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Comptroller of the Currency  
Administrator of National Banks

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US Department of the Treasury

## **Semiannual Risk Perspective**

**From the National Risk Committee**

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Office of the Comptroller of the Currency  
Washington, D.C.

Spring 2012

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## **About This Report**

The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises national banks and federal savings associations<sup>1</sup> (collectively, banks). It supervises these banks to ensure they operate in a safe and sound manner and comply with applicable laws and regulations, including those requiring fair treatment of customers and fair access to credit and financial products.

The OCC's National Risk Committee (NRC) monitors the condition of the banking system and emerging threats to the system's safety and soundness. NRC members include senior agency officials who supervise banks of all sizes, as well as officials from the law, policy, and economics departments. The NRC meets quarterly and issues guidance to examiners that provides perspective on industry trends and highlights issues requiring attention.

The OCC *Semiannual Risk Perspective* addresses key issues facing banks. The OCC publishes the report twice a year, drawing upon mid-year and year-end data. This report reflects OCC data as of December 31, 2011.

Banks face risks and opportunities. As a report discussing risks, the *Semiannual Risk Perspective* focuses on issues that pose threats to the safety and soundness of banks rather than opportunities that banks may encounter at the same time. Other available sources assess opportunities and discuss the upside potential of those opportunities. This report presents data in four main areas: the operating environment; the condition and performance of the national banking system; funding, liquidity, and interest rate risk; and regulatory actions.

The OCC welcomes feedback on this report by e-mailing [NRCReport@occ.treas.gov](mailto:NRCReport@occ.treas.gov).

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<sup>1</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act transferred supervision of federal savings associations to the OCC on July 21, 2011.

## ***Executive Summary***

The U.S. banking industry continues to emerge from the recession of 2007 and 2009 and to adjust to significant shifts in its operating and regulatory environments. These shifts are inducing large changes in the risk and profitability profiles of banks. In the aftermath of the recent crisis, levels of capital and allowance for loan losses (ALLL) across the industry are more robust and of higher quality than prior to the recession. The higher levels and better quality of capital are most notable at the largest banks, but the improvement is widespread across the industry.

This report discusses the OCC's three major risk concerns: (1) the aftereffects of the recent housing-driven credit boom-bust cycle; (2) the challenges to banking industry revenue growth in a post-recession, slow-growth economy; and (3) the potential that banks may take excessive risks in an effort to improve profitability.

## ***Key Risk Themes***

The three themes introduced above define the current risks facing the banking system. All three risks apply to all banks, though their intensity may vary greatly between small and large banks.

### ***Aftereffects of the Housing-Driven Credit Boom-Bust***

- The overhang of severely delinquent and in-process-of-foreclosure residential mortgages continues to significantly challenge large banks with extensive mortgage operations and continues to affect the economic environment for all banks. While corrective actions are being implemented, flaws in foreclosure processing are exacting large remediation costs, record penalties, and reputational damage for mortgage servicers.
- Asset-quality indicators show continued improvement across small and large banks. Small bank delinquency and loss rates did not reach the peaks seen at the larger banks, but their pace of improvement has been slower. Housing-related loans continue to demonstrate above average rates of delinquency and charge-off.
- Commercial real estate (CRE) performance is improving, but vacancy rates and the level of problem assets continue to be high—a particular concern for many community lenders.

### ***Revenue Growth Challenges From a Slow Economy and Heightened Financial Market Volatility***

- Outside of commercial and industrial (C&I) lending, loan growth remains tepid, which has weighed on net interest income by pressuring asset yields for banks of all sizes.
- The persistence of historically low interest rates continues to hamper margin upside by limiting the ability of many banks to further reduce funding costs.
- Low interest rates have contributed to extraordinary growth in non-maturity deposits, especially by businesses. These deposits may be vulnerable to run-off and significant upward repricing if businesses start redeploying these funds or if interest rates rise. Rapidly rising funding costs because of rising interest rates could limit any upside to margins from the normal strengthening in loan volumes that would accompany stronger economic growth.
- As net interest income has declined, non-interest income faces ongoing pressures from legislative, regulatory, and market changes that have depressed fee income, servicing and

securitization income, and may restrain future trading revenue. These pressures are most intense at the largest banks, though smaller banks also feel the effects.

- European sovereign debt issues and the threat of a breakup of the Euro have led to a sharp slowdown in European economic growth, and contributed to worsening credit quality, increased financial market uncertainty, and perceptibly weakened global economic activity. These developments have contributed to an increase in the cost of long-term debt and equity financing for large European and U.S. financial institutions as these issues continue to weigh on market confidence and the economic recovery in Europe and the United States.

### ***Potential That Search for Higher Profitability May Lead to Taking on Inappropriate Levels of Risk***

- Underwriting standards are under pressure as banks compete for higher earning assets to improve profitability.
- “New product” risk is increasing as banks seek to enter new or less familiar markets to offset declines in revenues from core lines of business.
- Increased operational risk is a key concern as banks try to economize on systems and processes to enhance income and operating economies. This risk may be amplified by the use of third-party products or distribution systems.
- Credit performance overall remains vulnerable to weak economic growth and potential shocks, such as from global financial markets or energy markets.
- The low interest rate environment continues to make banks vulnerable to rate shocks. Small banks, in particular, are increasingly adding to investment portfolio positions and increasing duration to obtain higher yields.
- The unprecedented volume and scope of change in the domestic and international regulatory environment challenges business models and revenues. These challenges increase the importance of strategic planning and prudent resource allocation.

### ***OCC Risk Perspective: Outlook by OCC Business Line***

#### **Community and Midsize Banks**

Community banks continue to suffer from the aftereffects of the housing-driven credit boom of the past decade as well as the challenge of adapting to the evolution of the operating and regulatory environments in the financial services industry. Their main concern is defining and implementing a strategy that will allow community banks to thrive in the face of lingering credit stress, historically low margins, competitive pressures from larger banks, and uncertainty about future regulatory changes.

- The performance and residual embedded risks of income-producing CRE portfolios continue to raise concerns for banks with CRE concentrations. Losses from income-producing CRE have been less than expected, but these loans have benefitted from low interest rates. Performance will be adversely affected if net operating income does not improve or interest rates increase.
- Some banks are seeking asset growth by expanding or starting new product lines for which they may lack the appropriate control processes and expertise. Examples include commercial

and industrial (C&I), indirect auto, and oil and gas lending. Additionally, banks that previously built up concentrated exposures to CRE loans may transition to concentrated positions in C&I lending without appropriate control processes.

- Margins are under pressure in the low interest-rate environment due to growth in deposits and weak loan demand. This provides an incentive to increase the duration of the investment portfolio and purchase more complex structured products. Both actions increase exposure to interest rate risk and require heightened risk analysis to fully assess vulnerability.

### **Large Banks**

Large banks continue to face profitability challenges from legal, operational, and reputational costs stemming from prior residential mortgage underwriting and servicing deficiencies and continued uncertainties in the housing market, as well as persistently high levels of credit stress in residential real estate loan portfolios. Meanwhile, they face fundamental changes in their business models that are dampening revenue growth, including shifts in the role of trading, securitization, and consumer fee income. Operational risk is heightened during this period of transition.

- Operational risk is the primary concern in banks with high transaction volume or high growth. A key priority for some of the largest banks is addressing identified weaknesses in the foreclosure process and mortgage servicing. Deficiencies in mortgage servicing and foreclosure practices continue to present significant reputational risk, and the cost of litigation, remediation, and penalties is dampening profitability and productivity.
- Threats to information security pose an ongoing concern as criminals challenge bank preventive controls and monitoring abilities.
- Exposures to troubled periphery countries in Europe are relatively small compared with bank capital levels. Financial market participants, however, remain sensitive to the effectiveness of efforts to address sovereign debt issues and the contagion effects that result from both counterparty risks and the economic impact of austerity measures.

### ***OCC Risk Perspective: Policy and Supervisory Actions***

Heightened regulation and supervisory standards designed to strengthen the resiliency of the financial sector and to implement legislative mandates are significant, both domestically and internationally. Codification and implementation of these changes in bank regulation continue to be a focus of policy and supervision units within the OCC and other federal financial services regulators.

Reflecting the improved condition of the national banking system, the number of OCC-supervised banks with composite CAMELS ratings of 4 or 5 has stabilized, and regulatory actions appear to have peaked for this business cycle. After increasing steadily since 2004, matters requiring attention (MRA) issued to OCC supervised banks fell in 2011, and enforcement actions also declined in 2011.

Supervision and policy actions are focused on the following areas for community, midsize, and large bank segments:

### Community and Midsize Bank Supervision

- **CRE:** The OCC supervisory staff will continue to evaluate exposures to CRE and assess the appropriateness of the ALLL. OCC supervisory staff will assess management's ability to conduct sensitivity analysis of CRE portfolios for those banks with concentrations of risk.
- **Interest Rate Risk (IRR):** OCC supervisory staff will continue to focus on the identification of outlier banks with regard to IRR. OCC supervisory staff will also continue outreach to federal savings associations on the implementation of asset and liability management models because of the sunset of the Office of Thrift Supervision (OTS) Net Portfolio Value model.
- **New and Less Familiar Products:** OCC supervisory staff will evaluate new products and C&I loan portfolios to ensure adequate underwriting and risk management standards and practices.
- **Strategic Planning:** OCC supervisory staff will focus on both the board's and management's evaluation of the bank's current situation and their plans for ensuring the bank's safety and soundness as the operating environment evolves.

### Large Bank Supervision

- **Foreclosures and Mortgage Servicing:** Mortgage servicing problems emerged as a key operating weakness and drew a strong regulatory response through the consent order process. The OCC's supervisory staff continues to focus on lapses in operational processes and the implementation of upgrades to systems and processes to meet enhanced mortgage servicing requirements.
- **High Volume and Rapid Growth:** The OCC's supervisory staff will leverage lessons learned from mortgage servicing problems in the examination of other high volume and rapid growth products to identify any systems weaknesses within an institution.
- **Eurozone Exposures:** OCC supervisory staff will continue to track Eurozone exposures and conduct reviews of related contingency plans.
- **New C&I Loan Underwriting:** The OCC supervisory staff will continue their ongoing scrutiny of commercial credit underwriting practices of new originations.
- **Risk Management:** The OCC supervisory staff will continue their examination focus on risk management practices and implementation of heightened expectations for governance and oversight functions.



