Office of the
Comptroller of the Currency

Semiannual Risk Perspective

From the National Risk Committee

Office of the Comptroller of the Currency
Washington, D.C.
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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 (collectively, banks) and licenses, regulates, 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, accounting, 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 2015 report reflects bank financial data as of December 31, 2014.

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. Other available sources assess opportunities and discuss the upside potential of those opportunities. This report presents data in four main areas: the operating environment, bank condition, key risk issues, and regulatory actions.

The OCC welcomes feedback on this report by e-mail: NRCReport@occ.treas.gov.

Executive Summary

The financial performance of federally chartered banks was slightly weaker in 2014 compared with 2013 because of lower profitability. Net income for the federal banking system declined 4 percent year over year in 2014 because of lower noninterest income and higher noninterest expenses. Net income for the federal banking system returned to its pre-recession peak of 2006, albeit on $2 trillion more in assets at the end of 2014, reflecting the challenges in the low interest rate environment. Profitability as measured by return on equity declined from almost 10 percent in 2013 to just over 9 percent in 2014. Net interest income rose year over year given continued loan growth at small and large banks, but the increase was not enough to mitigate the decline in noninterest income. Small banks—those with total assets less than $1 billion—posted strong net income growth in 2014, which continues to outperform that of larger banks. Commercial loan growth remained strong, with growth centered in multifamily commercial real estate (CRE), commercial and industrial (C&I) loans, and loans to nondepository institutions.

Strategic, cybersecurity, compliance, underwriting, and interest rate risks remain top supervisory concerns for the OCC. While traditionally lagging asset quality metrics continue to improve, the OCC is seeing evidence of increasing credit risk within the banking sector. Examiners have observed weak underwriting standards for syndicated leveraged loans, as well as loosening of standards and increased layering of risk in other types of loan products, such as indirect auto lending, asset-based lending (ABL), CRE lending, and C&I lending. Recent examinations of commercial loan portfolios have identified increases in policy and underwriting exceptions, including examples of risk layering (e.g., increasing collateral advance rates, waiving or loosening guarantees, and more liberal repayment terms, such as extended periods of interest-only payments). Bankers continue to express concerns about the effects that intensified competition with other regulated financial institutions and nonbank financial firms are having on underwriting standards. Because of these trends, the OCC continues to focus on underwriting standards and encourages banks to assess their credit risk appetite as they manage their loan portfolios through this stage of the credit cycle.

Comptroller of the Currency Thomas J. Curry listed cybersecurity as a top priority in recognition of the growing risk to the industry in the OCC's *Annual Report Fiscal Year 2014*. Attackers are customizing malware to target banks and bank customers, and the methods of attack are evolving in response to banks' mitigating controls. These attacks allow the perpetrators to compromise customer, employee, or third-party credentials, which the perpetrators then use to steal an institution's data or disrupt the payment system. Attackers have identified and exploited vulnerabilities in widely used information technology (IT) products for all sizes of banks. In addition, the severity of compromises to business systems has increased at foreign financial institutions and U.S.-based nonfinancial companies, resulting in the loss of intellectual property and confidential data, as well as making systems inoperable. Given the risk of cyber threats, the OCC, along with other members of the Federal Financial Institutions Examination Council, have worked to raise awareness of threats to cybersecurity and steps banks can take to mitigate those risks.[1] Other supervisory efforts include increased focus on cybersecurity at third-party technology service providers.

The OCC's NRC is monitoring several risk issues that warrant awareness among bankers and examiners. These risks have the potential to develop into broader systemic issues and may already raise concern at individual institutions. The risks include

[1] See http://www.ffiec.gov/cybersecurity.htm for more information on actions taken by the FFIEC regarding cybersecurity.

- exposure to oil- and gas-related industries (e.g., service, office, and hotel sectors) as well as direct exposure to producers. The significant decline in oil prices in 2014 could put pressure on loan portfolios in the oil and gas production and services sector and on areas of the United States that are heavily dependent on this type of economic activity.
- increasing CRE concentrations coupled with easing of underwriting standards.
- weak real estate valuation processes.
- exposure to nonbank mortgage servicer companies.
- allowance for loan and lease loss (ALLL) adequacy.
- compliance with the new integrated mortgage disclosure requirements that become effective on August 1, 2015.

Key Risk Themes

Competitive pressures, the search for revenue growth, and the ongoing low interest rate environment continue to challenge bank risk management and influence risk appetite.

- Growth and earnings pressures are causing banks to reevaluate their credit risk tolerances, and many banks are changing their underwriting standards and granting more policy exceptions to bolster their competitive position.
- Competition is resulting in eased underwriting standards across a variety of credit products. Weakening standards are particularly evident in indirect auto and leveraged lending; some easing in underwriting and increased risk layering, however, are also occurring in other types of commercial loans, such as C&I, ABL, and CRE. Examinations, the OCC's *Survey of Credit Underwriting Practices*, and the Board of Governors of the Federal Reserve System's "Senior Loan Officer Opinion Survey on Bank Lending Practices" underscore these findings.
- The prolonged low interest rate environment continues to lay the foundation for future vulnerability. Some banks have reached for yield to boost interest income with decreasing regard for interest rate or credit risk. Banks that extend asset maturities to pick up yield could face significant earnings pressure and capital erosion, depending on the severity and timing of interest rate moves.
- The complexity of interest rate risk (IRR) management has been compounded by sustained post-crisis bank deposit inflows and shifts in deposit mix, resulting in a considerable amount of funding at historically low rates. Understanding the future behavior of these depositors, including the potential effect on liquidity, is a key component of the IRR modeling process.[2]
- Market participants are increasingly expressing concerns about diminished liquidity in the securities markets. Participants frequently cite the decline in dealer inventories, crowded trades, the increasing trend in electronic trading, and momentum traders as key contributing factors. Market depth issues could exacerbate liquidity concerns during a stress event that causes excessive volatility.
- The low interest rate environment also encourages asset managers to reach for yield on behalf of their clients. While some asset managers have sought yield through direct investments in alternative and structured products, others have obtained yield through increasing clients' holdings of fixed-income assets with increased duration, credit, and liquidity risk exposures. This scenario raises potential compliance and reputation risks, particularly if a bank fiduciary fails to act in a client's best interest in managing investment risks. Similar concerns exist with bank retail

[2] OCC Bulletin 2010-1, "Interagency Advisory on Interest Rate Risk Management" (January 8, 2010), reminds institutions of supervisory expectations regarding sound practices for managing IRR.

nondeposit investment sales programs that involve broker-dealers selling products with increased risk exposures through the bank distribution channel.

Strategic risk remains high for many banks as management teams search for sustainable ways to generate target rates of return or struggle to implement their strategic plans.

- Many banks continue to reevaluate their business models, deployment of capital, and risk appetites given the challenging operating environment. Some banks are taking on additional risks by expanding into new, less familiar, or higher-risk products without adequate due diligence or appropriate risk management and controls.
- Some banks are lowering overhead expenses by reducing control functions, exiting less profitable businesses, closing offices, and outsourcing critical control functions to third parties without establishing appropriate risk management processes.[3]
- Banks continue to face competitive pressure from nonbank firms expanding into traditional banking activities.
- As part of their strategy to deal with competitive pressures and to lower overhead expenses, banks are leveraging technology such as cloud computing and mobile banking, which can increase exposure to technological and operational risk.
- Management succession planning, attracting appropriate expertise, and retaining key experienced personnel are growing issues for many banks, particularly in the areas of credit, Bank Secrecy Act and anti-money laundering (BSA/AML), compliance management, enterprise risk management, and internal audit.
- Strategic planning is a challenge for many community banks given the current operating environment.

Operational risk is high as banks adapt business models, transform technology and operating processes, and respond to increasing cyber threats.

- Business models are under increasing pressure as bankers seek to launch new products, leverage technology, increase reliance on technology and automated controls, reduce staffing, outsource critical activities, and re-engineer business processes.
- Banks may not incorporate resiliency considerations, including recovery from cyber events, into their overall governance, risk management, or strategic planning processes, increasing their vulnerability.
- Banks and their employees, customers, and third-party service providers continue to be vulnerable to cyber attacks that can compromise data or systems or allow criminals to illegally obtain personally identifiable information.
- The number, nature, and complexity of domestic and foreign third-party relationships continue to expand, increasing complexity, concentration, and risk management challenges.
- Banks are not always adapting risk management and control processes to their changing business strategies or roles, e.g., as agents between consumers and merchants.
- While banks are increasingly using central counterparties (CCP), or central clearing houses, to reduce counterparty exposures and settlement risks, CCP memberships can expose banks to increased concentration, credit, and legal risks. In the case of foreign CCP membership, additional risks may be introduced from jurisdictional differences in rules, requirements, and authorities.

[3] OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance” (October 30, 2013), provides guidance to banks for assessing and managing risks associated with third-party relationships.

Compliance risk remains high as banks (1) manage BSA/AML risk and (2) must implement significant changes to policies and procedures to comply with new mortgage lending requirements.

- BSA/AML risks remain high, as technological developments that benefit customers through enhanced products and greater access to financial services are vulnerable to criminals who continue to exploit such innovations. BSA programs at some banks have failed to develop or incorporate appropriate controls as products and services have evolved, and insufficient resources and expertise have been devoted to BSA/AML in some banks.
- As BSA/AML risks continue to increase, banks must properly manage risks associated with customers with higher BSA/AML risk and their transactions by assessing customers on a case-by-case basis and instituting commensurate controls.
- The use of third parties to conduct all or a portion of consumer credit-related product development, implementation, and fulfillment can substantially increase the risk of unfair or deceptive practices. In recent years, a number of banks that failed to exercise adequate risk management and controls when developing and offering various add-on products to customers have been the subject of OCC enforcement actions, including the imposition of civil money penalties, for engaging in a range of activities that violated section 5 of the Federal Trade Commission Act.
- Fair lending risk also may increase when banks engage a third party to conduct all or a portion of the application or underwriting processes or make decisions regarding terms or pricing.
- The integrated mortgage disclosure requirements, which will apply to loan applications for most closed-end consumer credit transactions secured by real property received on or after October 1, 2015, are expected to pose significant operational and compliance challenges for some banks. In implementing the new disclosure requirements in regulations Z and X, compliance risk management should include, as necessary, revisions to policies and processes, technological changes, training, testing, and effective third-party risk management.

OCC Risk Perspective: Outlook by OCC Business Line

Large Banks

Overall, the large banks supervised by the OCC are in sound financial condition, with continued positive trends in traditional asset quality metrics, liquidity, and capital. Earnings and management, however, remain challenged. Risk management weaknesses predominantly associated with operations, BSA/AML, compliance, internal controls, and credit are driving concerns in matters requiring attention (MRA) and enforcement actions (EA).

Key risks facing large banks include

- weaknesses and gaps within governance and enterprise risk management practices to fully align with heightened standards.
- a high level of operational risk across a spectrum of activities.
- an increasing volume and sophistication of cyber threats and IT vulnerabilities.
- elevated consumer compliance risks.
- elevated BSA/AML risk.
- use of third-party providers without appropriate oversight and controls to monitor risks within those relationships.

- erosion of underwriting standards because of competitive pressures, particularly in leveraged lending, indirect auto, and commercial loans.
- high volumes and frequency of changes to information systems to address regulatory requirements, enhance risk monitoring reporting, and update compliance systems.

Community and Midsize Banks

The overall financial condition of community and midsize banks supervised by the OCC continues to improve, as reflected in continued positive trends in traditional asset quality indicators. The earnings outlook for community and midsize banks, however, is less uniform. While overall earnings are improving because of loan growth and reduced credit expenses, pressures persist at many banks because of acute competition for quality lending opportunities and declining investment yields.

Key risks facing community and midsize banks include

- high strategic risk as banks adapt their business models to respond to sluggish economic growth, low interest rates, and intense competitive pressures.
- management succession and retention of key staff.
- erosion of underwriting standards in various loan products.
- potential exposure to oil- and gas-related industries (e.g., service, office, and hotel sectors) as well as direct exposures to producers, given the precipitous drop in oil prices.
- expansion into new products and services that require specialized risk management processes and skills, such as participations in syndicated leveraged loans.
- increasing reliance on third parties to perform operational and business functions.
- increasing volume and sophistication of cyber threats.
- increasing BSA/AML risk because controls have not kept pace with higher-risk services and customer relationships, particularly in community banks.
- increasing exposure to IRR from banks with concentrations in longer-term assets, including mortgage-backed securities (MBS) and loans, and uncertainties about the potential runoff of nonmaturity deposits once interest rates increase.

OCC Supervisory Priorities for the Next 12 Months

The OCC's supervision and policy priorities are based on key risks. Key priorities are summarized below.

Large Bank Supervision

The OCC develops and executes an individually approved supervisory strategy for each large bank that prioritize risks and addresses the OCC's supervisory objectives. The top priorities for the next 12 months include the following:

- **Governance and oversight:** OCC supervisory staff will review business model and strategy changes, bank governance, and risk management practices, with a focus on identifying substantive gaps in relation to the guidelines for heightened standards.[4] Examiners will assess whether the bank

[4] OCC Bulletin 2014-45, "Heightened Standards for Large Banks; Integration of 12 CFR 30 and 12 CFR 170" (September 25, 2014), issued enforceable guidelines that establish minimum standards for the design and implementation of a risk

has clearly documented and communicated gaps and that management has committed to appropriate time frames to close them.

- **Credit underwriting:** OCC supervisory staff will focus on commercial and retail credit underwriting practices, especially for leveraged loans and indirect auto loans. This focus will include completion of the annual interagency Shared National Credit (SNC) review. Examiners will also continue to review banks' efforts to mitigate home equity line of credit (HELOC) end-of-draw (EOD) risk.[5]
- **Compliance:** OCC supervisory staff will coordinate with the Consumer Financial Protection Bureau to determine compliance with consumer laws, regulations, and guidance. Examiners will continue to assess compliance with the Flood Protection Act of 1973 and the Servicemembers Civil Relief Act of 2003 and focus on the adequacy of enterprise-wide compliance risk management. OCC staff will also assess banks' effectiveness in identifying and responding to applicable risks posed by new products and services or terms.
- **Cyber threats:** OCC supervisory staff will review banks' programs for assessing and mitigating the evolving threat environment and cyber resilience. These reviews will include assessments of data and network protection practices, business continuity practices, risks from vendors, and compliance with any new guidance.
- **Operational risk:** OCC supervisory staff will focus primarily on model risk management, third-party risk management, and change management processes.
- **BSA/AML:** Bank BSA/AML programs and controls should continually evolve to address changing customer profiles, advanced money laundering schemes, the rapid pace of technological change, and the overall risk that money laundering and terrorist financing activities create. OCC supervisory staff will assess bank management's efforts to maintain an effective, well-staffed program.
- **Fair access:** OCC supervisory staff will continue to assess banks' efforts to meet the needs of creditworthy borrowers and monitor banks' compliance with the Community Reinvestment Act (CRA), fair lending laws, and other consumer protection laws.
- **MRAs and EAs:** OCC supervisory staff will continue to focus on timely corrective action on outstanding concerns addressed in MRAs and EAs and will communicate clearly any additional actions needed to fully remediate an identified deficiency.
- **IRR:** OCC supervisory staff will focus on interest rate risk measurement processes to ensure that management properly assesses banks' vulnerability to changes in interest rates and implements measurement tools to monitor and control this risk. Emphasis will be on the banks' ability to accurately assess nonmaturity deposit changes under varying model scenarios.

