

## Semiannual Risk Perspective

From the National Risk Committee

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

Fall 2014

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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 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 fall 2014 report reflects data as of June 30, 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 five main areas: the operating environment; bank condition; key risk issues; the range of practice in interest rate risk modeling; and regulatory actions.

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

## Executive Summary

The financial performance of federally chartered institutions through the first six months of 2014 was weaker than the same period in 2013, as revenues and profitability declined. Overall, system profitability as measured by return on equity (ROE) remained just under 10 percent year-to-date through June 30, 2014. Smaller-bank ROE has improved, however, and nearly matches that of larger banks. Net income (NI) could have been even weaker, if not for lower provision and non-interest expenses. Year-to-date revenue for all banks through June was lower than year-ago levels because of weakness in noninterest income. Net interest income (NII) was slightly higher year-over-year, as fewer banks are seeing net interest margin (NIM) compression compared with a year ago, especially smaller banks. Commercial loan growth continued its healthy revival driven by strong gains in commercial real estate (CRE) and commercial and industrial (C&I) loans, and loans to non-depository institutions. While stronger loan growth is beneficial, the revenue generated by this growth is constrained by continued low interest rates that weigh on NIMs. Also, almost one in three institutions with assets less than \$1 billion had no loan growth (or an outright decline) over the past year, as they struggle with legacy credit quality issues, competition, and limited local loan demand.

As noted in our last report,<sup>1</sup> the OCC sees 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 direct and 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 nonbanks are having on underwriting standards. Given these trends, the OCC continues to focus on underwriting standards and encourages banks to diligently assess their credit risk appetite as they grow their loan portfolios.

Banks' operational environments face increasing challenges from the combination of evolving cyber threats and newly identified information technology (IT) vulnerabilities. Attackers are demonstrating advanced proficiency in compromising bank employee, third party, and system credentials to gain access, install malicious software, steal sensitive information, and operate inside systems for extended periods without detection. Breaches at non-financial firms have resulted in direct and indirect costs to banks. Projects to modernize systems and implement or adapt risk management for new regulatory requirements or evolving risks make expense reduction difficult to achieve without diminishing the quality of control environments.

The limited ability to increase revenue and operating profit (income before provision expense) while not taking excessive risk remains a key challenge. Many banks are seeking to boost the pace of loan growth, increasing the temptation to weaken underwriting standards or pricing. Low interest rates and inconsistent fee income patterns still hinder revenue growth. If interest rates rise, banks are likely to have to raise deposit rates to retain some of the large quantities of the deposits that surged into the banking system during the financial crisis.

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<sup>1</sup> See "[Semiannual Risk Perspective](#)," Spring 2014.

## Key Risk Themes

*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 effectively.*

- 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 appropriate levels of due diligence.<sup>2</sup>
- Banks continue to face competitive pressure from nonbank firms seeking to expand into traditional banking activities.
- As part of their strategy to deal with competitive pressures and lower overhead expenses, banks are leveraging technology such as cloud computing and mobile banking, which can increase exposure to additional technological risk.
- Bank Secrecy Act (BSA) and anti-money laundering (AML) risks remain prevalent given changing methods of money laundering and growth in the volume and sophistication of electronic banking fraud. BSA/AML risk continues to increase because of higher-risk customers and businesses migrating to other banks. The OCC has noted smaller community banks taking on higher-risk relationships even though they may not have the BSA risk management infrastructure in place to manage such risks. In addition, BSA programs at some banks have failed to develop or incorporate appropriate controls as products and services have evolved over time. A lack of resources and expertise devoted to BSA/AML in some banks often compounds these issues.
- Management succession planning, attracting appropriate expertise and retaining key experienced personnel is a growing issue for many banks, particularly in the credit and BSA/AML areas.
- Many community banks struggle to execute strategic and capital plans given the current operating environment.

Banks' boards of directors and senior managers should ensure that strategic planning and product approval processes appropriately consider expertise, management information systems, and risk controls for the banks' business lines and activities.<sup>3</sup> Banks also should incorporate management succession and retention of key personnel into their strategic planning process. Compliance programs should keep pace with the volume and complexity of regulatory changes, as well as the changing nature of bank customers and transactions.

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<sup>2</sup> [OCC Bulletin 2013-29](#), "Third-Party Relationships: Risk Management Guidance," provides guidance to banks for assessing and managing risks associated with third-party relationships.

<sup>3</sup> [OCC Bulletin 2004-20](#), "Risk Management of New, Expanded, or Modified Bank Products and Services: Risk Management Process," provides guidance on processes to prudently manage the risks associated with new, expanded, or modified bank products and services.

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

- Business models are under increasing pressure as bankers seek to launch new products, use IT automation, reduce staffing, and re-engineer business processes.
- Banks may not be incorporating cybersecurity considerations into their overall governance, risk management, or strategic planning processes.
- Banks are increasingly permitting employees and third parties to access their systems from personal devices, such as mobile phones and tablets. These arrangements can create opportunities for credentials to be stolen and for bank systems to be infected with malware. In many instances, banks and third parties do not promptly resolve high-risk vulnerabilities that are identified by detective controls.
- The number, nature, and complexity of foreign and domestic third-party relationships continue to expand.
- Changing business strategy can involve the bundling of products and services, or new bank roles as agent between consumers and merchants.
- While banks increasingly use central counterparties (CCP) to reduce foreign counterparty risk, foreign CCP memberships may expose a bank to increased legal and political risks. In addition, use of CCPs can increase the concentration of credit risk.

Bankers should maintain heightened awareness and appropriate resources to identify and mitigate cyber threats and vulnerabilities, and should incorporate cyber-resilience planning and controls into their business continuity planning and testing. Bankers should also ensure that risk management of third-party relationships is commensurate with the breadth, complexity, and criticality of these arrangements as outlined in [OCC Bulletin 2013-29](#). As banks experience increased system and process interconnectedness, as well as increased concentration risk when vendors consolidate, they need to identify and monitor risks of third-party relationships and ensure resilience against business disruption. Banks also should identify and assess cross-channel payment, operational, and compliance risks, and ensure their ability to measure, monitor, and control risks associated with new activities.

***Competitive pressures, the need for revenue growth, and the ongoing low interest rate environment continue to complicate bank risk management.***

- Competition is resulting in eased underwriting across a variety of products. Weakening standards are particularly evident in indirect auto and leveraged lending; however, some easing in underwriting and increased risk layering also occur in other types of commercial loans such as C&I, ABL, and CRE. While not widespread, some examiners note multiple policy and underwriting exceptions on individual credit decisions. 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.
- Growth and earnings pressures are causing banks to re-evaluate their credit risk tolerances, and many are lowering their underwriting standards without corresponding increases in allowance for loan and lease loss (ALLL) balances to bolster their competitive position.
- 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 potential 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 is a key component of the IRR modeling process, considering the risk of atypical rate sensitivity in these deposits. The OCC completed a supervisory review of the range of practices for IRR management in community and midsize banks that is summarized in part IV of this report.
- 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. When interest rates rise, such fixed-income holdings will likely depreciate, become less liquid, and adversely affect investment portfolio performance. This scenario raises potential compliance and reputation risks, particularly if a bank fiduciary failed to act in a client's best interest in managing investment risks. Similar concerns exist with bank retail nondeposit investment sales programs that involve broker-dealers selling products with increased risk exposures through the bank distribution channel.
- Financial asset prices experienced an extended period of very low volatility through June 30. As a result, measures of price risk, such as value-at-risk (VaR), remained at very low levels. The reduced willingness of dealers to hold securities in inventory could contribute to greater price swings going forward and increased price risk.

Banks' boards of directors and senior managers need to monitor elevated policy exceptions to established underwriting standards and be alert to the product terms that layer on additional risks. ALLL processes should be reviewed to determine whether additional qualitative adjustments are needed to reflect the increased risk in loan portfolios. Banks with significant concentrations in longer-term assets should assess their vulnerability to a sudden rise in interest rates. Banks also need to assess how nonmaturity deposits (NMD) react to rising rates and consider the uncertainty of depositor behavior in their model assumptions and resulting risk exposure.<sup>4</sup> Banks should ensure investment decisions meet their fiduciary customers' investment objectives, needs, and risk tolerances. It is also important to ensure that the oversight of the retail nondeposit investment sales program includes an assessment of the product platform's appropriateness for the bank's client base.

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<sup>4</sup> [OCC Bulletin 2010-1](#), "Interest Rate Risk: Interagency Advisory on Interest Rate Risk Management," reminds institutions of supervisory expectations regarding sound practices for managing IRR.



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

### ***Large Banks***

Overall, large bank companies are in sound financial condition, with continued positive trends in asset quality, liquidity, and capital. Earnings and management, however, remain challenged. High levels of capital and liquidity reduce the likelihood of failure in times of stress, but create earnings and balance sheet management challenges in the normal course of business. Risk management weaknesses predominantly associated with operations, BSA/AML, compliance, internal controls, and credit are driving Matters Requiring Attention (MRA) and enforcement actions.

Key risks facing large banks include

- a high level of operational risk across a spectrum of activities.
- an increasing volume and sophistication of cyber threats and pervasive IT vulnerabilities.
- elevated compliance and BSA/AML risks.
- growing use of third-party arrangements that introduce concentration risk.
- erosion of underwriting standards because of competitive pressures, particularly in leveraged lending, indirect auto, and commercial loans.
- ongoing enhancements to data systems required for effective risk monitoring and compliance.

The outlook for large banks includes

- moderate to strong commercial loan growth into 2015.
- cyclical margin expansion that is possible in 2015 and beyond, in the event short-term interest rates begin to rise.
- increasing ALLL provisions.

### ***Community and Midsize Banks***

The overall financial condition of community and midsize banks supervised by the OCC continues to improve, as reflected by continued positive trends in asset quality indicators. The earnings outlook for this segment of the banking industry, however, is less uniform. While earnings overall are improving because of selected loan growth and reduced credit expenses, pressures persist at many small banks because of acute competition for existing loan demand 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.
- properly planning for management succession and retention of key staff.
- erosion of underwriting standards in various loan products.
- expansion into loan products that require specialized risk management processes and skills, such as participations in syndicated leveraged loans.
- increasing exposure to IRR at banks with concentrations in long-term assets (including mortgage-backed securities [MBS] and loans) and uncertainties about the behavior of NMDs once interest rates increase.
- appropriate oversight of third parties that perform operational and business functions.
- increasing volume and sophistication of cyber threats.

- increasing BSA/AML risk because of higher-risk services and customer relationships, particularly in community banks.
- ensuring effective compliance management systems and staffing.

The outlook for community and midsize banks includes

- moderate to strong loan growth, stabilizing NIM, and stronger capital ratios.
- suppressed mortgage-banking revenue and lower gain-on-sale margins.
- a continued search for higher-yielding assets and profitable strategic business niches.
- expansion into new products and services to meet rate-of-return objectives.

## ***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 will execute supervisory strategies for each large bank that prioritize risks, achieve supervisory objectives, and effectively use OCC resources. Heightened supervisory attention will focus on the following:

- **Governance and oversight:** OCC supervisory staff will continue to assess bank governance and risk management practices with a focus on identifying substantive gaps in relation to the OCC's heightened standards guidelines. Examiners will focus on ensuring the gaps are clearly documented and communicated, and that management has committed to appropriate time frames to close them. The OCC expects banks to be in substantial compliance on or before their respective compliance date.
- **Operational risk:** OCC supervisory staff will focus on compliance with the foreclosure consent orders, model risk management, third-party risk management, information and cybersecurity and data protection, and change management initiatives. Lapses in controls, operational processes, and oversight, and the resulting effects across a bank's activities highlight the interconnectedness of risks and the importance of managing those risks in an integrated fashion throughout the entire bank.
- **Credit underwriting:** OCC supervisory staff will review commercial and retail credit underwriting practices, especially for leveraged loans, indirect auto, and commercial loans.
- **Compliance:** OCC supervisory staff will coordinate with the Consumer Financial Protection Bureau (CFPB) to determine compliance with consumer laws, regulations, and guidance. OCC supervisory staff will continue to assess compliance with the Flood Disaster Protection Act of 1973 and the Servicemembers Civil Relief Act of 2003, and 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. OCC staff will also assess banks' effectiveness in identifying and responding to applicable risks posed by new products and services and loosening underwriting.
- **New regulatory requirements:** OCC supervisory staff will develop and implement plans for assessing banks' compliance with new regulatory requirements, including those related to capital, liquidity, trading activities, residential mortgages, and risk retention.
- **Fair access:** OCC supervisory staff will continue to encourage banks to meet the needs of creditworthy borrowers and monitor banks' compliance with the Community Reinvestment Act (CRA), fair lending and other consumer protection laws.
- **Enforcement action compliance reviews:** OCC supervisory staff will plan and complete sufficient work to determine compliance with enforcement actions and, when appropriate, recommend termination in a timely manner. Examiners-in-charge will clearly communicate any additional actions needed to satisfy requirements in an enforcement action.
- **MRA corrective action follow-up:** OCC supervisory staff will assess corrective action and close MRAs in a timely manner. Examiners-in-charge will clearly communicate any additional actions needed to satisfy the MRA's requirements and expectations.

