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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.

Fall 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) and supervises the federal branches and agencies of foreign 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 midyear and year-end data. The fall 2012 report reflects OCC data as of June 30, 2012.

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 banking system; funding, liquidity, and interest rate risk; and regulatory actions.

The OCC welcomes feedback on this report by e-mail to [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 spring 2012 OCC *Semiannual Risk Perspective* focused on three themes:

- Potential that the search for higher profitability may lead to taking inappropriate levels of risk.
- Revenue growth challenges arising from a slow economy and heightened financial market volatility.
- Aftereffects of the housing-driven credit boom and bust.

This report updates each of these themes, which remain areas of concern, and provides additional insights on the impact that a low-interest-rate, slow-growth economic environment is having on the banking sector's ability to generate sustainable returns. In particular, recent lending and economic growth have been inhibited by the deleveraging of households, spurred by both tighter underwriting and legacy credit stress, as well as by uncertainty around fiscal and banking policies in the United States and Europe. Capital and liquidity, however, remain near historically high levels, affording banks the ability to grow credit at a faster pace should the economy accelerate, while also bolstering them against the potential risks identified in this report.

## **Key Risk Themes**

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

- Strategic risk, including threats to business models from low rates, sluggish economic growth, and the historic volume of new banking regulations, remains high. How well banks plan, prioritize, and allocate resources in this new environment will be critical to the ability of banks to sustain earnings that will attract capital. Because of the increasing regulatory expectations created by recent legislation, banks will continue to be challenged in identifying alternative sources of revenue, prudently diversifying balance sheets and revenues, and effectively managing the costs of compliance.
- Underwriting standards remain under pressure as banks compete aggressively for limited high-quality opportunities to expand lending. Standards for leveraged loans in particular have continued to weaken over the past 18 months and yields on high-risk assets are at record lows, with risk continuing to rise. Similarly, the underwriting for middle-market commercial and industrial (C&I) lending is showing signs of slippage as banks compete for lending opportunities in these markets.
- The pace of credit quality improvement in bank portfolios is stabilizing. As a result, reserve releases, which have fueled much of the growth in bank earnings, may likewise need to stabilize or subside from recent levels. Examiners will continue to focus on adequacy of the allowance for loan and lease losses (ALLL).
- Compliance and reputation risks remains high as banks struggle to keep pace with an increasing volume and scope of new and emerging regulations and, in some cases, the pressure to control noninterest expense. Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) risks are increasing as BSA programs at some banks fail to evolve in response to the development of products and services that require appropriate BSA controls; to threats from changing methods of laundering cash throughout the financial system; and to an increase in electronic banking fraud cases. These issues are often compounded by a lack of sufficient resources and BSA/AML expertise in the banks. Noncompliance with laws and regulations will create heightened reputation risk and could impair earnings and capital. Reputation and compliance risks will remain in the forefront as the industry contends with these issues.

- The desire to grow earnings, especially from new business lines, combined with the pace of new regulatory requirements can lead to increased operational risks if banks do not adequately invest in control processes, systems, or talent.

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

- Economic forecasts for the remainder of 2012 have been revised downward because of the cumulative weight of soft U.S. labor markets, the Eurozone crisis, slowing growth in emerging markets, and uncertainty regarding U.S. fiscal policy including the resolution of the “fiscal cliff.”<sup>2</sup> While domestic demand for loans has improved, particularly for commercial loans and in the manufacturing-led Midwest, further meaningful gains will depend on sustained economic growth.
- Over the past four years, corporations and individuals have de-levered while most sovereigns have increased leverage. How these trends develop over the medium term will affect the pace of sustainable lending and revenue growth in the banking system, here and abroad.
- Low interest rates seem likely to persist for some time, keeping pressure on net interest margins, as older assets continue to mature or default and are replaced with lower-yielding instruments.
- An increased vulnerability to interest rate shocks in coming years exacerbates the recent reduction in revenue from tighter margins. Once stronger loan growth resumes, any increase in net interest income may be offset by a faster-than-expected rise in funding costs. Uncertainty about the likely pattern of margins is heightened by the protracted period of near-zero short-term interest rates, which may have altered historical rate and volume sensitivities on many deposit products. The impact of these changes will be difficult to gauge until these unusual influences abate.
- The persistence of market volatility, economic uncertainty, and low interest rates presents revenue growth challenges for asset management businesses. Fiduciary and other asset management income contributes significantly to non-interest income. Clients’ continued risk aversion has dampened asset management revenues and has increased demand for fixed-income instruments.

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

- Midyear data show stabilization in the housing sector with modest price increases in selected markets and a slowing in new foreclosures and mortgage defaults. Construction permits are picking up, providing modest stimulus from a sector that has been hard hit by the collapse of the housing bubble.
- Large and midsize banks with extensive mortgage servicing operations have been making progress in remediating standards and practices, but the cost, both financial and reputational, remains high. Servicing fee income has increased because of high refinancing volumes driven by historically low rates. This has been important for banks at a time when other sources of fee income are under pressure.

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<sup>2</sup> The “fiscal cliff” refers to the collective effect of the expiration of tax cuts from 2001 and 2003, the expiration of payroll tax cuts and extended unemployment benefits, and mandated sequester under the Budget Control Act that are scheduled to occur on December 31, 2012.

- Commercial real estate (CRE) exposures continue to show improvement across most credit quality metrics, but problem asset ratios remain above historical means and appear vulnerable to risk concentrations at some banks, and to any additional economic stress.
- Maturities and amortization of Home Equity Lines of Credit (HELOC) are an emerging risk as end of draw periods are reached and payments increase to meet amortization requirements. This transition from revolving to payout period will also require more comprehensive ALLL analysis to ensure an appropriate reflection of the risk of loss in these portfolios.

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

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

Community banks continue to suffer from the aftereffects of the real-estate-driven credit boom of the past decade as well as the challenge of adapting to evolving operating and regulatory environments in the financial services industry. Strategic risk is a primary concern as community banks need to define and implement strategies that will allow them to thrive in the face of lingering credit stress, historically low margins, competitive pressures from larger banks, and uncertainty about future regulatory changes.

- Credit quality is improving but problem asset levels remain high and will take some time to work out. Thus, banks with high CRE concentrations are still vulnerable to any further deterioration in CRE markets.
- While credit risk is stable to declining, earnings are under increased pressure because of modest loan demand, the lack of risk-appropriate, higher-yield investment alternatives, and declining non-interest income. These factors have substantially increased strategic vulnerability as banks seek to bolster income through new products, services, expansion of business lines, or reducing costs.
- Some banks are increasing the maturities of their investment portfolios and purchasing more complex structured products in response to persistently low market yields. Both actions increase exposure to shifts in interest rates and require heightened analysis to assess vulnerability to parallel and non-parallel shifts in rates.
- While credit quality and profitability have rebounded, midsize banks face many of the same strategic challenges affecting community and large banks. They continue to seek quality lending opportunities, and some have expanded into new products and services in order to offset margin and revenue pressures. Compliance and operational risks necessitate sound and effective risk management functions. Information security also is important since midsize banks increasingly experience threats from cyber-criminals.

#### ***Large Banks***

Large banks face profitability challenges from legal, operational, and reputational risks 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 as a result of weakening revenue growth, including shifts in the role of trading, securitization, and consumer fee income. Operational risk is heightened during this transition period.

- Operational risk remains a primary concern in banks with high transaction volume or high growth. A key priority for some of the largest banks continues to be addressing identified weaknesses in foreclosure processes and mortgage servicing, which continue to present reputational risk.

- The cumulative cost of fines, restitution, and remediation related to compliance and control breakdowns are dampening the profitability, productivity, and reputations of affected institutions.
- Information security poses an ongoing challenge as criminals seek to circumvent banks' controls and monitoring systems.

### ***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. Policy and supervision units within the OCC and other federal financial services regulators continue to focus on the codification and implementation of these changes in bank regulation.

Reflecting the improved condition of the banking system, the number of OCC-supervised banks with composite CAMELS ratings of 4 or 5 has stabilized. Matters requiring attention (MRA) and enforcement actions issued to OCC-supervised banks declined through the first half of 2012.

Supervision and policy actions focus on the following areas for community, midsize, and large bank segments.

#### ***Community and Midsize Bank Supervision***

- **CRE:** OCC supervisory staff will continue to evaluate exposures to CRE and assess the appropriateness of the ALLL. OCC supervisory staff will assess the adequacy of sensitivity analysis in banks with elevated levels of CRE concentrations.
- **C&I Loan Underwriting:** OCC supervisory staff will continue their scrutiny of commercial credit underwriting practices of new originations for slippage in structure and terms.
- **Strategic Planning:** OCC supervisory staff will focus on the adequacy of the bank's strategic plan and capital planning processes to ensure assumptions are reasonable for this economic environment. Specific emphasis will be placed on the processes for managing risks associated with new products and services or significant expansion of a product line.
- **Interest Rate Risk (IRR):** OCC supervisory staff will continue to focus on IRR measurement processes to ensure that banks are fully assessing vulnerability to changes in interest rates, and as appropriate, implementing measures to minimize and control this risk. The adequacy of interest rate stress scenarios and the appropriate support for key modeling assumptions (nonmaturity deposits assumptions in particular) continue to warrant supervisory attention.
- **New Products and Services:** OCC supervisory staff will evaluate new products to assess the adequacy of due diligence, to identify inherent risks, and to ensure appropriate risk management infrastructure is in place before new products are rolled out.
- **Compliance:** OCC supervisory staff will continue to assess banks' effectiveness in complying with consumer laws, regulations, and guidance, including applicable compliance and reputation risks posed by new products and services. Examiners will continue to focus on the adequacy of BSA/AML programs given evolving money laundering schemes. The OCC will continue to evaluate BSA compliance as a matter of safety and soundness and will now include examination conclusions within the management component of the CAMELS rating. Additionally, in assessing a bank's BSA/AML compliance program, a presumption exists that serious deficiencies may adversely affect the bank's management component rating.

#### ***Large Bank Supervision***



- **Strategic Planning:** OCC supervisory staff will focus on strategic business and new product planning to ensure that adequate consideration of safe and sound business practices, including potential compliance and reputation risks, is evident.
- **Foreclosures and Mortgage Servicing:** Mortgage servicing problems emerged as a key operating weakness and drew a strong regulatory response through the consent order process.<sup>3</sup> The OCC's supervisory staff will continue to focus on lapses in operational processes and the implementation of upgrades to systems and processes to meet enhanced mortgage servicing requirements.
- **Operational Risk Arising From High Volume and Rapid Growth:** The OCC's supervisory staff will apply lessons learned from mortgage servicing problems found in the examinations of other revenue-generating activities involving high volume and rapid growth. Staff will use this knowledge to identify systems weaknesses and process flaws. Ideally, improvements in operational risk management will result in operational efficiencies and enhanced customer satisfaction while mitigating vulnerabilities to Unfair and Deceptive Acts and Practices (UDAP) and know-your-customer risks.
- **Eurozone Exposures:** OCC supervisory staff will continue to track Eurozone exposures and conduct reviews of related contingency plans.
- **New C&I Loan Underwriting:** OCC supervisory staff will continue their ongoing scrutiny of commercial credit underwriting practices of new originations.
- **Governance and Oversight:** OCC supervisory staff will continue their examination focus on achievement of the five heightened expectations for corporate governance and oversight in the 19 large national banks. These expectations relate to board willingness to provide credible challenge; talent management and compensation processes; defining and communicating risk appetite across the company; the development and maintenance of strong audit and independent risk management functions; and board responsibility to preserve the sanctity of the national bank charter.
- **Compliance:** OCC supervisory staff will continue to assess banks' effectiveness in complying with consumer laws, regulations, and guidance, including applicable compliance and reputation risks posed by new products and services. Improvements in this area will also help institutions mitigate vulnerabilities to potential UDAP violations and ensure that consumers are provided with relevant and clear product information. Examiners will continue to focus on the adequacy of enterprise-wide BSA/AML programs, given evolving money laundering schemes and technological developments. The OCC will continue to evaluate BSA compliance as a matter of safety and soundness and will now include examination conclusions within the management component of the CAMELS rating. Additionally, in assessing a bank's BSA/AML compliance program, a presumption exists that serious deficiencies may adversely affect the bank's management component rating.

