

## **Semiannual Risk Perspective**

**From the National Risk Committee**

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Office of the Comptroller of the Currency  
Washington, D.C.

Fall 2013

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## ***About This Report***

The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises national banks and federal savings associations<sup>1</sup> (collectively, banks) and supervises the federal branches and agencies of foreign banks. 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 fall 2013 report reflects data as of June 30, 2013.

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 (IRR); and regulatory actions.

The OCC welcomes feedback on this report by e-mail: [NRCReport@occ.treas.gov](mailto:NRCReport@occ.treas.gov).

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<sup>1</sup> The Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 transferred supervision of federal savings associations to the OCC on July 21, 2011.

## **Executive Summary**

The financial performance of federally chartered institutions continued to improve through the first six months of 2013. Earnings increased on lower provisions for loan losses and ongoing reductions in noninterest expenses. Revenues remained relatively flat, however, as uneven increases in noninterest income offset the ongoing decline in net interest income. Return on equity for the federal banking system exceeded 10 percent, but community banks still lagged. Notwithstanding the overall positive trend in profitability, questions remain regarding its sustainability as the improvement continues to reflect gains from reserve releases and cost reductions rather than organic growth.

In 2013, steady growth in the private sector supported economic activity and offset the withdrawal of federal fiscal stimulus, but the pace of employment growth remained sluggish, leaving the unemployment rate at a historically elevated level. The housing sector continued to strengthen and contribute to economic growth. Housing construction and home price appreciation improved because of growing demand and limited supply in most regions. The volume of severely delinquent first-lien residential mortgages and the level of foreclosures in process remained high, but both indicators showed improvement.

Traditional credit quality indicators—such as net charge-off (NCO), delinquency, and nonperforming asset ratios—showed continued improvement. NCO ratios remained below historical averages for all loan types except residential real estate. Despite the ongoing improvement in loan performance, recent rapid growth in some lending segments, such as commercial loans, may engender future credit stress; this risk would become evident should the economy slow or decline. That said, economists' consensus outlook foresees somewhat better, but still historically modest, economic growth in 2014, suggesting that credit performance metrics will continue to improve over the near-term.

Nevertheless, the banking industry faces significant headwinds. Banks voice concerns about the limited ability to increase revenues and operating profit (income before provisions). Low interest rates, narrow and slow total loan growth, and inconsistent fee income patterns still hinder revenue gains, while lower loan-loss provisions are a key support to better profits. Longer-term interest rates have moved higher while monetary policy continues to keep short-term rates at or near historical lows. Accordingly, net interest margins remained under pressure since most loans are priced off these historically low short-term interest rates. Although mortgage rates have increased with the rise in longer-term rates, the near-term effect has been a sharp reduction in mortgage-related revenues, as refinance volume has been sharply curtailed. Various concerns over sovereign debt levels, weak economic and credit growth, and fiscal and monetary policy uncertainty in Europe, the United States, and Japan continue to limit gains in business and consumer confidence, weighing on the pace of global economic growth.

## **Key Risk Themes**

***Strategic risk remains high for many banks as management searches for sustainable ways to generate target rates of return.***

- Strategic risk remains elevated as many banks continued to reevaluate their business models and risk appetites given the challenging operating environment. Some banks are lowering overhead expenses, often by reductions in control functions, by exiting less profitable businesses, and by outsourcing critical control functions to third parties without appropriate levels of due diligence. Further, some banks are taking on additional risks by expanding into new, less familiar or higher risk products. OCC examiners are evaluating the adequacy of strategic planning and new product

approval processes to ensure banks appropriately consider the requisite expertise, management information systems, and risk controls.

- Bank strategies aimed at aggressively boosting asset yields are elevating strategic risk. The low level of financial market volatility at present suggests a smaller band of potential future price movements, thus reducing implied risk. Low-volatility environments, however, also encourage investors to “chase” yield, often taking on more interest rate or credit risk without a commensurate increase in return. Furthermore, high market liquidity is often associated with low-volatility environments, which leads to lower credit spreads encouraging increased leverage to achieve specific return objectives.

***Narrow growth opportunities and unusual interest rate climate further complicate bank risk management.***

- Banks are layering risk in ways that are difficult to quantify using traditional, lagged risk measures. Recent market data, government surveys, and supervisory examination findings all point to increased risk, highlighting weakened underwriting standards driven by strong non-bank investor demand and increased investor risk tolerance. Competition for limited commercial and industrial (C&I) lending opportunities continues to intensify, resulting in increased risk tolerance, especially in the syndicated leveraged-lending market. Increased risk tolerance is evident in loosening underwriting standards, weak or no covenants, and tightening spreads, particularly in new or unfamiliar loan products. Middle-market C&I and auto lending standards also are showing signs of slippage, as competition to attract or retain quality borrowers increases.
- The pace and magnitude of releases from allowance for loan and lease losses (ALLL) compared with underlying credit trends reveal a growing disconnect. Significant ALLL releases continue despite loosening underwriting standards, lower pricing for risk, and increased risk layering. As a result, ongoing ALLL releases are not sustainable; accordingly, banks should avoid becoming dependent on these releases to augment earnings.
- The recent increase in long-term interest rates underscores the need to understand and quantify bank vulnerability to rising interest rates. The prolonged low interest rate environment continues to lay the foundation for future vulnerability. Some banks have reached for yield by acquiring interest income with decreasing regard for interest rate or credit risk. OCC examiners are focusing on banks with significant concentrations in longer-term assets or liability structures that make them vulnerable to quickly increasing rates. The rise in interest rates in the second quarter slowed mortgage-banking activity and dramatically lowered unrealized gains in investment portfolios. Banks that reach for yield by adding IRR could face significant earnings pressure, in some cases possibly to the point of capital erosion, as interest rates increase further.
- Price risk — changes in market value across asset classes — has experienced very low volatility for an extended period of time but may be susceptible to higher volatility should monetary policy change. The reduction in market maker inventory could contribute to greater price swings going forward.
- The low and uncertain interest rate environment also increases risks to fiduciary and other asset management business lines, which contribute meaningfully to noninterest income at many banks. Persistent uncertainty raises customers’ risk aversion; this aversion then dampens asset management revenue growth by increasing demand for fixed-income instruments over other asset classes. At the same time, the current environment raises extension risk and the potential of sharp future declines in these assets’ values.

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

- Cyber-threats continue to increase in sophistication and frequency and require heightened awareness and appropriate resources to identify, mitigate, and respond to the associated risks. Known impacts include reduced availability or diminished response times of online banking Web sites, identity theft, fraud, and theft of intellectual property. The costs and resources needed to manage the risks continue to increase; at the same time, the tools and knowledge to conduct the attacks are more readily available. Additionally, institutions' early adoption of new technology and their growing reliance on third-party providers may expand the overall system's vulnerabilities to these attacks. According to industry threat reports, attackers may increasingly target smaller institutions that they perceive to lack the resources necessary to identify and prevent successful attacks. Sometimes attackers execute denial-of-service attacks to divert attention away from other systems, such as wire transfers. Moreover, the interconnectedness of systems across the banking industry creates growing concern that cyber-attacks may increasingly affect multiple organizations at once.
- Some banks are changing the way they apply technologies, including adopting new and less market-tested applications, reengineering business processes, and increasing the banks' use of outsourcing to reduce operating costs. While these tactics can help banks 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.
- Reliance on a third party to perform multiple activities, often to such an extent that the third party becomes an integral component of the bank's operations, can elevate operational risk and requires commensurate monitoring and risk management.
- 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, changing methods of money laundering and growth in the volume and sophistication of electronic banking fraud are increasing threats. A lack of resources and expertise devoted to BSA/AML risk management in some banks often compounds these issues. Some banks are addressing resource constraints and internal control challenges through a strategy of de-risking specific higher risk and unprofitable customers.
- 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 reputation costs remain high.

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

***Community and Midsize Banks***

The overall financial condition of community and midsize banks continues to improve, as reflected by ongoing improvement in asset quality indicators. Earnings also improved because of reduced provision and other real estate owned (OREO) expenses. Pressure on earnings for many banks, however, will persist because of weak loan demand and declining investment yields.

Key risk issues facing community and midsize banks include

- higher strategic risk as banks adapt their business models to respond to sluggish economic growth.
- planning for management succession and retention of key staff.
- erosion of underwriting standards because of competitive pressures.
- expansion into loan products that require specialized risk management processes and skills.
- increased exposure to IRR at some banks related to concentrations of agency-issued mortgage-backed securities (MBS).
- increasing use of third parties to perform operational and business functions.

### ***Large Banks***

Asset quality metrics at large banks continue to improve as classified and nonperforming assets, net charge-offs, and loan-loss provisions decline. Capital remains strong and well above pre-crisis levels. Profitability also continues to improve, but remains under pressure from declining net interest margins and increasing costs related to compliance, control, and operational failures. These failures resulted in formal enforcement actions with negative financial and reputational effects that persist at the affected institutions.

Key risk issues facing large banks include

- a high level of operational risk across a spectrum of activities.
- compliance and BSA/AML risks.
- erosion of underwriting standards because of competitive pressures.
- third-party arrangements that introduce concentration risk.
- increasing volume and sophistication of cyber-threats.

## ***OCC Risk Perspective: Policy and Supervisory Actions***

New regulation and heightened 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 enhancements to bank regulation.

Supervision and policy actions are based on key risks by business line as well as risk themes that we have identified across business lines. Our actions will focus on the following:

### ***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.
- **Operational risk:** OCC supervisory staff will assess the operational risk from banks' contemplated changes to business models and responses to strategic opportunities, such as the introduction of new or revised business products, processes, or delivery channels. Examiners will focus on all phases of the risk management life cycle, including planning, due diligence, internal controls, reporting, contract negotiations, and ongoing monitoring. Robust preparation and contingency planning for operational or technology disruptions as well as natural disasters remain essential.
- **Loan underwriting:** OCC supervisory staff will scrutinize the underwriting practices of new or renewed originations from the indirect auto, asset-based lending, middle market C&I, and energy portfolios for slippage in structure and terms.
- **Interest rate risk:** 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 in particular) will be a particular focal point.
- **Compliance:** OCC supervisory staff will assess effectiveness in complying with consumer laws, regulations, and guidance. Their reviews will include applicable compliance, legal, and reputation risks posed by new products and services and emerging technologies, in particular those that introduce inherently higher compliance or reputation risk. Examiners will focus on the adequacy of BSA/AML programs to keep pace with rapidly evolving money-laundering schemes as well as new products, services, and customers.

### ***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 throughout 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.

- **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.
- **New C&I loan underwriting:** OCC supervisory staff will scrutinize commercial credit underwriting practices, especially for leveraged loans.
- **Home equity lines of credit (HELOC):** Maturities and amortization of HELOCs are an emerging risk as these products reach end-of-draw periods 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.
- **Foreclosures and mortgage servicing:** Mortgage servicing problems emerged as a key operating weakness and have drawn a strong regulatory response through the consent order process.<sup>2</sup> OCC supervisory staff will continue to 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.
- **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.

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<sup>2</sup> 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](http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html).

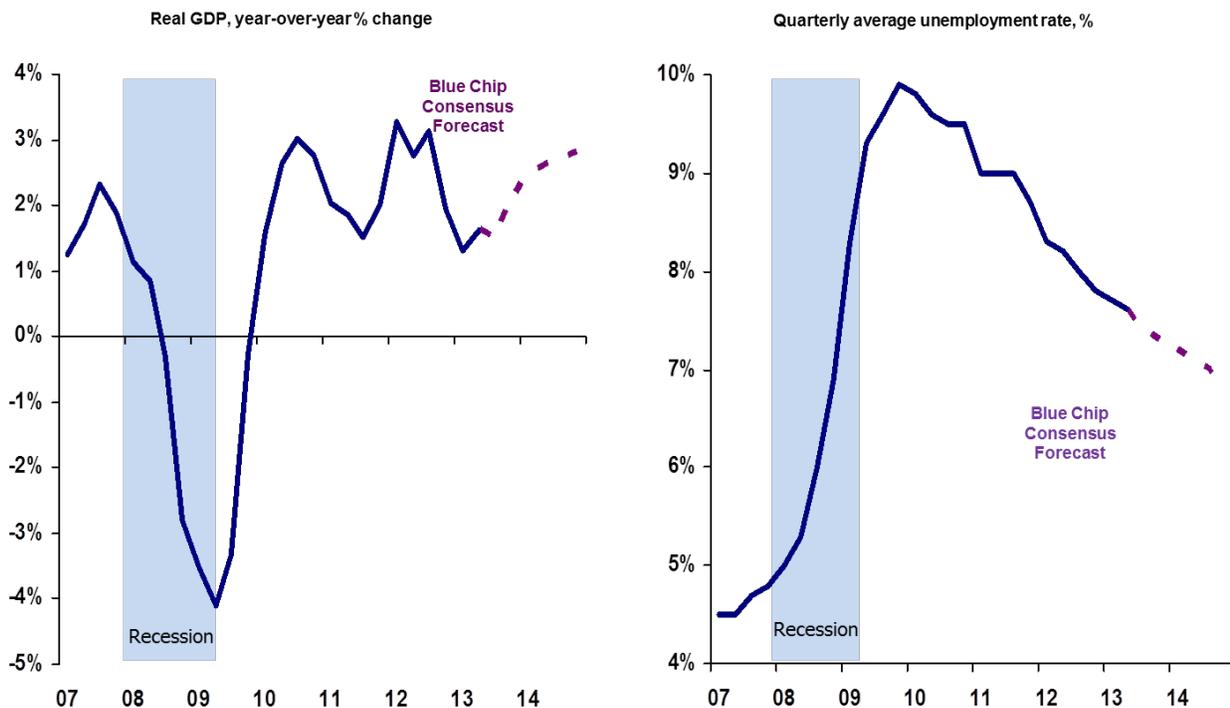
## **Part I: Operating Environment**

Employment has been growing faster than expected given the drag on the economy from tighter federal fiscal policy. Stock market gains have boosted equity prices and household wealth. Increased wealth has improved consumer confidence, drawing consumers back to auto showrooms and shopping malls, and contributing to the recovery in house prices and sales. Nevertheless, even with solid growth in spending, growth in the gross domestic product (GDP) remains sluggish and the economy will continue to face challenges from still-high unemployment, uncertain business conditions, and slow growth abroad.

### **Slow U.S. Economic Growth Weighs on Labor Market**

The pace of economic growth remains sluggish. Real GDP increased 1.6 percent in the second quarter of 2013 from the second quarter of 2012 (see figure 1). That pace of growth remains below the 25-year average of 2.5 percent. Employment growth also remains subpar. Nevertheless, the unemployment rate continues to decline, in part the result of a smaller labor force. The consensus of private sector forecasters is for economic growth to improve but remain lackluster in 2014 because of ongoing problems in Europe, slowing growth in emerging markets, and uncertainty regarding the U.S. fiscal situation. The consensus estimate is that 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: BEA, BLS/Haver Analytics, Blue Chip Indicators (September 2013)

## Sluggish European Growth Also Likely to Weigh on U.S. Economic Growth in Near-Term

Market concerns over the health of European peripheral sovereign countries have eased noticeably in the past year, after European Central Bank President Mario Draghi pledged in July 2012 to do “whatever it takes” to protect the Eurozone from collapse. The cost of buying credit protection on the peripheral countries in the credit default swap market has fallen sharply in reaction to that pledge (see figure 2), as well as to improving economic fundamentals in Europe. The economy in Europe has only recently emerged from recession, and both economic and credit conditions remain weak by recent historical standards (see figure 3).

