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National: Ensuring the Safety and Soundness of the National Banking System

Bank supervision is the OCC's core mission. Our goal is to determine whether a national bank is operating in a safe and sound manner and whether national banks comply with applicable laws and regulations—laws that, among other things, protect consumers, support fair lending, prevent money laundering, protect critical bank and customer information, and promote community reinvestment.

Each national bank's supervisory strategy is customized to its condition and circumstances, and is continually modified as appropriate. When a bank's risk profile or condition changes, the supervisory strategy for that institution changes with it. For example, examiners may decide some banks need more frequent reviews, or they may target specific bank activities that warrant supervisory attention.

The OCC's approach to bank supervision evolved over nearly a century and a half. Soon after the agency was created, its leaders realized that proper supervision required examiners to do more than simply inspect the bank's ledgers. In the 1880s, Comptroller Henry W. Cannon admonished examiners to evaluate the overall competence and prudence of a bank's management, as well as its asset quality. Since that time, the OCC has built on this foundation, focusing not only on how individual loans are underwritten and administered, but also on how bankers assess and manage risks across the institution.

In FY 2007, the OCC continued to implement and strengthen its risk-based approach to bank supervision. Our supervision emphasizes the need for strong risk controls, clearly defined objectives, and a well-developed business strategy. We work to promote effective management and strong corporate governance, ensuring that bankers and direc-

tors understand the critical role that each of them plays, and that they have the skills and the tools they need to effectively carry out those roles. The board and management must also ensure that the bank maintains adequate reserves and capital levels to cover both expected and unexpected losses.

In the "national" section of this report, we look at the issues that shaped the OCC's supervisory strategies in FY 2007 and the steps that were taken by the agency to strengthen the national banking system's legal and regulatory framework.

Fostering Better Management of Credit Risk

Reaffirming Credit Quality

National banks face many different forms of risks. None poses greater potential for financial loss than credit risk—the possibility that a loan or investment will not be fully repaid.

FY 2007 was a year of rising, but still moderate, credit risk. The percentage of loans that were non-current rose, and provisions for loan and lease losses increased nearly 90 percent over the 12 months ending June 30, 2007. As a result, national bank earnings were not as strong in the first half of this year as they were last year. Annualized year-to-date return on equity at national banks (as of the second quarter of calendar year 2007) was 12.73 percent—nearly 1 percent lower than it was for 2006. (See chart 1.)

This rise in credit risk was not unexpected. The U.S. economy has been expanding for six years, and it is typical for loans booked early in an economic cycle to show increasing signs of weakness as the expan-

sion matures. Also, loan underwriting standards customarily slip in the later stages of an expansion as lenders compete for a shrinking pool of the most creditworthy borrowers and begin to dip deeper into the risk pool for customers. In recent years, a highly liquid secondary loan market intensified that competition, as did the growth in the number of nonbank lenders, such as mortgage brokers, who packaged and sold loan products to third-party investors. All these factors helped increase credit risk and put pressure on bank earnings.

The dip in earnings must be viewed against the long-term profitability of national banks. National bank earnings have been strong for the past 15 years, and these strong earnings have contributed to healthy capital ratios. In a statement before the House Committee on Financial Services on September 5, 2007, Comptroller Dugan underscored the system's strength, noting that "national banks remain active in major markets and continue to extend credit to corporate and retail customers, including mortgage credit." He pointed out that "the worst problems we have seen in the markets—insufficient liquidity resulting in substantial declines in capital and sometimes in failure—have occurred *outside* the commercial banking system."

By historical standards, the loan portfolios of national banks showed low levels of losses and problem assets. Supervisory performance ratings of national banks remained strong (see table 1). This is partly because national banks were proportionally

less involved in the increasingly troubled market for subprime mortgages. Still, these troubles offered an object lesson in the importance of sound underwriting. Even before these problems began to emerge, the OCC was reemphasizing the need for national banks to verify the mortgage borrower's capacity to repay and to set aside prudent provisions for losses.

Commercial real estate portfolios were another focus of credit risk concerns in FY 2007. Growing concentration levels in these portfolios, particularly at mid-size and community banks, raised concerns. The banking supervisory community responded by publishing guidance providing that banks with commercial real estate concentrations should maintain robust risk management systems and should preserve prudent underwriting standards in the face of competitive pressures.

Surveys of Credit Risk

The OCC conducts regular surveys to identify and monitor systemic trends in credit risk and emerging credit risk. In FY 2007, as in previous years, the OCC produced its annual Survey of Credit Underwriting Practices, participated in the interagency Shared National Credit Review, and conducted a series of horizontal reviews of large banks.

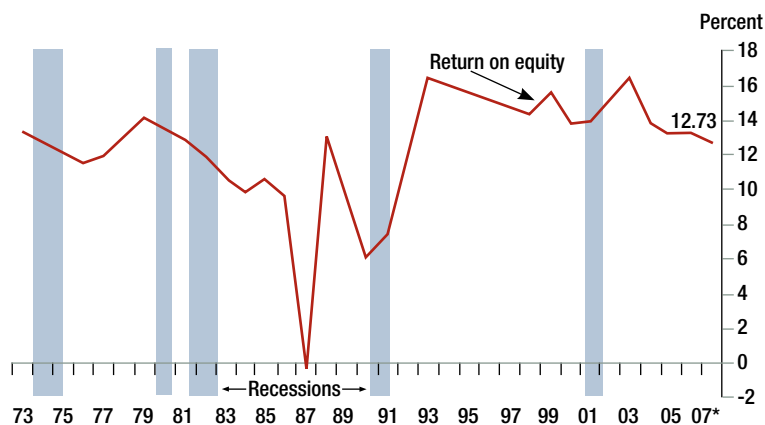
Survey of Credit Underwriting Practices

This survey identifies trends in lending standards and credit risk for the most common types of commercial and retail credit products offered by national banks. It assesses how factors such as competition are affecting the pricing and underwriting of loans and whether OCC examiners believe that the inherent credit risk in banks' portfolios is increasing or decreasing.