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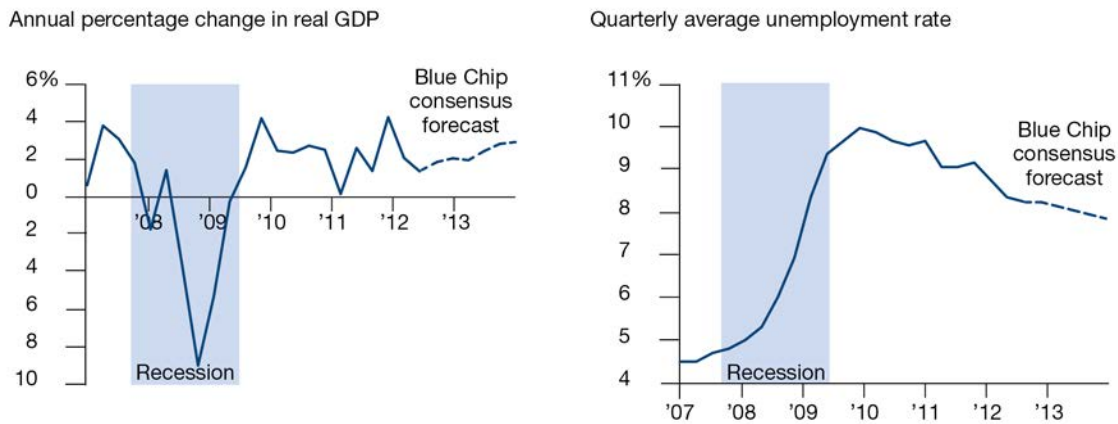
<sup>3</sup> The OCC [announced](http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html) consent orders against large mortgage servicers in April 2011, requiring comprehensive changes in mortgage servicing and foreclosure processes. See [www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html](http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html).

**Part I: Operating Environment**

**Slow Economic Recovery and Loan Growth**

The U.S. economy continues to grow in 2012, albeit at a slower rate than expected earlier in the year (see figure 1). Nearly three years into the recovery, gross domestic product (GDP) is about 7 percent above its recession trough but barely above its pre-recession level. Employment growth has been uneven in 2012, coming in below expectations in the second quarter before rebounding in the summer. Many analysts have revised downward their economic forecasts for the remainder of 2012 because of the weakness in U.S. labor markets, the Eurozone crisis, slowing in emerging markets, and uncertainty regarding the U.S. fiscal situation. The consensus private sector forecast suggests unemployment will remain above normal through 2013. This slow recovery also implies slow growth in spending and loan activity, and limited acceleration in improving credit performance.

**Figure 1: GDP and Unemployment Trends**

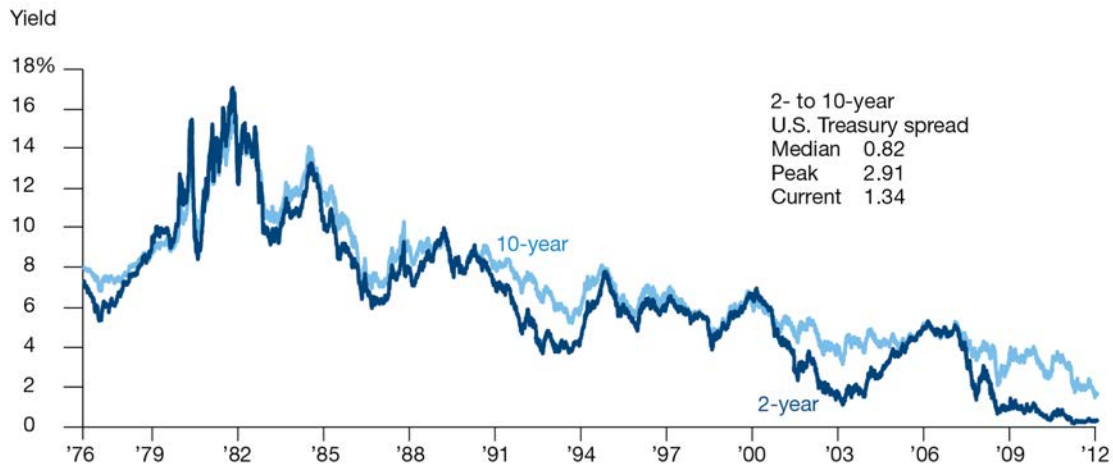


Sources: Bureau of Economic Analysis, Bureau of Labor Statistics/Haver Analytics, Blue Chip Indicators, August 2012.

**Treasury Yields Remain Historically Low**

Treasury yields have been at or near historical lows for the past several years (see figure 2). The yield curve has flattened but remains positively sloped. The spread between 2-year and 10-year yields has declined from its peak but remains above the historical median. An upward-sloping yield curve implies market expectations for higher yields, suggesting 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 the value of investment securities, including many mortgage-related securities. Higher rates also could raise debt service burdens for retail and commercial borrowers, although the net effect on credit quality is not clear, since a stronger economy could support higher revenue growth and higher incomes.

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



Source: Federal Reserve Board.

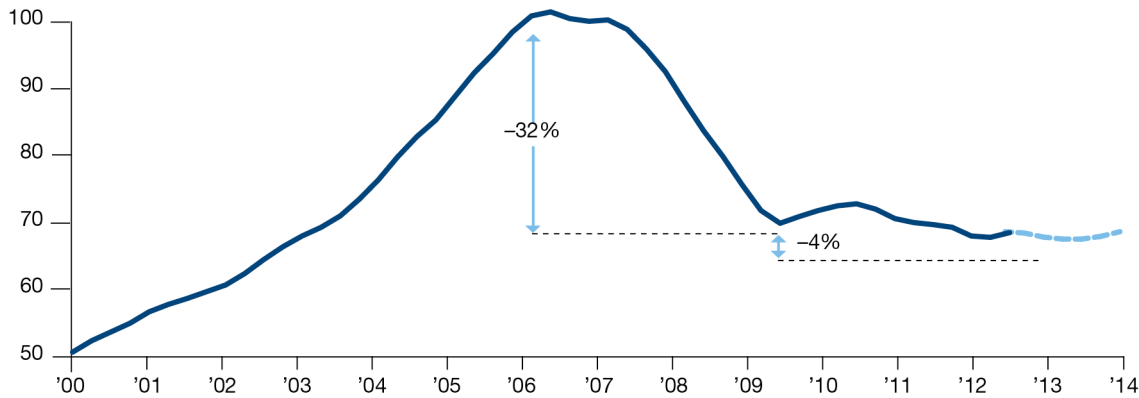
Note: Treasury yield curve estimates, coupon equivalent par-yields are updated as of June 29, 2012.

### Distressed Sales Continue to Weigh on Housing Market

The housing market continues to struggle as the overhang of distressed properties weighs on prices (see figure 3). New-home inventories, however, are now at a 50-year low, and many markets are back in balance. Case-Shiller repeat-sales data show home prices up 1.2 percent year over year through the second quarter of 2012. Distressed sales account for 20 percent of total sales, however, hindering a recovery in home values. The remaining distressed inventory is increasingly concentrated in states with judicial foreclosure requirements. Average prices remain more than 30 percent below their peak. The percentage of mortgages that are seriously delinquent (loans 60 or more days delinquent plus bankruptcies that are 30 or more days delinquent) declined to 4.4 percent from 4.9 percent a year earlier (see table 1). The percentage of foreclosures in process increased from 4 percent as of June 30, 2011, to 4.1 percent at the end of the second quarter of 2012. Any slowing in the economy could include a slower recovery in residential real estate, a key component of problem assets in the banking industry.

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

Case-Shiller 20-metro composite home price index, seasonally adjusted, to the second quarter 2006



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

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

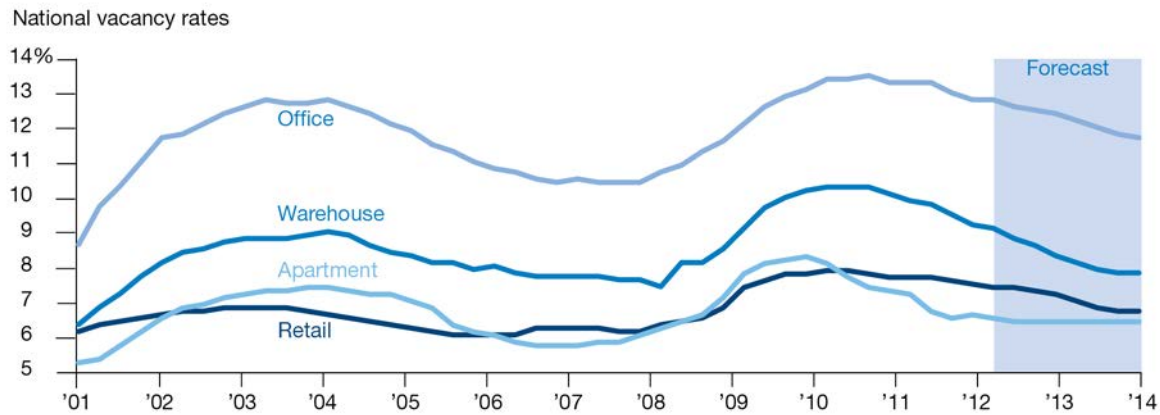
Percentage of mortgages in the portfolio							
	6/30/11	9/30/11	12/31/11	3/31/12	6/30/12	%Change from previous quarter	%Change from previous year
Current and performing	88.1%	88.0%	88.0%	88.9%	88.7%	-0.3%	0.7%
30-59 days delinquent	3.0%	3.0%	3.0%	2.5%	2.8%	12.1%	-7.5%
<b>Three categories are classified as seriously delinquent</b>							
60-89 days delinquent	1.1%	1.2%	1.2%	0.9%	1.0%	7.4%	-11.0%
90 or more days delinquent	2.8%	2.7%	2.8%	2.5%	2.3%	-5.2%	-16.4%
Bankruptcy 30 or more days delinquent	1.0%	1.0%	1.0%	1.1%	1.1%	1.9%	13.8%
<b>Subtotal for seriously delinquent</b>	<b>4.9%</b>	<b>4.9%</b>	<b>5.0%</b>	<b>4.5%</b>	<b>4.4%</b>	<b>-0.8%</b>	<b>-9.2%</b>
Foreclosures in process	4.0%	4.1%	4.0%	4.1%	4.1%	-0.9%	0.8%

Source: "OCC Mortgage Metrics Report" for the second quarter of 2012.

### Commercial Real Estate Vacancy Rates Improving

CRE vacancy rates remained high through June of 2012 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. Low interest rates have helped CRE borrowers, but many borrowers may find it difficult to refinance in the near term because of elevated loan-to-value ratios. Small banks in general have higher CRE concentrations and are therefore more vulnerable to declines in this asset class.

**Figure 4: CRE Vacancy Rates**

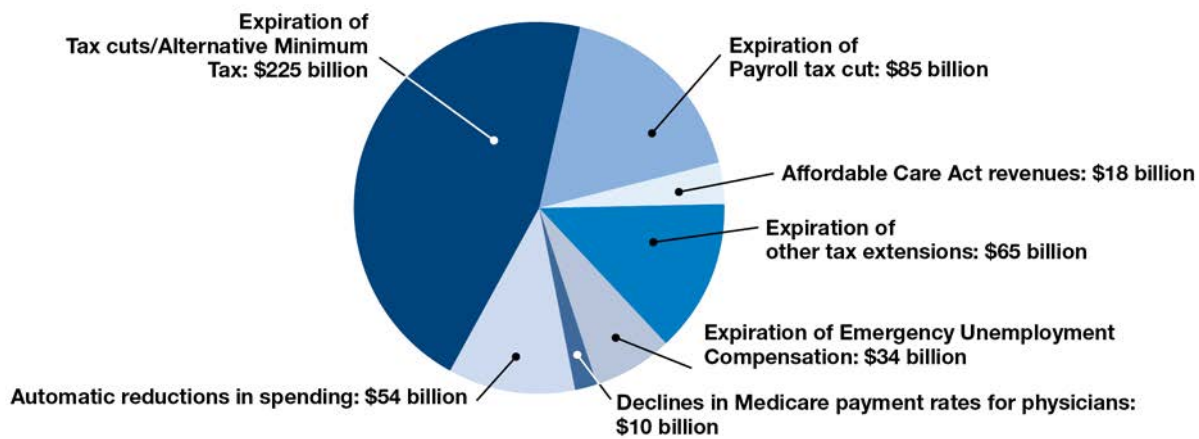


Source: Property & Portfolio Research, fourth quarter 2012 baseline forecast.

