Comptroller of the Currency
Administrator of National Banks

A Telephone Seminar

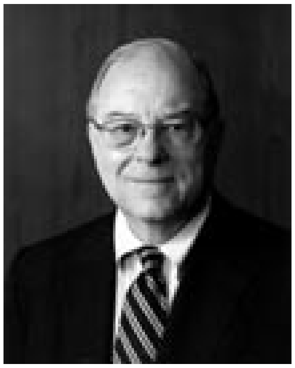
Condition of the Banking Industry

Tuesday, April 20, 2004
and again on
Wednesday, April 21, 2004

Speaker Biographies
Electronic Polling Question
Power Point Presentation

John D. Hawke, Jr.

Comptroller of the Currency



John D. Hawke, Jr. was sworn in as the 28th Comptroller of the Currency on December 8, 1998. After serving for 10 months under a Recess Appointment, he was sworn in for a full five-year term as Comptroller on October 13, 1999.

The Comptroller of the Currency is the Administrator of National Banks. The Office of the Comptroller (OCC) supervises about 2,200 federally chartered commercial banks and about 52 federal branches and agencies of foreign banks in the United States comprising more than half of the assets of the commercial banking system. The Comptroller also serves as a Director of the Federal Deposit Insurance Corporation, the Federal Financial Institutions Examination Council, and the Basel Committee on Banking Supervision.

Prior to his appointment as Comptroller, Mr. Hawke served for 31⁄2 years as Under Secretary of the Treasury for Domestic Finance. In that capacity he oversaw the development of policy and legislation in the areas of financial institutions, debt management, and capital markets, and served as Chairman of the Advanced Counterfeit Deterrence Steering Committee and as a member of the board of the Securities Investor Protection Corporation. Before joining Treasury, Mr. Hawke was a Senior Partner at the Washington, D.C., law firm of Arnold & Porter, which he first joined as an associate in 1962.At Arnold & Porter he headed the Financial Institutions practice, and from 1987 to 1995 he served as Chairman of the firm. In 1975 he left the firm to serve as General Counsel to the Board of Governors of the Federal Reserve System, returning in 1978.

Mr. Hawke was graduated from Yale University in 1954 with a B.A. in English. From 1955 to 1957 he served on active duty with the U.S. Air Force. After graduating in 1960 from Columbia University School of Law, where he was Editor-in-Chief of the Columbia Law Review, Mr. Hawke was a law clerk for Judge E. Barrett Prettyman on the U.S. Court of Appeals for the District of Columbia Circuit. From 1961 to 1962 he served as counsel to the Select Subcommittee on Education in the House of Representatives.

From 1970 to 1987 Mr. Hawke taught courses on federal regulation of banking at the Georgetown University Law Center. He has also taught courses on bank acquisitions and financial regulation and serves as the Chairman of the Board of Advisors of the Morin Center for Banking Law Studies at Boston University School of Law.

In 1987 Mr. Hawke served as a member of a Committee of Inquiry appointed by the Chicago Mercantile Exchange to study the role of futures markets in connection with the stock market crash in October of that year.

Mr. Hawke has written extensively on matters relating to the regulation of financial institutions, and is the author of Commentaries on Banking Regulation, published in 1985. He was a founding member

of the Shadow Financial Regulatory Committee, and served on the committee until joining Treasury in April 1995.

Mr. Hawke is a member of the Cosmos Club, the Economic Club of Washington, and the Exchequer Club of Washington.

Born in New York City on June 26, 1933, Mr. Hawke resides in Washington, D.C. He was married in 1962 to the late Marie R. Hawke and has four adult children, Daniel, Caitlin, Anne, and Patrick, and two grandchildren, Spencer Patrick Hawke and Camerynn Marie Hawke.

Nancy A. Wentzler

Deputy Comptroller

Global Banking and Financial Analysis

Nancy Wentzler is deputy comptroller for Global Banking and Financial Analysis in the Office of the Comptroller of the Currency (OCC). She is in charge of the economic and financial analysis of potential risks to the banking system and the development of risk models to serve as early warning tools for such risks.

Prior to her work at the OCC, she served from 1991 through 1994 with the Office of Thrift Supervision in charge of the development of systems for early identification of problem thrifts and provided regular reports through press conferences on the thrift crisis. From 1989 through 1990, she was economic advisor and subsequently Inspector General with the Commodity Futures Trading Commission, and from 1980 through1989 she served as senior economist with the Office of Management and Budget. Ms. Wentzler held an adjunct professor position with Virginia Tech from 1989 through 2000.

She holds a Ph.D. in economics from the University of Wisconsin and B.S. in economics and business from Penn State University.

Kathryn E. Dick

Deputy Comptroller for Risk Evaluation
Office of the Comptroller of the Currency

Kathryn Dick is the deputy comptroller for Risk Evaluation, of the Office of the Comptroller of the Currency (OCC). Ms. Dick serves as the Comptroller's principal advisor on systemic risks facing the national banking system and chairs the OCC's national Risk Committee, which coordinates the agency's risk identification practices.

Prior to her current position, Ms. Dick served four years as the director, Treasury & Market Risk Division (TMR). As TMR director she was responsible for developing bank regulatory and supervisory policies and examiner guidance for trading, interest rate risk, liquidity, securitization, derivatives, and dealer activities. She also served as the agency's primary liaison with its cadre of capital market examiners.

Ms. Dick spent three years managing the OCC's London office. In her capacity there, Ms. Dick was responsible for supporting the supervision of U.S. national bank branches throughout Europe.

Ms. Dick has spent most of her 20-year career at the OCC examining the capital markets activities of national banks. She earned an MBA from the Carlson School of Management, University of Minnesota in 1983, and a B.A. from the University of Minnesota in 1981. Ms. Dick received the Chartered Financial Analyst (CFA) designation in 1992.

Mark Diller

Systemic Risk Analyst and National Bank Examiner

Office of the Comptroller of the Currency

Mark Diller currently serves as a systemic risk analyst in the Global Banking and Financial Analysis Division of the Office of the Comptroller of the Currency (OCC). In his current position, he participates in the OCC's ongoing effort to understand the prospective risks facing the national banking system.

Diller began his career with the OCC in 1982. He was commissioned a national bank examiner in 1986. He has participated in the examinations of banks of all sizes and condition throughout the United States. He is an experienced bank analyst having held positions as a senior field office analyst and environmental analyst in the Central District. He served as chairman of the OCC's Central District Risk Committee from 2000-2003.

Diller received a BS degree in finance from the University of Wyoming in 1981.

Kristin A. Kiefer

Assistant Deputy Comptroller
New York Metro Field Office

Kristin Kiefer is the assistant deputy comptroller at the New York Metro field office supervising community banks and data servicers. This office covers Manhattan, North and Central New Jersey, Hudson River Valley and southern Connecticut. She also chairs the District Risk Committee.

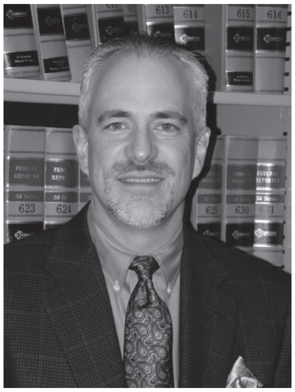
Kris joined the OCC in 1979 as a field examiner in Minneapolis, Minnesota where she worked in community and regional banks in Minnesota, Wisconsin, and the Dakotas. In 1983, she transferred to San Francisco and worked in community and multinational banks. She supervised a portfolio of troubled and failing institutions in the Western United States from 1984 to 1990. She was commissioned as a national bank examiner in 1984. In 1991, Kris worked as risk analyst working with bank examiners and economists to identify potential risks in banking and developing supervisory strategies to address those risks.

Prior to taking her current position, Kris was the field manager of the New Jersey field office. In this position, she supervised community and mid-size banks located in central and northern New Jersey, and federal branches of foreign banks located in New York.

A native of St. Cloud, Minnesota, Kris was graduated from St. Cloud University, St. Cloud, Minnesota with a BS in finance. She also received an MBA from the University of California at Berkeley.

William D. Haas

Assistant Deputy Comptroller
Midsize Bank Supervision



William Haas became assistant deputy comptroller for Midsize Bank Supervision in March, 2003. In this position, he oversees a portfolio of midsize national banks, a group that includes 25 banking companies with assets ranging from $3 to $25 billion.

Haas joined the OCC in 1984 and was commissioned as a national bank examiner in 1988. He has served in a variety of supervisory positions in both the community and large bank divisions. He has been a credit team leader in the large bank division, has participated in numerous special credit projects on a national scope, and has developed and delivered numerous credit training programs for the OCC and for Risk Management Associates.

Haas has a BS degree in business administration and political science from Hastings College, Hastings, Nebraska.

Polling Question
4/20/04 and 4/21/04 Teleconferences

1 How many people are at your listening site? Press:
2 for two people
3 for three people
4 for four people
5 for five people
6 for six people
7 for seven people
8 for eight people
9 for nine or more people listening at your site.

Condition of the Banking Industry

OCC Telephone Seminar
April 2004

Today's discussion...

Bank performance and vulnerabilities

Discussion of our key concerns

- Credit administration
- Commercial real estate
- Interest rate risk
- Risk management of new products
- Retail credit

Question and answer session

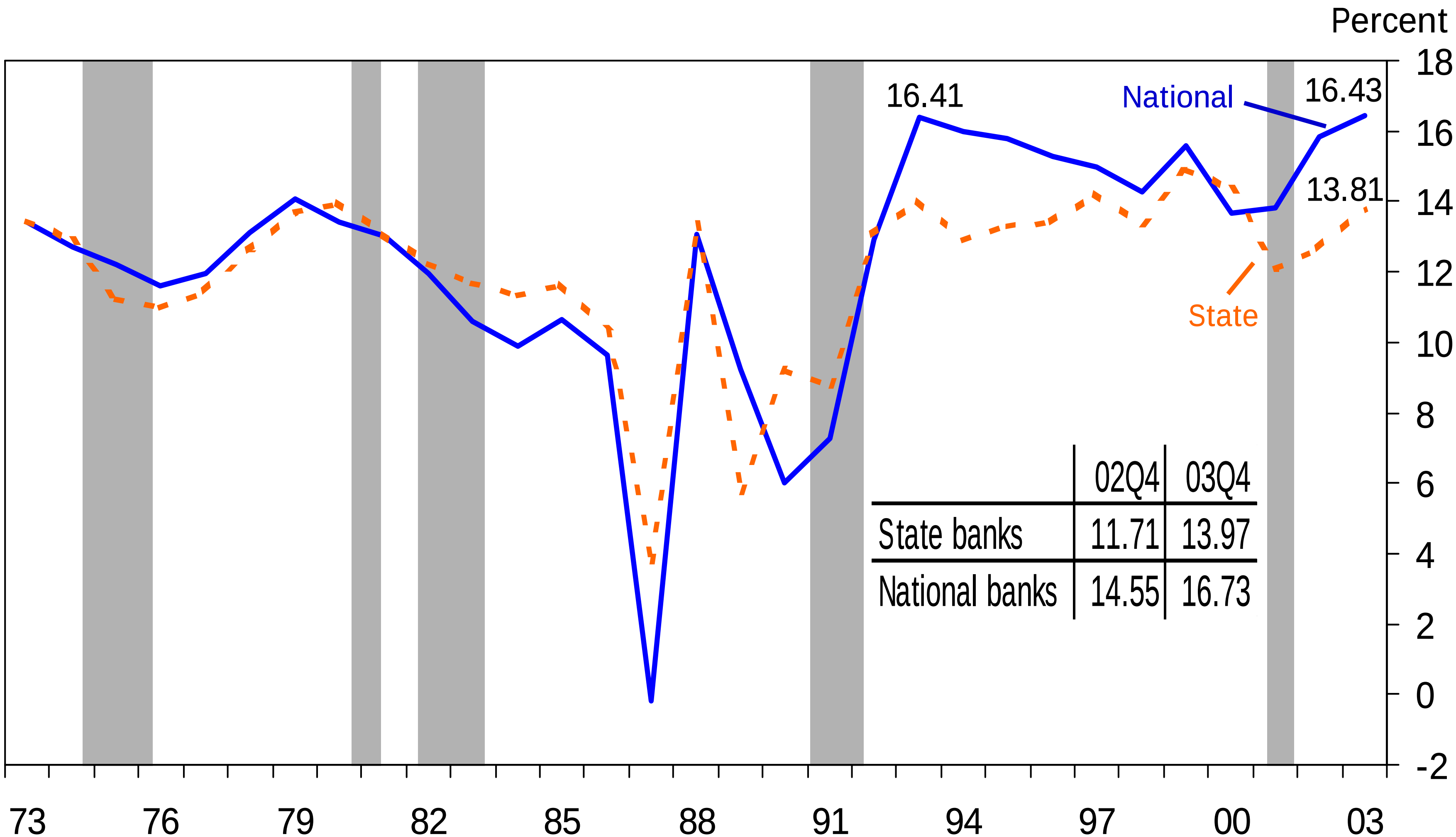
Bank Performance and Vulnerabilities

Bank earnings strong, but maintenance in 2004 will be challenging.