The 2007 survey, released in October 2007, covered the 12-month period ending March 31, 2007, and included results from the 78 largest national banks, representing more than 85 percent of all outstanding loans in the national banking system.

The survey found that retail and commercial credit underwriting standards eased for a fourth consecutive year, primarily from competitive pressures. The easing that occurred in retail banking was most notable in home equity lending (conventional and

Chart 1: National bank profitability dipped in 2007Q2



Source: Integrated Banking Information System (OCC)

* 2007 data as of June 30, 2007. All other data as of year-end. Shaded areas represent periods of recession.

Table 1: Supervisory performance measures, FY 2007

Performance Measures	Target	Actual (9/30/07)¹
Percentage of national banks that are categorized as well capitalized ²	95%	99%
Percentage of national banks with composite CAMELS rating of 1 or 2 ³	94%	97%
Rehabilitated problem national banks as a percentage of the problem national banks one year ago (CAMELS 3, 4, or 5) ⁴	40%	52%
Percentage of national banks with consumer compliance rating of 1 or 2 ⁵	94%	97%

high loan-to-value loans) and residential real estate lending. Although commercial underwriting standards eased in general, the amount of easing in commercial real estate underwriting declined slightly.

Not all sizes of national banks eased underwriting standards. While large banks continued to do so, especially for leveraged and large corporate products, and mid-size banks eased modestly, the community banks that were included in the survey tightened underwriting standards.

Shared National Credit Review

The Shared National Credit (SNC) review is a joint program of the OCC, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). Published annually (this year on September 25, 2007), the review evaluates the classification of large syndicated loans held by multiple banks. The 2007 review covered approximately 7,700 loans (or 5,265 borrowers) with commitments totaling \$2.3 trillion. SNC commitments increased by nearly \$401 billion, or 21.4 percent.

Although FY 2007's review showed an increase in the volume of criticized commitments, they remained at less than half of their peak dollar level in 2002. Criticized credits were 5 percent of total commitments, about the same rate as in the past three SNC reviews.

This year's review also examined the quality of underwriting of a representative sample of shared credit. This review disclosed a significant increase in underwriting weaknesses, especially in the syndicated leveraged loan market and particularly in non-investment grade or leveraged credit facilities.

Horizontal Reviews of Large Banks

The OCC's Large Bank Supervision Department conducted three horizontal reviews to determine how well large banks are complying with inter-agency guidance that addressed credit risk. A horizontal review is an examination across a portfolio of banks with similar characteristics. Horizontal reviews offer many benefits, notably the opportunity to exchange best practices and to ensure consistent expectations and supervisory practices across all

¹ Numbers in italics are estimates.

² The Federal Deposit Insurance Act established a system of prompt corrective action that classifies insured depository institutions into five categories—well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, based on their capital levels relative to their risks.

³ The composite CAMELS rating reflects the overall condition of a bank. It is based on the Uniform Financial Institutions Rating System. Evaluations are made on Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. Ratings are on a scale of 1 through 5, 1 being best.

⁴ The OCC's early intervention can lead to successful remediation of problem banks. More than half of the problem banks on 9/30/2006 were rehabilitated within a year after following the OCC's recommendations for corrective action.

⁵ Each bank is assigned a consumer compliance rating based on an evaluation of its present compliance with consumer protection and civil rights statutes and regulations, and the adequacy of its operating systems designed to ensure continuing compliance. Ratings are on a scale of 1 through 5, 1 being the best.

the banks. Typically conducted by experts in the area of focus, horizontal reviews provide an independent assessment. These reviews not only provide the OCC with information on systemic risks, but also afford a quick assessment of how banks are complying with laws, regulations, and other regulatory guidance. They also allow the OCC to focus on higher risk banks and to adjust supervisory strategies and staffing.

In FY 2007, horizontal reviews focused on the guidance on nontraditional mortgages (OCC Bulletin 2006-41, “Nontraditional Mortgage Products: Guidance on Nontraditional Mortgage Product Risks”); the guidance on managing credit risk in home equity lending (OCC Bulletin 2005-22, “Home Equity Lending: Credit Risk Management Guidance”); and the guidance on managing credit card accounts (OCC Bulletin 2003-1, “Credit Card Lending: Account Management and Loss Allowance Guidance”).

Helping To Stabilize Mortgage Markets

The OCC has long discouraged abusive and irresponsible lending practices in the national banking system. That’s one reason why national banks were relatively less involved in the subprime mortgage market, and why OCC-supervised institutions were not as significantly affected by the setbacks many subprime lenders experienced during FY 2007. Only 10 percent of new subprime loans in 2006 were originated by national banks, and the rate of default among national bank subprime borrowers was significantly lower than that of subprime borrowers generally.

Nevertheless, the OCC has been active in regulatory efforts to address issues in the mortgage markets and to assist troubled subprime borrowers. These latter efforts are discussed in detail in part VIII of this report, “Consumers: Promoting Fairness and Transparency.” Throughout 2007, the OCC and the other federal banking regulatory agencies also issued guidance to lenders to encourage arrangements with at-risk borrowers that would enable them to remain in their homes whenever possible.

OCC efforts included:

- Working with individual borrowers seeking information or assistance through the OCC’s Customer Assistance Group (CAG).
- Issuing interagency guidelines to lenders regarding underwriting and consumer disclosure practices for nontraditional and subprime mortgage products.
- Monitoring compliance with regulatory guidance and potential adverse affects on bank earnings, liquidity, and capital markets activities.
- Working with community groups and bankers to identify and promote foreclosure prevention strategies.
- Working with the Financial Accounting Standards Board and the Securities and Exchange Commission to clarify how financial institutions and mortgage conduits can modify loan terms of borrowers unable to meet the terms of their original mortgage obligations.
- Working with two nonprofit organizations, NeighborWorks America and the Ad Council, on a series of public service announcements encouraging delinquent mortgage borrowers to get help from their lenders or a trusted housing counselor.