Community and Midsize Bank Supervision

The OCC will develop and execute supervisory strategies for each community and midsize bank that prioritize risks and address the agency's supervisory objectives. The top priorities for the next 12 months include the following:

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governance framework for large insured national banks, insured federal savings associations, and insured federal branches of foreign banks.

[5] OCC Bulletin 2014-29, "Risk Management of Home Equity Lines of Credit Approaching the End-of-Draw Periods" (July 1, 2014).

- **Governance and oversight:** OCC supervisory staff will assess business model and strategic plan changes and reinforce the importance of sound corporate governance calibrated to the size and complexity of each bank. Examiners will focus on determining the adequacy of strategic, capital, and succession planning and execution in light of risks in new products or services. If applicable, examiners will assess the bank's merger and acquisition processes and procedures.
- **Credit underwriting:** OCC supervisory staff will evaluate the underwriting practices of new or renewed loans in banks' loan portfolios for easing in structure and terms. These reviews will focus on new products, areas of highest growth, or portfolios that represent concentrations. Reviews may also include an assessment of the banks' efforts to mitigate HELOC EOD risk, as appropriate. Where indicated, examiners will also assess banks' actions to assess, monitor, and manage both direct and indirect exposures to the oil and gas sector, given the recent decline in oil prices and the potential for a protracted period of low or volatile prices.
- **Cyber threats:** OCC supervisory staff will review banks' cyber resilience and programs for assessing and mitigating the evolving threat environment. This review will include assessing the risks associated with vendors.
- **Operational risk:** OCC supervisory staff will focus on information security and data protection, model risk management, and third-party risk management. This focus includes assessing each bank management's plans to respond to increasing operational risk through the introduction of new or revised business products, processes, delivery channels, or third-party providers.
- **BSA/AML:** OCC supervisory staff will review BSA/AML programs and controls to assess effectiveness in addressing changing customer profiles, advancing money laundering schemes, the rapid pace of technological change, and the overall risk that money laundering and terrorist financing activities create. This work will include a review of bank management's efforts to maintain an effective, well-staffed program.
- **Compliance:** OCC supervisory staff will focus on assessing banks' effectiveness in identifying and responding to applicable risks posed by new regulations, products, services, or terms.
- **IRR:** OCC supervisory staff will focus on banks' management of IRR, including banks' ability to accurately identify and quantify IRR in assets and liabilities under varying model scenarios. This work will also include an assessment of the level of IRR that bank management is willing to take.
- **Fair access:** OCC supervisory staff will continue to assess banks' efforts to meet the needs of creditworthy borrowers and monitor banks' compliance with the CRA, fair lending laws, and other consumer protection laws.
- **MRAs and EAs:** OCC supervisory staff will continue to focus on timely corrective action on outstanding concerns in MRAs and EAs. Examiners-in-charge will communicate clearly any additional actions needed to fully remediate an identified deficiency.

Supervisory Policies and Processes

The OCC will continue its efforts to improve the effectiveness and efficiency of bank supervision activities. Priorities include the following:

- Anticipating, assessing, and addressing emerging risks by working through the OCC's NRC and on an interagency basis.
- Continuing to implement the work plans established to address the findings and recommendations of the international peer review team.[6]

[6] See OCC News Release 2014-75, "OCC Announces Actions to Respond to International Peer Review Recommendations" (May 28, 2014).

- Collaborating with other regulators to enhance the effectiveness and efficiency of all supervisory strategies and activities.
- Prioritizing the resources necessary to develop and implement new or updated guidance. Staff will incorporate front-line supervision’s perspectives on key supervisory initiatives, rulemakings, and guidance to strengthen the flow of information to the NRC from business-line risk and technical groups.
- Enhancing analytical tools for the agency on bank performance and compliance with new regulatory requirements.
- Identifying opportunities to supplement supervisory activities with technical assistance, resource materials, comparative data, and tools that provide added benefit to all banks.
- Conducting outreach sessions with the industry and other appropriate parties to present OCC perspectives on emerging issues, explain new policies and regulations, clarify supervisory expectations, and provide bankers with the opportunity to discuss their concerns with regulators and peers.

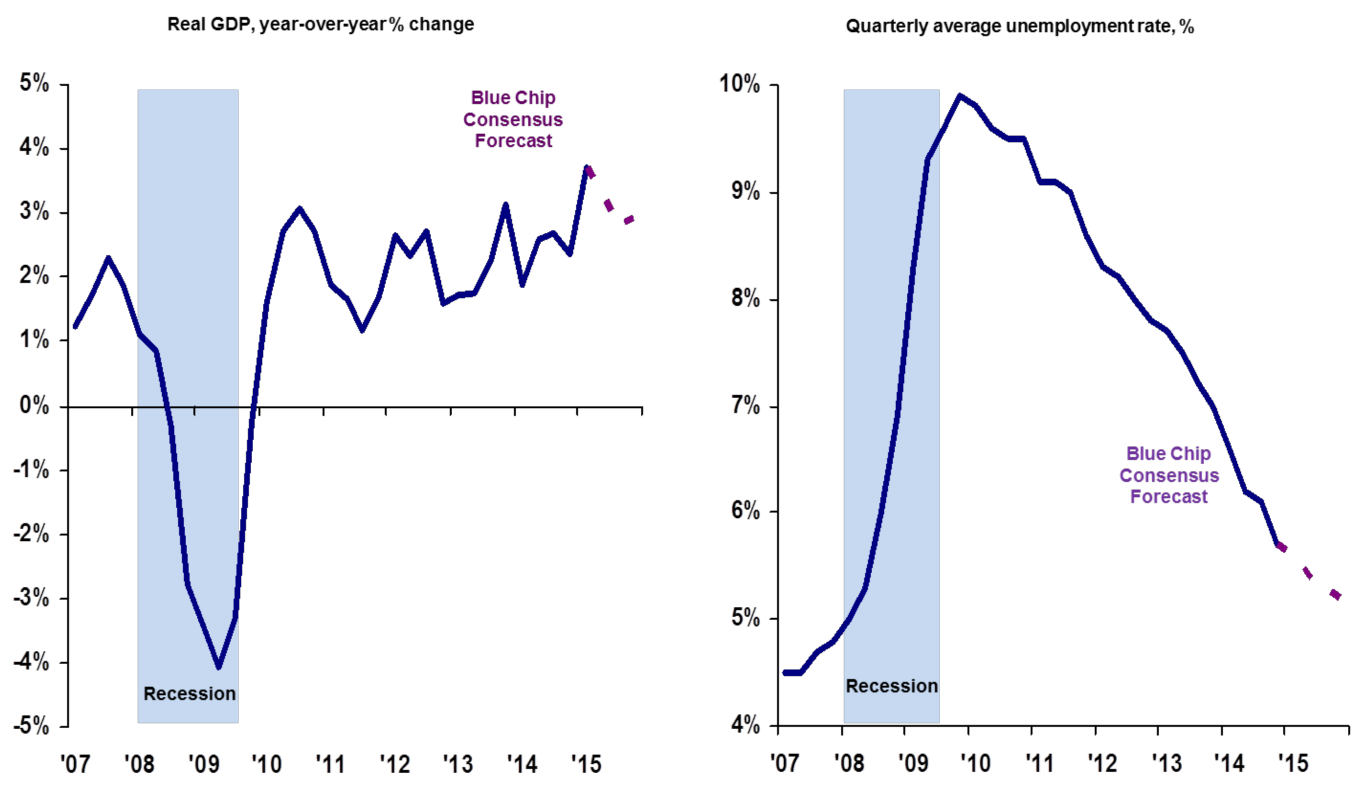
Part I: Operating Environment

Economic fundamentals improved in 2014. The economy added more than 3 million new jobs in 2014, in all industries, pay grades, and regions. With layoffs near record lows and job openings surging, most analysts expect similar job gains in 2015. This would bring the economy back near the levels last reached 10 years ago. One source of job growth has been the housing sector, which recorded 1 million home starts in 2014, with more expected in 2015. Some signs of weakness linger in labor markets. Real wages are not yet growing, and the share of long-term unemployed remains well above average. Risks to the generally positive U.S. economy include geopolitical risks and slumps in investment and regional real estate prices due to sustained low oil prices.

U.S. Economic Growth Still Constraining Labor Market Improvement

Real gross domestic product (GDP) increased 2.4 percent in the fourth quarter of 2014 from the fourth quarter of 2013 (see figure 1). The unemployment rate continued to improve, partly because of a declining labor force. The consensus of private sector forecasters is for economic growth to gradually strengthen but remain restrained by sluggish growth (and a potential recession) in Europe, the possibility of an abrupt slowdown in emerging markets (especially China), and uncertainty regarding the pace and intensity of U.S. monetary policy tightening.

Figure 1: GDP and Unemployment Trends

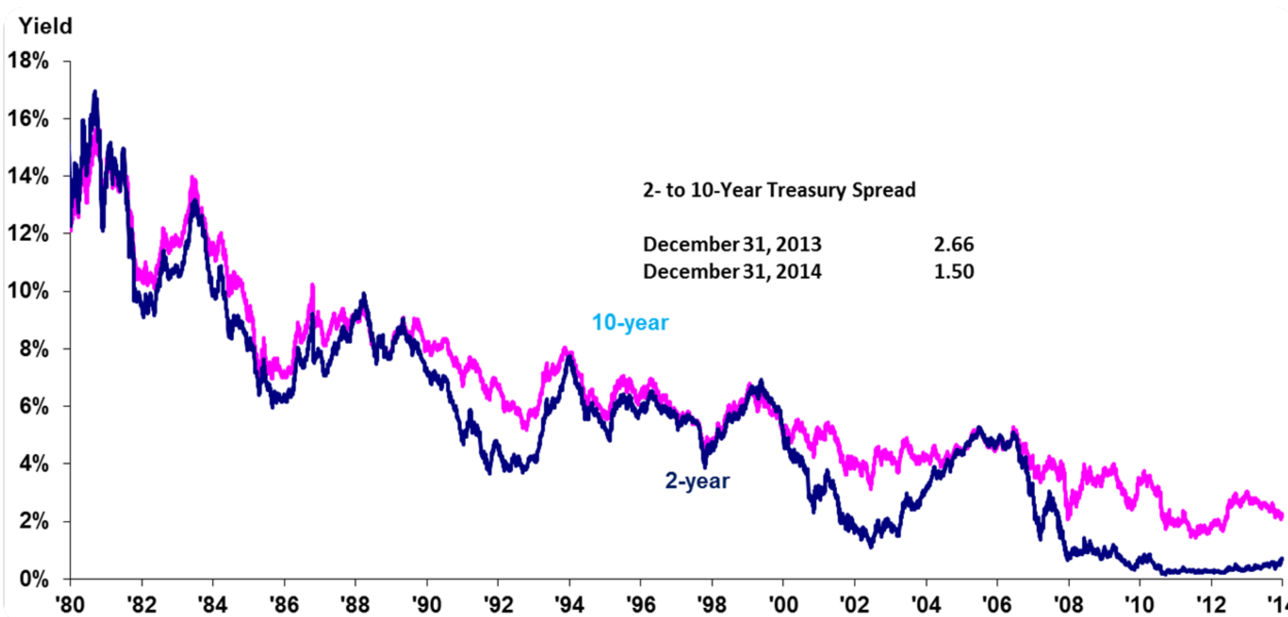


Sources: Bureau of Economic Analysis, Bureau of Labor Statistics/Haver Analytics, Blue Chip Indicators (March 2015)

Treasury Yields Remain Historically Low

Treasury yields remain at or near historical lows. The slope of the yield curve flattened in 2014 as the spread between 2-year and 10-year U.S. Treasury notes contracted from 266 basis points (bps) at the end of 2013 to 150 bps as of December 31, 2014 (see figure 2). The yield curve remains steep by historical standards. This relative steepness bodes well for bank loan growth and asset yields, since an upward-sloping yield curve typically signals market expectations for continued economic growth and a potentially higher level of interest rates. Bank investment portfolios with concentrations of long-duration, low-rate, fixed-yield assets, however, could see significant erosion of value once interest rates start to rise. Increased debt service costs for borrowers are another potential risk from rising interest rates. This risk is particularly acute for borrowers with recession-weakened revenues or incomes and high leverage who meet debt obligations only because of the low interest rate climate.

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



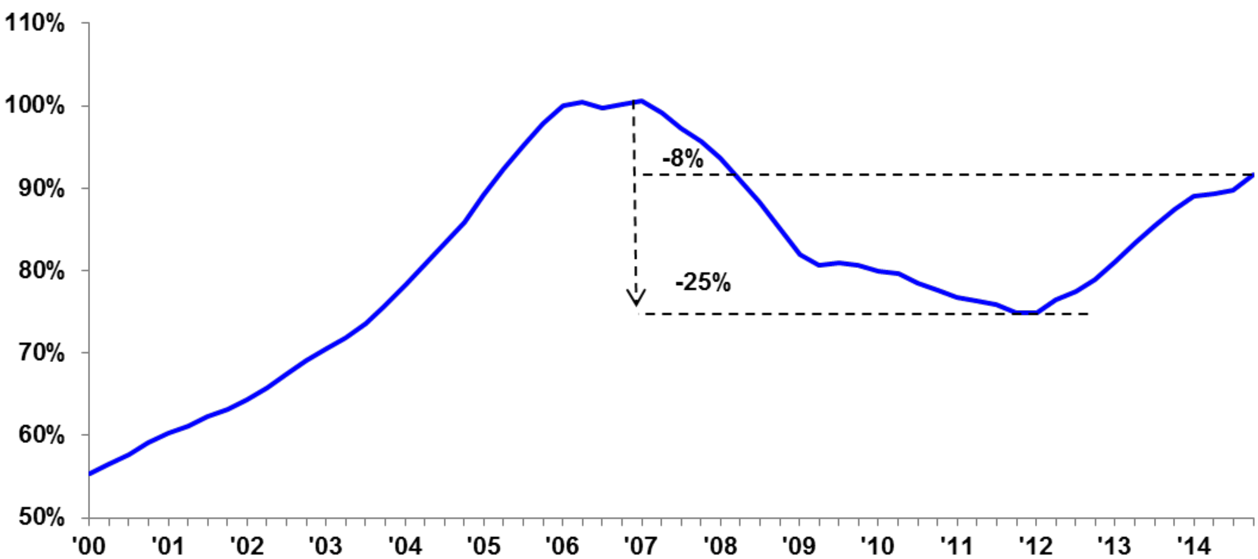
Source: Federal Reserve Board
Note: Treasury yield curve estimates, coupon equivalent par-yields. Data as of December 31, 2014.