- Margin compression may remain with loan growth expected to decline
- Business lending may be slow to recover
- Sluggish employment growth/need for structural adjustments impair regional outlook
- CRE issues may surface with slow economic recovery
- Interest rate risk remains a concern

ROE hits record high for national banks.

National and state bank ROE



	02Q4	03Q4
State banks	11.71	13.97
National banks	14.55	16.73

Source: Integrated Banking Information System (OCC)

Data as of year-end. Shaded areas represent periods of recession.

For 2003, provisioning decline key to net income gains.

National banks

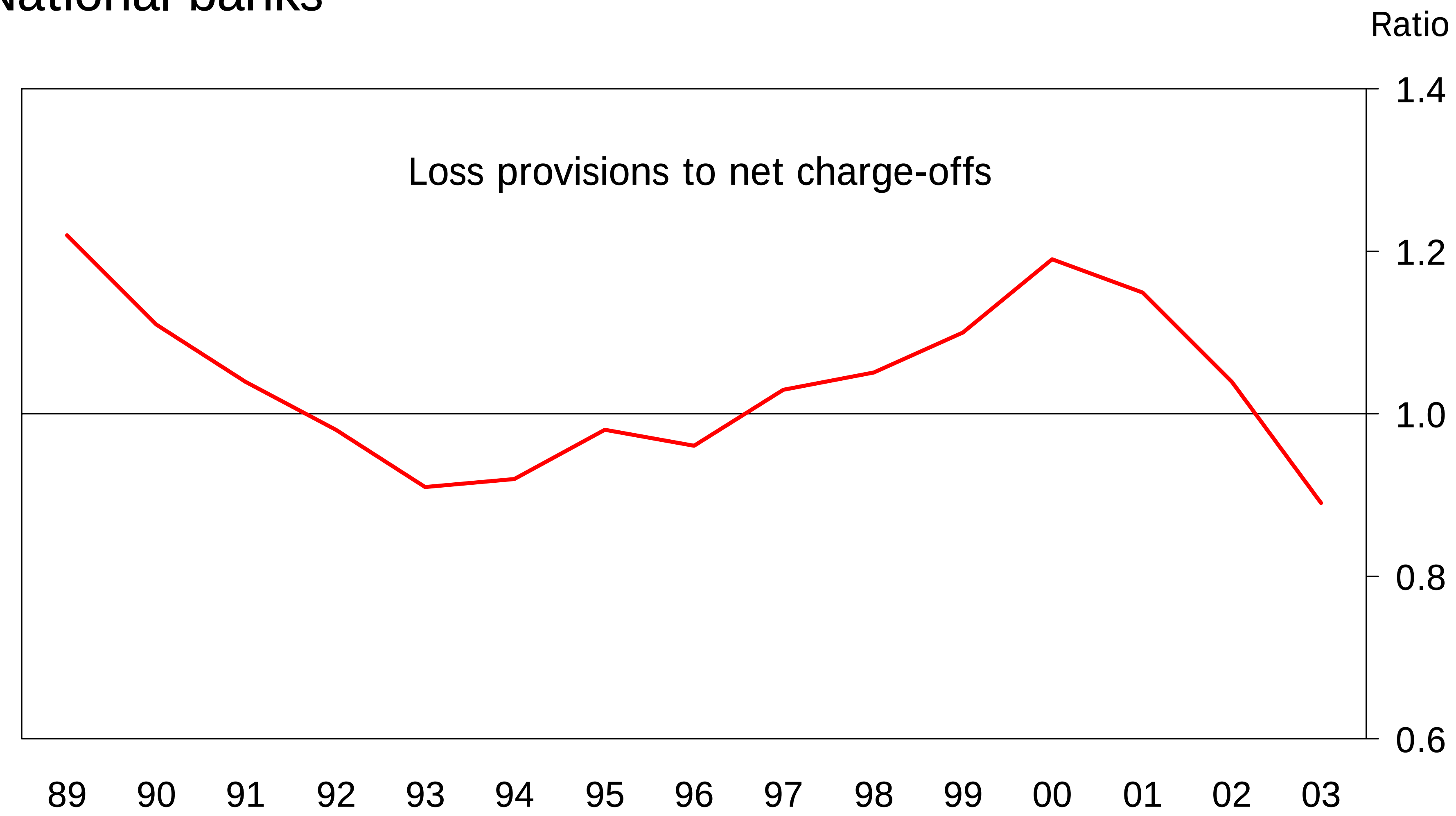
Major income components
(Change, $ millions)

	2001-2002	% Change	2002-2003	% Change
Revenues				
Net interest income	16,001	12.8%	1,787	1.3%
Real gains/losses sec	739	30.9%	-266	-7.2%
Noninterest income	9,674	9.7%	6,287	5.7%
Expenses				
Provisioning	3,692	12.8%	-8,606	-26.4%
Noninterest expense	5,122	3.4%	8,069	5.9%
Net income	12,437	28.2%	6,339	11.2%

Source: Integrated Banking Information System (OCC)

Lower provisioning reflects optimism on credit quality.

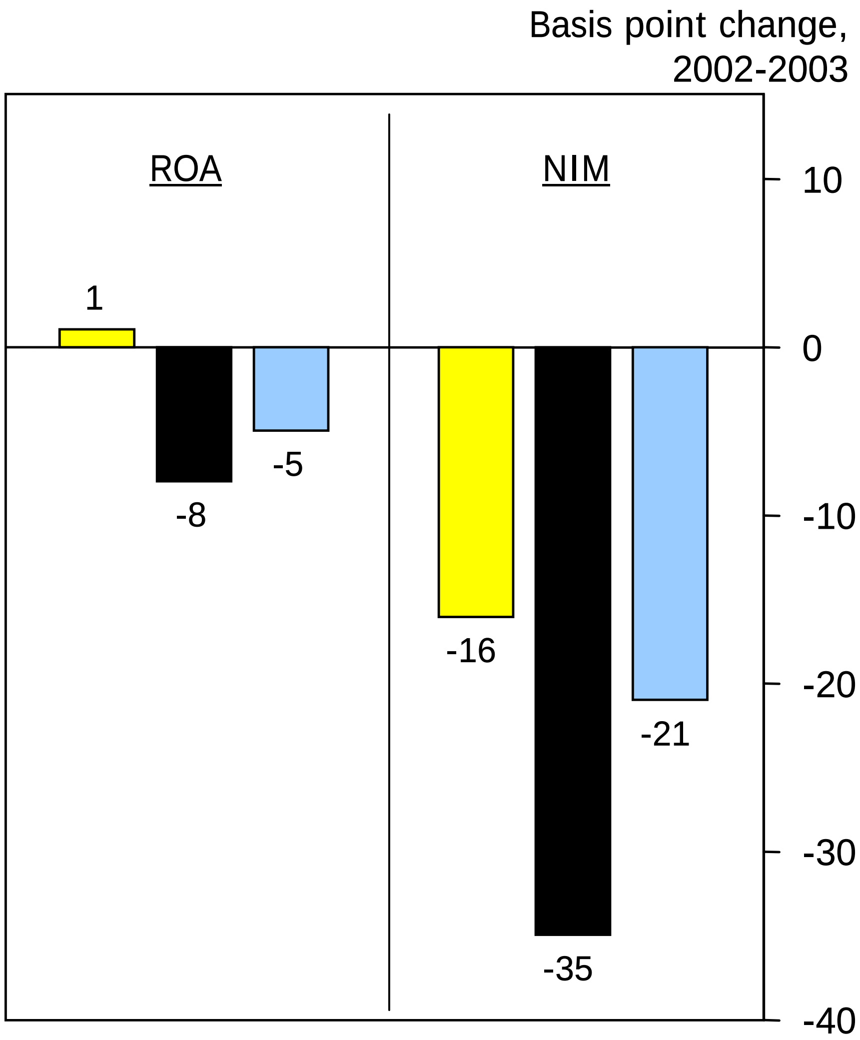
National banks

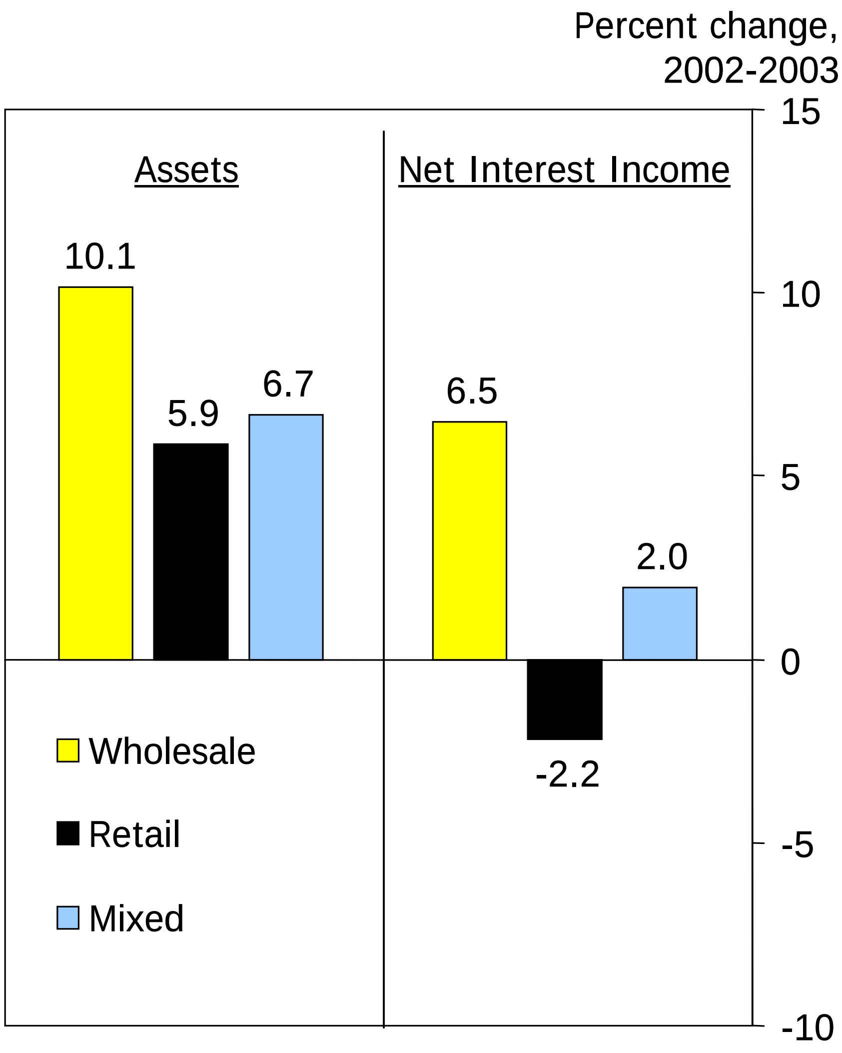


Source: Integrated Banking Information System (OCC)

Data as of year-end.

