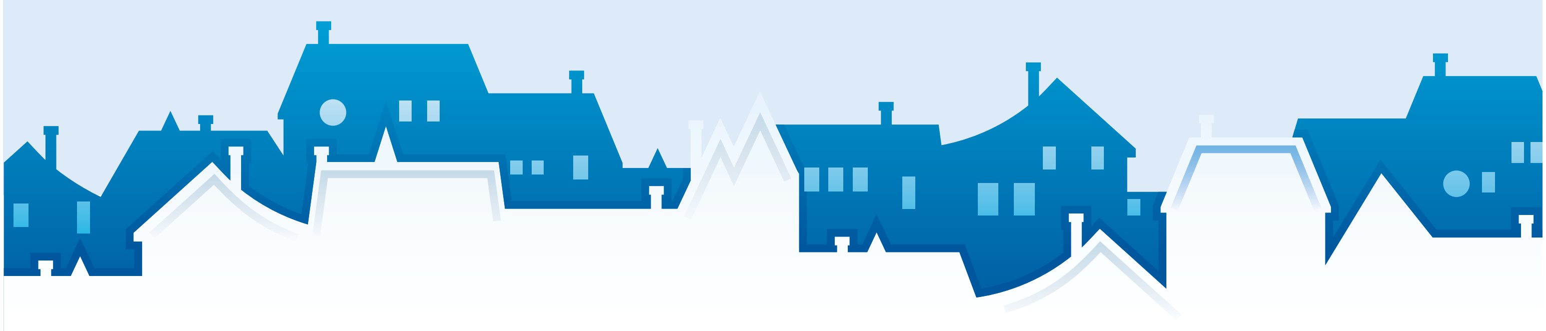
Profitability measured by return on equity at OCC-supervised banking institutions rose to 7.7 percent for the second quarter, which is above the level of a year earlier but still well below levels of recent history.



Section Three

Condition of the National Banking System

Summary

Earnings at national banks and federal savings associations continued to improve in calendar year 2011 from the low levels posted during the financial crisis. Bank capital showed a notable increase. Provision expenses declined again from year-earlier levels but remained well above pre-crisis levels. Credit quality improved, as net charge-off rates fell for all major loan categories. In contrast, erosion in net interest income drove down pre-provision revenues. With loan demand still weak, the substitution of lower-yielding securities for higher-yielding loans compressed interest margins.

Discussion

Net income at OCC-supervised banking institutions for the first half of calendar year 2011 increased by $10.3 billion compared with the first half of 2010. Profitability measured by return on equity rose to 7.7 percent for the second quarter, which is above the level of a year earlier but still well below levels of recent history.

Funding and lending. Business and retail deposits rose sharply during the financial crisis, as other investments appeared less attractive and savers turned to banks for safety. Businesses in particular have accounted for a significant surge in checkable deposits since 2008. Large banks have been the main recipients of these new deposits, which help hold down their funding costs; this pattern extended into 2011. Should business confidence and investment pick up, or returns on alternative investments rise, banks may experience an outflow of these deposits.

Lending by national banks, as measured by the total value of all types of loans on their books, has been declining since the onset of the recession. Loan growth shows only limited signs of recovery. Through the middle of 2011, lending continued to decline in consumer loans, residential real estate, construction, and commercial real estate. The one area of growth in loans for the system as a whole (other than interbank lending) was lending to commercial and industrial borrowers.

Provisions and credit quality. Credit quality has improved steadily over the past two years. Charge-off rates declined for all major loan categories in the first half of 2011 compared with a year earlier. Loan-loss provisions fell by $40.4 billion in the first half of 2011 compared with a year earlier and are now running about 70 percent below the levels that prevailed at the peak of the financial crisis in 2009.

Despite generally improved credit performance, loss rates have remained high for residential real estate loans, due at least in part to the overhang of foreclosed properties. Moreover, about 20 percent of all first-lien mortgages exceed the current value of the homes financed, with much higher shares in the hardest hit states, including Florida, Arizona, and Nevada.

With so many borrowers owing more than their homes are worth and with high rates of joblessness, even many prime residential mortgages are seeing defaults. These forces make a near-term recovery in residential mortgage loss rates less likely. For commercial real estate loans, charge-off rates have stopped rising, but fundamental performance measures, such as vacancy rates and net operating income, are not expected to improve for another year or so.

Revenues. For all OCC-supervised banking institutions, pre-provision net revenues for the first half of 2011 fell 19.7 percent compared with the same period a year earlier, as net interest income eroded. The weak economy has pressured interest margins, as a surge in deposits was funneled into safe but low-yielding cash and securities rather than loans.

Lending remained weak though June 2011, in part because economic growth has been slower than during past recoveries. Continued deleveraging by consumers also appeared to be constraining loan demand. These developments point to continued slow growth in consumer spending (and borrowing), even if gross domestic product growth improves. Corporate profits have recovered to pre-recession levels, but with many firms accumulating cash, and even medium-size firms now able to access the bond markets, banking institutions have experienced less growth in business lending than they did during earlier recoveries.

Noninterest income also fell in the first half of 2011, compared with a year earlier, the result of a sharp drop in deposit and servicing fees and little growth elsewhere. For some of the largest banking institutions with extensive international operations or significant trading activities, noninterest income held up better, though costs related to residential mortgages weighed on the performance of large real estate lenders.

For smaller banks and federal savings associations, revenue growth has been even more of a concern than at larger institutions. Funding costs for smaller institutions did not benefit as much from the sharp drop in interest rates since 2008, and their pre-provision net revenues as a percent of assets have shown little growth in the recovery so far.

Capital. Over the past two years, national banking institutions have significantly increased their capital levels and strengthened the quality of that capital. While this improvement has been evident across the board, it is especially notable at the largest institutions. A number of forces combined to spur the improvement in capital at large banks; they included market and supervisory pressure, anticipated changes in regulatory capital requirements, and capital increases related to mergers and acquisitions, in addition to a general need to rebuild capital lost during the financial crisis.