Office of the
Comptroller of the Currency

Semiannual Risk Perspective

From the National Risk Committee

Office of the Comptroller of the Currency
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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[1] (collectively, banks) and supervises the federal branches and agencies of foreign banks. The OCC 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 consumers and fair access to credit and financial products.

The OCC's National Risk Committee (NRC) monitors the condition of the federal 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's *Semiannual Risk Perspective* addresses key issues facing banks. The OCC publishes the report twice a year, drawing upon midyear and year-end data. The spring 2013 report reflects data as of December 31, 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: NRCReport@occ.treas.gov.

[1] 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 financial performance of federally chartered institutions improved in 2012. Profitability increased to its highest level since 2006, albeit aided by lower provisioning expenses. Asset quality improved at large and small banks as problem assets continued to decline from peaks reached in early 2010.

The economic outlook for 2013 is positive. Loan growth continues to improve, although it remains concentrated in commercial and industrial (C&I) loans. Retail borrowing should accelerate with the continued improvement of the housing sector. A decline in in-process foreclosures, strengthening housing prices throughout much of the United States, the rebound in home sales, and growth in residential construction indicate that the housing sector is providing a meaningful boost to economic growth after several years of drag.

Notwithstanding these favorable prospects, the banking industry continues to face headwinds. Investors' concern over sovereign debt levels and banking system problems in Europe, as well as uncertainty about fiscal and monetary policies in key countries such as the United States and Japan, threaten confidence and could weigh on global economic growth. The anxiety of banks over slow growth in revenue and core profits remains high. Low interest rates, narrow loan demand, and lower fee income continue to hinder stronger revenue gains, while lower loan-loss provisions have largely supported profits. Monetary policymakers have indicated their intention to keep interest rates at or near historical lows over the near-term, which will continue to put pressure on net interest margins. Margins also are under pressure as banks compete aggressively by cutting rates because of limited lending opportunities, and as they reinvest proceeds from maturing higher-yield assets at lower yields.

Key Risk Themes

Strategic risk continues to increase and remains high for many banks as management searches for ways to generate acceptable returns.

- Against a backdrop of sluggish economic growth and interest rates that remain near historical lows, loan growth is at half its average pace over the last twenty-five years. Noninterest income growth has resumed at a moderate pace but lags behind peak levels, while noninterest expense continues to reflect the ongoing resolution of foreclosure and other related issues; fines and litigation from business process or control breakdowns; and the costs of responding to regulatory requirements imposed by recent legislation. These factors create a challenging operating environment, which is leading many banks to reevaluate their overall strategies and business models.
- Sound corporate and risk governance processes are central to planning, prioritizing, and allocating resources effectively in the current operating environment.
- Banks must address the challenges of carefully identifying alternative sources of revenue, prudently diversifying balance sheets and revenue sources, and effectively managing their cost structures.
- New products and services may present unfamiliar risks for which some banks may lack the requisite expertise, management information systems, and appropriate risk controls.
- Lower-volatility environments imply a smaller band of potential future price movements, which means lower risk. However, low-volatility environments encourage investors to "chase" yields, often taking more interest rate or credit risk to maximize return. High market liquidity is often associated with low-volatility environments, which leads to lower credit spreads, encouraging investors to increase leverage to achieve specific return objectives.

Revenue growth challenges from a slow economy continue to pressure profitability and increase the risk that banks may reach for yield.

- Economists' forecasts for modest economic growth for 2013 are subject to both downside and upside risk. The cumulative effect of soft U.S. labor markets, the Eurozone crisis, slowing growth in emerging markets, and ongoing uncertainty regarding U.S. fiscal policy could increasingly weigh on confidence and the willingness to spend and invest more aggressively. On the other hand, the rapidly accelerating recovery in housing may significantly boost near-term economic growth.

- While domestic demand for loans has improved, particularly for commercial loans, further meaningful gains depend on sustained economic growth, particularly from housing and consumer spending.

- Competition for limited C&I lending opportunities continues to intensify, eroding underwriting standards and reducing pricing for risk. This is especially evident in the leveraged lending market. Market data on syndicated loan underwriting indicate weakening covenant protection and higher leverage. Underwriting standards for middle-market C&I also have shown signs of slippage as competition has become more aggressive.

- The pace of credit quality improvement in bank portfolios is stabilizing. As a result, reductions in provisions for loan losses, which have fueled growth in bank earnings, may likewise need to stabilize or subside from recent levels.

- The low interest rate environment increases the vulnerability of banks that reach for yield (acquiring interest income with decreasing regard for interest rate or credit risk). This historically low interest rate environment increases the risk that banks will become too concentrated in longer-term assets and build significant extension or credit risk. When interest rates increase, banks that reached for yield could face significant earnings pressure, possibly to the point of capital erosion.

- The low interest rate environment also affects fiduciary and other asset management business lines in which revenues can significantly contribute to noninterest income. Continued risk aversion on the part of customers dampens asset management revenues and increases demand for fixed-income instruments, which in the current environment are subject to extension risk and declines in value.

Increasingly sophisticated cyber-threats, expanding reliance on technology, and changing regulatory requirements are heightening operational risk.

- Cyber-threats continue to increase in sophistication and require heightened awareness and appropriate resources to identify and mitigate the associated risks. The effects of cyber-attacks include reduced availability or diminished response times of online banking services, identity theft, fraud, and theft of proprietary information. The costs and resources needed to manage the risks continue to increase as the attacks broaden and intensify. Over time, the effects could expand as the capabilities and tactics of cyber-criminals evolve.

- Some banks are changing the way they apply technologies, including adopting new and less market-tested applications, reengineering business processes, and increasing their use of outsourcing to reduce operating costs. While these tactics can help meet strategic business objectives, banks need to understand and manage the associated risks and provide effective ongoing oversight. For example, the consequences of business process reengineering for lower operating costs may fall disproportionately on compliance, audit, risk management, operations, or internal control mechanisms and may adversely affect a bank's ability to identify, measure, and control risks.

- Bank Secrecy Act (BSA) and Anti–Money Laundering (AML) risks are increasing as BSA programs at some banks fail to evolve or incorporate appropriate controls into new products and services. In addition, threats are increasing as a result of changing methods of money laundering and an increase in the volume and sophistication of electronic banking fraud. These issues are often compounded by a lack of sufficient resources devoted to BSA/AML risk management in some banks.
- The pace of new regulatory requirements can challenge the change-management capabilities of some banks and can lead to increased operational and compliance risks if banks do not adequately invest in control processes, systems, or staff.
- Large and midsize banks with extensive mortgage servicing operations have been making progress in remediating standards and practices, but the financial and reputational costs remain high.

OCC Risk Perspective: Outlook by OCC Business Line

Community and Midsize Banks

Strategic risk remains a primary concern for community and midsize banks, as they adapt business models to respond to slow economic growth, historically low interest rates, intensified competitive pressures, and uncertainty about regulatory changes.

- Profitability remains under pressure due to sluggish loan growth, the lack of safe higher-yielding investment alternatives, and declining noninterest income. These factors have substantially increased strategic vulnerability as banks seek to bolster income through new products and services, expansion of business lines, or aggressive cost reductions.
- More banks are assessing expansion into asset-based lending, leveraged loans, indirect auto financing, leasing and equipment financing, mortgage banking, and energy lending. These lending specialties require specialized risk management processes and skills.
- Some banks are increasing the duration of their investment portfolios and purchasing more mortgage-backed securities in response to persistently low rates, thereby increasing exposure to rising interest rates. The historically unusual rate climate requires more complex analytics to assess interest rate risk vulnerabilities.
- 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 to offset margin and revenue pressures. Compliance and operational risks necessitate sound and effective risk management functions. Information security continues to be an important component, since midsize banks have increasingly experienced threats from cyber-criminals.

Large Banks

Profitability at large banks remains under pressure. Litigation costs and legal settlements stemming from prior residential mortgage underwriting and servicing deficiencies and the costs to remediate the underlying operational weaknesses remain elevated. In addition, uncertainties in the housing market and persistently high levels of credit stress in residential real estate loan portfolios are also diminishing lending profitability. Meanwhile, large banks are grappling with the need for fundamental changes to their business models as a result of weakening revenue growth, including shifts in trading, securitization, and consumer fee income. Operational risk remains heightened during this transition period.

- Operational risk remains high across a spectrum of activities. Internal control failures, breakdowns in operational processes, and lapses in oversight control functions were significant contributors to a number of recent high-profile events, including defective mortgage foreclosure and settlement processes, noncompliance with BSA/AML laws, losses from complex hedging and investment strategies, and inappropriate business practices. While a primary concern in banks with high transaction volume, operational risk is elevated as well for many banks that have pursued outsourcing arrangements for operational efficiency or add-on product revenue. A key priority for some of the largest banks continues to be addressing weaknesses in foreclosure processes and mortgage servicing in compliance with OCC consent orders.
- In addition to dampened profitability from the cumulative cost of fines, restitution, and remediation related to compliance and control breakdowns, affected institutions are experiencing reductions in productivity and negative reputational effects.
- Compliance and control breakdowns are increasingly resulting in formal enforcement actions, particularly for BSA/AML noncompliance, with negative financial and reputational effects.
- The increasing volume and sophistication of cyber-threats pose an ongoing challenge to the confidentiality, integrity, and availability of systems. Criminals seeking to steal information, commit fraud, or disrupt, degrade, or deny access to information systems strain bank resources and can cause financial, operational, and reputational harm.

OCC Risk Perspective: Policy and Supervisory Actions

Heightened regulation and supervisory standards designed to strengthen 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.

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

Community and Midsize Bank Supervision

- **Strategic planning:** OCC supervisory staff will focus on the adequacy of strategic and capital planning processes in light of assumed risks and planned initiatives to ensure that appropriate risk management processes are established.
- **Risk management of new or modified products and services and outsourcing:** OCC supervisory staff will evaluate the adequacy of risk management processes supporting new or modified products as well as outsourcing activities. The OCC will focus on the adequacy of due diligence and the establishment of effective internal controls before implementation of a new product, service, or activity, as well as the appropriateness of monitoring and oversight after implementation.
- **Operational risk:** OCC supervisory staff will focus the review and assessment of operational risk on contemplated changes to business models and responses to strategic opportunities, such as the introduction of new or revised business products, processes, or delivery channels. Robust preparation and contingency planning for operational or technology failures, as well as natural disasters, remain essential.
- **C&I loan underwriting:** OCC supervisory staff will scrutinize the commercial credit underwriting practices of new or renewed originations for slippage in structure and terms.

- **Interest rate risk (IRR):** OCC supervisory staff will focus on IRR measurement processes to ensure management assesses vulnerability to changes in interest rates and, as appropriate, implements measurement tools to monitor and control this risk. The adequacy of interest rate stress scenarios and the appropriate support for key modeling assumptions (non-maturity deposits assumptions in particular) warrant supervisory attention.
- **Compliance:** OCC supervisory staff will assess effectiveness in complying with consumer laws, regulations, and guidance, including applicable compliance, legal, and reputation risks posed by new products and services and emerging technologies. Examiners will focus on the adequacy of BSA/AML programs to keep pace with rapidly evolving money-laundering schemes.
- **Commercial real estate (CRE):** OCC supervisory staff will evaluate exposures to CRE and assess the appropriateness of the allowance for loan and lease losses (ALLL). OCC supervisory staff will also assess the adequacy of sensitivity analyses in banks with elevated levels of CRE concentrations.

Large Bank Supervision

- **Governance and oversight:** OCC supervisory staff will focus on progress on the five heightened expectations for corporate governance and oversight in the 19 largest 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, development and maintenance of strong audit and independent risk management functions, and board responsibility to preserve the sanctity of the charter.
- **Operational risk:** Lapses in controls, operational processes, and oversight, and the resulting influences across a range of bank activities, highlight the interconnectedness of risks and the importance of managing those risks in an integrated fashion across the entire enterprise. OCC supervisory staff will apply lessons learned from mortgage servicing to problems found in the examinations of other revenue-generating activities involving high volume and rapid growth. They will use this knowledge to identify control, oversight, and systems weaknesses and process flaws across customer-facing products and activities and to promote resilient compliance programs.
- **Cyber-threats:** OCC supervisory staff will review programs for assessing the evolving threat environment and continuously adjusting controls, as well as for robust vulnerability assessments and timely correction, access management, and incident response programs.
- **Strategic planning:** OCC supervisory staff will focus on strategic business and new product planning to determine whether adequate consideration of safe and sound business practices is evident, including consideration of potential compliance and reputation risks.
- **Foreclosures and mortgage servicing:** Mortgage servicing problems have emerged as a key operating weakness and have drawn a strong regulatory response through the consent order process.[2] OCC supervisory staff will focus on assessing the corrective actions taken to strengthen operational processes and the implementation of any necessary upgrades to systems and processes to meet enhanced mortgage servicing requirements.
- **New C&I loan underwriting:** OCC supervisory staff will continue scrutiny of commercial credit underwriting practices, especially for leveraged loans.

[2] The OCC announced 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.

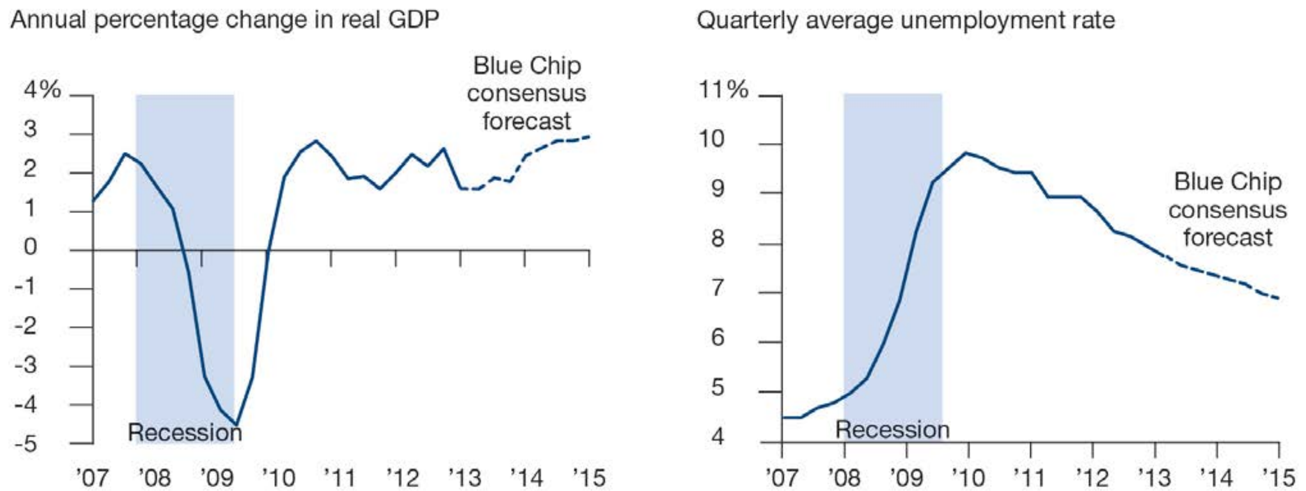
- **Basel standards:** OCC supervisory staff will be monitoring efforts to comply with the enhanced capital and liquidity standards.
- **Home equity lines of credit:** Maturities and amortization of home equity lines of credit (HELOC) are an emerging risk as end-of-draw periods are reached and payments increase to meet amortization requirements. OCC supervisory staff will evaluate the appropriateness of processes to quantify and address the risk from HELOCs that are approaching their end-of-draw periods.
- **Compliance:** OCC supervisory staff will coordinate with the Consumer Financial Protection Bureau to assess compliance with consumer protection laws, regulations, and guidance. OCC staff will also assess banks' effectiveness in identifying and responding to applicable compliance and reputation risks posed by new products and services. Appropriate internal controls in this area will help institutions mitigate vulnerabilities to potential unfair and deceptive acts and practices (UDAP) violations and ensure that banks provide consumers with relevant and clear product information. OCC supervisory staff will also focus on the adequacy of enterprise-wide compliance risk management including BSA/AML programs, in response to evolving money-laundering schemes and the rapid pace of technological change.
- **Eurozone exposures:** OCC supervisory staff will continue to assess Eurozone exposures and conduct reviews of contingency plans to address those exposures.

