National banks were generally able to absorb the financial shocks for a number of reasons. The first, and most important, is that banks, having entered this period in overall good health, had the earnings and capital to weather market downturns. Capital levels well in excess of regulatory minimums gave banks the flexibility to absorb sizable quantities of assets on their balance sheets when liquidity in the credit and capital markets became constrained. Throughout the year, banks took steps to further strengthen their balance sheets by increasing loan loss reserves, reducing dividends, and issuing capital in both public and private offerings. Their ability to raise capital reflected investors' belief in the underlying long-term viability of these franchises. Nonetheless, should credit performance worsen, additional loan loss reserves and capital may be required.

National banks, especially larger ones, benefited from diversified lines of business and funding sources. For example, although fees from loan sales, securitizations, and trading were adversely affected by the downturn in housing, other fee income sources remained. Indeed, throughout the year, the national banking system has generally been a source of strength for the financial sector, providing credit and liquidity to both the retail and commercial sectors, and absorbing companies and product lines that faltered or failed under the strains of market dislocation.

While the vast majority of national banks have had the financial capacity and management skills to weather the challenges of the past year, a few have not. In these cases, the OCC's goal has been to effect early and least-cost resolution of the bank so as to minimize losses to depositors and the FDIC insurance fund. During fiscal year 2008, the OCC appointed the FDIC as receiver in five bank failures.