**United States Moving Closer to the ‘Fiscal Cliff’**

Realization of the federal fiscal tightening mandated under current law will adversely affect U.S. economic growth in 2013 absent federal government action to blunt the impact. The Congressional Budget Office (CBO) estimates that spending cuts and revenue increases totaling \$491 billion will take effect in 2013 (see figure 5). The CBO further estimates that those spending cuts and revenue increases would result in an annualized decline in real GDP of 3.9 percent in the first quarter of 2013 (see table 2) and decrease employment by 2 million jobs over the course of the year. The CBO estimates a 0.5 percent decline in real GDP if all spending cuts and revenue increases occur and remain in place for the full year. The uncertainty associated with the “fiscal cliff” may already be diminishing confidence in financial markets, capital investment, and the real economy as firms defer hiring and investment decisions, and consumers retrench. Legislative actions may mitigate, but not fully eliminate, the potential drag on economic growth in 2013.

**Figure 5: CBO Fiscal Tightening Estimate**



Source: Congressional Budget Office Report, August 2012.

**Table 2: Projected Quarterly Real GDP Growth if All the Fiscal Tightening Occurs**

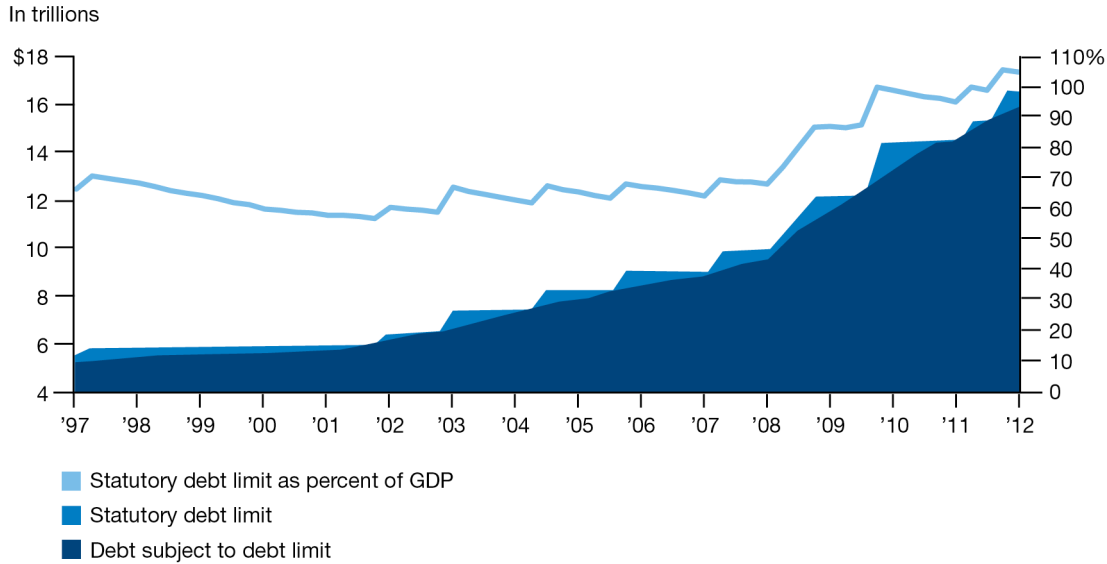
CBO projected quarterly real GDP growth								
	Q3 2012	Q4 2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014
GDP %	2.5	2.0	-3.9	-1.9	1.2	2.6	3.7	4.1

Source: Congressional Budget Office Report, August 2012.

### U.S. Debt Approaching Statutory Limit

The U.S. debt is expected to approach the statutory limit in late 2012 or early 2013 (see figure 6). The approaching statutory debt limit could further complicate the process of addressing the combined impacts of tax increases and spending cuts that define the “fiscal cliff” due to take effect in 2013 absent federal government action.

**Figure 6: U.S. Statutory Debt Limit**



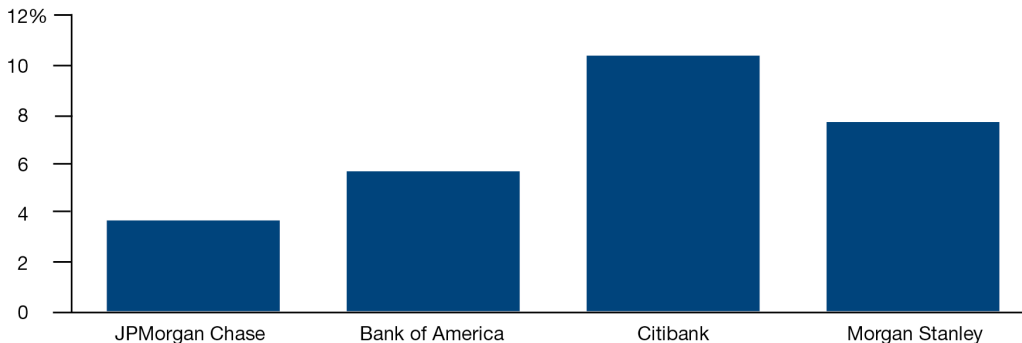
Source: Haver Analytics, Office of Financial Research.

### Direct Credit Exposure to European Peripheral Countries is Low

Weak economic conditions in Europe, sovereign debt quality concerns, and the uncertainties associated with a possible break-up of the euro have kept investors focused on U.S. bank credit exposures to those “peripheral” countries at the heart of the crisis in Europe. Direct U.S. bank exposure to these countries from loans, bonds, derivatives, and other credit transactions, as reported in company regulatory filings, is low relative to the firms’ capital (see figure 7). Although the direct exposures to peripheral countries are not large relative to capital, the indirect effects of material credit distress in peripheral countries are more difficult to predict.

**Figure 7: Direct Exposure to Peripheral European Countries**

As a percent of tier 1 capital plus the ALLL



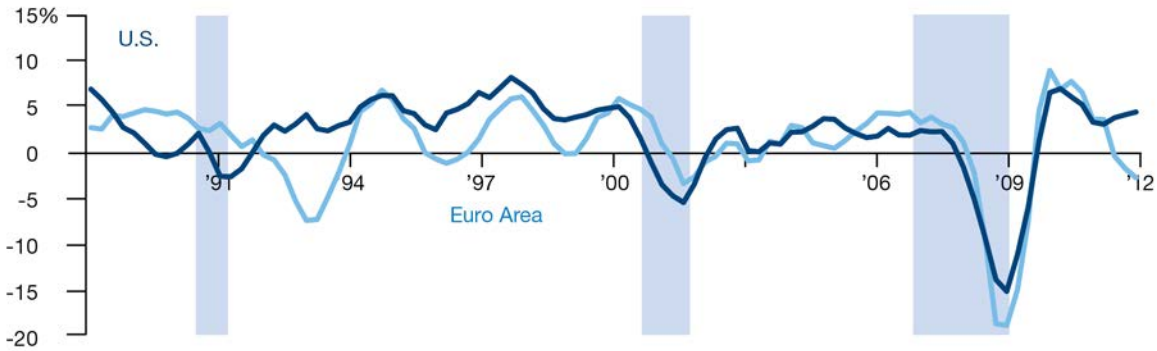
Source: Company 10Q filings for June 30, 2012.

**U.S. Banks Would Be Affected by Deterioration in Core European Countries**

The U.S. and European economies and financial markets tend to be closely associated, and therefore significant weakness in Europe would likely dampen growth prospects here (see figure 8). Exporters to the European Union (EU) are important employers across the United States. The impact would likely be felt first at the larger banks, but smaller banks would also be affected. Community banks in states where industries that export to Europe account for an important share of total employment, and where weakness in employment and income growth may be more pronounced, may see a spillover impact on loan growth and credit quality (see figure 9).

**Figure 8: Link Between U.S. and European Economies**

Industrial production excluding construction, year-to-year percent change



Stock market index, year-to-year percent change



Source: Organization for Economic Cooperation and Development; Dow Jones.

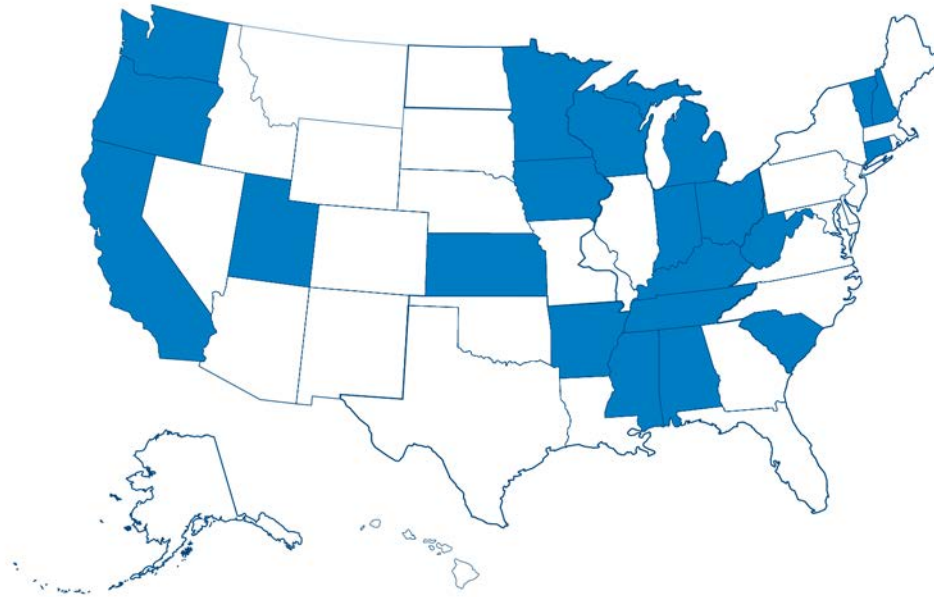
Note: Quarterly data through second quarter of 2012.

Euro Area is: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.



**Figure 9: States with More Than 5 percent of Total Employment in EU Export-Dependent Manufacturing Industries**

States with more than 5 percent of total employment in manufacturing industries dependent on exports to the EU.



Source: Bureau of Economic Analysis, Bureau of Labor Statistics.

**Part II: Condition and Performance of Banks****A. Profitability and Revenues: Improving Slowly****Banking Profitability Increasing**

Net income through the first six months of 2012 for banks increased 14 percent year over year to more than \$45 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 29 percent year over year, while net income for those with assets less than \$1 billion increased by 44 percent, the most of any category. The year-over-year gain in net income at banks with more than \$10 billion in assets was 13 percent through the first half of 2012 (see table 3).

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 each of the three categories of banks shown in table 3. Provisioning expenses declined across the industry, with the largest banks reporting a 25 percent reduction in provisions for loan losses. Those with assets between \$1 billion and \$10 billion had a 47 percent reduction in provisioning expenses, while those with less than \$1 billion in assets saw a 25 percent reduction. Provision expenses are at historical lows relative to charge-offs and therefore lower provisions are likely to provide a diminishing benefit-to-earnings performance. The largest banks reported a 1 percent increase in non-interest expense, while smaller banks saw gains of 4 to 5 percent year over year.