Figure 2: Peripheral Country Sovereign 5-Year Credit Default Swap Spreads

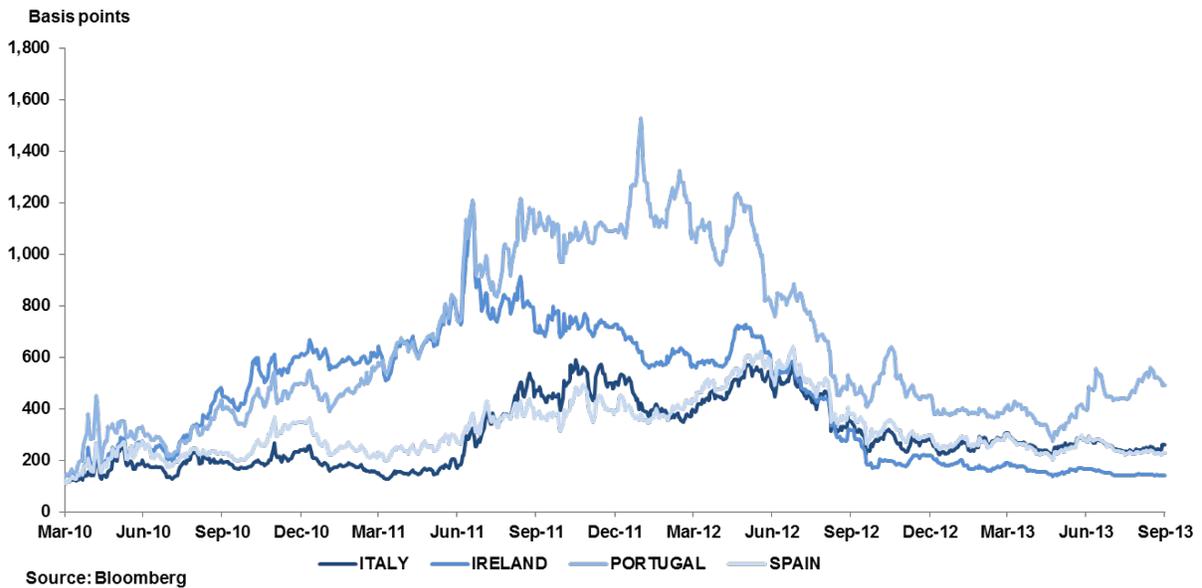
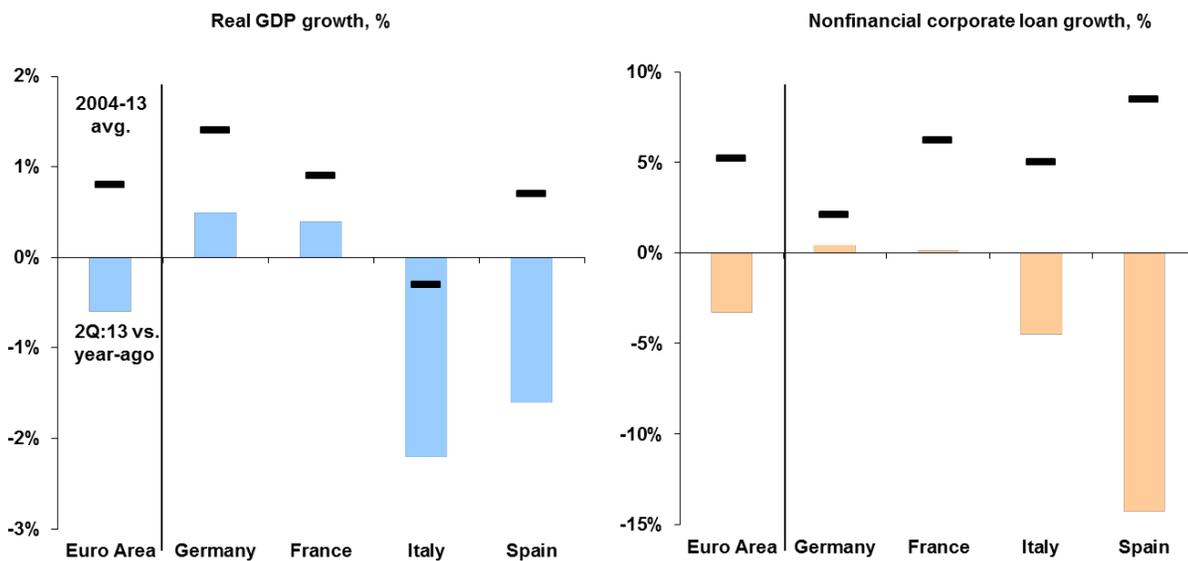


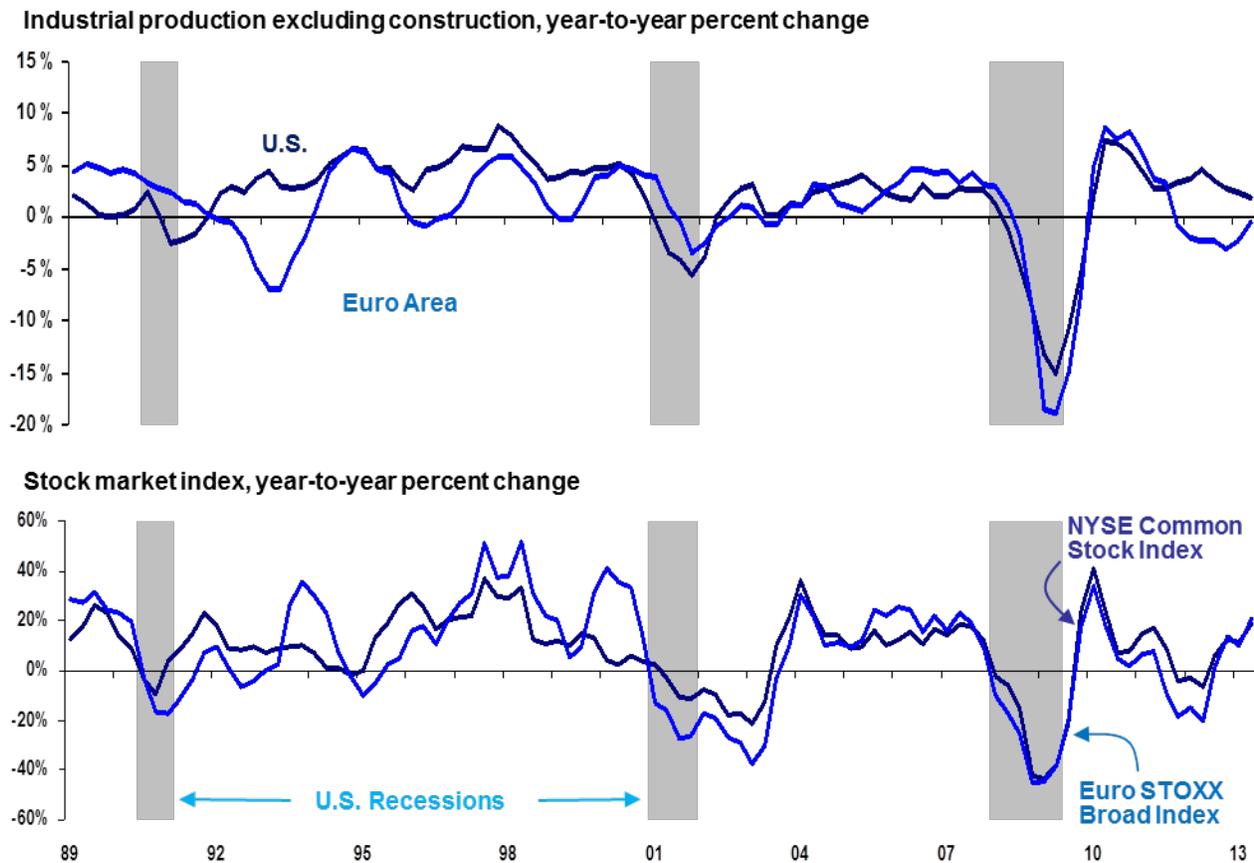
Figure 3: Economic and Credit Growth in Major European Countries



Source: G10 + Economic and Financial Indicators/Haver Analytics

Because the U.S. and European economies and financial markets are closely associated, ongoing weakness in Europe will likely continue to weigh on U.S. economic activity (see figure 4). Should stresses in Europe and its banking system intensify, perhaps triggered by market concerns ahead of the 2014 asset quality reviews and stress tests planned by the European Banking Authority and the European Central Bank, global financial markets could again experience some disruption. These markets remain a key potential stress-transmission channel to the U.S. economy and its banking system, particularly large internationally active U.S. banks. Limited growth prospects and low interest rates are the most likely near-term effects on the U.S. economic and banking system from sluggish conditions in Europe.

Figure 4: Link Between U.S. and European Economies



Sources: OECD; Dow Jones  
 Quarterly data through 2Q:2013

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

## Treasury Yields Remain Historically Low

Treasury yields have been at, or near, historical lows for the past several years (see figure 5). The slope of the yield curve steepened in the second quarter in response to market expectations that the Board of Governors of the Federal Reserve System would begin to “taper” bond purchases later in 2013. The spread between 2-year and 10-year yields remains below its peak but is more than twice the historical mean. An upward-sloping yield curve typically signals market expectations for an eventual increase in short-term interest rates in response to swifter economic growth and inflation. Banks would benefit from stronger growth, but the prolonged period of historically low interest rates, combined with limited loan demand, led many banks to increase the size of their investment portfolios. Accordingly, some bank investment portfolios may have a concentration of assets with fixed yields at historic lows. The historically low level of interest rates generally suggests that rates are likely to move sharply higher in response to any unexpected positive economic or inflation information. The most obvious negative effect of higher rates for banks is a further decline in the value of investment securities, including many mortgage-related securities. Another concern, however, is increased debt service burdens of borrowers. This risk is particularly acute for some marginal borrowers weakened during the recession who are meeting debt service payments now only because of the low rate climate.

**Figure 5: Spread Between 2-Year and 10-Year U.S. Treasury Notes**



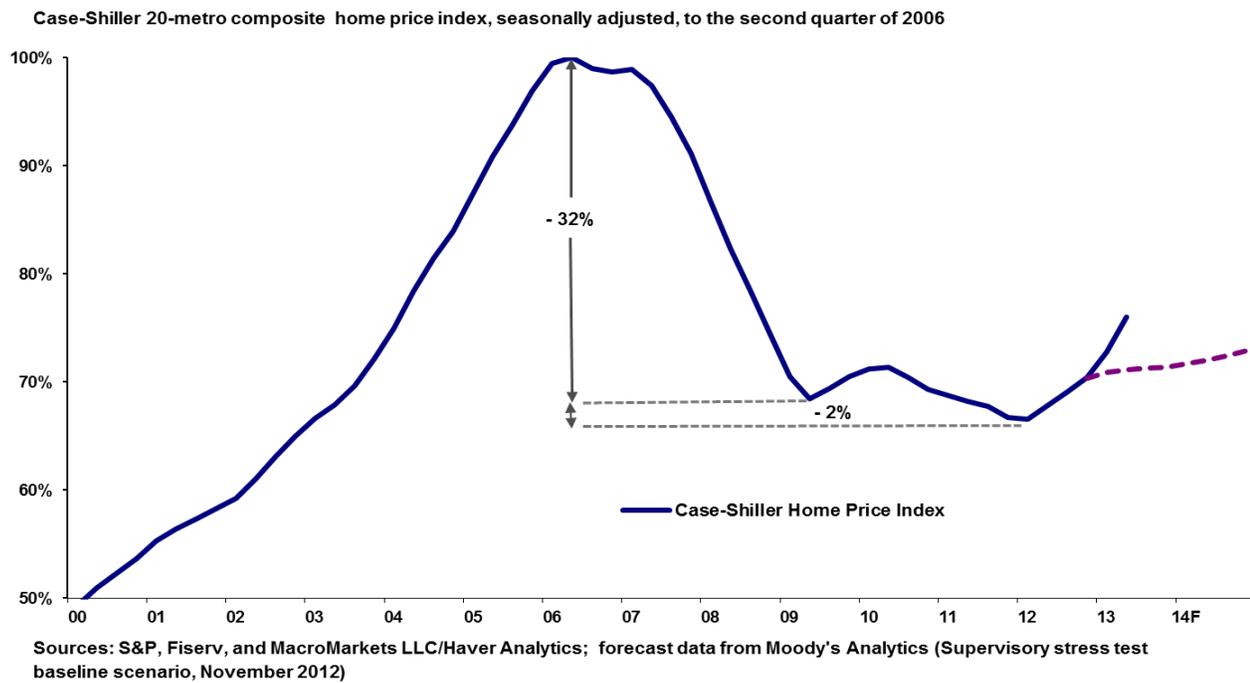
Source: Federal Reserve Board

Treasury yield curve estimates, coupon equivalent par-yields. Updated as of June 30, 2013.

### Housing Metrics Improved

The housing market improved in 2013 as increased investor demand helped to clear the inventory of foreclosed and distressed homes, putting upward pressure on home prices. Case-Shiller repeat-sales data show home prices up 12.1 percent year-over-year through the second quarter of 2013, exceeding most independent forecasts (see figure 6). Nevertheless, average prices remain almost 24 percent below their peak. The remaining distressed inventory is increasingly concentrated in states with judicial foreclosure requirements. Nationally, delinquency rates and foreclosures continue to show improvement. The percentage of mortgages that are seriously delinquent declined to 3.8 percent from 4.4 percent a year earlier (see table 1). The percentage of foreclosures in process declined more than 30 percent from 4.1 percent of loans outstanding in the second quarter of 2012 to 2.8 percent in the second quarter of 2013.

**Figure 6: Case-Shiller National Home Price Index**



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

Percentage of Mortgages in the Portfolio							
	6/30/12	9/30/12	12/31/12	3/31/13	6/30/13	1Q %Change	1Y %Change
Current and Performing	88.7%	88.6%	89.4%	90.2%	90.6%	0.4%	2.1%
30-59 Days Delinquent	2.8%	3.1%	2.9%	2.6%	2.9%	11.6%	1.8%
<b>The Following Three Categories Are Classified as Seriously Delinquent</b>							
60-89 Days Delinquent	1.0%	1.1%	1.1%	0.9%	0.9%	3.4%	-8.9%
90 or More Days Delinquent	2.3%	2.2%	2.3%	2.1%	1.9%	-11.2%	-19.0%
Bankruptcy 30 or More Days Delinquent	1.1%	1.1%	1.0%	1.0%	1.0%	-2.8%	-12.2%
<b>Subtotal for Seriously Delinquent</b>	<b>4.4%</b>	<b>4.4%</b>	<b>4.4%</b>	<b>4.0%</b>	<b>3.8%</b>	<b>-5.9%</b>	<b>-15.0%</b>
Foreclosures in Process	4.1%	3.9%	3.3%	3.2%	2.8%	-13.6%	-30.8%

Source: OCC Mortgage Metrics Report for the Second Quarter of 2013.

## Commercial Real Estate Vacancy Recovery Uneven Across Property Types

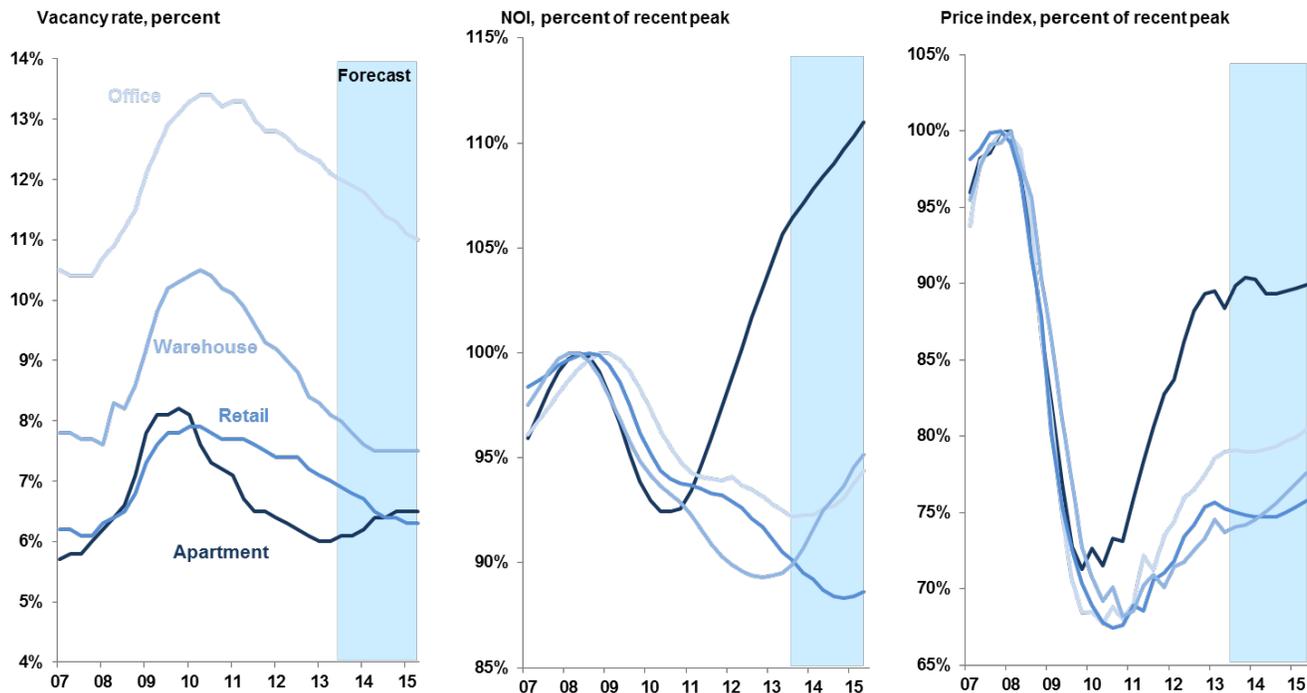
The commercial real estate (CRE) vacancy recovery underway since 2010 has been uneven across property types (see figure 7). Apartment is the only property type that has returned to its pre-recession level, largely because the decline in homeownership has led to increased apartment demand.