NIM weakness hard to offset for many community banks.
National community banks with less than $1 billion in assets





Source: Integrated Banking Information System (OCC)

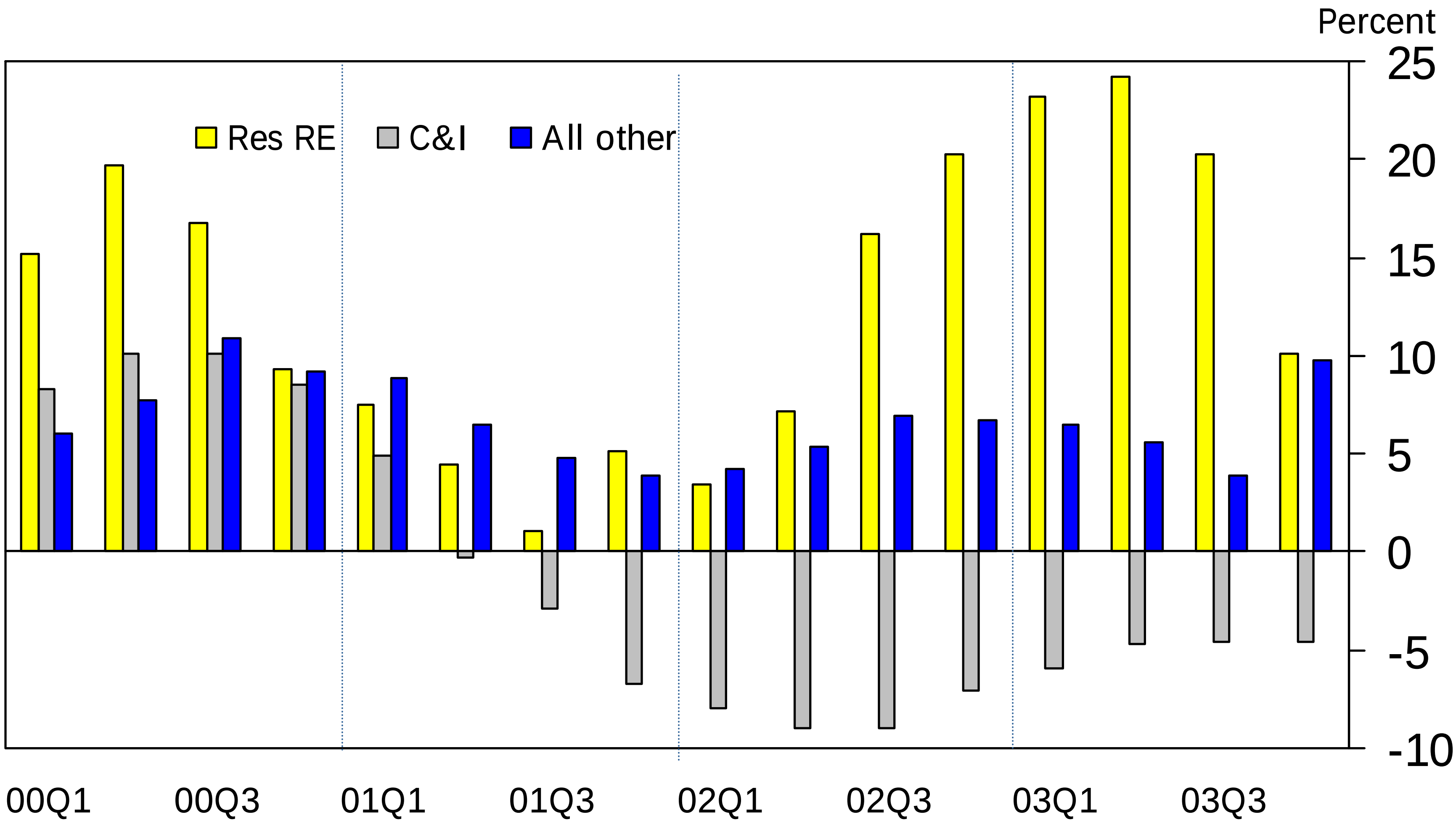
Banks held constant from period to period and in peer categories. Wholesale includes C&I and business RE. Retail includes residential RE and consumer. Mixed is wholesale and retail.

2004 likely to be more challenging

- Growth in core funding slows
- Loan growth could decelerate
  - How much steam still in residential real estate?
  - Consumer vulnerable to deteriorating sentiment
  - Flush business sector may constrain C&I demand

Residential real estate growth cools in 4th Q.

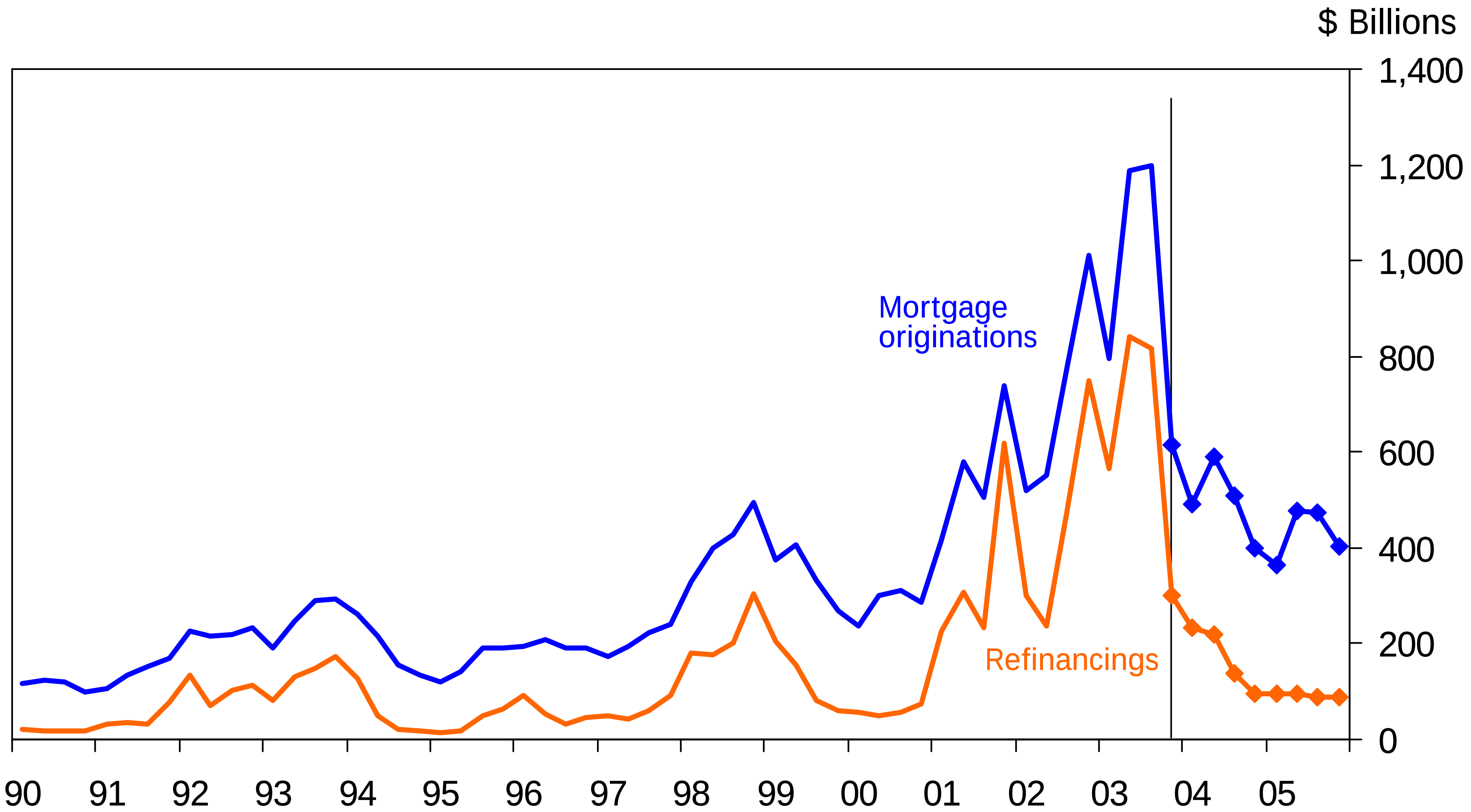
Commercial banks



Source: Integrated Banking Information System (OCC)

Growth calculated from the same quarter a year ago.
Residential RE is 1-4 family and home equity.

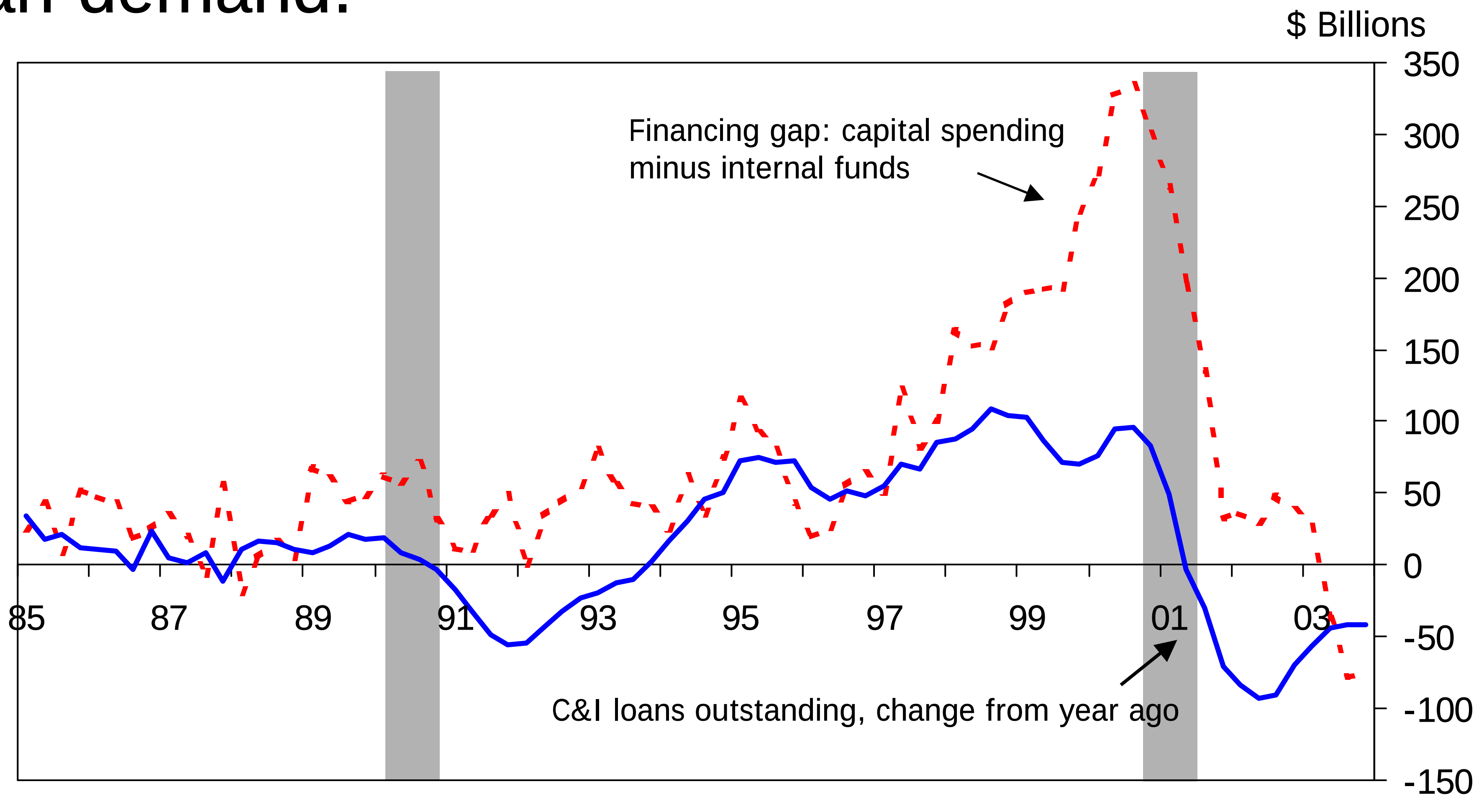
Expectations are for continued drop in residential mortgage volume.



Source: Mortgage Bankers Association, HUD

Actual data through 2003Q3; estimates through 2005Q4.

Strong corporate cash flow likely to limit C&I loan demand.



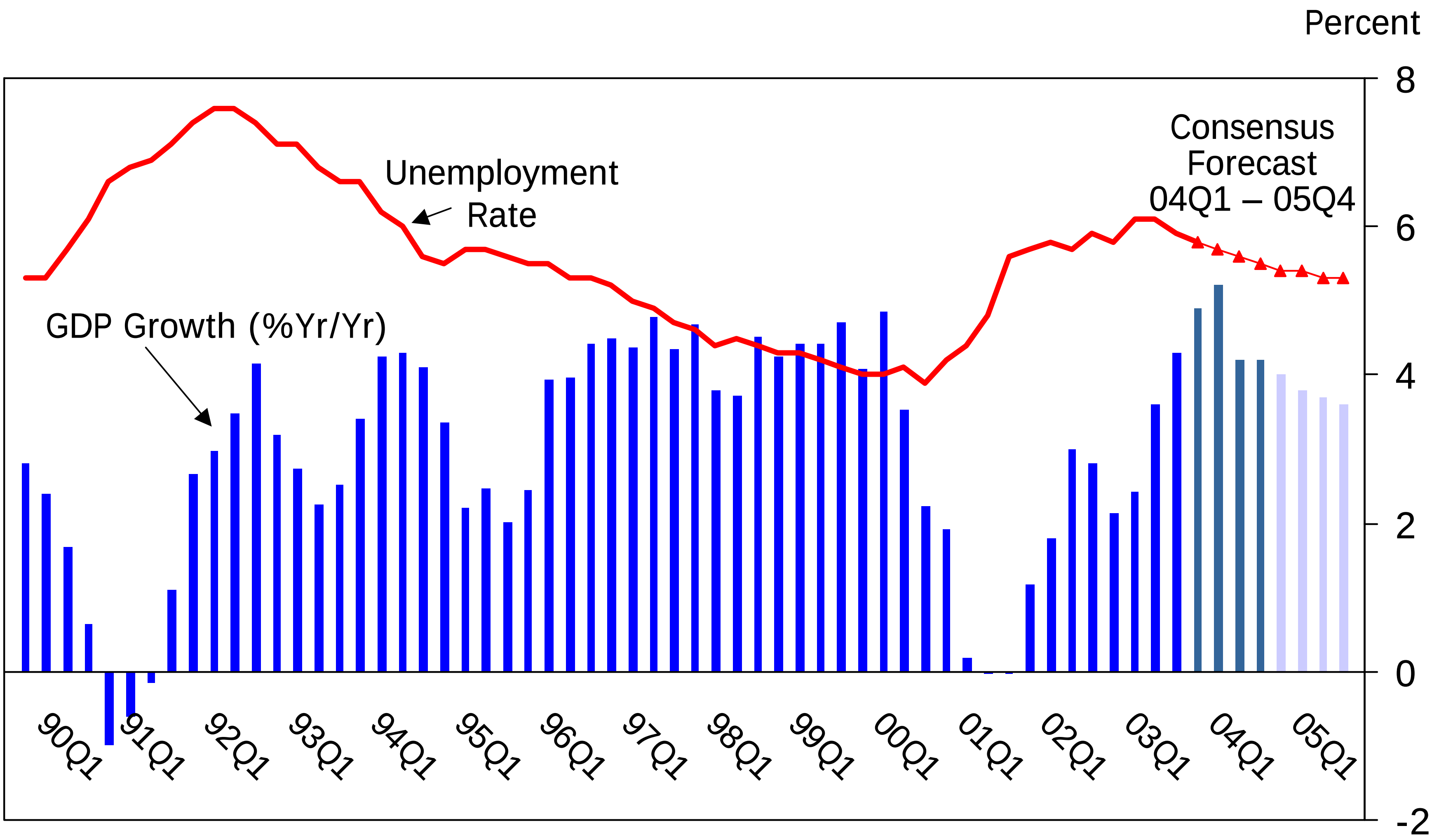
Source: Integrated Banking Information System (OCC), Federal Reserve Board/Haver Analytics