**Table 3: Income and Expenses for Banks**

	Assets greater than \$10 billion		Assets \$1 billion-\$10 billion		Assets less than \$1 billion	
	June 30, 2011	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011	June 30, 2012
Number of institutions	61	60	195	184	1,742	1,615
Total assets in billions	8,592	8,870	513	493.5	391.4	372.8
<b>Revenues: \$ billions</b>						
Net interest income	133.4	131.1	7.5	7.6	5.9	5.9
Non-interest income	79.5	81.2	3.3	3.3	1.4	1.7
Realized securities gains and losses	-0.6	2.9	0.1	0.2	0.1	0.1
<b>Expenses: \$ billions</b>						
Provisioning	26.1	19.6	1.5	0.8	0.8	0.6
Non-interest expense	131.1	132.9	7.4	7.8	5.4	5.6
Income taxes	17.6	20.2	0.6	0.7	0.3	0.4
Net Income	37.5	42.3	1.4	1.8	0.9	1.3

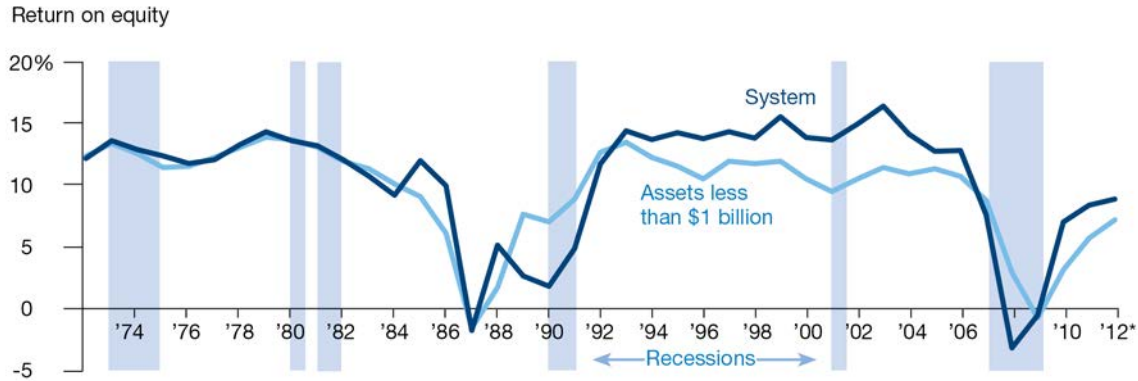
Source: OCC Integrated Banking Information System.

Data are merger-adjusted and held constant for institutions in continuous operation from the first quarter of 2006 to second quarter 2012. Credit card and trust institutions are excluded for data on banks with assets of \$10 billion or less.

### Return on Equity Improving

Return on equity improved for both large and small banks (see figure 10) but remained well below long-term averages. Returns remained under pressure because of weak loan growth and the low-interest-rate environment, which continue to compress margins. Banks have raised significant amounts of equity capital overall—strengthening their balance sheets, but also contributing modestly to the lower returns on equity.

**Figure 10: Return on Equity Trends for Banks**



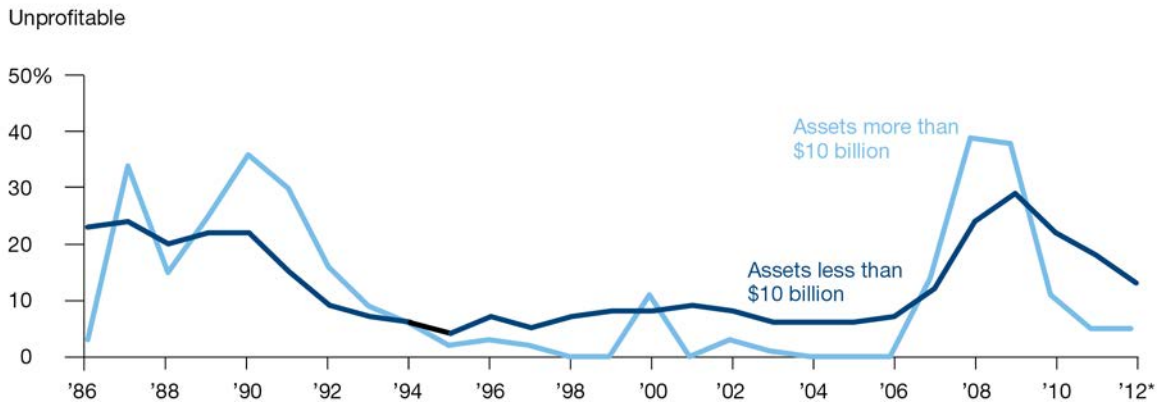
Source: OCC Integrated Banking Information System.

\* 2012 data as of June 30, 2012 (annualized). Sum of quarterly net income as a share of five-quarter trailing average equity. Results for 2008 are modified with estimates from bank holding company financial statements to restore missing data due to purchase accounting treatment of Washington Mutual (third quarter of 2008), Wachovia and NCC Bank (fourth quarter of 2008). Thrift data not available before 1984.

### Fewer Banks Report Losses

The percentage of unprofitable banks (see figure 11) continued to fall through the first half of 2012. The percentage of unprofitable banks with more than \$10 billion in assets declined to 5 percent through the second quarter of 2012 from a peak of 39 percent in 2008. The share of unprofitable smaller banks declined from 29 percent in 2009 to 13 percent as of June 30, 2012.

**Figure 11: Percentage of Unprofitable Banks**



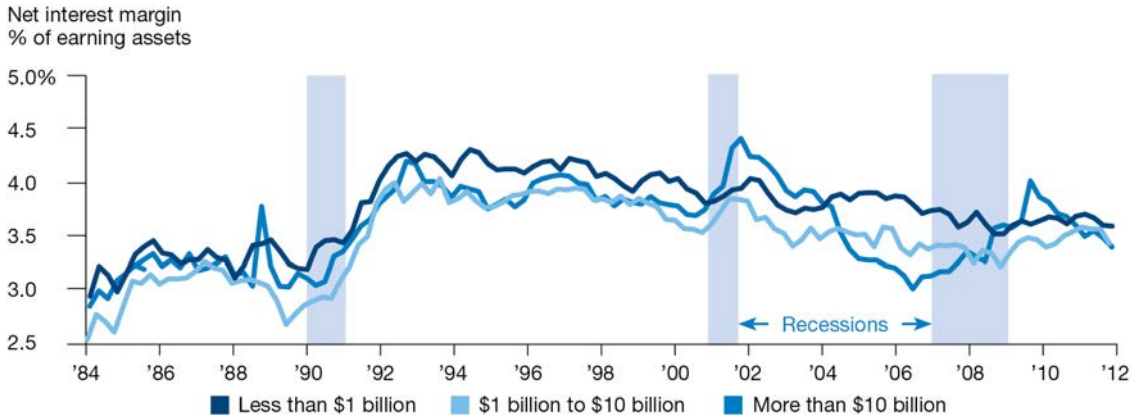
Source: OCC Integrated Banking Information System.

\* 2012 data as of June 30, 2012 (annualized); all other data as of year-end. Unprofitable means return on assets less than 0.

### Net Interest Margins Remain Under Pressure

Net interest margins increased from the lows of the 2007–09 recession, but they have come under renewed pressure over the past year (see figure 12). Margins at smaller banks improved little from recent lows. Weak loan demand has resulted in an increasing share of lower-yielding investment securities on balance sheets. 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 12: Trends in Net Interest Margins for Banks**



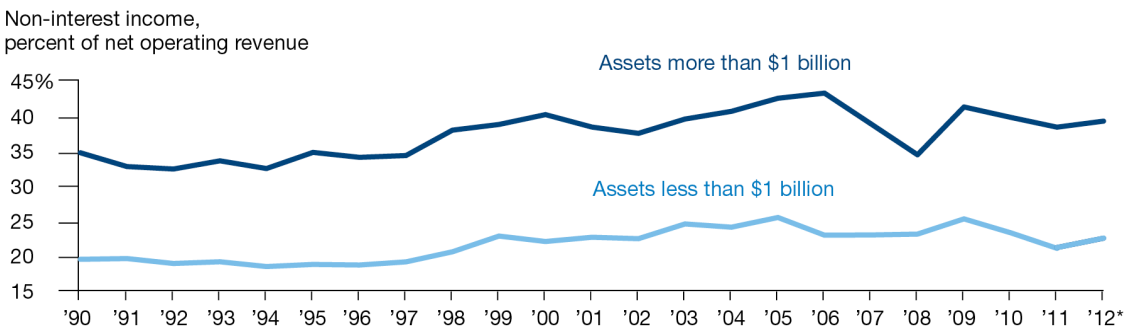
Source: OCC Integrated Banking Information System.

Note: Quarterly data through the second quarter of 2012. Data exclude credit card and trust banks.

### Non-interest Income Improved Modestly

Non-interest income is showing modest improvement through the first half of 2012. For non-specialist institutions (excluding credit card specialists and trusts), the decline in non-interest income as a percentage of net operating revenue began in 2006 for those with assets over \$1 billion and in 2009 for smaller banks (see figure 13). 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. Deposit service charges, overdraft fees, and revenue from interchange fees have declined in part due to recent changes in regulatory requirements.

**Figure 13: Trends in Non-interest Income for Banks**



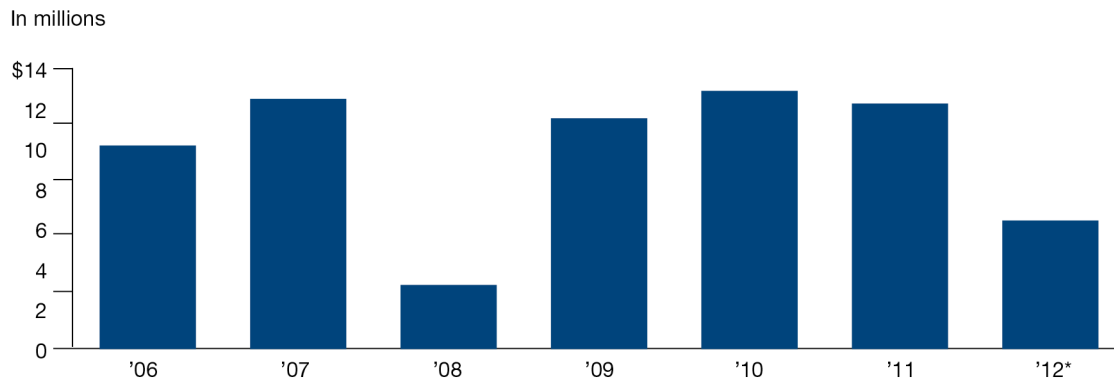
Source: OCC Integrated Banking Information System.

\* 2012 data as of June 30, 2012 (annualized); all other data as of year-end. Net operating revenue equals net interest income plus non-interest income. Data exclude credit card and trust banks.

## Trading Revenues Decline Sharply

Banks reported \$6.3 billion in trading revenues through June 30, 2012, 48 percent lower than the same six month period in 2011 (see figure 14). The weak performance relative to 2011 was entirely a second quarter event, as trading revenues were similar in the first quarter of both years. Trading revenues in the second quarter of 2012 were sharply lower (78 percent) than in 2011, falling from \$4.8 billion to \$1.3 billion. The poor second quarter trading performance can be attributed to a \$4.2 billion loss in credit trading, reflecting the well-publicized events at JPMorgan Chase, N.A. Beyond credit trading losses, however, trading revenues in the second quarter were further suppressed by weak client demand, a result of heightened uncertainty associated with accelerating concerns about global economic growth, the U.S. “fiscal cliff,” and the European sovereign debt crisis.

**Figure 14: Trading Revenues for Banks**



Source: OCC Integrated Banking Information System.