### *Community and Midsize Bank Supervision*

The OCC will execute supervisory strategies for community and midsize banks that prioritize risks, achieve supervisory objectives, and effectively use OCC resources. Heightened supervisory attention will focus on the following:

- **Strategic planning and execution:** OCC supervisory staff will focus on the adequacy of strategic, capital, and succession planning processes in light of assumed risks and planned initiatives, assessing whether banks' plans are realistic and appropriate risk management processes are established and followed.
- **Corporate governance:** OCC supervisory staff will reinforce the importance of sound corporate governance appropriately calibrated to the size and complexity of the individual bank.
- **Stress testing:** OCC supervisory staff will review the appropriateness of Dodd–Frank Act stress testing processes conducted by banks with more than \$10 billion in assets.
- **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 risk management, including planning, due diligence, internal controls, reporting, contract negotiations, and ongoing monitoring. Robust preparation and contingency/resiliency planning for operational or technology disruptions, as well as for natural disasters, remain essential.
- **Cyber threats:** OCC supervisory staff will review banks' 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.
- **Loan underwriting:** OCC supervisory staff will evaluate the underwriting practices for new or renewed loans in banks' indirect auto, ABL, middle market, C&I, CRE, and energy portfolios for slippage in structure and terms.
- **IRR:** OCC supervisory staff will focus on IRR measurement processes to ensure that management properly assesses a bank's vulnerability to changes in interest rates and, as appropriate, implements measurement tools to monitor and control this risk. The OCC will use data from IRR supervisory reviews, and financial reports, to assess IRR exposure. A bank's ability to accurately identify and quantify IRR in both assets and liabilities (e.g., investment securities and nonmaturity deposits) under varying model scenarios will be a key focal point. Examiners will also monitor portfolio composition for changes in risk appetite.
- **Compliance:** OCC supervisory staff will assess effectiveness in complying with consumer laws, regulations, and guidance. Staff reviews will include applicable compliance, legal, and reputation risks posed by new products and services and emerging technologies, in particular those that introduce 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 with new products, services, and customers.
- **Fair access:** OCC supervisory staff will continue to encourage banks to meet the needs of creditworthy borrowers. OCC staff also will continue to monitor banks' compliance with the CRA, fair lending, and other consumer protection laws.

### *Supervisory Policies and Processes*

The OCC will continue implementing recommendations from its international peer review<sup>5</sup> along with its internal strategic initiatives to improve the effectiveness and efficiency of bank supervision activities. Priorities include the following:

- **Peer review findings:** OCC managers and staff will implement the work plans established to address the findings and recommendations of the international peer review team.
- **Supervisory analytics:** OCC staff will work collaboratively to enhance analytical tools for examiners and management information systems on bank performance. This work will include benchmarks and performance dashboards, and improved tracking and reporting of MRAs and other enforcement actions. Banks that meet certain trading thresholds and engage in covered trading activity under the Volcker Rule provide quantitative measurements, or metrics, to the OCC on a monthly basis. The OCC will assess whether a bank's trading activities are consistent with permitted activities under the Volcker Rule in scope, type, and profile. Metrics assist in the identification of transactions or activities that may warrant more in-depth analysis or review under the Volcker Rule.
- **Risk assessment:** The OCC will improve its ability to anticipate and address emerging risks by working effectively with the Financial Stability Oversight Council, the Office of Financial Research, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the CFPB to identify systemic risk and related metrics.
- **Collaboration:** OCC managers and staff will stress collaborative efforts across the OCC and with other regulators to enhance the effectiveness and efficiency of all supervisory activities.
- **Technical assistance:** OCC examiners and subject matter experts will identify opportunities to supplement supervisory activities with technical assistance, resource materials, comparative data, and tools that provide added benefit to all banks, particularly community and midsize banks.
- **Industry outreach:** OCC managers and staff will conduct 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 an opportunity to discuss their concerns with regulators and peers.

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<sup>5</sup> See OCC News Release 2014-75, "[OCC Announces Actions to Respond to International Peer Review Recommendations.](#)"

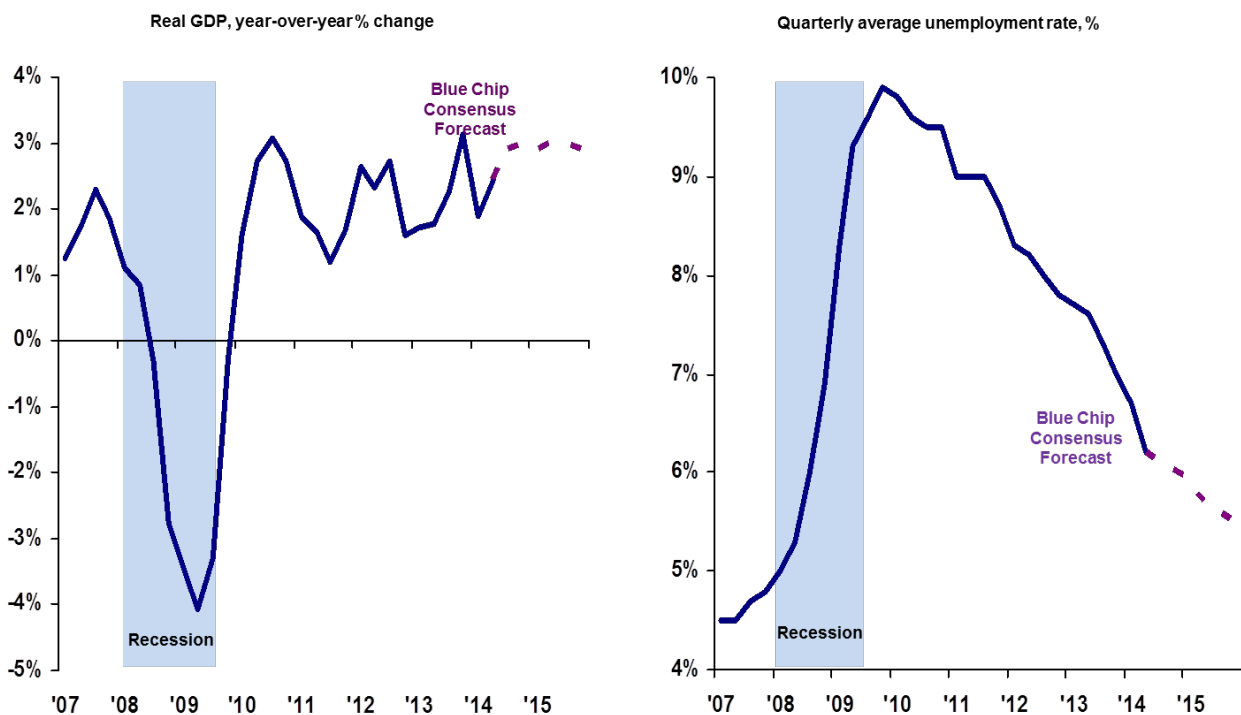
## **Part I: Operating Environment**

A solid second quarter dispelled fears of weakness in economic fundamentals. Consumption has been rising, especially for durable goods such as cars and appliances. Jobs are growing in most industries, regions, and pay grades. Nevertheless, the long-term unemployment rate remains high, as does the share of the population out of the labor force altogether. A slowdown in the housing sector, which began in late 2013, is limiting gross domestic product (GDP) growth. The European economy has weakened in recent months, partly from the threat to stability and economic sanctions arising from armed conflict in Ukraine, but also because of private sector deleveraging and the lingering effects of fiscal austerity policies.

### **U.S. Economic Growth Still Constraining Labor Market Improvement**

Real GDP increased 2.6 percent in the second quarter of 2014 from the second 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**

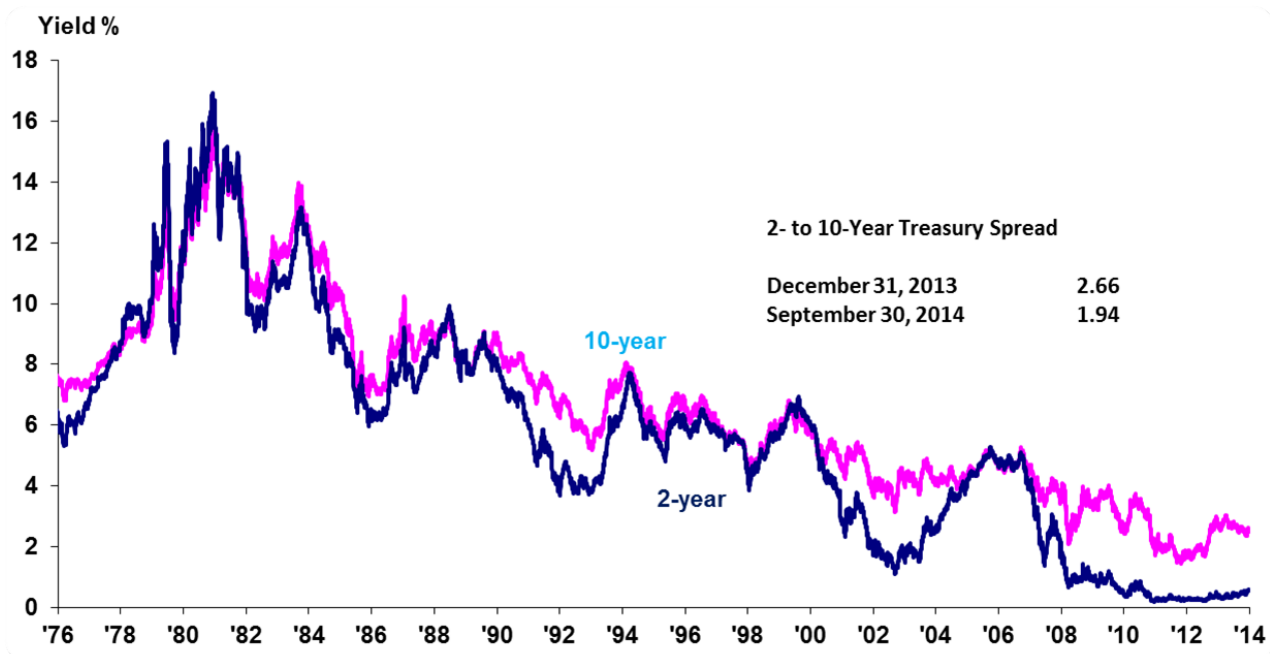


Sources: Bureau of Economic Analysis, Bureau of Labor Statistics/Haver Analytics, Blue Chip Indicators (March 2014)

## 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 year-end 2013 to 194 basis points as of September 30, 2014 (see figure 2). Despite this flattening, the yield curve remains steep by historical standards. This relative steepness bodes well for bank loan growth and asset yields as 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 and low-rate, fixed-yield assets, however, could see significant erosion of value once interest rates start to rise, particularly if rates rise more abruptly than expected. Increased debt service costs for borrowers is another potential risk from rising interest rates. This risk is particularly acute for borrowers with recession-weakened revenues or incomes 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

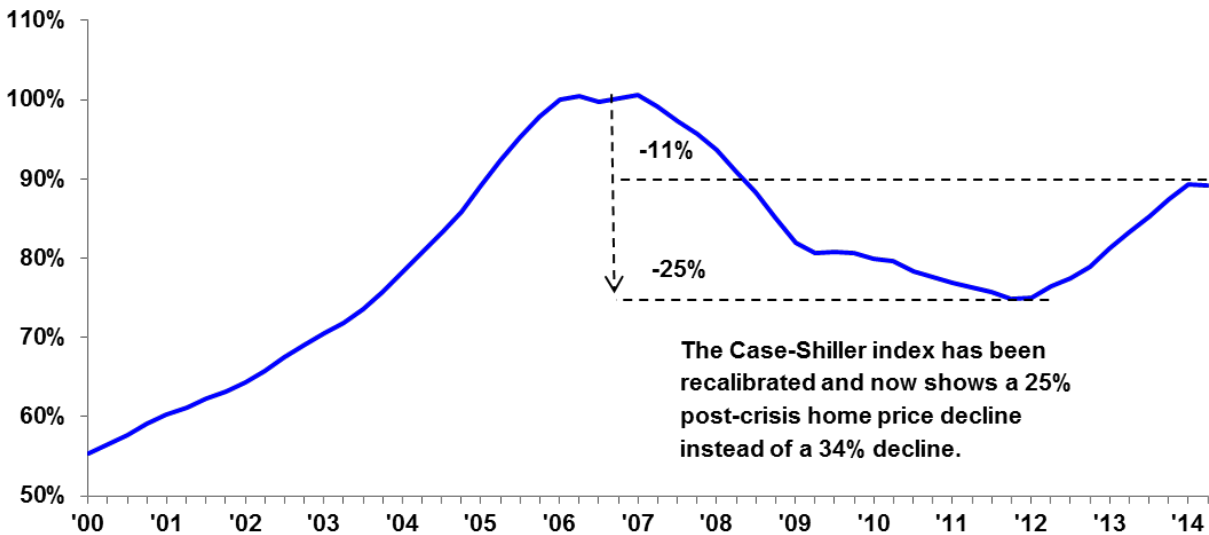
Note: Treasury yield curve estimates, coupon equivalent par-yields. Data as of September 30, 2014.