Quarterly data through 2003Q4. Shaded areas represent periods of recession.

Lingering economic difficulties likely to complicate challenge.

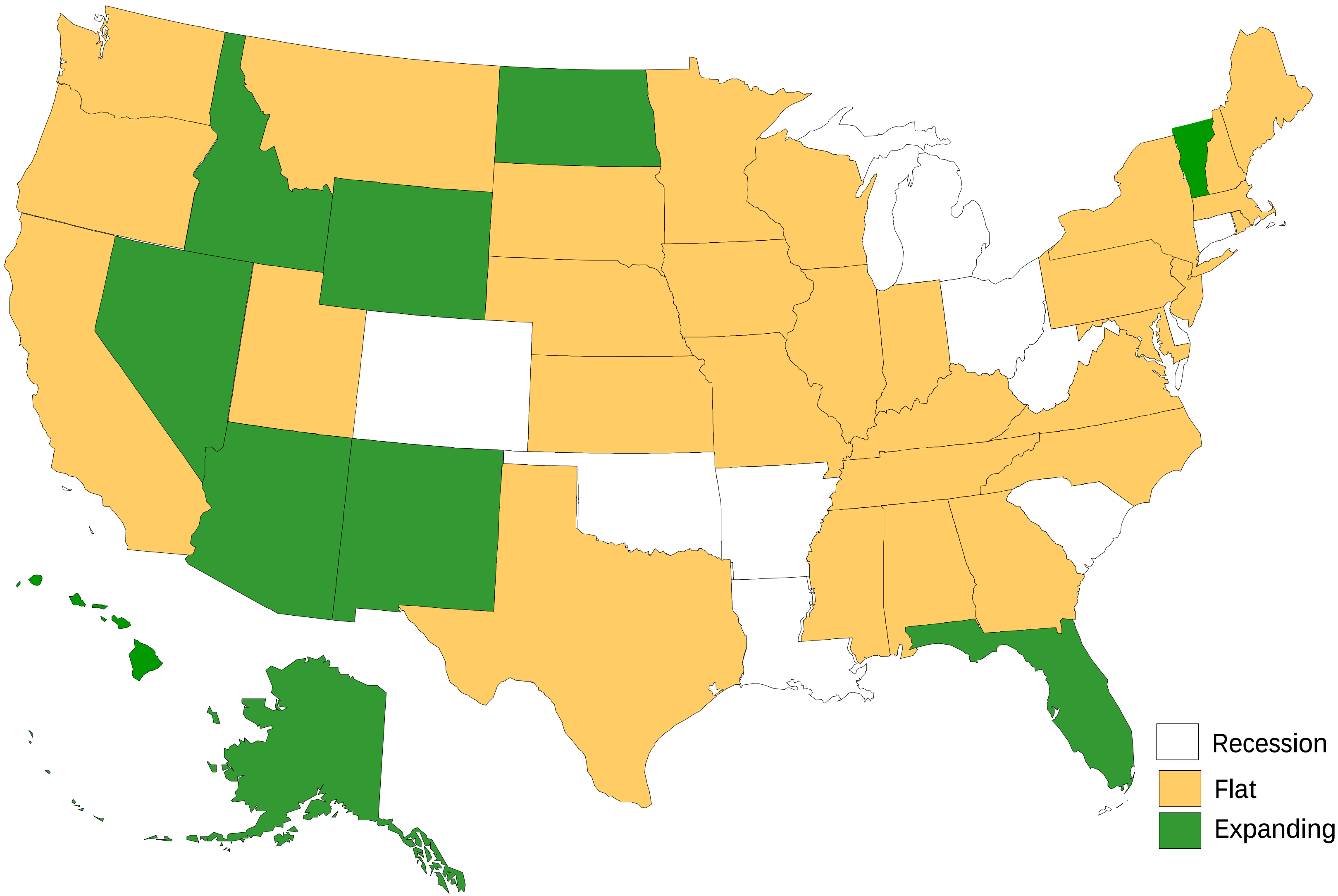
- Significant regional differences remain
- Most MSAs continued to lose jobs through year-end 2003
- Ongoing structural adjustments will take time with considerable spillover effects

Consensus: solid GDP growth, but only modest employment gains



Source: Commerce Department and Bureau of Labor and Statistics from Haver Analytics
Quarterly data through 2003Q4 as of 2/10/2004. Forecasts from Blue Chip Economic Indicators, 2/10/2004.

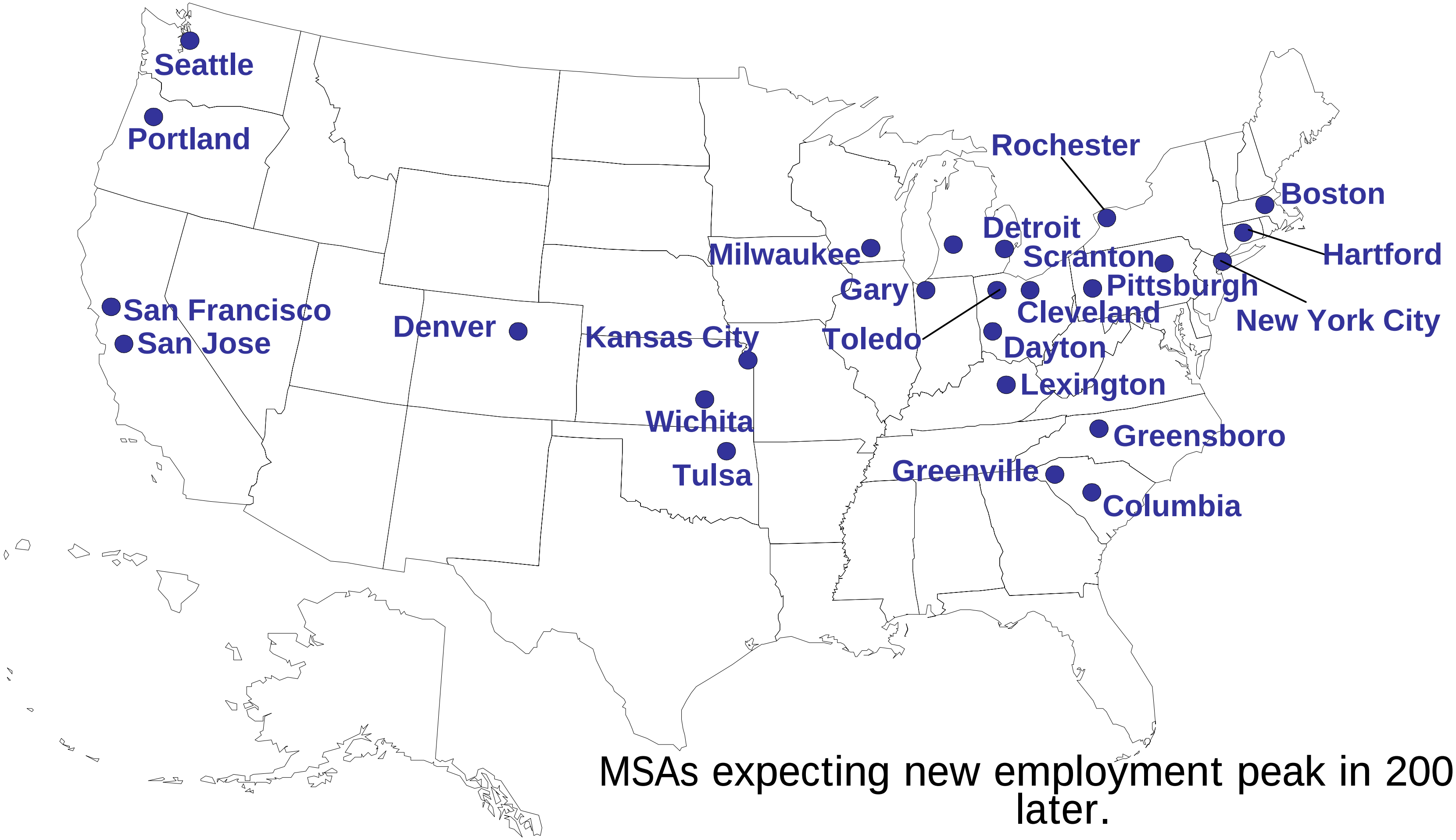
Recovery stronger in the west



Source: Economy.com

Based on employment and industrial production through December 2003.

Job growth expected to lag in many markets.



MSAs expecting new employment peak in 2006 or later.

Auto assembly / Investment banking / Money management / Aircraft / Tech innovation

Source: Economy.com, December 2003 Forecast

Summary of performance and vulnerabilities

Earnings maintenance in short-term will be challenging.

- Loan growth may slow even as margins remain compressed
  - Consumer loan growth likely to slow
  - Business loan growth may not provide the offset

- Structural adjustments in major industries will result in slow growth in employment and some local stresses

Top Risks in Community Banks

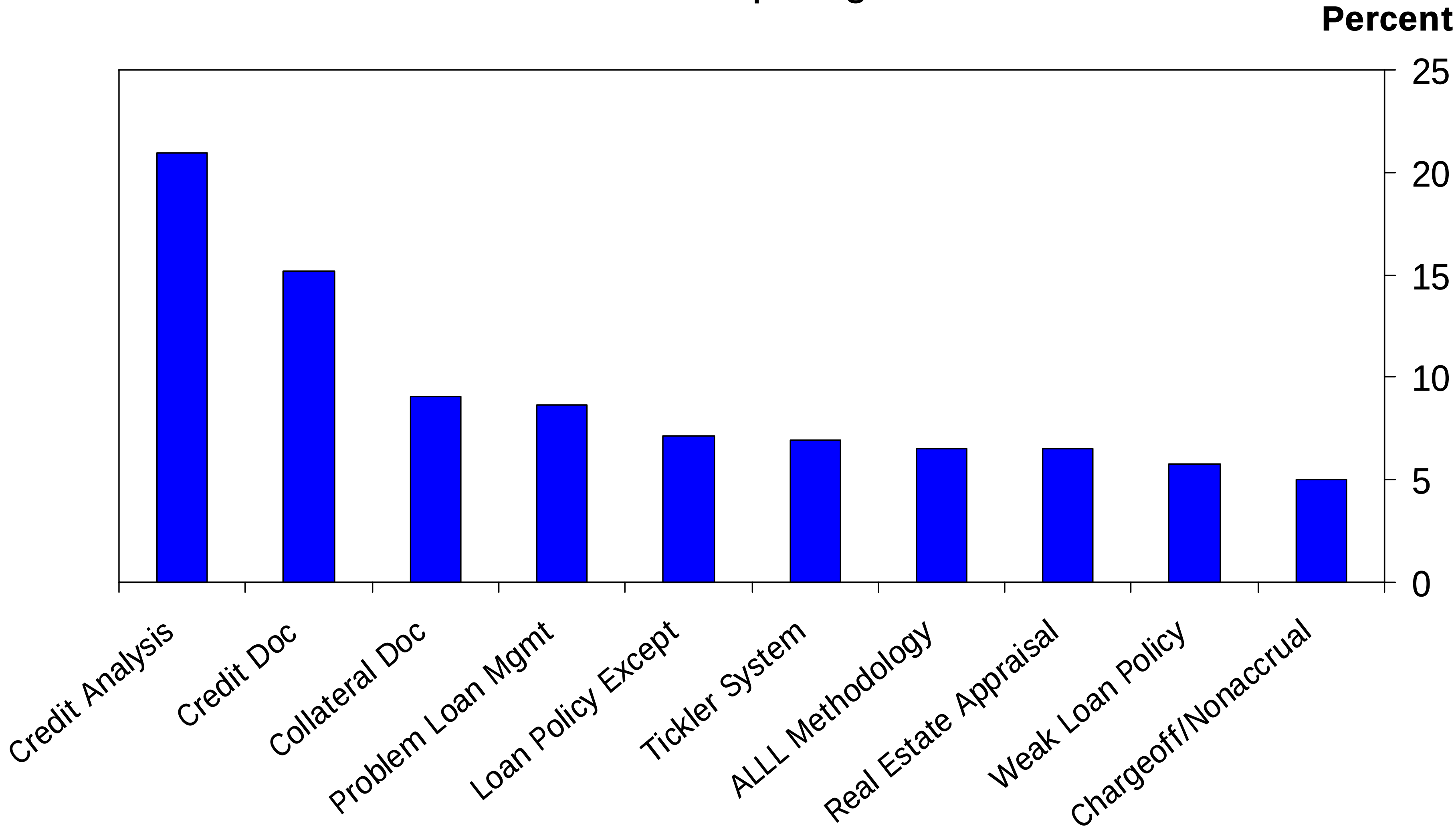
- Credit Administration
- Commercial Real Estate Concentrations
- Interest Rate Risk
- Inadequate Risk Management of New Products
- Retail Credit

Credit Administration
Why a Concern?