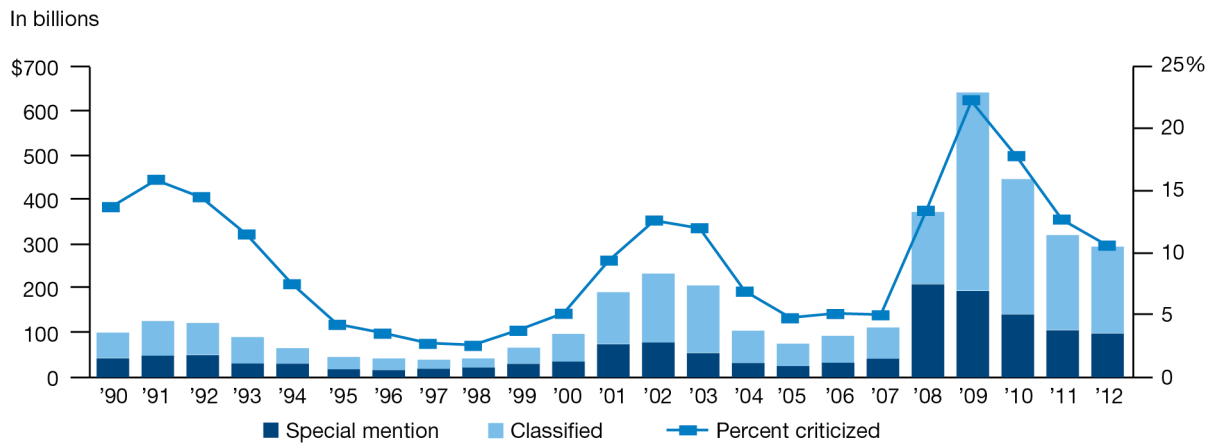
\* Data as of June 30, 2012.

**B. Credit Quality: Continued Improvement Though Real Estate Loans Lag**

**Shared National Credit Review Shows Improving Asset Quality**

The Shared National Credits (SNC) Review for 2012 indicates credit quality improved for the third consecutive year for large corporate loan commitments (see figure 15). The volume of criticized loans (loans rated special mention, substandard, doubtful, or loss) declined 8.1 percent, however, remained high at \$295 billion relative to levels before the financial crisis. Criticized assets represent 10.6 percent of the SNC portfolio, compared with 12.7 percent in 2011. Reasons for improvement in credit quality include better operating performance among borrowers, debt restructurings, bankruptcy resolutions, and ongoing access to bond and equity markets. Despite the improvement, poorly underwritten loans originated in 2006 and 2007 continued to adversely affect the SNC portfolio. While the overall quality of underwriting of SNCs that were originated in 2011 was significantly better than in 2007, some easing of standards was noted, specifically in leveraged finance credits, especially compared with the relatively tighter standards present in 2009 and the latter half of 2008. Total SNC commitments increased \$268 billion (10.6 percent) to \$2.79 trillion from the 2011 review. Total SNC loans outstanding increased \$125 billion to \$1.24 trillion, an increase of 11.2 percent.

**Figure 15: Shared National Credits Review Results**

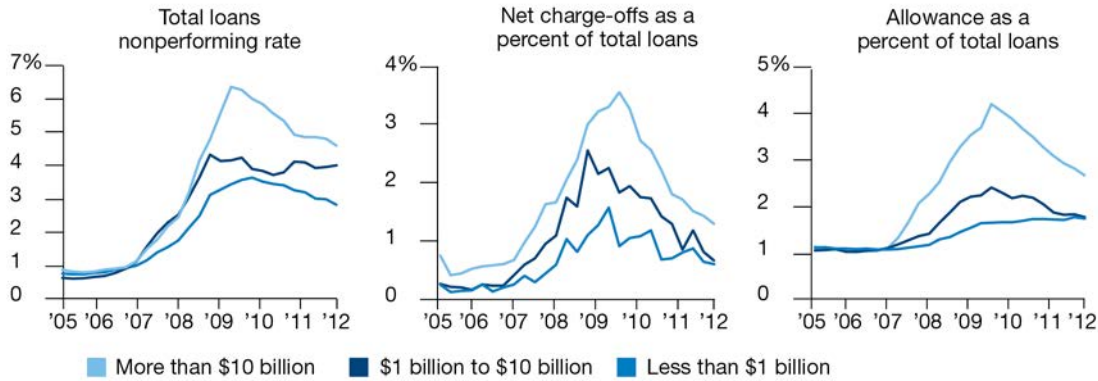


Source: OCC.

### Credit Performance Continues to Improve

The credit cycle showed continuing improvement through the first half of 2012 (see figure 16). Nonperforming loans (NPL)—those 90 days or more past due or on nonaccrual—declined for large and small banks, though not as quickly as charge-offs, but remain historically elevated. Typical of previous credit cycles, loan recoveries have increased in the aftermath of the worst quarters of the downturn. Recoveries collected on loans charged off in prior quarters have reduced net charge-offs. The ALLL, which remains historically high, continued to decline in the first half of 2012 as a percentage of total loans, consistent with the lower level of NPLs.

**Figure 16: Credit Cycle Analysis for Banks**



Source: OCC Integrated Banking Information System.

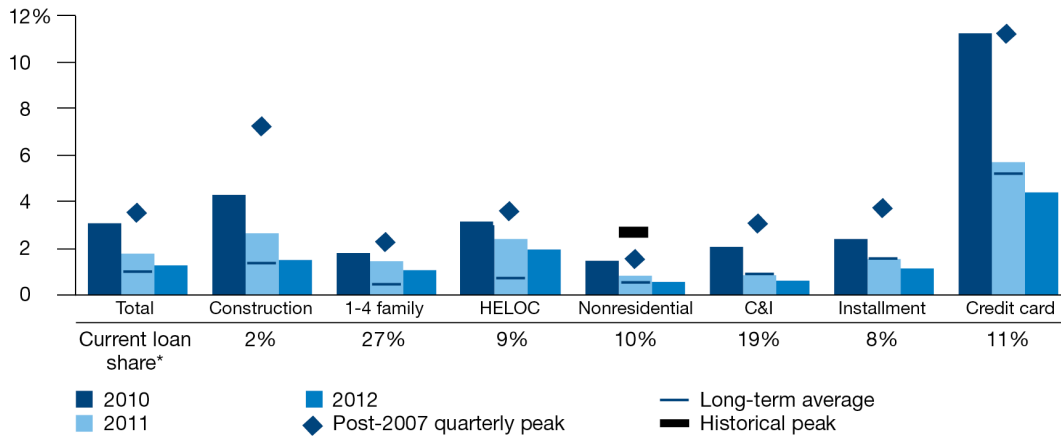
Note: Data are merger-adjusted and held constant for banks in continuous operation from the first quarter of 2006 to the second quarter of 2012.

### Charge-Off Rates Return to Long-Term Averages

Charge-off rates decreased sharply through the second quarter of 2012 to near the long-term averages across most loan types, with the exception of losses on residential real estate that remain above the long-term average (see figure 17). 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 HELOC rates showing the highest differential. Credit card, C&I, and commercial mortgage charge-off rates are now near or below their post-1990 average levels.

**Figure 17: Charge-Off Rates by Asset Class for Banks**

Net charge-off rates, percent annualized



Source: OCC Integrated Banking Information System.

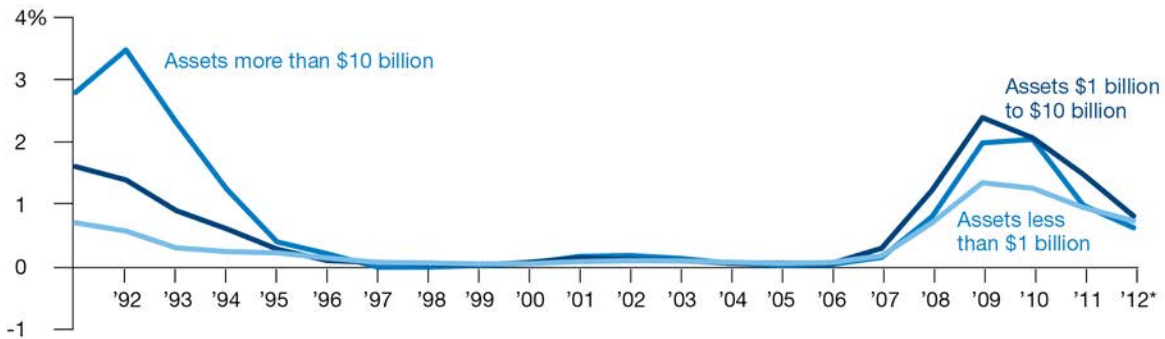
\* Not all loan categories are shown. Net charge-offs are shown as a percent of loans in respective category.

### Commercial Real Estate Charge-Off Rates Continue to Decline

Losses on commercial mortgage and construction loans 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 second quarter of 2012 (see figure 18). While still above long-term averages, CRE losses at small banks have come down near the levels of their larger peers.

**Figure 18: CRE Charge-Off Rates for Banks**

Total CRE net charge-off rates



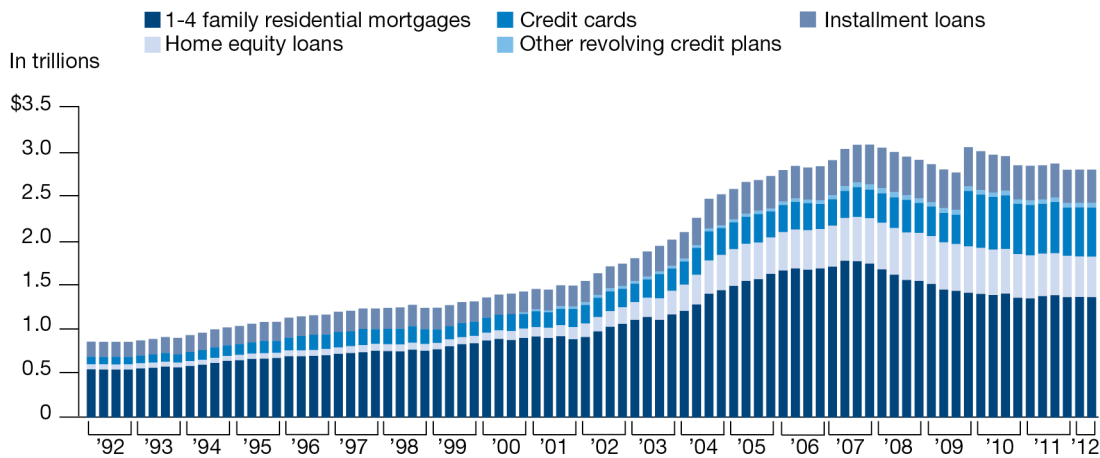
Source: OCC Integrated Banking Information System.

\* 2012 data as of June 30, 2012 (annualized); all other data as of year-end. Net charge-offs are shown as a percent of loans in respective category. CRE includes non-residential real estate, multi-family, and construction loans.

### Attrition Continues in Consumer Credit Portfolios

Consumer credit portfolios continued to contract as charge-offs and pay-downs outpaced new loan originations (see figure 19). Except for an accounting change affecting credit cards at the beginning of 2010, the steady loan-balance decline that began in mid-2007 continued through the second quarter of 2012. Activity remains tepid as lenders and borrowers adjust to more disciplined underwriting and lower housing values. The general decline in consumer portfolios since mid-2007 has been led by mortgages. Recently, however, some segments such as credit cards are showing modest increases.

**Figure 19: Consumer Credit Balances for Banks**



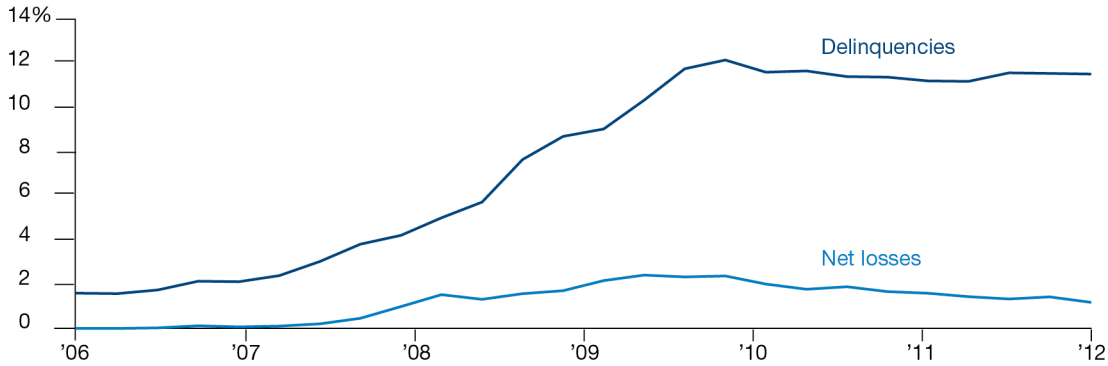
Source: OCC Integrated Banking Information System.