Accordingly, apartment net operating incomes (NOIs) are already above their previous peak and are expected to grow as rents increase further. Because of a significant increase in construction, however, apartment vacancy rates are rising in some markets, slowing rent growth.

Office, retail, and warehouse vacancies continue to decline but remain high historically, with average rents still 6 percent to 13 percent below their previous peaks. Consequently, NOIs are near cyclical lows, as many in-place leases continue to renew at lower rents. Retail still shows the most sluggish recovery in vacancy rates and rents, as weak personal income growth limits discretionary spending, and the long-term trend toward online shopping reduces new store openings.

Given expectations for weak economic growth, most forecasts call for continued slow improvement in CRE market fundamentals. Property prices remain below peak for all property types at the national level, but the apartment sector outperforms other property types because of superior fundamentals. Low interest rates and stronger fundamentals have allowed CRE prices to begin to recover, but the market expects minimal improvement in commercial property values over the next two years since higher interest rates will partially offset the impact from strengthening fundamentals.

**Figure 7: CRE Vacancy Rates**



Source: Property & Portfolio Research; second quarter 2013 baseline PPR forecast

## **Part II: Condition and Performance of Banks**

### **A. Profitability and Revenues: Improving Slowly**

#### **Profitability Increasing**

Net income for the first six months of 2013 increased 25 percent over the same period in 2012 to more than \$55 billion. The operating performance of banks of all sizes continues to improve (see table 2). Larger banks had the largest percentage increase in net income. Net income at banks with assets between \$1 billion and \$10 billion increased 16 percent from the same period in 2012, while net income for banks with assets less than \$1 billion increased by 7 percent. Net income at banks with more than \$10 billion in assets was almost 29 percent higher than the same period in 2012.

The primary drivers of higher system earnings over the past year was lower provision expense and a rise in noninterest income. Lower noninterest expense also supported profit growth for the largest banks. Net interest income remains under pressure from sluggish loan growth and the low interest rate environment, which resulted in continued margin compression at large and small banks.

Provision expenses declined over the past year across the industry, with the largest banks reporting a 29 percent reduction in provisions for loan losses. Those with assets between \$1 billion and \$10 billion had a 63 percent reduction in provision expenses, while those with less than \$1 billion in assets saw a 40 percent reduction. Provision expenses for the system overall remain at historical lows relative to charge-offs and near their all-time lows as a share of total loans. Therefore, lower provisions are likely to provide a diminishing benefit to earnings performance going forward—assuming loan growth stays modest and loan-loss reserves stabilize as expected.

**Table 2: Income and Expenses for Banks**

	Assets greater than \$10 billion		Assets between \$1 billion and \$10 billion		Assets less than \$1 billion	
	June 30, 2012	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012	June 30, 2013
Number of institutions	60	59	184	166	1,615	1,491
Total assets in billions	8,870.0	9,161.3	493.5	437.9	372.8	356.7
Year-to-date revenues in \$ billions						
Net interest income	132.1	129.1	6.9	6.7	5.7	5.5
Noninterest income	80.7	91.2	3.1	3.4	2.7	3.0
Realized securities gains and losses	4.1	2.3	0.1	0.2	0.1	0.1
Year-to-date expenses in \$ billions						
Provisioning	19.7	14.0	0.8	0.3	0.5	0.3
Non-interest expense	133.8	127.1*	6.6	6.9	6.0	6.1
Income taxes	20.2	25.6	0.8	0.8	0.5	0.5
Net Income	43.0	55.4*	1.9	2.2	1.5	1.6

Source: Integrated Banking Information System (OCC)

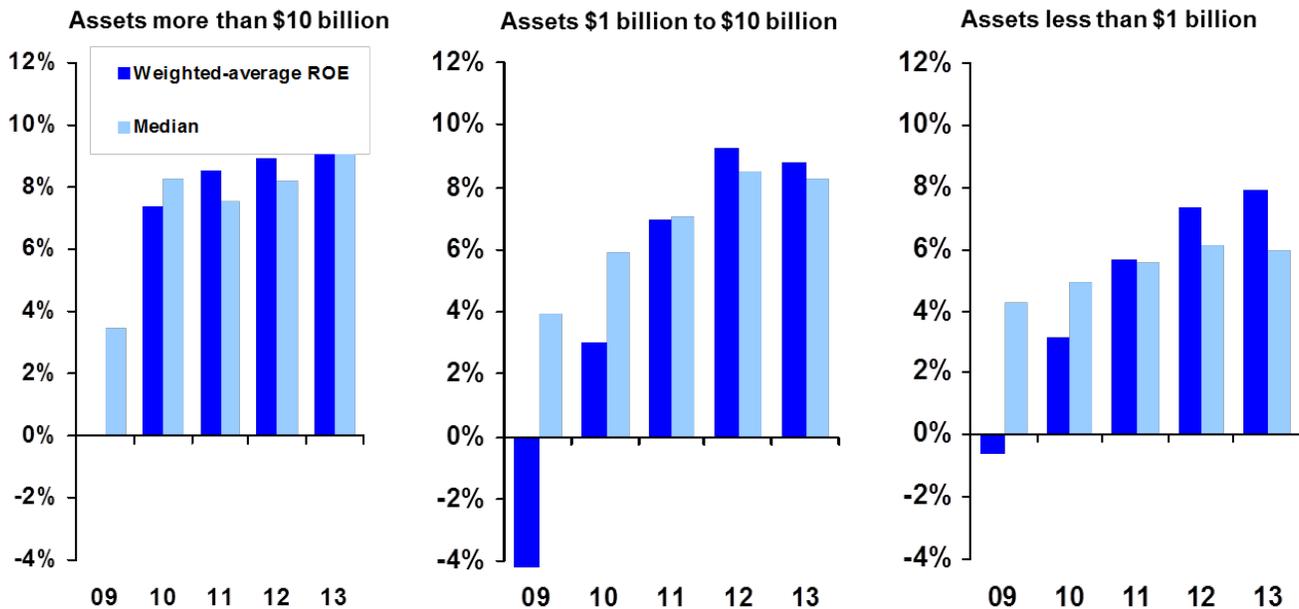
\*Excludes \$4 billion goodwill expense at one large bank because of amended Call Report filing received after the second quarter 2013 submission deadline.

Data are merger-adjusted and held constant for institutions in continuous operation from the first quarter of 2013 to the second quarter of 2013. One bank that sold off a significant amount of assets in the first quarter of 2013 is excluded from the less than \$1 billion group.

## Return on Equity Improving, Led by Larger Banks

Return on equity (ROE) generally improved in 2013 for banks with assets more than \$10 billion and banks with assets less than \$1 billion, but slipped slightly for banks with assets between \$1 billion and \$10 billion (see figure 8). Weighted-average ROE for the largest and smallest banks continues to perform better than the median ROEs for these two groups; the largest banks within each of these groups are recovering at a more rapid pace than the “typical” banks in each of these groups. In particular, the smallest banks under \$1 billion are seeing a significant degree of differentiation in profitability that was not seen before 2008, as those hit hardest by the recession continue to struggle, while others are seeing fairly rapid loan growth and much improved profits.

Figure 8: Return on Equity Trends by Bank Size



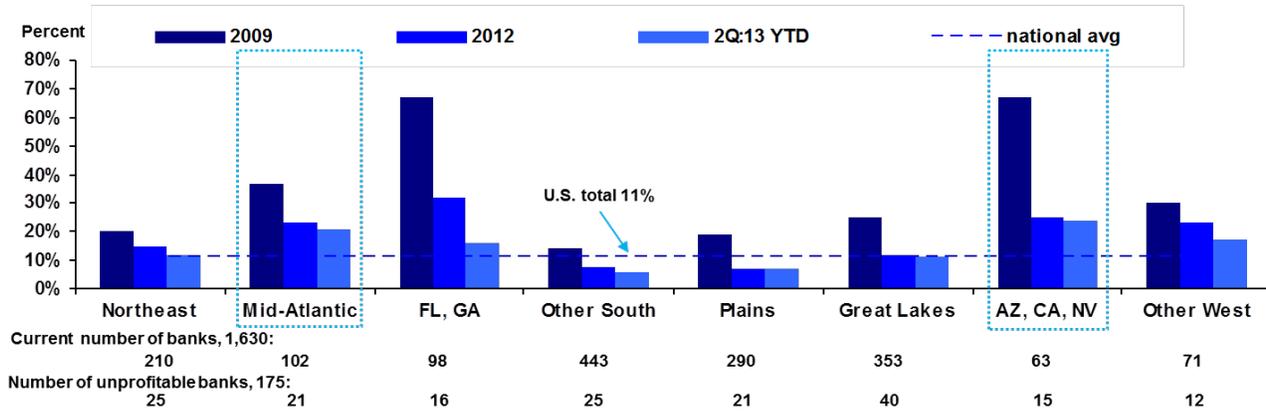
Source: Integrated Banking Information System (OCC)

Note: 2013 data as of June 30, 2013; all other data as of year-end. Sum-of-quarterly net income as a share of 5-quarter trailing average equity.

## Fewer Banks Report Losses

The percentage of unprofitable banks fell through the first six months of 2013. Regionally, unprofitable banks remained concentrated in the states most adversely affected by the housing crisis, such as Arizona, California, and Nevada, as well as some mid-Atlantic states (Delaware, Maryland, North Carolina, South Carolina, Virginia, and West Virginia) and the District of Columbia (see figure 9). For many banks in these locations, legacy issues from the housing crisis continue to put pressure on profits and loan performance because of elevated nonaccruals and provisions as well as reduced growth potential.

Figure 9: Unprofitable Banks by Percent of Regional Population

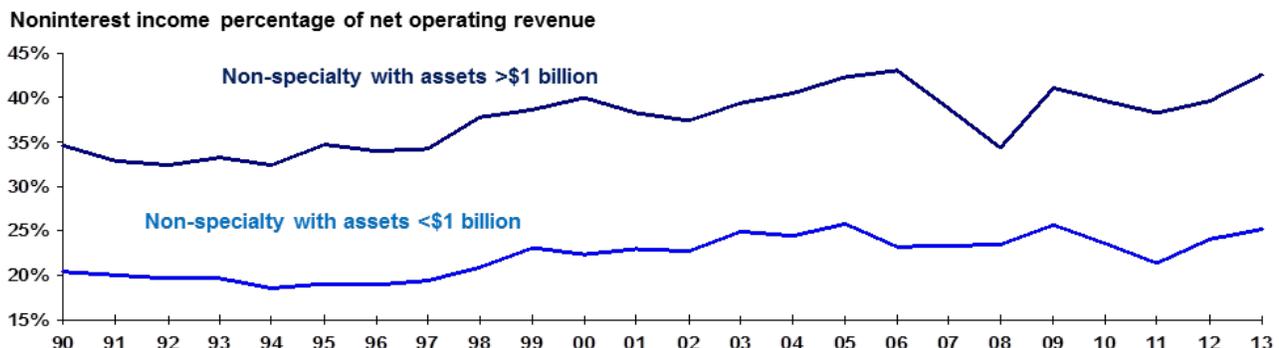


Source: Integrated Banking Information System (OCC)  
 All data as of year-end. Data are merger-adjusted and use the current supervision designation. Unprofitable is ROA < 0.  
 Northeast = CT, MA, ME, NH, NJ, NY, PA, RI, VT    Mid-Atlantic = DC, DE, MD, NC, SC, VA, WV    Other South = AL, AR, KY, LA,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

## Noninterest Income Improving for Large and Small Banks

Although a much larger contributor for banks with assets more than \$1 billion, the share of revenue from noninterest income continues to rise for both large and small banks. Noninterest income, as a share of net operating revenue, increased to almost 43 percent for banks with assets greater than \$1 billion and more than 25 percent for smaller institutions (see figure 10). Trading losses at large banks drove the big drop in 2008, but since 2011, more consistent trading revenues have helped push noninterest income higher as a share of total revenue. Asset management revenue also continues to provide a steady stream of noninterest income for some banks. The ongoing pressure on net interest income also contributes to the rising prominence of noninterest income in bank revenue.

Figure 10: Trends in Noninterest Income for Banks

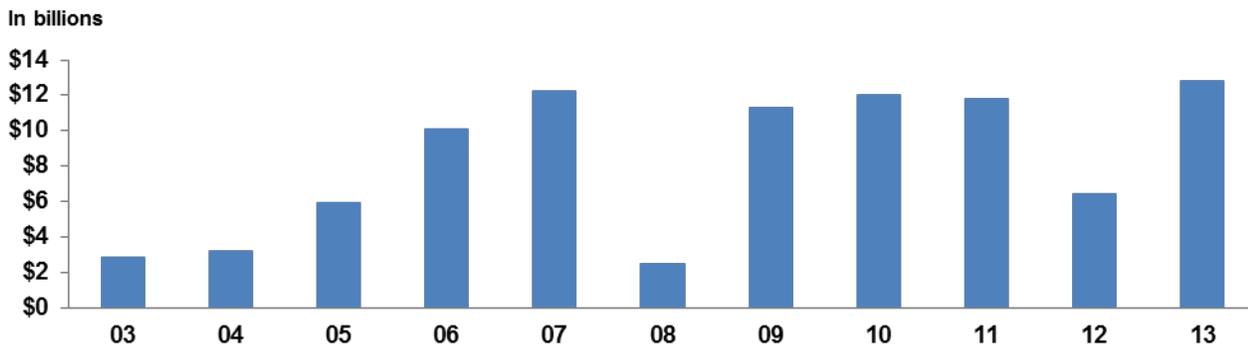


Source: Integrated Banking Information System (OCC)  
 Note: 2013 data as of June 30, 2013 (annualized); all other data as of year-end. Net operating revenue = net interest income + noninterest income

## Trading Revenues Return to Pre-Crisis Levels

Banks reported \$12.9 billion in trading revenues through mid-2013, nearly twice the results through the same period in 2012 (see figure 11). The weak 2012 results reflected the well-publicized losses at JPMorgan Chase Bank. Aside from the financial crisis of 2008 and the unusual results in 2012, trading revenues in the banking industry have been relatively consistent since 2006. Even including the two outlier years (2008 and 2012), trading revenues have averaged \$9.9 billion for the first half of each year since 2006. The trading of interest rate contracts remains the largest single contributor to total trading revenue, even exceeding the combined revenues from foreign exchange, commodities, and equities. Trading revenues are historically concentrated in the first half of the year, so it is unlikely that banks will duplicate their recent performance in the second half of 2013.

Figure 11: Trading Revenues for Banks

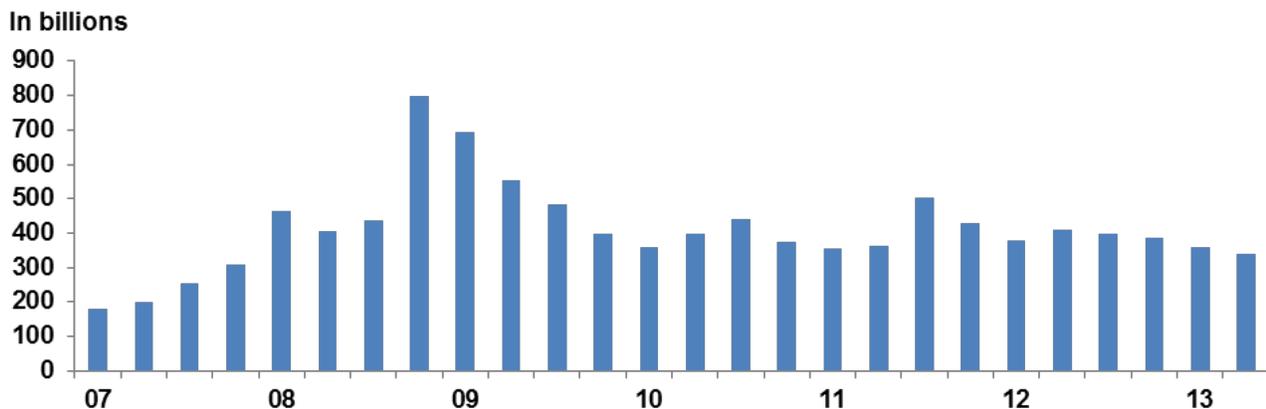


Source: Integrated Banking Information System (OCC). All data points as of June 30.