Part I: Operating Environment

Slow Economic Growth Continues to Weigh on Labor Market

The U.S. economy grew 2.2 percent after inflation in 2012. Real gross domestic product (GDP) increased 1.7 percent in the fourth quarter of 2012 from the fourth quarter of 2011 (see figure 1). That pace of growth was below the 25-year average of 2.5 percent. Employment growth was uneven in 2012, coming in below expectations in the second quarter before rebounding in the fourth quarter. The consensus forecast is that economic growth will remain lackluster in 2013 because of softness in U.S. labor markets, the ongoing Eurozone crisis, slowing growth in emerging markets, and uncertainty regarding the U.S. fiscal situation. The consensus private sector forecast suggests unemployment will continue to decline but will remain above its 25-year average of 6 percent through the end of 2014.

Figure 1: GDP and Unemployment Trends

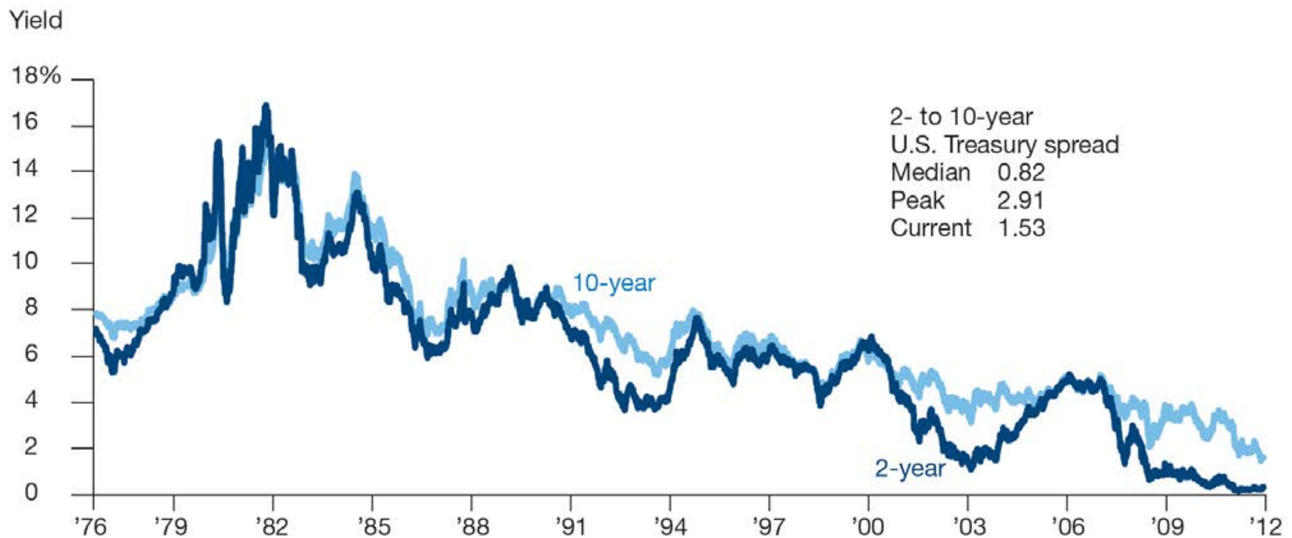


Sources: Bureau of Economic Analysis, Bureau of Labor Statistics/Haver Analytics, Blue Chip Indicators, February 2013.

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 remains positively sloped and relatively steep. The spread between 2-year and 10-year yields has declined significantly from its peak on February 4, 2011, but remains well above the historical mean. An upward-sloping yield curve implies market expectations for higher short-term interest rates because of stronger economic growth and the potential for higher inflation. Given the historically low level of overall interest rates, the current interest rate climate subjects banks to a high level of interest rate risk. Interest rates are more likely to move sharply higher in response to any unexpected positive economic or inflation information. 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. Generally, a stronger economy implies higher household and corporate income and revenue growth. A meaningful increase in debt service burden, however, would affect marginal borrowers who were weakened during the recession and have not yet recovered fully.

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



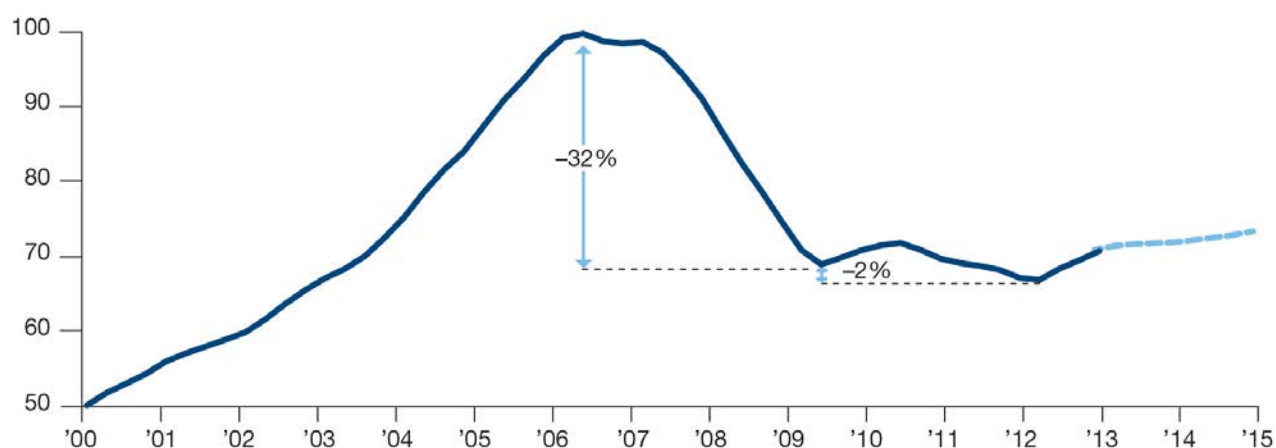
Source: Federal Reserve Board.

Note: Treasury yield curve estimates, coupon equivalent par-yields. Updated December 31, 2012.

Economic Data Show Improvement in Housing

The housing market showed signs of improvement in 2012 due to increased investor demand and the limited supply of new and existing homes for sale. New-home inventories remain at a 50-year low, and many markets are back in balance. Case-Shiller repeat-sales data show home prices up 5.5 percent year over year through the fourth quarter of 2012 (see figure 3). Average prices remain almost 30 percent below their peak as distressed sales continued to account for a historically elevated 20 percent of sales last year. The remaining distressed inventory is increasingly concentrated in states with judicial foreclosure requirements. Nevertheless, nationally, delinquency rates and foreclosures have shown a meaningful decline. 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 5 percent a year earlier (see table 1). The percentage of foreclosures in process declined from 4 percent of loans outstanding at the end of 2011 to 3.3 percent at the end of 2012.

Figure 3: Case-Shiller National Home Price Index



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

Table 1: Mortgage Portfolio Performance for Banks

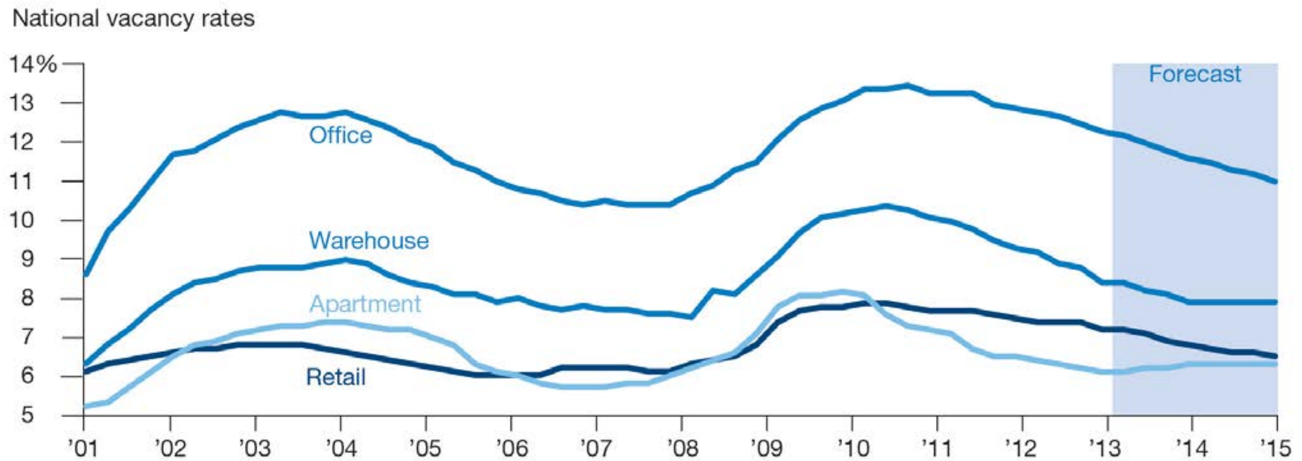
Percentage of Mortgages in the Portfolio							
	12/31/11	3/31/12	6/30/12	9/30/12	12/31/12	1Q %Change	1Y %Change
Current and performing	88.0%	88.9%	88.7%	88.6%	89.4%	0.8%	1.6%
30–59 days delinquent	3.0%	2.5%	2.8%	3.1%	2.9%	-8.2%	-6.1%
The following three categories are classified as seriously delinquent							
60–89 days delinquent	1.2%	0.9%	1.0%	1.1%	1.1%	0.2%	-9.6%
90 or more days delinquent	2.8%	2.5%	2.3%	2.2%	2.3%	3.2%	-17.1%
Bankruptcy 30 or more days delinquent	1.0%	1.1%	1.1%	1.1%	1.0%	-2.2%	0.6%
Subtotal for seriously delinquent	5.0%	4.5%	4.4%	4.4%	4.4%	1.1%	-11.6%
Foreclosures in process	4.0%	4.1%	4.1%	3.9%	3.3%	-14.1%	-17.0%

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

Commercial Real Estate Vacancy Rates Improving

CRE vacancy rates remained high through year-end 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.

Figure 4: CRE Vacancy Rates

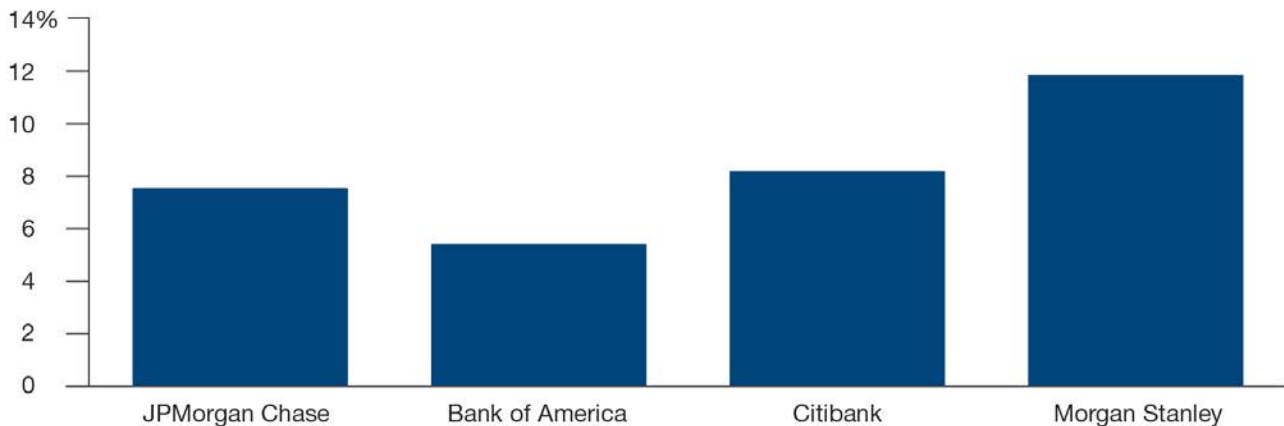


Source: Property & Portfolio Research, fourth quarter 2012 baseline forecast.

Direct Credit Exposure to Peripheral European Countries Is Low

Weak economic conditions in Europe, sovereign debt-quality concerns, and heightened uncertainty over the health of the European banking system have kept investors focused on U.S. bank credit exposures to the 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 5). 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 5: Direct Exposure to Peripheral European Countries

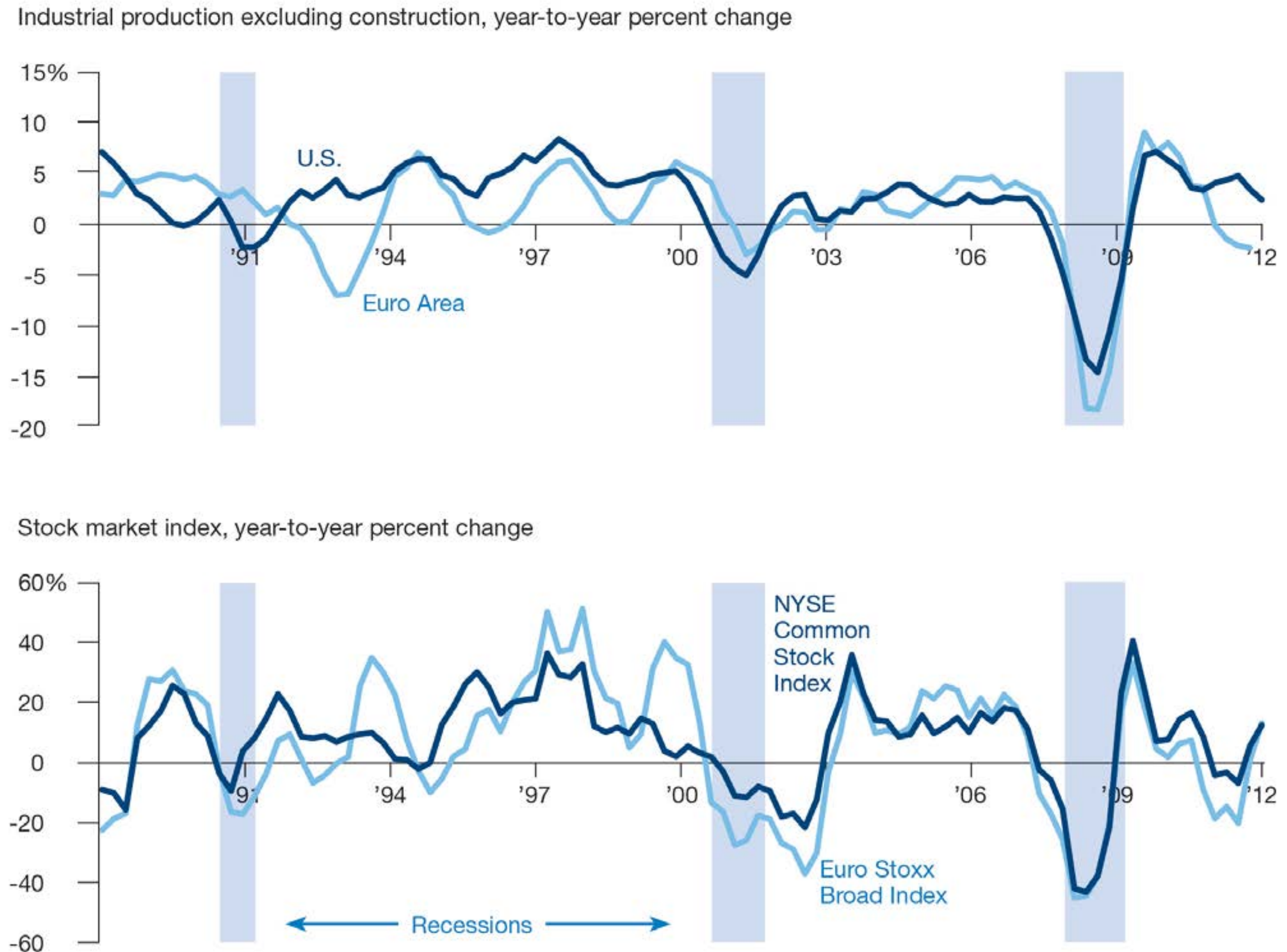


Source: Company 10-Q filings for December 31, 2012.