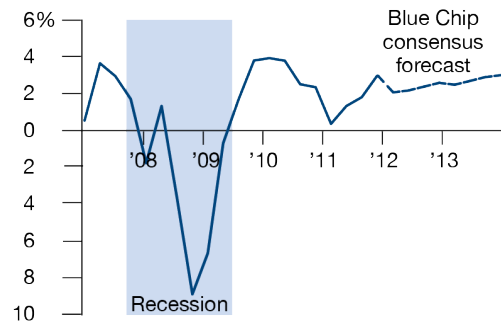
**Part I: Operating Environment**

**Slow Economic Recovery Likely to Remain a Drag on Loan Growth**

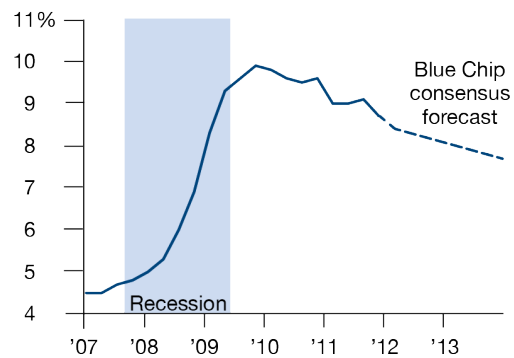
The U.S. economy expanded in 2011 albeit at a slower rate than had been expected earlier in the year (see figure 1). Faster than expected employment growth, gains in household income, and strong business investment have improved expectations for 2012. Hiring trends improved with the private sector posting employment growth for 24 consecutive months and small firms beginning to hire again. Nevertheless, the consensus private sector forecast indicates unemployment will remain above normal through 2013. This slow recovery is expected to weigh on consumer confidence, spending, loan growth, and credit performance.

**Figure 1: GDP and Unemployment Trends**

Annual percentage change in real GDP



Quarterly average unemployment rate



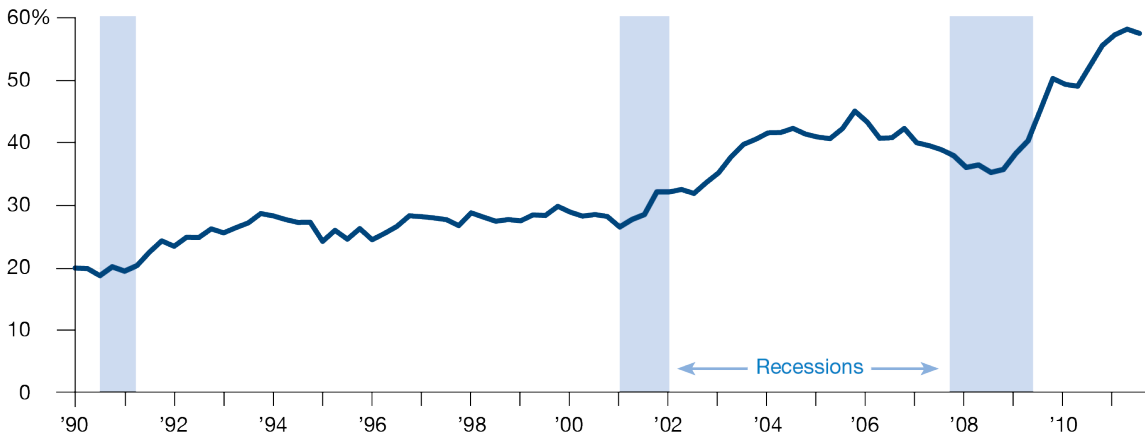
Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Blue Chip Indicators, February 2012.

**Corporate Balance Sheets Exceptionally Liquid**

Large nonbank corporations are extraordinarily liquid (see figure 2), and their consistent profitability suggests that they are likely to remain so. This has contributed to an increase in deposits in the banking system and muted the demand of large nonbank corporations for loans. These strong corporate liquidity positions also suggest that corporate customers will be able to use internal funds to finance investment and expansion, implying that corporate demand for bank credit could remain modest even as the economy recovers.

**Figure 2: Percentage of Liquid Assets/Short-Term Liabilities, Nonfinancial Corporations**

Quick ratio



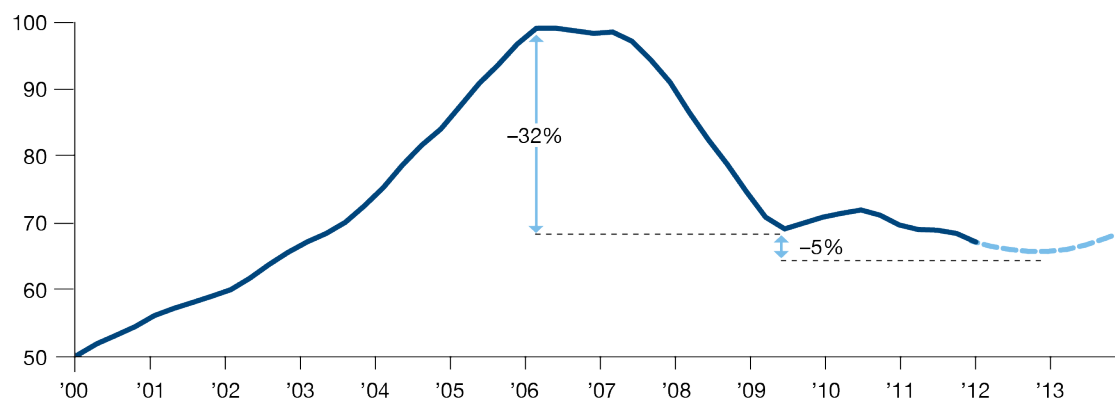
Sources: Federal Reserve/Haver Analytics.

## Housing Market Remains Weak

The housing market continues to struggle and home prices continue to decline and remained well off their peak (see figure 3). The percentage of mortgages that were seriously delinquent (loans 60 or more days delinquent plus bankruptcy and 30 or more days delinquent) increased to 5 percent from 4.9 percent at June 30, 2011, but decreased from 5.3 percent a year earlier (see table 1). The percentage of foreclosures in process increased from 4 percent at June 30, 2011 and December 31, 2010 to 4.1 percent. A large overhang of foreclosures suggests that many areas may see further declines in home prices. Any slowing in the economy could affect the recovery in real estate values, a key component of problem assets in the banking industry.

**Figure 3: Case-Shiller National Home Price Index**

Case-Shiller national home price index, seasonally adjusted, to the first quarter 2006



Sources: Standard & Poor's, Fiserv, and MacroMarkets LLC/Haver Analytics; forecast data from Moody's Analytics, February 2012 baseline.

**Table 1: Mortgage Portfolio Performance for Banks**

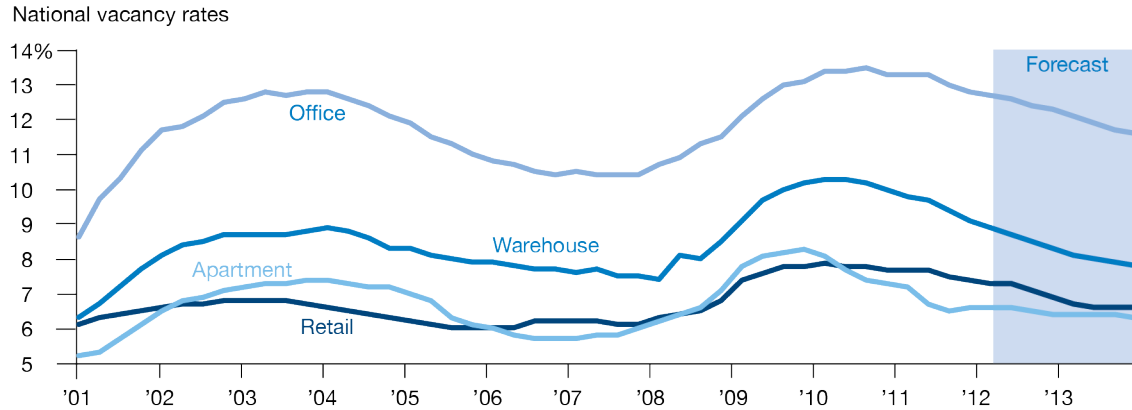
Percentage of mortgages in the portfolio							
	12/31/2010	3/31/2011	6/30/2011	9/30/2011	12/31/2011	1Q % change	1Y % change
Current and performing	87.6%	88.6%	88.1%	88.0%	87.9%	-0.1%	0.4%
30-59 days delinquent	3.1%	2.6%	3.0%	3.0%	3.0%	1.2%	-2.3%
Three categories classified as seriously delinquent							
60-89 days delinquent	1.3%	1.0%	1.1%	1.2%	1.2%	-0.3%	-9.2%
90 or more days delinquent	3.1%	2.8%	2.8%	2.7%	2.8%	2.2%	-11.1%
Bankruptcy 30 or more days delinquent	0.9%	0.9%	1.0%	1.0%	1.0%	4.3%	17.5%
<b>Subtotal for seriously delinquent</b>	<b>5.3%</b>	<b>4.8%</b>	<b>4.9%</b>	<b>4.9%</b>	<b>5.0%</b>	<b>2.0%</b>	<b>-5.9%</b>
Foreclosures in process	4.0%	4.0%	4.0%	4.1%	4.1%	-0.9%	-1.5%

Source: OCC Mortgage Metrics Report for the fourth quarter of 2011.

**Commercial Real Estate Vacancy Rates Improving but Remain High**

CRE vacancy rates remained high through the end of 2011 but improved for all types of commercial property (see figure 4). Private-sector forecasts call for continued improvement but at a slow pace given expectations for weak economic growth. Small banks remain vulnerable to deterioration in portfolio quality given their concentration in CRE loans.

**Figure 4: CRE Vacancy Rates**

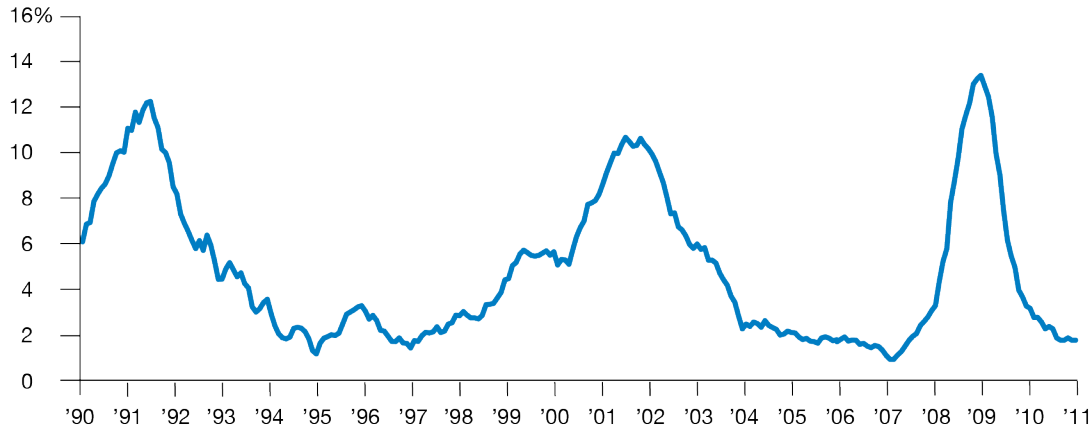


Source: Property & Portfolio Research, first quarter 2012 baseline forecast.