## Counterparty Credit Exposure on Derivatives Continues to Decline

Counterparty credit exposures from derivatives are a significant potential risk in trading activities. After peaking at \$800 billion at the end of 2008 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 (see figure 12). NCCE is now at its lowest level since the end of 2007. The difference between very low current swap rates and prevailing swap rates in dealers' interest rate books, which creates credit exposure, has narrowed because of the extended period of low interest rates and the substantial growth in notional derivatives that has occurred during this low-rate period.

Figure 12: Net Current Credit Exposure Declining

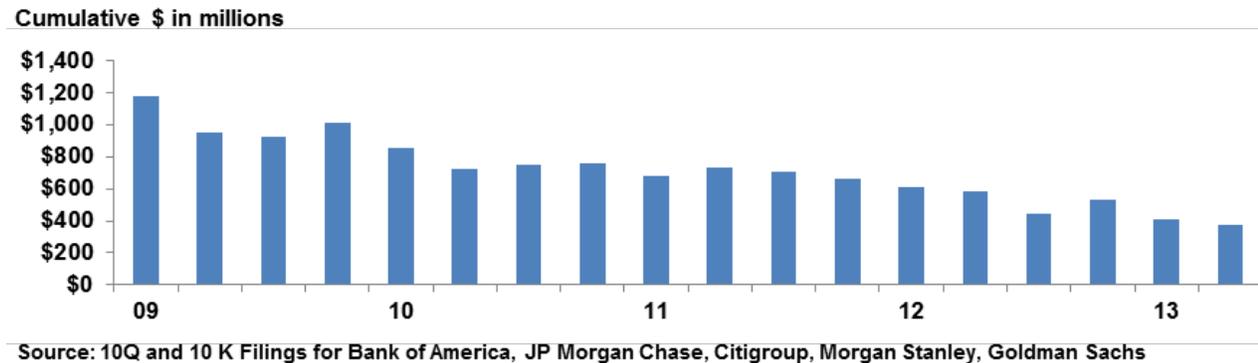


Source: Integrated Banking Information System (OCC)

## Low Market Volatility May Understate Risk

Unprecedented monetary policy easing has resulted in sharply lower interest rates, higher stock prices, and lower market volatility. Market volatility is a key factor in computing many risk measures. For example, banks use value-at-risk (VaR) models to measure the risk of trading activities. Aggregate VaR measures have dropped significantly since the end of the financial crisis at the five largest U.S. banking companies with trading operations (see figure 13). A concern in today’s unusual low volatility environments, however, is that risk measures such as VaR can understate potential risk. In a more normal volatility environment, bank VaR measures are much higher. Accordingly, it is important to recognize that the steep decline in VaR measures largely reflects the lower volatility environment, rather than fundamental changes in the composition of bank portfolios to reduce risk.

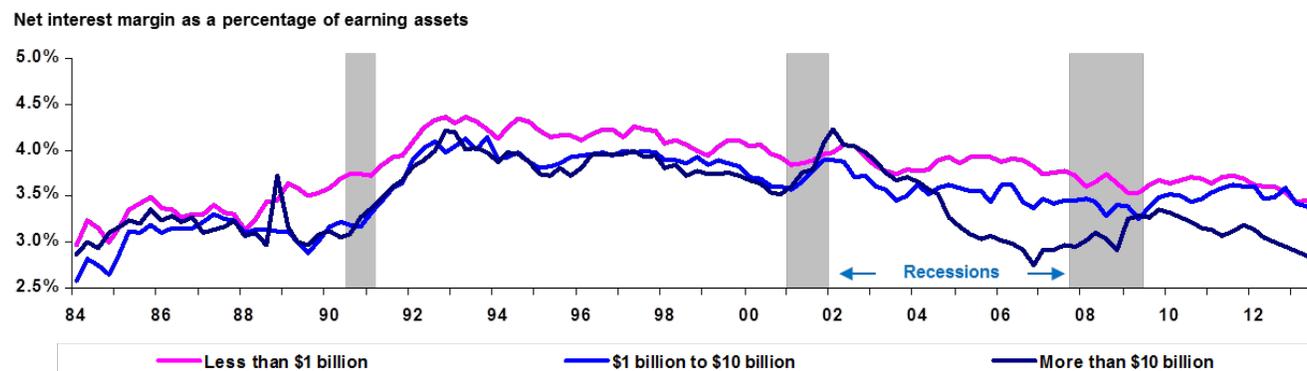
Figure 13: Aggregate Value-at-Risk at Five Large Banking Companies



## Net Interest Margin Compression Continues

Net interest margins remain under pressure as assets reprice at lower interest rates (see figure 14). 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 less than \$1 billion. The low interest rate climate continues to limit the ability of many banks to grow net interest income through volume. Consumer and commercial loans with pricing tied to short-term indices are unlikely to show improvement in the near-term, until the federal funds rate begins to increase. Accordingly, with the yield curve steepening, the incentive for banks to grow loan volume by loosening underwriting standards or investing excess cash into longer-maturity securities has increased, potentially increasing banks’ exposure to credit and IRR.

Figure 14: Trends in Net Interest Margins for Banks



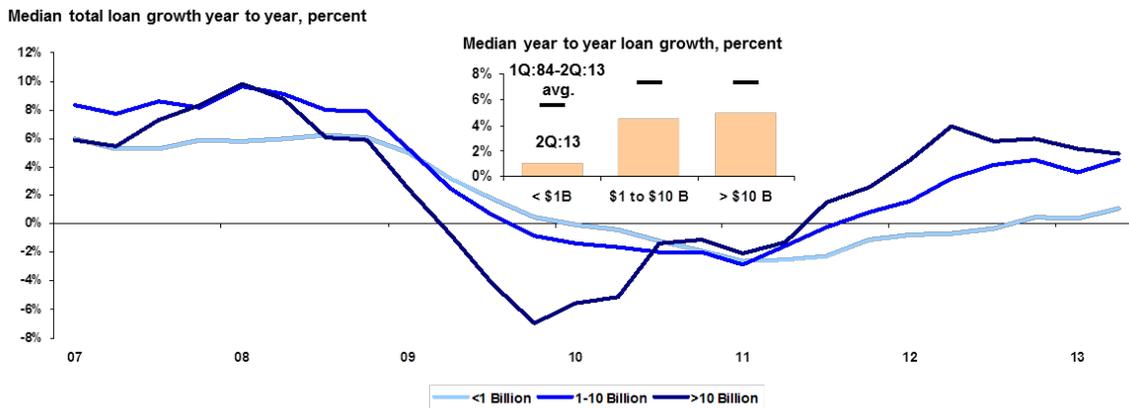
Source: Integrated Banking Information System (OCC)  
 Quarterly data through the second quarter of 2013. Non-specialty category excludes credit card and trust banks.

## B. Loan Growth Challenges

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

While slowly improving, loan growth remained weak through mid-2013. The largest banks continue to drive overall loan growth, while loan growth remained concentrated in commercial loans. The median year-to-year loan growth rate, while just over 4 percent for larger banks, was a much weaker 1 percent for banks with total assets of less than \$1 billion. Median loan growth for all size groups is well below long-term average rates (see figure 15).

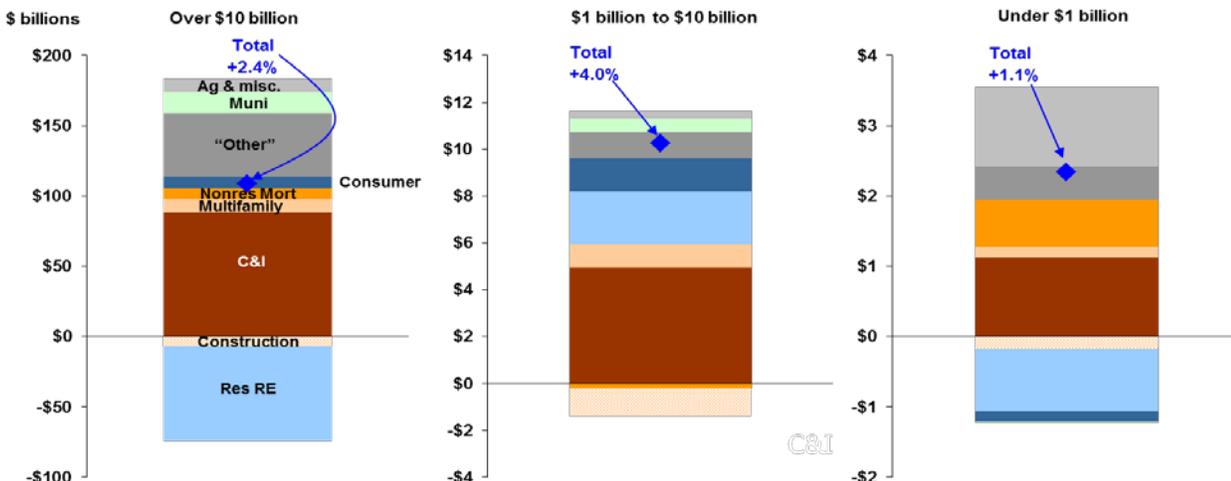
Figure 15: Median Loan Growth Trends for Banks



Source: Integrated Banking Information System (OCC)

C&I loans continue to be a large contributor to total loan growth for banks of all sizes (see figure 16). Loan demand from larger firms, fueled by improving business opportunities, continues to grow. Larger banks provide most of the credit support for these firms and, accordingly, have benefited most consistently from this trend. Smaller banks typically lend to small businesses, which still struggle, and C&I loan growth at small banks is more uneven. Some small banks are reporting robust C&I loan growth, while others continue to show declines. As of June 2013, and after adjusting for mergers, banks with less than \$1 billion in assets as a group reported just 1 percent growth in total loans outstanding over the past year, due in part to this bifurcation in small bank loan activity.

Figure 16: Loan Growth Trends for Banks, Second Quarter 2012 to Second Quarter 2013



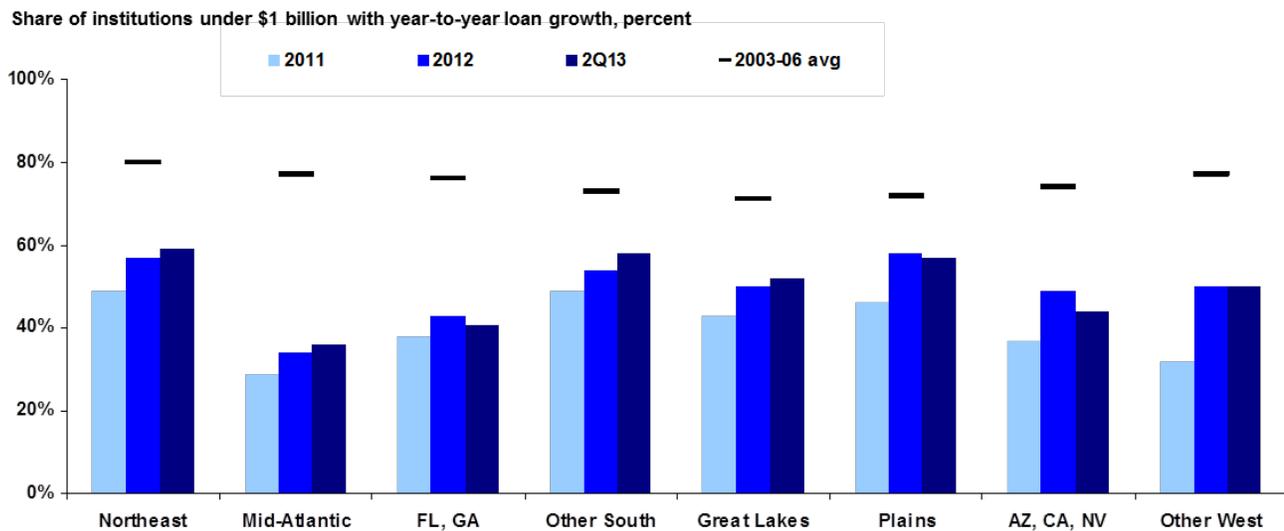
Source: Integrated Banking Information System (OCC)

Data are merger-adjusted and held constant for institutions in continuous operation from first quarter of 2006 to second quarter of 2013

Note: Scales differ

The weak and uneven recovery in C&I growth at smaller banks is part of a broader pattern in their lending trends. Loan growth among small banks has not been as widespread as in normal economic times (see figure 17). On a regional basis, only 40 percent to 50 percent of banks with less than \$1 billion in assets reported loan growth over the past 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 remain particularly hard pressed for small-bank loan growth include the mid-Atlantic states, Florida, and Georgia. Meanwhile, the Northeast, the Southern states outside of Florida and Georgia, and the Plains states had some of the highest incidence of loan growth at small institutions. Local economic conditions drive these patterns, as strong agriculture, 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 17: Loan Growth for Small Banks by Region**



Source: Integrated Banking Information System (OCC)

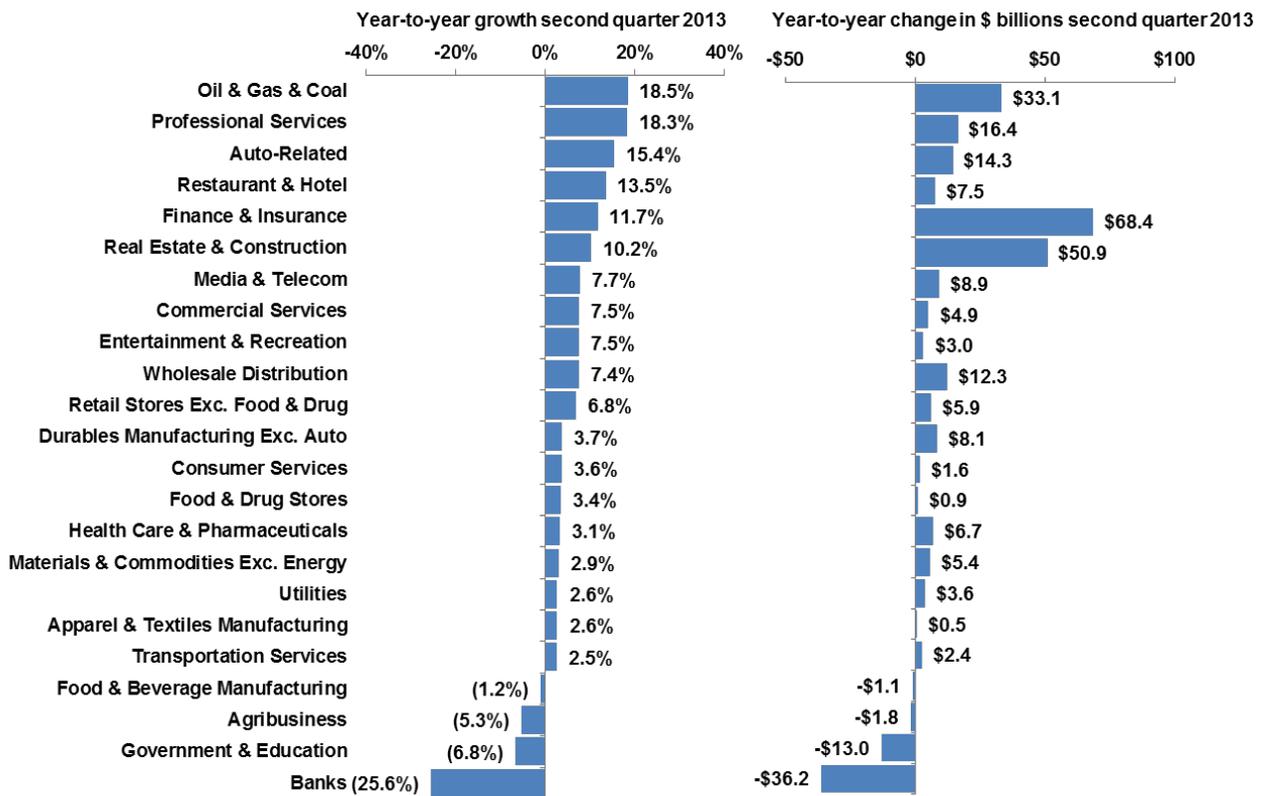
Northeast = CT, MA, ME, NH, NJ, NY, PA, RI, VT  
 Great Lakes = IL, IN, MI, OH, WI  
 Other South = AL, AR, KY, LA, MS, TN, TX, OK

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

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

Large and midsize banks reporting into the OCC’s Credit Analytics<sup>3</sup> data system experienced commercial loan growth across a wide array of industries, with 20 of 24 industry groups experiencing growth over the past year. While loan growth was evident across most industry groups, lending to finance and insurance (non-bank financials), real estate and construction, and energy led the way (see figure 18). Other industry groups with strong double-digit growth include professional services, automobile-related, and restaurant and hotel. Lending to the energy sector is one of the new areas of focus for many banks. These banks need to ensure they have the necessary expertise to understand the risk in this industry.