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 in the United States (see figure 6). If stresses in Europe and its banking system intensify, global financial market instability will remain a key potential stress-transmission channel to both the U.S. economy and its banking system. U.S. exporters to the European Union (EU) are important employers in many states (see figure 7). Larger banks would likely feel any negative real-economy spillovers from Europe first, but smaller banks would eventually feel some effect via heightened credit stress and lower growth prospects.

Figure 6: Link Between U.S. and European Economies



Sources: Organization for Economic Cooperation and Development, Dow Jones.

Note: Quarterly data through the fourth 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 7: States With More Than 5 Percent of Total Employment in EU-Export-Dependent Manufacturing Industries

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

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

Part II: Condition and Performance of Banks

A. Profitability and Revenues: Improving Slowly

Profitability Increasing

Net income for 2012 increased 12 percent year over year to more than $94 billion. Banks of all sizes experienced improvements in operating performance (see table 2). Smaller banks had the largest percentage increase in net income. Net income at banks with assets between $1 billion and $10 billion increased 44 percent year over year, while net income for banks with assets less than $1 billion increased by 56 percent, the most of any category. The gain in net income at banks with more than $10 billion in assets was 10 percent for 2012.

The primary driver of improved earnings over the past year was lower provision expense, although noninterest income and realized securities gains also supported profit growth. Gains from loan sales rose notably across the industry last year; 2012 growth in noninterest income also benefitted from a weak-base effect (stresses at a few very large banks constrained system noninterest income for 2011). Much of the year-to-year increase in securities gains was also due to a weak-base effect from 2011. The maturing credit cycle and higher capital levels increased banks' ability to dispose of troubled legacy portfolios at better prices last year. Mortgage refinance activity also continued to boost system revenue, although that source of strength may ease in 2013. Net interest income remained under pressure from weak loan growth and the low interest rate environment, which resulted in continued margin compression at banks with assets over $10 billion and banks with assets less than $1 billion.

Provision expenses declined across the industry, with the largest banks reporting a 21 percent reduction in provisions for loan losses. Those with assets between $1 billion and $10 billion had a 44 percent reduction in provision expenses, while those with less than $1 billion in assets saw a 38 percent reduction. Provision expenses remain at historical lows relative to charge-offs and therefore lower provisions are likely to provide a diminishing benefit to earnings performance in 2013, should loan-loss reserves stabilize as expected. Absent the decline in provision expense, net income would have been relatively flat for the year.

Table 2: Income and Expenses for Banks

	Assets greater than $10 billion		Assets $1 billion-$10 billion		Assets less than $1 billion	
	December 31, 2011	December 31, 2012	December 31, 2011	December 31, 2012	December 31, 2011	December 31, 2012
Number of institutions	62	60	187	174	1,682	1,544
Total assets in billions	8,777	9,149	496.0	469.3	384.8	364.7
Revenues: $ billions						
Net interest income	265.8	261.8	13.8	13.9	11.4	11.4
Non interest income	157.5	166.2	5.5	6.1	2.9	3.6
Realized securities gains and losses	3.2	6.5	0.2	0.2	0.2	0.2
Expenses: $ billions						
Provisioning	51.3	40.7	2.5	1.4	1.6	1.0
Non interest expense	261.6	266.4	13.0	13.5	10.7	11.0
Income taxes	33.8	38.7	1.2	1.3	0.6	0.7
Net income	80.1	88.2	2.7	3.9	1.6	2.5

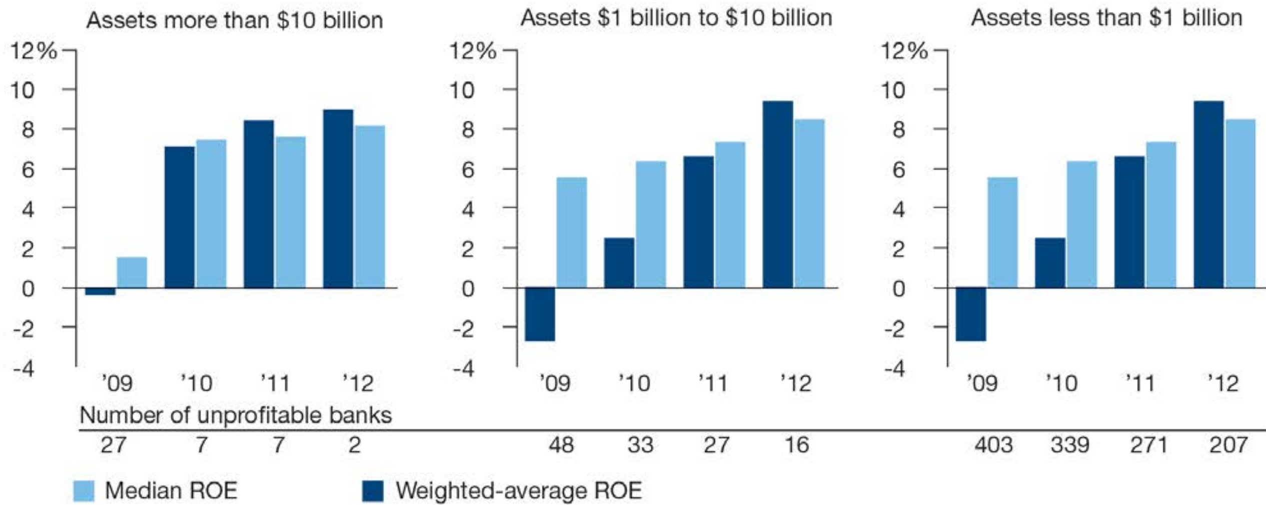
Source: OCC Integrated Banking Information System.

Note: Data are merger-adjusted and held constant for institutions in continuous operation from the first quarter of 2006 to the fourth quarter of 2012. Credit card and trust institutions are excluded.

Return on Equity Improving for Smaller Banks

Return on equity (ROE) on a weighted-average basis improved in 2012 for banks of all sizes, but smaller banks showed the most significant relative improvement (see figure 8). Weighted-average ROE for each group is now more in line with group medians, which is typical of more normal conditions, when fewer stressed banks act to depress the weighted average.

Figure 8: Return on Equity Trends by Bank Size



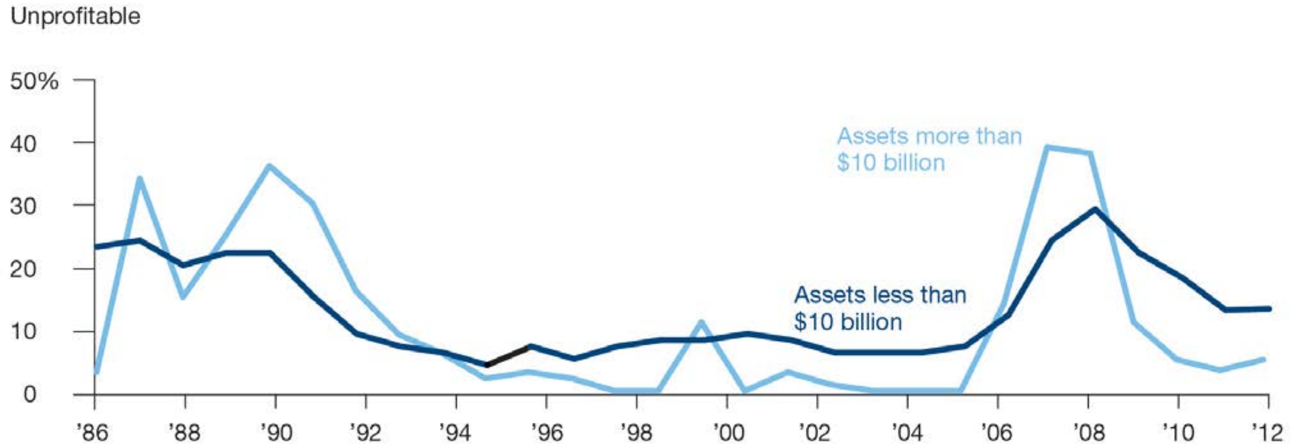
Source: OCC Integrated Banking Information System.

Note: All data as of year-end. Sum-of-quarterly net income as a share of five-quarter trailing average equity. Data are merger-adjusted and use the current size designations.

Fewer Banks Report Losses

The percentage of unprofitable banks continued to fall in 2012 (see figure 9). The percentage of unprofitable banks with more than $10 billion in assets declined to roughly 3 percent through the fourth quarter of 2012 from a peak of 39 percent in 2008. The share of unprofitable smaller banks declined from 29 percent in 2009 to below 13 percent as of December 31, 2012.

Figure 9: Percentage of Unprofitable Banks

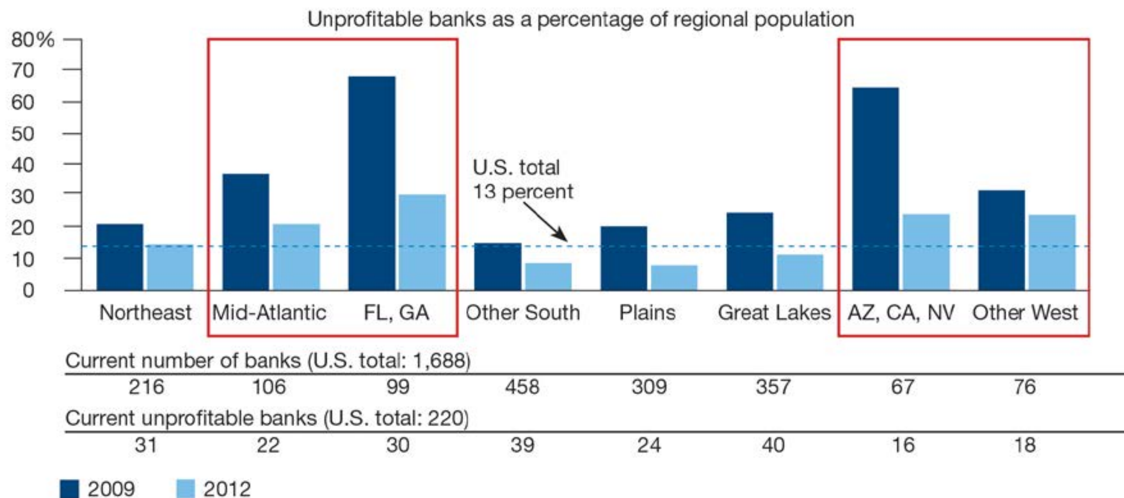


Source: OCC Integrated Banking Information System.

Note: All data as of year-end. Unprofitable is defined as return on assets of less than 0.

Regionally, unprofitable banks remain concentrated in the states most adversely affected by the housing crisis, such as Florida and Georgia, as well as some mid-Atlantic states (Delaware, Maryland, North Carolina, South Carolina, Virginia, and West Virginia) and the District of Columbia (see figure 10). For many banks in these locations, legacy issues from the housing crisis continue to put pressure on loan performance, especially construction and residential mortgage loans, weighing on profits through elevated nonaccruals and provisions, as well as reduced growth potential.

Figure 10: Unprofitable Banks, by Region



	Northeast	Mid-Atlantic	FL, GA	Other South	Plains	Great Lakes	AZ, CA, NV	Other West
Current number of banks (U.S. total: 1,688)	216	106	99	458	309	357	67	76
Current unprofitable banks (U.S. total: 220)	31	22	30	39	24	40	16	18

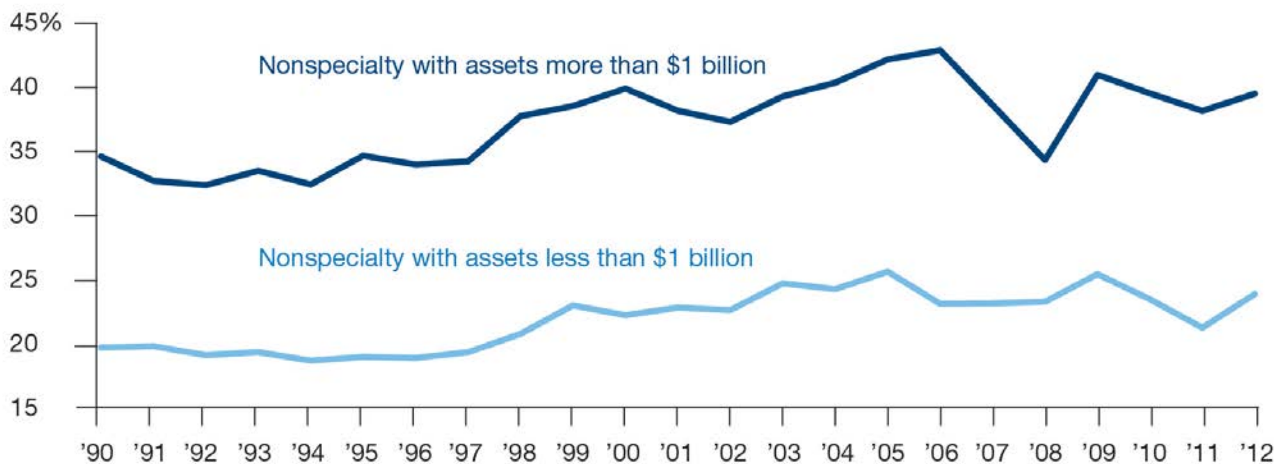
Source: OCC Integrated Banking Information System.

Note: All data as of year-end. Data are merger-adjusted and use the current supervision designation. Unprofitable is defined as return on assets of less than 0. Northeast: CT, MA, ME, NH, NJ, NY, PA, RI, VT. Great Lakes: IL, IN, MI, OH, WI. Other South: AL, AR, KY, LA, MS, TN, TX, OK. Mid-Atlantic: DC, DE, MD, NC, SC, VA, WV. Plains: IA, KS, MN, MO, ND, NE, SD. Other West: AK, CO, HI, ID, MT, NM, OR, UT, WA, WY.