## Housing Markets Slowly Improving

The housing market continued to improve through the second quarter of 2014 albeit at a slower pace than in 2013. While still 11 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 eighth consecutive quarter, as delinquency rates and foreclosures declined further. The percentage of mortgages that are seriously delinquent slipped to 3.1 percent from 3.8 percent a year earlier (see table 1). The percentage of foreclosures in process declined by almost half, from 2.8 percent of loans outstanding in the second quarter of 2013 to 1.6 percent in the second 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

Case-Shiller National Home Price Index seasonally adjusted, 2006Q1 = 100



Source: S&P

Table 1: Mortgage Portfolio Performance

Percentage of mortgages in the portfolio							
	6/30/13	9/30/13	12/31/13	3/31/14	6/30/14	1Q %Change	1Y %Change
Current and Performing	90.6%	91.4%	91.8%	93.1%	92.9%	-0.2%	2.6%
30–59 Days delinquent	2.9%	2.6%	2.6%	2.1%	2.4%	15.0%	-17.3%
<b>The following three categories are classified as seriously delinquent</b>							
60–89 Days delinquent	0.9%	0.9%	1.0%	0.7%	0.8%	9.6%	-12.3%
90 or More days delinquent	1.9%	1.8%	1.7%	1.6%	1.5%	-3.6%	-18.3%
Bankruptcy 30 or more days delinquent	1.0%	0.9%	0.8%	0.8%	0.8%	0.8%	-19.2%
<b>Subtotal for seriously delinquent</b>	<b>3.8%</b>	<b>3.6%</b>	<b>3.5%</b>	<b>3.1%</b>	<b>3.1%</b>	<b>0.6%</b>	<b>-17.0%</b>
Foreclosures in process	2.8%	2.4%	2.1%	1.8%	1.6%	-8.2%	-42.2%

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



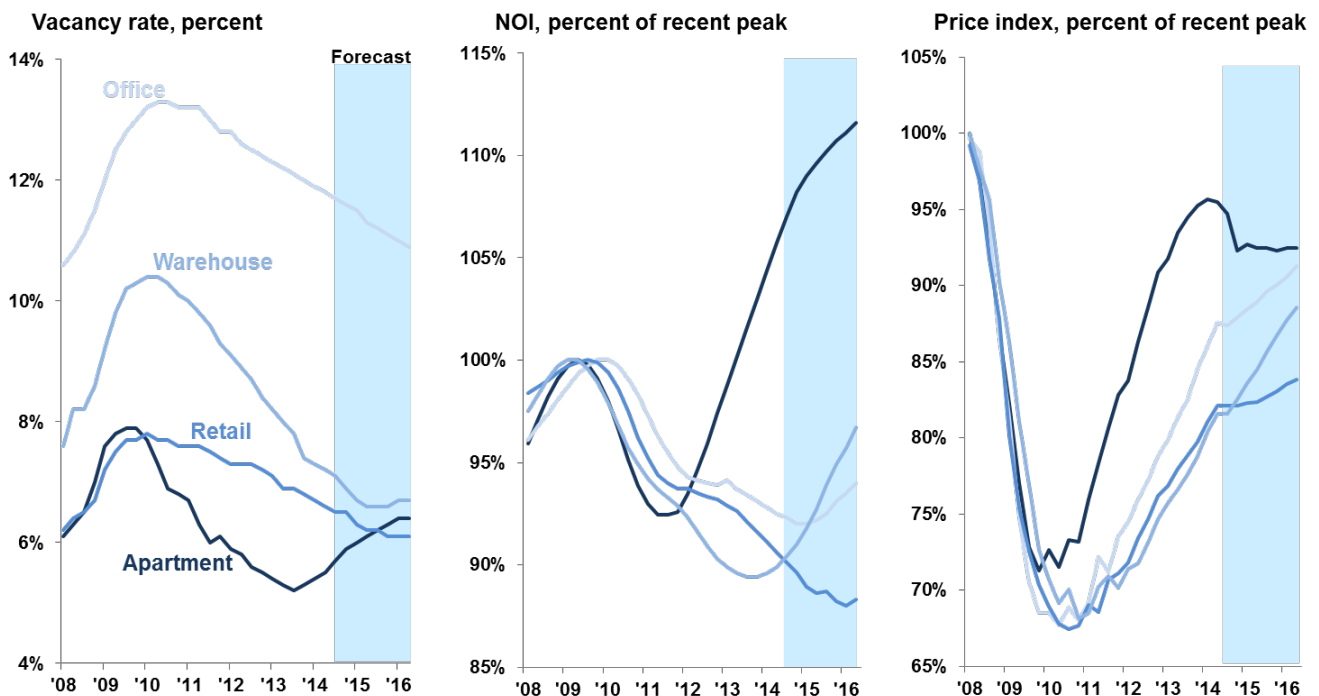
## CRE Outlook Is Mixed

Vacancy rates for office and retail properties are expected to continue to improve toward pre-recession levels over the next few years, while the recent improvement in warehouse vacancy rates may soon stabilize. Vacancies in the booming apartment market may rise further from their 2013 lows, but stay below their 2009 recession peaks (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. Because of a significant increase in apartment construction, however, vacancy rates are rising in some markets, slowing the pace of growth in rental rates.

Office and retail vacancies are declining even though companies are using less square footage per office worker, and consumers are doing more online shopping—both of which should reduce the demand for office and retail space. The warehouse recovery has recently accelerated because of online retailers opening more distribution centers, but warehouse construction remains limited. For these three major nonresidential property types, however, average rents are still 3 to 11 percent below their previous peaks. Consequently, NOIs are near cyclical lows; also, some in-place leases continue to renew at lower rents.

Given expectations for an average pace of economic growth over the near term, 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 is expected to outperform other property types because of superior fundamentals. Low interest rates and stronger demand have allowed CRE prices to increase, especially in major markets that attract foreign investors, but forecasters expect minimal improvement in commercial property values over the next two years since higher interest rates will partially offset the impact from strengthening property lease fundamentals.

Figure 4: CRE Vacancy Rates

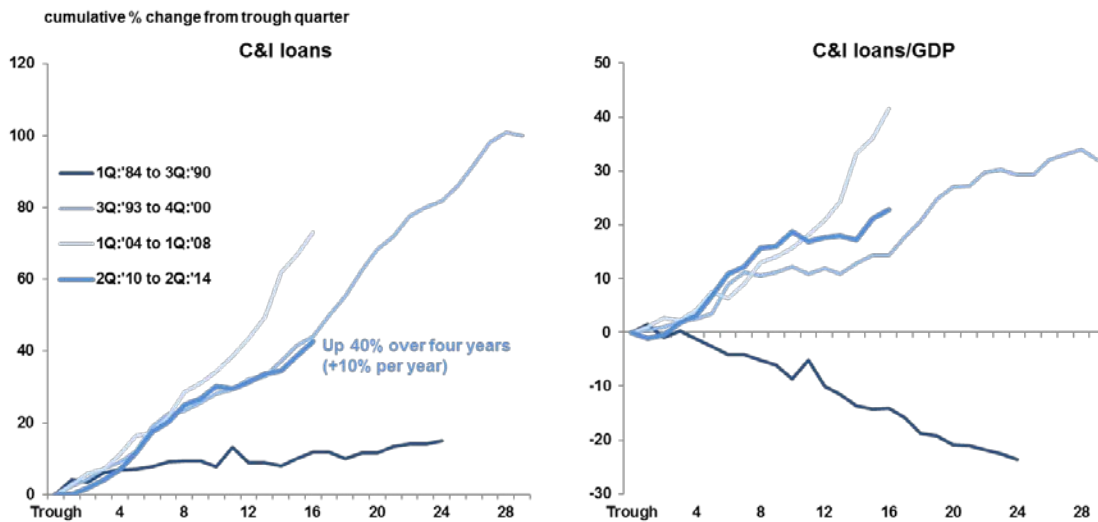


Source: CoStar Group (formerly PPR); 2Q 2014 baseline forecast for 54 Tier 1 markets.

## C&I Loan Growth Tracking the 1990s Credit Cycle

So far during this expansion, C&I loans at national banks and federal thrifts have grown by 40 percent, or 10 percent per year. This robust pace is in line with C&I growth during the seven-year cycle of the 1990s; in contrast, the 2004–07 cycle peaked after posting cumulative growth twice that of the current cycle over the same amount of time (see figure 5). Today’s pace of C&I growth does not necessarily indicate overheating even if adjusted for today’s slower pace of GDP growth. Forecasts of more modest advances in corporate inventory and receivables financing needs over the next few years suggest that demand for C&I loans could slow; such a slowdown could aggravate already intense competition and further weaken underwriting and loan pricing.

Figure 5: C&I Loan Growth Cycles



Sources: Integrated Banking Information System (OCC); BEA; OCC Calculations

C&I growth cycles are defined as time from trough to peak in level of system C&I loan balances. Data for each cycle are merger-adjusted for institutions in continuous operation over the time periods studied.

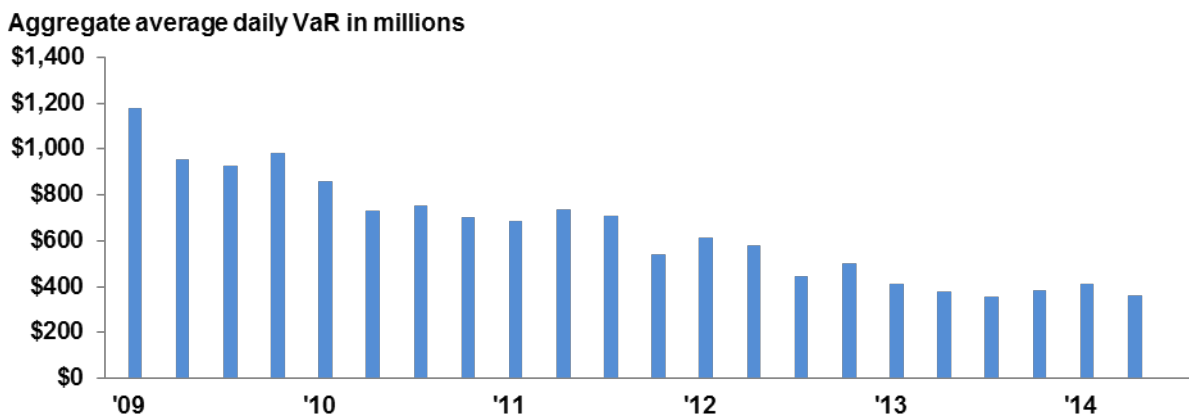
## Low Market Volatility May Understate Risk

Market volatility is a key factor in computing many risk measures, such as VaR for trading activities. Aggregate VaR has dropped significantly since the end of the financial crisis at the five largest U.S. banking companies with trading operations (see figure 6). Some of the decline is because of lower client activity and reduced bank trading risk appetite, the same factors that have led to lower-trending trading revenue. Most of the decline, however, results from the extended period of low volatility.

The OCC has two general concerns about low volatility environments. First, history suggests that sustained low volatility environments give rise to higher risk appetites, as low volatility suggests limited changes in future prices. Leverage tends to increase, as low volatility results in lower credit and other market spreads. Banks therefore need more assets to generate desired levels of income. Second, history suggests that extended periods of low volatility are often interrupted by abrupt and significant changes in market conditions. When this interruption occurs, trading risk measures such as VaR increase, and losses are realized in trading positions that have a low probability of a high loss impact.

Thus, the low VaR numbers may understate trading risk in the banking system.

**Figure 6: Aggregate VaR at Five Large Banking Companies**



Source: 10-Q and 10-K filings for Bank of America, JP Morgan Chase, Morgan Stanley, and Goldman Sachs.

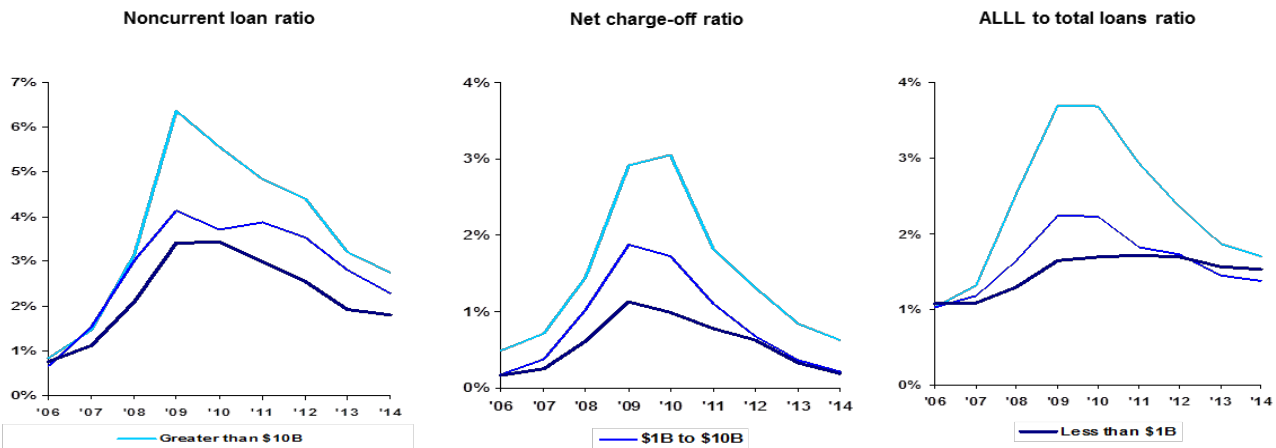
**Part II: Bank Condition**

**A. Overall Credit Quality Continues to Improve**

**Credit Metrics Continue to Improve, but Noncurrent Loans Lag**

Key credit risk metrics continued to improve through the first six months of 2014 (see figure 7). Total noncurrent loans—those 90 days or more past due or on nonaccrual—declined further for large and small banks, but remain stubbornly high. The ALLL as a percentage of total loans has also declined as credit quality improves and stabilizes. The OCC expects the pace of the decline in the ALLL ratio to abate as allowance levels return to a more normal share of total loans. Because noncurrent loans remain elevated and the economic outlook remains guarded, the ALLL to total loans ratio may stabilize above its pre-crisis level.