Figure 18: Commercial Loan Growth by Industry for Select Banks



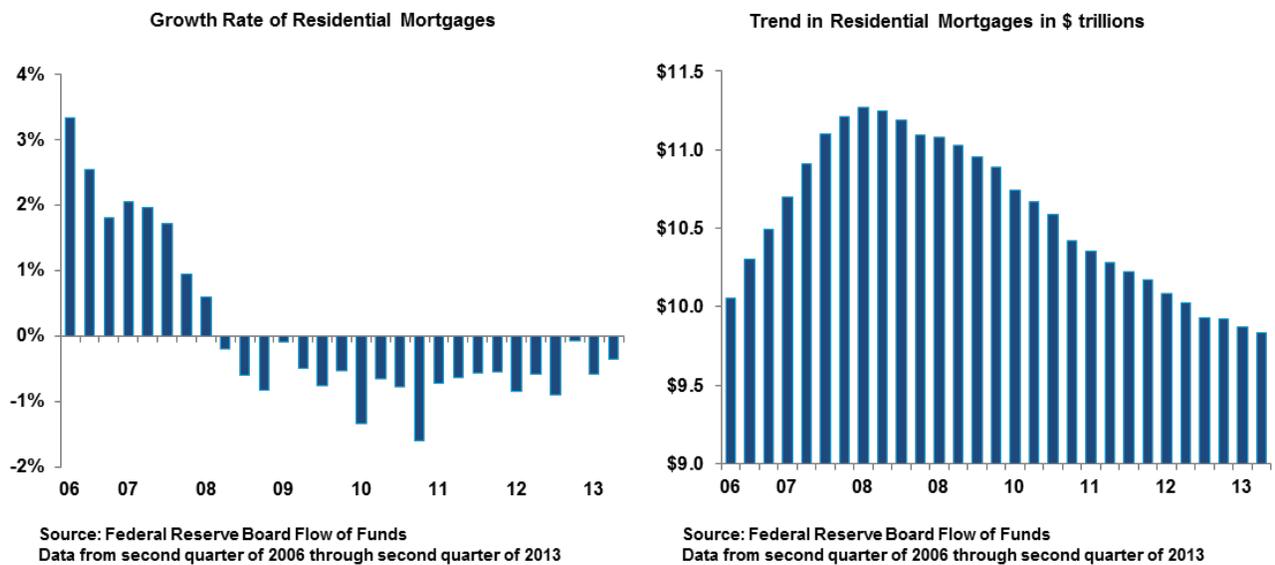
Source: OCC Credit Analytics

<sup>3</sup> 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.

## Residential Mortgage Runoff Continues, Offsetting Rising Demand for Auto and Student Loans

The residential real estate market had experienced a substantial amount of mortgage origination activity in the first half of 2013 (though activity began to wane late in the period as mortgage rates rose). Even so, institutions continue to have an unprecedented runoff in residential mortgages. The contraction of economy-wide residential mortgage credit has extended to 21 consecutive quarters (from the second quarter of 2008 through the end of the second quarter of 2013) and is down nearly 13 percent since peaking at \$11.3 trillion at the end of March 2008 (see figure 19). 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.<sup>4</sup> 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 increase in mortgage interest rates since early May has caused banks to reduce mortgage banking personnel.

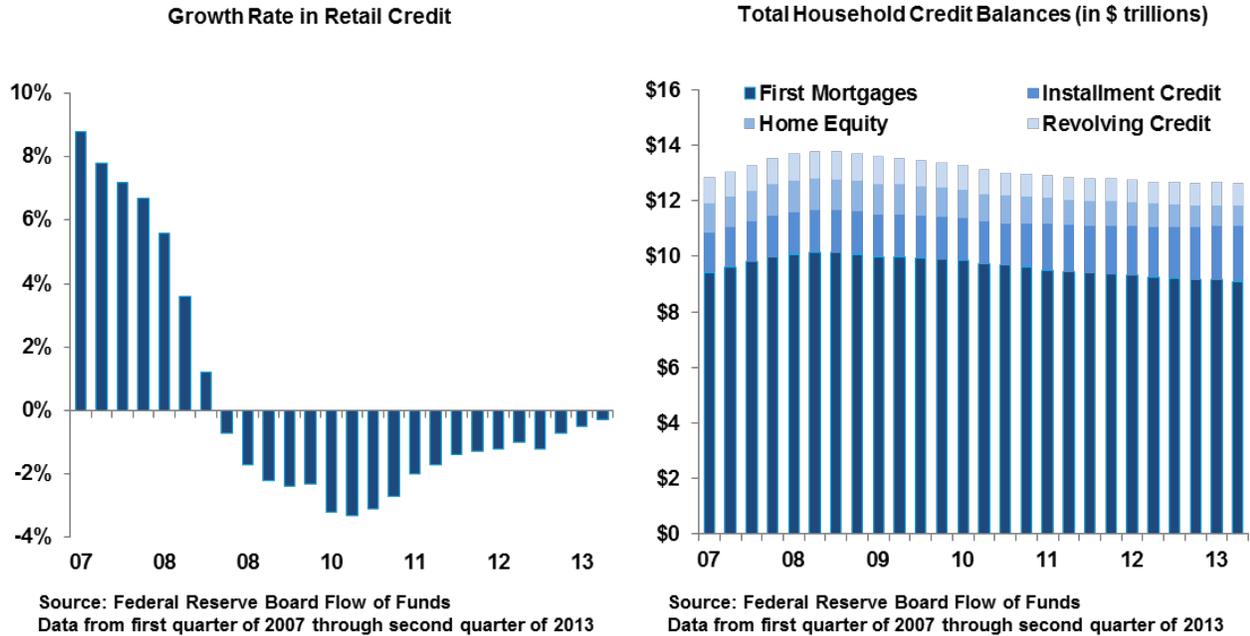
**Figure 19: Quarterly Trend in Residential Mortgages Outstanding**



<sup>4</sup> The prevalence of cash-only investor purchases and short sales in recent years has contributed to constraining aggregate growth in outstanding mortgage debt.

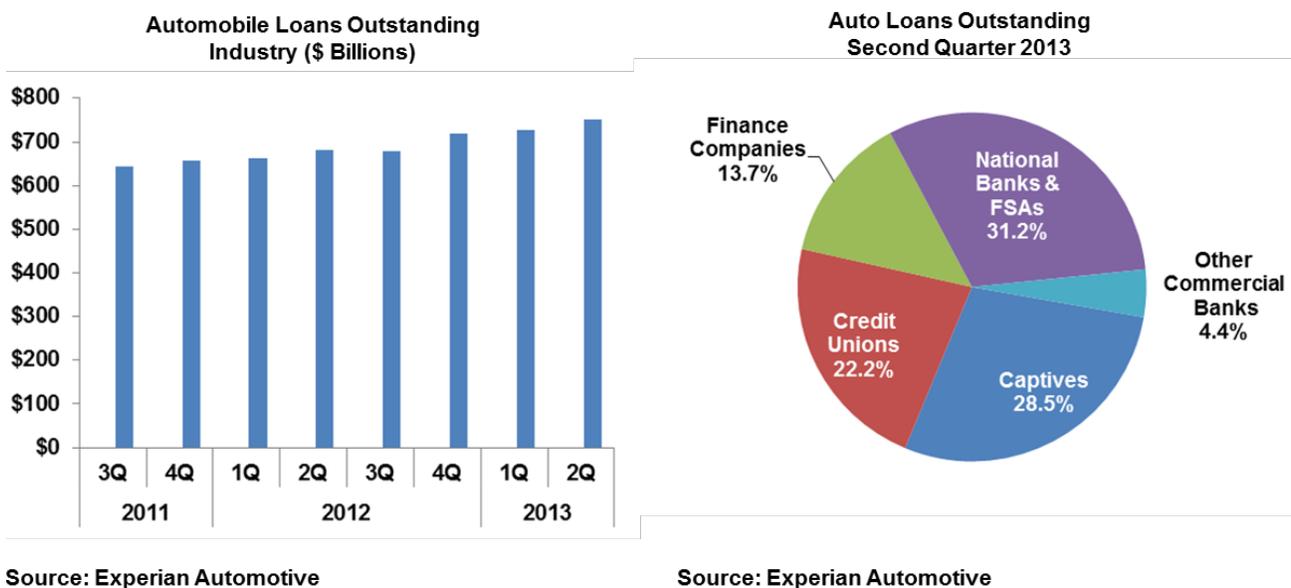
Tighter underwriting standards and runoff in residential mortgages continued to drive the decline of household debt levels through the first half of 2013. Indeed, this contraction in outstanding mortgage loans has more than offset the recent increased demand for installment credit in auto and student loans (see figure 20).

**Figure 20: Total U.S. Household Credit Balances**



Although consumer lending overall moderated through mid-2013, automobile lending saw steady growth (see figure 21). Industry-wide, the year-over-year growth was 8.5 percent in the second quarter of 2013, the 10th consecutive positive-growth quarter. Growth patterns are similar in national banks and federal savings associations, and OCC-regulated companies continue to hold a substantial market share with outstanding loans of \$234 billion, or 28 percent of the total auto lending market.

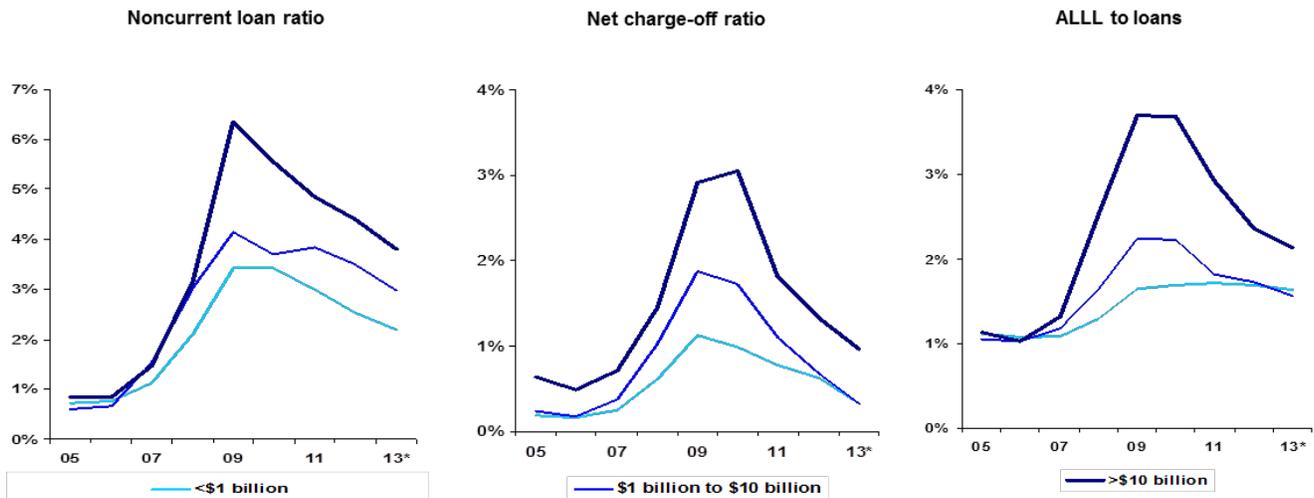
**Figure 21: Industry Trends in Auto Lending**



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

The credit cycle continued to show improvement through the first half of 2013 (see figure 22). Noncurrent loans—those 90 days or more past due or on nonaccrual—declined for large and small banks, although not as quickly as did net charge-offs at these banks. Consistent with the direction of the noncurrent loan ratio, the ALLL continued to decline in the first half of 2013 as a percentage of total loans. The OCC expects the recent, rapid decline in ALLL to abate as it returns to a more normal share of total loans. Since noncurrent loans remain historically elevated and the economic outlook remains guarded, however, the ALLL may need to stabilize as a share of total loans that is above its pre-crisis level.

Figure 22: Credit Cycle Analysis for Banks



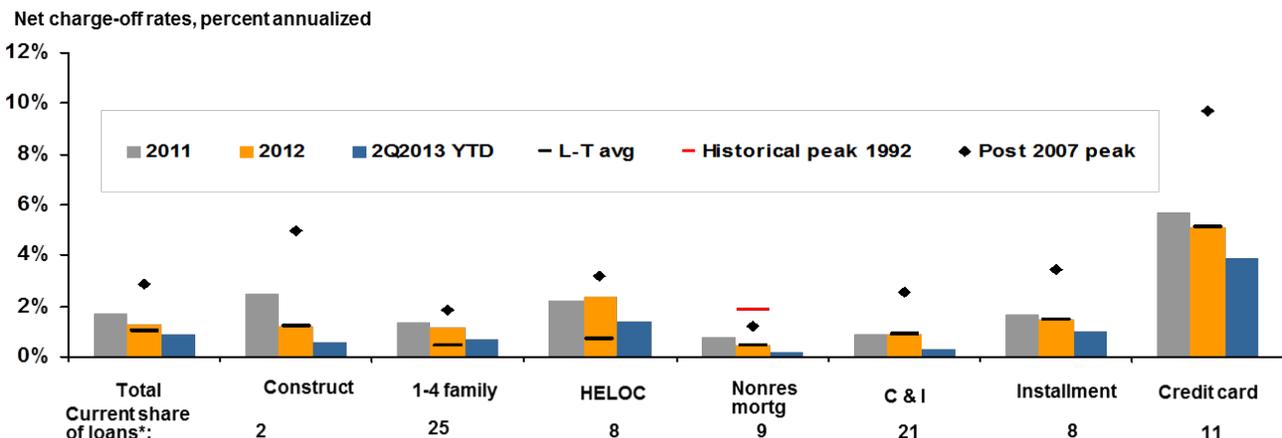
Source: Integrated Banking Information System (OCC)

\* 2013 data as of June 30, 2013; all other data as of year-end. Noncurrent loans are 90-days or more past due and nonaccruals.

### Charge-Off Rates for Most Loan Types Drop Below Long-Term Averages

Charge-off rates continued their decline through the first half of 2013 for all major loan types (see figure 23). The current loss rate levels for all major loan types except HELOCs and one- to four-family residential remain below the post-1990 long-term average.

Figure 23: Charge-Off Rates by Asset Class for Banks



Source: Integrated Banking Information System (OCC)

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

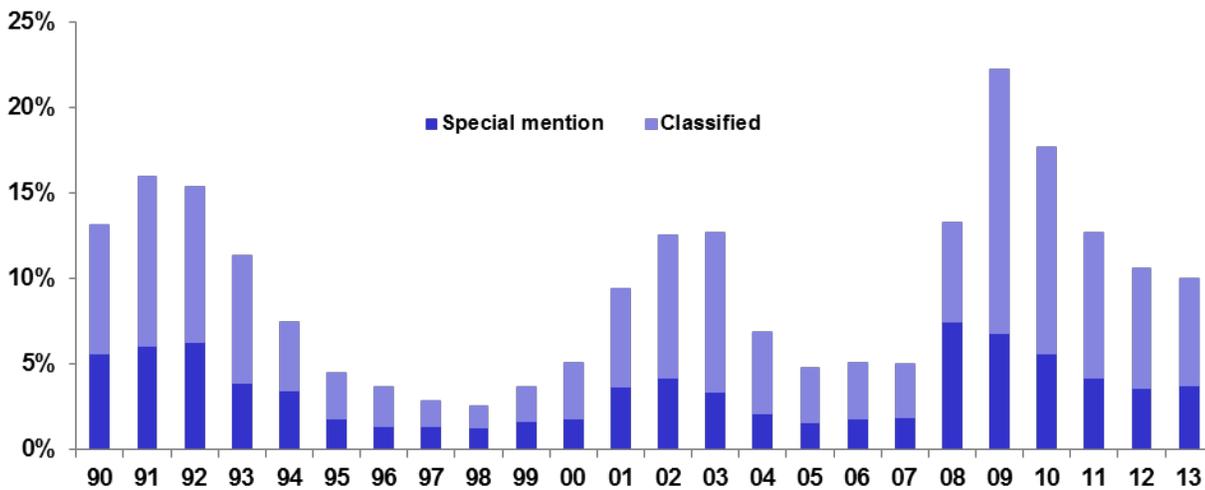
## Shared National Credit Review: Adversely Rated Credits Still Above Average Levels

The interagency Shared National Credit (SNC) Review for 2013 reported that credit quality remained broadly unchanged from last year's review (see figure 24). Both the volume and percentage of classified assets declined over the year but remained above long-term averages. Classified assets declined by \$9 billion to 6.2 percent of the portfolio from 7.0 percent last year. Special mention assets increased by \$16 billion, up 16 percent from last year, and represent 3.8 percent of the portfolio, up from 3.6 percent last year.