Noninterest Income Continues to Show Modest Improvement

Noninterest income continues to be more important for larger banks. As a share of net operating revenue, noninterest income has stabilized near 40 percent for banks with assets greater than $1 billion and near 25 percent for smaller institutions. The share of revenue from noninterest income rose in 2012 for both large and small banks (see figure 11). This was largely the result of increased gains from loan sales, as mentioned previously. Trading losses at large banks drove the big drop in 2008, but since 2009, noninterest income has been a slightly smaller share of total revenue. This was largely the result of an accounting rule change, causing income from credit card assets to be captured in interest income. Deposit service charges, overdraft fees, and revenue from interchange fees also have declined, partly because of recent changes in regulatory requirements. Asset management revenue, however, continues to provide a steady stream of noninterest income for some banks.

Figure 11: Trends in Noninterest Income for Banks



Source: OCC Integrated Banking Information System.

Note: All data as of year-end. Net operating revenue equals net interest income plus noninterest income. Data exclude trust and credit card charter banks.

Trading Revenues Decline Sharply

Banks reported $14.6 billion in trading revenues in 2012, $6.5 billion (31 percent) lower than the $21.1 billion reported in 2011 (see figure 12). Very strong trading performance in the fourth quarter of 2012 relative to 2011 could not offset weaker performance in the second and third quarters. Each of the large national bank dealers reported weaker trading revenues in 2012 than in 2011. The weaker 2012 performance resulted primarily from very poor results from credit trading. Banks reported $8 billion in losses for trading credit products in 2012, an $11.7 billion shift from the $3.7 billion in revenues booked in 2011. Each of the large national bank dealer firms reported full-year credit trading losses. The credit trading losses more than offset very strong performance from interest rate trading (see figure 13). Banks reported $13.5 billion in revenues from trading rates contracts, $5.9 billion more than in 2011.

The poor credit trading results in 2012 stemmed from the well-publicized losses at JPMorgan Chase Bank N.A., as well as valuation adjustments for derivatives liabilities because of the significant credit-spread tightening for banks in 2012. Tightening credit spreads, associated with an improving economy and reduced concerns about systemic risk from Europe increased the credit-adjusted fair value of derivatives liabilities. Banks report the increased value of their derivatives liabilities as trading losses.

Figure 12: Trading Revenues for Banks

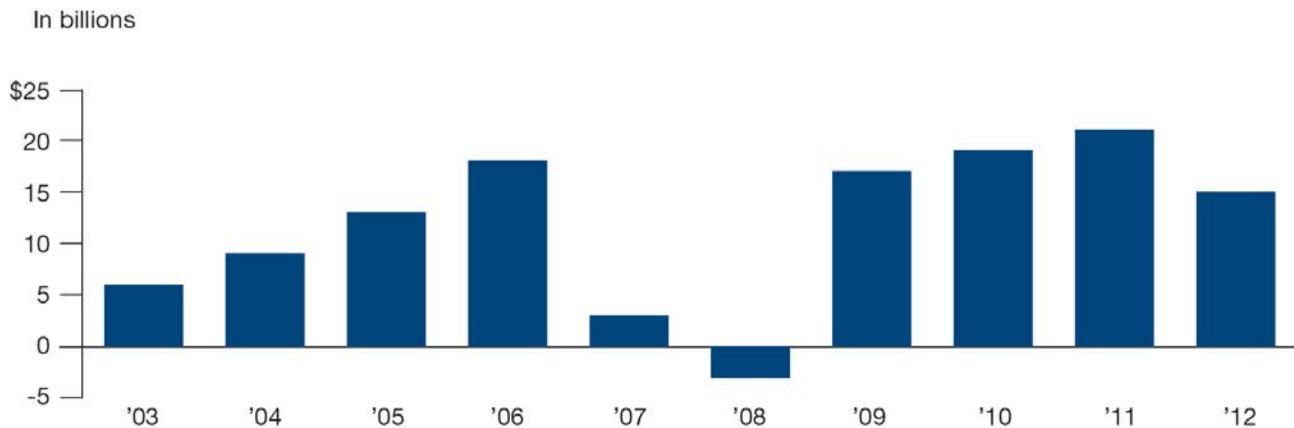
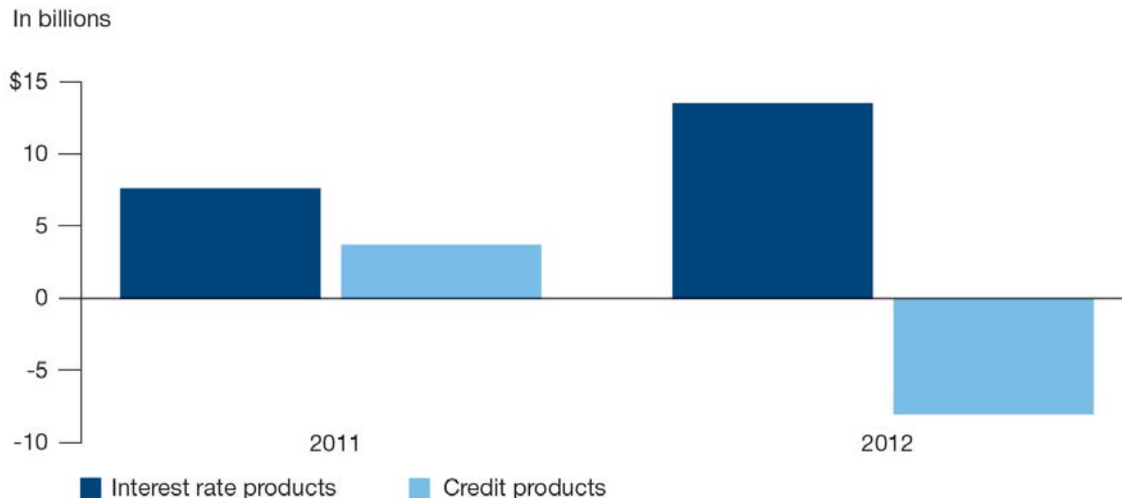


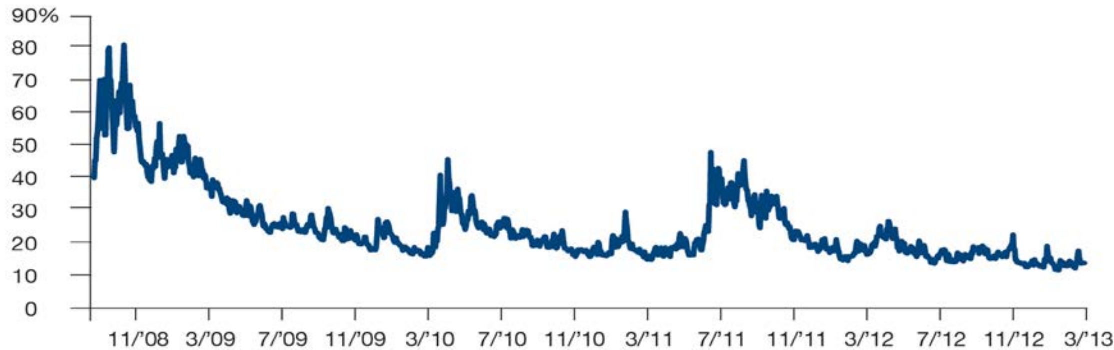
Figure 13: Trading Revenues for Banks from Interest Rate and Credit Products



Low Market Volatility May Understate Risk

Quantitative easing by the Federal Reserve Board to help the U.S. economy recover from the financial crisis has resulted in sharply lower interest rates, higher stock prices, and lower market volatility. The low volatility environment, in turn, has encouraged lower correlations among asset classes. For example, the VIX, a popular measure of the implied volatility of Standard & Poor's 500 index options and commonly known as the "fear gauge," illustrates the sharp decline in volatility (see figure 14). The VIX and volatility measures for the bond market have been at very low levels for more than a year.

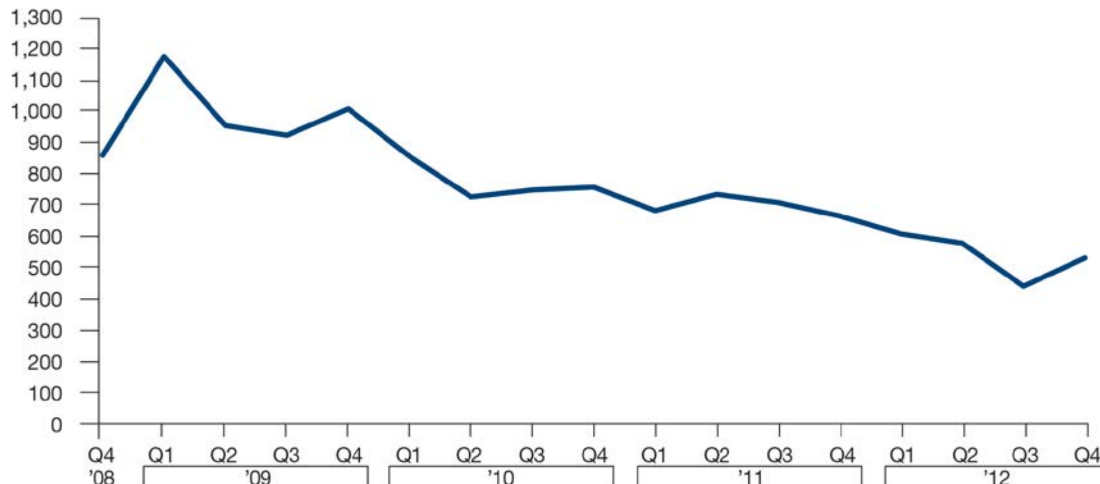
Figure 14: The VIX Reflects the Decline in Volatility



Market volatility is a key factor in computing many risk measures. For example, Value-at-Risk (VaR) models are used to measure the risk of trading activities. Value-at-Risk is a statistical measure that banks use to quantify the maximum loss that could occur, over a specified horizon and at a certain confidence level, in normal markets. Volatility remains low and continues to decline. Aggregate VaR measures at the five largest U.S. banking companies with trading operations have dropped significantly since the financial crisis and in the past year (see figure 15).

One issue associated with low volatility environments is the proper interpretation of risk measures such as VaR. In a more normal volatility environment, bank VaR measures would be much higher. Accordingly, it is important to recognize that the steep decline in VaR measures mostly reflects the lower volatility environment, rather than a conscious desire among banking companies to reduce risk.

Figure 15: Aggregate Value-at-Risk at Five Large Banking Companies

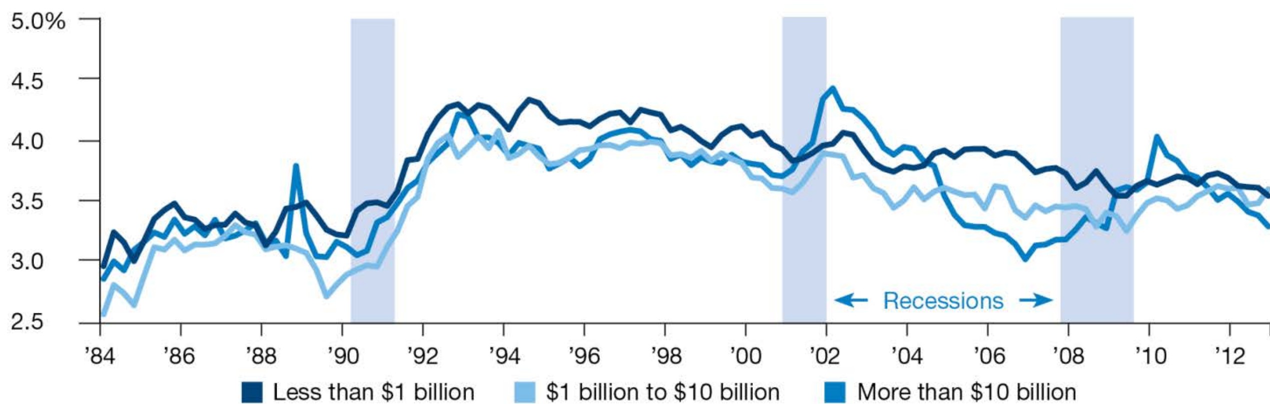


Net Interest Margins Remain Under Pressure

Net interest margins remain under pressure as assets reprice at lower interest rates (see figure 16). Margins for many nonspecialty banks (which exclude credit card or trust specialists) continue to compress, although there has been some recent stabilization for those with assets between $1 billion and $10 billion. Given little expected change in interest rates in 2013, net interest margins will likely show little improvement in the near term. Weak loan demand has thus far limited the ability of many banks to grow net interest income through volume. The low level of interest rates also is keeping a lid on the yields of any new loans (or assets) added to the balance sheet. Meanwhile, already low deposit rates make it unlikely that banks will realize further benefits from lower funding costs. Thus, the incentive for many banks is to invest excess cash into longer-maturity securities, increasing their exposure to interest rate risk.

Figure 16: Trends in Net Interest Margins for Banks

Net interest margin, percent of earning assets



Source: OCC Integrated Banking Information System.

Note: Quarterly data through the fourth quarter of 2012. Non specialty category excludes credit card and trust institutions.

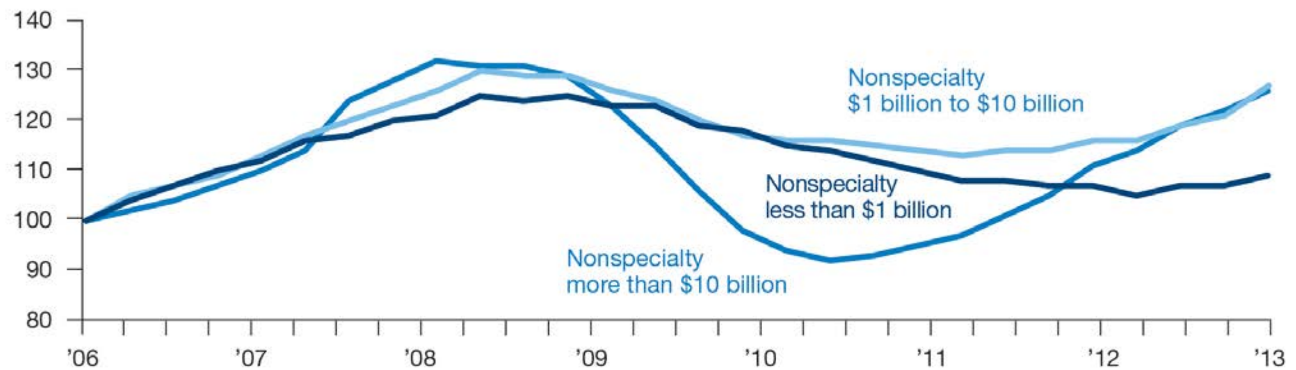
B. Loan Growth Challenges and Opportunities

Total Loan Growth: C&I Driven at Large Banks and Regionally Uneven for Small Banks

Overall loan growth continues to be driven by larger banks and remained concentrated in C&I lending last year. Total loans for the system increased 2 percent last year—half the 25-year average annual pace. This growth was almost entirely because of a 16 percent rise in C&I loans outstanding.

C&I loan growth at the largest banks is providing a much needed source of revenue support and is far outpacing growth at smaller banks (see figure 17). Loan demand from larger firms is growing, fueled by improving business opportunities. Because the credit needs of these firms are mostly supported by large banks, the latter have benefitted most from this trend. In fact, the level of C&I loan volume is back to near pre-crisis levels at large banks. The pace of recovery in C&I lending at smaller banks, however, continues to lag behind that of their larger peers. Smaller banks typically lend to small businesses, which continue to struggle. C&I loan growth at small banks also is uneven. Some small banks are reporting robust C&I loan growth, while others continue to show declines.