- Have seen fast-paced loan growth in many community banks
- Credit control and MIS systems not keeping up with increasing size and complexity of many portfolios
- Credit administration issues the most frequently cited Matters Requiring Attention in our examination reports

Credit analysis & credit documentation most common credit administration weaknesses

Credit administration related matters requiring attention in 2003



Credit Administration
What Bankers Should Do:

- Pre- and post-funding analysis critical
- MIS and loan portfolio management systems need to be developed and used to understand the risk in your portfolio
- Concentration management should go beyond identifying concentrations – understand the risk they pose and consider setting limits
- Ensure lenders are expected to identify problem loans – should not rely solely on loan review

Credit Administration
What Examiners Will Do:

- Assess credit underwriting and monitoring processes
- Test for compliance with policy
- Determine adequacy of MIS and other credit risk management processes, including concentration management
- Test adequacy of loan review, audit, and appraisal review functions

Commercial Real Estate
Why a Concern?

- CRE has performed well through recent economic weakness

- Despite this, CRE is high on our radar screen due to:

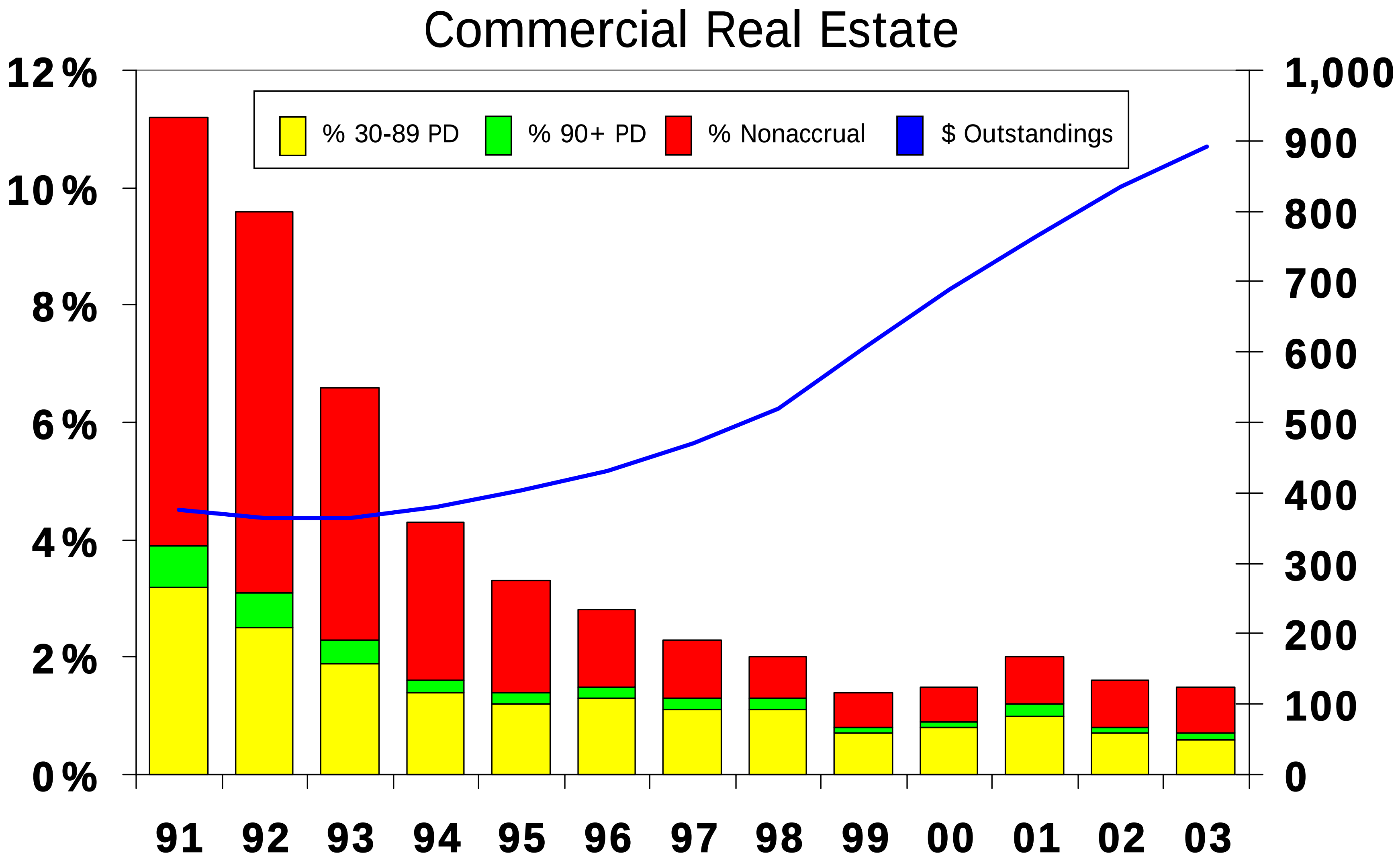
  - Concentration levels

  - CRE market forecasts

  - Interest rate risk considerations

  - Recent underwriting observations

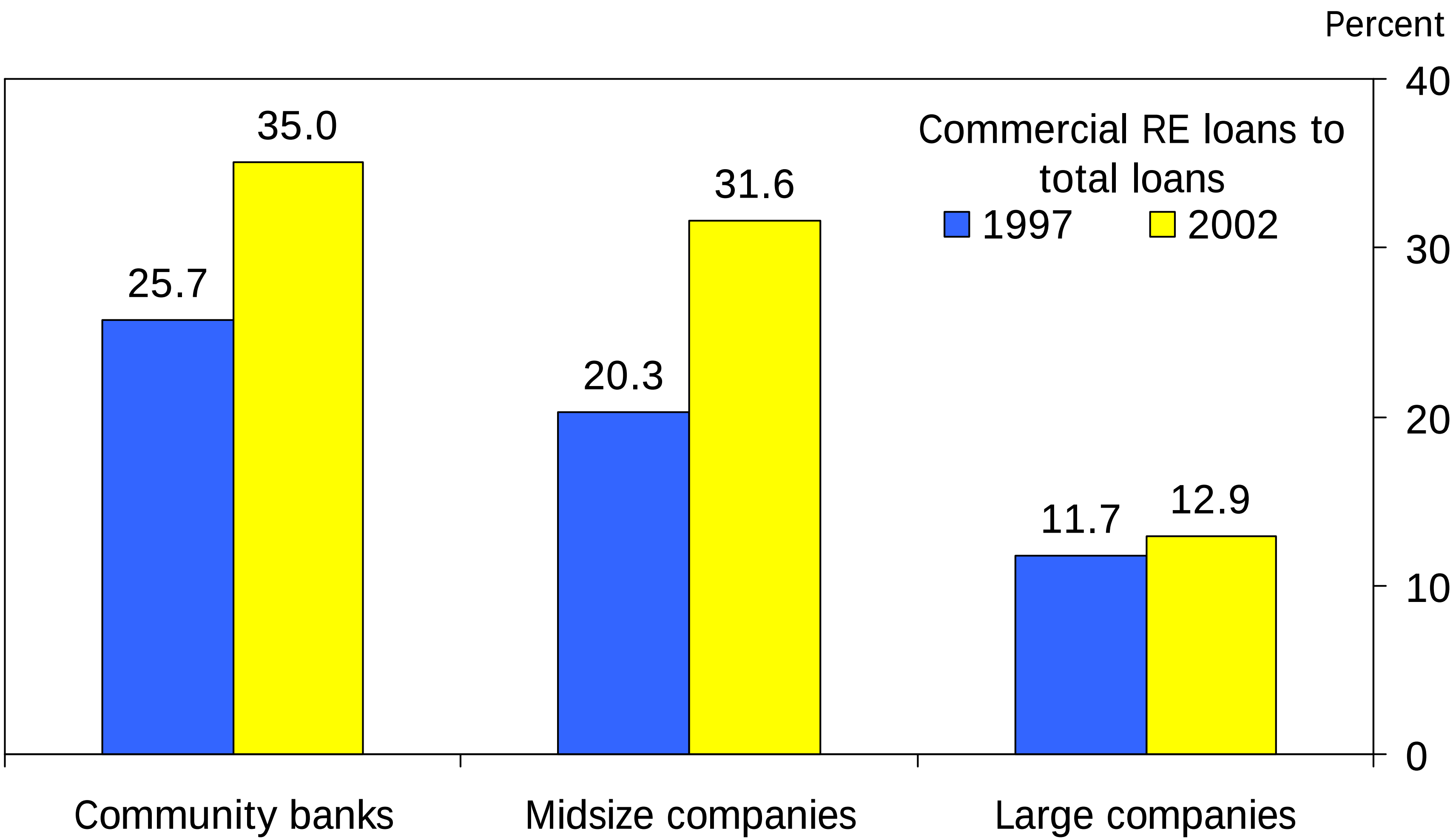
Concentrations - CRE



Source: Call Reports

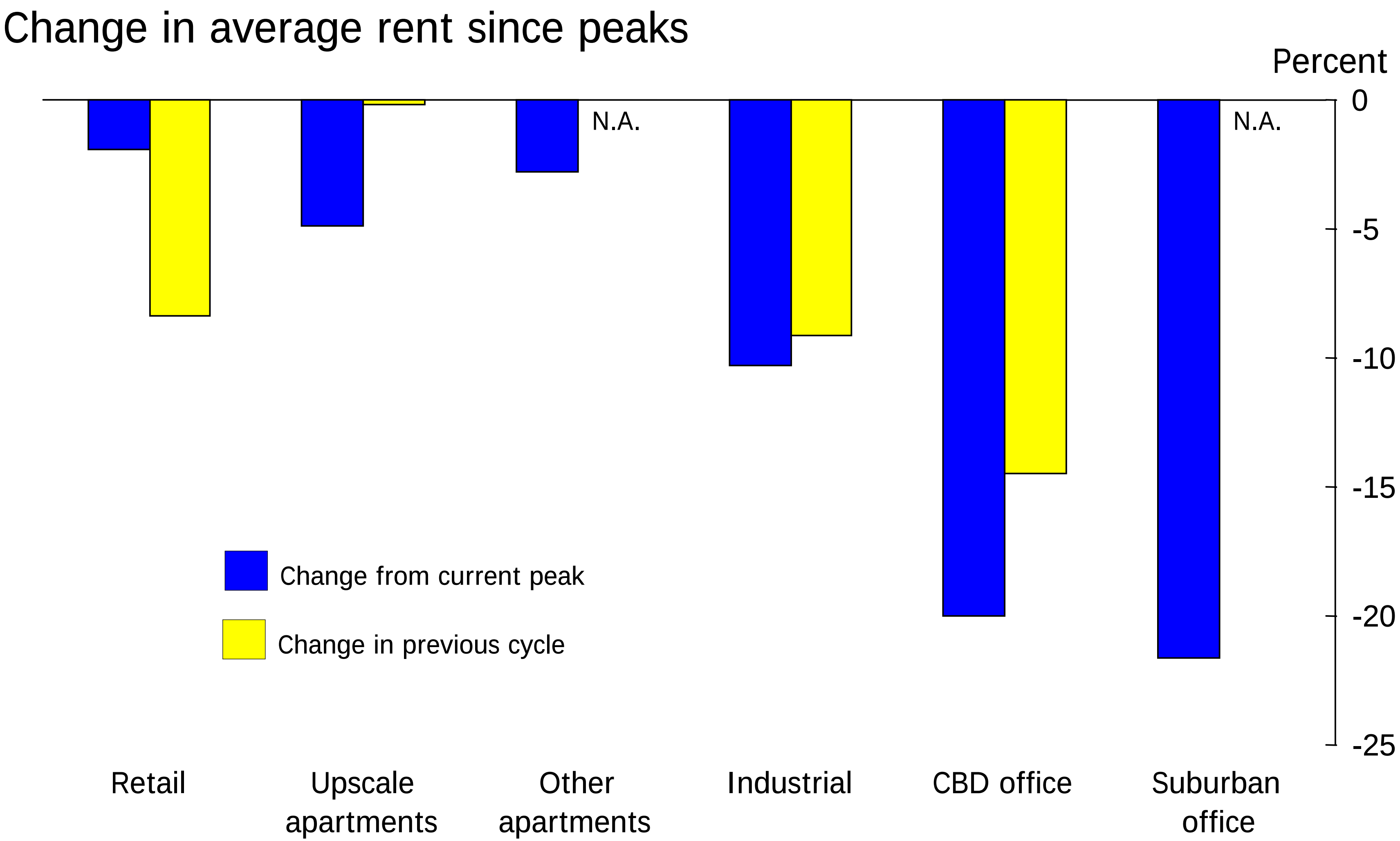
Rapid growth in CRE at community and midsize banks over last five years