Leveraged loans accounted for only 18 percent of the SNC portfolio but 75 percent of special mention and classified assets collectively. Further, the review classified or rated as special mention 42 percent of the leveraged loan portfolio. Moreover, the review identified material weaknesses in the underwriting standards of 34 percent of leveraged loans issued in 2012 and 2013. This represents a substantial increase from the previous three reviews. Overall, the review cited 24 percent of all recent vintage SNCs as having weak underwriting; this was a higher rate than the previous three years. Weaknesses in underwriting were concentrated in excessively high leverage; the absence of prudent loan covenants; inadequate capital; and the inability to de-lever to reasonable levels.

The SNC report sent a message that syndication arrangers and distributors should ensure they do not heighten risk to the financial system by originating poorly underwritten and low-quality loans. Consistent with the "Interagency Guidance on Leveraged Lending" that was issued on March 22, 2013, the appropriate federal banking supervisor will criticize institutions engaged in leveraged lending without strong risk management processes.

**Figure 24: Trend in Shared National Credit Review**

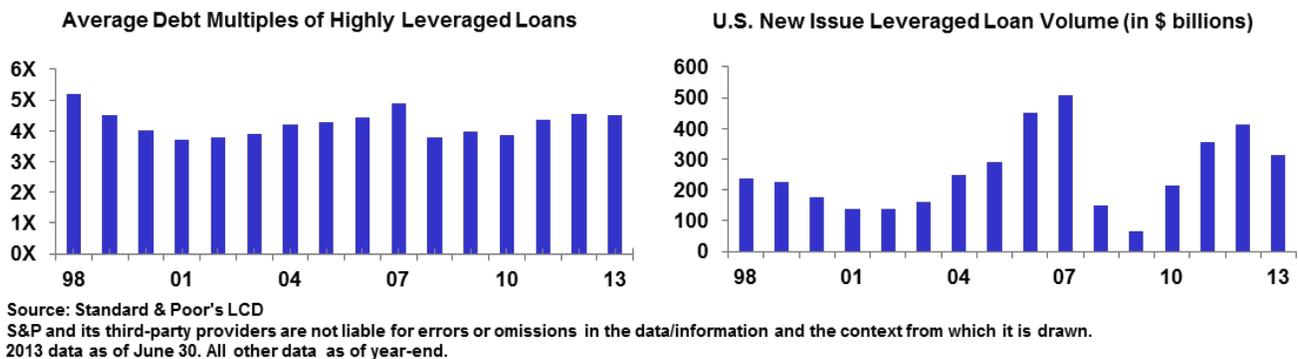


Source: SNC Database

## Significant Leveraged Loan Issuance Accompanied by Weaker Underwriting

U.S. leveraged loan issuance was significant during the first six months of 2013, driven by demand from institutional investors searching for high yields and by refinancing of 2006 and 2007 vintage loans (see figure 25). Leveraged loan issuance during the first six months of 2013 exceeded \$400 billion, a level exceeded only by the volume issued in the comparable period of 2007. Signs of aggressive underwriting standards in 2013 include high and increasing debt ratios and weakened or non-existent loan covenants. The average total debt-to-EBITDA (earnings before interest, taxes, depreciation, and amortization) multiple for highly leveraged loans issued in the first six months of 2013 was 4.6X, a level last exceeded in 2007 (see figure 25). Higher leverage is historically associated with increasing competition for lending opportunities and evidenced by the continued narrowing of credit spreads. The combination of higher leverage, tighter credit spreads, and weaker covenant protections such as leverage, capital expenditures, and cash flow covenants provide ample evidence of increasing credit risk in the syndicated leveraged loan market.

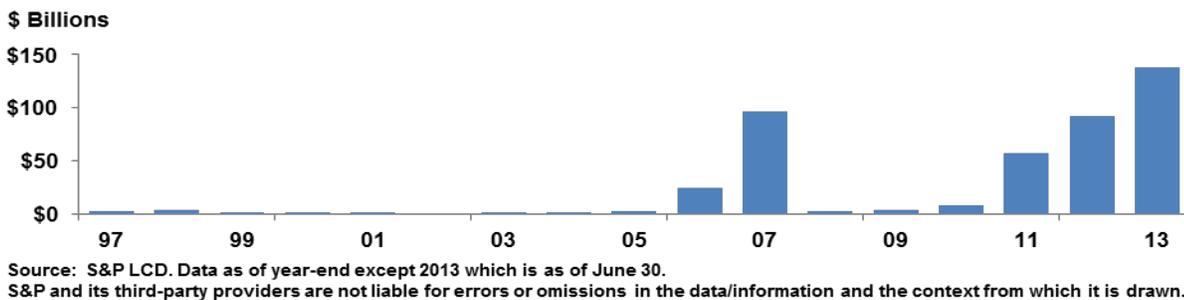
**Figure 25: Average Total Debt-to-EBITDA Multiples & Leveraged Loan Volume**



## New Issuance Covenant-Lite Leveraged Loan Volume Surges

Investor demand for high-yield products continued to surge, with noticeably more relaxed structures incorporating fewer covenants and lender protections. New-issue covenant-lite<sup>5</sup> loans totaled \$138 billion in the first half of 2013, a level that eclipsed the previous annual record of \$97 billion in 2007 and follows on the \$91 billion issued in all of 2012 (see figure 26). Accordingly, the quality of underwriting in the syndicated leveraged loan space remains a supervisory concern.

**Figure 26: New Issuance of Covenant-Lite Leveraged Loans**



<sup>5</sup> Covenant-lite includes syndicated loans that have no covenants or have limited, bond-like incurrence covenants rather than traditional maintenance covenants.

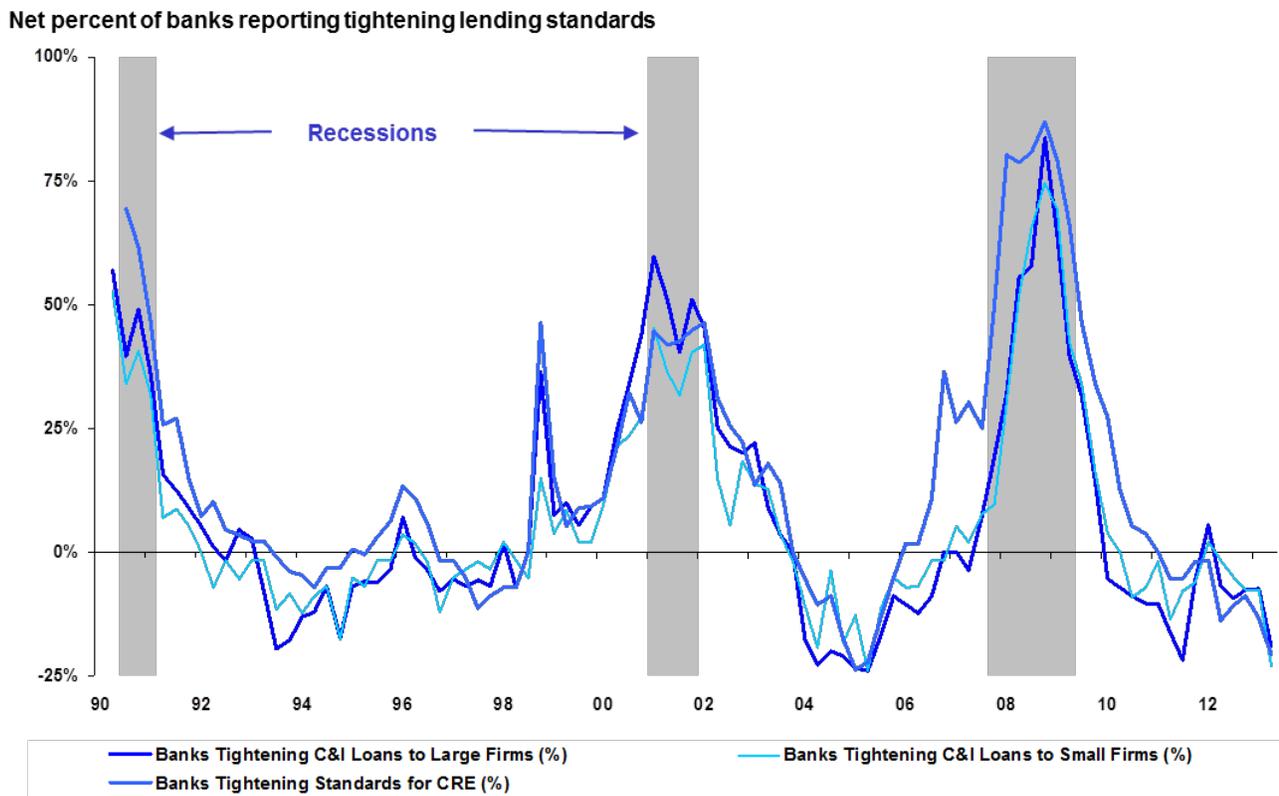
## Commercial Loan Underwriting Standards Easing

The OCC's underwriting survey results (as of June 30, 2013) show that underwriting standards are easing in both commercial and retail products. Examiners reported that large banks saw the most widespread easing, and banks' increasing risk appetite, competition, and market liquidity were cited as the main reasons behind the weakened underwriting. Loan portfolios that experienced the most easing in standards included indirect consumer, credit cards, large corporate, asset-based lending, international, and leveraged loans. Changes in collateral requirements, loosening covenants, and scorecard cutoffs were the primary methods that banks used to ease standards. Loan portfolios with the most tightening in underwriting included high loan-to-value home equity and conventional home equity.

The Federal Reserve Board's July 2013 "Senior Loan Officer Opinion Survey on Bank Lending Practices" reported that nearly 20 percent of surveyed banks (on net) eased their lending policies and underwriting standards on C&I loans in the second quarter of 2013. C&I lending standards have eased for four consecutive quarters and in 12 of the past 13 quarters (see figure 27). Aggressive competition from banks and non-bank lenders and an improving economic climate were among the reasons cited for the net easing of standards. Most of the easing was reported in loan covenants, maturity, and pricing.

Recent regulatory examinations also have reported an increased risk appetite for C&I loans and easing of underwriting standards for commercial loans in general.

**Figure 27: Percentage of Survey Respondents Tightening C&I and CRE Underwriting Standards**

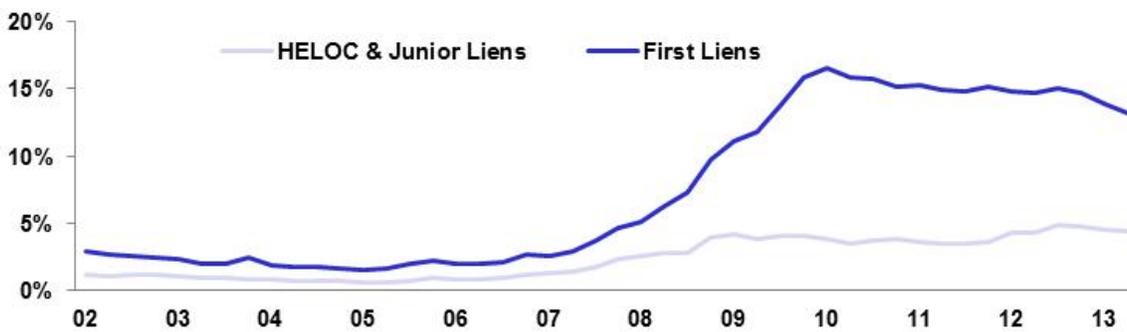


Source: Federal Reserve Board/Haver Analytics (August 2013)

## Mortgage Delinquencies Declining, but Remain Elevated

The delinquency rate for on-balance-sheet senior and junior residential mortgages declined to 13.1 percent and 4.4 percent, respectively, at the end of the second quarter of 2013 (see figure 28). Elevated delinquency rates suggest that above-average net charge-off rates will continue for this loan segment as lenders dispose of troubled loans. Junior lien performance also reflects the early stages of the HELOC end-of-draw issue. Depressed home values in some markets 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 expects banks offering HELOC products to establish processes to quantify and address this risk of increased delinquencies and losses. Taking action at an early stage will provide greater flexibility for borrowers and will allow banks to quantify and mitigate a portion of this risk.

Figure 28: Trend in Residential 30+ Day Mortgage Delinquencies for Banks

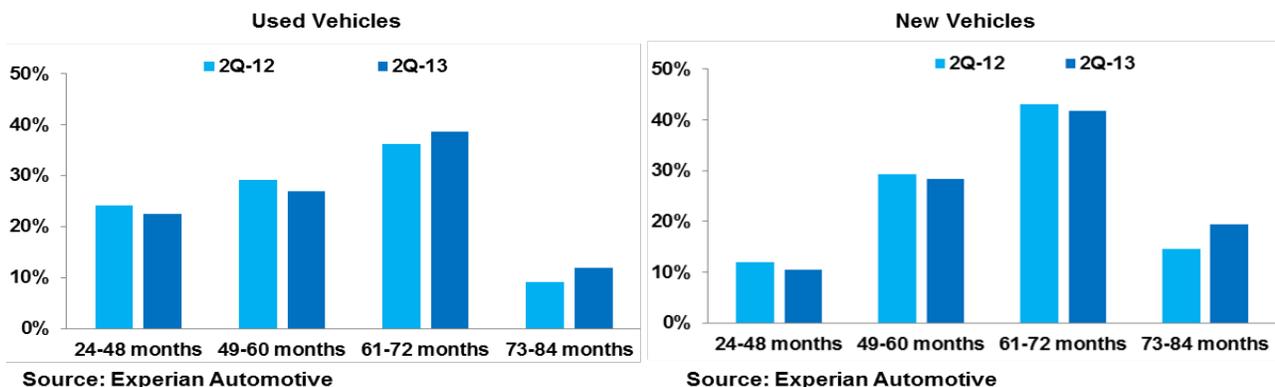


Source: OCC Integrated Banking Information System

## Auto Lending Terms Extending

Auto delinquencies and losses are reasonably stable, though they are drifting higher. While these lagging indicators are not yet a concern, changes in product structures and payment terms may be embedding future risk in the portfolio. Most notable among these changes is the lengthening of loan terms in an attempt to make monthly payments more affordable. Recent Experian data show the shift to extended terms for both new and used vehicles, with substantial volumes longer than the traditional 48-to-60 month payment schedules (see figure 29). Lenders originated 61 percent of new vehicles and 50 percent of used vehicles, with terms greater than 60 months. Because automobile underwriting often uses unverified income, this migration to longer loan terms adds another layer of risk that is difficult to measure. The OCC will monitor these trends closely over the coming quarters.

Figure 29: Share of Auto Financing by Term



Source: Experian Automotive

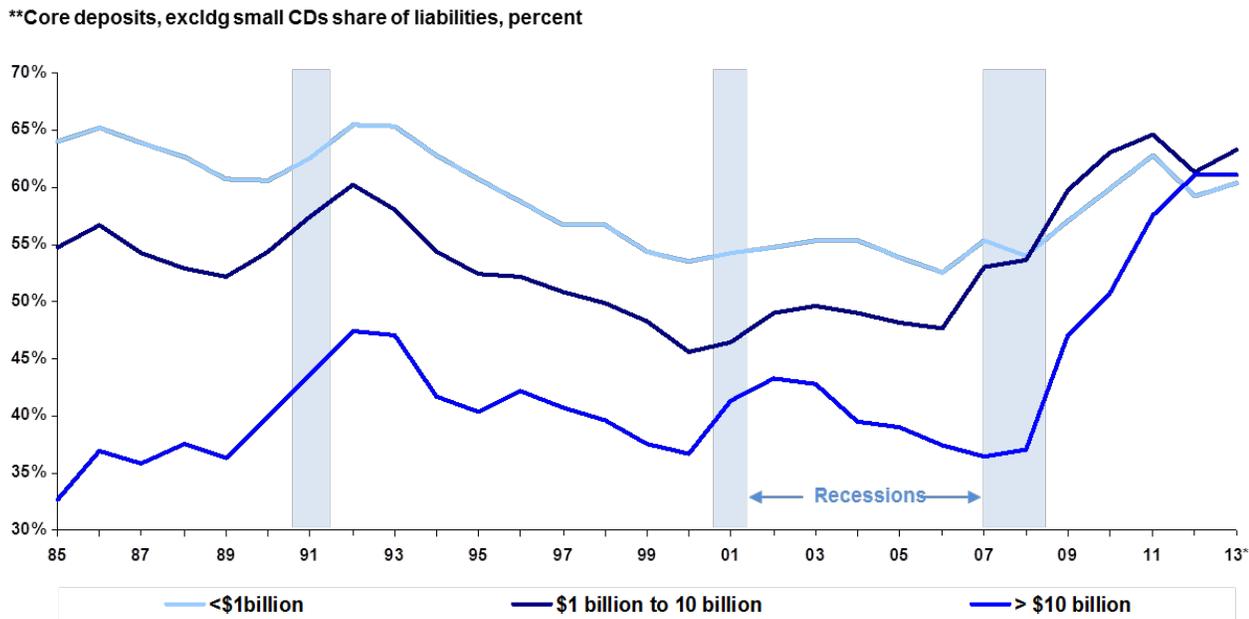
Source: Experian Automotive

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

**Retention Rate of Post-Crisis Core Deposit Growth Remains Uncertain**

The retention rate (and pricing) of post-crisis deposits remains a key behavioral factor in IRR models. During 2012, banks under \$10 billion in assets showed the first decline in the core deposit share of total liabilities since the financial crisis; the share for the largest banks rose (see figure 30).<sup>6</sup> Bankers need to analyze core deposits carefully because they are potentially more sensitive to rising interest rates than historical relationships would suggest. These deposits flowed quickly into the U.S. banking system and are at risk of rising more rapidly in cost or moving out of the banking system. Recent communications with the industry and ongoing IRR supervisory efforts focus on deposit pricing and runoff assumptions in stressed rate environments. Deposit modeling assumptions are a key component of IRR measurements and a driver of earnings and economic capital exposures in modeled rate scenarios. Institutions should establish methods to capture deposit behavior to improve the accuracy of IRR measurements. At a minimum, the OCC expects banks to model alternative deposit assumptions to test the potential effect on earnings and economic capital at risk from changes in interest rates.