Housing Markets Slowly Improving

The housing market continued to improve through 2014, albeit at a slower pace than in 2013. While still 8 percent below 2006 peak levels, Standard & Poor's (S&P) Case-Shiller repeat-sales data showed home prices up 7 percent year over year in 2014 (see figure 3). Nationally, mortgage performance improved for the 10th consecutive quarter, as delinquency rates and foreclosures declined further. The percentage of mortgages that were seriously delinquent declined to 3.1 percent from 3.5 percent a year earlier (see table 1). The percentage of foreclosures in process also continued to decline, dropping from 2.1 percent of loans outstanding in the fourth quarter of 2013 to 1.4 percent in the fourth quarter of 2014. Most remaining distressed housing inventory (and thus future potential foreclosure risk) is increasingly concentrated in states with judicial foreclosure requirements.

Figure 3: S&P/Case-Shiller U.S. National Home Price Index

Seasonally adjusted, 2006Q1 = 100



Source: S&P

Table 1: Mortgage Portfolio Performance

Percentage of mortgages in the portfolio							
	12/31/13	3/31/14	6/30/14	9/30/14	12/31/14	1Q %Change	1Y %Change
Current and Performing	91.8%	93.1%	92.9%	93.0%	93.2%	0.2%	1.5%
30–59 Days delinquent	2.6%	2.1%	2.4%	2.4%	2.4%	-2.3%	-9.4%
The following three categories are classified as seriously delinquent							
60–89 Days delinquent	1.0%	0.7%	0.8%	0.9%	0.9%	-0.3%	-10.2%
90 or More days delinquent	1.7%	1.6%	1.5%	1.5%	1.5%	0.6%	-11.2%
Bankruptcy 30 or more days delinquent	0.8%	0.8%	0.8%	0.7%	0.7%	-4.7%	-16.6%
Subtotal for seriously delinquent	**3.5%**	**3.1%**	**3.1%**	**3.1%**	**3.1%**	**-0.9%**	**-12.2%**
Foreclosures in process	2.1%	1.8%	1.6%	1.5%	1.4%	-9.0%	-35.0%

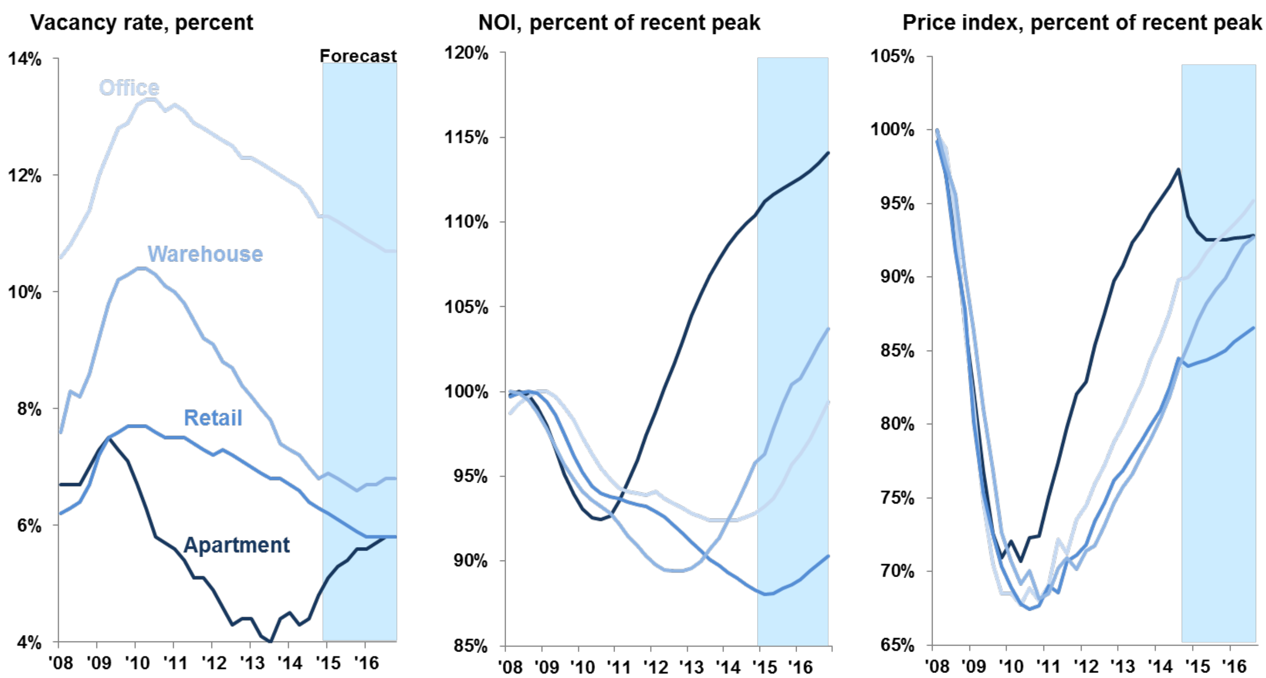
Source: *OCC Mortgage Metrics Report* for the Fourth Quarter of 2014.

CRE Outlook Is Mixed

CRE market fundamentals have been improving for several years. Vacancy rates for office and retail properties are expected to continue to decline toward pre-recession levels over the next few years because of limited new construction and a growing economy. The recent improvement in warehouse vacancy rates may soon stabilize as more supply becomes available. Vacancies in the booming apartment market may rise further from their 2013 lows but are expected to stay below their 2009 recession peak (see figure 4). Apartment vacancies returned to pre-recession levels before other property types, bottoming in 2013 largely because a decline in homeownership increased apartment demand. Accordingly, indices of apartment net operating income (NOI) are already above their previous peak and are expected to grow as rents increase further. A significant increase in apartment construction in some markets may cause vacancy rates to increase, slowing the pace of growth in rental rates. Apartment prices may even fall in some markets where heavy construction is causing NOI growth to slow.

Given expectations for stronger economic growth over the near term, most forecasts call for continued slow improvement in CRE market fundamentals. Low interest rates and attractive returns relative to investment alternatives have allowed CRE prices to increase, especially in major markets that attract foreign investors. Forecasters, however, expect less growth in commercial property values over the next two years, since higher interest rates will partly offset the impact from strengthening property lease fundamentals.

Figure 4: CRE Vacancy Rates

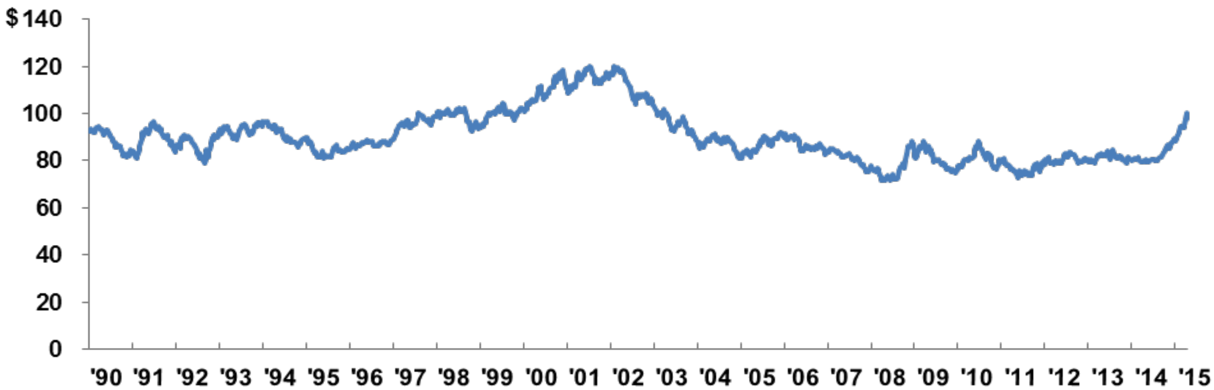


Source: CoStar Group (formerly PPR); 4Q 2014 baseline forecast for 54 Tier 1 markets.

U.S. Dollar Surges

The U.S. dollar appreciated during the past year because of stronger economic performance in the United States and expectations of rising short-term U.S. interest rates. The Bloomberg U.S. Dollar Spot Index rose almost 24 percent from June 2014 through March 2015 (see figure 5). The appreciation of the U.S. dollar may pose an additional challenge to U.S. companies' ability to hedge risk and compete in export markets.

Figure 5: Trend in Bloomberg U.S. Dollar Spot Index

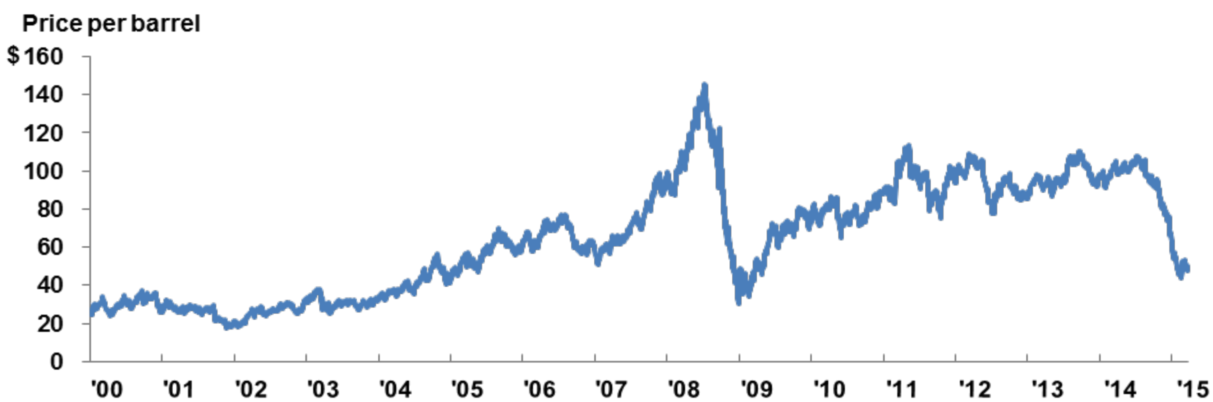


Source: Bloomberg
The Bloomberg Dollar Spot Index tracks the performance of a basket of leading global currencies versus the U.S. dollar.

Sharp Decline in Oil Prices Raises Potential for Correlated Effects

The West Texas Intermediate crude oil price declined by more than 50 percent from June 2014 to the first quarter of 2015, as increased production from the United States and OPEC nations coincided with weaker global demand (see figure 6). The oil price decline does not represent a systemic supervisory concern from direct exposures at this time, but the OCC is monitoring the effects. The duration of the price decline, degree of leverage at oil and gas production companies, and the expense and sophistication of each company's production operations will determine the severity of the impact on local economies. The potential spillover effects could be greatest in residential and nonresidential construction, retail and wholesale trade, accommodation and food services, and local governments (through declining tax revenue). Colorado, Louisiana, North Dakota, Oklahoma, Pennsylvania, Texas, and Wyoming previously thrived from oil exploration and development activities and are likely to be the states most affected if companies pull back, cancel significant projects, or lay off employees.

Figure 6: Trends in the Price of West Texas Intermediate Crude Oil



Source: Bloomberg

Market Liquidity and Depth

One measure of market liquidity is the size of the bid/offer spread, as well as the depth or number of participants. Liquid markets have tight bid/offer spreads and good depth, implying that the cost of entering and exiting transactions is low and that large transactions can occur without resulting in severe price dislocations. Illiquid markets with poor depth exhibit the opposite pattern: Bid/offer spreads are wide, and even relatively small transactions can move the market. Two recent examples have focused interest on market liquidity and depth:

- On October 15, 2014, 10-year U.S. Treasury note yields fell by 33 bps in less than two hours ("flash rally")—an extraordinary six-standard-deviation move that should happen only once in roughly 500 million days—only to reverse the majority of that move by the close of trading. The fact that the overall change in yield for the day was limited may suggest fundamental factors such as market moving economic news did not play a material role in explaining the huge intra-day yield swing.
- On January 15, 2015, the Swiss National Bank announced it would no longer hold the Swiss franc at a fixed exchange rate with the euro, triggering a nearly 30 percent intra-day rally by the Swiss franc against the euro. Many market participants contend that the intra-day move exceeded what could be justified on fundamental grounds. Some dealers indicated that they were unable to hedge their Swiss franc positions because of a lack of liquidity, increasing their market losses.

Market depth is a particularly critical attribute during times of turmoil. Uncertainty around market depth casts doubt over an investor's ability to liquidate a large position at prices that reflect fundamental values. The decline in corporate bond inventories at major dealers since the end of the financial crisis underscores the concerns regarding market depth (see figure 7). Market participants suggest that the following structural and other factors are contributing to an increasing concern about market depth:

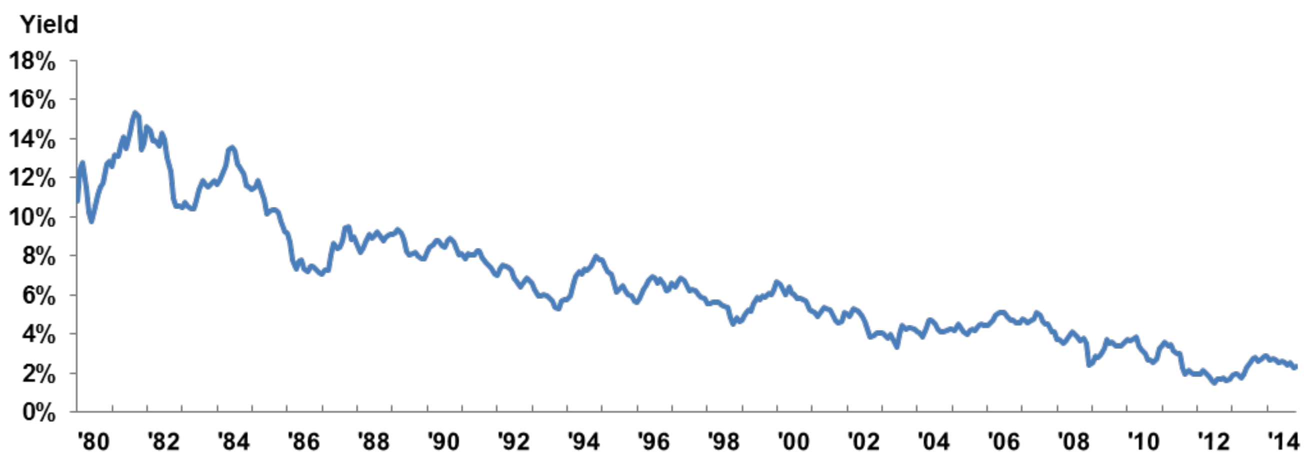
- Crowded trades in financial instruments, where investors have chased yields in both emerging and developed market corporate obligations, given the low interest rate and low volatility environments resulting from central bank quantitative easing.
- The increasing importance of electronic trading, where algorithms may not handle large order imbalances effectively.
- A generation of investors who trade based on price momentum, regarding it as a fundamental rather than a technical factor.
- More limited risk appetite by market makers, due to enhanced regulatory capital and liquidity requirements and other changes that may limit the size of dealer inventories.