Figure 17: C&I Loan Trends for Banks



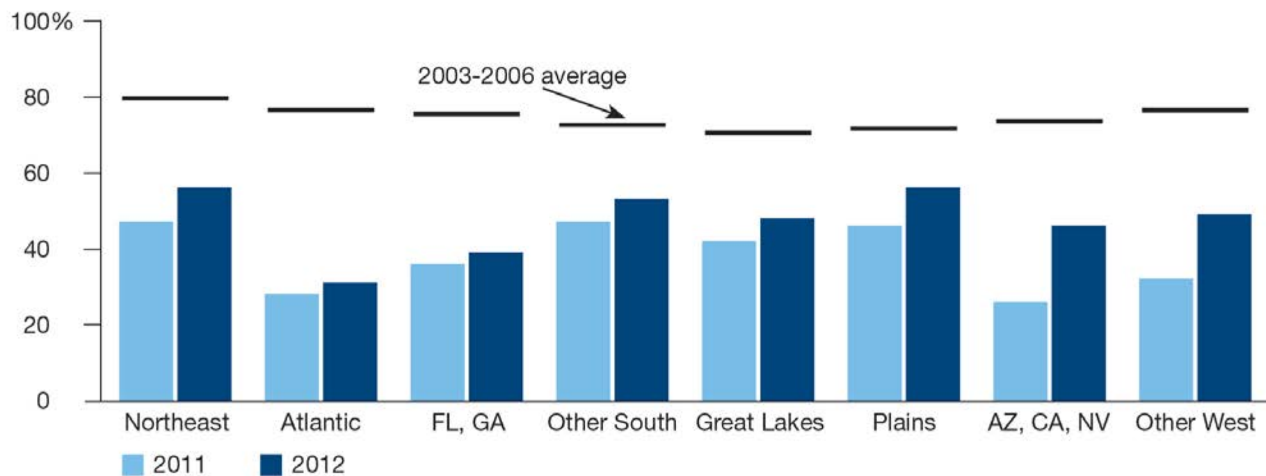
Source: OCC Integrated Banking Information System.

Note: Data are merger-adjusted and held constant for banks in continuous operation from the first quarter of 2006 to the fourth quarter of 2012. Nonspecialty category excludes credit card and trust banks.

This weak and uneven recovery in C&I growth at smaller banks is manifesting itself in broader lending trends. Banks under $1 billion in assets as a group reported no change in total loans outstanding last year, after adjusting for mergers. One reason for this is that loan growth has not been as widespread as in normal economic times (see figure 18). On a regional basis, only 40 percent to 50 percent of the banks under $1 billion reported loan growth last year, compared with a more normal range of 80 percent. Furthermore, growth varies widely by region, whereas it was more uniform in the past. The regions that remained particularly hard-pressed for small-bank loan growth last year included the mid-Atlantic states, Florida, and Georgia. Meanwhile, the Northeast and Plains states had some of the highest incidence of loan growth at small institutions. Local economic conditions drive these patterns, as strong energy and resource production has boosted local economies in certain states, while lingering real estate problems continue to weigh disproportionately on others (or have not weighed on those areas that largely escaped the housing crisis).

Figure 18: Loan Growth for Small Banks by Region

Share of institutions under $1 billion with year-on-year loan growth.



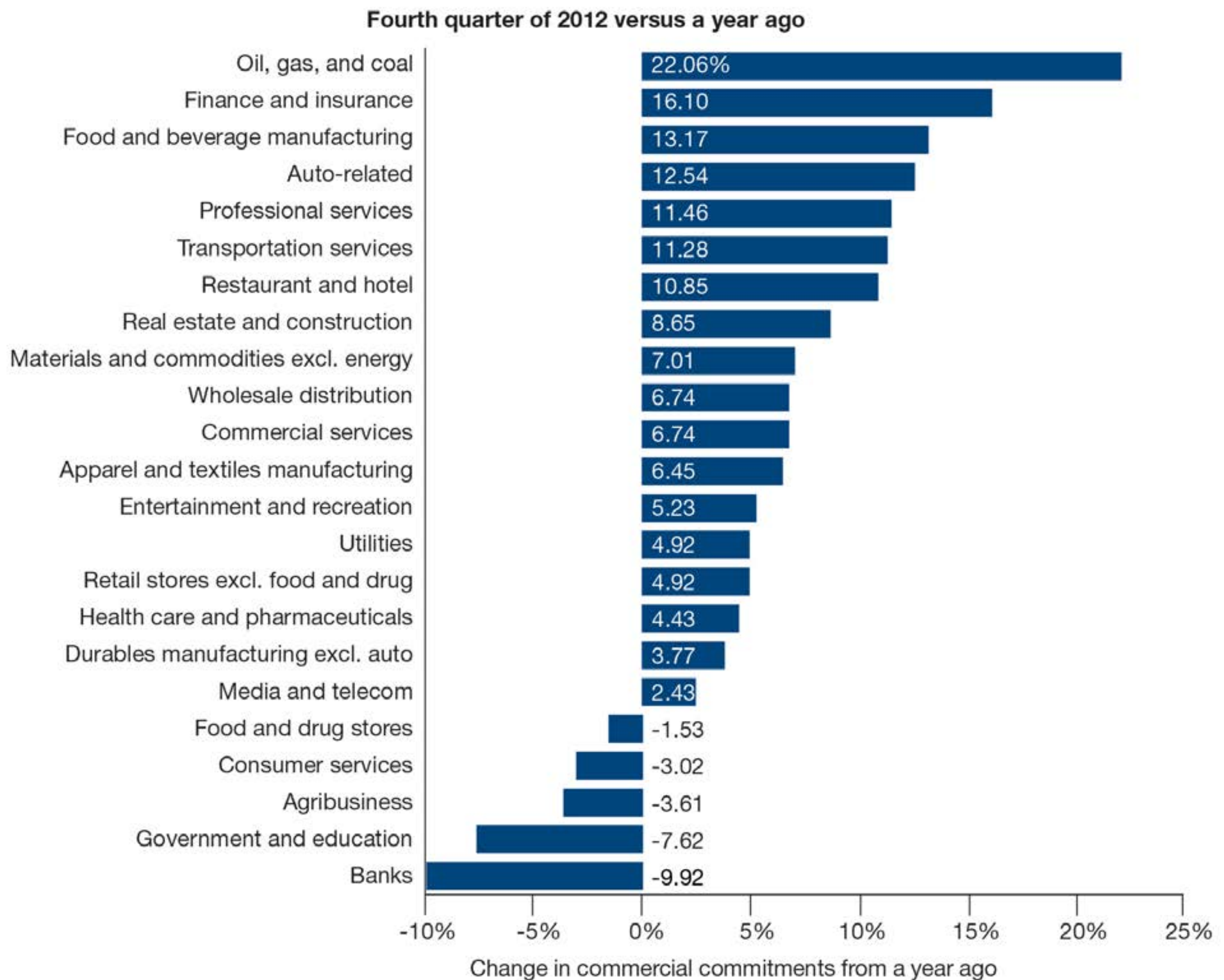
Source: OCC Integrated Banking Information System.

Northeast: CT, MA, ME, NH, NJ, NY, PA, RI, VT. Great Lakes: IL, IN, MI, OH, WI. Other South: AL, AR, KY, LA, MS, TN, TX, OK. Mid-Atlantic: DC, DE, MD, NC, SC, VA, WV. Plains: IA, KS, MN, MO, ND, NE, SD. Other West: AK, CO, HI, ID, MT, NM, OR, UT, WA, WY.

C&I Loan Growth Led by Energy Sector

Banks reporting into the OCC's Credit Analytics[3] data system experienced growth across a wide array of industries (both C&I and real estate), with 24 of 26 banks experiencing growth. While loan growth was evident across many industry segments (see figure 19), lending to oil, gas, and coal energy industries led the way, with a strong showing by nonbank finance and insurance businesses as well. Lending to the energy sector was up a strong 22 percent year over year, whereas in many other sectors, growth last year was less than half that pace.

Figure 19: Commercial Loan Growth by Industry for Select Banks

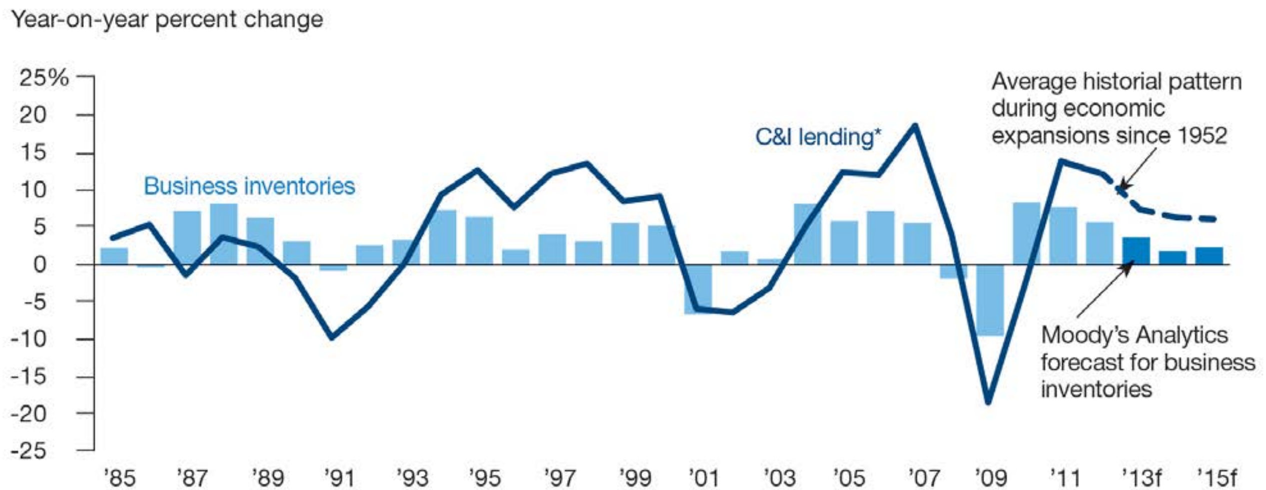


[3] Credit Analytics is an OCC-sponsored, voluntary data-sharing program for analyzing commercial credit trends. The participants represent a substantial share of total commercial lending by the federal banking system.

Demand for C&I Loans May Wane With Slower Growth in Inventories

Despite the recent strength, demand for new C&I loans could slow in the next few years, based on historical patterns (see figure 20). The Moody's Analytics March 2013 baseline forecast expects business inventories to grow at a slower pace in the next few years. Although they are not the only factor, business inventory growth patterns have historically shown a close relationship to those for overall C&I lending (they may matter less in some sectors, however, such as energy). In particular, periods of slower inventory accumulation have typically accompanied periods of slow C&I growth. Using this inventory forecast and extending the historical growth relationship between inventories and C&I loans at FDIC-insured institutions suggest that C&I loan growth could slow from its double-digit pace of the past few years. Any slowdown in C&I loan demand would likely intensify already aggressive competitive conditions for lenders looking to boost loan growth. This in turn could further compromise the quality of underwriting.

Figure 20: Potential C&I Loan Growth Based on Forecast for Business Inventories



Sources: OCC Integrated Banking Information System; U.S. Census Bureau; Moody's Analytics (March 2013 baseline forecast).

*All FDIC-insured institutions. 2013-15 loan growth extends historical relationship to business inventories during periods of economic expansion (estimated annually) between 1952 and 2011.

CRE Loan Demand May Increase With Projected Rise in Development

Demand for new CRE loans is tied to trends in new nonresidential structure investment—a measure of commercial property development activity. New properties to market typically need both construction and longer-term mortgage financing. The Moody's Analytics March 2013 baseline projects the rate of nonresidential structure investment growth to strengthen gradually over the next few years but remain subdued relative to the 2006-07 peak pace. Based on this forecast, the recent recovery in CRE lending could continue over the near term (see figure 21). Extending the five-decade average relationship between commercial property investment growth and changes in CRE lending at FDIC-insured institutions during times of economic expansion suggests an improving outlook for CRE lending activity. The pace of CRE loan growth, however, also would likely stay below its pre-recession average rate. While the potential for increased CRE loan demand may support margin and revenue growth at many banks, those with already significant CRE concentrations and high shares of underwater commercial mortgages may benefit less than their peers.

Figure 21: Potential CRE Loan Growth Based on Forecast for CRE Development

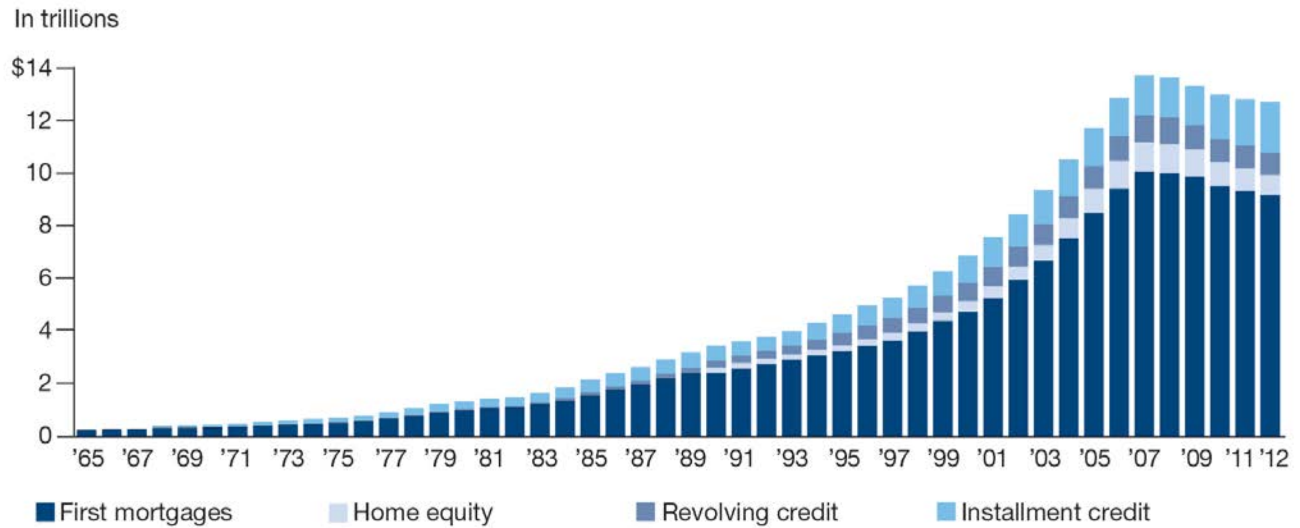
Sources: OCC Integrated Banking Information System; U.S. Census Bureau; Moody's Analytics (March 2013 baseline forecast).

*All FDIC-insured institutions. CRE includes nonresidential mortgages, multifamily, and construction loans. 2013-15 loan growth extends historical relationship to nonresidential structure investment during periods of economic expansion (estimated annually) between 1952 and 2011.

Muted Demand for Household Credit Continues

Household debt levels in the United States continued to decline in 2012. Contraction in mortgage origination has offset the recent increased demand for installment credit in auto and student loans (see figure 22). The steady decline in consumer debt outstanding that began in mid-2007 continued through the second quarter of 2012. Refinancing continues to drive the recent consumer demand for mortgages, and new mortgage originations remain lackluster.

