Section Two
Condition of the Federal Banking System

Summary
As measured by return on equity (ROE), national banks and federal savings associations were generally profitable in fiscal year 2014. System-wide, ROE stood at approximately 10 percent in the first half of calendar year 2014, slightly below the level of a year earlier. While noninterest income fell during that period, the fall was offset by declines in provisions for loan and lease losses and noninterest expenses. ROE at community banks, those with less than $1 billion in total assets, rose over the same period, on the strength of higher noninterest income, lower provisions, and lower noninterest expenses. ROE at midsize banks edged down, as falling noninterest income more than offset a modest rise in net interest income. Credit quality continued to improve throughout the federal banking system, with charge-off rates for all major loan categories now at or below their 25-year averages.

Discussion
For the first half of calendar year 2014, net income at OCC-supervised banks decreased by $1.7 billion compared with a year earlier. System profitability as measured by ROE stood at 9.9 percent for the second quarter, above the 9.4 percent posted a year earlier but still well below pre-crisis levels. Also in the second quarter, profitability rose at large banks and community banks but slipped at midsize banks. Banks still face pressure on net interest margins (NIM) because of the unprecedented length and duration of the low interest rate environment. Compared with a year ago, however, fewer midsize and community banks experienced NIM compression. The factors supporting earnings over the past several years, mainly falling loan-loss provisions and cost cutting, are not likely to be sustainable sources of profit growth.

Operating profit. Pre-provision net revenues fell by $6.0 billion (6.3 percent) in the first half of 2014 compared with the first half of 2013. Noninterest income, largely in the form of fees on bank products and services, fell by $9.0 billion, noninterest expense fell by $2.5 billion, and net interest income rose by $0.5 billion, reflecting modest loan growth. A $3.9 billion drop in provision expenses also boosted pretax net income.

Loan-loss provisions, which have declined since 2009, are now running at only two-thirds the level of net charge-offs. As a share of total loans, provisions stand at a three-decade low and may not have much more room to fall. The low level of provisions is a matter of supervisory focus.

Pressure is likely to continue on net interest income, the main source of revenue for most banks. Loan volume is growing again, but in the first half of 2014 declining loan yields (due to the low interest rate climate) offset slightly higher loan volume for the federal banking system as a whole.

Community banks have narrowed the gap in ROE with larger banks. In the first half of 2014, net interest income for community banks rose 3.3 percent on a 4.4 percent increase in loans on the books. Smaller

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55 Only data for the first half of calendar year 2014 were available by publication deadline. This section of the Annual Report presents consolidated data for national banks and federal savings associations, reflecting the expansion of the OCC’s mission under Dodd–Frank.
banks have not been as successful as their larger peers, however, in reducing noninterest expenses, some of which are attributable to higher compliance and regulatory costs. Further, the steady decline in provisions that has boosted net income for several years must reverse at some point.

**Loan performance.** Loan performance has improved steadily over the past four years. For all major loan categories, charge-off rates declined again in the first half of 2014 compared with a year earlier, and are now below their 25-year averages.

To strengthen their positions, many banks increased the amount and quality of capital and raised their liquidity over the last several years. The result is a stronger banking system than existed before the crisis.