**Corporate Default Rate Falling**

The corporate speculative-grade default rate has fallen back to near pre-crisis levels. While this is a sign of positive developments in the corporate credit arena post-crisis, sustained low levels can be a leading indicator of increasing credit risk, as was the case in the mid-1990s and the mid-2000s (see figure 5). Sustained periods of low default rates may encourage excessive risk taking, which would become evident in the form of easing underwriting standards and declining credit spreads.

**Figure 5: Corporate Default Rates**



Source: Moody's Investors Service, Inc.

### Treasury Yields Remain Historically Low

Treasury yields have been at or near historical lows for the past several years (see figure 6). In recent periods, however, the yield curve has been unusually steep. The spread between two-year and 10-year yields has been more than three times the historical median, although by year-end 2011 it had declined more than 100 basis points. An upward sloping yield curve typically implies market expectations for higher rates, which suggests a heightened risk of increased interest rates when economic growth picks up. For banks, the possible negative effects of higher rates include a decline in value of negatively convex securities, including many mortgage-related securities, and the higher probability of credit problems for retail and commercial loan obligors.

**Figure 6: Spread Between 2- and 10-Year U.S. Treasury Notes**



Source: Federal Reserve Board.

Note: Treasury yield curve estimates, coupon equivalent par-yields are updated as of February 28, 2012.

## **Part II: Condition and Performance of Banks**

### **A. Profitability and Revenues: Improving Slowly**

#### **Bank Profitability Increasing**

Net income in 2011 for banks increased 27 percent year over year to almost \$87 billion. Banks of all sizes experienced improvements in operating performance. Smaller banks had the largest percentage increase in net income. For example, net income at banks with assets between \$1 billion and \$10 billion increased 300 percent, the most of any category, while for banks with assets less than \$1 billion, net income increased by 71 percent. The gain in net income at banks with more than \$10 billion in assets was 22 percent in 2011 (see table 2).

The primary driver of improved earnings over the past year was lower provisioning expense as gross revenues in all three income categories (net interest income, non-interest income, and realized securities gains and losses) remained relatively flat or declined for the three categories of banks shown in table 2. Banks of all sizes reduced provisioning expenses, with the largest banks reporting a 52 percent reduction in provisions for loan losses. Those with assets between \$1 billion and \$10 billion had a 49 percent reduction in provisioning expenses, while those with less than \$1 billion in assets saw a 37 percent reduction. The largest banks reported a 7 percent increase in non-interest expense, in sharp contrast to a 9 percent decline for banks with assets between \$1 billion and \$10 billion and 1 percent increase for those with less than \$1 billion in assets.

**Table 2: Income and Expenses for Banks**

	Assets more than \$10 billion		Assets \$1 billion to \$10 billion		Assets less than \$1 billion	
	Fourth quarter 2010	Fourth quarter 2011	Fourth quarter 2010	Fourth quarter 2011	Fourth quarter 2010	Fourth quarter 2011
Number of institutions	66	62	197	187	1,790	1,682
Total assets in billions	8,457	8,770	495	496	401	385
<b>Revenues in billions</b>						
Net interest income	276.7	264.7	15.8	16.1	12.5	12.5
Non-interest income	162.2	157.9	8.5	7.0	5.6	5.8
Realized securities gains and losses	6.6	3.2	0.2	0.1	0.1	0.2
<b>Expenses in billions</b>						
Provisioning	106.7	50.9	5.7	2.9	2.7	1.7
Non-interest expense	244.6	261.0	16.3	14.9	13.3	13.4
Income taxes	27.2	33.9	1.4	1.7	0.7	1.0
<b>Net income</b>	<b>66.0</b>	<b>80.2</b>	<b>1.0</b>	<b>4.0</b>	<b>1.4</b>	<b>2.4</b>

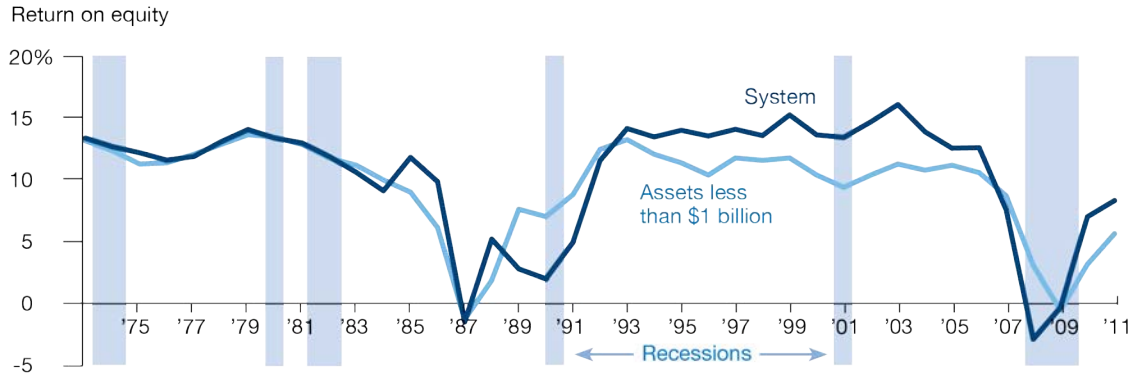
Source: OCC Integrated Banking Information System.

Note: Data are merger-adjusted and held constant for institutions in continuous operation from the first quarter of 2006 through the fourth quarter of 2011.

### Return on Equity Improving Slowly

Return on equity improved for large and small banks (see figure 7) but remained well below long-term averages. Returns were about half of peak returns reached in the prior decade. Even though provisions dropped dramatically last year, they remained high historically thus continuing to weigh on income. Further, returns at small banks remained under pressure due to weak loan demand and the low interest rate environment. Banks have raised significant amounts of equity capital, strengthening their balance sheets, which also contributed to the lower returns on equity.

**Figure 7: Return on Equity Trends for Banks**



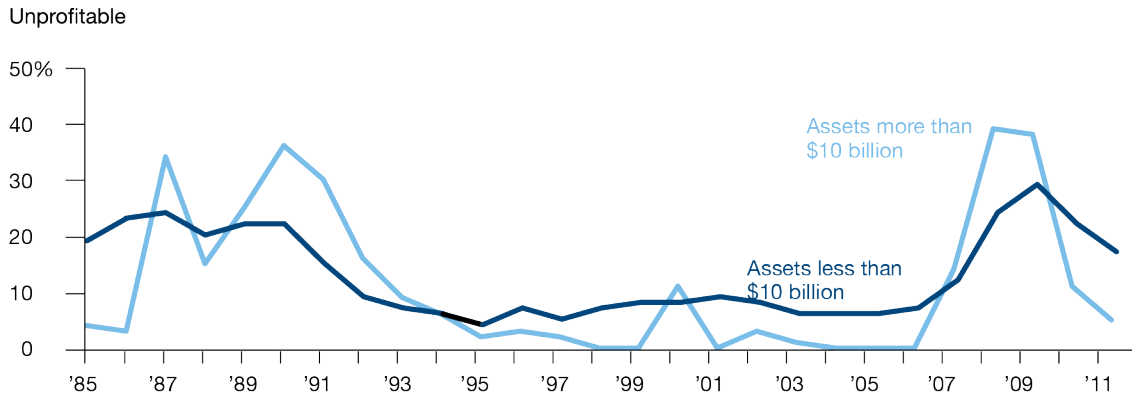
Source: OCC Integrated Banking Information System.

Note: Sum of quarterly net income as a share of five-quarter trailing average equity. Results for 2008 are modified with estimates from the Consolidated Financial Statements for Bank Holding Companies-FR Y-9C to restore missing data due to purchase accounting treatment of Washington Mutual, third quarter of 2008, Wachovia and National City, fourth quarter of 2008. Federal savings associations data not available (not included in chart) prior to 1984.

### Fewer Banks Report Losses

The percentage of unprofitable banks (see figure 8) continued to decline in 2011. The percentage of banks with more than \$10 billion in assets that were unprofitable declined to 5 percent in 2011 from 39 percent in 2008. The percentage of banks with less than \$10 billion in assets that were unprofitable showed slightly less improvement, declining from 24 percent in 2010 to 17 percent last year.

**Figure 8: Percentage of Unprofitable Banks**



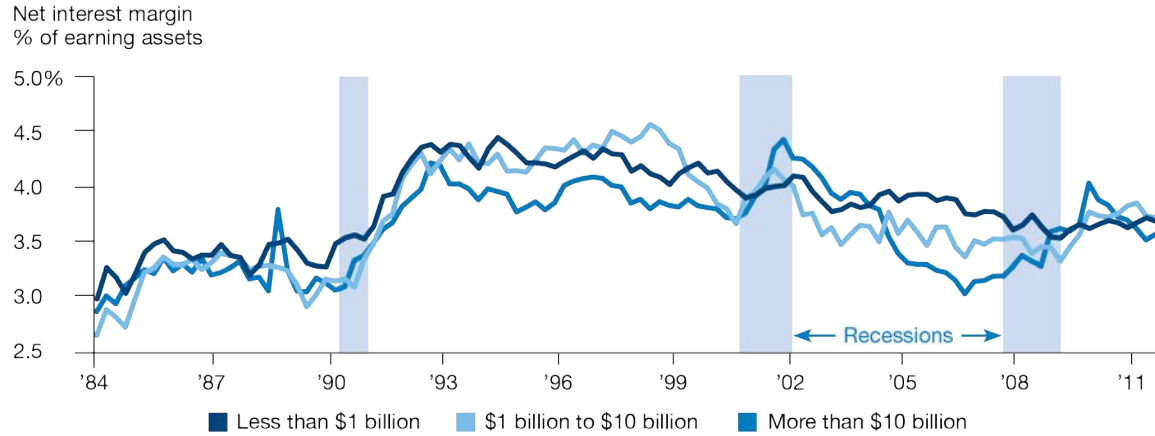
Source: OCC Integrated Banking Information System.

Note: Data is as of year-end. Unprofitable means return on assets less than 0.

### Net Interest Margins Remain Under Pressure

Net interest margins have rebounded from the lows during the recession of 2007 through 2009, but they have come under renewed pressure at banks over the past year (see figure 9). Margins at smaller banks improved little from recent lows. Weak loan demand led banks to accumulate an increasing share of lower yielding investment securities on balance sheet. Moreover, after three consecutive years of record low interest rates, banks are unlikely to realize further benefits from lower funding costs. Given a fairly static outlook for interest rates and loan growth in 2012, net interest margins will likely show little incremental improvement in the near term.

