



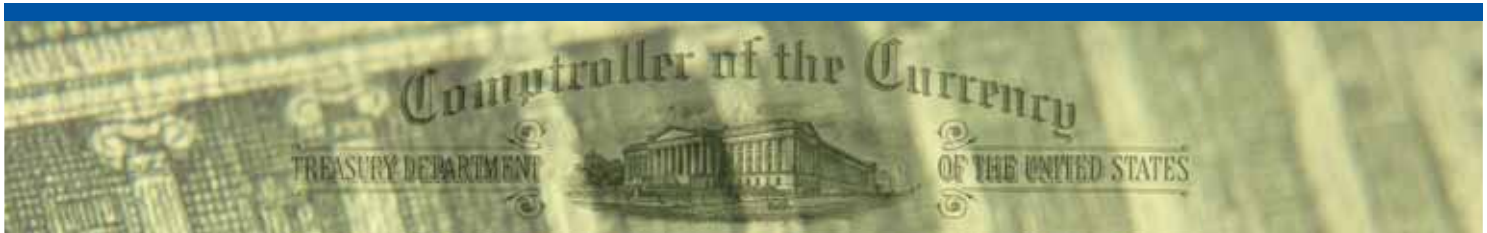
Comptroller of the Currency
Administrator of National Banks

US Department of the Treasury

Office *of the* Comptroller *of the* Currency

ANNUAL REPORT

Fiscal Year 2008



OCC VISION

The Office of the Comptroller of the Currency (OCC) seeks to assure a banking system in which national banks soundly manage their risks, comply with applicable laws, compete effectively with other providers of financial services, offer products and services that meet the needs of customers, and provide fair access to financial services and fair treatment of their customers.

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OCC Offices in the Continental United States



Figure 1: Statistical Profile of the OCC's Fiscal Year 2008

Number of Total Employees	3,122
Number of National Bank Examiners	2,079
Number of Safety and Soundness Examinations Conducted	1,266 ¹
Number of Specialty Examinations Conducted	630
Number of Consumer Assistance Personnel	48
Number of Written Consumer Complaints Processed	41,656
Total Revenue	\$736.1 million ²
Percentage of Revenue Derived from Assessments	96.1


¹ Large and midsize national banks receive continuous supervision.

² Ninety-six percent of OCC revenue is derived from assessments.

Figure 2: Statistical Profile of the National Banking System

Number of National Banks	1,678
Percentage of Total Commercial Banks	20
Number of Uninsured National Trust Companies	73
Number of Federal Branches of Foreign Banks	49
Assets of National Banks (Excluding Federal Branches of Foreign Banks)	\$8.3 trillion
Percentage of Total U.S. Commercial Banking Assets	62
Total Insured Deposits	\$4.886 trillion
Number of Employees of National Banks	1,247,143
Community Development Investment Authority	\$3.7 billion

Source: OCC, 2008.



Comptroller's Viewpoint

For the financial system, both here and abroad, the fiscal year that ended September 30 was without question the most extraordinary of my lifetime. In fact, when I look back on all that has happened since we published our last annual report, I am struck by the sheer number of events involving severe credit and market stress, any one of which could have been the most serious financial problem of the year in the much quieter period before 2007.

Just naming the worst of them is both telling and exhausting. The first annual decline in nationwide house prices. Record foreclosure levels. Brutal losses on subprime loans. The near shutdown of interbank lending markets and the liquidity freeze for asset-backed commercial paper and structured investment vehicles, or SIVs. The government takeover of Fannie Mae and Freddie Mac. The failure of Lehman Brothers, IndyMac, and WaMu. The distress sales of Countrywide to Bank of America, Bear Stearns to JPMorgan Chase, and Wachovia to Wells Fargo. The administration plan to use \$700 billion to unfreeze the credit markets.

Could all of these major financial events have really happened in just one year? The answer, of course, is yes. In fact, many of the most dramatic of them happened in just over a month. In reflecting on this “100-year flood,” let me provide a few observations from the perspective of the OCC.