**Figure 7: Credit Cycle Analysis**

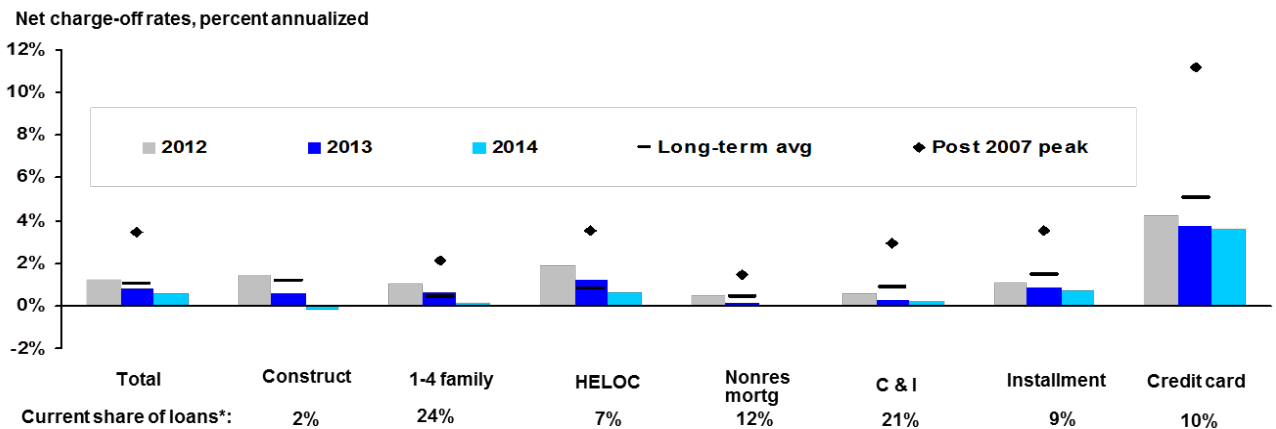


Source: Integrated Banking Information System (OCC)  
 Note: Data for 2014 are as of June 30. All other data as of year-end. Noncurrent loans are 90 days or more past due and nonaccruals.

**Charge-Off Rates for All Loan Types Now Below Long-Term Averages**

Loan-loss rates continue to improve. Net charge-off rates are at or below their 25-year averages for all major loan categories (see figure 8).

**Figure 8: Charge-Off Rates by Asset Class**

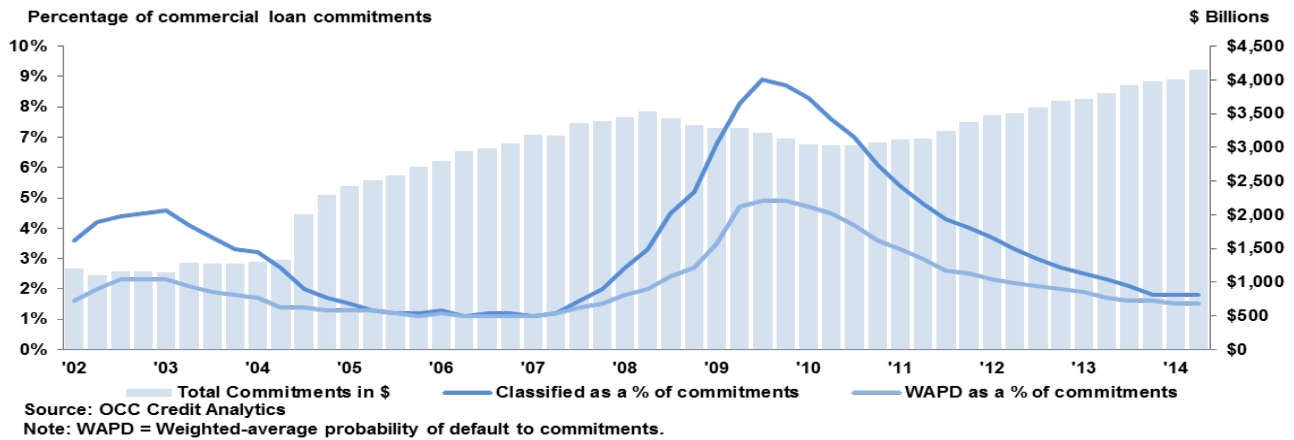


Source: Integrated Banking Information System (OCC)  
 \* Not all detail loan categories are shown. Net charge-offs as a percent of loans in respective category.

## Commercial Loan Quality Improved

In aggregate, commercial credit quality improved slightly in the first half of 2014, and quality metrics began to stabilize in the second quarter of 2014. The weighted-average probability of default rate and classified loans to capital ratio for loans included in the OCC’s Credit Analytics data system<sup>6</sup> have stabilized at levels slightly higher than those experienced prior to the start of the financial crisis (see figure 9). Improvement in real estate and construction credit quality continue, and other industries are about evenly split between slight improvement and slight deterioration through the first two quarters of 2014.

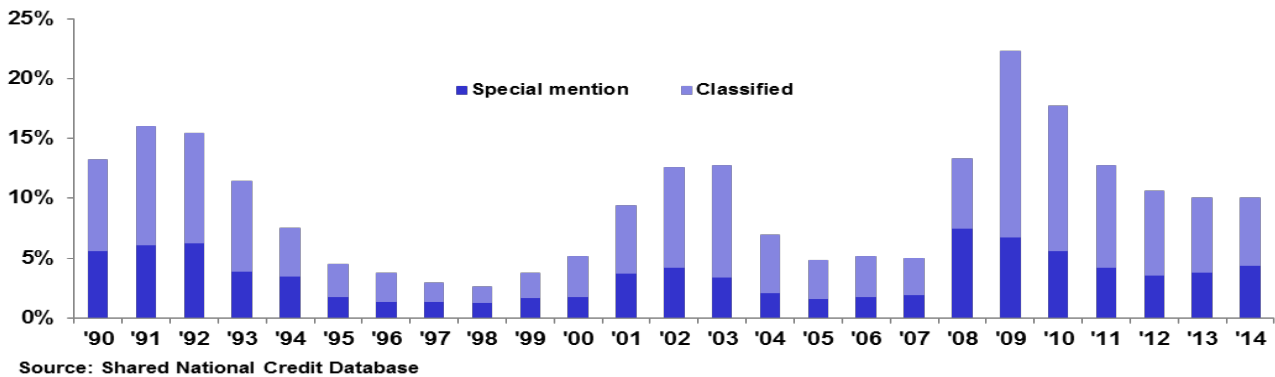
Figure 9: Commercial Loan Trends for Select Banks



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

The interagency Shared National Credit Review for 2014 reported that credit quality remained broadly unchanged from last year’s review (see figure 10). The percentage of classified assets declined over the year but remained above long-term averages. Classified assets declined to 5.6 percent of the portfolio from 6.2 percent last year. Special mention assets increased to 4.4 percent of the portfolio, up from 3.8 percent last year.

Figure 10: Trend in Shared National Credit Review



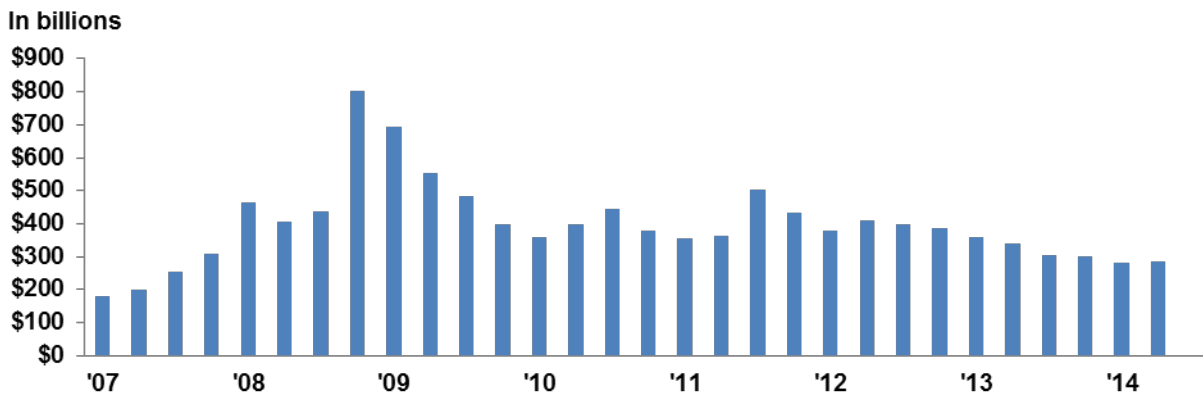
<sup>6</sup> Credit Analytics is an OCC-sponsored, voluntary data-sharing program for analyzing commercial credit trends. The data represents more than 80 percent of total commercial loan commitments in the federal banking system.

## Counterparty Credit Exposure in Derivatives Declines

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 and remains near its lowest level since the third quarter of 2007 (see figure 11).

NCCE is falling because the extended period of very low interest rates has narrowed the difference between current market swap rates and the contract rates in dealers' interest rate books. Because interest rate contracts comprise 81 percent of all notional derivatives, credit exposures from those contracts drive the aggregate NCCE.

**Figure 11: Net Current Credit Exposure**



Source: Integrated Banking Information System (OCC)

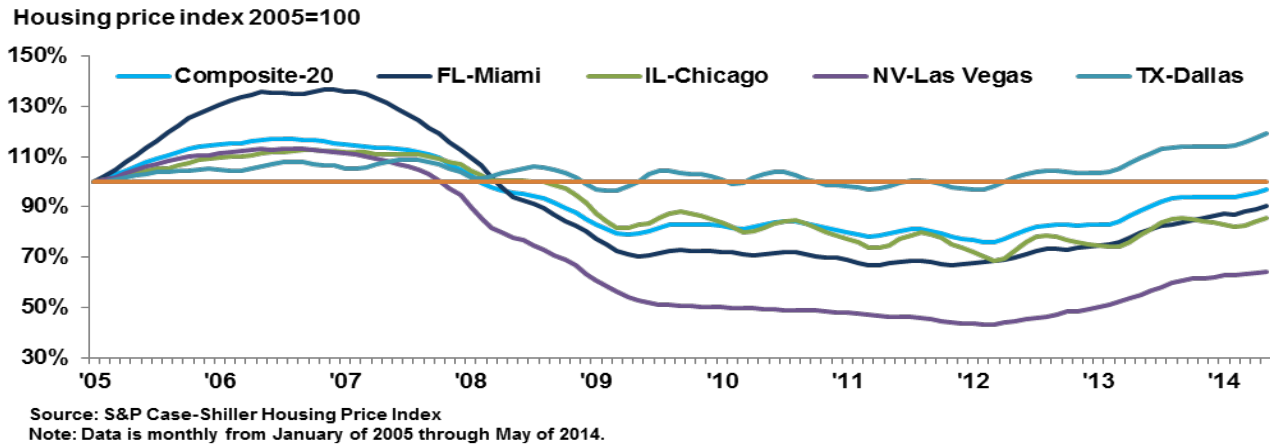
Central clearing mandates in Dodd–Frank have led to a significant increase in centrally cleared derivatives transactions. A CCP reduces risks to participants in the derivatives and securities markets through multilateral netting of trades, imposing risk controls, and maintaining financial resources commensurate with the risks participants carry. Central clearing allows market participants to face the credit risk of the CCP rather than each other, as the CCP acts as the buyer to every seller, and the seller to every buyer.

One consequence of increased central clearing is that credit risk becomes concentrated in a small number of CCPs, in contrast to more widely distributed risk when trades are conducted only on a bilateral basis. Some contractual agreements allow CCPs 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 they also mutualize credit risk across members. Several CCPs have amended their rules to require members to cover non-default losses from investing activities after the CCP depletes its capital. For example, earlier this year a CCP in South Korea required members to contribute capital to cover a loss incurred after a trade error caused the failure of one of its members. Because of this mutualization of risk, banks need to conduct appropriate due diligence prior to becoming CCP members and determine then and thereafter whether the CCP has appropriate risk management controls in place.

## Residential Mortgage Delinquencies Continue to Decline As House Prices Rise

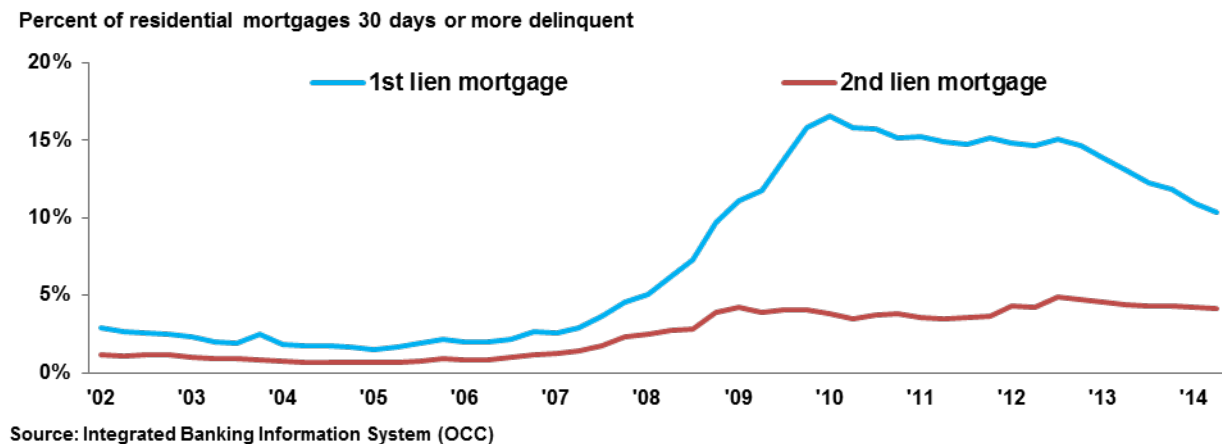
Housing prices for most metropolitan statistical areas (MSA) rose over the past year and a half; the composite housing price index for 20 MSAs increased 26 percent since January 2012. Even with this sustained increase, however, home prices remain below pre-crisis levels, and the rate of improvement has varied by MSA (see figure 12). As banks address potential issues with home equity lines of credit (HELOC) approaching their contractual end-of-draw periods, the favorable trend in prices and the interest rate environment may help temper exposures and give lenders and borrowers a wider range of options.