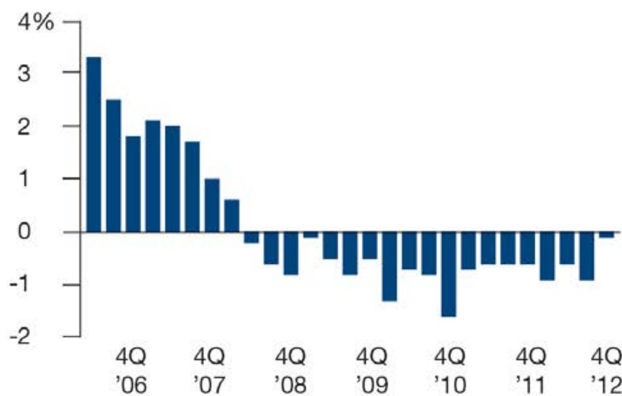
Figure 22: Total U.S. Household Credit Balances

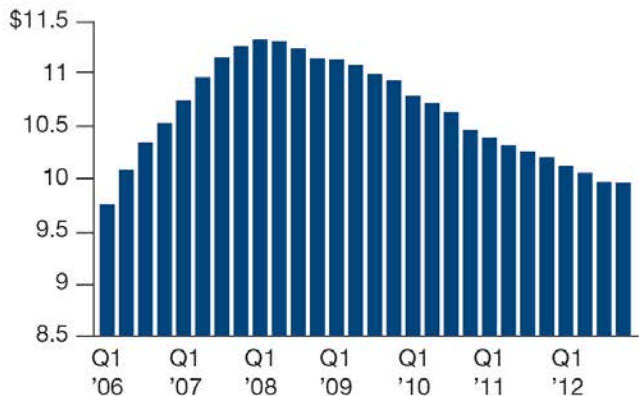


Residential Mortgages Continue an Extended Period of Contraction

Unlike the recent improvement in growth for consumer credit, the economy has continued to experience an unprecedented period of runoff in residential mortgages, although this trend has abated somewhat. The contraction of economy-wide residential mortgage credit has extended to 19 consecutive quarters (from the second quarter of 2008 through the end of 2012) and is down 12 percent since peaking at $11.27 trillion at the end of March 2008 (see figure 23). Households continue to reduce their mortgage debt through payoffs and, more significantly, through elevated defaults. These effects far outweigh any growth in new mortgage demand. Although existing home sales have shown stronger growth recently, these sales often result in a transfer of mortgage debt, rather than new growth.[4] Continued low levels of single-family new-home construction and sales likely pose an impediment to strong near-term balance sheet growth in one- to four-family home mortgages at OCC-supervised institutions. The extended period of low interest rates has fueled refinancing activity, but applications for home purchase mortgages remain near their recent recession low point—a 15-year low. That said, trends in purchase originations have improved recently, rising steadily since June 2012—applications were up 15 percent year over year as of February 2013, according to the Mortgage Bankers Association. Further sustained upside on this front is likely to depend on stronger growth in new home sales.

Figure 23: Quarterly Trend in Residential Mortgages Outstanding





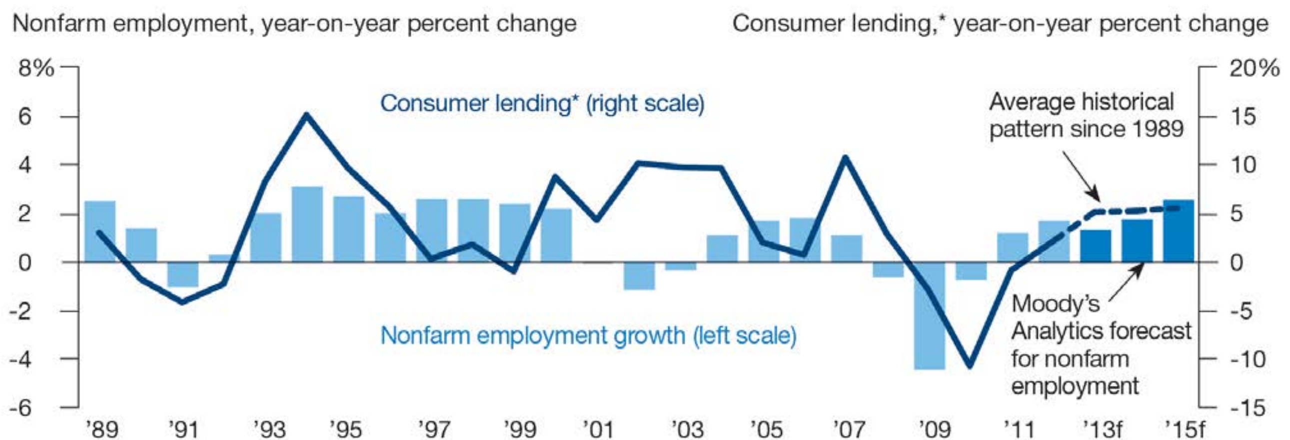
Source: Federal Reserve Board flow of funds data.

[4] The prevalence of cash-only investor purchases and short sales in recent years has had the effect of constraining aggregate growth in outstanding mortgage debt.

Potential Modest Consumer Loan Growth Based on Employment Forecasts

Consumer lending is closely tied to the health of the labor market. Stronger rates of job and income growth typically boost consumer spending, much of which is financed through auto, credit card, and other consumer loans. A recent exception, however, was in the early 2000s. Although the recession of 2001 was followed by the nation's second "jobless recovery," consumer spending and loan growth held up well during this time because of special factors, such as expanding bank involvement in auto lending and rising home equity. The Moody's Analytics March 2013 baseline expects the pace of nonfarm job growth to gradually strengthen back toward a 1990s-average pace. Likewise, if the historical relationship with consumer lending at FDIC-insured institutions holds, this would imply a modest pace of consumer loan growth going forward (see figure 24). Recent improvements in underwriting standards for consumer loans may be more difficult to maintain if competition intensifies because of slow demand growth in this loan segment.

Figure 24: Consumer Lending Follows Employment Growth



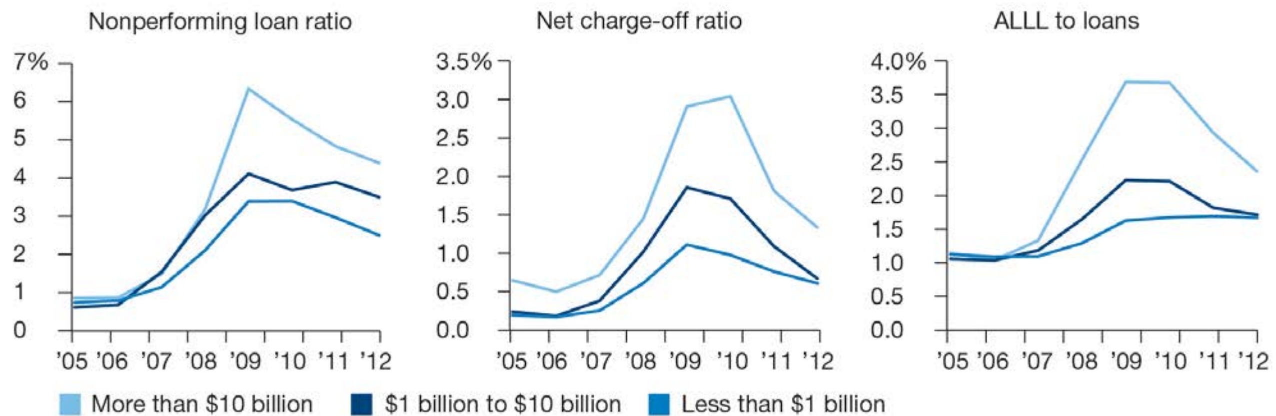
Sources: OCC Integrated Banking Information System; Census; Moody's Analytics (March 2013 baseline forecast).

*All FDIC-insured institutions. Consumer lending includes auto, student, credit card, and other non-realestate related household borrowing. 2013-15 loan growth extends historical relationship of consumer credit with job growth since 1989. 2010 loan growth rate adjusted to remove influence of FAS 166 asset on-boarding.

C. Credit Quality: Continued Improvement, Although Residential Real Estate Lags

The credit cycle showed continuing improvement through the second half of 2012 (see figure 25). Nonperforming loans—those 90 days or more past due or on nonaccrual—declined for large and small banks, although not as quickly as charge-offs. Consistent with the direction of the noncurrent loan ratio, ALLL continued to decline in the second half of 2012 as a percentage of total loans. The recent, rapid decline in ALLL is expected to abate as it returns to a more normal share of total loans. Furthermore, noncurrent loans remain historically elevated. Given that the economic outlook also remains guarded, ALLL may need to stabilize at a share of total loans that is above its pre-crisis level—a level that is appropriate for the current economic risk climate and loan mix and that accounts for the still-high level of noncurrent loans. Adoption of a proposed accounting rule to change life-of-loan reserving also is likely to raise overall ALLL balances.

Figure 25: Credit Cycle Analysis for Banks



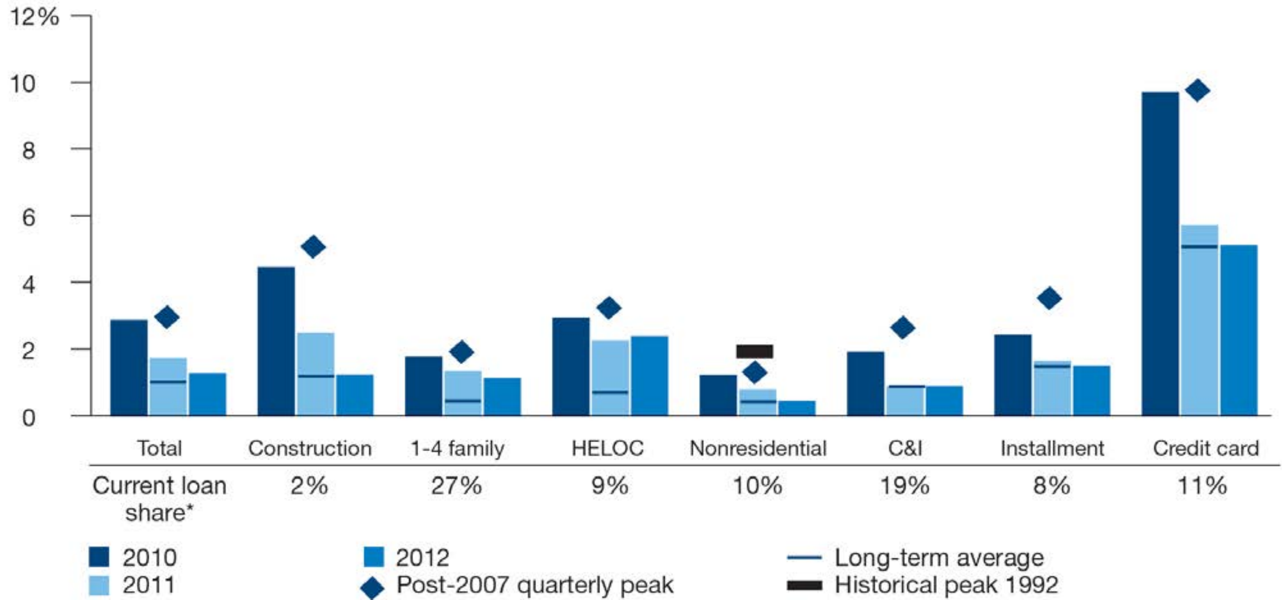
Source: OCC Integrated Banking Information System.

Note: Nonperforming loans are 90 days or more past due and nonaccruals.

Charge-Off Rates for Most Loan Types Return to Long-Term Averages

Charge-off rates declined through the fourth quarter of 2012 (see figure 26). The one exception was HELOCs. The 2012 loss rate for HELOCs increased primarily because of the charge-off of Chapter 7 bankruptcy accounts in the third quarter of 2012, but quarterly loss rates generally continued on a downward trend. For all other major loan types (one- to four-family home mortgages, credit card, consumer installment, C&I, and commercial mortgages) charge-off rates fell in 2012, and all but one- to four-family home mortgages are near or below their post-1990 average levels.

Figure 26: Charge-Off Rates by Asset Class for Banks



Source: OCC Integrated Banking Information System.

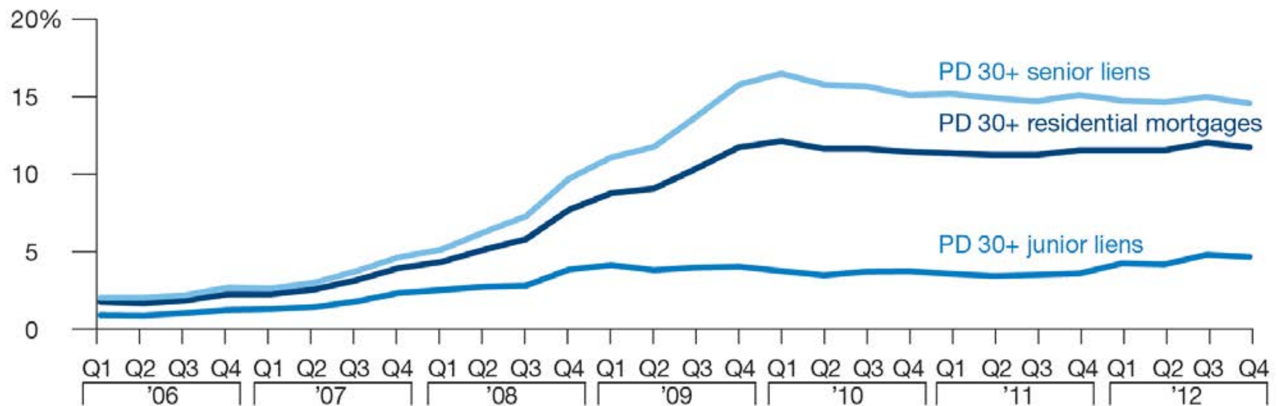
* Not all loan categories are shown. Net charge-offs are shown as a percentage of loans in respective category. 2010 credit card charge-off rate calculated using 2010 year-end credit card balance.

Mortgage Delinquencies Remain Elevated

The delinquency rate for on-balance-sheet residential mortgages, both senior and junior liens, was just under 12 percent at the end of 2012. A slow decline in senior lien delinquency rates was offset by an increase in junior lien delinquency rates. These opposing trends resulted in little change for total mortgage delinquencies (see figure 27). Even though the first mortgage delinquency rate has declined from its peak in the third quarter of 2010, it remains historically elevated at 14.6 percent. At 4.75 percent, the delinquency rate for junior liens remains near its all-time high. Lenders continue to have difficulty disposing of troubled loans because of the slow recovery in the housing market combined with an overhang of distressed properties and lingering issues with the foreclosure process. Elevated delinquency rates suggest that above-average net charge-off rates will continue for this loan segment in 2013.

Junior lien performance also reflects the early stages of the HELOC end-of-draw issue. The year 2013 will see the first waves of end-of-draw transitions, when borrowers no longer have access to credit lines and monthly payments increase due to amortization. Declining home values and tightened underwriting standards will exclude some borrowers from market-based refinancing into new draw periods, and the higher scheduled payments will put upward pressure on delinquency levels. The OCC believes all banks offering HELOC products should establish processes to quantify and address this risk of increased delinquencies and losses. Banks should begin implementing the structured reporting, outreach, and modification programs necessary to address the significant volumes of HELOCs transitioning to the end-of-draw scheduled for 2014–17. Taking action will provide greater flexibility for borrowers and will allow the banks to quantify and mitigate a portion of this risk.