### Foreclosure Delays Cloud Measures of Residential Mortgage Performance

Delinquencies for residential mortgages, senior and junior liens, are above 10 percent for the 13th consecutive quarter (see figure 20). Softness in housing markets related to the sluggish recovery, combined with the overhang of distressed properties and deficiencies in foreclosure processing, have extended disposition time frames for troubled loans. Banks continue to implement corrective actions required by the OCC, but the results will take time to filter through to performance metrics that monitor and gauge mortgage portfolio quality.

**Figure 20: Residential Mortgages 30+ Days Delinquent for Banks**

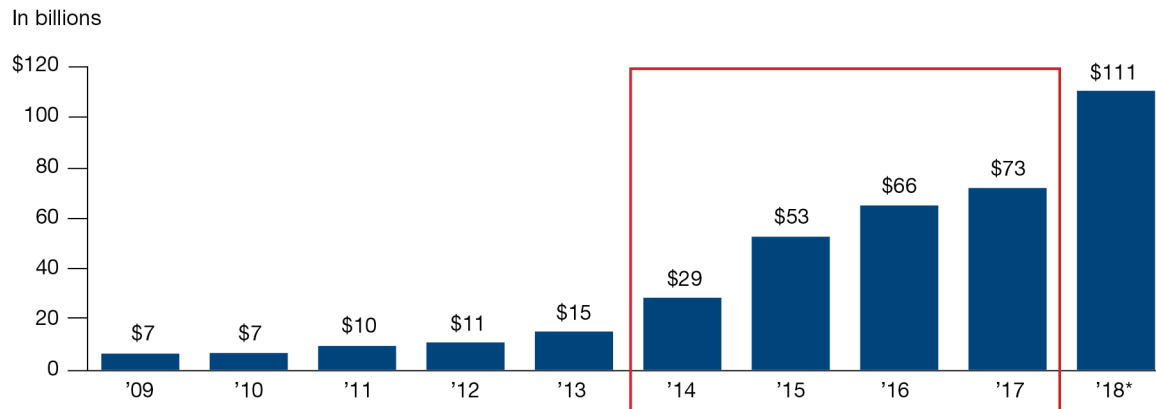


Source: OCC Integrated Banking Information System.

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

Over the next several years a significant number of home equity products originated in 2003 through 2007 will reach the end of their draw periods (see figure 21). The chart below reflects the volume of HELOCs originated by the nine largest banks, and it provides a reasonable proxy for the industry as a whole. Many banks will have issues refinancing borrowers into new HELOCs (and therefore new interest-only draw periods) because underwriting standards have tightened and housing values are generally lower than when the lines were first granted (see figure 22). Given these challenges, the OCC will be monitoring how lenders approach account management and loss mitigation programs; accounting practices such as troubled-debt restructure (TDR) recognition, income recognition, and ALLL segmentation; and risk management issues such as oversight, reporting, and quality control.

**Figure 21: HELOC Outstanding Balances by End-of-Draw Year for Nine Largest Banks**

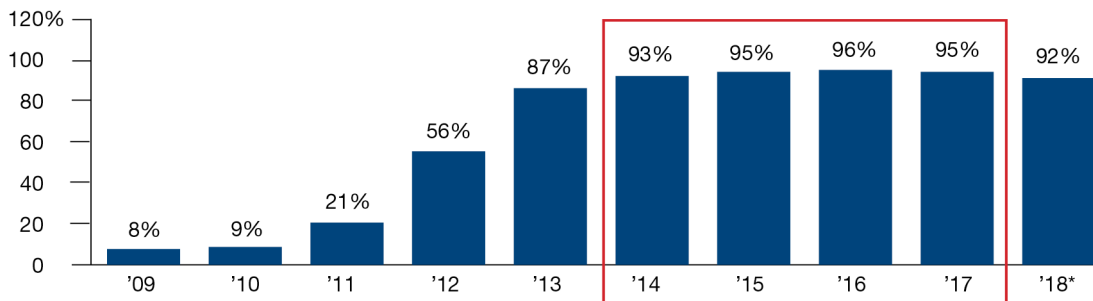


Source: OCC.

\*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. TDR accounting will be necessary given the financial distress faced by many borrowers.

**Figure 22: Percentage of HELOC Balances With Interest-Only Payments by End-of-Draw Year**



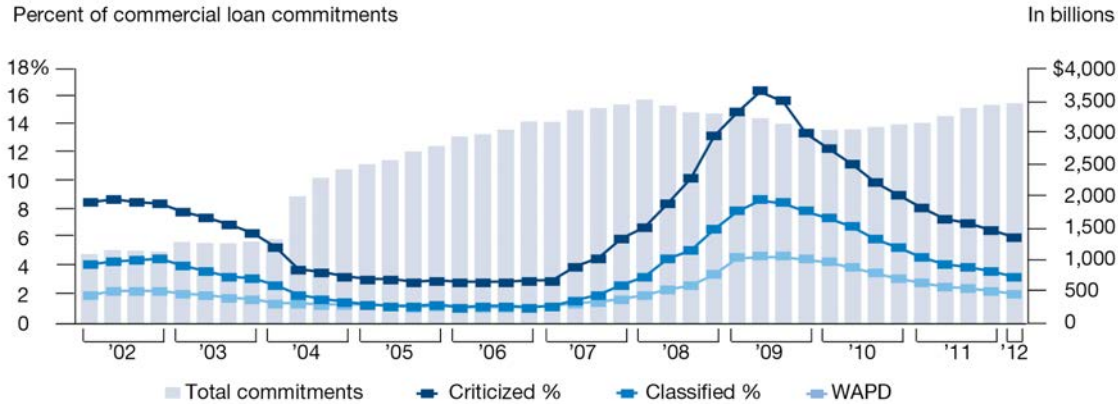
Source: OCC.

\* 2018 and beyond.

### Commercial and Industrial Loan Performance Improving

The OCC’s Credit Analytics shows that commercial loan commitments have increased for eight straight quarters through the second quarter of 2012 (see figure 23). While the rate of growth slowed in the second quarter of 2012, C&I commitments grew by almost 10 percent year over year. This growth is centered in C&I loans from the largest banks. Criticized and classified loans as well as the weighted average probability of default continue to decline, albeit at a slower pace than last year.

**Figure 23: Commercial Loan Trends for Select Banks**



Source: OCC Credit Analytics.

WAPD = Weighted Average Probability of Default to Commitments.

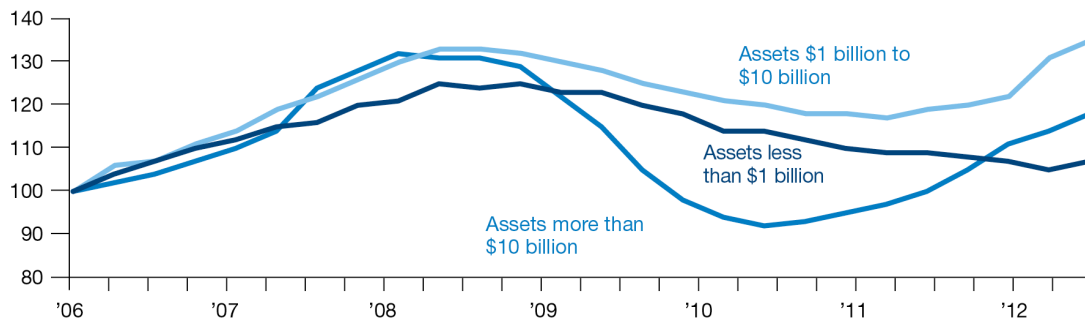
Note: Credit Analytics is an OCC-sponsored, voluntary data-sharing program for analyzing commercial credit trends in the national banks. The participants represent a substantial share of total commercial credit lending by the national banking system.

### Commercial and Industrial Loans Showing Strong Growth

C&I loan growth accelerated in 2012 at the largest banks and is centered in loans over \$1 million. Loan demand from larger firms is growing, fueled by stronger profits. C&I loans at banks with assets between \$1 billion and \$10 billion are back to pre-crisis levels. Smaller banks continued to lag in C&I loan growth, as they typically lend to small businesses, which continue to struggle (see figure 24). Loan demand from small businesses will likely continue to lag until sales and profits at these firms begin to recover.

**Figure 24: C&I Loan Trends for Banks**

C&I loan growth indexed to first quarter 2006



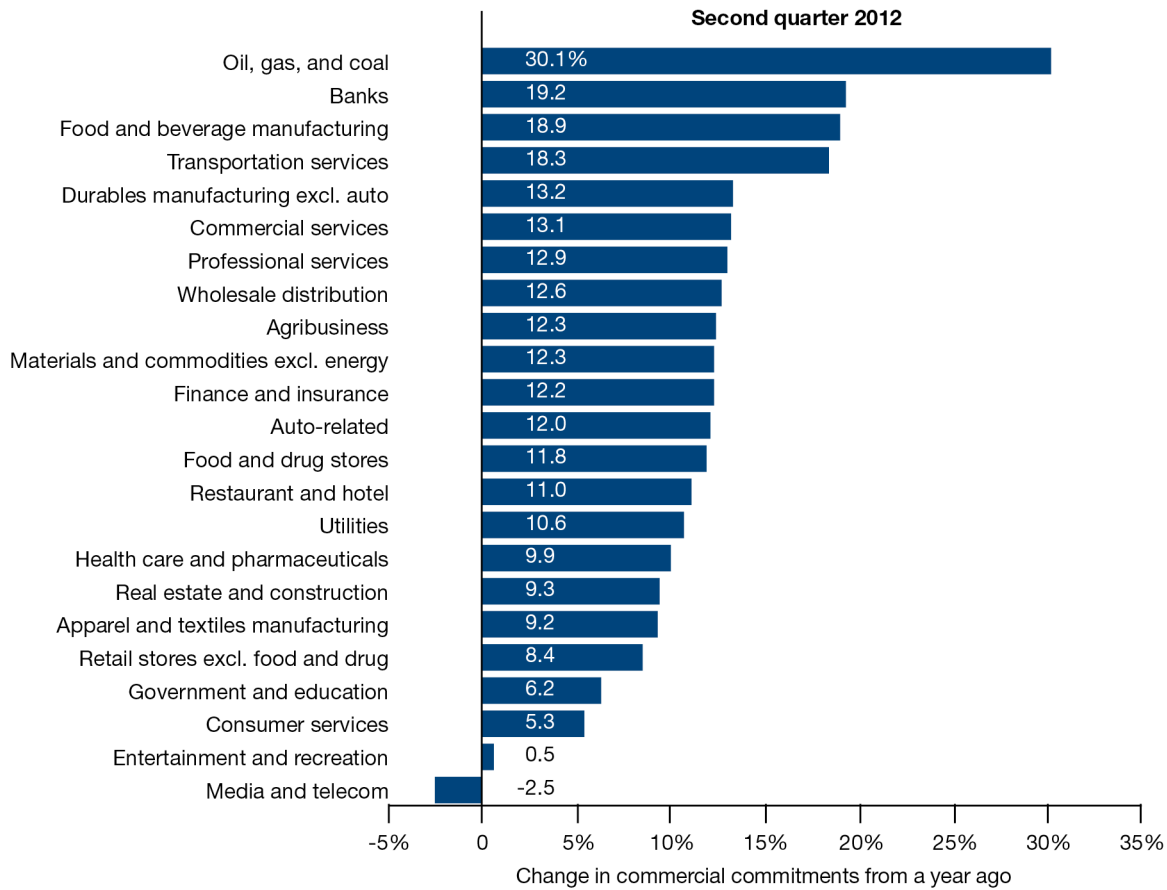
Source: OCC Integrated Banking Information System.

Note: Data are merger-adjusted and held constant for banks in continuous operation from first quarter of 2006 to second quarter of 2012. Data exclude credit card and trust banks.

### Commercial and Industrial Loan Growth is Widespread

Growth in C&I portfolios is widespread, with 22 of 26 national banks included in the OCC’s Credit Analytics database reporting growth (see figure 25). While loan growth was evident across many industry segments, transportation, finance and insurance, and energy led the way. The energy sector reported strong growth, up 8 percent in the second quarter and 30 percent year over year.