Figure 12: Trend in Housing Price Index



The share of outstanding first-lien residential mortgages delinquent more than 30 days has dropped from almost 15 percent in early 2012 to just more than 10 percent over the past two years (see figure 13). While the trend is encouraging, delinquency levels remain persistently high, at more than double their long-term average. The declining trend is expected to continue as the backlog of foreclosures clears, since the 30 days or more delinquency measure includes homes in the process of foreclosure. Unlike first liens, second-lien mortgage delinquency rates did not experience a seven-fold increase following the housing bust; still, second-lien delinquency rates remain at historically elevated levels. The OCC will continue to monitor second-lien credit trends as large volumes of HELOCs approach their contractual end-of-draw periods in 2015, 2016, and 2017.

Figure 13: 30+ Mortgage Delinquencies

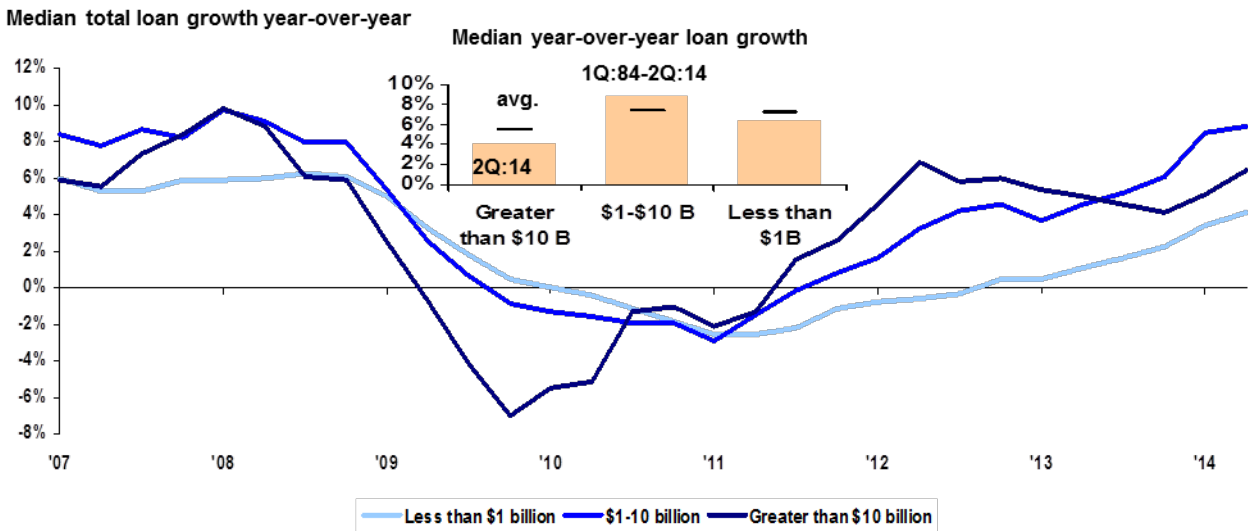


**B. Loan Growth Momentum Builds; Underwriting Standards Weaken**

**Total Loan Growth: Centered in C&I Lending in Banks of All Sizes**

Loan growth is accelerating across banks of all sizes, but the median growth rate remains slightly below the long-run average for banks with total assets less than \$1 billion and for banks with total assets greater than \$10 billion (see figure 14). The median year-over-year loan growth rate for total loans was just more than 4 percent for banks with assets less than \$1 billion and 6 percent for banks with assets greater than \$10 billion as of midyear. Banks with total assets between \$1 billion and \$10 billion had the strongest median growth rate at almost 9 percent.

**Figure 14: Median Loan Growth Trends**

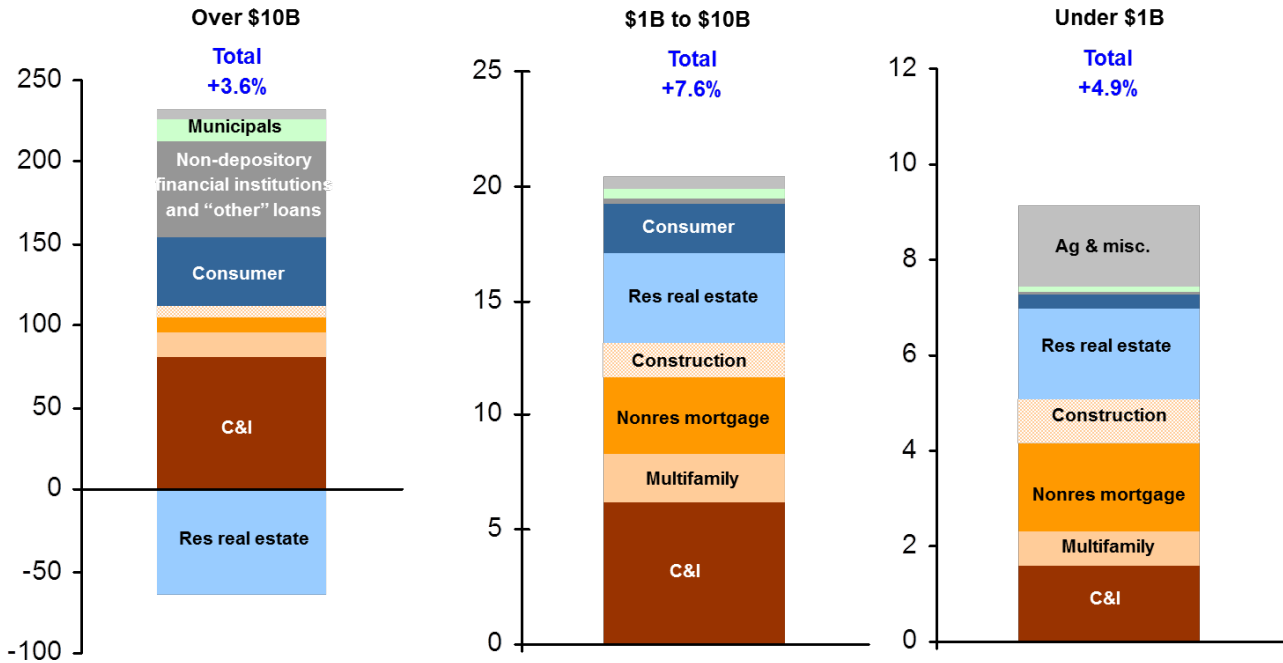


Source: Integrated Banking Information System (OCC)

Banks of all sizes report stronger total loan growth, led by a year-over-year increase of 7.6 percent at banks with total assets between \$1 billion and \$10 billion (see figure 15). Loan growth for these banks centers in C&I, CRE (sum of construction, nonresidential mortgage, and multifamily), and residential mortgage lending. Banks with less than \$1 billion in assets as a group reported 4.9 percent growth in total loans year-over-year, driven by several major categories: C&I, CRE, residential mortgages, and agricultural lending. Loan growth in these smaller banks remains bifurcated, with some reporting robust loan growth while others continue to show limited to no growth. Almost one in three 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 lags smaller banks because of continued contraction in residential real estate lending. Sources of loan growth for the larger bank group centers in C&I and consumer lending, as well as loans to nonbank financial firms and “other” loans.



Figure 15: Loan Growth Trends, Second Quarter 2013 to Second Quarter 2014



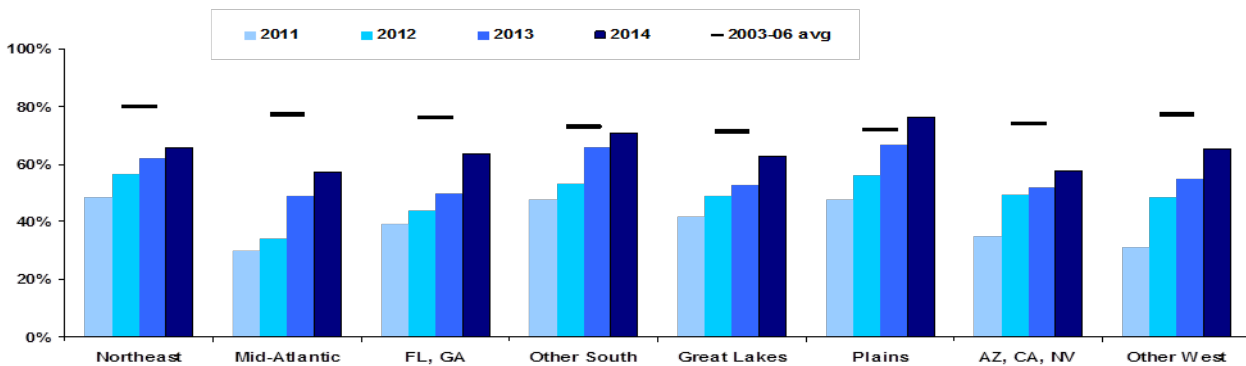
Source: Integrated Banking Information System (OCC)

Data are merger-adjusted and held constant for institutions in continuous operation from 1Q:06 to 2Q:14. Loans to U.S. non-depository financial institutions increased \$24 billion and account for about 40 percent of growth in combined total of loans to non-depository financial institutions and "other" loans.

Loan growth among small banks has not been as widespread as in normal economic times (see figure 16). On a regional basis, 57 percent to 76 percent of banks with less than \$1 billion in assets reported loan growth over the past year, compared with a more normal figure of 80 percent. Furthermore, growth varies widely by region, whereas it was more uniform in the past. The regions where small-bank loan growth remains the weakest include the mid-Atlantic states, Arizona, California, and Nevada. Meanwhile, the Northeast, the Southern states except Florida and Georgia, and the plains states are seeing some of the highest loan growth at small institutions. Local economic conditions drive these patterns, as strong agriculture and energy production have boosted local economies in certain states, while lingering real estate problems weigh disproportionately on other regions.

Figure 16: Loan Growth for Small Banks by Region

Percentage of institutions with assets less than \$1 billion showing year-over-year loan growth



Source: Integrated Banking Information System (OCC)

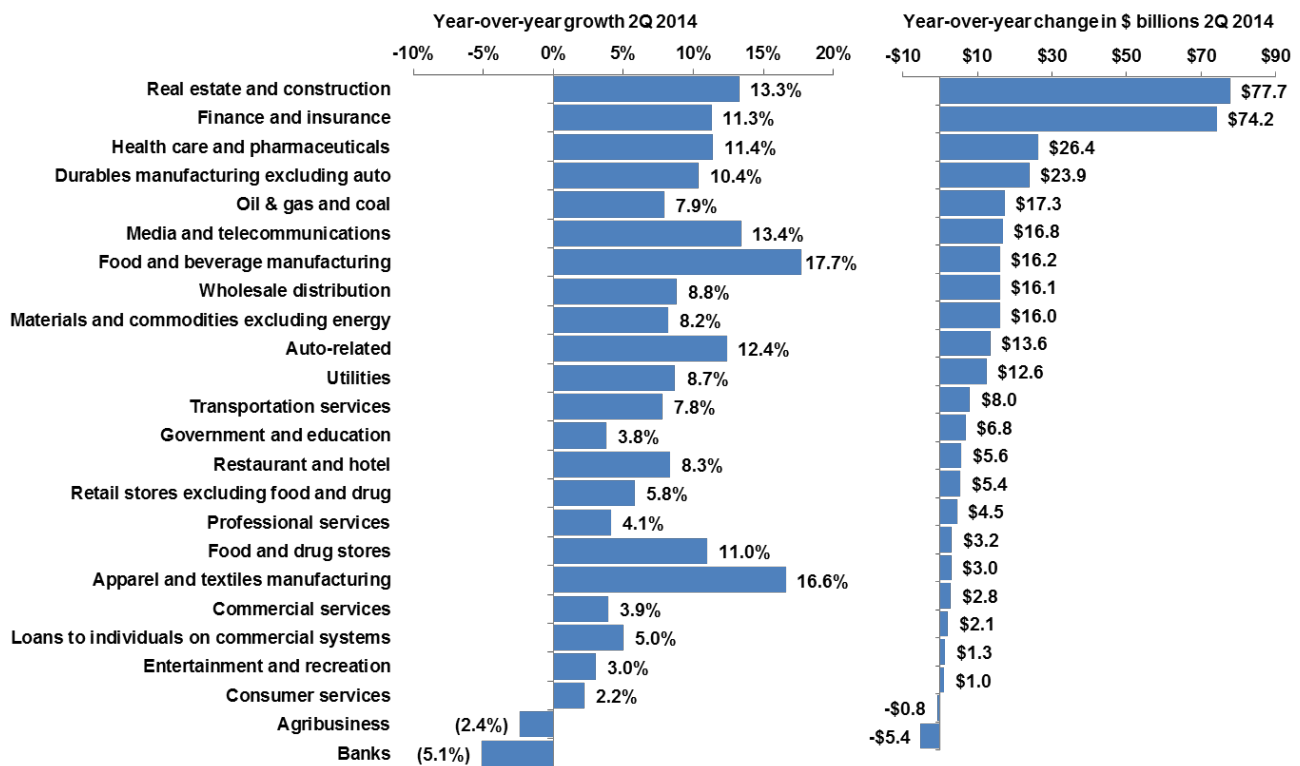
Northeast = CT, MA, ME, NH, NJ, NY, PA, RI, VT  
 Great Lakes = IL, IN, MI, OH, WI  
 Other South = AL, AR, KY, LA, MS, OK, TN, TX

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

Banks reporting to the OCC’s Credit Analytics data system experienced growth in commercial commitments exceeding 9.1 percent, or \$346 billion, year-over-year as of June 30, 2014. While credit growth was evident across most industry groups, lending to the real estate and construction group and the finance and insurance group (nonbank financial firms) led the way, with \$77.7 billion and \$74.2 billion, respectively (see figure 17). Among the finance and insurance industry groups, the fastest growth is shown by funds and other financial vehicles. The strongest growth within real estate lending was commercial mortgages to owners and lessors of residential property, mainly apartments. Other industry groups with strong double-digit growth include food and beverage manufacturing, apparel and textiles manufacturing, media and telecommunications, and automobile-related (principally auto parts and auto dealers). The OCC continues to emphasize the need for banks to ensure that they have the necessary expertise to understand the risks in these industries.