**Figure 9: Trends in Net Interest Margins for Banks**



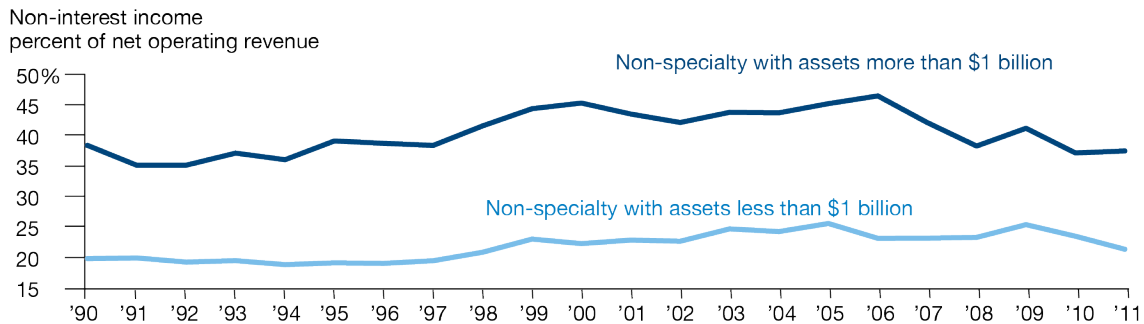
Source: OCC Integrated Banking Information System.

Note: Quarterly data is through the fourth quarter of 2011.

### Non-interest Income Declining for Large and Small Banks

The decline in non-interest income, while more noticeable at the largest banks, affected large and small banks (see figure 10). The decline in non-interest income as a percentage of net operating revenue began in 2006 for the largest banks and in 2009 for smaller banks. Largely as a result of the fallout from the housing bust, the recent declines in non-interest income can be attributed in large measure to lower securitization and servicing revenues, as well as lower gains on sales of loans, other real estate owned, and other assets. Regulatory limits on consumer fees and a greater consumer reluctance to pay for banking services have also led to declines in deposit service charges and “other” non-interest income.

**Figure 10: Trends in Non-interest Income for Banks**



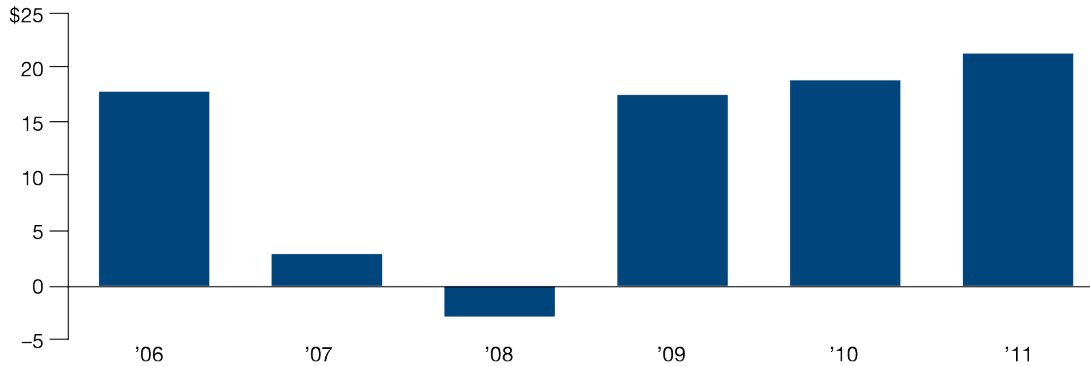
Source: OCC Integrated Banking Information System.

Note: Data is as of year-end. Net operating revenue equals net interest income plus non-interest income.

## Trading Revenues Increase

Banks reported a record \$21.2 billion in trading revenues in 2011, 13 percent higher than the previous high in 2010 (see figure 11). Despite the higher revenue, trading revenue for the fourth quarter of 2011 declined 74 percent from the third quarter of 2011 and 30 percent from the fourth quarter of 2010. A seasonal decline in trading revenues is typical for the fourth quarter, but the 2011 decline was exacerbated by concerns about sovereign debt and the health of European banks, which reduced the risk appetite of banks and their customers. Though a relatively small percentage of gross revenue for the banking system, trading is an important source of revenue for some banks. Trading revenues are an important source of revenue diversification for large banks.

**Figure 11: Trading Revenues for Banks**



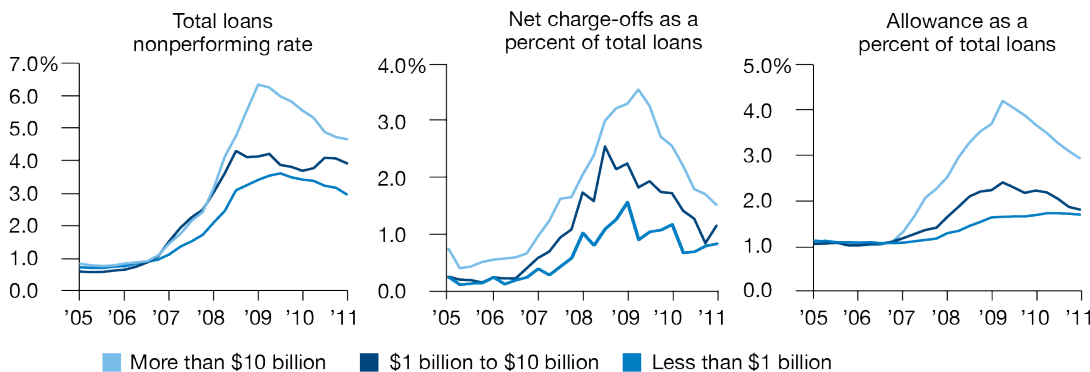
Source: OCC Integrated Banking Information System.

## B. Credit Quality: Real Estate Related Loans Still Stressed

### Credit Cycle Improvement Pronounced at the Largest Banks

The credit cycle showed continuing improvement through the end of 2011 (see figure 12). Nonperforming loans (NPL), loans 90 days or more past due or on nonaccrual, declined for large and small banks, though not as quickly as charge-offs. Typical of previous credit cycles, recoveries have increased in the aftermath of the worst quarters of the downturn. Net charge-offs have benefited by recoveries collected on loans charged off in prior quarters. The ALLL declined somewhat in 2011 as a percent of total loans, reflecting the lower level of NPLs, and remains historically high. Banks with more than \$10 billion in assets have seen a significant decline in delinquent loans and charge-offs over the past five quarters.

**Figure 12: Credit Cycle Analysis for Banks**



Source: OCC Integrated Banking Information System.

Note: Data are merger-adjusted and held constant for banks in continuous operation from the first quarter of 2006 to the fourth quarter of 2011.

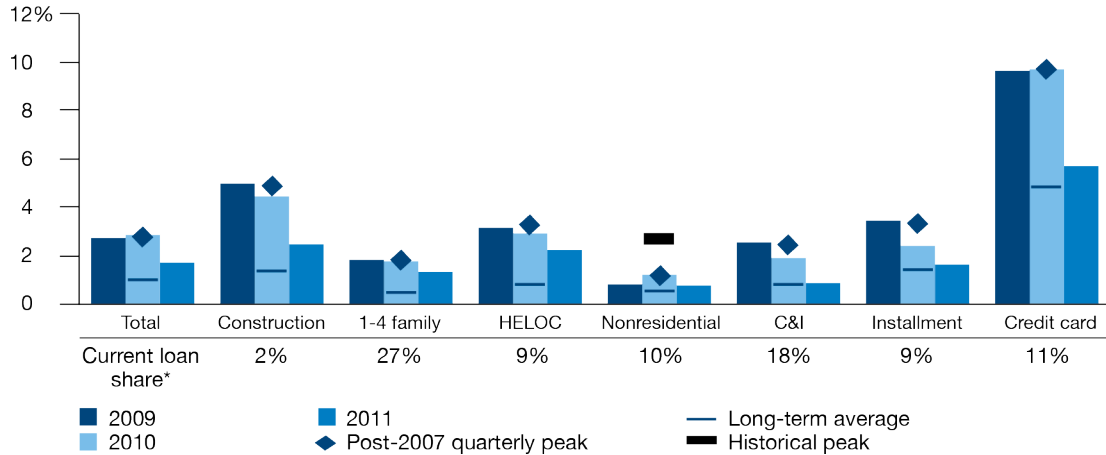


### Charge-Off Rates Remain High

Charge-off rates for banks decreased sharply in 2011 but generally remained above historical averages (see figure 13). The improvement in charge-off rates varies notably by loan type. For real estate construction and residential mortgage products, charge-off rates remain high relative to historical norms, with junior lien home equity lines of credit (HELOC) showing the highest differential. Credit card, C&I, and commercial mortgage charge-off rates are now very close to their post-1990 average levels.

**Figure 13: Charge-Off Rates by Asset Class for Banks**

Net charge-off rates, percent annualized



Source: OCC Integrated Banking Information System.

\*Not all detail loan categories are shown. Net charge-offs are shown as a percent of loans in respective category.

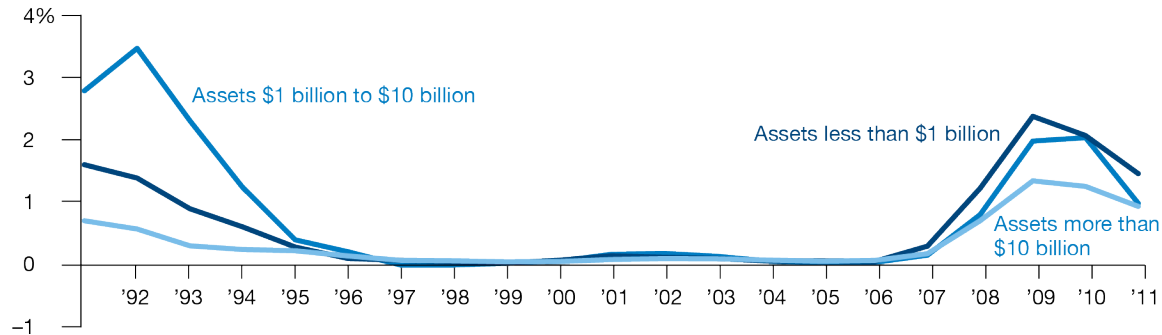
Note: 2010 credit card charge-off rate is calculated using 2010 year-end credit card balance.

### Commercial Real Estate Charge-Off Rates Decline

Losses on CRE (commercial mortgage and construction loans combined) have been an important driver of charge-offs, which reached the highs for this cycle in 2009. Charge-offs declined sharply from the peak through the end of 2011 (see figure 14). While well below peak levels reached in the early 1990s, the continued high level of losses is a key reason that bank provisions for loan losses (especially for smaller banks) remain above historical norms.