**Figure 30: Trends in Core Deposits for Banks**



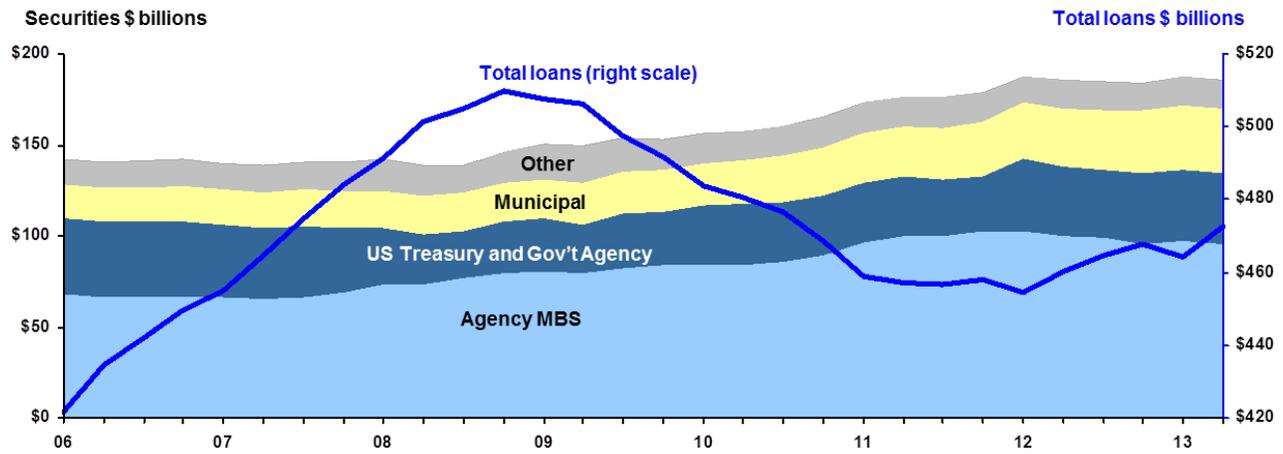
\*2013 data as of June 30, 2013; all other data as of year-end. \*\*Core deposits defined as domestic deposits less time deposits of \$100k or more. Ratio also excludes small CDs.

<sup>6</sup> Core deposits as analyzed here are equal to domestic deposits, less time deposits (CDs) of any size.

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

Banks with assets less than \$10 billion have increased their aggregate investment portfolios since mid-2008 in response to ongoing strong deposit growth and a decline in loan balances (see figure 31). The increase in the investment portfolios remained centered in MBS. Material concentrations in MBS could make some banks more vulnerable to IRR because of the potential duration extension in a rising rate environment.

Figure 31: Investment Portfolio Mix for Banks With Total Assets Less Than \$10 Billion

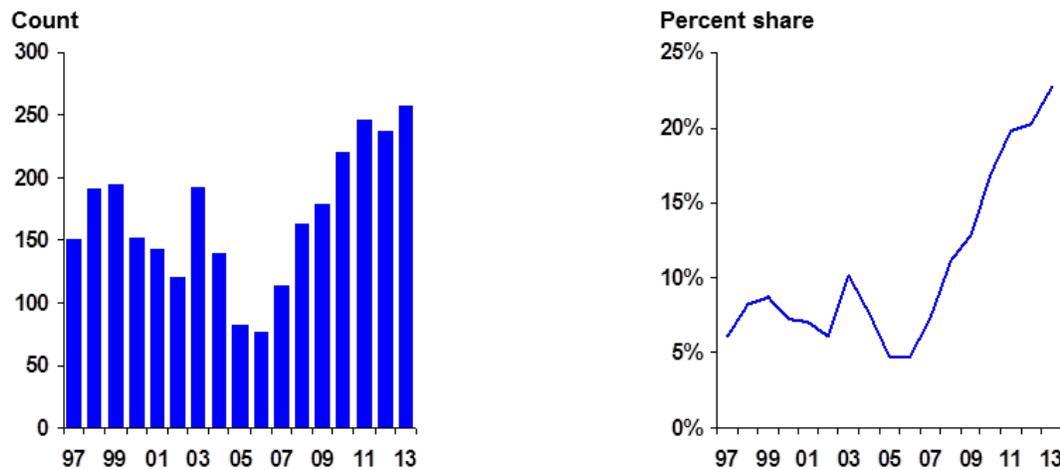


Source: Integrated Banking Information System (OCC)

Data are merger-adjusted and held constant for institutions in continuous operation from the first quarter of 2006 to the second quarter of 2013.

Many national banks with assets less than \$10 billion also have increased their holdings of long-term securities (see figure 32). The number of national banks with less than \$10 billion in assets holding 25 percent or more of their total assets in long-term securities increased from 77 (or 5 percent) at year-end 2006 to 258 (or 23 percent) in the second quarter of 2013.

Figure 32: Trends in Holdings of Long-Term Securities\* by National Banks With Total Assets Less Than \$10 Billion



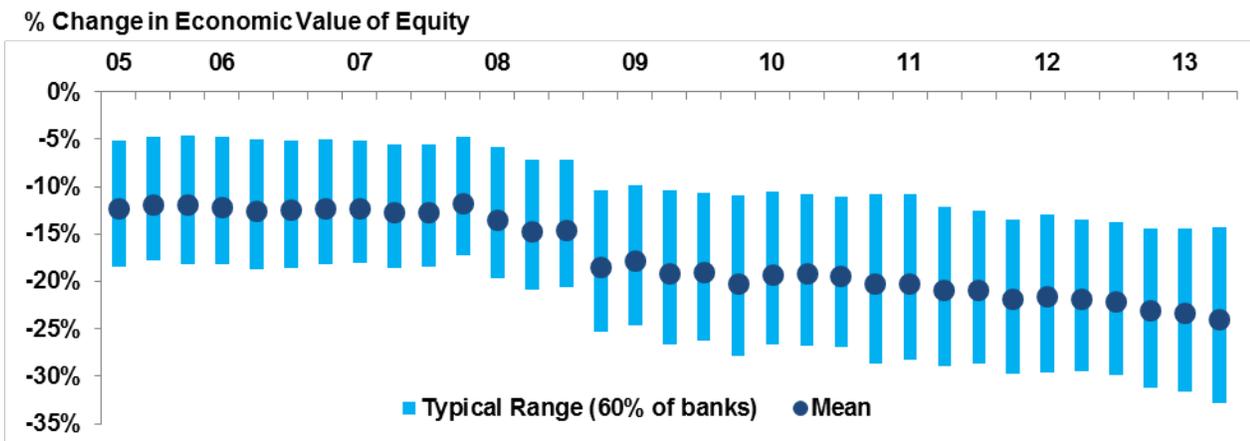
Source: Integrated Banking Information System (OCC)

\*Banks with at least 25% of total assets held in the form of long-term securities with the following maturities: pass through MBS and other non-mortgage securities over 5 years; other MBS (CMOs/REMICs) over 3 years. 2013 data as of June 30, 2013; all other data as of year-end. Data exclude credit card and trust specialists.

## Commercial Banks Increasing Economic Value of Equity Risk

Economic value of equity (EVE) is one measure of IRR used by commercial banks. The EVE approach focuses on a longer-term time horizon, captures all future cash flows expected from assets and liabilities, and effectively considers embedded options. Banks with longer maturity assets tend to experience a decline in EVE when interest rates rise, as rising funding costs outstrip the benefit from any simultaneous increase in asset yields. According to data from Olson Research Associates (and consistent with the industry’s increased holdings of longer-term MBS), given a 200 basis point interest rate increase (shock), commercial banks would now see an average negative adjustment of 24 percent to their EVE—versus only half that as recently as mid-2007 (see figure 33).<sup>7</sup>

Figure 33: Commercial Bank Average EVE Exposure to a +200 Parallel Change in Interest Rates



Source: Olson Research Associates, Inc.  
Data from the second quarter of 2005 through the second quarter of 2013.

<sup>7</sup> This finding is based on publically available data modeled by Olson Research Associates. The sources of data are regulatory reporting, security investment downloads, supplemental data supplied by bank management, and modeling assumptions. Assumptions are based on historical bank data, industry norms, and supplemental information supplied by bankers.

## **Part IV: Elevated Risk Metrics**

The OCC’s NRC tracks a number of risk metrics to help monitor and communicate system-level financial risks in a user-friendly way to internal OCC audiences, including its examination staff, and to the industry. At present, the group of indicators monitored by the NRC is starting to show some movement back toward an increased risk appetite, following several years of risk aversion. This is especially evident in some of the underwriting indicators and other areas of concern discussed in this report. Increased risk appetite by itself is not generally a supervisory concern, provided banks maintain an effective governance framework. The NRC developed this collection of indicators by identifying notable movements and patterns in certain indicators that provided advanced signals of elevated risks during past economic cycles. These indicators are based on a contrarian view of risk—that is, they look for signals of unusually benign economic and market conditions. Historically, it is under such conditions that many bankers and investors begin to increase their risk appetites. For example, figure 34 shows that before the financial crisis of 2008, market volatility was very low, home prices were quickly increasing, and traditional credit indicators showed little risk. In that environment, many bankers increased their risk appetite because they assumed these indicators would remain positive. These indicators, when viewed collectively, help inform supervisory policy early in the credit cycle by providing a gauge of shifting risk appetite relative to historical levels—long before any potential negative consequences from these shifts become evident in lagging indicators, such as rising delinquency rates.

### **VIX Index Signals Low Volatility**

The VIX, a popular measure of the implied volatility of Standard & Poor’s 500 index options and commonly known as the “fear index,” illustrates the general downtrend in volatility in recent years (see figure 34). Many market participants refer to the VIX as a fear index because it measures market expectations of near-term volatility, which tends to rise when market prices fall. VIX levels below 20 (and especially below 15) suggest complacency in the stock market, which has often led to sustained increases in risk appetite and subsequent market instability. While volatility moved higher in the second quarter of 2013, after the Federal Reserve Board suggested that it might begin to “taper” bond purchases later in the year, volatility remains extremely low by historical standards. The longer volatility remains low, the more likely investors are to “chase” yields (maximize returns), often selling options that expose them to losses if prices drop suddenly or taking on increased credit risk. Accordingly, it is important that banks and investors take special care to maintain discipline in their risk control frameworks during periods of low volatility.

**Figure 34: The VIX Reflects the Decline in Volatility**

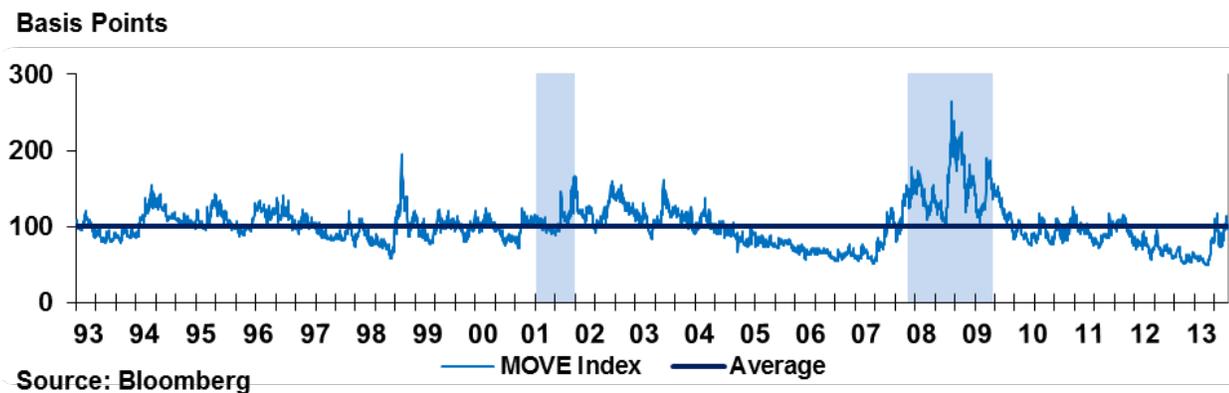


Source: Bloomberg

## Bond Volatility Rising but Near Long-Term Average

The Merrill Option Volatility Estimate (MOVE) is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options. It is the weighted average of volatilities on the 2-, 5-, 10-, and 30-year Treasuries. Market participants often refer to the MOVE as the bond market’s “fear index.” A high number reflects fear while a low number reflects complacency. Historically, sustained readings below 80 suggest extreme complacency, encouraging an increase in risk appetite as banks and other market participants view future price changes as more likely to occur within a narrow band. Such periods have often preceded instability in markets. The MOVE touched an all-time low in December 2012 and remained low until the second quarter of 2013, after the Federal Reserve Board suggested that it could begin to “taper” bond purchases later in the year (see figure 35). The MOVE has receded from its recent high and remained just below the long-term average of 100 as of June 30.

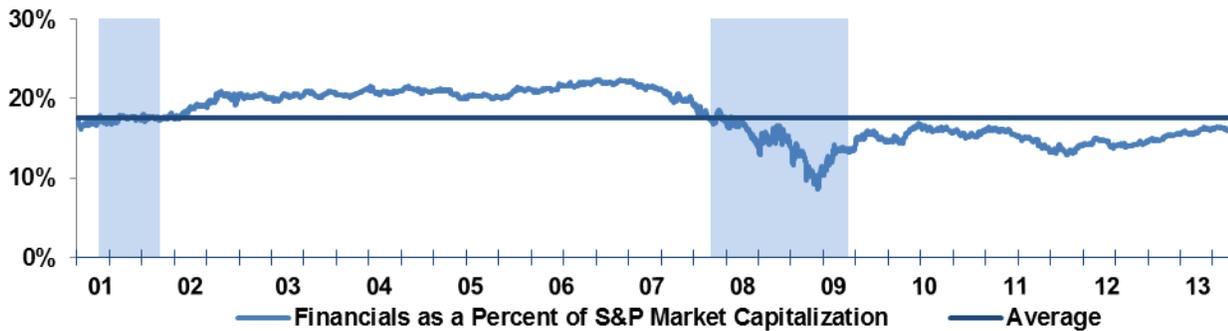
Figure 35: The MOVE Index Reflects the Increase in Bond Volatility



## Financials' Share of the S&P 500 Rising but Remains Below Average

High rates of income growth have historically proven to indicate increasing risk in the banking system, especially when they occur in the mature phase of an economic expansion. The current market capitalization of the S&P financial sector as a percentage of the current market capitalization of the S&P is indicative of the strength of market expectations for bank earnings. When financial companies represent a disproportionate share of the S&P 500's market value, it indicates that investors anticipate stronger relative growth in future banking industry earnings. Banks, in turn, may increase their risk profiles to deliver on these expectations. Currently, this metric is still below the long-term average of 18 percent, suggesting investors are not currently expecting significant earnings growth from the banking industry (see figure 36).