Figure 17: Commercial Loan Growth by Industry for Reporting Banks



Source: OCC Credit Analytics

**Part III: Key Risk Issues**

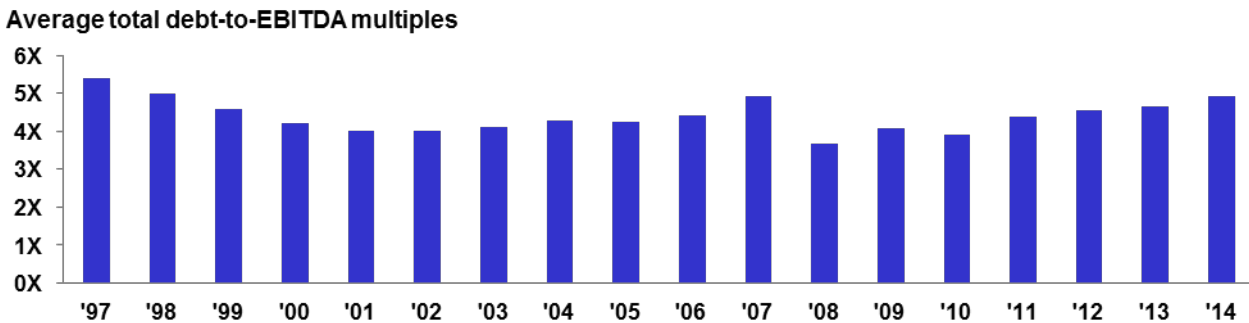
**A. Competition Drives Easing in Underwriting Standards**

**Significant Growth in Leveraged Loans Accompanied by Weaker Underwriting**

U.S. syndicated leveraged loan issuance was strong in the first half of 2014 although issuance was 9 percent below issuance in the first half of 2013. The comparative period decline resulted from a 50 percent drop in re-pricing transactions, as there were fewer repricing opportunities in the current interest rate environment. However, search for yield by investors drives a strong risk appetite for leveraged loans, and merger and acquisition (M&A) activity is increasing. M&A loan volume totaled \$133 billion in the first six months of 2014 and is on a pace to equal or exceed the 2006 volume, which was the second highest level over the past decade. Loans for leveraged buyouts also increased in the first half of 2014, but volume remains well below both 2006 and 2007 volume levels.

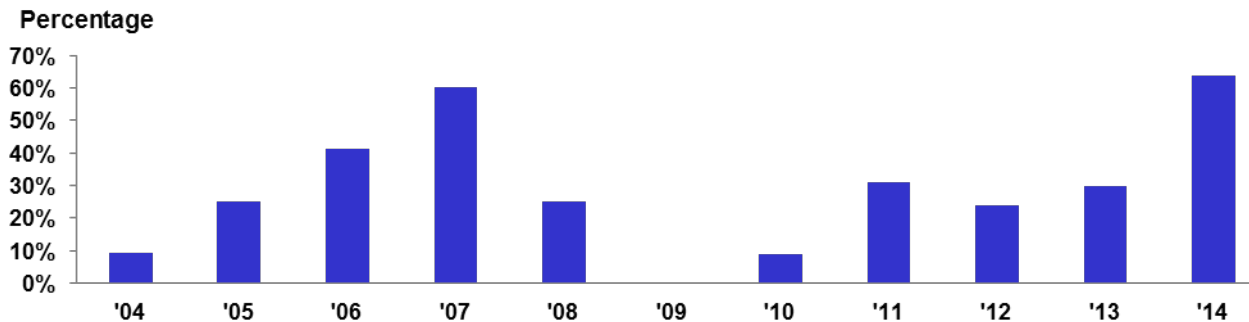
The average leverage ratio measured as total debt to earnings before interest, taxes, depreciation and amortization (EBITDA) for new money large corporate loans issued in the first six months of 2014 increased to 4.9 times, a ratio last reached in 2007, compared with 4.7 times for all 2013 loan issuances (see figure 18). In another sign of increasing risk, 64 percent of leveraged buyout transactions were originated with a leverage ratio in excess of 6 times (see figure 19).

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



Source: S&P LCD. Data for 2014 are as of June 30. All other data as of year-end.  
 Note: Excludes existing tranches of add-ons and amendments & restatements with no new money.  
 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.

**Figure 19: Leveraged Buy-Outs Structured With Debt-to-EBITDA Multiples More Than 6 Times**

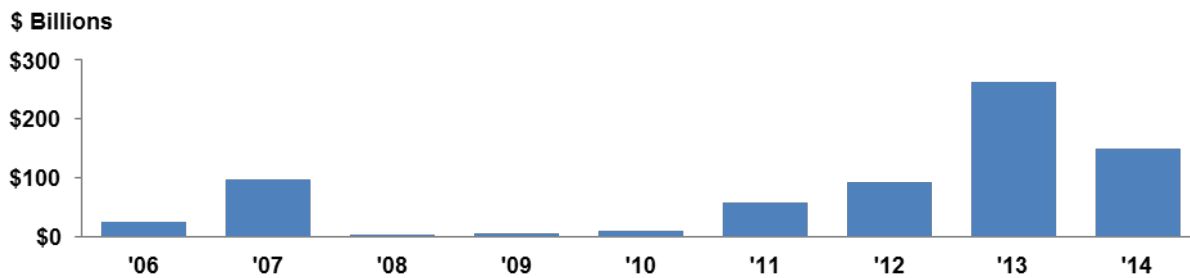


Source: S&P LCD. Data for 2014 is as of June 30. All other data as of year-end.  
 Note: Excludes existing tranches of add-ons and amendments & restatements with no new money.  
 S&P and its third-party providers are not liable for errors or omissions in the data/information and the context from which it is drawn.

## Volume of New-Issue Covenant-Lite Leveraged Loans Rises

Investor demand for higher-yielding products remained strong in the first half of 2014, driving more relaxed transaction structures that incorporate fewer, if any, loan covenants and other lender protections. New-issue, covenant-lite loans represented more than 60 percent of institutional loans originated through the first six months of 2014, compared with 57 percent in 2013 (see figure 20). Many credit agreements grant borrowers more flexibility, larger credit facilities, and the ability to add more debt in the future. Sixty-three percent of new issuance leveraged transactions rated by S&P in the first half of 2014 were assigned ratings of B+ or lower, approaching the 64 percent peak share seen in 2007. The combination of higher initial leverage, weaker creditor structural protections, and generally riskier borrowers increases credit risk and remains a supervisory concern.

**Figure 20: New Issuance of Covenant-Lite Leveraged Loans**



Source: S&P LCD. Data for 2014 is as of June 30. All other data as of year-end.

Note: Excludes existing tranches of add-ons and amendments & restatements with no new money.

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.

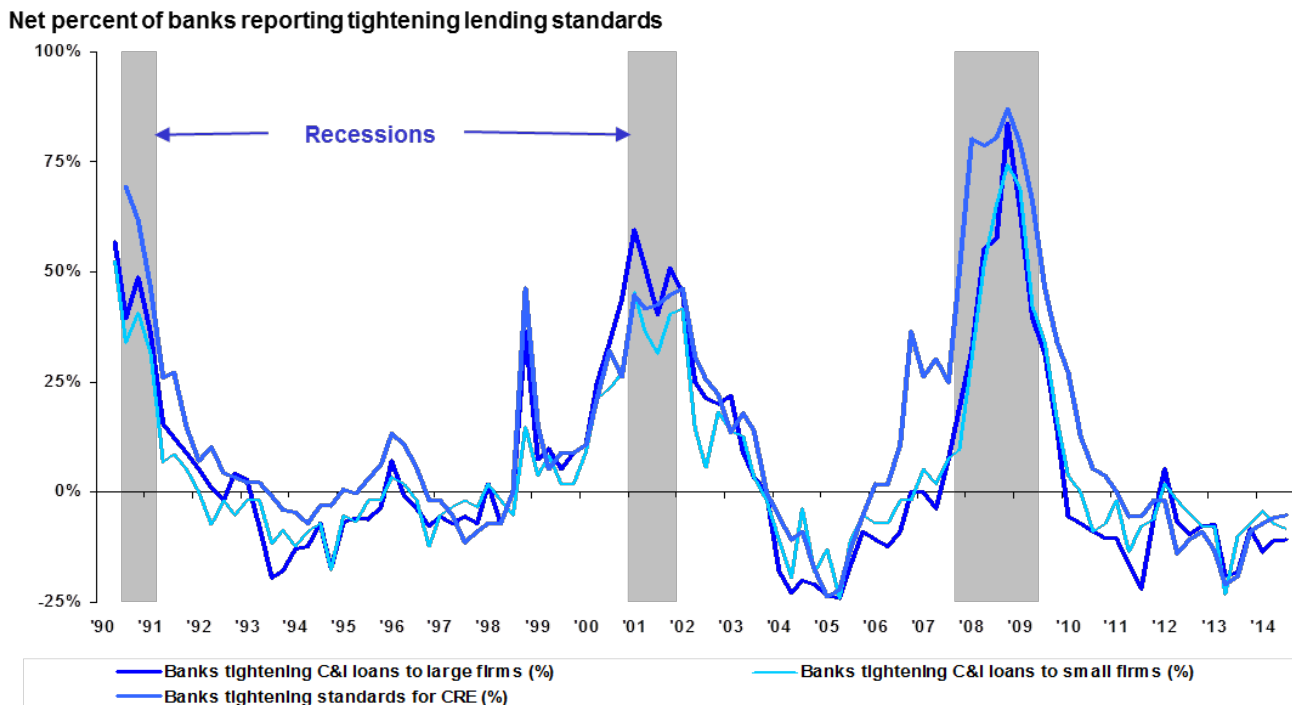
## Loan Underwriting Standards Easing

The OCC’s 2014 Survey of Credit Underwriting Practices shows that underwriting standards are easing in both commercial and retail products, as competitive forces and changing economic conditions continue to stretch underwriting standards. Even so, examiners reported moderate or conservative underwriting practices for commercial products (98 percent) and retail products (96 percent).

Large banks reported the highest share of eased underwriting standards. Examiners cited competition, the economic outlook, market strategy, and increasing risk appetite as factors resulting in eased standards. Easing of standards was broad-based across loan products, including leveraged loans, large corporate, international, indirect consumer, CRE (both construction and other types), and credit cards. Changes in pricing, collateral requirements, covenants, credit lines, and scorecard cutoffs were the primary methods that banks used to ease standards. Loan portfolios with the most tightening in underwriting were the retail portfolios of high loan-to-value (LTV) home equity and conventional home equity. Commercial portfolios in general showed only nominal tightening.

The Federal Reserve Board’s July 2014 [“Senior Loan Officer Opinion Survey on Bank Lending Practices”](#) reported continued net easing of lending policies and underwriting standards on C&I and CRE loans in the second quarter of 2014 as well as a broad based pickup in demand. The survey reported net easing of lending standards for ten 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. Most of the easing was reported in maximum size of credit lines, pricing, loan covenants, and use of interest rate floors.

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

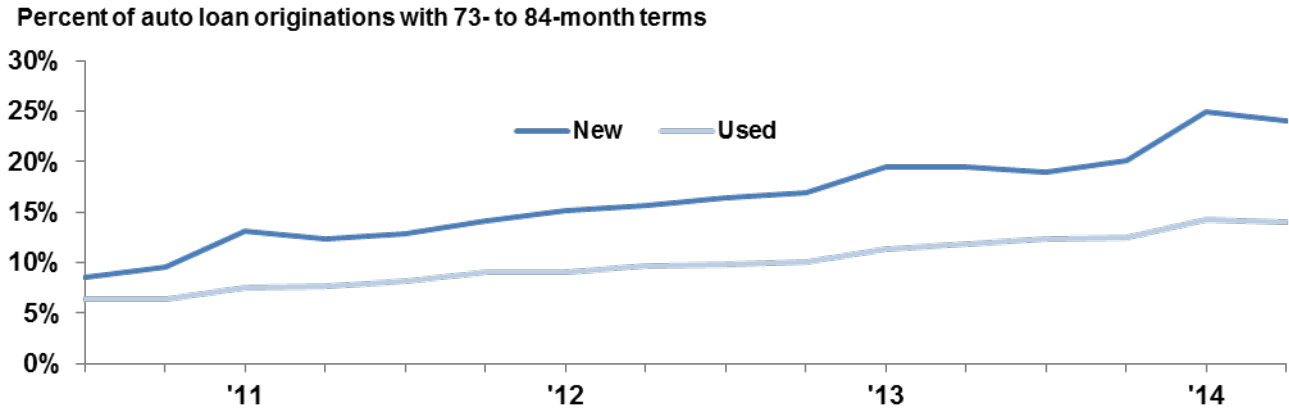


Source: Federal Reserve Board/Haver Analytics (July 2014)

## Growing Risks in Auto Lending Continue

Auto loan terms continue to lengthen as lenders and borrowers attempt to manage monthly payments even as amounts financed and LTVs increase. In the past two years, the share of 73- to 84-month auto loans as a percentage of the total market doubled from 12 percent to 24 percent for new vehicles. For used vehicles, this share has also doubled, going from 7 percent to 14 percent (see figure 22).