**Figure 14: CRE Charge-Off Rates for Banks**

Total CRE net charge-off rates



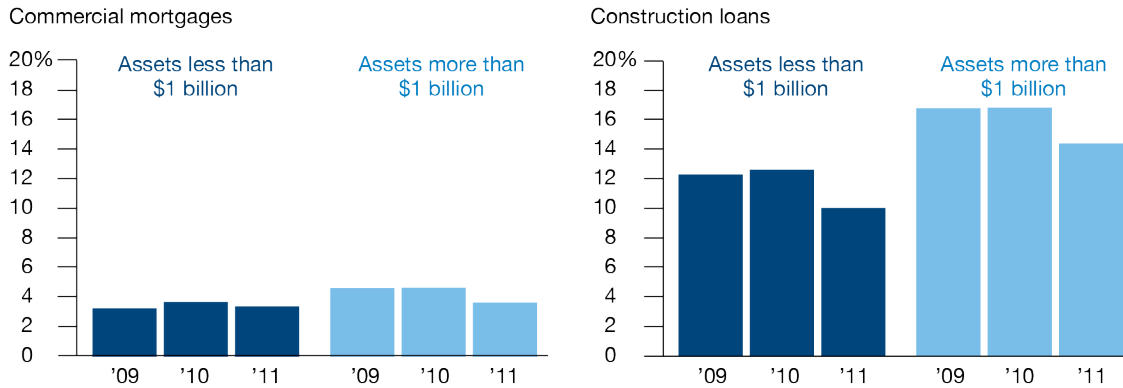
Source: OCC Integrated Banking Information System.

Note: Net charge-offs are shown as a percent of loans in respective category. CRE includes non-residential real estate, multi-family, and construction loans.

### Commercial Real Estate Noncurrent Loan Rates Decline

Noncurrent loan rates for CRE declined in 2011 (see figure 15). Noncurrent commercial mortgage loans showed modest improvement for small banks while noncurrent construction and land development loans (C&D) had a more significant decline primarily because of charge-offs. The percentage of C&D loans that were 30 or more days past due remained four times as high as for commercial mortgages. While C&D loans were only 14 percent of total CRE lending at the end of 2011, noncurrent C&D loans were 39 percent of total noncurrent CRE loans.

**Figure 15: Noncurrent Commercial Real Estate Loan Rates for Banks**



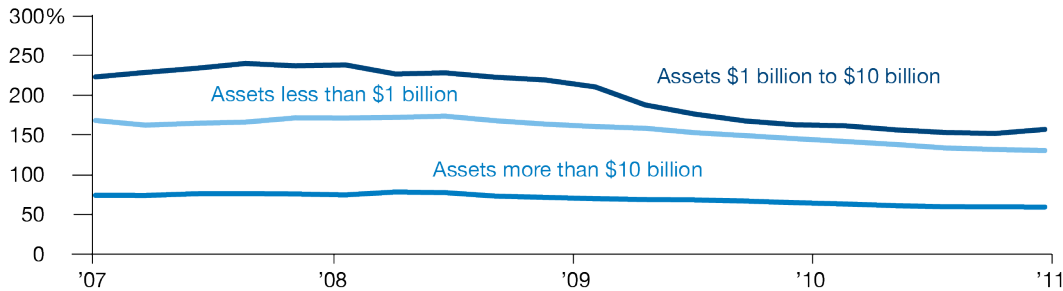
Source: OCC Integrated Banking Information System.

Note: Commercial mortgages include non-residential real estate and multi-family loans.

### Commercial Real Estate Concentrations Remain Elevated

CRE concentrations remain elevated in smaller banks, although there has been considerable improvement since 2008. While CRE concentrations, as defined in the 2006 interagency CRE guidance,<sup>2</sup> at the largest banks have declined from a high of 77 percent of capital in 2007 to 58 percent at the end of 2011, concentrations remained well over 100 percent of capital (see figure 16) at smaller banks. C&D lending has declined more than 50 percent from its 2008 peak; high charge-offs and increasing capital contributed to the improvement in concentration ratios.

**Figure 16: CRE Concentrations as a Percentage of Tier 1 Risk-Based Capital for Banks**



Source: OCC Integrated Banking Information System.

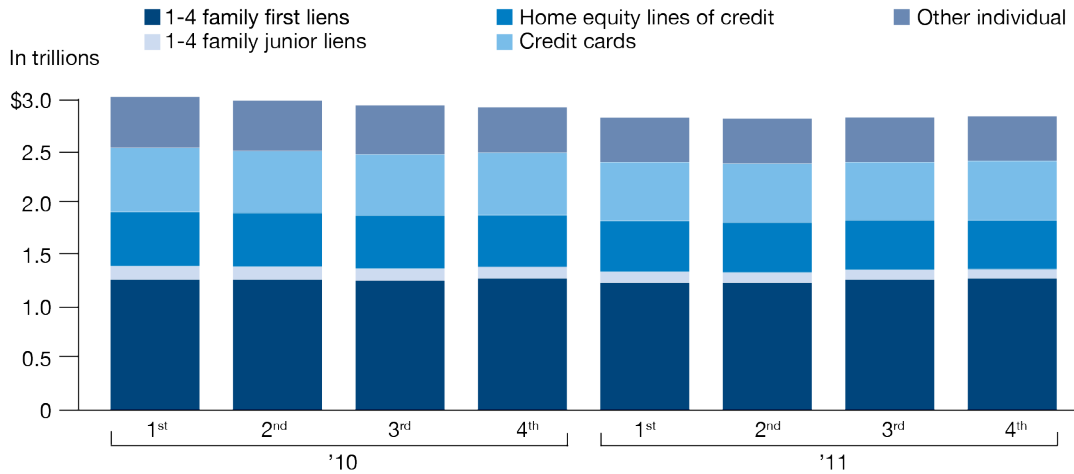
Note: Total CRE is as defined by 2006 CRE guidance (excludes owner-occupied commercial mortgages).

<sup>2</sup> See <http://www.occ.gov/news-issuances/news-releases/2006/nr-ia-2006-131a.pdf>.

### Residential Real Estate Leads Decline in Consumer Credit Balances

Consumer credit portfolios at banks continued to contract as consumer lending remained slow and banks charged off NPLs (see figure 17). Outstanding loan balances decreased in 2011 for all major portfolios of loans, most notably in credit cards and home equity. Home equity portfolios continued to shrink as banks tightened underwriting standards and home values declined in many parts of the country.

**Figure 17: Consumer Credit Balances for Banks**

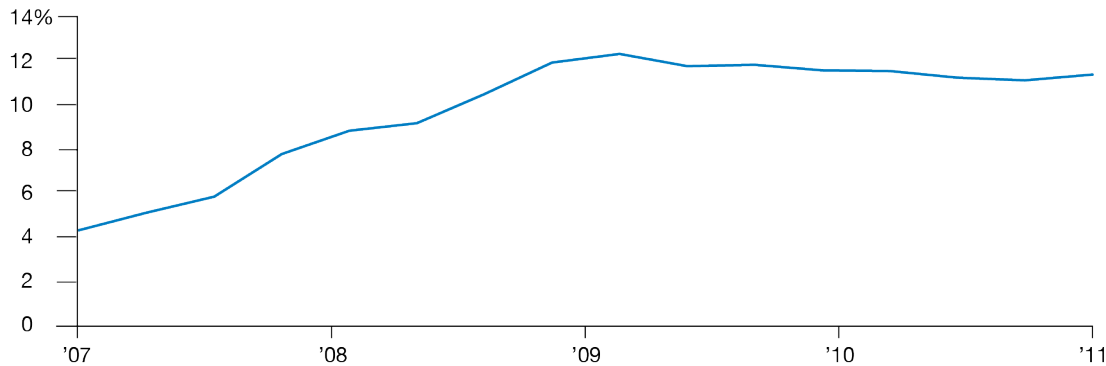


Source: OCC Integrated Banking Information System.

### Mortgage Performance Remains Distorted by Foreclosure Delays

Delinquencies for residential mortgages, senior and junior liens, on bank balance sheets declined slightly in 2011 but remained above 11 percent (see figure 18). Softness in housing markets related to the sluggish recovery, combined with the overhang of distressed properties and deficiencies in foreclosure processing, has extended the time it takes lenders to dispose of troubled loans. Fourteen of the largest servicers continue to implement corrective actions required by enforcement orders issued by the OCC and the Federal Reserve in April 2011. In addition, five large mortgage servicers reached a major settlement with federal agencies and state attorneys general on servicing and foreclosure activities. These events may help ease the backlog of foreclosures and allow housing markets to find price equilibrium.

**Figure 18: Residential Mortgages 30+ Days Delinquent for Banks**

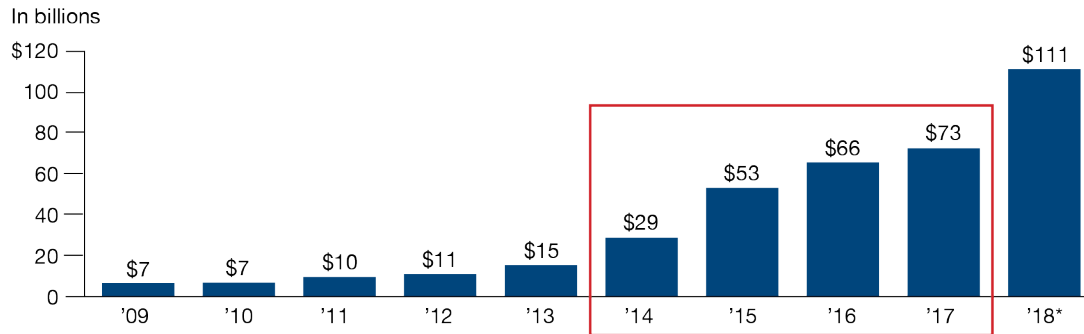


Source: OCC Integrated Banking Information System.

### Home Equity Risk May Escalate in the Next Few Years

Over the next several years a significant volume of home equity products will reach the end of their draw periods. When these products were originated, most of the contracts required that at the end of the draw period the outstanding balance would require a full amortization over a pre-determined period of time. Generally, the term of the home equity contract including both the draw period and full amortization is 30 years although numerous other types of structures are prevalent including those with a draw period and a balloon payment. The end-of-draw volumes significantly increase beginning in 2014 (see figure 19). Approximately 58 percent of all HELOC balances are due to start amortizing between 2014 and 2017. Home equity borrowers face three potential issues: (1) risk from rising interest rates because most HELOCs are adjustable rate and interest rates have been very low (see figure 20); (2) payment shock because loans will move from an interest only period to fully amortizing; and (3) refinancing issues because collateral values have declined significantly since these loans were originated.

**Figure 19: HELOC Outstanding Balances by End of Draw Year for Banks**

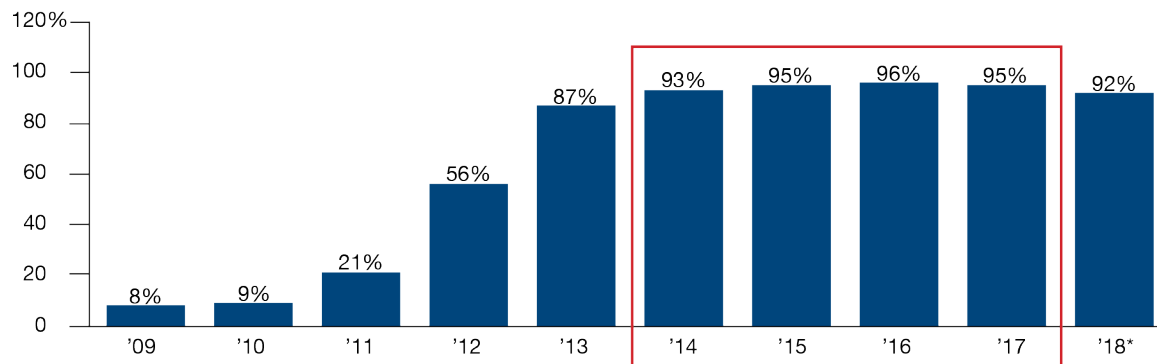


Source: OCC.