First, national banks took important steps to strengthen their positions. Large banks that experienced difficulties responded by aggressively raising capital to shore up their balance sheets, attracting well over \$100 billion. As a result, virtually all national banks continued to satisfy the definition of “well capitalized” on September 30. Banks of all sizes have rapidly increased loan loss reserves to address the spike in troubled loans—in some cases to unprecedented levels. While fiscal 2008 was a difficult year with many tense moments, we should not lose sight of these very tangible positive signs amid the steady drumbeat of negative news.

Second, despite the unprecedented nature of these events, the OCC anticipated many of them before they occurred and dealt with them once they arrived. We sounded early public warnings in guidance and speeches about risk layering, payment shock, and declining underwriting standards for “payment option” mortgages and home equity lending. Our higher standards for subprime mortgage underwriting kept most of that lending out of national banks. The subprime loans that national banks did make were generally of higher quality than those originated elsewhere.

For commercial real estate (CRE) concentrations in community banks, we conducted rigorous horizontal reviews in each of the four OCC districts starting in 2004; we pushed hard for the CRE guidance subsequently issued in 2006 over industry opposition; and we delivered our messages again and again in speeches, outreach meetings, and examinations all over the country.

Our annual underwriting surveys repeatedly spotlighted the trend of declining underwriting standards, particularly with respect to leveraged loans. We also recognized early on that community bank failures would accelerate in 2008; we talked about that publicly; and we planned for it. Distressed institutions—large and small—have demanded far more attention and supervision than normal, and at times, tensions have run high. OCC examiners stepped up to each unfolding event with speed, maximum effort, and teamwork. We needed the best from our examiners, and they delivered. It is no accident that banks have gotten more realistic about recognizing delinquency and loss; raised significant amounts of capital when they could; aggressively built loan loss reserves and agreed to tangible actions that would fundamentally improve their risk management. It is an examiner’s job to get banks to take these sometimes painful steps to



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improve their safety and soundness, but it has not always been easy.

The OCC has also initiated new data gathering to help address the recent problems. Perhaps the best example is our Mortgage Metrics project. An unprecedented effort accomplished in record time, this project gathered loan level data on over 40 percent of the mortgages serviced in the United States. Importantly, the data are both standardized and validated. We now know much more than we once did about trends in delinquency, modification, and foreclosure with respect to prime, subprime, and Alt-A mortgages, and we have begun to use that data in a variety of ways to support our supervision and our efforts to mitigate the impact of the economic crisis on homeowners. We have also begun to develop similar metrics for home equity and credit card lending, and we think that data, too, will prove very important to our supervision and our consumer protection initiatives.

But there were some problems we clearly did not anticipate, and we need to learn some lessons and make some improvements going forward. Here are a few that stand out.

- *Liquidity.* A number of banks were not as prepared to deal with liquidity strains as they should have

been, thinking that their access to funding, even in times of stress, would be much better than it proved to be. I think the regulatory community had that same misimpression, and a number of us have concluded that our liquidity metrics were not sufficiently robust. We have been working with banks all over the country to improve their liquidity positions. In addition, the Basel Committee issued a very thoughtful paper on liquidity risk management, and we have spent a considerable amount of time developing a better template for gathering data to measure liquidity risk. I believe these efforts will produce real improvement over time.

- *Risk management for complex financial instruments.* Collateralized debt obligations (CDOs) backed by subprime mortgages were the prime example of the need for better efforts here. Despite the inherent risk of the underlying collateral, the industry and regulators were lulled into a false sense of security by the triple-A ratings given to the super-senior tranches of these securities. Some of the exposure was masked in off-balance-sheet vehicles in ways that clouded the full extent of exposure. Indeed, some senior bank management thought they had avoided

this: some concentrations can be so large that even the best risk management will fall short when an economic storm focuses on that same asset class. While the jury is very much still out, and the subject is controversial, regulators and policymakers in the future may very well need to revisit the issue of appropriate levels of concentration.