Figure 7: Trends in Primary Dealer Inventories

Source: Federal Reserve Bank of New York

Fixed-income investors have generally had an uninterrupted bull market for more than 30 years (see figure 8). Very few market participants who trade interest rates have seen a bear market in bonds, raising questions about market dynamics when a bear market ultimately does return. The market depth that many securities have historically exhibited may be in the process of changing because of the structural factors noted above. As a result, banks that have large positions (either in their own portfolios or in client portfolios) in securities and other instruments that they do not plan to hold to maturity should recognize the potential for market dislocations and price changes that do not reflect fundamental value. Investors should carefully assess the liquidity profile and market depth of their holdings to evaluate whether the holdings remain consistent with investors' liquidity and asset/liability management objectives.

Figure 8: Trends in 10-year U.S. Treasury Bond Yields



Source: Treasury yield curve estimates, coupon equivalent par-yields. Data as of December 31, 2014.

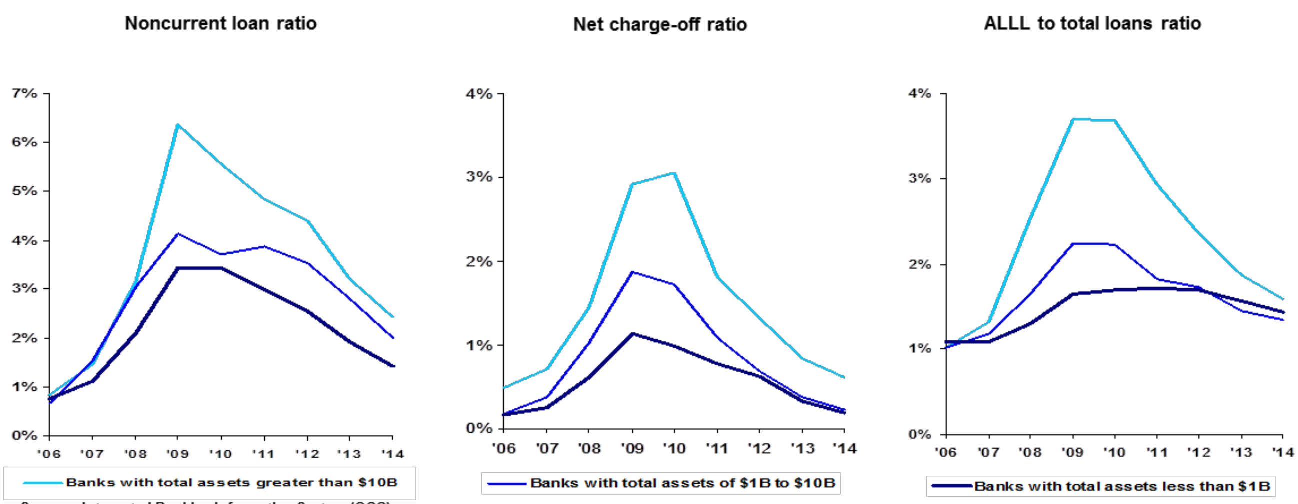
Part II: Bank Condition

A. Overall Credit Quality Continues to Improve

Credit Metrics Continue to Improve, but Noncurrent Loans Lag

Key credit quality metrics continued to improve through 2014 (see figure 9). Total noncurrent loans—those 90 days or more past due or on nonaccrual—declined further for large and small banks, but remain elevated. Net charge-off ratios have approached pre-crisis levels. The ALLL as a percentage of total loans has also declined as credit quality improves. The decline in the ALLL ratio is slowing as allowance levels return to a more normal share of total loans. Accordingly, the ratio of ALLL to total loans should stabilize above its pre-crisis level.

Figure 9: Credit Cycle Analysis



Source: Integrated Banking Information System (OCC)

Note: Data are as of year-end. Noncurrent loans are 90 days or more past due and nonaccruals.

Commercial Loan Quality Metrics Approaching Pre-Recession Lows

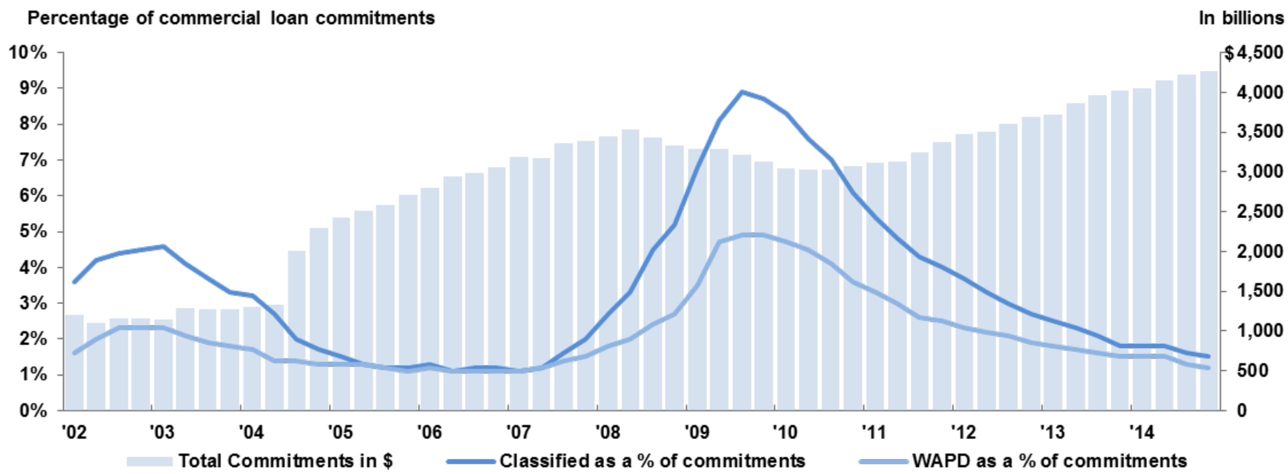
In aggregate, commercial credit quality improved slightly in the second half of 2014, with the system now approaching the level that credit quality indicators achieved before the last recession. The commercial past-due and nonaccrual ratio dropped to 0.84 percent at the end of 2014 from 1.20 percent at the end of 2013, with nonperforming commercial loans declining to 0.57 percent from 0.88 percent over the same period. In addition, the commercial loan net charge-off ratio for 2014 was 0.12 percent, compared with 0.20 percent in 2013.

For loans included in the OCC's Credit Analytics data system,[7] the weighted-average probability of default rate ended 2014 at 1.2 percent and the ratio of classified commitments to total commitments ended at 1.5 percent, compared with 1.5 percent and 1.9 percent, respectively, at the end of 2013 (see figure 10). Classified commitments ended 2014 at 6.4 percent of aggregate tier 1 capital and reserves, a level below the previous low point of 7.2 percent reached in 2006, reflecting improved credit quality and higher capital levels. Improvement in real estate and construction credit quality continued, with

[7] Credit Analytics is an OCC-sponsored, voluntary data-sharing program for analyzing commercial credit trends. The data represent more than 80 percent of total commercial loan commitments in the federal banking system.

other industry groups evenly split between slight improvement and slight deterioration through the final two quarters of 2014.

Figure 10: Commercial Loan Trends for Select Banks

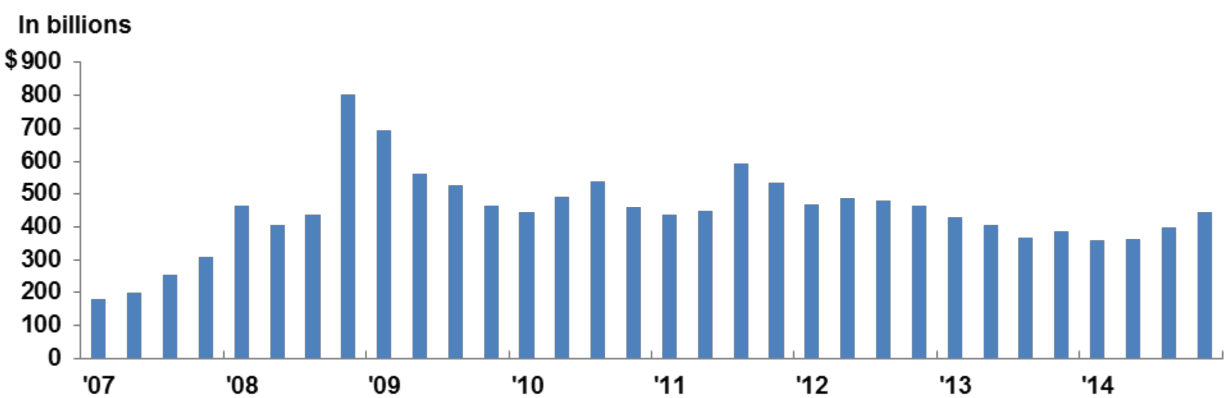


Source: OCC Credit Analytics
Note: WAPD = Weighted-average probability of default to commitments.

Counterparty Credit Exposure in Derivatives Rebounds

Counterparty credit exposure from derivatives is a significant potential risk in trading activities. After peaking at $804 billion at the height of the financial crisis, net current credit exposure (NCCE), the primary metric the OCC uses to evaluate credit risk in bank derivatives activities, has declined steadily as a general matter since the end of the financial crisis. Because of falling interest rates, however, NCCE increased by $47 billion (12 percent) in the fourth quarter of 2014 (see figure 11).

Figure 11: Net Current Credit Exposure



Source: Integrated Banking Information System (OCC)

Central clearing mandates in the Dodd–Frank Wall Street Reform and Consumer Protection Act have led to a significant increase in centrally cleared derivatives transactions. Central clearing allows market participants to face the credit risk of the CCP rather than each other, because the CCP acts as the buyer to every seller, and the seller to every buyer. A CCP reduces risks to participants in the derivatives and securities markets through multilateral netting of trades.

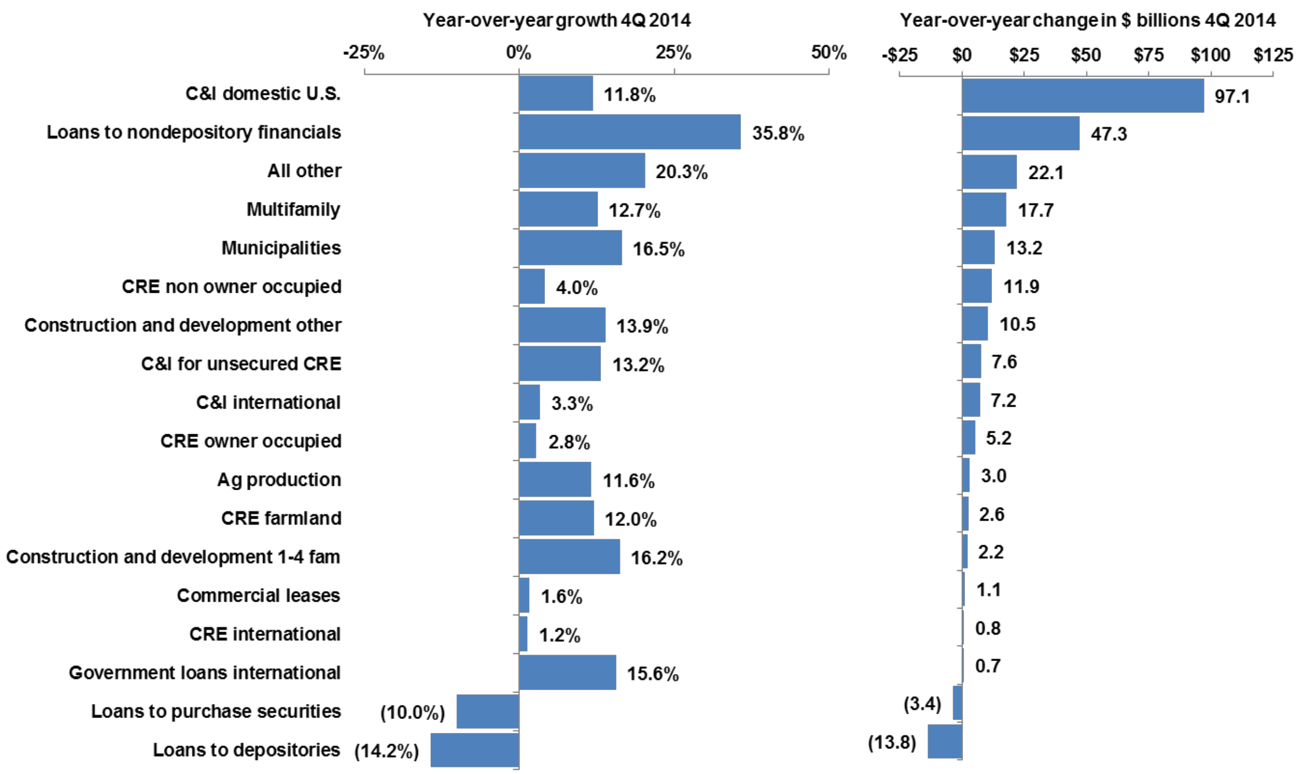
One consequence of increased central clearing, however, is that credit risk becomes concentrated in a small number of CCPs. CCPs impose risk controls and hold capital to support the risks they take, but membership agreements allow CCPs in certain cases to shift credit losses to their members. Such provisions can help CCPs perform their critical role in reducing credit risk in a market crisis, but these provisions also mutualize credit risk across members and create contingent exposures that are difficult for members to measure. Because of this risk mutualization, banks need to conduct appropriate due diligence before, and continuously after, becoming CCP members. CCP exposures have become the largest counterparty credit exposures for most large derivatives dealers.

B. Loan Growth Momentum Continues; Underwriting Standards Weaken

Commercial Loan Growth Led by Finance and Insurance, Real Estate, and Energy

Commercial loans increased 8.4 percent in 2014, compared with 7.8 percent in 2013. Growth was concentrated in domestic C&I loans (11.8 percent), loans to nondepository financials[8] (35.8 percent), multifamily (12.7 percent), and the miscellaneous category "all other" (20.3 percent) (see figure 12). Over the past three years, loans to nondepository financial firms have increased by more than 230 percent and are now the fifth largest commercial loan call report category, compared with 11th largest at the end of 2011. C&I growth was concentrated in health care, oil and gas extraction, and wholesale distribution. Another area of strong growth was loans to municipal governments, up by 16.5 percent in 2014 and by more than 80 percent over the past three years.