Addressing Concentrations in Commercial Real Estate Lending

Examiners increased their attention on credit risk arising from concentrations in commercial real estate loans in 2007. The emphasis followed the publication in December 2006 of final interagency guidance, “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.” The guidance, which was a response to the increasing numbers of small- and medium-sized banks enlarging their portfolios of commercial real estate loans, was especially timely in light of the turmoil in the real estate-related markets in 2007.

The guidance was intended to make sure that banks enhance their risk management systems to accommodate concentrations of such loans, especially if

the primary source of repayment for many of the loans is cash flow from real estate collateral. Although the federal banking agencies support the effort to supply credit for business and real estate development, they grew increasingly concerned about the potential effects of such concentrations on earnings and capital if commercial real estate markets were to weaken.

The guidance provided supervisory criteria, including numerical indicators, to help identify commercial real estate loan concentrations that warrant enhanced risk management. The OCC and its examiners emphasized that the criteria do not constitute limits or caps on a bank's ability to make commercial real estate loans.

Updating the Allowance for Loan and Lease Losses

The federal banking regulatory agencies and National Credit Union Administration (NCUA) published a comprehensive "Interagency Policy Statement on the Allowance for Loan and Lease Losses" (ALLL) in December 2006. This updated guidance came just as many banks were preparing to increase their loss provisions in the first half of 2007.

A valuation reserve charged to a bank's operating income, ALLL is one of the most significant buffers against credit risk. ALLL is the sum of two estimates: 1) estimated credit losses on individually evaluated loans determined to be impaired, and 2) estimated credit losses on the remainder of the loan and lease portfolio. Although maintaining adequate reserves is always important to safety and soundness, it takes on special significance as the credit cycle matures.

Before the latest update, the last comprehensive interagency statement on ALLL had been published in 1993. Much about ALLL policy has changed since then: the banking agencies published significant updates in 1999, 2001, and 2004. The December 2006 statement incorporates those changes.

The statement describes the ALLL-related responsibilities of boards of directors, management, and examiners (including the factors that must be con-

sidered when estimating the ALLL), and the objectives and elements of an effective loan review system, including a sound credit-grading system.

The agencies issued a series of frequently-asked questions to help institutions apply the guidance (see OCC Bulletin 2006-47, "Allowance for Loan and Lease Losses: Guidance and Frequently Asked Questions on the ALLL").

To ensure that OCC examiners fully understand the guidance, the OCC conducted ALLL training at each of its field offices in FY 2007. The OCC gave ALLL training to large bank examiners throughout the nation in the fall of 2007.

Hedge funds are private pools of capital that often combine aggressive investment strategies with the use of innovative financial instruments.

Promoting Better Risk Management of Innovative Markets and Products

Many national banks are leaders in developing new products and services to better serve their customers and compete effectively in today's global economy. But innovation brings risks as well as opportunities, and the OCC expects national banks to have people and systems in place to manage any increased risk they have assumed.

In FY 2007, OCC executives and examiners paid particular attention to large national banks that do business with hedge funds, engage in complex structured finance transactions, and deal in derivatives. They worked to ensure that the banks' risk management systems were capable of controlling the risks of these complex activities.

Doing Business with Hedge Funds

Hedge funds are private pools of capital that often combine aggressive investment strategies with the use of innovative financial instruments. Some large banks provide credit to hedge funds as counterparties in over-the-counter derivatives transactions and by financing transactions such as repurchase agreements.

Doing business with hedge funds presents attractive revenue opportunities for banks, but it also poses heightened credit and price risk. As a result, hedge fund relationships generally are appropriate for only

the largest and most sophisticated banks. In February 2007, Comptroller Dugan participated in the President's Working Group on Financial Markets (PWG), which called on highly sophisticated lenders, investors, and counterparties to impose "market discipline" on hedge funds. The group offered guidelines for doing so embodied in the "Agreement among PWG and U.S. Agency Principals on Principles and Guidelines regarding Private Pools of Capital," and OCC examiners expect large national banks to follow those guidelines in 2007 and beyond. Accordingly, banks doing business with hedge funds should carry out appropriate due diligence before entering into a credit relationship with a hedge fund and should establish information flows that enable them to monitor credit exposures effectively.

Comptroller Dugan explained why the PWG chose guidelines over regulation: "When deciding between requirements and guidelines, governments must determine which will have a more positive long-term effect on the markets. The PWG chose guidelines rather than a prescriptive regulatory approach to avoid discouraging financial innovation. But the success of that approach depends on hedge fund investors and creditors exercising appropriate due diligence."

For more on the PWG, see the sidebar "Dugan Sees Growing Role for the President's Working Group on Financial Markets."

Complex Financial Products

Large national banks use and offer an expanding array of complex financial products. The OCC's resident examination staffs at these banks closely monitor the use of these products to ensure that banks have adequate risk management policies and controls in place to govern them.

Certain complex structured finance transactions (CSFTs), such as those that appear designed to achieve questionable tax objectives, pose heightened reputation and legal risk. In January 2007, the federal banking agencies and the Securities and Exchange Commission (SEC) issued the "Interagency

Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Transactions." This final statement describes the types of internal controls and risk management procedures that are needed for financial institutions to identify, manage, and address the heightened risks that may arise from certain CSFTs. OCC examiners require banks engaging in CSFTs to ensure that their risk management systems can identify the elevated risk of CSFTs during new product approval and transaction approval processes and that the banks implement appropriate risk controls.