Figure 27: Trend in Residential Mortgage Delinquencies for Banks

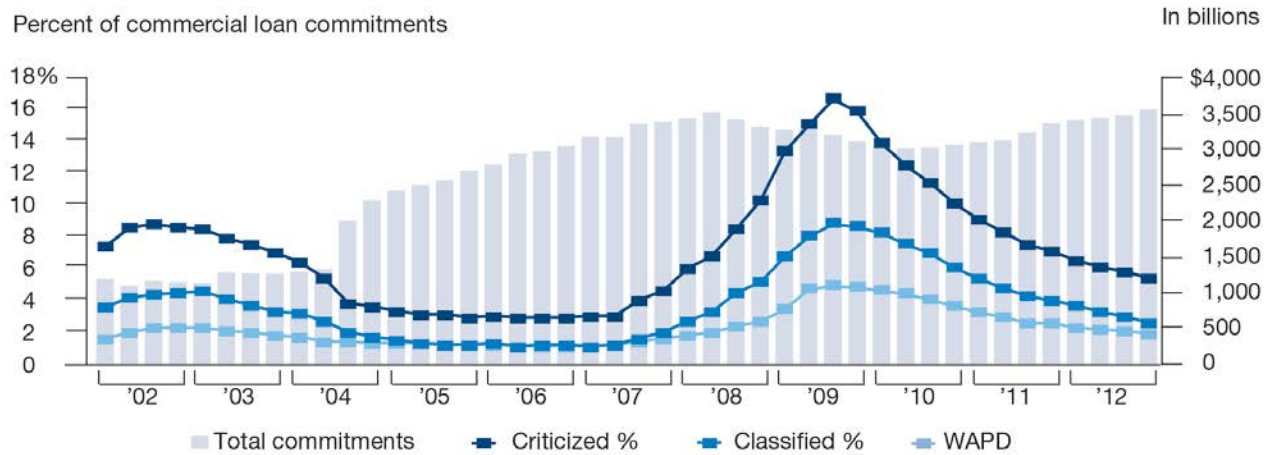


Source: OCC Integrated Banking Information Systems.

C&I Loan Performance Improving

The OCC's Credit Analytics data show that commercial loan commitments increased for 10 straight quarters through the fourth quarter of 2012 (see figure 28). Still, commercial commitments and outstanding loans grew at a more modest rate in the second half of 2012 than in the first half. Criticized and classified loans, as well as the weighted-average probability of default, declined, albeit at a slower pace than last year.

Figure 28: Commercial Loan Trends for Select Banks



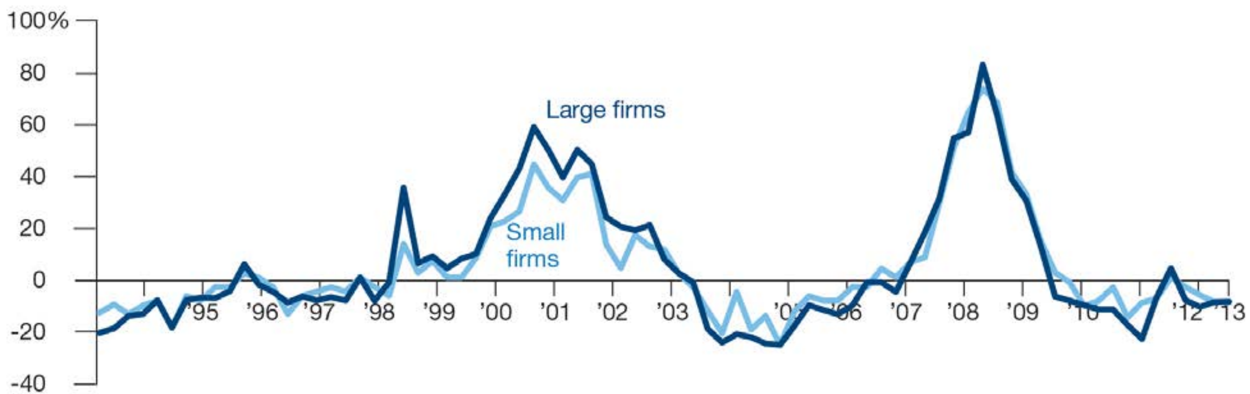
Source: OCC Credit Analytics.

WAPD = Weighted-average probability of default to commitments.

C&I Loan Underwriting Standards Easing

The January 2013 quarterly "Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices" reported that lending standards on C&I loans eased modestly in the fourth quarter of 2012. C&I lending standards have eased for four consecutive quarters and 12 of the last 13 quarters (see figure 29). Data showing underwriting standards loosening in the leveraged loan market (discussed later in this report) corroborates the survey results.

Figure 29: Percentage of Survey Respondents Tightening C&I Underwriting Standards



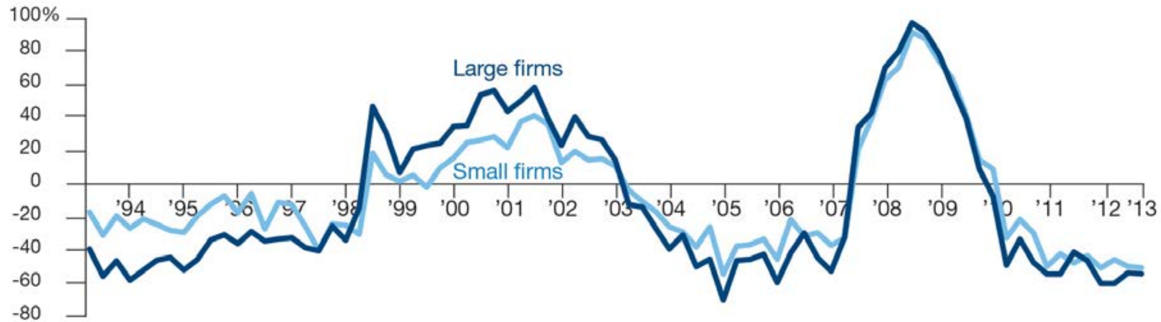
Source: Federal Reserve Board Senior Loan Officer Survey (January 2013).

Note: Negative value indicates net percent loosening standards. The survey asks respondents separately about their standards for and demand from large and middlemarket firms, which are generally defined as firms with annual sales of $50 million or more, and small firms, those with annual sales of less than $50 million.

Commercial Loan Rate Spreads Decreasing

The "Federal Reserve Board Senior Loan Officer Opinion Survey on Bank Lending Practices" also indicated that a majority of respondents reported decreasing spreads (see figure 30). The survey indicates that 54 percent of bankers that lend to large firms reported decreasing spreads on C&I loans and 51 percent of bankers lending to small firms reported decreasing spreads, suggesting a highly competitive lending climate.[5] Serial easing in credit terms has historically led to higher-risk credit portfolios.

Figure 30: Percentage of Survey Respondents Increasing Loan Rate Spreads



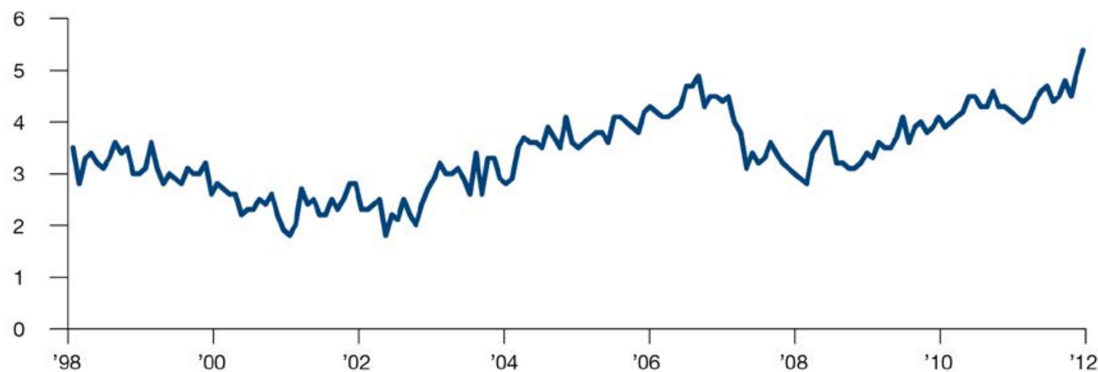
Source: Federal Reserve Board Senior Loan Officer Survey (January 2013).

Note: Negative value indicates net percent reporting lower spreads.

Leveraged Loan Debt Multiples Increase Sharply

Leveraged loan underwriting remained aggressive in 2012. The average total debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) multiple for highly leveraged loans issued in December 2012 rose to 5.4X and averaged 4.8X for the year—a level exceeded only by the 2007 average multiple of 4.9X (see figure 31). Higher leverage is historically associated with increasing competition for lending opportunities, as is further evidenced by continued narrowing of credit spreads. The combination of higher leverage and weaker spreads, in addition to softening of other credit terms, indicates increasing risk in commercial loan portfolios.

Figure 31: Average Total Debt-to-EBITDA Multiples for Highly Leveraged Loans



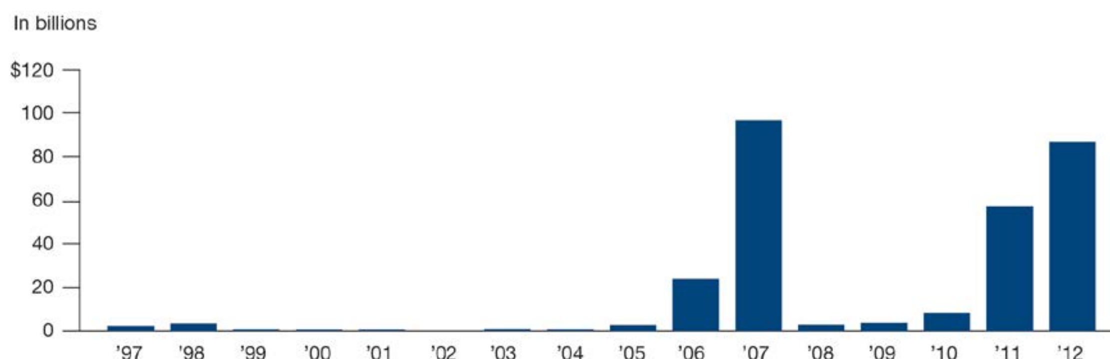
Source: Standard & Poor's LCD. S&P and its third-party providers are not liable for errors or omissions in the information and the context from which it is drawn.

[5] Another Federal Reserve Board survey (E.2 Survey of Terms of Business Lending) corroborates this decline in spreads for loans of all sizes, although for large-denomination C&I loans (over $1 million), spreads remain historically elevated.

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[6] loans increased to the second highest on record through the end of 2012 (see figure 32). Accordingly, the quality of underwriting remains a concern.

Figure 32: New Issuance of Covenant-Lite Leveraged Loans



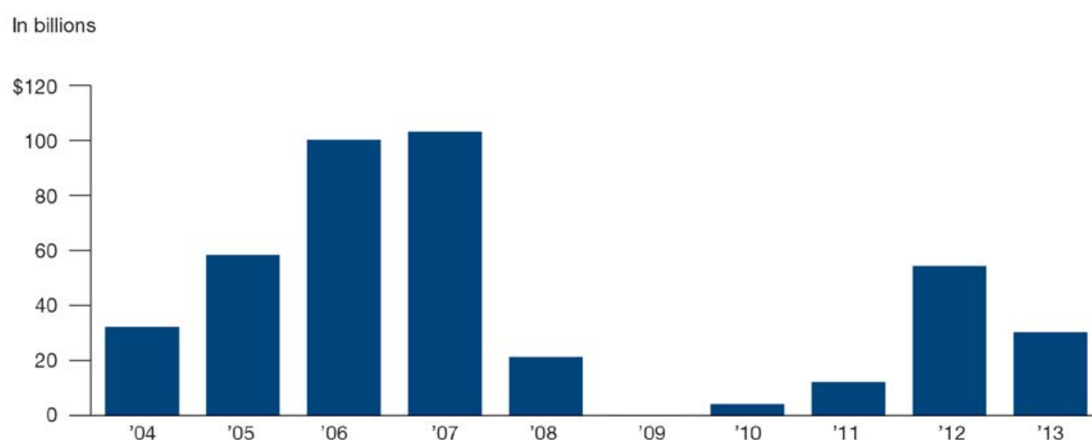
Source: Standard & Poor's LCD. Standard & Poor's and its third-party providers are not liable for errors or omissions in the information and the context from which it is drawn.

Note: Excludes existing tranches of add-ons and amendments and restatements with no new money. Excludes DIP, second liens, and unsecured transactions. These numbers comprise loans denominated in U.S. dollars and are subject to revision as Standard & Poor's LCD collects additional data.

Issuance of Collateralized Loan Obligations Soars in 2012

The demand for high-yield loan-related products such as collateralized loan obligations (CLO) increased dramatically in 2012. CLO issuance surged to the highest level since 2007 (see figure 33). CLOs and other sources of demand for high-yield loans captured more than 80 percent of the primary market for highly leveraged loans in 2012. Heightened investor appetite for greater yield, and the resulting surge in issuance, is likely to continue to produce greater quantities of weakly underwritten loans. The originate-to-distribute model has accommodated the CLO demand for high-yield loans, much as it did before the financial crisis. The associated weakening in underwriting standards and narrowing credit spreads underscore the rising level of credit risk in these products.

Figure 33: CLO Issuance



Source: Credit Suisse.

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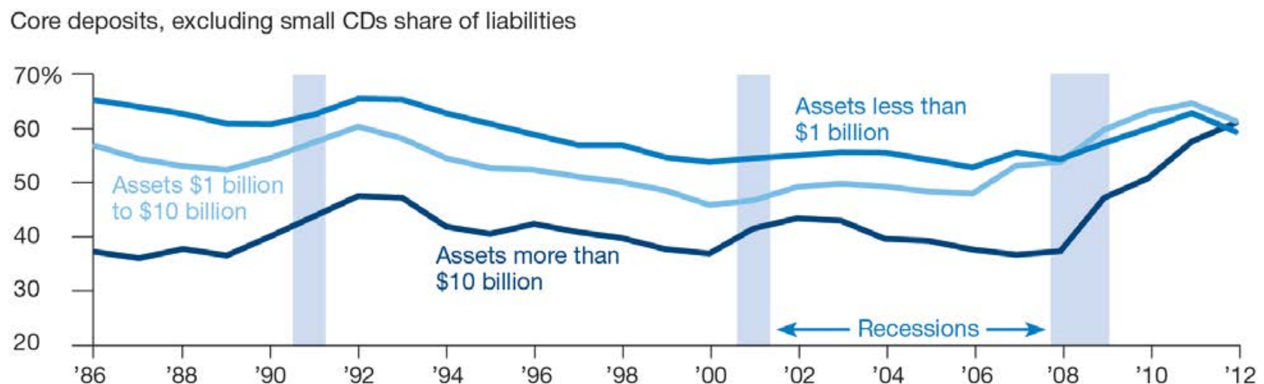
[6] Covenant-lite includes syndicated loans that have no covenants or have limited, bond-like incurrence covenants rather than traditional maintenance covenants.