\*2018 and beyond.

Housing price declines have led to questions for the banking industry about carrying values and allowance levels that support home equity portfolios. To further heighten awareness of risk in junior liens, the bank regulatory agencies issued ALLL guidance in January 2012.

**Figure 20: Percentage of HELOC Balances With Interest Only Payments by End-of-Draw Year for Banks**



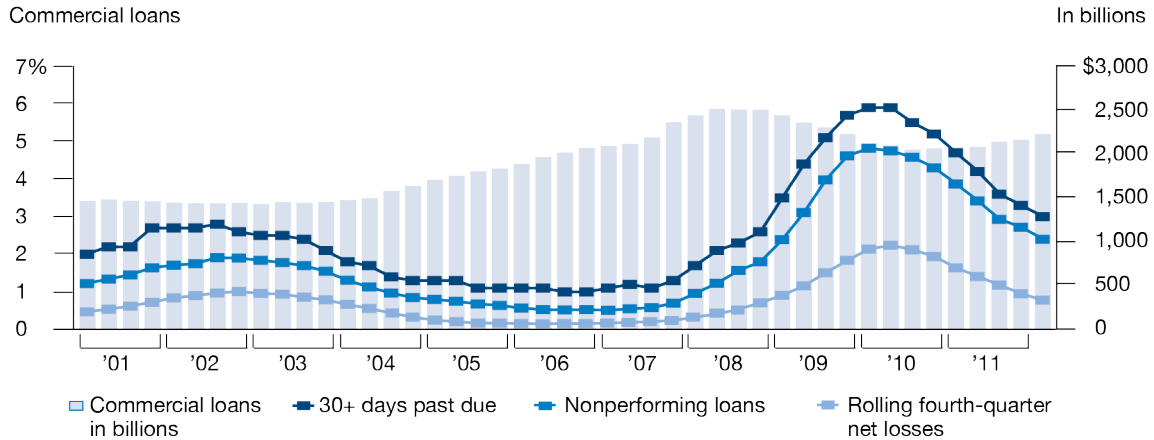
Source: OCC.

\*2018 and beyond.

### Commercial Loan Performance Improving

By the end of 2011, commercial loan volume had increased for six straight quarters (see figure 21). This growth centered in C&I loans from the largest banks. Delinquent loans, NPLs, and credit charge-offs declined the past six quarters.

**Figure 21: Commercial Loan Trends for Banks**



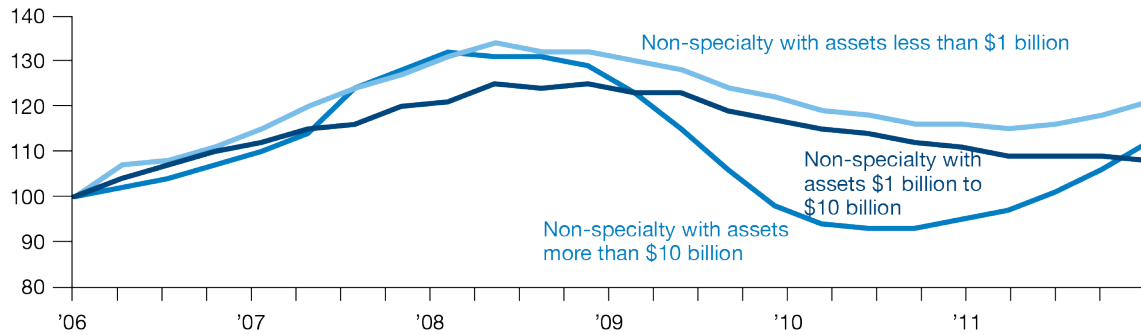
Source: OCC Integrated Banking Information System.

### Commercial and Industrial Loans Showing Modest Growth

C&I loan growth accelerated in 2011 in the largest banks. Smaller banks continued to lag in C&I loan growth as they typically lend to small businesses, which continued to struggle in the second half of 2011 (see figure 22). Loan demand for these banks will likely lag until sales and profits at small businesses begin to recover.

**Figure 22: C&I Loan Trends for Banks**

C&I loan growth indexed to first quarter 2006



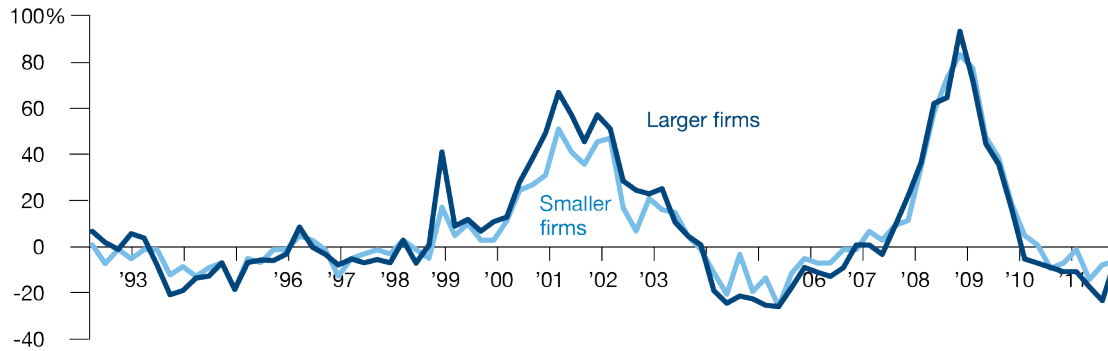
Source: OCC Integrated Banking Information System.

Note: Data are merger-adjusted and held constant for banks in continuous operation from first quarter of 2006 to fourth quarter of 2011. Data exclude credit card and trust banks.

### Commercial and Industrial Loan Underwriting Standards Loosening

The quarterly “Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices” for C&I loans indicated that underwriting standards loosened for the eight quarters through the end of 2011, after a period of sharp tightening (see figure 23). In the fourth quarter of 2011, the survey result moved closer to a balance between tightening and loosening, indicating stabilization in willingness to lend. The OCC 2012 *Survey of Credit Underwriting Practices*, conducted in February 2012, includes banks with total assets of \$3 billion or more and supports this point. Examiners-in-charge reported that only 14 percent of banks observed easing in commercial credit standards and 70 percent reported no change, pointing to a stabilization of lending standards.

**Figure 23: Percentage of Survey Respondents Tightening C&I Underwriting Standards**



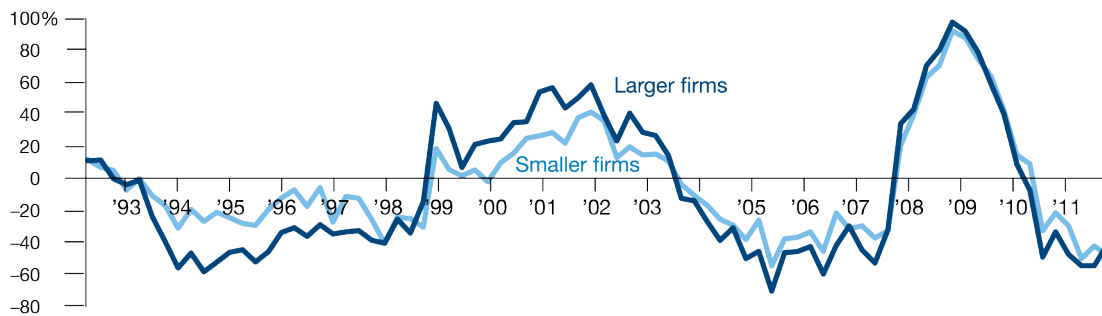
Source: Federal Reserve Board “Senior Loan Officer Opinion Survey on Bank Lending Practices,” January 2012.

Note: Negative value indicates net percent loosening standards. The survey includes 60 domestically chartered commercial banks.

### Commercial Loan Rate Spreads Decreasing

Respondents to the “Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices” also indicated that spreads on commercial loans continued to fall in 2011 (see figure 24). The survey indicates that almost 50 percent of bankers reported decreasing spreads on C&I loans, suggesting a continuing increase in competition for lending. Lower rates may stimulate economic growth and borrowing. Extended periods of narrow spreads in the past, however, have generally been an indication of excessive risk taking.

**Figure 24: Percentage of Survey Respondents Increasing Loan Rate Spreads**



Source: Federal Reserve Board “Senior Loan Officer Opinion Survey on Bank Lending Practices,” January 2012.

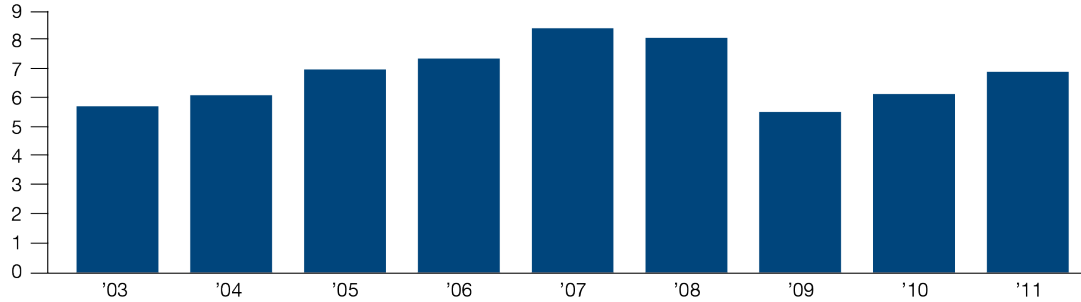
Note: Negative value indicates net percent lower spreads. The survey includes 60 domestically chartered commercial banks.

### Leveraged Loan Multiples Increasing

In the OCC 2012 *Survey of Credit Underwriting Practices*, examiners noted 38 percent of banks were loosening standards on highly leveraged lending. According to Standard & Poor’s LCD, leveraged loan underwriting became more aggressive in 2011 as the average of the upper quartile for total debt-to-earnings before interest, taxes, depreciation, and amortization (EBITDA) multiple rose to 6.9 times for highly leveraged loans (see figure 25).