Figure 36: Financials' Capitalization as a Percentage of the S&P 500

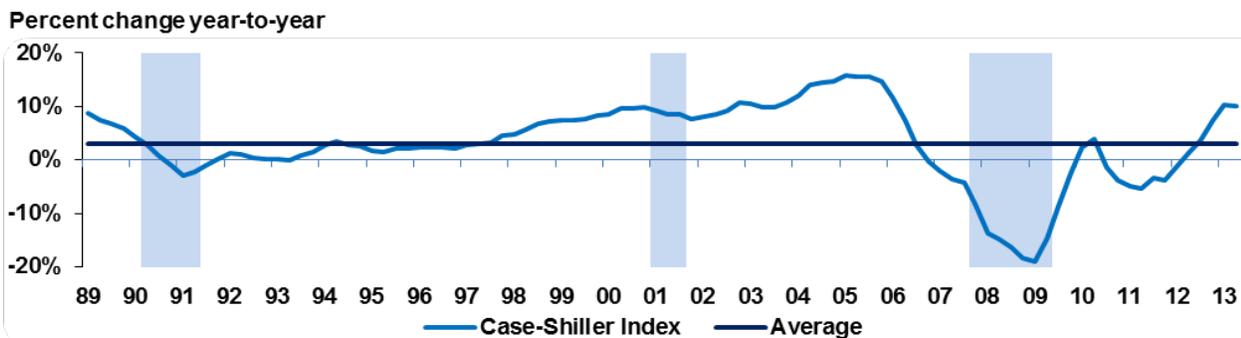


Source: Bloomberg

## Home Prices Rising

Generally, rising home prices encourage more aggressive real estate lending as collateral values rise and reduce stated loan-to-value ratios, but this can lead to significant losses once price growth moderates. The S&P/Case-Shiller composite home price index covering 20 large U.S. metropolitan markets provided some advance warning of the recent housing bubble and subsequent collapse. Figure 37 shows the year-to-year percentage changes in this home price index over time—with growth of about 10 percent during the past two quarters. Although the recent 10 percent annual price increases seem similar to those in 2003 in the early stages of the last home price bubble, it is important to note that in the current climate, all-cash investor sales have played an inordinate role in driving up home prices from their post-bust low points, especially in many of the hardest hit markets. Thus, the risk to underwriting standards from excessive optimism on real estate prices is likely low at the present time; indeed, total U.S. home mortgage debt continued to decline through June 2013.

Figure 37: Long-Term Trends in the S&P Case-Shiller Home Price Index

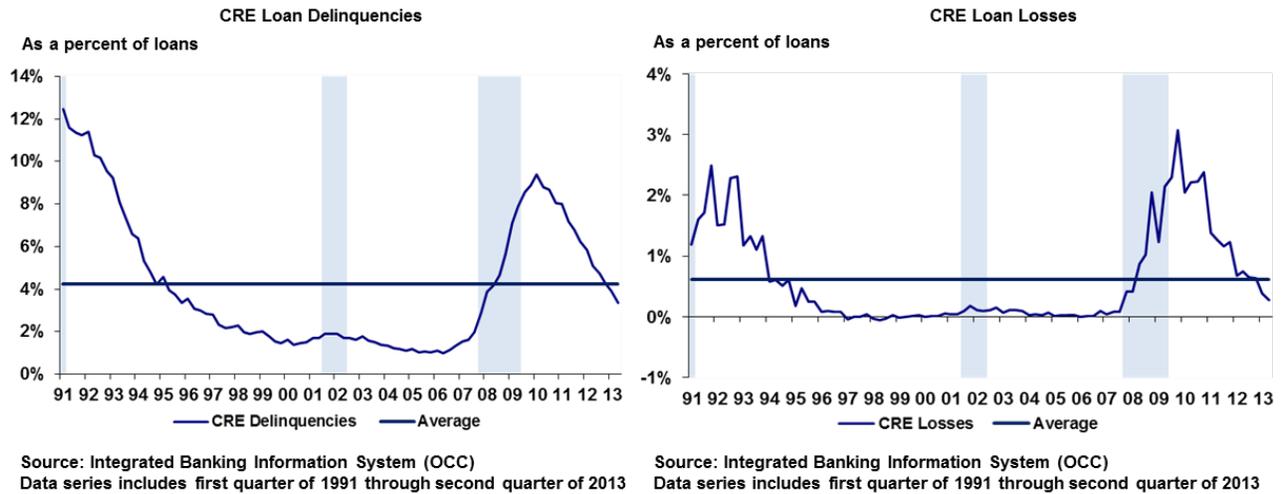


Source: Bloomberg

## Commercial Loan Delinquencies and Losses Decline to Near or Below Average

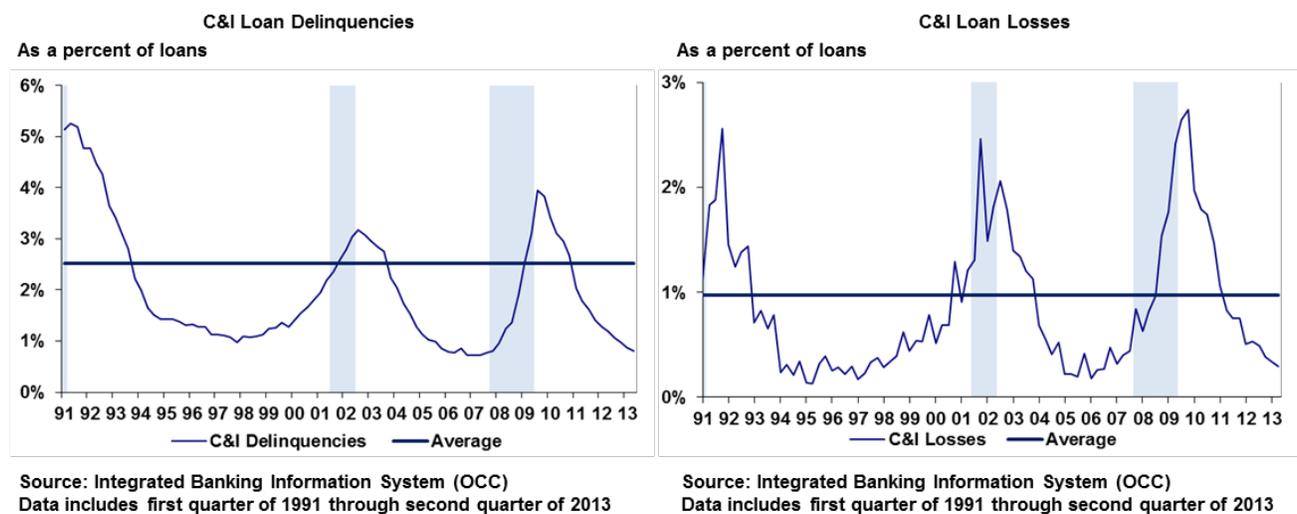
Historically, sustained periods of very low delinquencies have encouraged bankers to become more aggressive in competing for new business. CRE loan delinquency and loss rates have declined sharply since the end of the financial crisis, to just below their long-term averages (see figure 38).

**Figure 38: CRE Loan Delinquencies and Losses**



Similar to CRE loans, periods of very low C&I delinquencies also have preceded periods of troubled asset quality and above average delinquencies. C&I loan delinquencies and losses have declined well below long-term averages and are currently approaching a post-1984 low point (see figure 39). Very low commercial loan delinquency levels over an extended period of time have often led to increasing risk appetite and the erosion of credit underwriting standards; the same is occurring now, as cited earlier in this report.

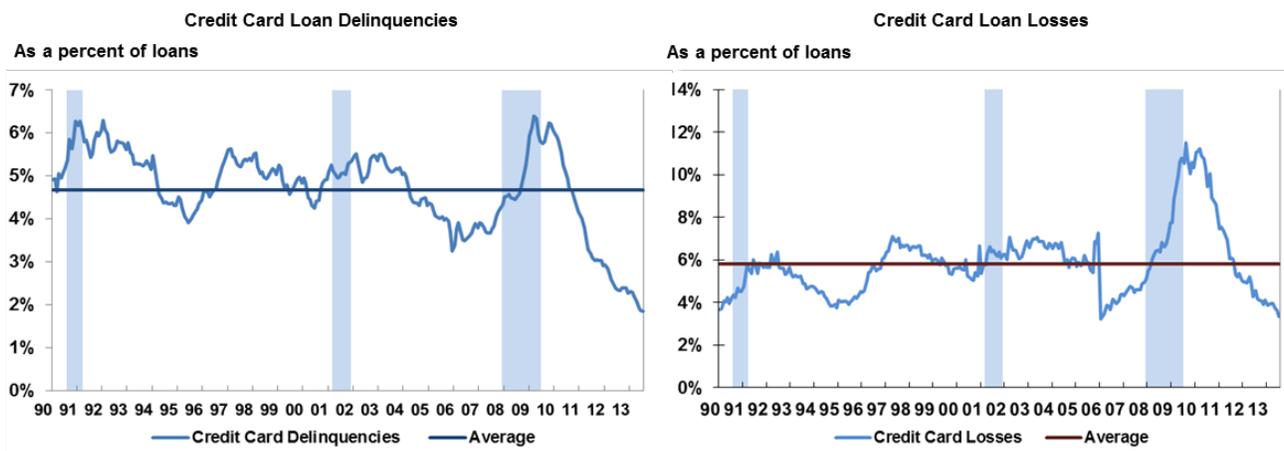
**Figure 39: Trends in C&I Loan Delinquencies and Losses**



## Credit Card Delinquencies and Losses Near Cyclical Lows

Credit card delinquencies and losses have declined sharply and are at or very near 20-year lows (see figure 40). In the past, when delinquencies and losses remained very low for an extended period, lenders tended to become more sanguine about credit risk. This often resulted in banks extending credit to borrowers with lower credit scores whose ability to repay their loans is typically more sensitive to any weakening in the economic climate. Like home prices, however, there has been a fundamental shift in this market in recent years. Tighter underwriting standards during the crisis moved more portfolios to reflect a higher share of high-FICO, convenience users that seldom carry outstanding balances from month to month. In addition, fewer card underwriters offer low-rate teaser transfer offers to borrowers with high debt levels. This “positive selection” bias may mute the immediacy of any risk signals offered by this kind of metric.

Figure 40: Credit Card Delinquencies and Losses



Source: Moody's Investors Services, Inc.

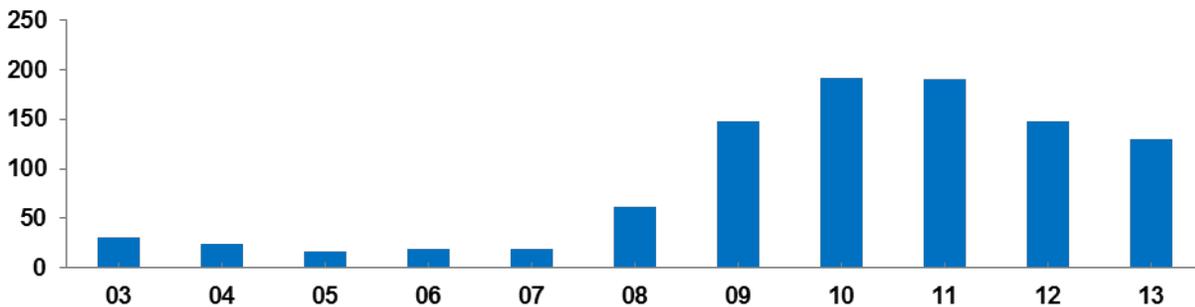
Source: Moody's Investors Services, Inc.

## **Part V: Regulatory Actions**

### **Banks Rated 4 or 5 Continue to Decline**

The number of OCC-supervised banks rated 4 or 5 continues to decline after peaking in 2011 (see figure 41). The decline is mainly attributable to the recapitalization and positive trends in the institutions.

**Figure 41: Number of Banks Rated 4 or 5**

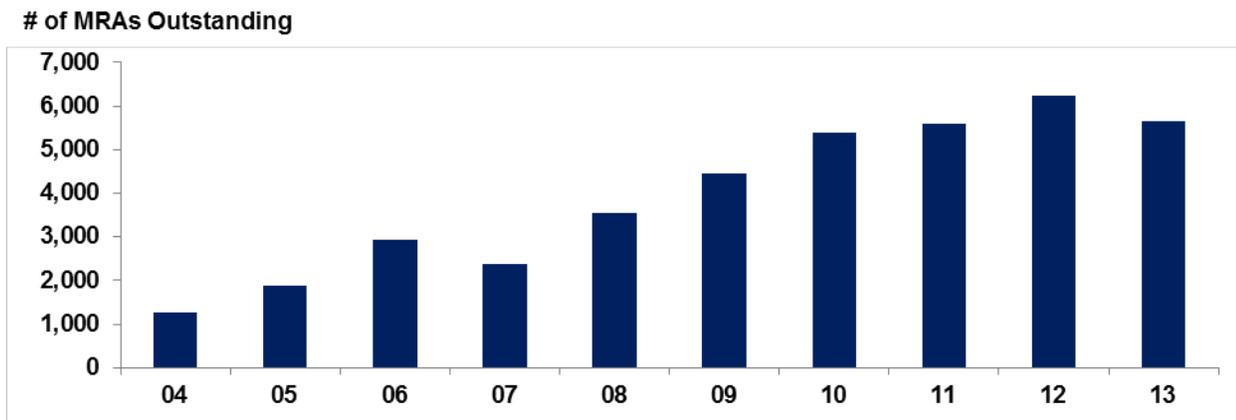


Source: OCC  
2013 data is as of June 30, 2013

### **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 a decline through the first half of 2013 (see figure 42). The increase in 2012 reflects the addition of 560 federal savings associations. The top five MRA categories for small banks, which remain unchanged from our spring 2013 report, are credit administration (32 percent), compliance (12 percent), management (11 percent), information technology (9 percent), and audit (6 percent). For large banks, the top five categories also remain unchanged with MRAs centered in credit risk (32 percent), operational risk (19 percent), BSA/AML (13 percent), consumer compliance (11 percent), and internal controls (9 percent).

**Figure 42: Trend in Outstanding MRAs for Banks**

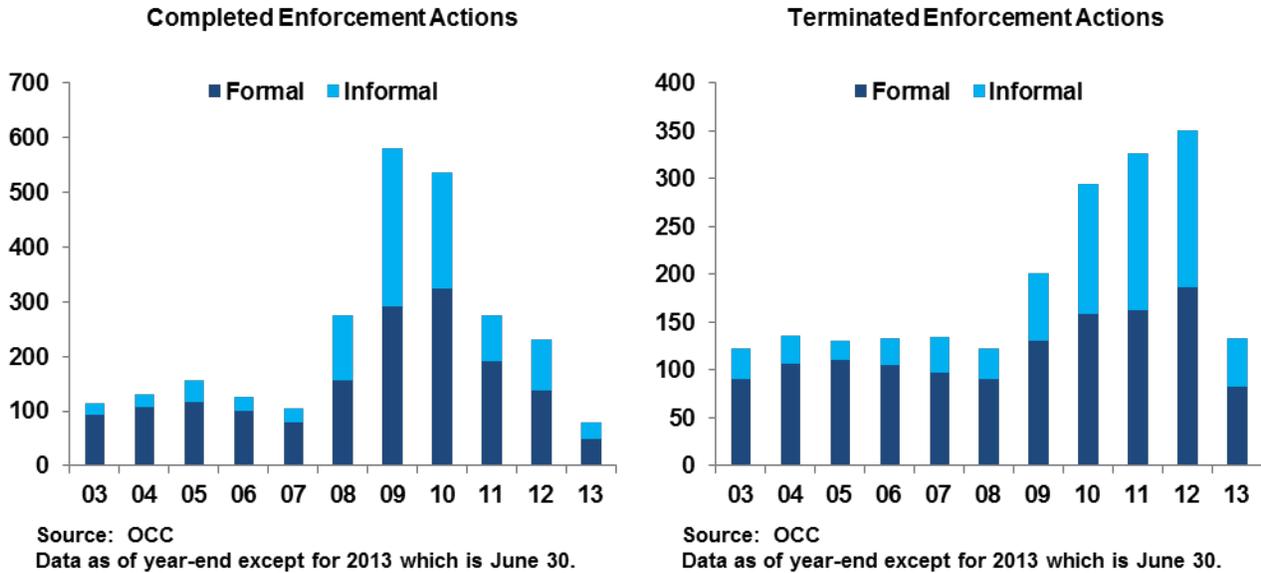


Source: OCC

## Enforcement Actions Against Banks Slow in 2013

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 fewer enforcement actions against banks during the first half of 2013 than in recent years (see figure 43) reflecting the overall improvement in the condition of federally chartered banks.

Figure 43: Enforcement Actions Against Banks



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