Figure 12: Commercial Loan Balances and Year-Over-Year Growth by Call Report Category

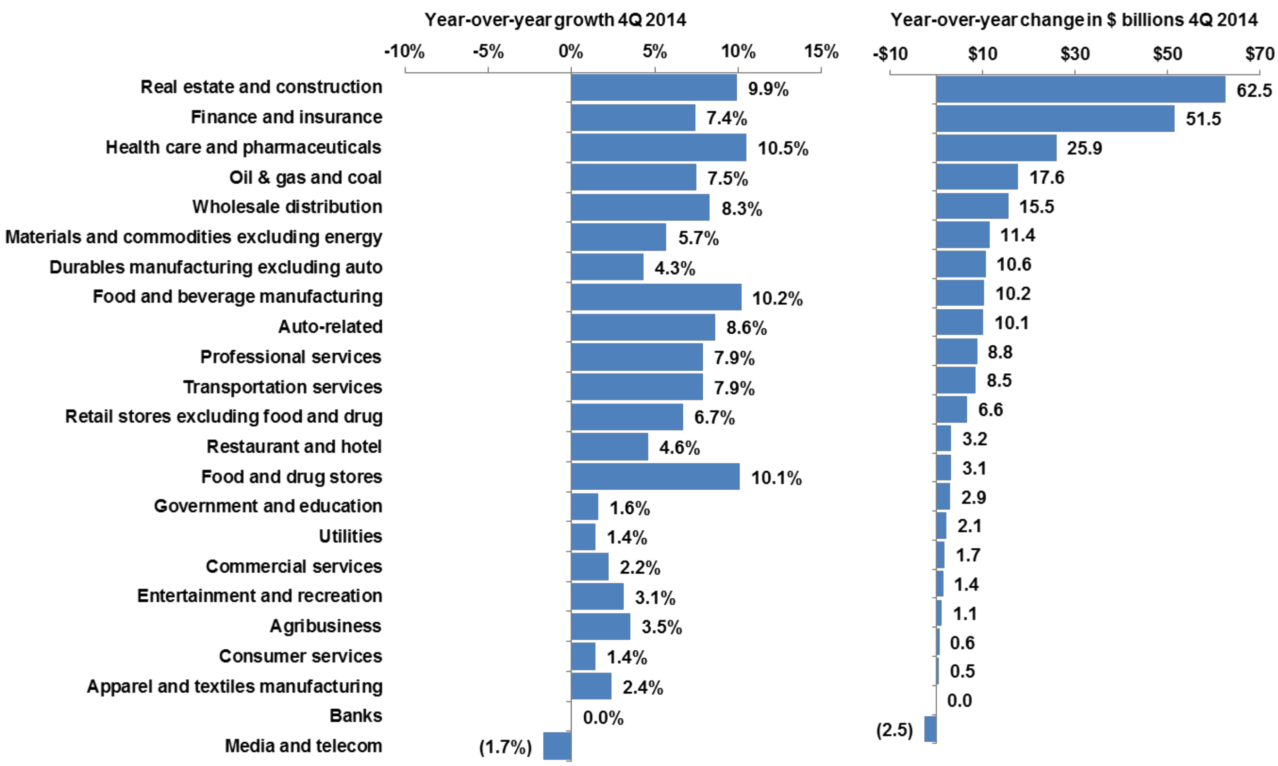


Source: Integrated Banking Information System (OCC)

[8] Loans to nondepository financial institutions generally include (1) loans to real estate investment trusts and to mortgage companies that specialize in mortgage loan originations and warehousing or in mortgage loan servicing; (2) loans to holding companies of other depository institutions; (3) loans to insurance companies; (4) loans to finance companies, mortgage finance companies, factors, and other financial intermediaries, short-term business credit institutions that extend credit to finance inventories or carry accounts receivable, and institutions whose functions are predominantly to finance personal expenditures; (5) loans to federally sponsored lending agencies; (6) loans to investment banks; (7) loans and advances made to the bank's own trust department; and (8) loans to other domestic and foreign financial intermediaries whose functions are predominantly the extending of credit for business purposes, such as investment companies that hold stock of operating companies for management or development purposes.

Banks reporting to the OCC's Credit Analytics data system experienced growth in commercial commitments of $253 billion, or 6.3 percent, in 2014, compared with 8.9 percent in 2013. Credit growth was evident across most industry groups. The real estate and construction and the finance and insurance groups (nonbank financial firms) led the way, with $62.5 billion and $51.5 billion of growth, respectively (see figure 13). The strongest growth within the real estate industry was commercial mortgages to owners and lessors of nonresidential property. Within the finance and insurance industry, the fastest growth was in loans to investment funds and other financial vehicles, and loans to nondepository credit intermediaries, securities firms, and equipment-leasing firms also increased. Industry groups with double-digit growth include health care and pharmaceuticals, food and beverage manufacturing, and food and drug stores. The OCC continues to emphasize that banks should have the necessary expertise to understand and appropriately manage the credit risk in the industries to which they lend.

Figure 13: Commercial Commitment Growth by Industry for Reporting Banks

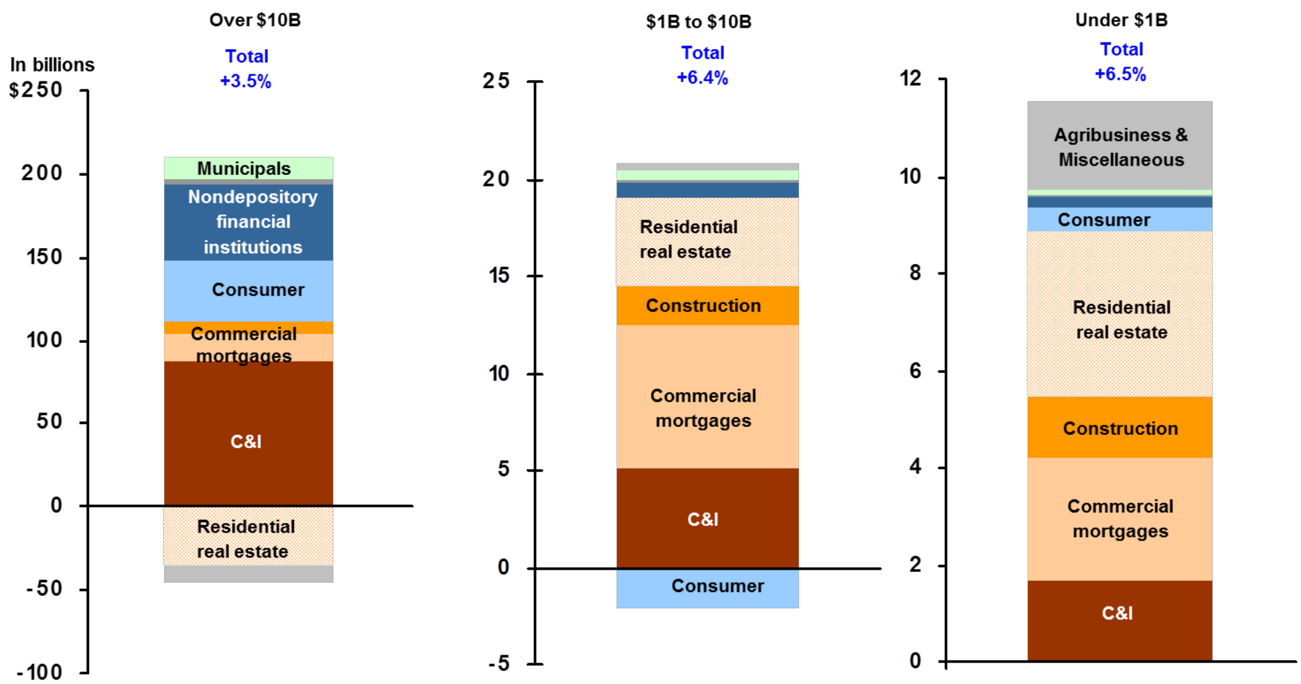


Source: OCC Credit Analytics

Loan Growth at Smaller Banks Centered in Commercial Lending

Banks of all sizes report stronger total loan growth, led by a year-over-year increase of 6.5 percent at banks with total assets less than $1 billion (see figure 14). Loan growth for these banks is centered in C&I, CRE (sum of construction, nonresidential mortgage, and multifamily), and residential mortgage lending. Banks with total assets between $1 billion and $10 billion as a group reported 6.4 percent growth in total loans year over year, also driven by C&I, CRE, and residential mortgage lending. Loan growth in these smaller banks remains bifurcated, with some reporting robust loan growth while others continue to show limited to no growth. One in four institutions with assets less than $1 billion had either no growth or declining loan balances over the past year. The overall growth rate for banks with total assets more than $10 billion continues to lag behind that of smaller banks. Sources of loan growth for larger banks are centered in C&I, nondepository financial institutions, and consumer lending.

Figure 14: Loan Growth Trends, Fourth Quarter 2013 to Fourth Quarter 2014

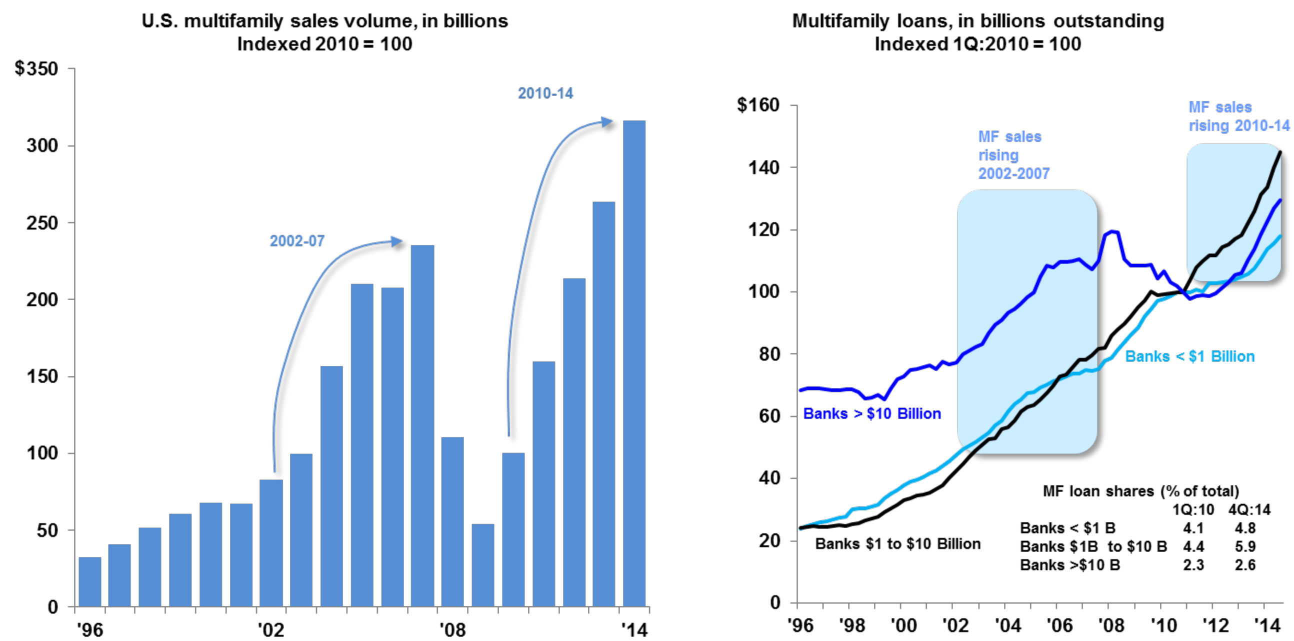


Source: Integrated Banking Information System (OCC)
Note: Data are merger-adjusted and held constant for institutions in continuous operation from 1Q:06 to 4Q:14.

Growth in Multifamily Lending Is Building Concentrations in Small Banks

Multifamily real estate lending by banks is increasing as strong property market conditions continue to attract investment. Multifamily lending accounts for a relatively small portion of loans in the federal banking system, but since 2010 growth has accelerated and posted the highest year-over-year growth in 2014 since the mid-1980s (see figure 15). Multifamily lending is a growing concentration for many banks. While multifamily lending may not pose a systemic risk to the banking system, since it makes up only a relatively small share of total loans, it is a significant concentration and a meaningful source of loan growth for many banks with total assets of less than $10 billion. Banks are also at an elevated risk of collateral values on multifamily projects falling when interest rates increase. While this risk applies to all forms of CRE lending, multifamily lending may be of particular concern given that capitalization rates are at or near historical lows.

Figure 15: Growth in Multifamily Lending at Banks



Sources: Integrated Banking Information System (OCC); CoStar Group

Note: Historical multifamily loan data are merger-adjusted. Data reflect all institutions in operation as of 4Q:2014.

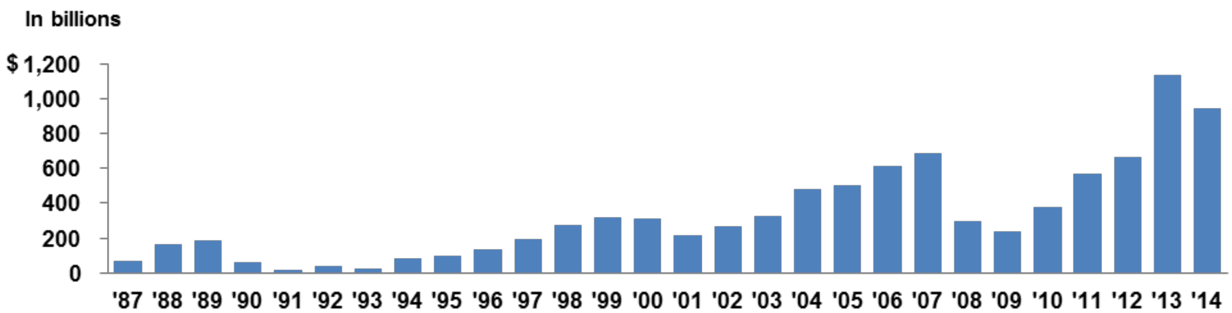
Part III: Key Risk Issues

A. Competition Drives Easing of Underwriting Standards

Significant Growth in Leveraged Loan Issuance Accompanied by Weaker Underwriting

Though U.S. syndicated leveraged loan issuance fell 17 percent in 2014, compared with the record-setting volume in 2013, it was still at the second-highest level in the past 20 years (see figure 16). While refinancing volume continued to decline from previous years, new loans related to merger and acquisition (M&A) transactions increased 21 percent in 2014, continuing a trend started in 2012. The OCC continues to monitor changing trends in leveraged lending. Banks are making progress in implementing the interagency leveraged lending guidance. The quality of newly originated loans will continue to be a focal point in the agencies' SNC review for 2015.

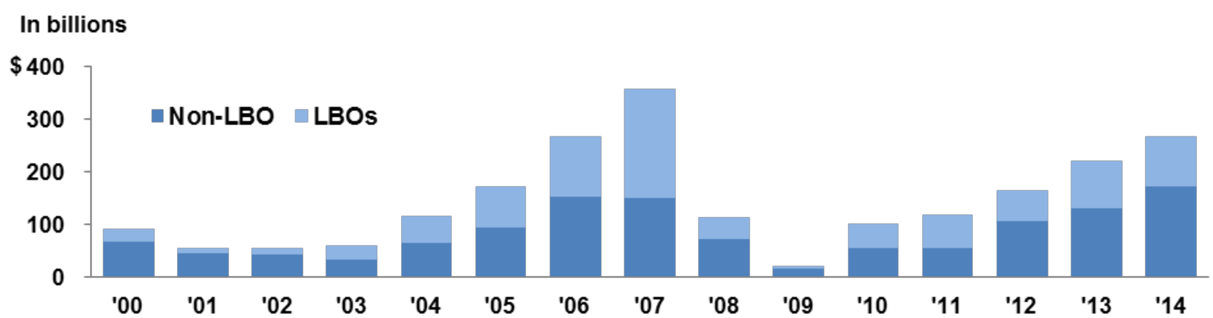
Figure 16: Syndicated Leveraged Loan Issuance



Source: Thomson Reuters LPC.
Note: All data are as of year-end.