**Figure 25: C&I Loan Growth by Industry for Select National Banks**



Source: OCC Credit Analytics.

Note: Credit Analytics is an OCC-sponsored, voluntary data-sharing program for analyzing commercial credit trends in the national banks. The participants represent a substantial share of total commercial credit lending by the national banking system.

### Commercial and Industrial Loan Underwriting Standards Easing

The quarterly “Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices” for C&I loans indicates that underwriting standards have eased on net for eight quarters after a period of sharp tightening (see figure 26). In the second quarter of 2012, the survey shows modest net loosening.

**Figure 26: Percentage of Survey Respondents Tightening C&I Underwriting Standards**



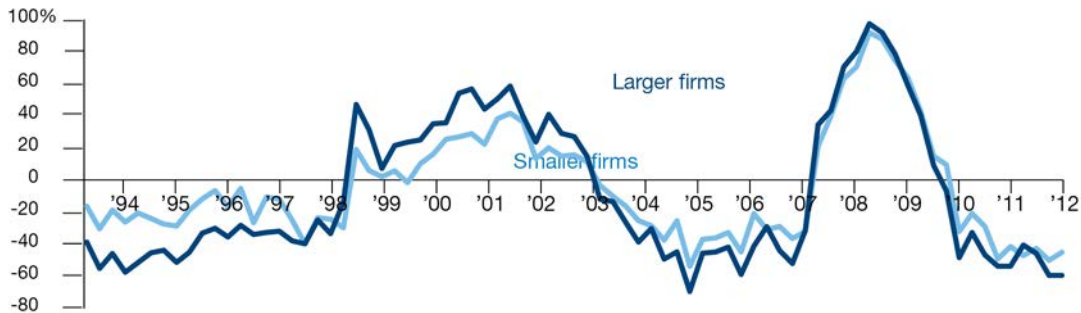
Source: Federal Reserve Board “Senior Loan Officer Opinion Survey on Bank Lending Practices,” July 2012.

Note: Negative value indicates net percent loosening standards.

### 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 through the second quarter of 2012 (see figure 27). The survey indicates that 60 percent of bankers reported decreasing spreads on C&I loans to large firms while 46 percent lending to small firms report decreasing spreads, suggesting that the highly competitive lending climate continues. 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 27: Percentage of Survey Respondents Increasing Loan Rate Spreads**



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

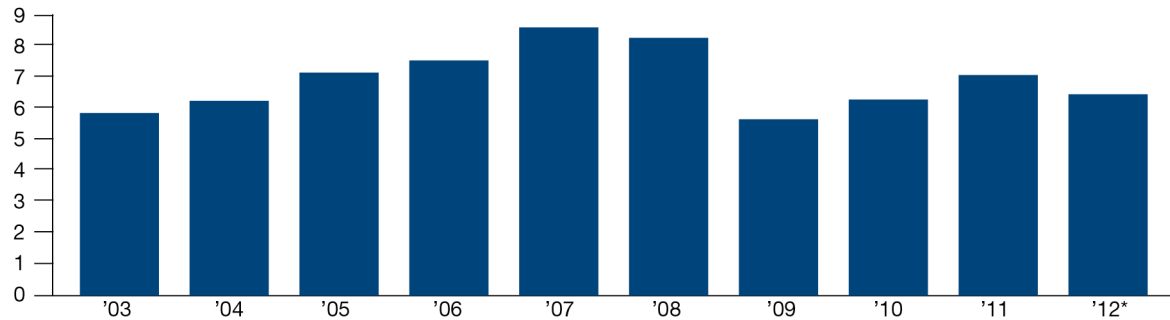
Note: Negative value indicates net percent reporting lower spreads.

### Leveraged Loan Multiples Remain Elevated

In the OCC’s 2012 *Survey of Credit Underwriting Practices*, examiners noted 38 percent of survey respondents loosened standards on highly leveraged lending. 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 before easing back to 6.3 times in the first half of 2012 (see figure 28).

**Figure 28: 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 information and the context from which it is drawn.

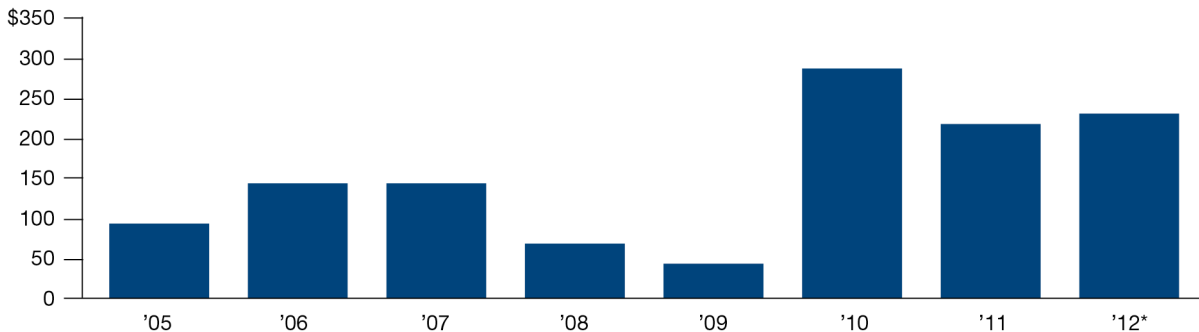
\* June 30, 2012.

### High-Yield Bond Issuance Surging

High-yield bond issuance surged year-to-date in 2012 (see figure 29). Investors have driven yields on high-yield bonds to historical lows and provided an opportunity for some of the most highly levered borrowers to refinance commercial loans in the high-yield bond market.

**Figure 29: High Yield Bond Issuance**

In billions



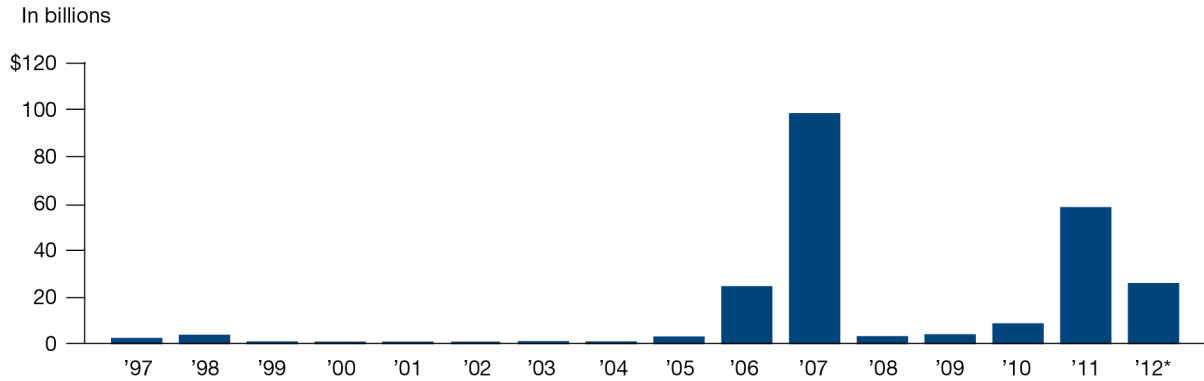
Source: Standard & Poor’s LCD. Standard & Poor’s and its third-party providers are not liable for errors or omissions in the information and the context from which it is drawn.

\* September 18, 2012.

### Increase in New Issuance of Covenant-lite Leveraged Loans Continues

Investor demand for high-yield products continues to surge, with noticeably more relaxed structures incorporating fewer covenants and lender protections. The proportion of new-issue covenant-lite<sup>4</sup> loans increased to the third highest on record through the first half of 2012 (see figure 30). Accordingly, the quality of underwriting remains a long-term concern.

**Figure 30: New Issuance of Covenant-lite Leveraged Loans**



Source: Standard & Poor's LCD. Standard & Poor's and its third-party providers are not liable for errors or omissions in the information and the context from which it is drawn.

\* June 29, 2012.

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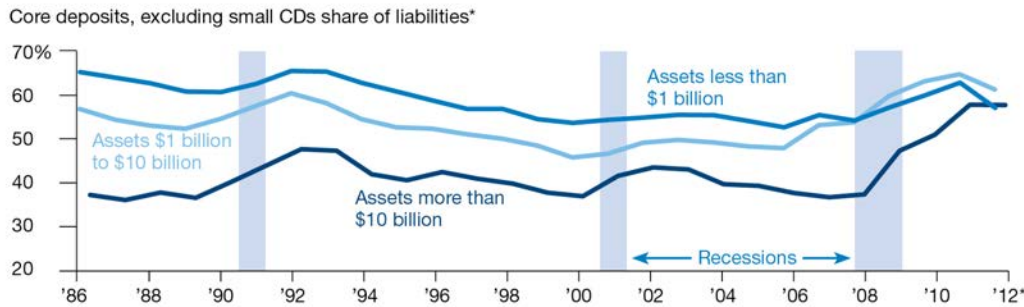
<sup>4</sup> Covenant-lite includes syndicated loans that have no covenants or limited bond-like incurrence covenants rather than traditional maintenance covenants.

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

**Core Deposit Growth Flattens from Peak Levels**

Core deposits grew rapidly and reached record levels by the end of 2011 but are showing the first decline since the financial crisis at smaller banks (see figure 31). At the largest, which were most affected by the liquidity concerns during the financial crisis, core deposits increased from 36 percent of liabilities to almost 57 percent, though growth has been flat through the first six months of 2012. 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 should interest rates move higher or economic activity increase. The volume and/or cost to retain non-interest-bearing transaction accounts also could be materially affected in 2013 with the expected end of the temporary unlimited deposit insurance provided under the Dodd-Frank Act.

**Figure 31: Trends in Core Deposits for Banks**



Source: OCC Integrated Banking Information System.

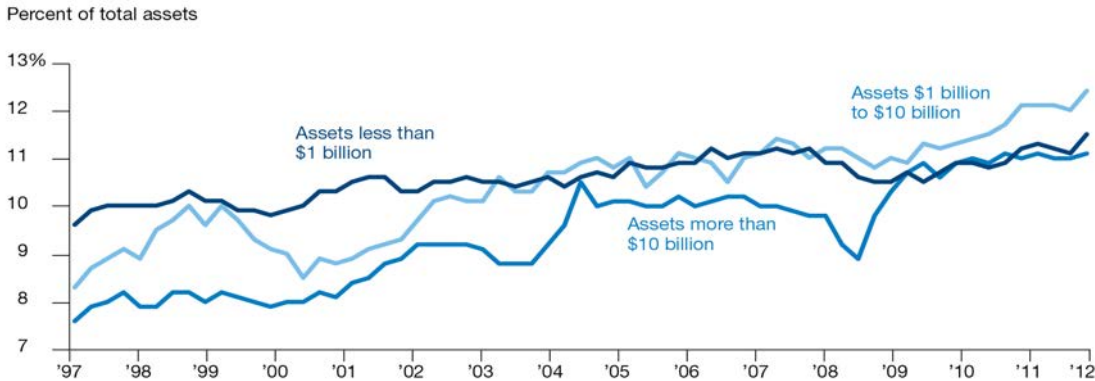
\* 2012 data as of June 30, 2012; all other data as of year-end.

\*\* Core deposits 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 relative to total assets (see figure 32). This has occurred across size segments, with those with more than \$10 billion in assets making the most progress, spurred collectively by the need to rebuild capital lost during the financial crisis, merger-related asset growth, and in response to anticipated increases in regulatory requirements. Most segments were at or near historical highs for equity capitalization at the end of the second quarter of 2012 compared with the past 15 years.