OCC examiners often work with staff in the OCC's Credit and Market Risk Division and the OCC Law Department's Securities and Corporate Practices Division to determine whether the products or activities in question raise supervisory or legal issues that must be addressed. Before banks use novel

derivatives products, for example, the OCC is often required to write legal opinions on their use. (See "Legal Opinions" under "Legal and Regulatory Framework" for more on the legal and regulatory opinions that the OCC issued during the past year.)

Additionally, examiners review a bank's control processes for new derivative products to assess whether the bank can conduct the activity in a safe and sound manner. A bank cannot begin to engage in a novel derivatives activity until the examiner-in-charge (EIC) determines that the bank has a satisfactory risk management and control framework for the product's risks.

Dealing in Derivatives

Dealing in derivatives—instruments whose value is tied to that of underlying securities or other assets—is big business in the banking industry, and the OCC supervises the five largest bank derivatives dealers in the United States. As Comptroller Dugan pointed out in a November 2006 speech to the New York Bankers Association, "such a large and concentrated credit exposure has the potential to affect both markets and systemic stability."

In FY 2007, OCC examiners evaluated the adequacy of the systems used by these bank dealers to

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monitor and control the collateral with which they mitigate their risk exposures in these transactions. Examiners also worked to determine whether dealer banks were performing adequate stress testing and scenario analysis to measure derivatives' credit and price risk. (Price risk is the possibility that a dealer bank will incur trading losses, especially in market downturns.) Stress testing and scenario analysis allow banks to simulate adverse financial events, helping them to identify potential contagion or "spillover" effects and loss exposures.

To help keep the industry and examiners abreast of derivatives activity, the OCC compiles and issues

the *Quarterly Report on Bank Derivatives Activities*, which tracks the volume and trends of derivatives and trading activities within the U.S. commercial banking system.

In FY 2007, the OCC worked with other U.S. and international regulators and major dealers to improve the trade and settlement processing systems that support the global derivatives market. The objective of these efforts is to reduce the level of unconfirmed transactions and make manual processing systems increasingly electronic, decreasing the time it takes to confirm and settle derivatives trans-

Dugan Sees Growing Role for President's Working Group on Financial Markets

A stable financial sector is essential to a well-functioning U.S. economy. Ensuring that public policies are conducive to that stability is the job of the President's Working Group on Financial Markets (PWG), in which the OCC participates.

In February 2007, the PWG released a set of principles and guidelines to guide U.S. financial regulators as they address public policy issues associated with the rapid growth of private pools of capital, including hedge funds. The agreement among the PWG and U.S. agency principals, which concentrates on how to provide investor protection and control systemic risks, serves as a framework for evaluating other market developments.

Chaired by the Secretary of the Treasury, the PWG includes the chairs of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. The PWG has been prominent in addressing a number of high-profile problems facing the financial markets, such as the near collapse of Long-Term Capital Management, a highly leveraged hedge fund, in 1999. That potential collapse posed considerable risk to market stability.

Comptroller Dugan sees an even larger role for the PWG as markets become more global and sophisticated: "When it comes to controlling systemic risks to the U.S. economy and responding to market uncertainty, it's important for the federal government to develop a concerted strategy quickly and to respond with a consistent message," said the Comptroller. "That's what makes the Working Group an essential part of the nation's financial supervisory system."

actions. The result will be more reliable operations systems as derivatives markets continue to grow.

Finalizing New Capital Rules

Capital—the amount by which assets exceed liabilities—is a broad measure of a bank’s ability to withstand financial difficulty. Modern risk management systems calculate capital adequacy by weighting bank assets according to their risk.

The OCC, Federal Reserve Board, the FDIC, and OTS worked to finalize the regulatory aspects of risk-based capital in FY 2007. The final rule would implement within the United States the Basel Committee on Banking Supervision’s revised capital accord known as Basel II.

The Basel II framework is designed to incorporate information from the advanced risk management and measurement systems used by large banks. In September 2006, the agencies issued for comment a notice of proposed rulemaking to implement Basel II and published revisions to their rules on market risk capital. In February 2007, the agencies sought comment on proposed supervisory guidance for Basel II (OCC Bulletin 2007-10, “Supervisory Guidance Related to Basel II Implementation: Proposed Supervisory Guidance”).

When the Basel II proposal was issued, the agencies contemplated that the largest, internationally active U.S. banks (“core banks”) would be required to use the Basel II rule. Certain other banks (“opt-in banks”) could use the Basel II rule with the permission of their primary federal supervisor. Banks that were neither core banks nor opt-in banks would be subject to an alternative rule. In December 2006, the agencies sought comment on this alternative proposal (see OCC Bulletin 2006-50, “Risk-Based Capital: Domestic Capital Modifications: Notice of Proposed Rulemaking”). The proposal came to be known as Basel 1A.

In July 2007, Comptroller Dugan and the principals of the other three federal banking agencies announced their agreement on how Basel II would be finalized. The agreement included a plan to propose a new standardized approach to replace the proposal known as Basel 1A. Although a standardized approach was part of the original Basel II framework, such an approach had not previously been proposed

for U.S. banks. Work to finalize the Basel II rule and to issue this new standardized proposal concluded just after the end of the fiscal year.

Providing Regulatory Relief to National Banks

Regulations are intended to enhance safety and soundness. Yet regulations that impose an excessive compliance burden have the potential to undermine, rather than enhance, the system’s viability. That’s why the OCC conducts regular reviews of its regulations and continually searches for ways to achieve its regulatory objectives at reduced cost to the institutions it supervises.