**Figure 25: Upper Quartile for Leveraged Loan Multiples (Total Debt-to-EBITDA)**

Average of upper quartile debt multiples of highly leveraged loans



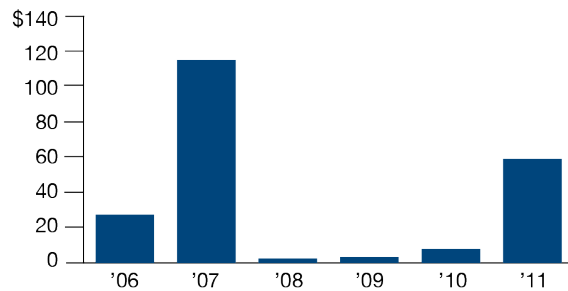
Source: Standard & Poor’s LCD—average of upper quartile’s total debt-to-EBITDA (loan market only). Standard & Poor’s and its third party providers are not liable for errors or omissions in the data/information and the context from which it is drawn.

### Leveraged Loan Underwriting Loosening

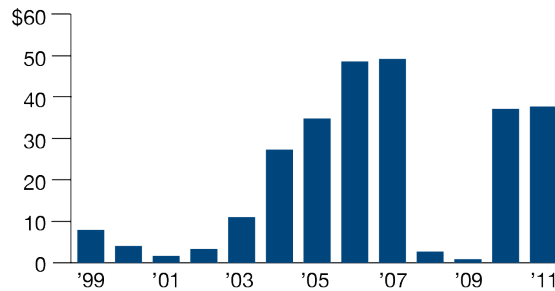
As investor demand surged in early 2011, borrowers sought lower prices and more relaxed structures—at one point, more than 50 percent of transactions were refinancings. An upside was a two- to three-year shift in the maturity profile, but downsides included a reduction in lender protections because of more liberal structures with fewer covenants. During this period, the proportion of covenant-lite<sup>3</sup> and dividend-recapitalization issuances accelerated (see figure 26). Terms and conditions have tightened since mid-year, but the quality of underwriting is a long-term concern. The bank regulatory agencies published proposed revisions to the interagency leveraged finance guidance for comment in March 2012 to address this concern.

**Figure 26: Issuance of Covenant-lite and Dividend/Stock Recap Leveraged Loans**

Covenant-lite issuance, in billions



Dividend/stock recap issuance, in billions



Source: Standard & Poor’s LCD, December 31, 2011.

Source: Standard & Poor’s LCD, December 31, 2011.

Standard & Poor’s and its third party providers are not liable for errors or omissions in the data/information and the context from which it is drawn.

<sup>3</sup> Covenant-lite includes syndicated loans that have no covenants or limited bond-like incurrence covenants rather than traditional maintenance covenants.

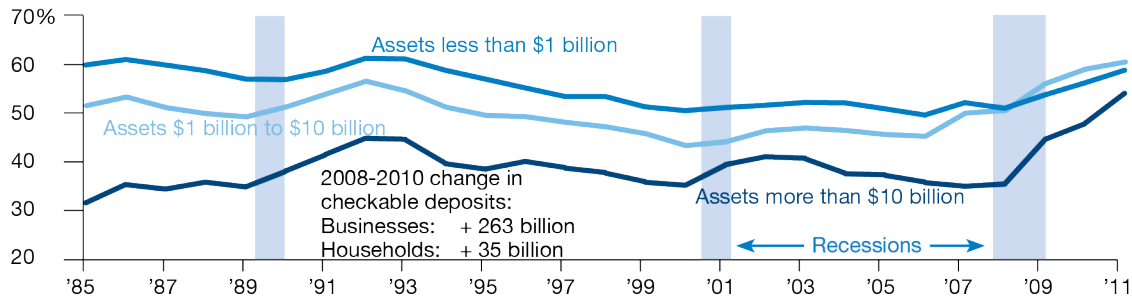
**Part III: Funding, Liquidity, and Interest Rate Risk**

**Deposits Increase as Commercial and Consumer Clients Delever**

Core deposits grew rapidly and reached record levels by the end of 2011 (see figure 27). At the largest banks, which were most affected by the liquidity concerns during the financial crisis, core deposits increased from 36 percent of liabilities to almost 57 percent. Smaller banks also experienced strong improvement, albeit from higher starting points. Much of the growth has been in non-maturity deposits including demand deposits, and it is not clear what fraction of those deposits will be retained when interest rates move higher or economic activity increases.

**Figure 27: Trends in Core Deposits for Banks**

Core deposits, excluding small CDs share of liabilities\*



Source: OCC Integrated Banking Information System.

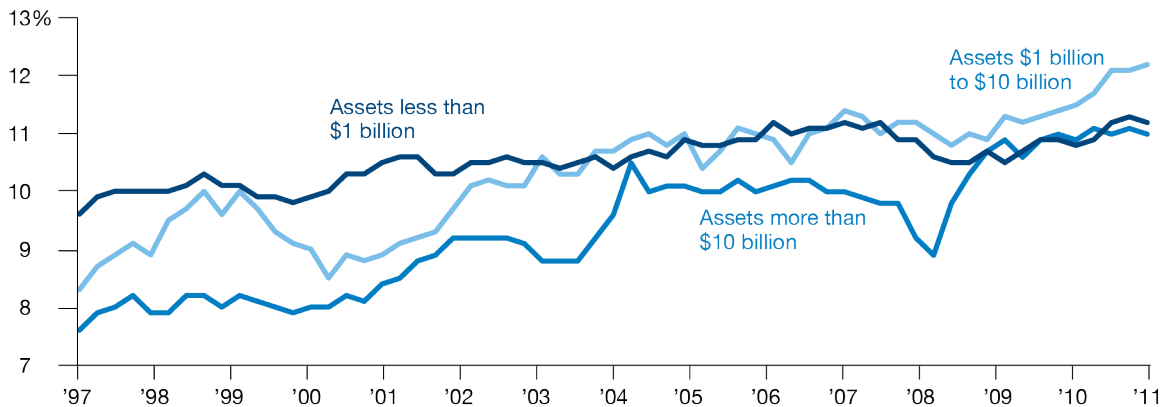
\*Core deposits are defined as domestic deposits less time deposits of \$100,000 or more. Ratio also excludes small CDs.

**Equity Capital Increasing Relative to Total Assets**

Over the past two years, banks have increased equity capitalization (see figure 28). This has occurred across banking segments, with banks with more than \$10 billion in assets making the most progress, spurred collectively by the need to rebuild capital lost during the financial crisis, asset growth because of mergers and acquisitions, and in response to anticipated increases in regulatory requirements. Most segments were at or near record highs for equity capitalization at the end of 2011 compared with the past 15 years.

**Figure 28: Equity Capital to Total Assets for Banks**

Percent of total assets



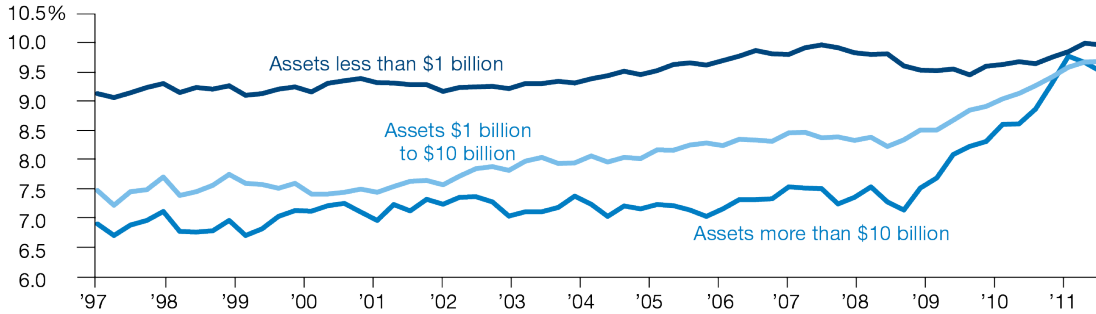
Source: OCC Integrated Banking Information System.



### Median Tier 1 Leverage Capital Ratio Improving

Capital quality has strengthened notably in recent years for the largest banks, as measured by the median percentage of Tier 1 capital relative to total assets (see figure 29). Banks with assets less than \$1 billion may have more limited access to capital, but they continue to show historically high levels of high-quality capital. All segments have improved from pre-crisis levels.

**Figure 29: Median Tier 1 Leverage Capital for Banks**

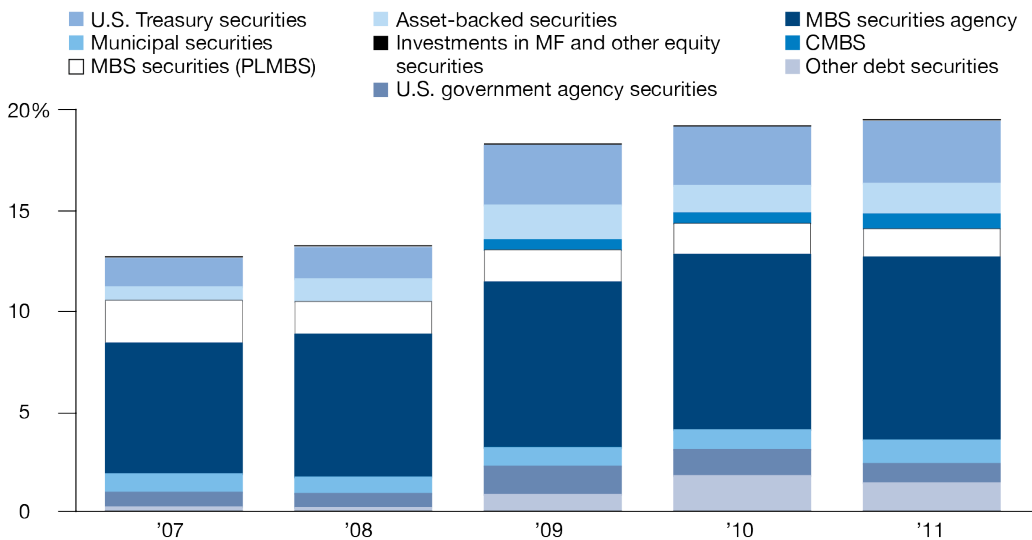


Source: OCC Integrated Banking Information System.

### Investment Security Portfolios Growing at National Banks

National banks have increased their holding of investment securities<sup>4</sup> over the past three years to strengthen liquidity and in response to a lack of quality loan demand (see figure 30). In the aggregate, national bank investment portfolios, driven by the largest banks, increased from 13 percent of total assets in 2007 to almost 20 percent at the end of 2011. This growth has been centered in agency mortgage instruments, “other” debt securities, and U.S. Treasury securities.

**Figure 30: National Bank Investment Security Portfolio Growth**



Source: OCC Integrated Banking Information System.

Note: MBS means mortgage backed securities. PLMBS means private label mortgage backed securities. MF means mutual funds.

<sup>4</sup> Investment security data used for figures 30-33 include national banks only as federal savings associations did not report the same level of granularity as commercial banks.

**National Banks Shorten Investment Portfolio Maturity Composition**

While national banks showed significant growth in their investment securities portfolios since the end of 2007, the maturity composition shifted toward shorter term assets (see figure 31). More specifically, from the end of 2007 through the end of 2011, the percentage of securities with maturities of less than five years increased from 31 percent to 42 percent, while the percentage with maturities five years or more declined from 69 percent to 58 percent. Nevertheless, some national banks hold a material volume of mortgage-related securities and remain vulnerable to extension risk if interest rates rise.