Although it has not reached 2007 levels, 2014 M&A issuance exceeded every other reported year since 2007 in volume (see figure 17).

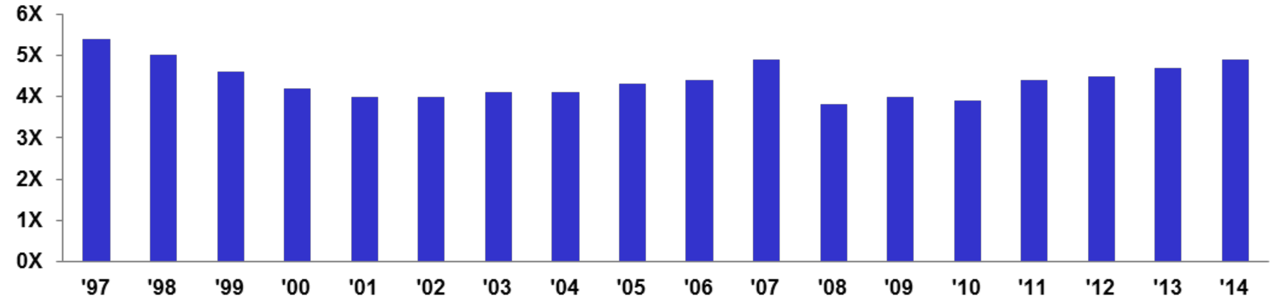
Figure 17: Syndicated M&A Leveraged Loan Issuance



Source: Thomson Reuters LPC.
Note: All data are as of year-end. LBO = leveraged buyout.

The average leverage ratio measured as total debt to earnings before interest, taxes, depreciation, and amortization (EBITDA) for new large corporate loans issued in 2014 increased to 4.9 times, a level last reached in 2007, compared with 4.7 times for all 2013 loan issuances (see figure 18).

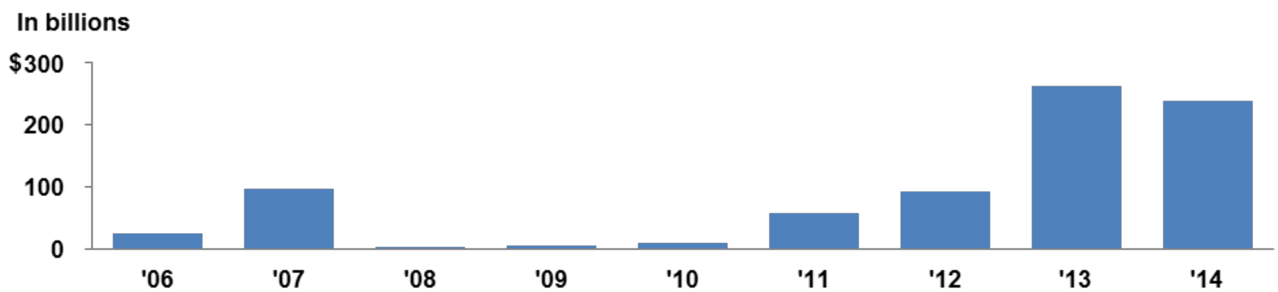
Figure 18: Average Total Debt-to-EBITDA Multiples for Leveraged Loans



Source: S&P LCD. S&P and its third-party providers are not liable for errors or omissions in the data/information and the context from which it is drawn.
Note: All data are as of year-end. Data exclude existing tranches of add-ons and amendments & restatements with no new money.

While retail investors (largely loan mutual funds) pulled back on purchases of primary leveraged loan issuance, aggregate investor demand remained strong in 2014, driven by record issuance of collateralized loan obligations and low interest rates. In this environment, loan structures continued to weaken, with covenant-lite transactions dominating institutional issuance at 74 percent, compared with 60 percent in 2013. Although covenant-lite volume fell 12 percent in 2014, reflecting the overall decline in leveraged loan issuance, covenant-lite volume was three times the 2007 level (see figure 19).

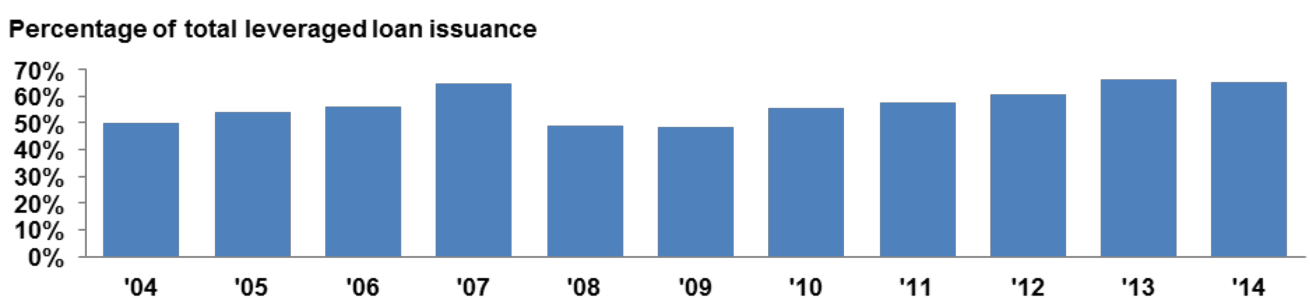
Figure 19: New Issuance of Covenant-Lite Leveraged Loans



Source: S&P LCD. S&P and its third-party providers are not liable for errors or omissions in the data/information and the context from which it is drawn.
Note: All data are as of year-end. Data exclude existing tranches of add-ons and amendments & restatements with no new money.

In 2014, S&P assigned corporate ratings of B+ or lower to 66 percent of leveraged loans issued, the same percentage as in 2013, but higher than the percentages before the last recession (see figure 20). The combination of higher initial leverage, weaker loan structures, and riskier borrower profiles indicates increasing credit risk in this segment, which remains a significant supervisory concern.

Figure 20: New Leveraged Loan Issuance Rated B+ or Worse

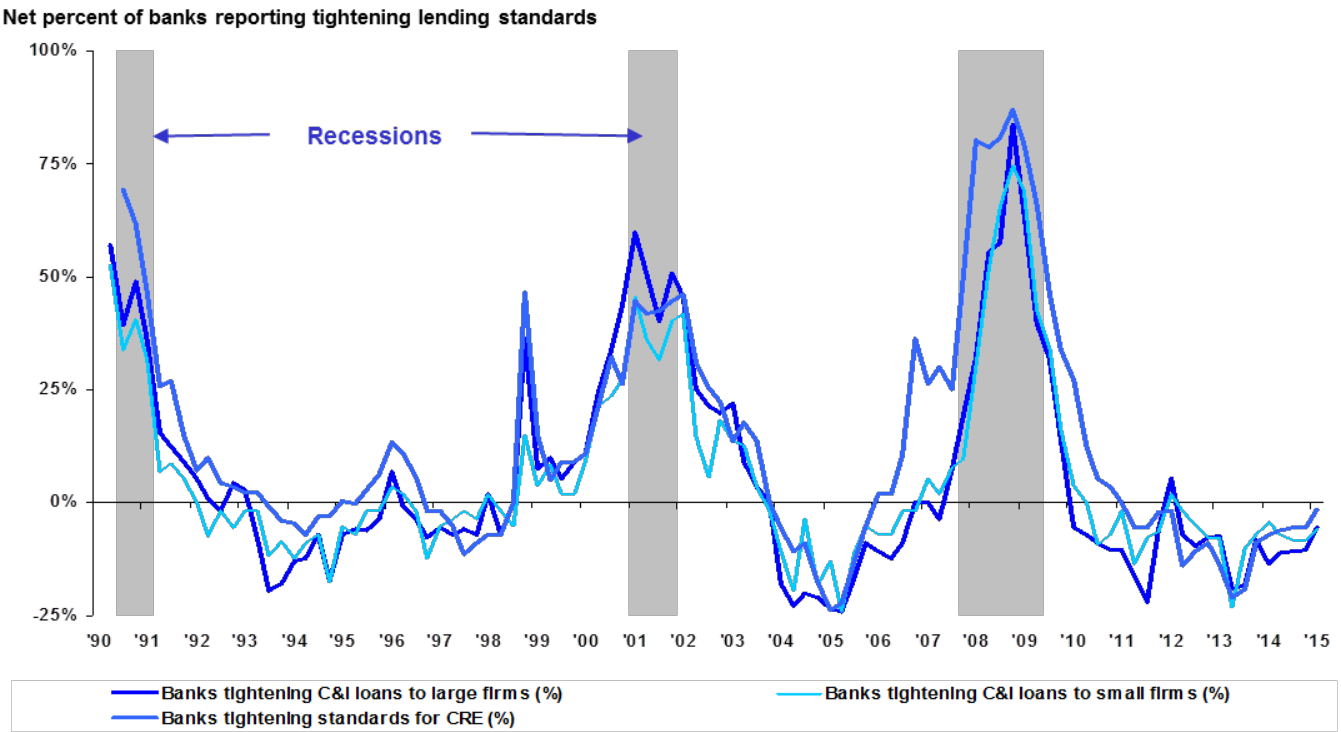


Source: S&P LCD. S&P and its third-party providers are not liable for errors or omissions in the data/information and the context from which it is drawn.
Note: All data are as of year-end.

Loan Underwriting Standards Easing

The Federal Reserve Board's January 2015 "Senior Loan Officer Opinion Survey on Bank Lending Practices" reported little change in underwriting standards for C&I and CRE lending. Some banks continued to report easing of standards in the fourth quarter of 2014 as well as an increase in demand. The survey reported net easing of lending standards for 12 consecutive quarters for both C&I and CRE (see figure 21). Most respondents cited more aggressive competition from banks and nonbank lenders for the net easing of standards. Further, most reported easing spreads, interest rate floors, and cost of credit lines.

Figure 21: Percentage of Survey Respondents Tightening C&I and CRE Underwriting Standards



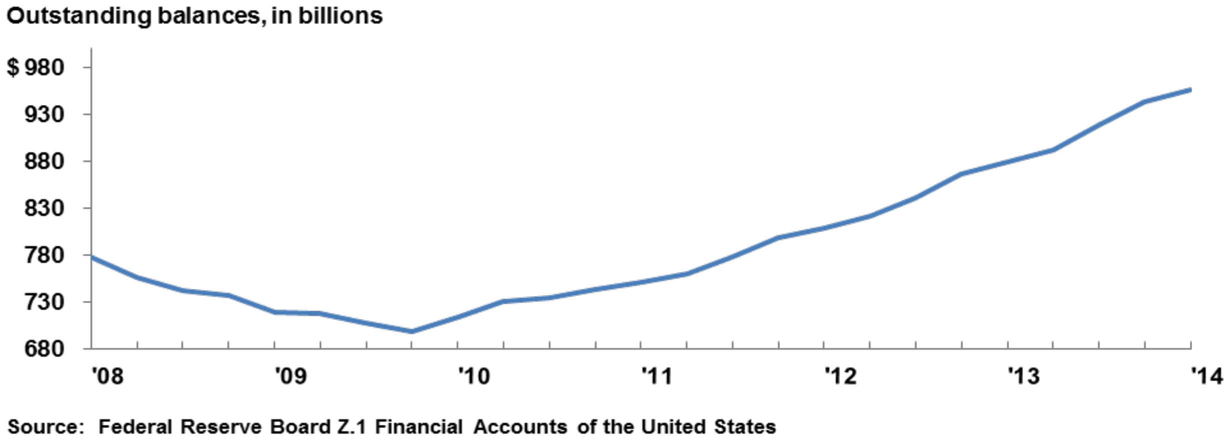
Source: Federal Reserve Board /Haver Analytics (January 2015)

CRE loan underwriting continues to ease in the face of competition, not only among banks but also by nonbank lenders such as life insurance companies, private equity firms, and securitizers. Amortization schedules have lengthened, and the number of loans structured with either partial interest-only payments or full interest-only payments has increased. Requirements for guarantees have diminished somewhat, with more loans structured with limited or no guarantees. While concentrations are not yet significant, they are developing at some banks, particularly in multifamily projects. Further, banks are relying on low loan-to-value ratios to mitigate other concessions in structure and terms. These valuations, however, are based on capitalization rates at or near historical lows and are vulnerable to rising interest rates. Looking forward, continued easing in underwriting criteria, growth in concentrations, and the impact rising interest rates may have on the value of real estate collateral and its repayment capacity are supervisory concerns.

Auto Lending Surveillance Continues

Auto loan growth remains strong. Industry-level balances outstanding reached $956 billion at the end of 2014, increasing 1.4 percent for the quarter and 8.8 percent for the year (see figure 22). Balances outstanding have grown for 17 straight quarters, a trend that began in the third quarter of 2010. Volumes at banks were similar, with a 9.5 percent increase during 2014 and a long-term pattern mirroring the industry. To date, delinquency and loss rates remain within manageable levels, aided by declining unemployment, low gasoline prices, and resilient used car prices (see figure 23).

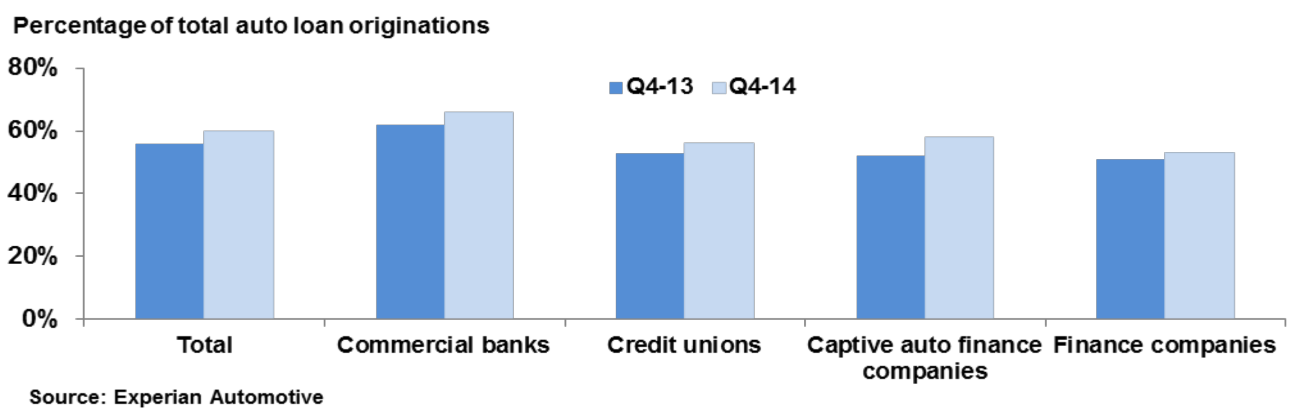
Figure 22: Trend in Auto Loan Growth From All Sources



While performance remains reasonable at present, the OCC continues to closely monitor underwriting practices and loan structures. Extended rapid growth is difficult to maintain and can sometimes mask early signs of weakening credit quality. Too much emphasis on monthly payment management and volatile collateral values can increase risk, and this often occurs gradually until the loan structures become imprudent. Signs of movement in this direction are evident, as lenders offer loans with larger balances, higher advance rates, and longer repayment terms. Each on its own may be manageable depending on the particular case, but combining the factors substantially increases risk.