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) requires the federal agencies that are members of the Federal Financial Institutions Examination Council (FFIEC) to review their rules every 10 years, to revise rules that are outdated, and to eliminate ones that are unnecessary. The EGRPRA further requires the agencies to submit a report on the review’s findings to Congress. Accordingly, in FY 2007, the OCC reviewed its regulations and issued the following proposed and final regulations:

- *18-Month Examination Cycle* (12 CFR 4; 72 *Federal Register* 17798; April 10, 2007). On September 21, 2007, the OCC finalized an interim rule raising the \$250 million ceiling for 18-month examinations to \$500 million for qualified, well-managed banks. (The general prescript calls for national banks to receive a full-scope, on-site examination at least once during every 12-month period.) The rule, which was finalized by the Federal Reserve Board, the FDIC, and OTS as well, implements section 605 of the Financial Services Regulatory Relief Act of 2006 and related legislation.
- *Regulatory Review Amendments* (74 *Federal Register* 36550; July 3, 2007). The OCC published a proposed rule that would revise several OCC rules to reduce unnecessary regulatory burden, update certain rules, and make certain technical, clarifying, and conforming changes to OCC regulations. This review of OCC regulations, and the resulting notice of proposed rulemaking, is consistent with EGRPRA. The

comment period for this proposed rule closed on September 4, 2007.

- *Lending Limits Pilot Program* (12 CFR 32; 72 *Federal Register* 31441; June 7, 2007). The OCC issued an interim final rule that makes permanent a lending limits pilot program. That program permits a national bank to use a higher lending limit for one- to four-family residential real estate loans, small business loans, and small farm loans if the state where the bank is located allows its state-chartered banks to use a higher lending limit for those types of loans.

Helping in the Fight against Terrorism and Money Laundering

The OCC is committed to preventing criminals and terrorists from misusing the financial system and to supporting law enforcement efforts to detect and prosecute criminal activities. This work is often carried out in partnership with other federal financial institutions regulatory agencies and the Financial Crimes Enforcement Network (FinCEN).

OCC examiners evaluate each national bank's compliance with Bank Secrecy Act/Anti-Money Laundering (BSA/AML) requirements; when they observe weaknesses, they seek corrective action from the bank. The OCC investigates national banks that fail to meet BSA/AML requirements and takes enforcement actions against them. Such enforcement actions in FY 2007 included:

- A cease and desist order by consent, and a \$10 million civil money penalty (CMP) assessed concurrently with a FinCEN CMP assessment, against a bank for violations of the Bank Secrecy Act and its implementing regulation. The enforcement actions were part of coordinated actions with the U.S. Department of Justice, which entered into a Deferred Prosecution Agreement with the bank, and an accompanying \$21,600,000 forfeiture in connection with charges that the bank failed to maintain an effective anti-money laundering program. The

OCC determined that the bank failed to monitor adequately certain Mexican casa de cambio accounts, to identify suspicious activity and file suspicious activity reports in a timely manner, and to comply with requirements that it improve its processes for identifying and reporting suspicious transactions. The bank's violations resulted in the movement of millions of dollars of suspected proceeds of drug sales through the foreign accounts without detection.



- A cease and desist order by consent and a \$500,000 CMP against a federal branch of a foreign bank for failure to meet BSA/AML requirements, including failure to identify suspicious activities and file suspicious activity reports.

- A \$250,000 CMP by consent against a bank for failing to meet BSA/AML requirements and for engaging in unsafe or unsound practices in the bank's capital markets division. In addition, the OCC issued cease and desist orders by consent and assessed civil money penalties against three officers.

- A cease and desist order by consent against a bank and civil money penalties against three former bank officers for allegedly causing or permitting violations of law, including failure to meet BSA/AML requirements.

Other BSA/AML activities included:

- Chairing the FFIEC BSA/AML Working Group that coordinates interagency BSA/AML issues.
- Participating in the update of the FFIEC's 2007 *BSA/AML Examination Manual*.
- Issuing the "Interagency Statement on Enforcement of BSA/AML Requirements." The policy promotes consistency among the FFIEC agencies, as well as transparency when taking enforcement decisions.
- Conducting the OCC's 2007 money laundering risk analysis. The analysis provides more than 1,650 community banks with succinct BSA/


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AML risk assessment information. This information also enhances the effectiveness of the OCC's BSA/AML supervision.

- Ensuring a high level of technical expertise for OCC examiners through OCC BSA/AML training (classroom and knowledge-sharing calls), FFIEC BSA/AML training, and external training classes and conferences.
- Participating in more than a dozen national and regional industry conferences, including conferences sponsored by the American Banker's Association/American Bar Association (on anti-money laundering enforcement), Florida International Banker's Association, Florida Banker's Association, Banker's Outreach at Kansas State University, and the National Automated Clearing House Association.
- Participating in the U.S. Treasury Department's Private Sector Dialogue outreach program, including the United States–Latin America program in Bogotá, Colombia and the United States–Middle East North Africa (MENA) program in New York City.
- Participating in the Bank Secrecy Act Advisory Group (BSAAG), whose purpose is to develop and implement appropriate policies and procedures for the financial services industry. FinCEN chairs the group on behalf of the Secretary of the Treasury. Made up of regulators, law enforcement officials, and representatives from industries subject to BSA rules, the BSAAG meets semi-annually. Through representative subcommittees, the BSAAG is able to provide regular and meaningful discussion of many aspects of the BSA.

Protecting National Banks against Mismanagement

One of the key responsibilities of national bank examiners is to appraise management's and directors' supervision of a bank and to evaluate the quality of their decision-making processes. Those processes include planning, policymaking, personnel administration, control systems, and management information systems. Although the formality and complexity of these processes differ, all banks must have management capability appropriate to their

organizational structure and operational diversity. It is the examiner's job to determine the adequacy of each bank's management processes, to identify problems before they seriously affect the bank's condition, and to ensure that corrective measures are taken.