Part III: Funding, Liquidity, and Interest Rate Risk

Core Deposit Growth Flattens From Peak Levels

Core deposits grew rapidly and reached a record, or near-record, share of liabilities by the end of 2011, depending on bank size. In 2012, however, banks under $10 billion in asset size showed the first decline in core deposit share since the financial crisis. In contrast, the share for the largest banks continued to rise, hitting a new high of 61 percent of liabilities (see figure 34). These large banks were the most affected by liquidity concerns during the financial crisis, and thus likely remain most sensitive to potential disruptions in wholesale funding. As a result, these large banks continue to pursue a greater share of core deposits in their funding mix. Much of the growth in recent years has been in non-maturity deposits, including demand deposits. It is not clear what fraction of these deposits will be retained if interest rates move higher or economic activity increases, making it difficult to include this key behavioral factor in interest rate risk models. Although there was some concern that the year-end expiration of the temporary unlimited deposit insurance provided under the Dodd–Frank Act would result in deposit outflows, especially from smaller institutions, there was limited evidence of this through March 2013. Anticipated and widely publicized tax law changes resulted in unusually volatile household dividend and bonus income flows over the winter months. These in turn resulted in a large up-and-down movement in the growth rate of non-jumbo certificates of deposit at U.S. banks, clouding any underlying trends that might have been caused by the insurance coverage expiration.

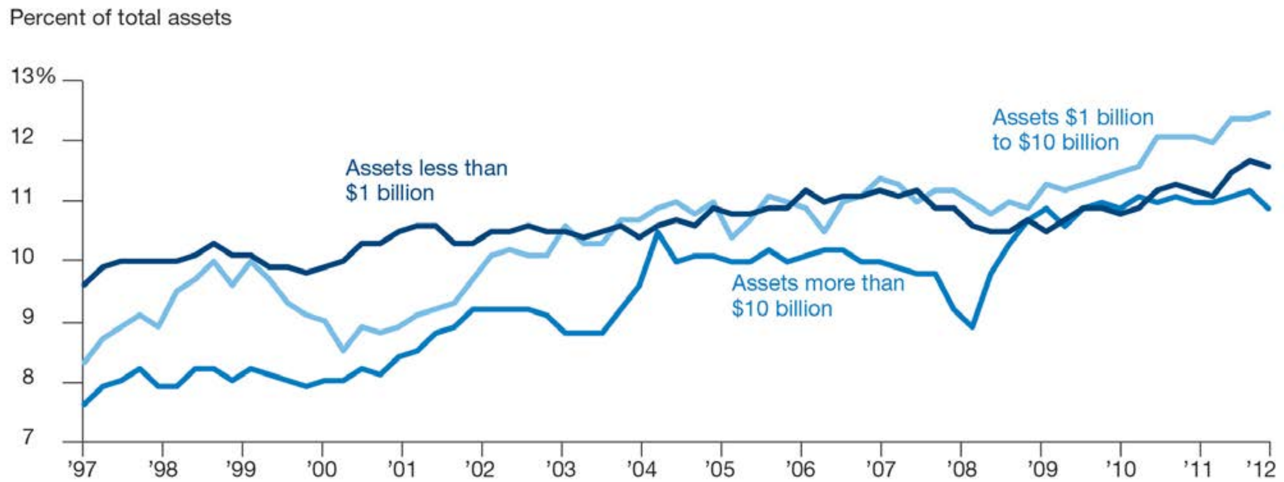
Figure 34: Trends in Core Deposits for Banks



Equity Capital to Total Assets Ratio Remains Near Highs

Banks have increased equity capitalization relative to total assets since the financial crisis (see figure 35). This has occurred across all asset size segments. Banks with more than $10 billion in assets have shown the most significant increase, spurred collectively by the need to rebuild capital lost during the financial crisis, by merger-related asset growth, and by anticipated increases in regulatory requirements. Most size segments were at or near 15-year highs for equity capitalization at the end of 2012. Furthermore, capital quality has strengthened notably in recent years, as more capital is in common equity form.

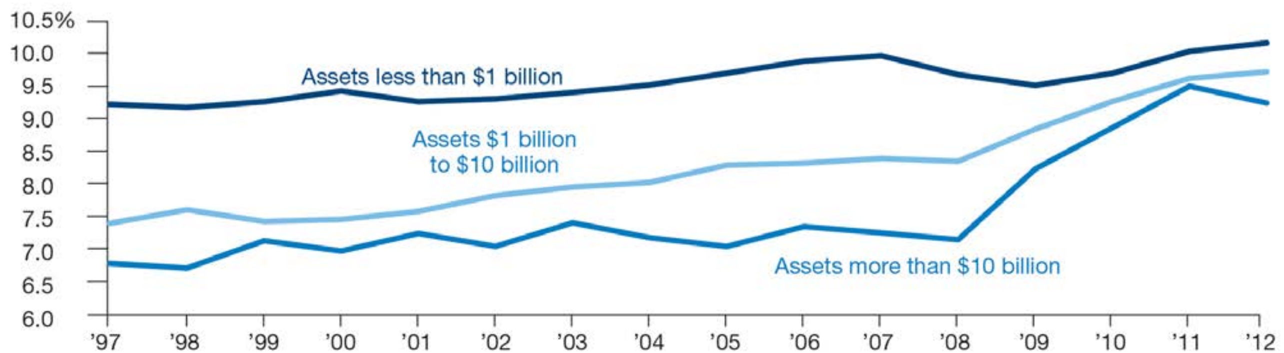
Figure 35: Equity Capital to Total Assets for Banks



Median Tier 1 Leverage Capital Ratio Improves

As measured by the median percentage of tier 1 capital relative to average total assets, the largest banks also have improved substantially from pre-crisis levels (see figure 36).

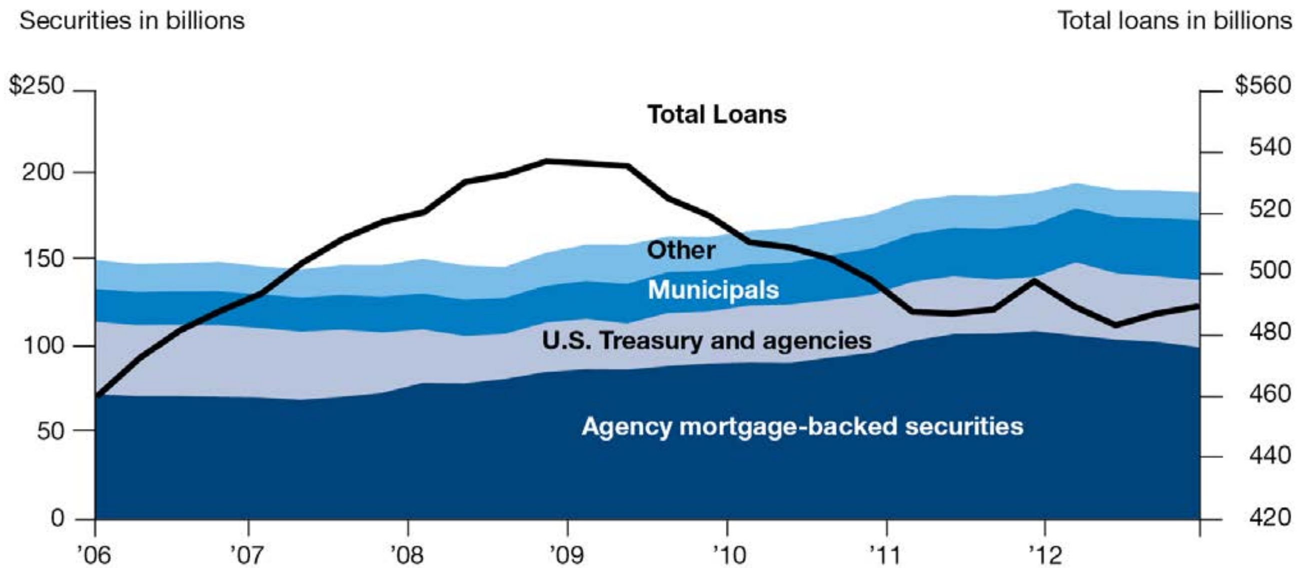
Figure 36: Median Tier 1 Leverage Capital for Banks



Small Banks' Investment Portfolios Concentrated in Mortgage Securities

Banks with assets less than $10 billion have increased their collective investment portfolios since mid-2008 in response to ongoing strong deposit growth and a decline in loan balances. The bulk of the increase in the investment portfolios has been centered in agency-issued mortgage-backed securities (MBS) followed by increases in municipal securities as well as in U.S. Treasury securities and agency securities (see figure 37). Increased holdings of MBS may make some institutions more vulnerable to interest rate risk because of the optionality associated with these instruments.

Figure 37: Investment Portfolio Mix for Banks With Total Assets Less Than $10 Billion



Source: OCC Integrated Banking Information System.

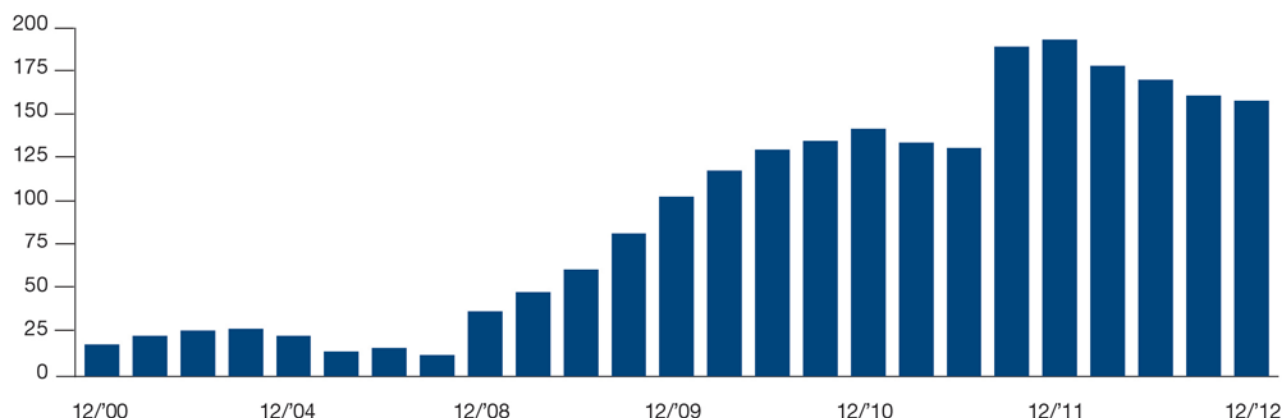
Note: Data are merger-adjusted and held constant for institutions in continuous operation from the first quarter of 2006 to the fourth quarter of 2012.

Part IV: Regulatory Actions

Banks Rated 4 or 5 Continue Declining Trend

The level of OCC-supervised banks rated 4 or 5 declined in 2012 (see figure 38). The decline is mainly attributable to the recapitalization and positive trends in the institutions. The increase in the third quarter of 2011 resulted from the addition of federal savings associations (FSA) to the OCC's supervision on July 21, 2011.

Figure 38: Banks Rated 4 or 5

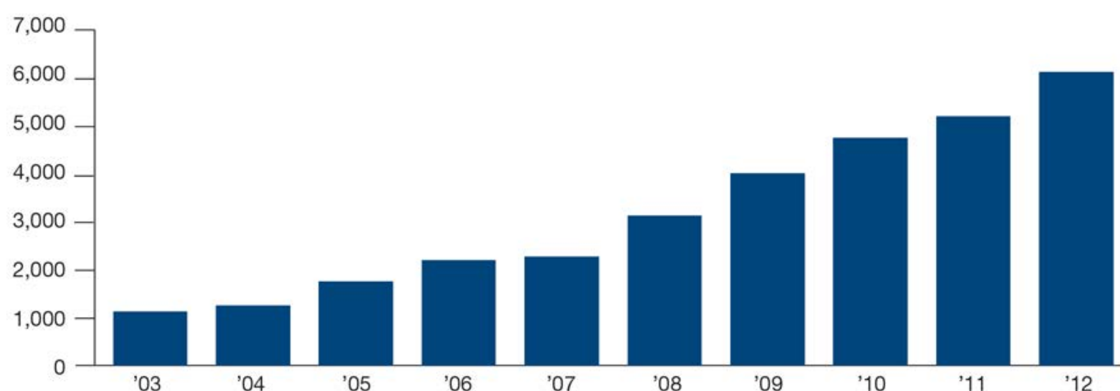


Source: OCC.

Matters Requiring Attention Gradually Decline

The OCC uses matters requiring attention (MRA) in the supervisory process when bank practices deviate from sound risk management principles. Such deviations, if not addressed appropriately, may adversely affect a bank's earnings, capital, risk profile, compliance, or reputation and could lead to formal enforcement action. The number of outstanding MRAs shows an increase in 2012 as the OCC absorbs the addition of 560 federal savings associations (see figure 39). MRAs for federal savings associations are incorporated into the OCC's tracking system as we complete examinations. Notwithstanding the increase in the aggregate, outstanding MRAs at national banks, where we have a complete time series of data, declined in 2011 and 2012. The top five MRA categories for small banks include credit administration (32 percent), compliance (12 percent), management (11 percent), information technology (9 percent), and audit (6 percent). The primary change from 2011 to 2012 is the inclusion of information technology and audit in the top five. For large banks, MRAs are centered in credit-risk-related issues (36 percent), operational risk (16 percent), BSA/AML (14 percent), consumer compliance (10 percent), and internal controls (8 percent). The primary change in the top five categories for large banks is the movement of BSA/AML and internal controls into the top five.

Figure 39: Trend in Outstanding MRAs for Banks

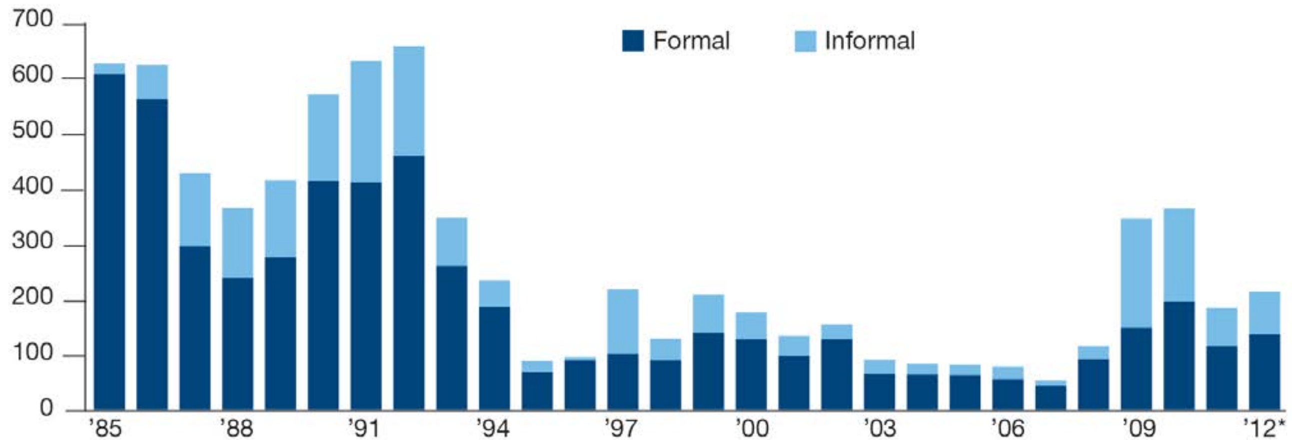


Source: OCC.

Enforcement Actions Against Banks Continue at a Slower Pace 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 during 2012 at a slower pace than in fiscal years 2009 and 2010 (see figure 40). The increase in actions in 2012 is attributed to it being the first full year that includes federal savings associations.

Figure 40: Enforcement Actions Issued Against Banks



Source: OCC.

Note: Includes federal savings associations since July 21, 2011.

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