Comptroller of the Currency
Administrator of National Banks

US Department of the Treasury

Office of the Comptroller of the Currency

ANNUAL REPORT

Fiscal Year 2006

Ensuring a Safe and Sound
National Banking System
For All Americans

We are living in a time of great uncertainty and constant change, but I am confident that we are prepared to evolve with the market, meet new challenges, and respond to emergencies—just as the OCC has done throughout its 143-year history.

I. Comptroller's Viewpoint

I am pleased to report that the national banking system not only remained strong throughout fiscal year (FY) 2006, but that both the OCC and the system are well equipped to meet the challenges that lie ahead.

This was the second consecutive year in which no national bank failed. Capital was strong and earnings increased, driven by strong growth in noninterest income. Healthy loan growth helped compensate for narrowing net interest margins. Losses and delinquencies were minimal. In short, the picture at year-end was quite positive.

Yet as supervisors, it is our job to worry about what comes next. Are we at the stage of the credit cycle where risks in the system begin to increase because of less favorable macroeconomic conditions, increased competition, and weaker underwriting standards? What must we be doing to prepare the banking system and the OCC for the challenges ahead?

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A great deal of our work during the year focused squarely on these questions. The interagency Shared National Credit review, a detailed assessment of large syndicated loans to major corporate borrowers, provided one important "snapshot" of national trends in credit quality. The review found only small increases in the number of criticized and classified commitments—and those increases were measured against 2005 levels, which were the lowest in six years. As positive as those results were, they did not answer the question of whether that small drop in credit quality portends a change in direction, or merely a small fluctuation around a high and stable level of credit quality in the syndicated loan market.

Of greater concern to me was the evidence of credit trends provided by the OCC's *Survey of Credit Underwriting Practices*, a detailed review of lending standards across 18 commercial and retail product lines, based on the professional judgment of examiners-in-charge at the 73 largest national banks. The 2006 survey results indicated that loan standards in both commercial and retail lending had eased for a third consecutive year under pressure from competition and optimistic expectations for loan volume, yield, and market share. The evidence included thinner pricing, reduced amortization, weaker covenants and controls, pervasive structural concessions in such terms as tenor and guarantor requirements, and increased exceptions to lending policies.

In commercial lending, the most pronounced slippage occurred in leveraged lending and large corporate loans. Commercial real estate also showed continued signs of net easing that, in combination with the increased concentrations in commercial real estate loans, heightened concerns in that area. In retail lending, there was significant easing in residential mortgage and home equity lending standards: longer interest-only periods, higher allowable debt-to-income and loan-to-value ratios, and greater volumes of loans with reduced documentation requirements. Significantly, this weakening of standards came at a time when prices in the previously red-hot housing market were leveling off and, in many local and regional markets, actually declining. Although these market trends would normally trigger tighter lending standards, all evidence suggested that standards were continuing to loosen because of intensifying competition among lenders for a shrinking pool of buyers.

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The evidence emerging from our analysis revealed symptoms that have historically been reliable predictors of future problems in the banking industry, if not addressed. Our challenge was to ensure that national banks managed this risk in an effective and timely way, while credit quality, loan loss reserves, and the economy remain strong.

It was with that objective in mind that the OCC addressed a broad range of risks facing the national banking system during FY 2006.

As the fiscal year drew to a close, the bank, thrift, and credit union regulatory agencies published guidance addressing nontraditional residential mortgages. At a time of rising house prices in many parts of the country, some lenders introduced options that, for a limited period, allow borrowers to forego regular principal payments ("interest-only" loans) or even to waive a portion of the interest due, resulting in negative amortization. Although these products clearly can benefit some consumers, we are concerned that banks may not properly manage the risks they entail, especially in an environment of rising interest rates and softening real estate markets. Our guidance therefore cautions banks to assess a borrower's ability to repay the loan at the fully amortized rate and to ensure that the borrower understands the terms and risks of the product before purchase.

Similar concerns lay behind this year's proposed guidance on commercial real estate (CRE) concentrations. The guidance does not take the position that CRE concentrations are inherently unsafe and unsound, or that hard limits should be set on such activities. Instead, it concludes that CRE concentrations pose special risk that can and must be managed effectively through appropriate management controls, including strong information systems.

Strong capital is a key element of any risk management regime—and the bulwark of a safe and sound banking system. A year marked by significant progress in the arduous process of writing, refining, testing, and critiquing the Basel II capital rules culminated in the long-awaited release of a Notice of Proposed Rulemaking that was issued for public comment. I am committed to continuing to work closely with all concerned parties to ensure that the Basel II capital rule that emerges from this process is one that deserves widespread support.

We undertook lower-profile, but no less important, initiatives throughout the year that further strengthen risk management in the national banking system. Our Community Bank Directors Workshop program offered a selection of one-day classes on such subjects as credit risk, compliance risk, and the OCC's risk assessment process. In February, more than 400 senior bank managers, academics, vendors, and regulators attended an OCC-sponsored conference on risk modeling, reflecting the growing importance of these sophisticated statistical tools in making underwriting decisions, managing and pricing accounts, and mitigating losses.

The banking system played an increasingly important role in safeguarding our nation's physical security. The OCC takes very seriously its responsibility to enforce the Bank Secrecy Act in a manner that is rigorous, consistent, measured, and fair. To help bankers better understand their responsibilities under the law and our supervisory procedures, we continued an ambitious industry outreach program and issued clarifying supervisory guidance. We also added a new director for Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) Compliance and increased the number of BSA/AML experts in our headquarters office, which substantially augmented the OCC's existing expertise in this critical area.