A major concern I have going forward is the pressure to lower underwriting standards for loans that are sold to others as opposed to those held in portfolio. Some banks applied different underwriting standards for loans sold to Wall Street securitizers for further sale to investors, while the standards were more rigorous for loans that banks kept on their books. The same was true for leveraged loans originated by our very largest banks.

In both cases, when examiners began to criticize the lower standards for loans that were sold, we often heard the same two arguments in response. First, some argued that weaker underwriting standards should not matter if the risk leaves the bank when the loan is sold to a willing buyer who understands the increased risk. And second, some claimed that if banks were forced to raise their standards above the level required by the market, they would lose business to others who did not have to raise their standards.

Events of the last year have revealed the fundamental flaw in those arguments. When funding markets lock up, banks can get stuck holding a large pipeline of the loans they planned to sell, and the weak underwriting can translate into huge writedowns and losses. That is what happened in the leveraged loan market, and it is also what happened to a number of banks with large mortgage warehouses.

So the painful lesson learned is that banks need to underwrite loans for sale as they would for loans held in portfolio, and we need to hold banks to that standard or something very close to it. That is easy enough to say now, when the loan sale market is closed, but it will be much harder to put in practice when the market reopens and banks start making the same arguments once again. Holding the line will clearly be one of our challenges for the future.



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subprime risk by deliberately choosing to avoid originating such loans in the bank—only to find out after the fact that their investment banks had purchased subprime loans elsewhere to structure them into CDOs. And when the market seized up, some banks that structured the CDOs for sale to third parties wound up holding large positions that no one wanted to buy. That resulted in huge concentrations, which in turn led to huge losses. There was too much reliance on triple-A ratings, not enough transparency and risk aggregation, and too much tolerance for concentrations.

- *Risk concentrations in commercial real estate.* The OCC and the banks we supervise did a tremendous amount to anticipate and address potential issues before they turned into problems, and we have been especially proactive in squarely addressing these problems as they have emerged. But I have been troubled in looking at the banks that have failed thus far—both national and state banks—by some toxic combinations of real estate concentrations, rapid growth, extremely high levels of brokered deposits, and out-of-area lending. In the future, I think we will need to do more to check these combinations before they cause unmanageable problems. And let me add

And now let me turn to my final observation about the recent credit turmoil, which is this: it is a long way from over. The administration's plan to invest capital in, and guarantee the debt to, financial institutions has helped stabilize the market. But as we approach the end of 2008, the economy has plainly weakened. At least in the near term, all of this is likely to mean more credit losses; more provisions to loan loss reserves; squeezed profits; strains on capital; and, in some cases, more bank failures.

Facing all of this, I think it is critical that the OCC continues to strive for the kind of balanced professional judgment that we have shown thus far. We have to be careful to be forthright in addressing problems as we see them and leaning on bank management to do exactly the same. But we have to be equally careful not to overreact and make problems worse by acting too precipitously or being more stringent than necessary.

It is also important that in our focus on credit and liquidity issues we not lose sight of our compliance and consumer protection responsibilities. We know that compliance lapses can do significant damage to a bank's reputation—the kind of damage that can take years to repair and that diverts time and attention away from the business of running the bank. I have asked our examiners to see to it that in dealing with the industry's safety and soundness, we do not allow significant compliance problems to develop in their place.

As we attempt to strike that balance in our supervision, it is all but certain that we will see more national bank failures, and some will ask if we should not have done more to prevent one bank failure or another, or if we should have moved sooner to close a troubled bank. These are important questions. But it is just wrong to argue that any bank that fails and costs the deposit insurance fund money could have been closed sooner at less cost. It is also wrong to suggest that any bank that fails means that supervisors did not do their jobs.

While either assertion could be true with respect to a specific bank, it is just as possible—and frankly, more likely—that neither is true with respect to a particular failure. The fact is, banks take risks when

they make loans, as they should, and sometimes they fail because the risks prove larger than they reasonably anticipated; or the local economy suffers severe stress, devastating businesses to which the banks lend; or extraordinary events like the ones we have seen in the last year put strains on banks that just could not be reasonably anticipated.