**Figure 31: Duration Composition of National Bank Investment Portfolios**

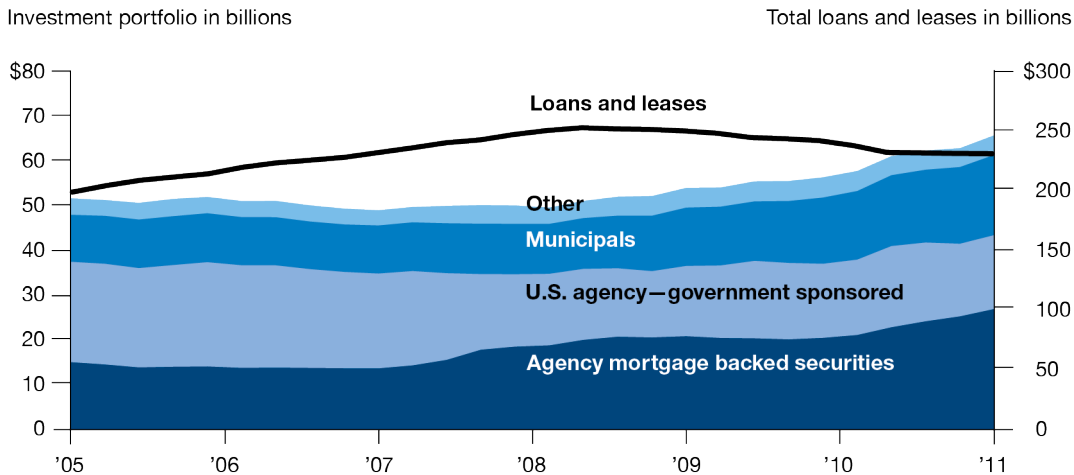


Source: OCC Integrated Banking Information System.

**Small National Banks Also Increase Investment Portfolios**

Small national banks also reported increases in investment portfolios to make up for the decline in loan demand. The bulk of the increase in the investment portfolio was centered in agency mortgage-backed securities (MBS) followed by increases in U.S. agency securities and municipal securities (see figure 32). The increase in agency MBS may potentially make some small national banks more vulnerable to interest rate risk.

**Figure 32: Investment Portfolio of National Banks with Total Assets Less Than \$1 Billion**

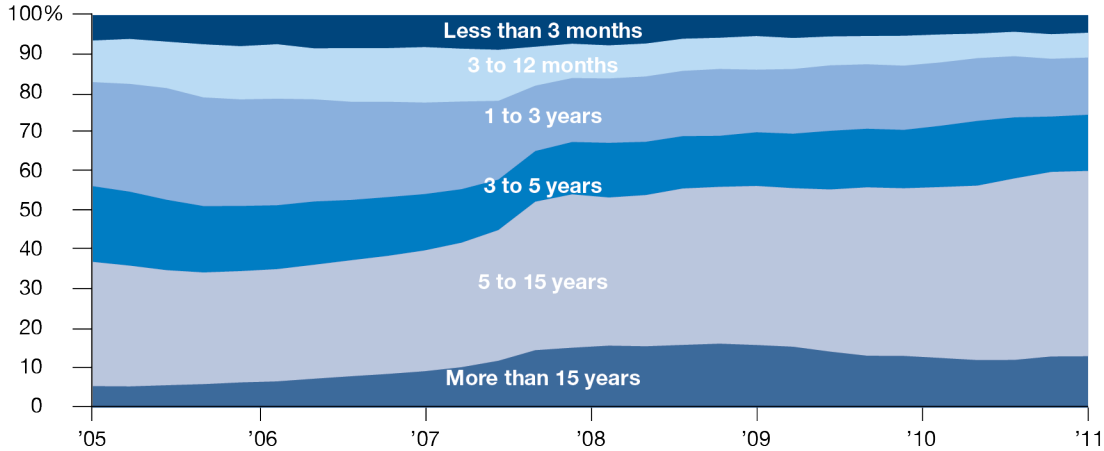


Source: OCC Integrated Banking Information System.

**Small National Banks Lengthen Investment Portfolio Maturities**

Small national banks also significantly increased the maturity profile of their investment portfolios (see figure 33). The portion of the portfolio with maturities five years or more increased from 34 percent at the end of 2005 to 60 percent at the end of 2011. This coincides with a term structure of U.S. Treasury securities at or near historical lows and a period of remarkably low bond volatility. Collectively, the transition to longer-tenor negatively convex securities during a period of low interest rates and low volatility may expose some small banks to potentially significant interest rate risk if rates were to rise rapidly as occurred in 1994.

**Figure 33: Maturity Structure for Investment Portfolios of Small National Banks**



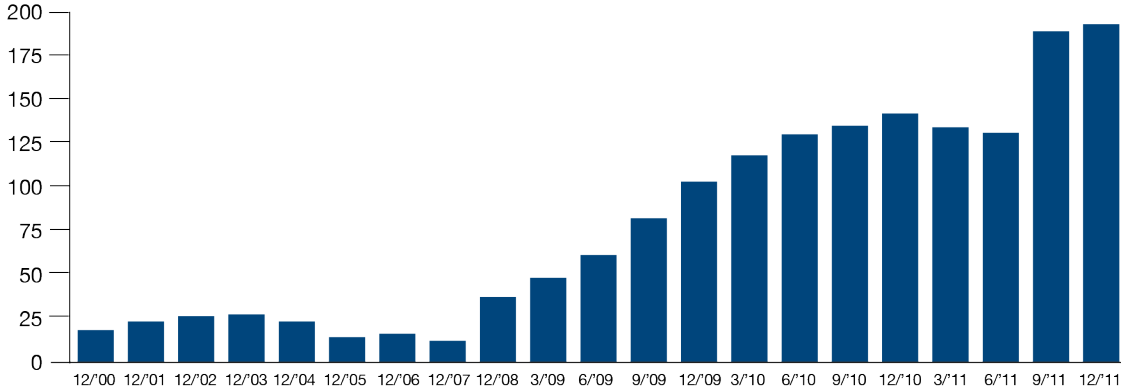
Source: OCC Integrated Banking Information System.

**Part IV: Regulatory Actions**

***Banks Rated 4 or 5 Stabilizing***

The percentage of OCC-supervised banks rated 4 or 5 remained relatively stable during 2011, although the actual number increased sharply in the third quarter due to the addition of federal savings associations on July 21, 2011 (see figure 34).

**Figure 34: Banks Rated 4 or 5**

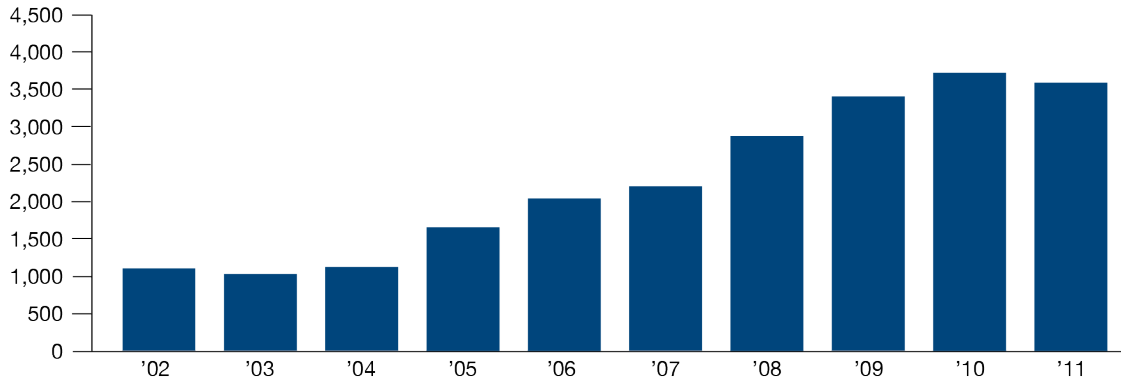


Source: OCC.

***Matters Requiring Attention Declining***

The OCC uses MRA in the supervisory process when bank practices deviate from sound risk management principles. Such deviations, if not addressed appropriately, may adversely affect a bank’s earnings, capital, risk profile, or reputation. The number of open MRAs declined slightly in 2011 after seven consecutive annual increases (see figure 35). The top five MRA categories for small banks are credit administration (28 percent), management (14 percent), compliance (9 percent), asset quality (9 percent), and capital (6 percent). For large banks, MRAs are centered in credit (38 percent), compliance (19 percent), capital markets (18 percent), safety and soundness (8 percent), and asset management (7 percent). Open MRAs include those cited for federal savings associations during supervisory activities conducted subsequent to the OCC adding supervision of federal savings associations in July 21, 2011.

**Figure 35: Trend in MRAs for Banks**

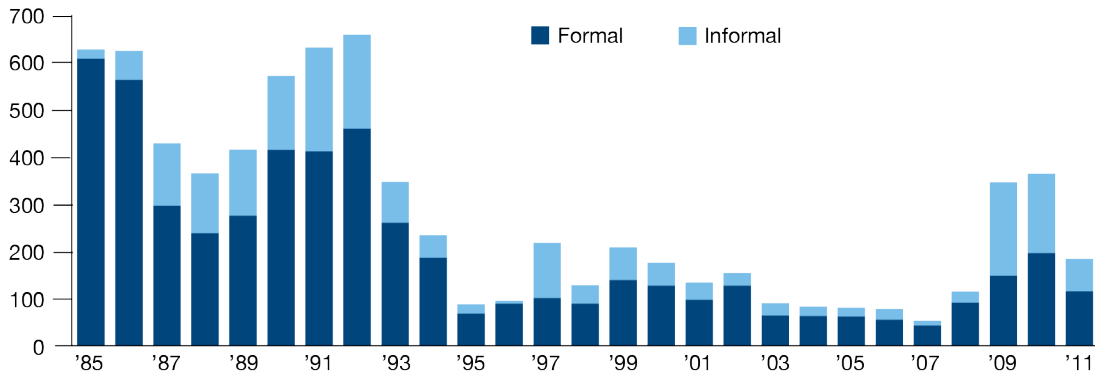


Source: OCC.

**Enforcement Actions Against Banks Declined in 2011**

The OCC uses enforcement actions to address more acute problems or weaknesses requiring corrective measures. Informal enforcement actions include commitment letters, memoranda of understanding, and approved safety and soundness plans. Formal enforcement actions, which are disclosed to the public, include cease and desist orders, capital directives, and formal agreements. The OCC issued enforcement actions against banks during fiscal year 2011 at a much slower pace than the levels seen in 2009 and 2010, reflecting the stabilization in the number of problem banks (see figure 36). These data include enforcement actions issued against federal savings associations subsequent to July 21, 2011.

**Figure 36: Enforcement Actions Issued Against Banks**



Source: OCC.

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