National banks by OCC supervisory class



Source: Integrated Banking Information System (OCC)

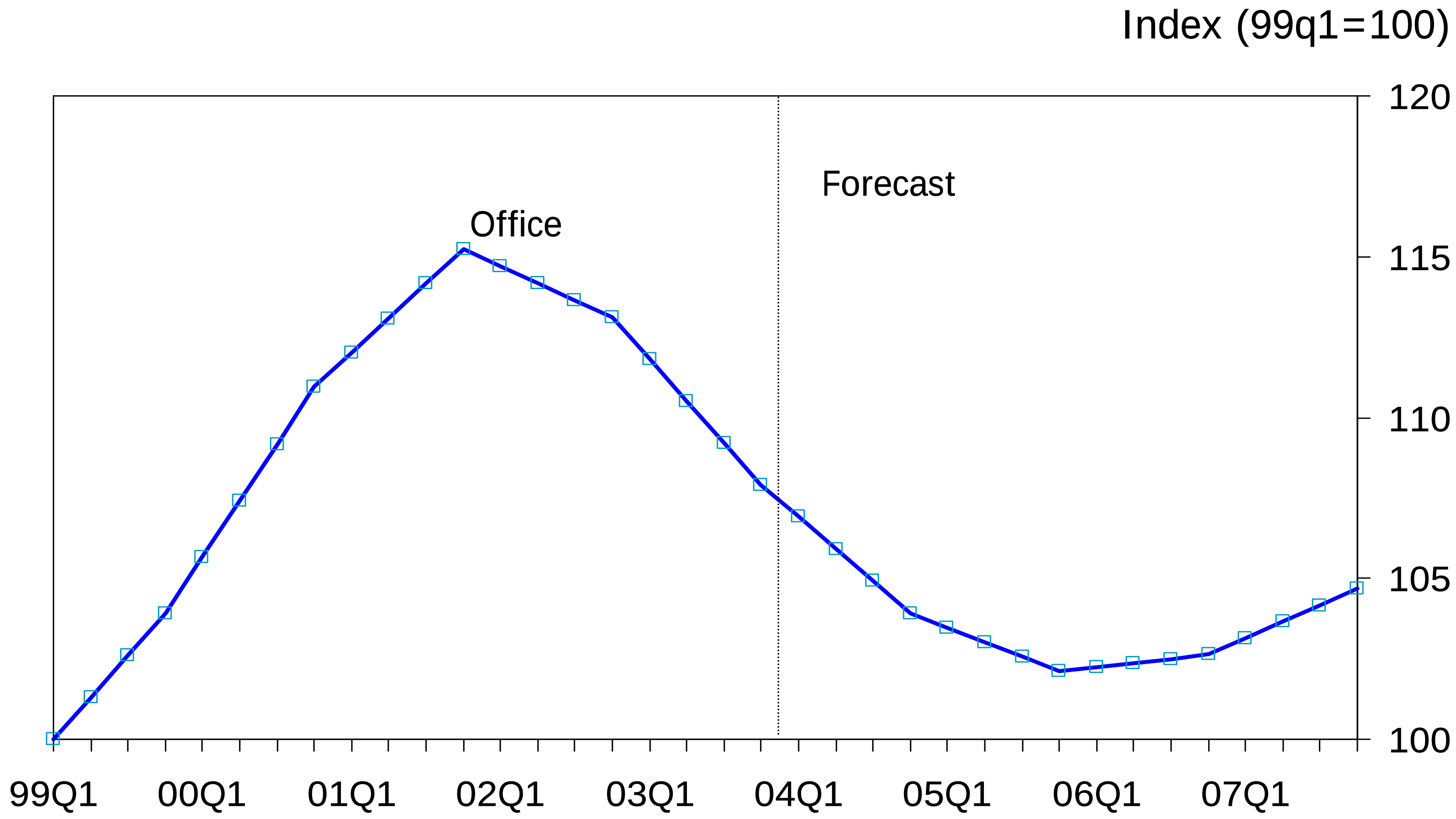
Rents have fallen for all property types.



Source: National Real Estate Index (data through 2003Q3)

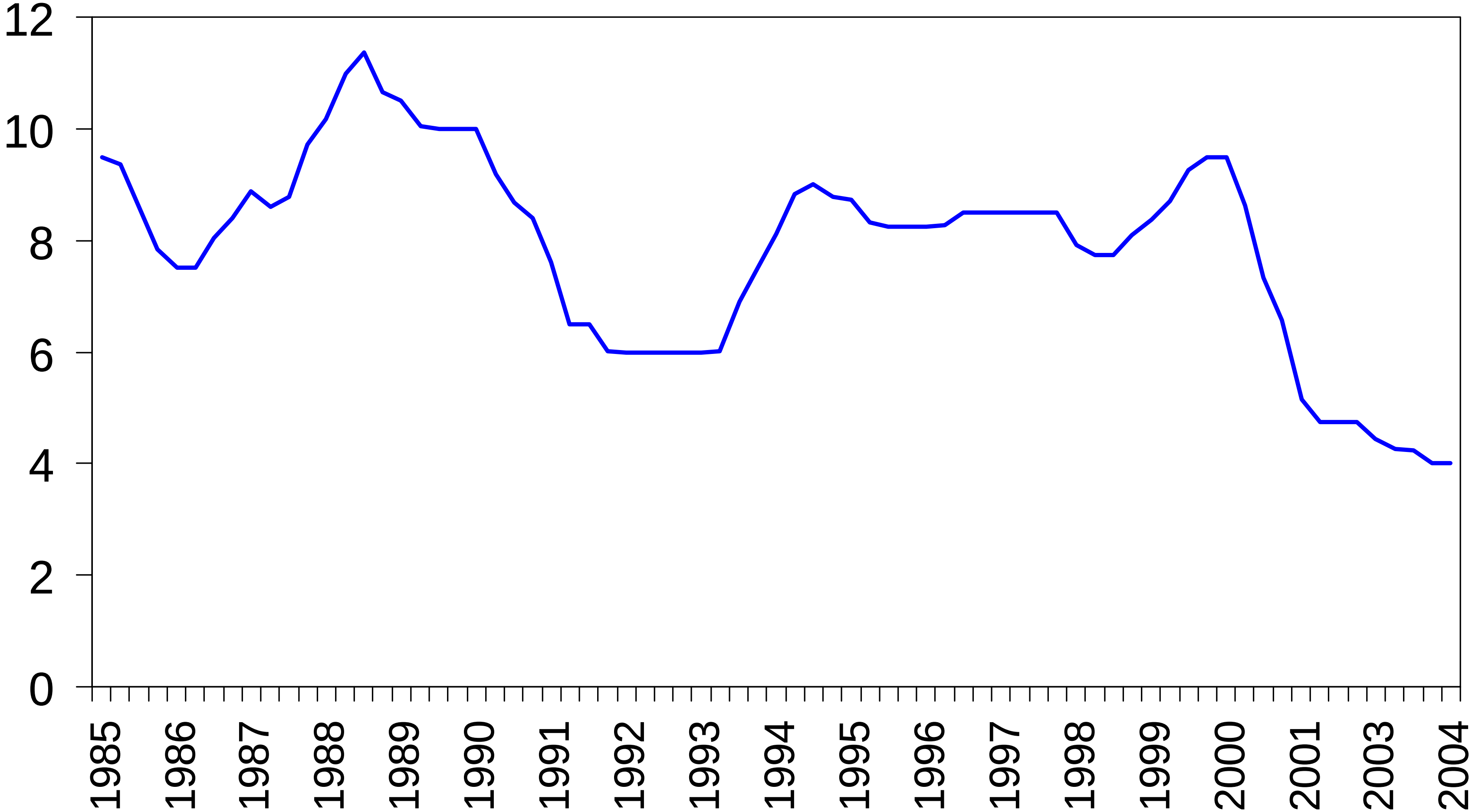
Current peaks occurred in 2000Q4, except for apartments, which peaked in 2001Q3 and the previous peaks in average rents occurred from 1989Q2 to 1991Q2. N.A. – not available.

Drop in office market net operating income could lead to credit quality problems.



Source: Property & Portfolio Research (2004 – 2007 forecast as of February 2004).

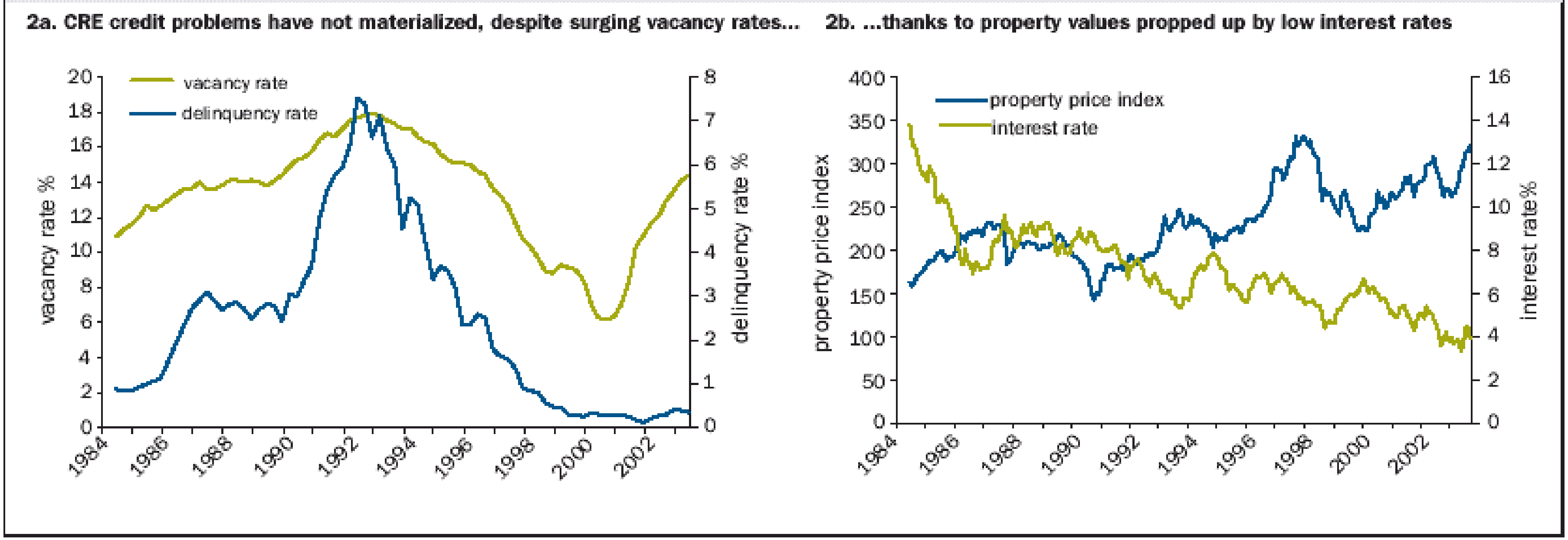
Can prime rate get any lower?



Source: FRB

How might rising rates affect project performance?

Figure 2a and 2b: Might higher interest rates trigger sharp rises in CRE losses?