When banks like these suffer large losses, examiners have to make hard judgments about viability. Should the bank be closed immediately with a certain loss to the deposit insurance fund? Or does it have a reasonable prospect of raising capital or being sold, preventing any loss to the fund? The latter option, of course, may take a little time to find out. Sometimes that time produces a positive result that avoids failure and loss altogether, and sometimes it does not. But even when it does not, it is not at all clear that the ultimate loss to the fund is greater than it would have been had the bank been closed earlier. In fact, that should not be the case if the bank is tightly regulated during the process to avoid excessive risk-taking, which is exactly what we do with a bank in these circumstances.

The bottom line is this: bank closing is an art, not a science. Sometimes it is better to do it fast, and sometimes it is much better to take the time, in controlled circumstances, to try to find a solution that avoids loss to the fund. Our most seasoned examiners make these kinds of viability determinations, working closely with the Federal Deposit Insurance Corporation (FDIC), and we think this is by far the best approach to least-cost resolution.

I am proud of the hard work and dedication OCC staff has shown in meeting the extraordinary challenges of the last year. One of my great comforts in serving as Comptroller is knowing that I can rely on such a strong corps of talented, dedicated people who are doing all they can to help ensure the safety and soundness of our national banks. The national banking system is the backbone of a strong U.S. economy, and we at the OCC will continue to work hard to ensure that it remains safe and sound, and capable of supporting American consumers and businesses.



Introduction

Against the backdrop of one of the most tumultuous years in U.S. financial history, the OCC's *Fiscal Year 2008 Annual Report* highlights how the OCC performs its primary mission of examining, supervising, and chartering national banks. In times like these, the agency is especially sensitive to how financial institutions touch the lives of the individual Americans who, as employees, shareholders, and customers, have a direct stake in their safety and soundness. The OCC's ultimate responsibility goes beyond the banks we supervise to the broader public interest we serve.

Processes and people are central to the accomplishment of the OCC's mission. The OCC routinely provides professional and independent bank supervision, and our people are widely recognized as exceptionally competent at what they do. We provide advanced training for examiners; integrate new technologies into bank supervision; develop sophisticated risk models to inform supervisory strategy and practice; place resident examining teams in our largest, most complex institutions; maintain separate supervisory approaches for midsize and community banks; offer an appellate process for national bankers; ensure that examiners have specialized expertise in such areas as compliance, bank technology, capital markets, mortgage banking, and operational risk; and provide national bank customers a state-of-the-art means of resolving complaints.

The OCC's risk-based approach to supervision provides a framework for identifying banks with elevated risk, assessing the risk those institutions

might pose to the national banking system, and deploying supervisory resources accordingly. Risk-based supervision proved especially important given the increased number of at-risk institutions in fiscal year 2008.

Despite the heavy focus on direct examination and supervision, the fiscal year saw a large number of policy initiatives. The OCC continues to work with legislators and other regulators to promote regulatory efficiency and enhance consumer protection, fair lending, and equal access to credit. Recognizing the importance of these aspects of supervision and the danger that market events might overshadow these issues, Comptroller Dugan cautioned that "market disruption could so dominate the attention of bankers and regulators that we lose focus on other still-important priorities. We simply cannot allow that to happen."

Responding to the challenges of the economy requires dedicated people with the right skills, motivation, and experience. This annual report spotlights OCC team members who represent some of the many diverse professions that must be integrated properly for the OCC to succeed—examiners working in national banks and in policy positions; attorneys who help write, interpret, and enforce laws and regulations; economists who provide data and analytical tools; management specialists who ensure efficient use of our human and material resources; information technology experts; community affairs officers; and many others, who, together, bring diverse perspectives to the OCC. This range of expertise, developed over 145 years, enables us to maintain high standards for bank supervision in good times and bad.