When directing management and directors to take these measures, examiners generally use the supervisory process to obtain the requisite responses. They issue reports, attend board meetings, participate in on-site activities, obtain commitment letters, and sign memorandums of understanding. However, when problems are serious and well-documented, formal administrative action may be warranted to address violations of laws, rules, and regulations; unsafe or unsound banking practices and breaches of fiduciary duty; and noncompliance with OCC directives or orders by national banks, their insiders, and other affiliated parties.

In combating mismanagement during FY 2007, the OCC took such formal enforcement actions as temporary cease and desist orders, final cease and desist orders, removal or prohibition orders, CMPs, and formal agreements. Documents relating to OCC enforcement actions can be found at www.occ.gov/EnforcementActions.

Enforcement Actions against Bank Insiders and Third Parties

Actions against insiders included cease and desist orders, restitution orders, and the assessment of CMPs. Insiders were the subject of these actions for misrepresenting and omitting material fact in regulatory filings, self-dealing, abusing overdraft protection, and misappropriating bank funds. The violations involved nominee loan schemes, improper fee waivers, improper extensions of credit, improper use of bank premises, improper practices in construction or acquisition of bank premises, failure to properly administer loans, abuses of expense procedures, fraudulent trade advance loans, and participation in adjusted price trades.

Actions involving third parties included issuance of a cease and desist order and assessment of a \$300,000 CMP against an auditing firm for reckless conduct when auditing the 1998 financial statements of the former First National Bank of Keystone (a failed national bank in West Virginia).

The Comptroller has stayed the enforcement action while the auditing firm appeals the action.

In another action, a law firm and an attorney of the firm signed agreements with the OCC governing their representation of insured depository institution clients and agreed to pay CMPs. In a separate agreement, the law firm agreed to pay more than \$7 million to the FDIC as the receiver for a failed bank. Although the OCC discovered evidence to suggest that the bank's officers had engaged in fraudulent transactions to hide bank losses, the law firm hired by the bank to investigate the matter issued reports clearing the officers of wrongdoing. The chairman and two other bank officers were subsequently charged and convicted of criminal offenses, and were incarcerated.

The OCC's Fast Track Enforcement Program used information from Suspicious Activity Reports to pursue prohibition or other enforcement actions when bank insiders and other institution-affiliated parties committed criminal acts or acts of significant wrongdoing involving banks, but no criminal action was taken.

Table 2 summarizes enforcement actions taken in FY 2007.

Strengthening the Legal and Regulatory Framework

Litigation

The OCC was a party to, or prepared "friend of the court" briefs for, several appellate cases that affirmed federal preemption of state law restricting national bank activities.

In *Watters v. Wachovia* [Supreme Court Docket Number 05-1342], the U.S. Supreme Court issued a seminal decision on the question of federal preemption and national bank powers. The issue before the Court was whether Michigan and Linda Watters, its Commissioner of Financial and Insurance Services, could require a mortgage operating subsidiary of a national bank, Wachovia Bank, N.A. (Wachovia), to register with and pay fees to the state. Michigan acknowledged that it would not have had the power to impose these requirements on Wachovia itself.

The Supreme Court's decision on April 17, 2007 in favor of Wachovia confirmed the findings of several federal district courts and federal courts of appeal that state laws must treat operating subsidiaries as if they were the national banks themselves. Basing its opinion on its *Barnett* decision of 1996, the Court reaffirmed the principle of preemption,

Table 2: Enforcement actions, FY 2007

Enforcement Actions, FY 2007	Against Banks	Against Institution-Affiliated Parties
Cease and Desist Orders	8	25
Temporary Cease and Desist Orders	1	0
12 USC 1818 Civil Money Penalties	4	65
12 USC 1818 Civil Money Penalties Amount Assessed	\$10,755,000	\$2,231,000
Flood Insurance Civil Money Penalties	10	0
Flood Insurance Civil Money Penalties Amount Assessed	\$629,369	\$0
Restitution Orders	0	4
Amount of Restitution Ordered	\$0	\$567,655
Formal Agreements	20	0
Memoranda of Understanding	9	0
Commitment Letters	1	0
Suspension Orders	0	1
Letters of Reprimand	0	8
12 USC 1818 Removal/Prohibition Orders	0	37
12 USC 1829 Prohibitions	0	108
Total Enforcement Actions	53	248

holding that state law may not significantly burden, curtail, or hinder a national bank's exercise of its powers under the National Bank Act.

The *Watters* case was one of four cases in which U.S. courts of appeal upheld decisions by district courts in California, Connecticut, Maryland, and Michigan that granted national banks declaratory and injunctive relief in suits challenging states' efforts to license and exercise enforcement authority over national bank mortgage subsidiaries. After issuing its ruling in the Michigan case, the Supreme Court denied petitions for Supreme Court review filed by Connecticut and Maryland.

In a related pending case, the Second Circuit Court of Appeals is considering a federal district court decision enjoining the exercise of State Attorney General visitorial authority and other state authorities over national banks.

Legal Opinions

When a national bank contemplates engaging in a certain activity, but is not certain whether it has the legal ability to do so, it may ask the OCC Law Department for its opinion on the matter. If the OCC determines that an activity is permissible, an individual national bank may engage in the activ-

The *Watters* Decision Clears the Air

The Supreme Court's decision in *Watters v. Wachovia* will have little direct effect on bank supervision. Courts will continue to view duplicative examination, supervision, and regulation of national banks by the states as preemption-triggering burdens. And national banks will continue to be subject to state laws of general application, provided those laws do not conflict with the provisions or purposes of the National Bank Act. But the Court's decision, which ratified the OCC's view that operating subsidiaries should not be treated differently than the bank itself, resolves a related supervisory dispute that had been raised in several lower court cases.