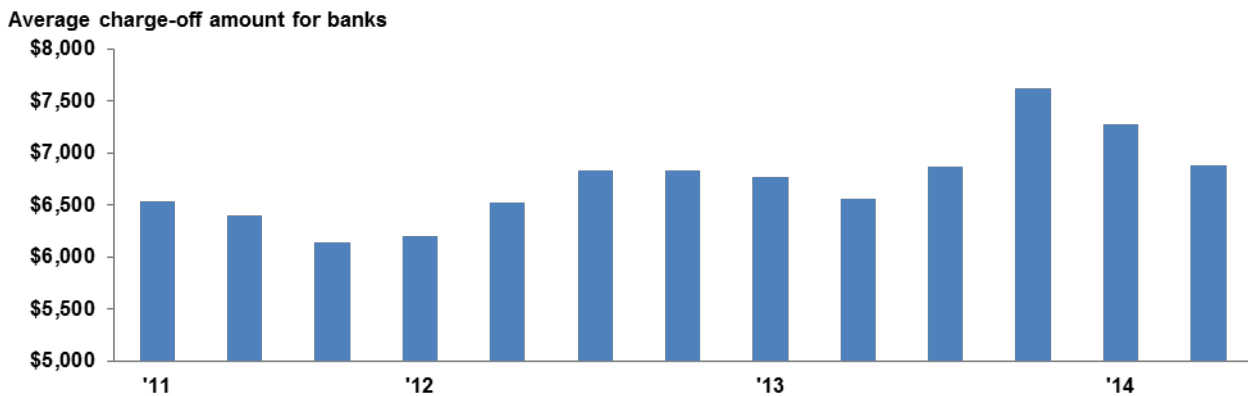
Figure 22: Trend in Auto Loan Originations With 73- to 84-Month Terms



Source: Experian  
Data are quarterly from the third quarter of 2010 through the second quarter of 2014.

Rapid growth in auto loan volume has offset any rise in lagging credit quality indicators that are expressed as a percent of volume, such as delinquency and loss rates. Average dollar losses per vehicle, however, continue to rise. Banks that followed competitive industry trends to longer terms and higher LTVs face increasing risk in their auto loan portfolios should collateral values collapse (see figure 23). The trend of bundling add-on products, extended warranties, and longer loan terms contributes to higher LTVs and may increase consumer compliance risk if such terms are not proportionate to the long-term value of the vehicle. Indirect auto lending practices, such as dealer mark-ups, may increase fair lending risk if not adequately controlled and monitored.

Figure 23: Average Charge-Off Amount for Banks



Source: Experian Automotive  
Note: Data are quarterly from the second quarter of 2011 through the second quarter of 2014.

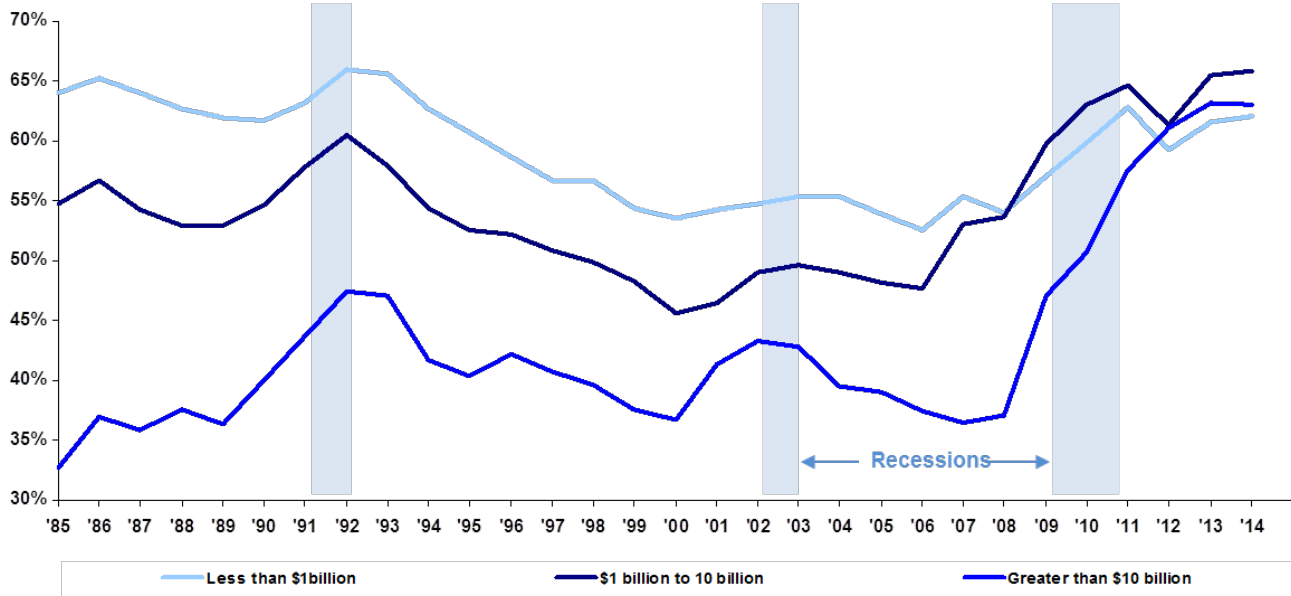
**B. IRR Vulnerabilities**

**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. The surge in deposits associated with the flight to quality that began during the financial crisis has continued (see figure 24). 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. Segments of a bank’s core depositors may react differently when interest rates increase than they have in this low rate environment. Banks need to analyze core deposits carefully, as some are potentially more sensitive to rising interest rates than historical relationships may suggest. 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. During the past year, OCC examiners have gathered data during their ongoing supervision to provide a better understanding of the range of practices that community and midsize banks use to identify and measure IRR. Part IV provides a summary of these findings.

**Figure 24: Trends in Core Deposits for Banks**

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



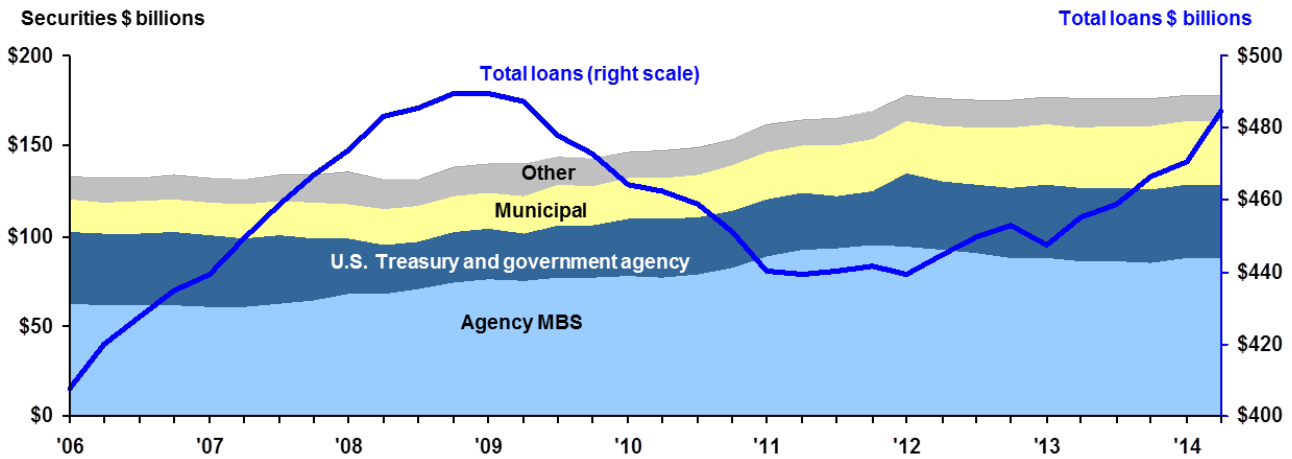
Source: Integrated Banking Information System (OCC)

Note: Data for 2014 are as of June 30. All other data are 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 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 NIM (see figure 25). 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 25: Investment Portfolio Mix for Banks With Total Assets Less Than \$10 Billion**



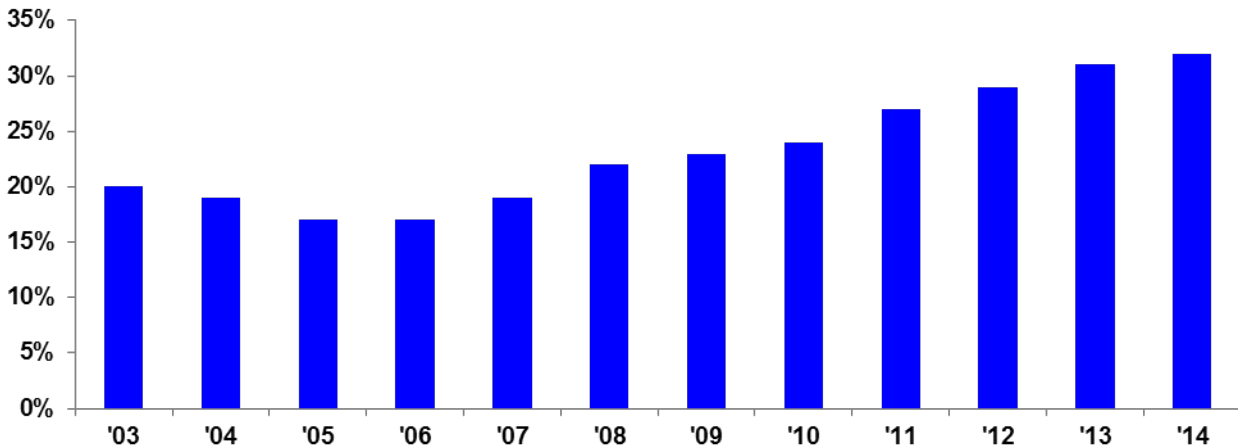
Source: Integrated Banking Information System (OCC)

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

### National Banks With Less Than \$1 Billion in Assets Increasing Long-Term Assets

Extension risk is increasing for banks with less than \$1 billion in assets as they search for yield by adding exposure to long-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 June 30, 2014 (see figure 26). In attempting to improve their NIM, national banks have increasingly relied on long-term assets with a focus on mortgage products.

**Figure 26: Long-Term Asset Concentrations for National Banks With Less Than \$1 Billion in Assets**



Source: Integrated Banking Information System (OCC)



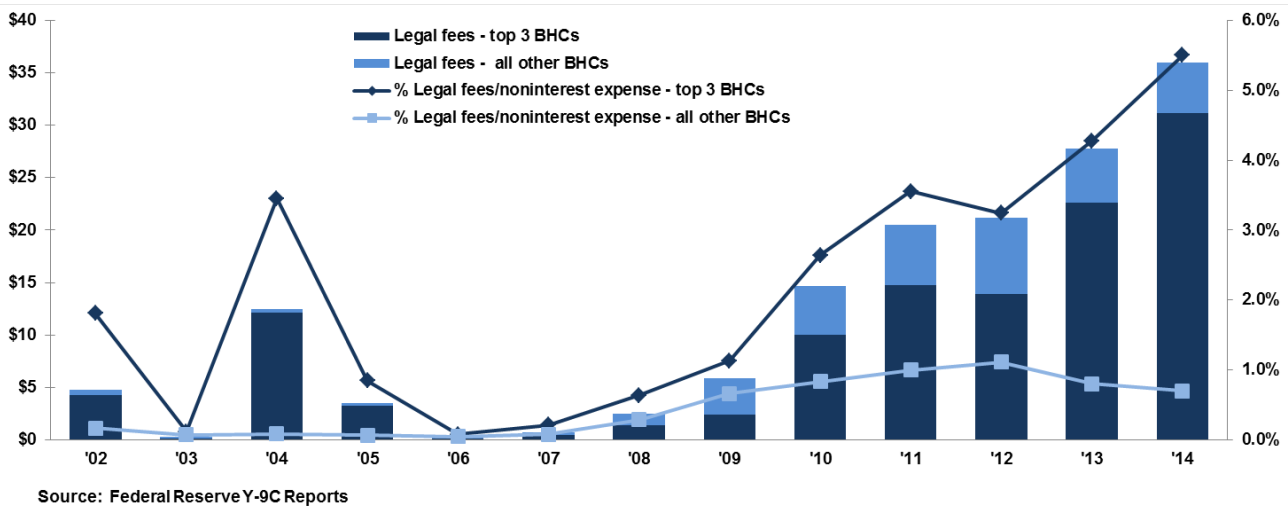
### C. Operational Risk Remains Elevated

#### Operational Risk Concentrated in the Largest Banks, but Increasing in Small Banks

Operational risk is elevated because of the amount and pace of internal and externally initiated change, greater interconnectedness and interdependencies that introduce information security and concentration vulnerabilities, and evolving and increased sophistication of cyber threats and pervasive IT vulnerabilities. While high operational risk has been primarily concentrated in the largest banks, operational risk is also increasing among smaller banks.

Legal fees and settlements are one measure of the financial impact of operational loss events. 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 27). U.S. Securities and Exchange Commission reporting as of June 30, 2014, indicates that the 12 largest bank holding companies (BHC) estimate maximum potential legal exposure of approximately \$21 billion in excess of reserves. The exposure amounts were \$14 billion, \$20 billion, and \$23 billion for 2011, 2012, and 2013, respectively.