Source: E-Risk Monthly, March 2004 – *from an Article written by Andy Hickman, E-Risk VP and Director of R&D*

Current CRE Concerns

- Significant embedded risks exist:
  - as interest rates rise
  - as leases rollover at lower rates
- ***Low interest rates have masked weak fundamentals in many CRE deals***

Underwriting Issues

- Deals underwritten to historically low rates vs. normalized or permanent market standards
- LTV and DSC often close to policy limits
- Artificially low cap rates
- Project CF based on full occupancy
  - Little CF upside as expenses rise
  - Expense budgets often exclude certain costs
- Long-term maturity/amortization without permanent market liquidity

Embedded Risk – an example

Example:

- 3MM office/retail construction project
- 50% pre-leased
- 2.2M financed - LTC 78% / LTV 74%
- 25 yr.amort, P+100 bp repriced every 3 yrs.
- Proforma DSC 1.3x on 5.5% initial rate

- Cap rate per appraisal and proformas ~ 7%

Embedded Risk – an example

Sensitivity Analysis - <u>individual changes</u>

200 bp rise in interest rates (to 7.5%):

- DSC dips from 1.3x to 1.10x

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200 bp increase in cap rate (to 9%)**:**

- Value declines to 2.4MM or 92% LTV

Vacancy factor increased from 10% to 25%:

- DSC drops to 1.0x

Embedded Risk – an example

Sensitivity Analysis - Concurrent changes

200 bp increase in interest rate and cap rate and a 20% vacancy factor:

- DSC drops to 0.93x
- LTV increases to 110%
- 200M required to reset LTV to 100%, 900M back to 75% max approved at inception

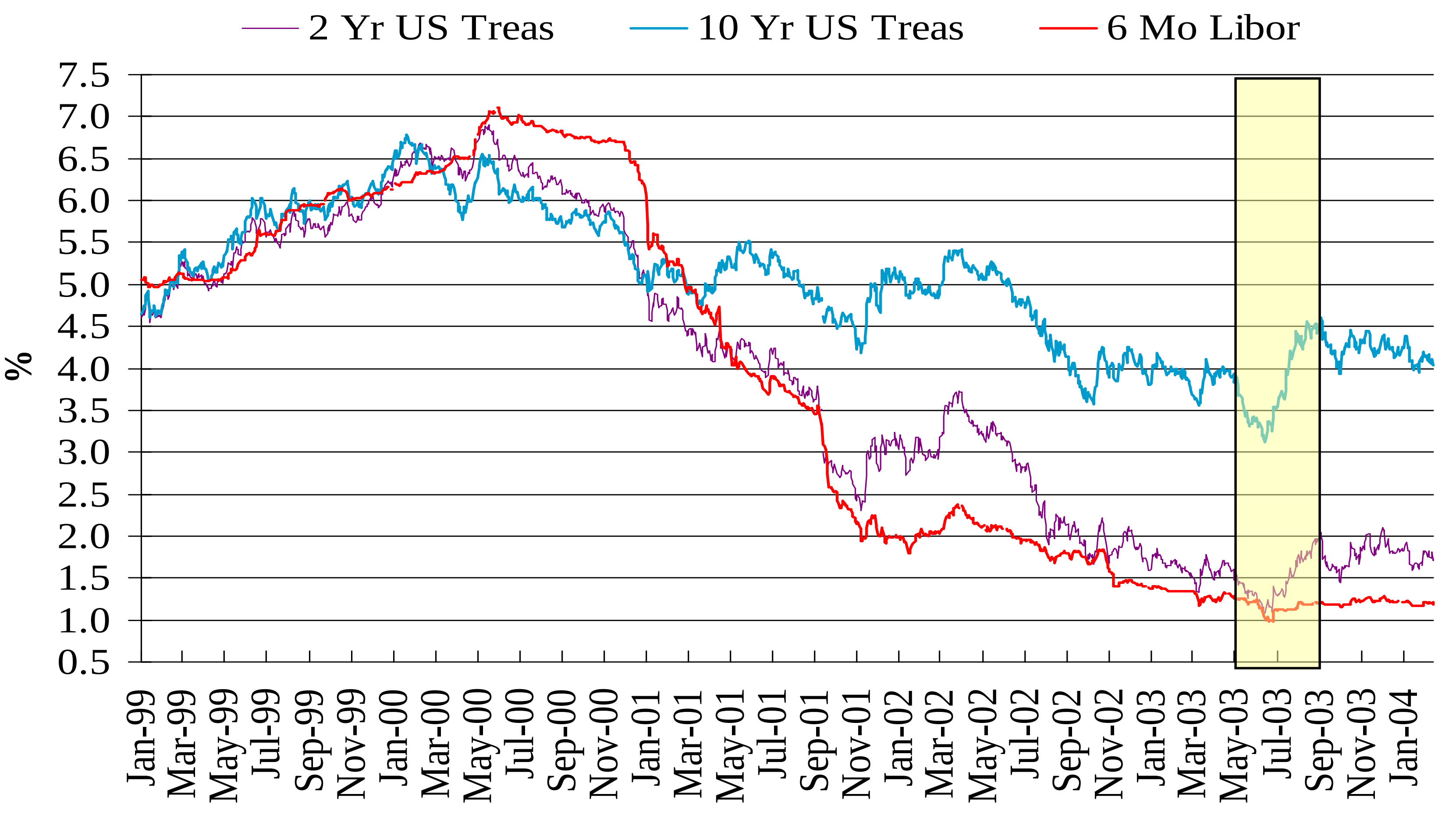
Commercial Real Estate Risk Management Considerations

- Consider a normalized rate environment
  - Consider interest rate increases, but also consider higher CAP rates
- Quantify rollover risk
- Perform meaningful stress testing
- Be selective
  - Consider borrower/guarantor support, past performance, focus on staying power
- Reassess portfolio structure, concentrations, and risk limits

Interest Rate Risk
Why a Concern?

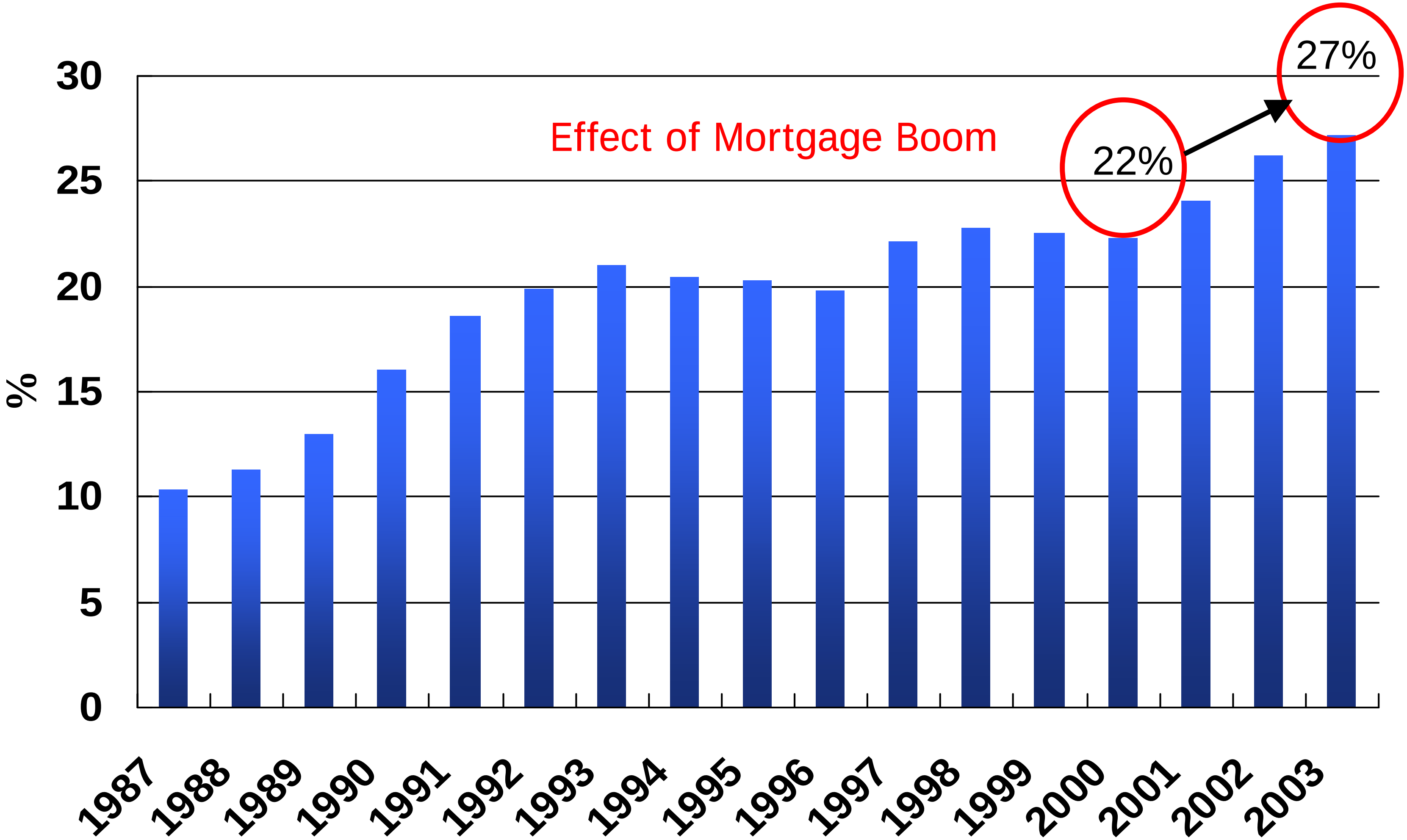
- Weak economy and low interest rates have put pressure on core bank earnings
- Steep yield curve provides incentive to borrow short and invest long
- Significant growth in mortgage assets and FHLB callable advances has left balance sheets full of embedded options
- Continued growth in deposits is questionable

Interest Rates – 45 year lows



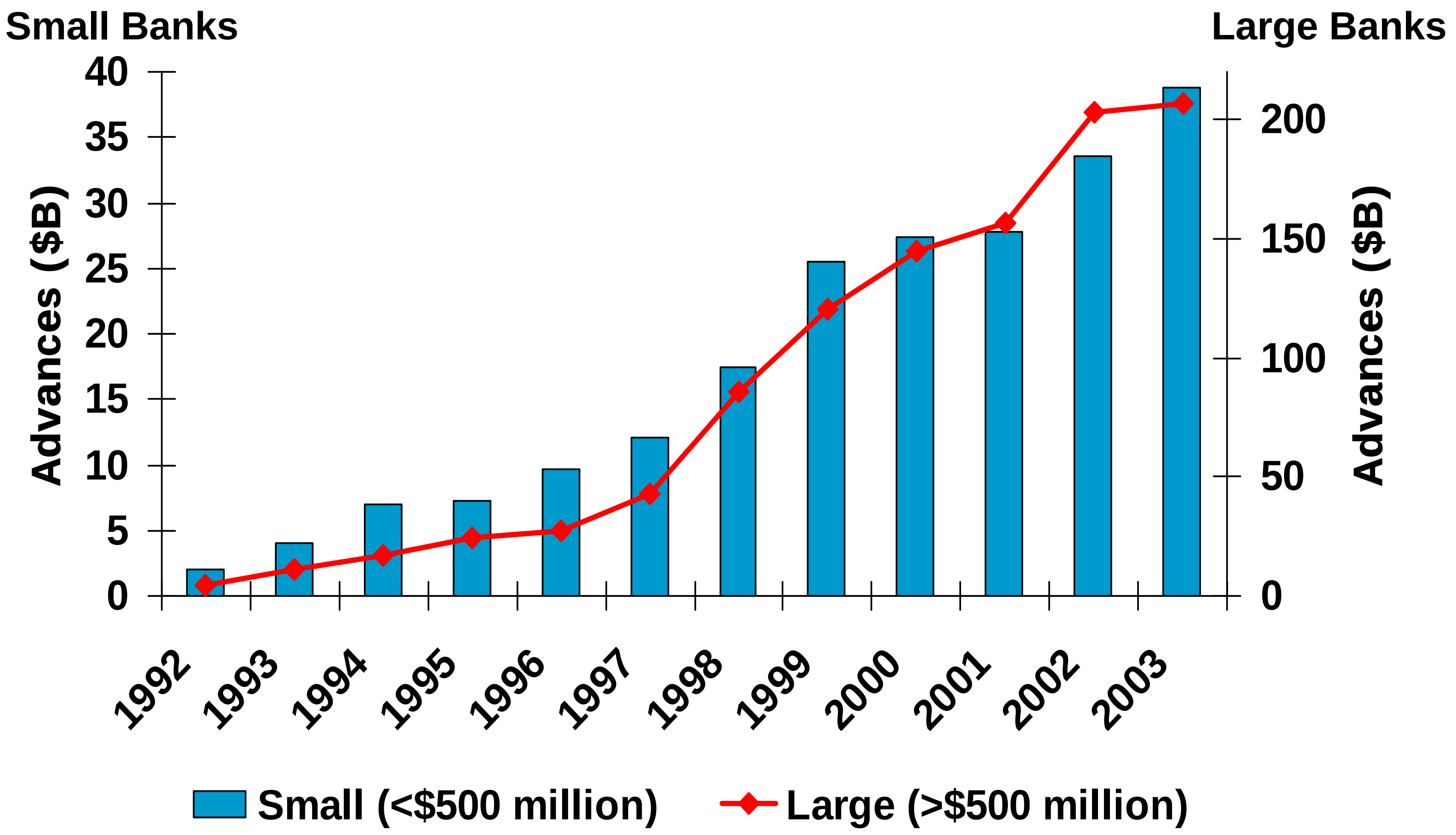
Source: Haver & Bloomberg Analytics. Data through February 12 , 2004.