Central (if implicit) to the case was this question: Who has the supervisory authority to ensure that the customers of national banks and their operating subsidiaries are treated fairly? Is it the states or the OCC? If the answer to that question was not clear before the *Watters* decision was handed down, it is now.

The Court's decision begins by describing the OCC's responsibilities as "oversee[ing] the operations of national banks and their interactions with the customers." That's a defining phrase—" . . . and their interactions with the customers"—because it clarifies that the OCC is the supervisor accountable for how national banks treat their customers.

And the OCC takes that accountability very seriously. The agency is committed not only to ensuring the safety and soundness of national banks, but also to enforcing strong protections for national banks' customers. The OCC views these dual commitments as consistent and complementary, and we have devoted considerable resources to ensuring that banks' consumer practices are as sound as their finances.

For more on the OCC's commitment to consumer protection, see the "Consumers" section of this report.

ity, subject to supervisory judgment that it has the capability to do so in a safe and sound manner. Legally supportable and safe and sound expansion of national bank activities enhances the national banking system's competitiveness in the modern financial marketplace.

Legal opinions issued in FY 2007 addressed issues relating to national bank custody activities, investments, lending, and derivatives. Banks engaging in permissible derivatives activities must have adequate risk management systems, risk measurement systems, and controls, and must meet any other supervisory requirements relevant to the particular proposal.

Among approved investments was a noncontrolling investment in a company that offers fraud prevention, identity verification, credential validation, and payment/deposit risk services to financial institutions and other companies in the financial industry.

The OCC, along with the other federal financial institution regulators, issued a joint opinion concluding that the Bank Merger Act does not apply to a financial institution's acquisition of a portfolio of credit card accounts from another financial institu-

tion that includes a small amount of credit balances. The full text of legal opinions issued by the OCC in FY 2007 can be found at www.occ.gov/law/guidance.htm.

Licensing Decisions

The OCC made several significant licensing decisions in FY 2007 involving national bank business realignments and acquisitions. In addition, the OCC completed bank chartering studies that will result in streamlined regulatory requirements, process improvements, reduced costs and barriers, and enhanced value of the national bank charter for bank organizers.

Table 3: Licensing and customer service performance measures, FY 2007

Performance Measures	Target	Actual
Percentage of licensing applications and notices filed electronically	40%	38%
Percentage of licensing applications and notices completed within established time frames	95%	96%
Average survey rating of the overall licensing services provided by OCC	≤ 1.5	1.2

Table 4: Corporate application activity, FY 2006 and FY 2007

	Applications received		FY 2007 Decisions			
	FY 2006	FY 2007	Approved	Conditionally Approved ⁴	Denied	Total*
Branches	1,872	1,673	1,724	4	0	1,729
Capital / Sub Debt	167	135	66	3	0	71
Change in Bank Control	9	8	2	0	0	6
Charters	47	32	3	27	0	30
Conversions ¹	15	25	6	5	0	11
Federal Branches	3	1	0	0	0	0
Fiduciary Powers	30	6	4	0	0	4
Mergers ²	62	49	40	0	0	0
Relocations	274	277	256	1	0	257
Reorganizations	123	108	81	13	0	94
Stock appraisals	0	2	0	0	0	0
Subsidiaries ³	27	14	21	10	0	31
12 CFR 5.53 Change in Assets	3	4	0	4	0	4
LTD NB Upgrade	5	2	0	1	0	1
Total	2,637	2,336	2,203	68	0	2,278

¹ Conversions to national bank charters.

² Mergers include failure transactions when the national bank is the resulting institution.

³ This count does not include 93 After-the-Fact notices received in FY 2006 and 81 After-the-Fact notices received in FY 2007.

⁴ On April 14, 2000, the Licensing department issued guidance imposing special conditional approval for all bank charters requiring the OCC to be notified before a significant deviation or change in the operating plan during the first three years of operation.

* Total includes alternative decisions or no objections.

Table 5: OCC licensing actions and timeliness, FY 2006 and FY 2007

Application Type	Target time frames in days ¹	FY 2006			FY 2007		
		Number of Decisions	Within Target		Number of Decisions	Within Target	
			Number	%		Number	%
Branches	45 / 60	1,790	1,721	96	1,729	1,690	98
Capital / Sub Debt	30 / 45	55	48	87	71	59	83
Change in Bank Control	NA /60	8	8	100	6	6	100
Charters ²		34	21	62	30	13	43
Conversions	30 / 90	12	9	75	11	8	73
Federal Branches	na/120	2	1	50	0	0	0
Fiduciary Powers	30 / 45	14	9	64	4	3	75
Mergers	45 / 60	64	54	84	40	36	90
Relocations	45 / 60	271	267	99	257	251	98
Reorganizations	45 / 60	132	100	76	94	84	89
Stock Appraisals	NA /90	2	2	100	0	0	0
Subsidiaries	NA	35	35	100	31	31	100
12 CFR 5.53 Change in Assets	NA/60	5	4	80	4	2	50
LTD NB Upgrade ³		1	0	0	1	0	0
Total		2,425	2,279	94	2,278	2,183	96

Note: Most decisions (98 percent in 2006 and 99 percent 2007) were decided in the district offices and Large Bank Licensing under delegated authority. Decisions include approvals, conditional approvals, and denials.

¹ Those filings that qualify for the “expedited review” process are subject to the shorter of the time frames listed. The longer time frame is the standard benchmark for more complex applications. New time frames commenced in 1997 with the adoption of the revised Part 5. The target time frame may be extended if the OCC needs additional information to reach a decision, permits additional time for public comment, or processes a group of related filings as one transaction.

² For independent charter applications, the target time frame is 120 days. For holding-company-sponsored applications, the target time frame is 45 days for applications eligible for expedited review, and 90 days for all others.

³ Ibid. 2.