Protecting the rights of bank consumers is one of our agency's fundamental obligations.

During fiscal year 2006, recovery began in earnest from the massive damage wrought by hurricanes Katrina, Rita, and Wilma on the Gulf Coast. National banks are playing a crucial role in that effort, beginning with the recovery of many local banks from damage sustained during the storms. During my several trips to the region, I was impressed by the way that banks have put competitive considerations aside and worked together to keep vital services flowing to citizens of the affected communities.

OCC staff members did their part, too. They worked with our banks to address the many regulatory issues raised by the storms and encouraged bank officials to work with their customers to help see them through the financial difficulties many of them faced. They also established relationships with community organizations and helped coordinate our outreach efforts to local citizens and governmental bodies. They helped mobilize the financial and intellectual resources of out-of-town bankers, many of whom attended an interagency banker forum held in New Orleans in March—as I did.

The OCC's commitment to community development is an around-the-country proposition. I saw the fruits of the partnerships between national banks and community-based organizations during my visits to neighborhoods in Chicago, Los Angeles, and Washington, D.C., during FY 2006. Small business formation and assistance, housing construction and renovation, financial literacy and foreclosure abatement programs—the range and vitality of community development initiatives undertaken with the support of national banks—are truly impressive.

Several regulatory initiatives during the fiscal year promise to make these partnerships even more successful. For example, we provided guidance on how small- and minority-owned business contracts that enhance the effectiveness of a bank's small business loan program may be considered favorably in the bank's Community Reinvestment Act evaluation. We also proposed that Congress approve legislation increasing the community development lending authority available to national banks under Part 24 of our regulations, and that measure was adopted and signed into law.

Under Part 24, national banks may make an investment in a minority-owned bank or thrift. The OCC is committed to supporting these institutions. Our outreach efforts this year resulted in constructive dialogue between minority-bank CEOs and OCC's senior executives, and helped us better understand the special issues they face.

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The national bank charter continued to be a vibrant vehicle for conducting the business of banking. This is reflected in the growth of the national banking system: assets under OCC supervision grew from $5.9 trillion to $6.5 trillion during the fiscal year, representing 67 percent of all U.S. commercial bank assets.

In a long-awaited decision, *Wachovia* v. *Schmidt,* the U.S. Supreme Court unanimously upheld the OCC's position that a national bank is a citizen of the one state in which its main office is located. This seemingly arcane issue is one of significant practical importance because it enhances the ability of national banks to have their cases heard in federal courts.

Important legal principles affecting national banks continue to be litigated, including the extent to which state laws are preempted by federal law under the National Bank Act, and the scope of the OCC's exclusive "visitorial" authority over national banks (the authority to examine, supervise, regulate, and sanction national banks). One issue, the question of whether state laws apply to national banks' operating subsidiaries to the same extent as they apply to the parent bank itself, will be considered by the Supreme Court in late 2006, and should be decided in 2007. This case, *Watters* v. *Wachovia Bank, N.A.,* arose from state efforts to regulate and require state licenses of mortgage banking operating subsidiaries of several large national banks. The OCC believes that if state law is inapplicable to a national bank because of federal preemption, the state law also would be inapplicable to the bank's operating subsidiary because the operating subsidiary is a federally authorized means through which the bank exercises its federally authorized powers.

Information security, long a focus of attention for the OCC, emerged as a critical issue during the year, as security breaches at some government agencies, including the loss of laptop computers, raised the visibility of this problem. A break-in at the OCC's Phoenix office exposed vulnerabilities even where security is high. In response to these developments, the OCC launched an end-to-end security review from which we expect to emerge with a strengthened security infrastructure fully capable of confronting the world of network linkages, high-speed transmission, and mass storage of easily portable electronic data that our supervisory work requires.

I have said to OCC staff that it is my responsibility to make sure that on my last day in office, the OCC is stronger than it was on my first. To achieve that goal, we must build staff resources and expertise that are equal to the growth in the size and complexity of the national banks we supervise. Our success depends on the supervisory staff that implements OCC policies: nearly 3,000 examiners, attorneys, economists, information technology experts, and other professionals and support staff. Directly or indirectly, they are responsible for the examination and supervision of the more than 1,800 national banks, federal branches of foreign banks, and uninsured national trust companies. Our front-line examiners serve as the OCC's face to the banking industry.

Recruitment, retention, and training are thus essential to the future of our organization and our ability to perform our important mission.

During the last year, we have focused intently on our organizational and human resource capabilities and requirements. The challenge we face is embedded in the OCC's changing demographics: fully 30 percent of our current employees and 50 percent of our managers will be eligible to retire in the next five years. Recruitment, retention, and training are thus essential to the future of our organization and our ability to perform our important mission.

During the last year, we have made unprecedented strides in recruitment and hiring of examination staff, bringing aboard 162 new college hires and 37 mid-career hires from industry and other agencies. We have also made great strides in assessing the agency's skill requirements and laying plans for the training programs needed to meet them. This is an advantageous moment to be tackling these challenges. The current sound condition of the national banking system allows us to focus on our personnel needs in a measured and orderly way. We are also well positioned by the OCC's own financial health, which is discussed elsewhere in this *Annual Report,* and our growing reputation as a workplace of excellence.

The OCC placed sixth among more than 170 peer agencies and bureaus in a survey of "The Best Places to Work in the Federal Government." Also, *BusinessWeek* magazine named us among the 50 best places in America to start a career. These results are not only a matter of organizational pride, but also an asset of considerable value to us as we work to recruit and retain the best qualified individuals to fill our evolving personnel needs.

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John C. Dugan
Comptroller of the Currency
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