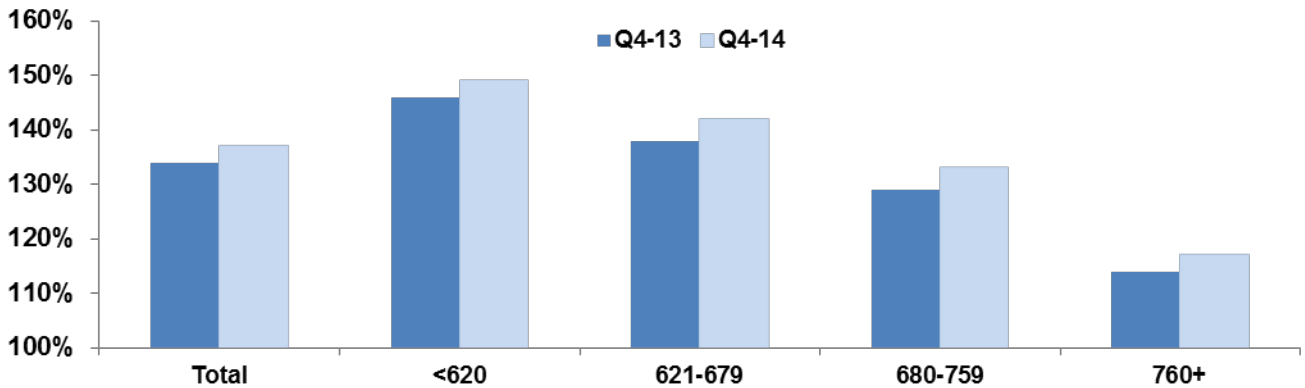
Extending loan terms is one way lenders are lowering payments, and this can increase risk to banks and borrowers. Industry data indicate that 60 percent of auto loans originated in the fourth quarter of 2014 had a term of 72 months or more (see figure 23). Extended terms are becoming the norm rather than the exception and need to be carefully managed.

Figure 23: Auto Loan Originations With Terms More Than 72 months



Collateral advance rates are also a concern. Experian data on origination loan-to-value (LTV) ratios indicate average advance rates well above the value of the autos financed. In the fourth quarter of 2014, the average LTV for used vehicle auto loans was 137 percent. Moreover, advance rates for borrowers across the credit spectrum are trending up, with used vehicle LTVs for subprime borrowers (credit score < 620) averaging nearly 150 percent at the end of 2014 (see figure 24). Sales of add-on products such as maintenance agreements, extended warranties, and gap insurance are often financed at origination. These add-on products in combination with debt rolled over from existing auto loans contribute to the aggressive advance rates.

Figure 24: Average Used Car LTV by Credit Score Range



Source: Experian Automotive

As in the mortgage markets, the OCC expects banks to fully consider cycles and trends in the auto markets and respond in a prudent and sound manner. Underwriting standards and product structures established in times of low interest rates and unusually high used car values may not prove prudent when conditions normalize or during times of stress. Competitive factors are important realities, but lenders also need to consider the results objectively and ensure that loan terms, underwriting standards, and portfolio concentrations remain within established and prudent risk appetite levels.

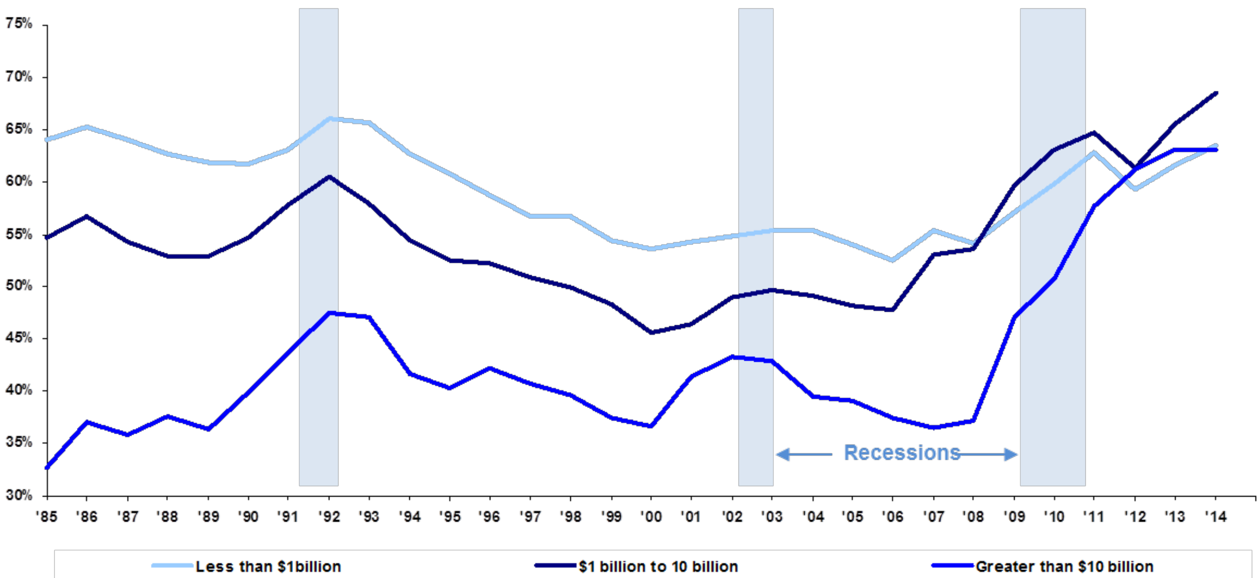
B. IRR Vulnerabilities

Retention Rate of Post-Crisis Core Deposit Growth Remains Uncertain

The retention rate and pricing of post-crisis deposits remain key behavioral factors in IRR models. The surge in deposits associated with the flight to quality that began during the financial crisis has continued (see figure 25). This trend is supported by the near-zero rate environment and the fact that low interest rates make it inexpensive for depositors to remain liquid. The OCC expects banks to model alternative deposit assumptions to understand the range of potential outcomes, given the uncertainty of the stability of surge deposits or the deposit mix where surge inflows were less evident. Banks should consider the long-term implications to earnings and capital when assessing model outcomes.

Figure 25: Trends in Core Deposits for Banks

Core deposits,** excluding small CDs share of liabilities, percent



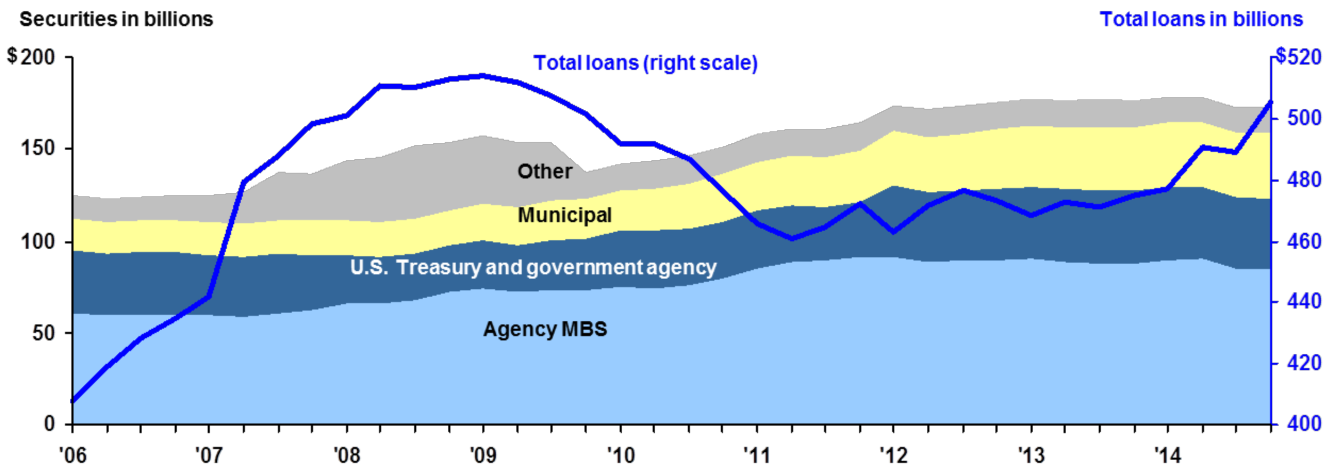
Source: Integrated Banking Information System (OCC)

Note: All data as of year-end. **Core deposits defined as domestic deposits less time deposits of $100k or more. Ratio also excludes small CDs.

Small Banks' Investment Portfolios Concentrated in MBS

Banks with assets of less than $10 billion increased their aggregate investment portfolios since the 2008 crisis, primarily because of strong deposit inflows, uneven loan growth, and continued pressure on net interest margins (NIM) (see figure 26). The increase in investment portfolios remains centered in MBS. Material concentrations in MBS could make some banks more vulnerable to IRR because of the potential for duration extension in a rising rate environment.

Figure 26: Investment Portfolio Mix for Banks With Total Assets Less Than $10 Billion



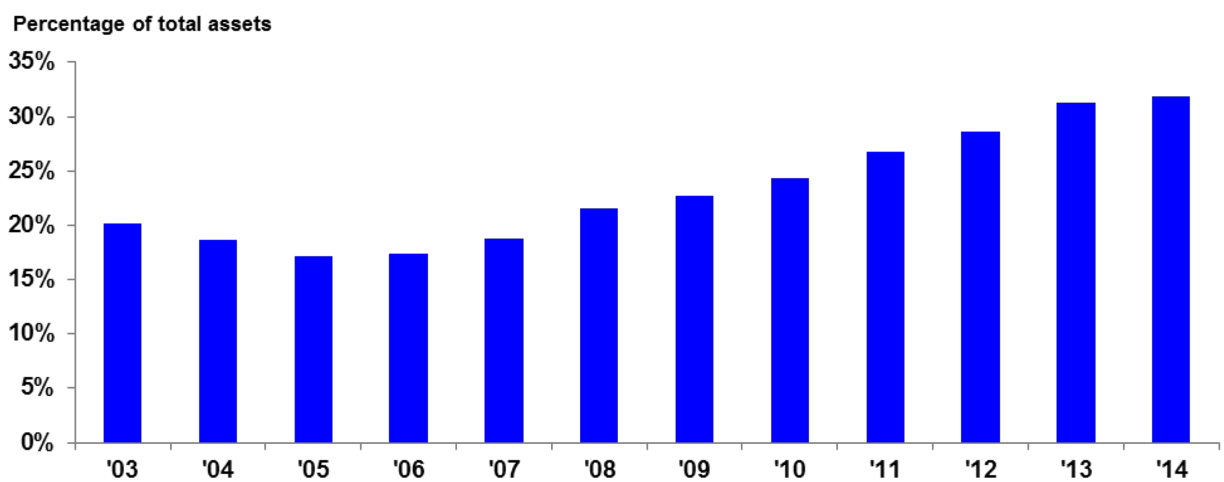
Source: Integrated Banking Information System (OCC)

Note: Data are merger-adjusted and held constant for institutions in continuous operation from the first quarter of 2006 to the fourth quarter of 2014.

National Banks With Less Than $1 Billion in Assets Increasing Longer-Term Assets

Extension risk is increasing for banks with less than $1 billion in assets as they search for yield by adding exposure to longer-term assets. National banks with less than $1 billion in assets increased long-term asset concentrations from 17 percent in 2006 to 32 percent through December 31, 2014 (see figure 27). In attempting to improve their NIM, national banks have increasingly relied on long-term assets with a focus on mortgage products.

Figure 27: Long-Term Asset Concentrations for National Banks With Less Than $1 Billion in Assets



Source: Integrated Banking Information System (OCC)
Note: Data are reported for national banks only as federal savings associations did not report this level of detail until 2013.

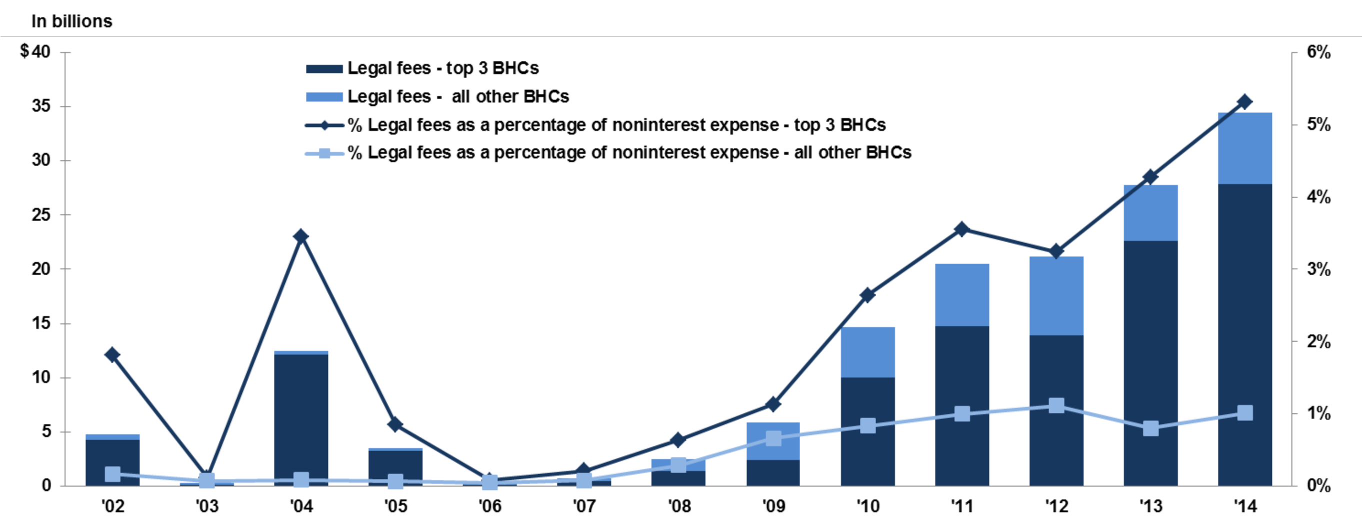
C. Operational Risk Remains Elevated

Operational Risk Concentrated in the Largest Banks, and Increasing in Smaller Banks

Operational risk is elevated for a number of reasons. These include the amount and pace of internally and externally initiated change, greater interconnectedness and interdependencies, increased sophistication of cyber threats, and pervasive technology vulnerabilities. While high operational risk has been primarily concentrated in the largest banks, operational risk is increasing among smaller banks.

Legal fees and settlements are one measure of the financial impact of operational loss events. U.S. Securities and Exchange Commission reporting as of December 31, 2014, indicates that the 12 largest bank holding companies (BHC) estimate maximum potential legal exposure of approximately $17.8 billion in excess of reserves. The exposure amounts were $14.0 billion, $20.1 billion, and $22.9 billion for 2011, 2012, and 2013, respectively. Several large and a small number of midsize banks continue to incur large legal settlements and regulatory penalties. Aggregate legal fees and settlements are increasing and are at a 10-year high (see figure 28).