Table 6: Change in Bank Control Act,¹ FY 2003–FY 2007

Year	Received	Acted On	Not Disapproved	Disapproved	Withdrawn
2007	6	6	0	0	0
2006	9	8	4	0	4
2005	17	17	17	0	0
2004	16	14 ²	13	0	0
2003	16	10	9	1	0

¹ Notices processed with disposition.

² Includes one notice with no activity. The OCC considered it abandoned.

Table 7: List of applications presenting Community Reinvestment Act issues decided, FY 2007

Bank, City, State	Interpretations and Actions	Document Number
JPMorgan Chase Bank, NA	October 2006	CRA Decision No. 136
HSBC Trust Company (Delaware), National Association, Wilmington, DE	October 2006	CRA Decision No. 137
City National Bank, Beverly Hills, CA	May 2007	CRA Decision No. 138
COFSB National Association, McLean, VA	May 2007	CRA Decision No. 139
Rabobank, NA, El Centro, CA	June 2007	CRA Decision No. 140

Working To Address the Needs of Minority Banks

The OCC has long been committed to expanding opportunities for minority-owned national banks (MONBs). In 2007, the agency took several steps toward increasing outreach and support to promote that goal.

First, the OCC established an interdepartmental Minority National Bank Working Group to address hot topics and emerging issues that pertain to MONBs. Headed by Mid-Size/Community Bank Supervision, the group developed two surveys that assessed the breadth and quality of the agency's efforts to support MONBs. The surveys should help the OCC to enhance its education, outreach, and technical assistance as well as improve the agency's strategies aimed at helping MONBs operate in a safe and sound manner, serve the banking needs of their communities, and preserve their minority-owned status.

Also in FY 2007, the OCC improved its communication and outreach with minority banks and trade associations. Among the recent MONB-related information produced and disseminated are the agency's print and online versions of the Winter 2006-2007 *Community Developments* newsletter, "Minority-Owned Banks—Making a Difference in Their Communities." This issue of the newsletter appears on the OCC's Web site at <http://www.occ.gov/cdd/commfoc.htm> and in the Community Affairs section of the National Banknet, the OCC's extranet for national banks.

The OCC also participated in several conferences throughout FY 2007. It co-hosted the Minority Depository Institution Interagency National Conference, where Chief of Staff John Walsh discussed opportunities and requirements under the Community Reinvestment Act and discussed the OCC's efforts to support minority banking and its supervision. OCC managers and staff participated in other 2007 events largely attended by minority bank CEOs, including the Annual Conference and the Legislative and Regulatory Conference of the National Bankers Association. "Increased dialogue with the minority banking community," said Glenda Cross, Senior Advisor for External Outreach and Minority Affairs, "has helped the OCC not only better understand the unique characteristics of minority-owned banks, but also to establish and share with its bank supervision staff best practices for working effectively with MONBs."

EVENTS

September 2006	The OCC and other federal banking agencies issue final guidance on nontraditional mortgage products.
October 2006	The OCC and other federal banking agencies inform consumers about nontraditional mortgage loans. The booklet “Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?” features a glossary of lending terms, a mortgage shopping worksheet, and a list of additional sources of information.
November 2006	The OCC hosts a meeting of directors of Large Banks to promote communications and enhance corporate governance.
December 2006	The OCC, Federal Reserve (FRB), and FDIC issue guidance on concentrations in commercial real estate lending. The OTS issued separate but parallel guidance. The OCC and other federal banking agencies provide guidance and FAQs to bankers and examiners on the allowance for loan and lease losses.
January 2007	The OCC, FRB, FDIC, OTS and SEC issue statement on complex structured financial transactions.
February 2007	The OCC, FRB, FDIC, and OTS seek comment on proposed supervisory guidance for the implementation of the Basel II advanced measurement approaches.
March 2007	The OCC and other federal banking agencies seek comment on the subprime mortgage lending statement. The proposal addresses concerns that subprime borrowers may not fully understand the risks and consequences of obtaining subprime mortgages.
April 2007	Supreme Court renders its decision in <i>Watters v. Wachovia</i> . The OCC, the other federal banking regulators, and the U.S. Department of Housing and Urban Development issue statement encouraging institutions to work with mortgage borrowers.
May 2007	Comptroller Dugan expresses concern over “stated income” subprime loans.
June 2007	Comptroller Dugan in testimony before the House Financial Services Committee announces new cooperative initiative with state agencies that aims to curb abuses by mortgage brokers. Comptroller Dugan unveils public service announcements encouraging delinquent borrowers to contact lenders for help to avoid foreclosure. OCC releases report highlighting best practices of loan servicers to prevent foreclosures. OCC and other federal banking regulators issued final statement on subprime mortgage lending.
July 2007	OCC publishes interim final rule amending 12 CFR 32, which governs lending limits. The revision allows national banks higher lending limits if state-chartered banks in the same locale are allowed higher limits. OCC, FRB, FDIC, and OTS issue final rule amending regulations on management interlocks. Federal banking agencies issue statement on enforcement of Bank Secrecy Act/anti-money laundering requirements. The statement aims to provide greater consistency in BSA enforcement among the agencies. OCC, FRB, FDIC, and OTS reach agreement on implementation of Basel II.
August 2007	Federal banking agencies propose illustrations of consumer information to support their statement on subprime mortgage lending. Financial regulatory agencies issue a revised BSA/AML manual.
September 2007	OCC brings together chief risk officers of Large Banks to discuss trends in credit markets. OCC, the other federal banking agencies, and the Conference of State Bank Supervisors issue statement on loss mitigation strategies for servicers of residential mortgage loans. Comptroller Dugan tells House committee that the National Banking System remains safe and sound despite challenging credit and mortgage markets. Results of the annual Shared National Credit review show an increase in criticized commitments but satisfactory overall credit quality.