**Figure 32: Equity Capital to Total Assets for Banks**



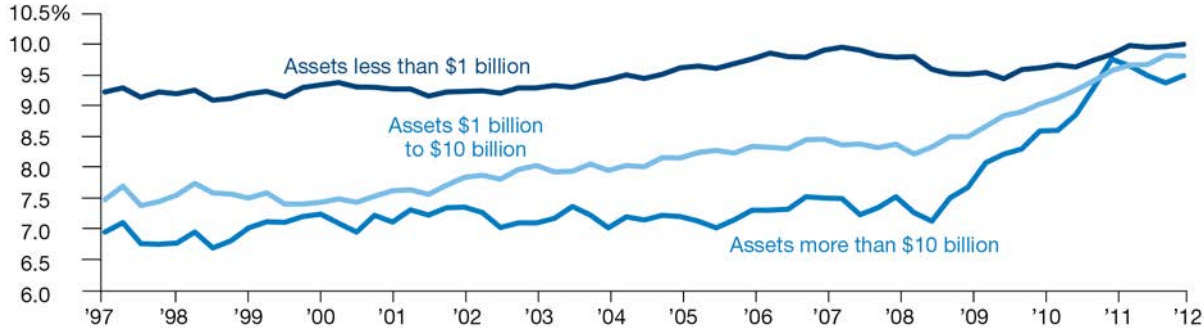
Source: OCC Integrated Banking Information System.



**Median Tier 1 Leverage Capital Ratio Improving**

Capital quality has strengthened notably in recent years, as measured by the median percentage of Tier 1 capital relative to total assets (see figure 33). All size segments have improved from pre-crisis levels.

**Figure 33: Median Tier 1 Leverage Capital for Banks**

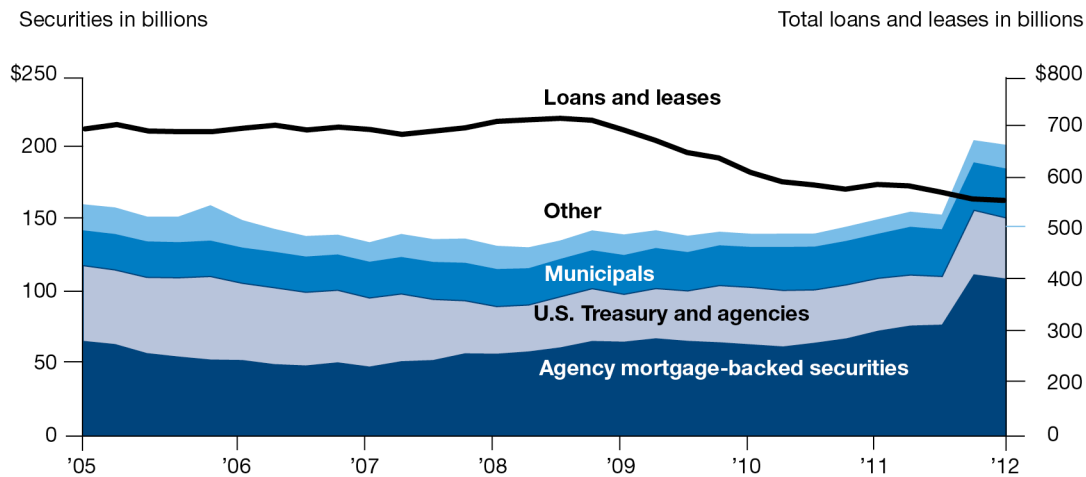


Source: OCC Integrated Banking Information System.

**Small Banks' Investment Portfolios Concentrated in Mortgage Securities**

Small banks increased their collective investment portfolios since 2007 in response to strong deposit growth and weak loan demand. The bulk of the increase in the investment portfolio is centered in agency mortgage-backed securities (MBS) followed by increases in U.S. agency and municipal securities (see figure 34). The increases in agency MBS may make some holders more vulnerable to interest rate risk because of the optionality associated with these instruments. Data include national banks for all time periods and federal savings associations beginning with the first quarter of 2012.

**Figure 34: Investment Portfolio for Banks with Total Assets Less Than \$10 Billion**



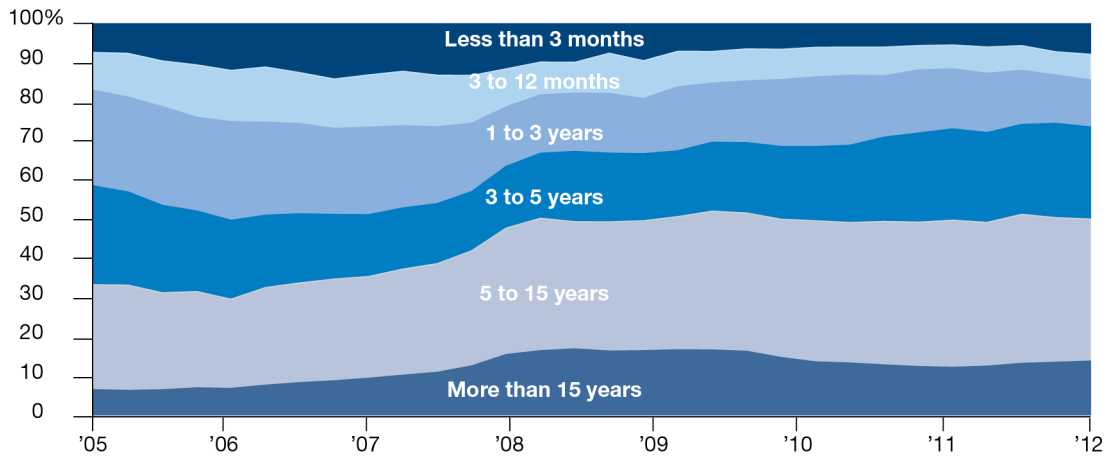
Source: OCC Integrated Banking Information System.

Note: Federal savings associations are included beginning in the first quarter of 2012.

### **Small Banks Lengthen Investment Portfolio Maturities**

Small banks also have increased the maturity profile of their investment portfolios since 2007 (see figure 35). The portion of the portfolio with maturities five years or more increased from 37 percent as of the second quarter of 2007 to 50 percent as of the second quarter of 2012. 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 MBS and bonds with multiple call dates during a period of low interest rates and low volatility may expose some to potentially significant interest rate risk if rates were to rise rapidly as occurred in 1994. Data include national banks for all time periods and federal savings associations beginning with the first quarter of 2012.

**Figure 35: Maturity Structure for Investment Portfolios at Banks with Total Assets Less Than \$10B**



Source: OCC Integrated Banking Information System.

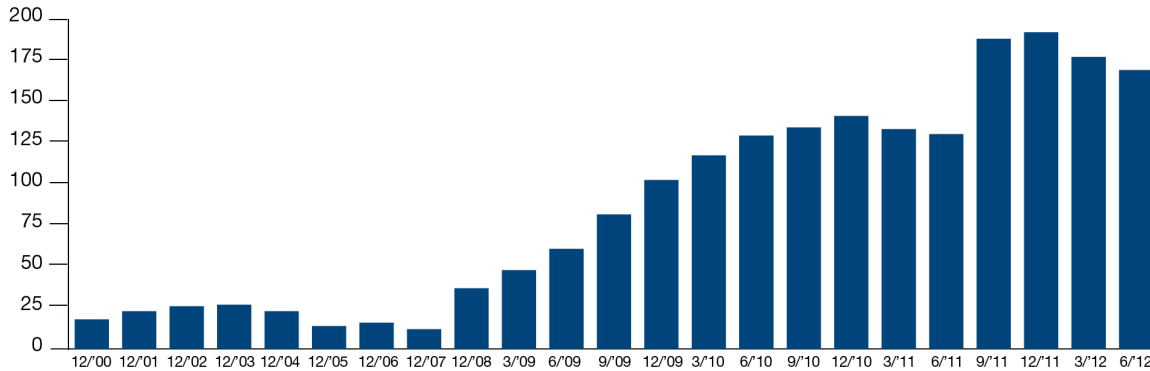
Note: Federal savings associations are included beginning in the first quarter of 2012.

**Part IV: Regulatory Actions**

***Banks Rated 4 or 5 Declining***

The percentage of OCC-supervised banks rated 4 or 5 declined through the first half of 2012 (see figure 36). While much of the decline is because of failures, the rate of downgrades is slowing as conditions improve. The increase in the third quarter of 2011 resulted from the addition of federal savings associations to the OCC’s supervision on July 21, 2011.

**Figure 36: Banks Rated 4 or 5**



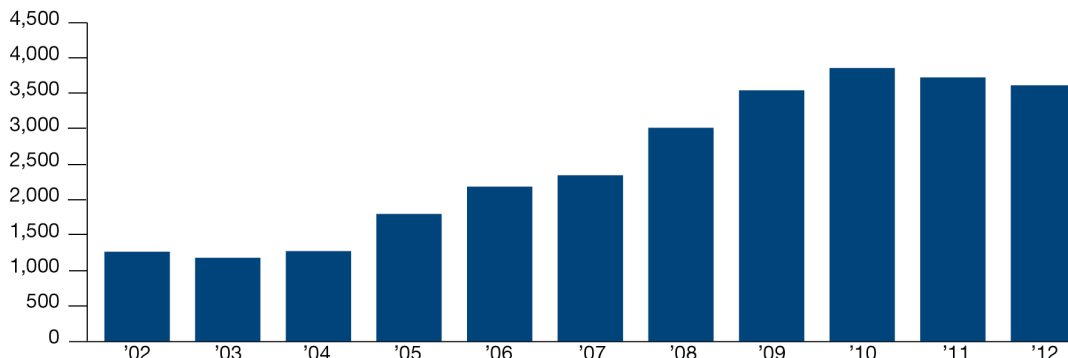
Source: OCC.

Note: Federal savings associations are included beginning in the third quarter of 2011.

***Matters Requiring Attention Declining***

The OCC uses MRAs 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, compliance, or reputation and could lead to formal enforcement action. The number of open MRAs continues to show a gradual decline through the second quarter of 2012 (see figure 37). The top five MRA categories for small banks are relatively unchanged since year-end 2011 and include credit administration (29 percent), management (15 percent), compliance (9 percent), asset quality (8 percent), and capital (6 percent). For large banks, MRAs are centered in credit (33 percent), operational risk (26 percent), consumer compliance (23 percent), capital markets (13 percent), and safety and soundness (6 percent). The primary change in the top five categories for large banks is the movement of operational risk into the top five. Open MRAs include those cited for federal savings associations during supervisory activities conducted subsequent to the OCC adding supervision of federal savings associations on July 21, 2011.

**Figure 37: Trend in MRAs for Banks**

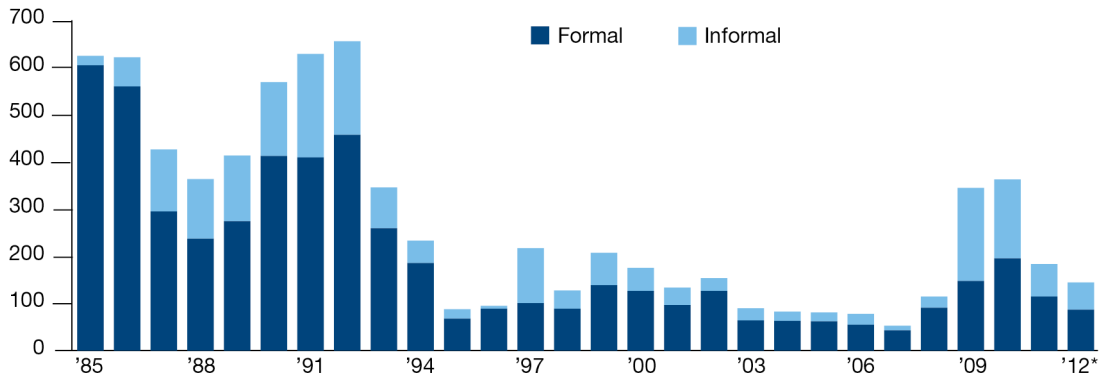


Source: OCC.

**Enforcement Actions Against Banks Continue to Decline in 2012**

The OCC uses enforcement actions to address more acute problems or weaknesses requiring corrective measures. Informal enforcement actions include commitment letters, memorandums 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 through June 30, 2012, at a much slower pace than the levels seen in fiscal years 2009, 2010, and 2011, reflecting the stabilization in the number of problem banks (see figure 38). These data include enforcement actions issued against federal savings associations subsequent to July 21, 2011.

**Figure 38: Enforcement Actions Issued Against Banks**



Source: OCC.

\* Data through June 30, 2012, for fiscal year ended September 30, 2012.

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