Figure 28: Trends in Legal Fees and Settlements



Source: Federal Reserve Y-9C Reports

D. Compliance Risk Remains High

Increased BSA/AML Risk Observed in New Offerings and Strategies

BSA risk continues to increase. Technological developments in enhanced delivery platforms for bank products may create new exposures to criminal activity. More traditional concerns, such as bulk cash smuggling, including via armored car service, as well as funnel account activity[9] also continue to present risks to banks.

Some institutions have reevaluated client BSA/AML risk profiles and closed the accounts of certain higher-risk customers. Displacement of customers due to reevaluation strategies by larger institutions may result in the continued on-boarding of higher-risk customers by banks that potentially have less experience with associated BSA risks, This displacement also may result in the financial exclusion of some customers from banking services. The OCC expects banks to assess the risks posed by individual customers on a case-by-case basis and implement controls to manage the relationships commensurate with these risks. As a general matter, the OCC does not direct banks to open, close, or maintain individual accounts, nor does the agency encourage banks to engage in the termination of entire categories of customer accounts without regard to the risks presented by an individual customer or the bank's ability to manage the risk.

Over the past five fiscal years, the number of OCC formal enforcement actions related to BSA has remained relatively consistent (see table 2). The increased dollar amounts of civil money penalties assessed, however, demonstrate BSA violations that are more significant or egregious.

Table 2: Trends in OCC BSA-Related Enforcement Actions

Fiscal year	2010	2011	2012	2013	2014	2015	Total
Formal enforcement actions	14	10	15	16	16	6	77
Civil money penalties	2	2	0	4	3	1	12
Dollar amount ($ millions)	$5.2	$15.0	$0.0	$551.6	$351.0	$0.5	$923.3

Source: FinCEN Consolidated Quarterly Reports
Note: Data for 2015 include enforcement actions issued through February 27. All other data as of year-end.

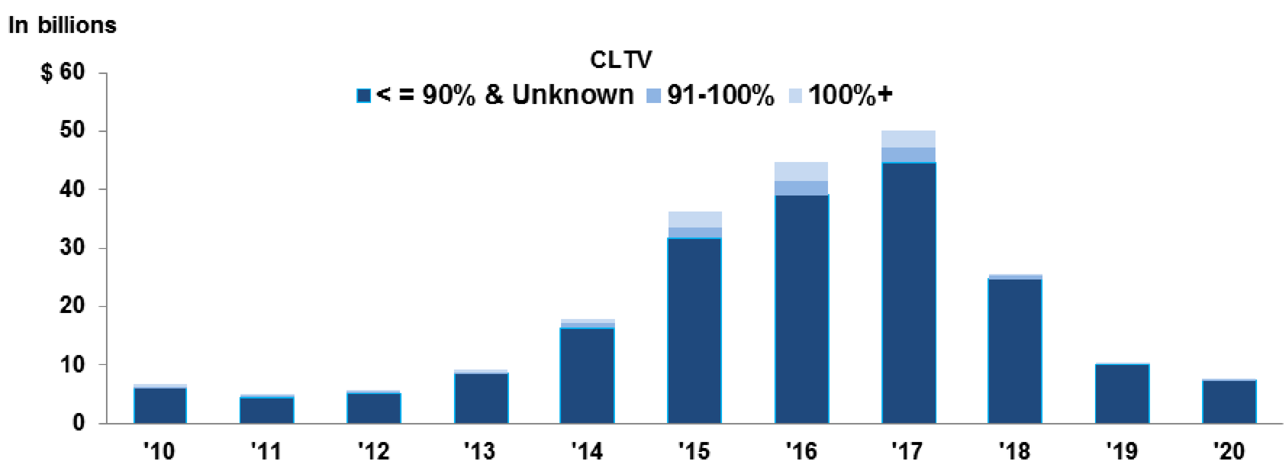
[9] A funnel account is an individual or business account located in one geographic area that receives multiple cash deposits, often in amounts below the cash reporting threshold, and from which the funds are withdrawn in a different geographic area with little time between the deposits and withdrawals.

E. HELOC End-of-Draw Exposure Comes Into Focus

Nearly Half of Outstanding HELOCs Will Reach End of Draw in 2015–2017

The first significant wave of HELOC accounts approaching EOD at the nine largest OCC-supervised home equity lenders began in 2015. While the $18 billion that reached EOD in 2014 provided these banks with a sense of the implementation issues, 2015 is the start of a three-year period when roughly $131 billion, or almost half of outstanding HELOC balances, have scheduled transitions from draw period to repayment (see figure 29). For most accounts, this transition means that monthly payments change from interest-only to amortizing, though a large number require full payment under a balloon note. Amortization periods generally range from six to 10 years, posing three main issues for borrowers: IRR from contractual resets and rising market rates, payment shock from additional principal payments, and refinancing difficulties due to lower property values and more conservative lender underwriting standards.

Figure 29: HELOC Balances by EOD and Combined Loan-to-Value (CLTV) Ratio

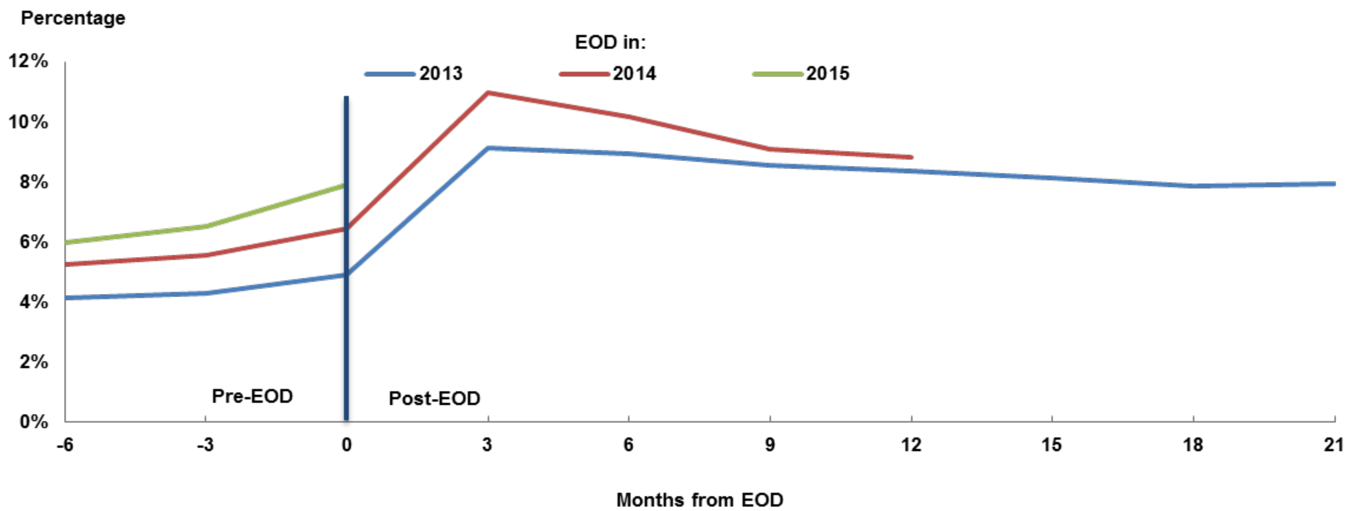


Source: OCC Home Equity Metrics Database

This third issue relating to refinancing poses a challenge for banks and borrowers. Home prices are recovering in many parts of the country, but LTV ratios for existing loans are still higher than most lenders prefer. Rough estimates for the $131 billion scheduled for EOD in the next three years show that almost $16 billion, or 12 percent, of HELOC balances have CLTV ratios above 90 percent (see figure 29). This fact means borrowers have little chance of refinancing the balances with anyone other than the original lender. Further, slow reactions (or inaction) by the lenders often lead to deteriorating performance as the payment shock from EOD occurs.

Delinquency performance for accounts with scheduled EOD periods for 2013, 2014, and 2015 reflect a marked delinquency surge in each year as EOD periods arrived and borrowers faced the three challenges noted above (see figure 30). Volumes in 2013 and 2014 were lower, and banks now have some experience with the issue, allowing them to put more effective programs in place. Still, the volume increases in 2015 shift the issue from potential to tangible, and many lenders have found the early stages more challenging than expected. The OCC will continue to monitor this exposure closely and expects banks to manage it in a proactive and prudent manner.

Figure 30: Average HELOC 30+-Day Delinquencies by EOD Year



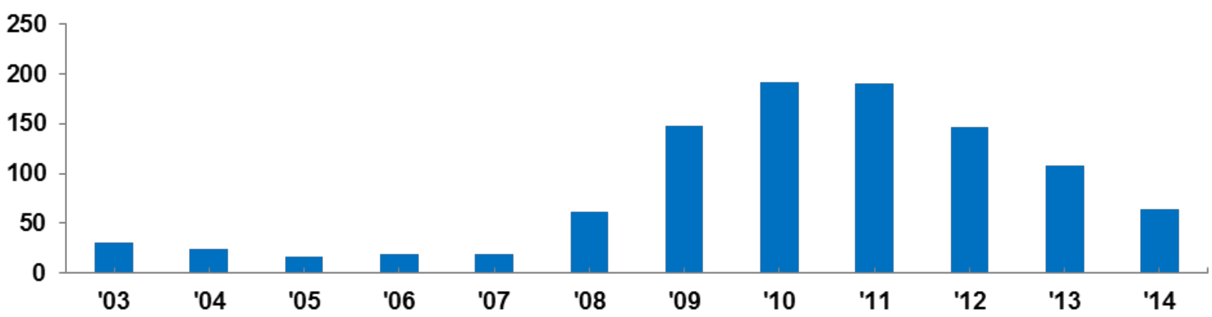
Source: OCC Home Equity Metrics Database

Part IV: Regulatory Actions

Number of Banks Rated 4 or 5 Continues to Decline

The number of OCC-supervised banks rated 4 or 5 continued to decline in 2014 after peaking in 2011 (see figure 31). The decline was attributable mainly to positive trends in the banks resulting from the slowly improving economy and recapitalizations.

Figure 31: Number of Banks Rated 4 or 5

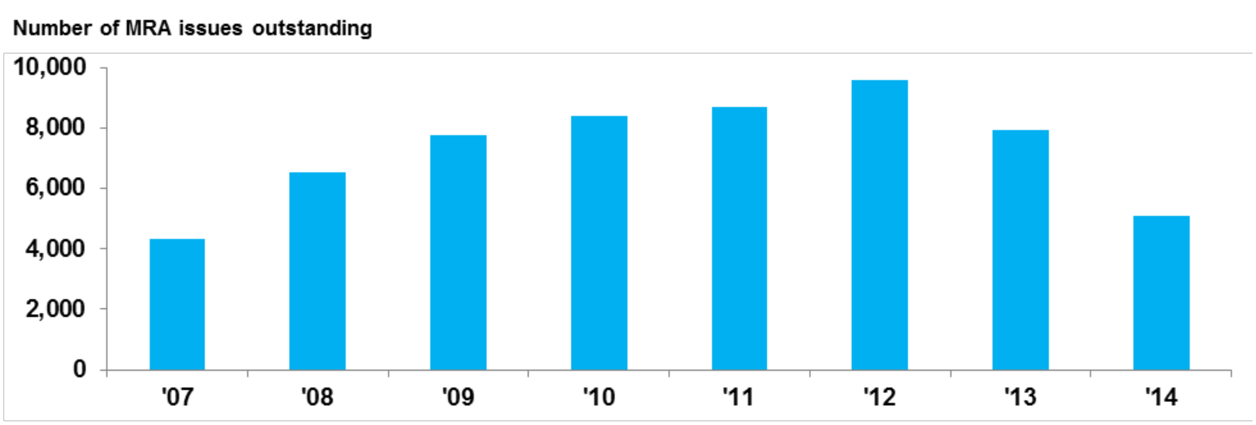


Source: OCC
Note: All data are as of year-end.

MRAs Decline

The OCC communicates supervisory concerns to a bank's board of directors and management as MRAs when bank practices deviate from safe and sound banking practices or sound risk management principles.[10] Such deviations, if not addressed appropriately, may adversely affect a bank's earnings, capital, risk profile, compliance, or reputation and could lead to an EA. The number of outstanding MRAs peaked in 2012 and declined through December 31, 2014 (see figure 32).

Figure 32: Trend in Outstanding MRA Concerns



Source: OCC

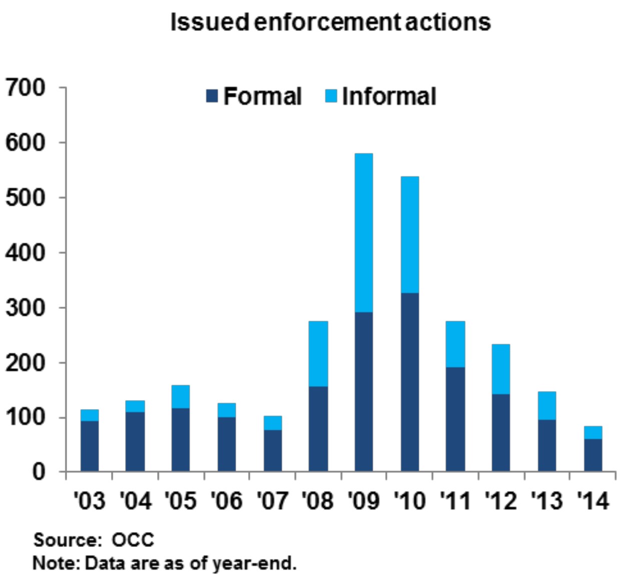
[10] Banking Bulletin 2014-52, "Matters Requiring Attention: Updated Guidance" (October 30, 2014), supports the agency's mission of ensuring a safe and sound federal banking system by emphasizing timely detection and correction of deficient bank practices before they affect the bank's condition. The updated guidance also makes consistent across the agency MRA terminology, format, follow-up, analysis, and reporting.

The order of the top five MRA categories for small banks included credit (37 percent), enterprise governance (16 percent), bank information technology (10 percent), consumer compliance (9 percent), and capital markets (9 percent). For large banks, MRAs were centered in credit risk (26 percent), consumer compliance (19 percent), general safety and soundness (19 percent), capital markets (16 percent), and information technology (10 percent).[11]

Enforcement Actions Against Banks Continue to Decline

The OCC uses EAs to address more acute problems or weaknesses requiring corrective measures. Informal EAs include commitment letters, memorandums of understanding, and approved safety and soundness plans. Formal EAs, which are disclosed to the public, include cease and desist orders, capital directives, and formal agreements. The OCC issued fewer EAs against banks during 2014 than in recent years (see figure 33), reflecting the continued overall improvement in the condition of federally chartered banks. Compliance or operational failures have resulted in a number of recent EAs. Remedial EAs have addressed a lack of appropriate governance, oversight, and risk management systems and controls. In addition, the OCC assessed significant civil money penalties for serious violations of law and unsafe or unsound practices.

Figure 33: OCC Enforcement Actions Against Banks



[11] The breakdown of MRA categories published for large banks has been corrected.

Index of Figures and Tables