Embedded options have risen significantly…

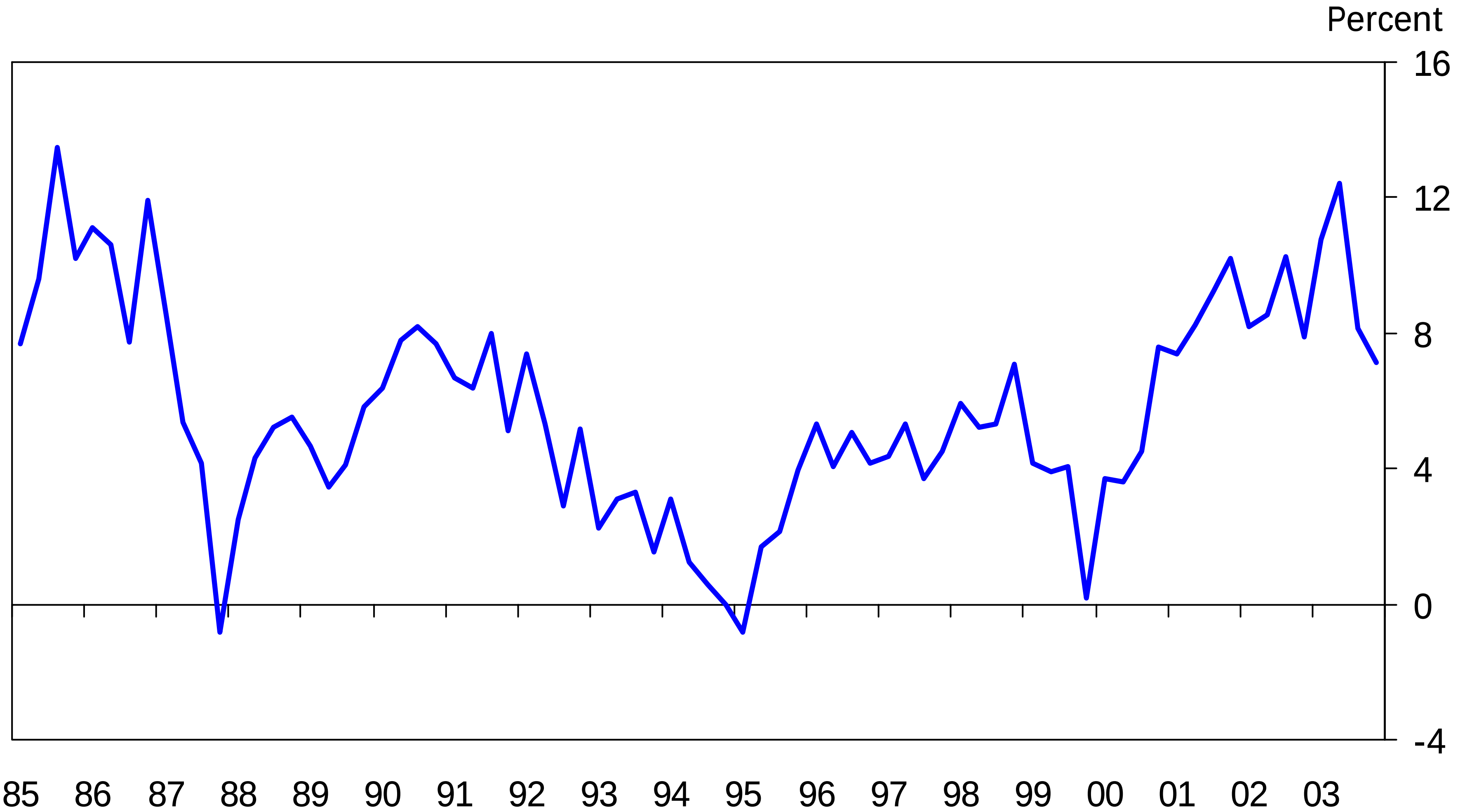


All data as of year end.
Source: Integrated Banking Information System

FHLB Outstanding Advances
to Commercial Banks (by Size), 1992-2003



Core deposit growth decelerating...
Commercial banks



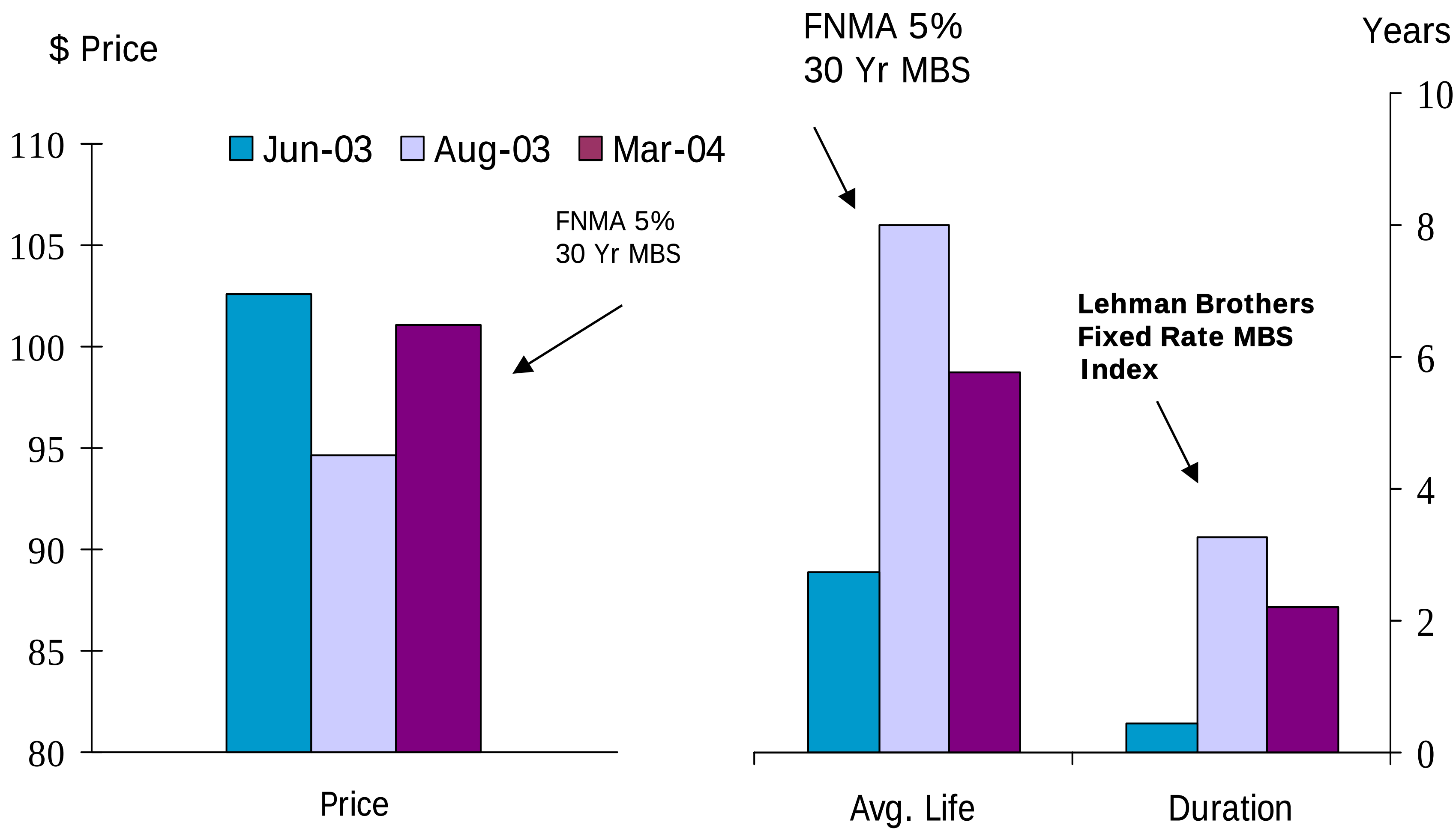
Source: Integrated Banking Information System (OCC)

Quarterly data through 2003Q4. Growth calculated from the same quarter a year ago.

Interest Rate Risk
What Are the Implications?

- As rates rise from current low environment, mortgage assets will extend
- Strengthening financial markets may give depositors incentives to look for higher returns
- As economy improves, banks will need balance sheet flexibility to meet loan demand

Price and Cash Flow Risk of Mortgage Assets



Data Source: Bloomberg, Lehman Brothers

Six Elements for Successful Interest Rate Risk Management

- Appropriately communicated risk tolerances
- Effective risk measurement tools – earnings-at-risk for all banks and equity-at-risk for banks where long-term or options exposures are material
- Meaningful risk limits
- Meaningful strategies for risk control
- Reliable management information systems
- Robust process for independent reviews

Interest Rate Risk
What Bankers Should Do:

- Ensure appropriate risk management framework is in place as described in Banking Bulletin 2002-19
- Revisit risk tolerances and ensure they are clearly communicated
- Verify that risk management tools are appropriate
- Estimate sensitivity of earnings and equity to changes in rates or structure of curve
- Evaluate options for reducing unwarranted exposures

Interest Rate Risk
What Examiners Will Do:

- Identify banks with highest interest rate exposures – evaluate earnings and equity implications
- Assess whether risk levels are commensurate with risk tolerances and risk management capabilities
- Take appropriate action if risk taking and risk management are imbalanced

The Window of Opportunity

- Now is the time to be proactive and reduce unwarranted exposures
- Consider:
  - Extension of mortgage assets
  - Repricing of callable FHLB advances
  - Run-off of deposit inflow
- Banks with balance sheet flexibility will have the greatest opportunity to capitalize on improved economic environment

New Product Risks
Why a Concern?

- Weak economy and low interest rates have compressed margins
- Bankers are looking for new ways to generate earnings
- Banks may be venturing into new products or strategies without proper diligence

New Product Risks
What Bankers Should Do:

- Proper due diligence – in advance
- Develop comprehensive controls and risk management processes
- Monitor performance against established goals and limits

New Product Risks
Due Diligence

- How does this product fit into the bank's overall business strategy?
- Assess the expertise needed to manage the product
- Consult with support personnel – legal, accounting, compliance – to determine risks, needed controls, and resources
- Research third-party vendors, brokers

New Product Risks
Controls and Processes

- Develop risk management process
- Relevant policy guidance
- Develop MIS and reporting
- Incorporate into bank's compliance process
- Ensure prudent third-party relationships as discussed in Banking Bulletin 2001-47

New Product Risks
Monitor Performance

- Set objectives and benchmarks for success
- Establish risk tolerance limits
- Establish periodic reporting to board to measure performance
- Assess success after a few months
- Develop an exit strategy – just in case

New Product Risks What Examiners Will Do:

- Review the risk potential of a new product or service
- Consider the impact on the strategic and reputation risk
- Assess the effectiveness of the bank's new product risk management program, including due diligence and oversight monitoring

Retail Credit Risk
Why a Concern?

- Rapid increase in exposure, especially in mortgage related products
- Underwriting standards are changing – weaker ratios, more liberal terms
- More loans to weaker borrowers
- Vulnerable to increasing rates and economic uncertainty

Retail Credit Risk
What Bankers Should Do:

- In this low rate environment, stress test for impact of interest rate increases
- Improve risk management of retail products
- Enhance MIS to monitor performance of retail loans
- Improve compliance with appraisal regulations

Retail Credit Risk
What Examiners Will Do:

- Assess lending complexity relative to management expertise and risk management processes
- Review the volume of retail lending and changes in portfolio mix and performance
- Assign examiners with high level of retail credit expertise to higher risk banks
- Assess account management programs for retail products

Summary

- The industry is strong and remains profitable
- System becoming more complex for even the community bank
- Risk management processes need to evolve with the changing environment
- Specific questions can be sent to your portfolio manager at firstname.lastname@occ.treas.gov

Questions

OCC Telephone Seminar