Figure 27: Trends in Legal Fees and Settlements



## **Part IV: Range of Practice in IRR Modeling**

### **Community and Midsize Banks Report a Wide Range of Practice in IRR Modeling**

The prolonged low rate environment has resulted in pressure on NIMs and NI as asset yields decline and cost of funds hit historic lows. Banks responded by positioning their balance sheets for either a rising rate scenario by remaining liquid, or for a prolonged low rate environment by increasing the maturity and repricing length of assets. The sustained volume of NMD inflows at historically low rates compounds the complexity of IRR management. Predicting the future behavior of these depositors is a key component of IRR modeling. The combination of lengthening or shortening asset duration while managing liability stability directly affects IRR.

During supervisory reviews of over 1,500 community and midsize banks, the OCC compiled information in the fourth quarter of 2013 and the first quarter of 2014 on IRR modeling to analyze the range of practices used to measure IRR. This information included multiple data points ranging from modeled exposure, for both short-term and long-term measures, to rate scenarios and NMD assumptions. The OCC is providing this data to communicate the range of practices for IRR modeling. The data shown are as reported by banks and have not been altered or validated by the OCC.

The data show that banks have diverse IRR measurement approaches. Modeling IRR exposures under multiple rate scenarios, including both earnings at risk (EAR) and economic value of equity (EVE), provides management with a more comprehensive assessment of structural risk. Most of the banks surveyed use EVE for long-term risk identification. EVE analysis measures the sensitivity of the present value of the current balance sheet to potential changes in interest rates. EVE data generated from rate shock scenarios provide a percentage change metric, one of the most common long-term measures. EAR is the primary method used for short-term risk identification with a variety of approaches, including NII or NI assessed over periods ranging from 12 to 24 months.

Overall, the range of modeled rate scenarios illustrates the variety of practices used by bank managers to measure their risk. Banks, appropriately, use multiple interest rate stresses, including shocks, ramps, and non-parallel movements. The majority of banks run shock and ramp scenarios using up and down parallel rate movements ranging from 50 bps to 400 bps. Given the low interest rate environment, stress scenarios using rate changes of plus 300 bps and plus 400 bps are appropriate.<sup>7</sup> Non-parallel rate movements are used to a lesser extent, but some banks model more complex key rate assessments, including flattening, steepening, inversion, and twists.

The IRR data show a wide range of practice for NMD assumptions. The diversity of the data indicates unique funding profiles and stressors, and different customer types and behaviors across geographies and depositor balances. NMD deposit assumptions are a key component of IRR measurements and a driver of earnings and economic capital exposures. Accordingly, it is important that banks not rely on external proxies and instead use assumptions that reflect the bank's unique profile in order to identify risk properly.<sup>8</sup>

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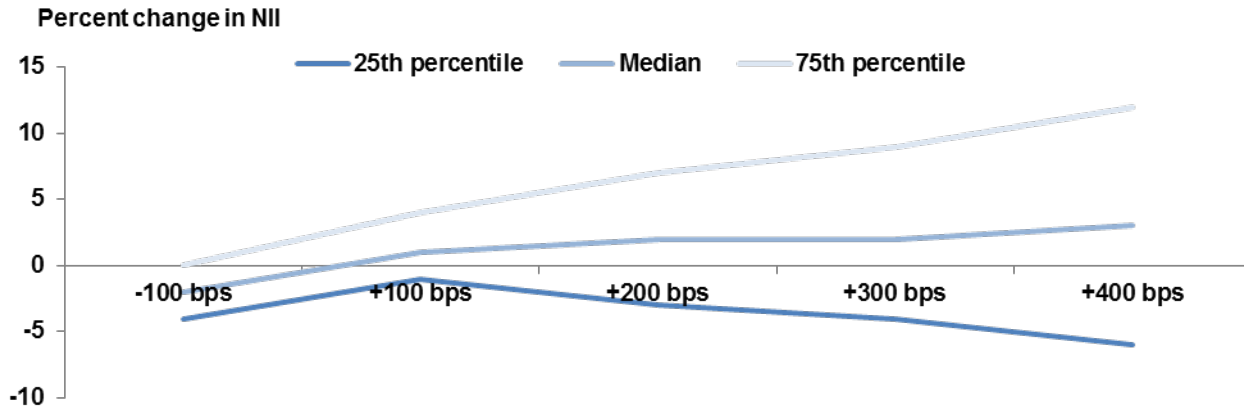
<sup>7</sup> [OCC Bulletin 2012-5](#), "Interest Rate Risk Management: FAQs on 2010 Interagency Advisory on Interest Rate Risk Management," responds to requests to clarify points in the Interagency Statement on IRR.

<sup>8</sup> Ibid.

**EAR**

Banks measure EAR to identify the short-term risk to changes in interest rates. Typically, banks measure earnings risk to NII. Some banks measure EAR to NI to capture risk from noninterest sources of revenue that are interest rate sensitive. Banks also measure EAR over multiple horizons including 12-month, 24-month, and longer horizons. The OCC uses the 12-month horizon as a basis for comparison in this analysis because it is the most common among all banks in the survey. The vast majority of banks report higher NII in rising interest rate scenarios (see figure 28).

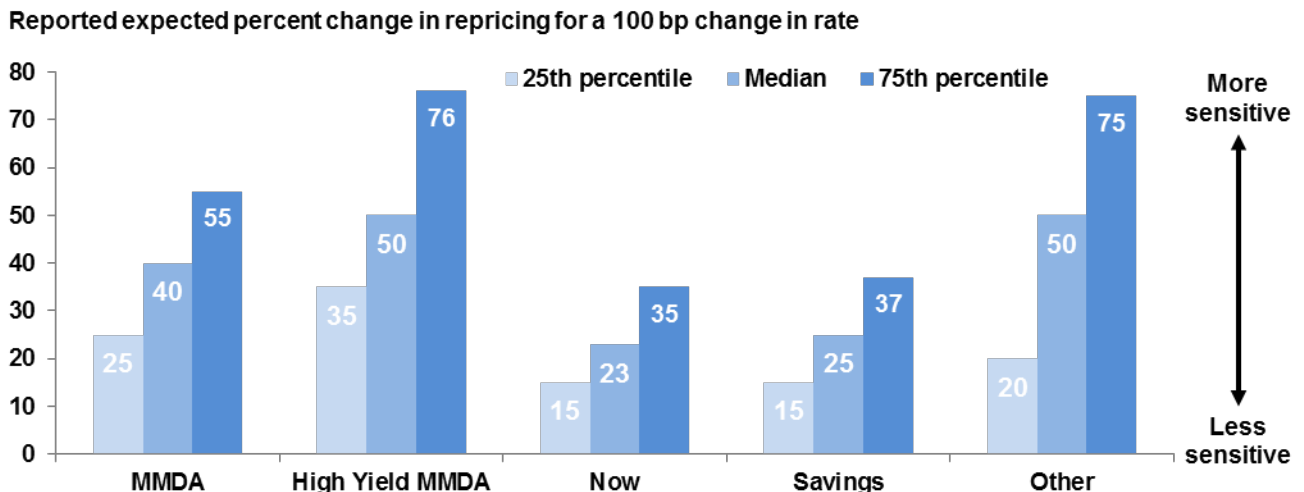
**Figure 28: Bank-Reported EAR Exposure**



Source: OCC

The IRR review included repricing assumptions, a measure of deposit volatility that identifies the change in deposit price for a given rate change, for five deposit categories. The OCC collected information for the up and down 100 bp rate scenarios. Banks reported a wide range of expected NMD repricing assumptions for a 100 bp change in interest rates (see figure 29). For example, the median money market deposit account (MMDA) repricing rate was 40 percent. This indicates that for an increase in interest rates of 100 bps, the majority of banks expect MMDAs to reprice upward 40 bps. Repricing assumptions, especially in MMDA-related accounts, vary widely, and should be analyzed carefully to ensure the sensitivity estimates appropriately reflect realistic expectations.

**Figure 29: Bank-Reported Expected Percent Change in Repricing for NMDs**

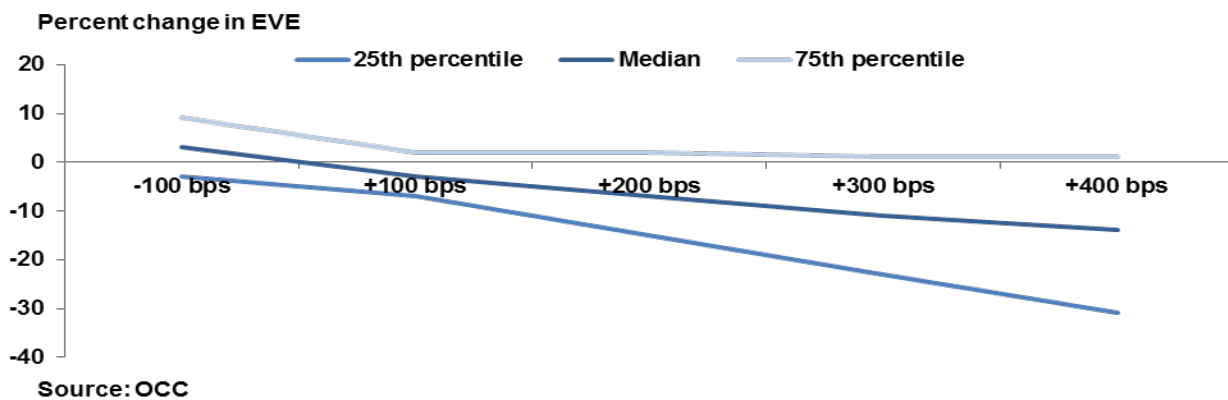


Source: OCC

## Long-Term Risk Measurement of IRR

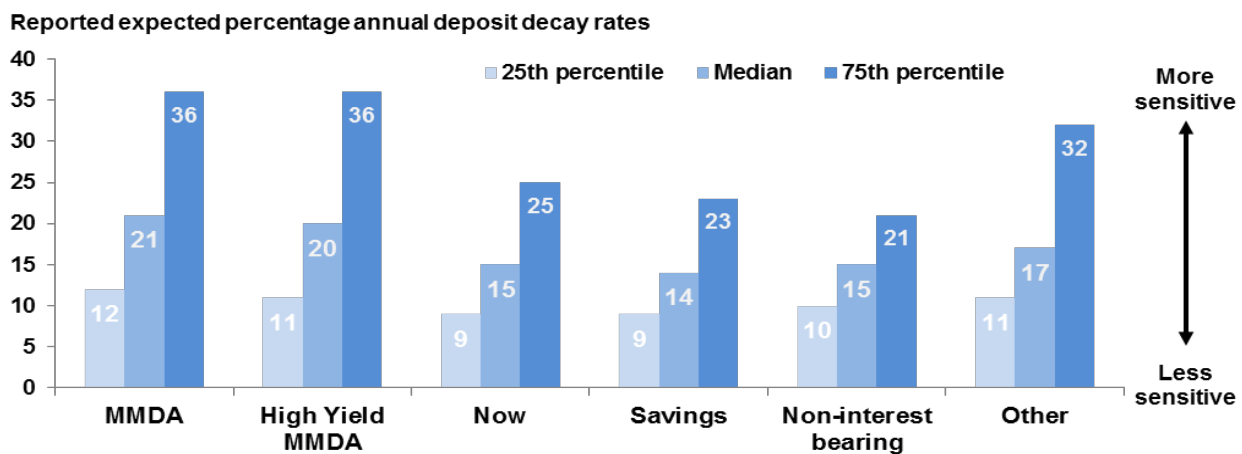
Long-term risk measurement is less diverse across banks than short-term risk measurement. While some banks report alternative approaches, the majority of banks use EVE. Banks assess EVE under a variety of rate scenarios with the majority using interest rate shocks (see figure 30). Similar to short-term risk measures, the plus 200 bp rate shock has the highest number of reporting banks. The results ranged from a 44 percent loss in EVE to a 29 percent increase in EVE. The median, 25<sup>th</sup>, and 75<sup>th</sup> percentiles indicate a much narrower band of results for most of the population (a 15 percent loss to a 2 percent increase), eliminating a number of outliers that affect the outer bounds of the shock ranges. Banks reporting exposures below the median should carefully consider the risk to capital and ensure the board and senior management understand the potential exposure and are comfortable with the risk.

Figure 30: Bank-Reported EVE Exposure



Banks reported expected decay assumptions for six different deposit categories. The decay rate estimates the percentage of an account that will “run-off” or move out of a particular deposit product for a given rate change. The decay rates reported by banks are, like the banks' reported repricing rates, contingent on multiple factors. Deposits that are more volatile (e.g., MMDA and High Yield MMDA), show higher decay rates than more stable savings accounts (see figure 31). Banks reported expected decay rates over the full range of possibilities (to 100 percent decay) for MMDA accounts. The OCC did not collect data indicating whether the decay volume leaves the banks or moves into different deposit categories as a part of this analysis. The wide range of decay rate assumptions should be analyzed carefully to ensure the sensitivity estimates appropriately reflect realistic expectations.

Figure 31: Bank-Reported Expected Decay Rate Assumptions for NMDs for an Up 100 bp Scenario



## **IRR Modeling Summary**

IRR supervision is a key risk theme in this report and is receiving additional scrutiny from examiners as banks prepare for a potential increase in interest rates. The OCC's supervisory review process in the fourth quarter of 2013 and first quarter of 2014 included a review of bank-reported IRR data from more than 1,500 community banks and midsize banks. The IRR data reported here reflect a range of modeling practices based on the complexity of banks' balance sheets and operations, as well as the sophistication of modeling assumptions. This information is provided for comparative purposes as banks gauge the adequacy of their IRR measurement processes and related risk assumptions and exposures.

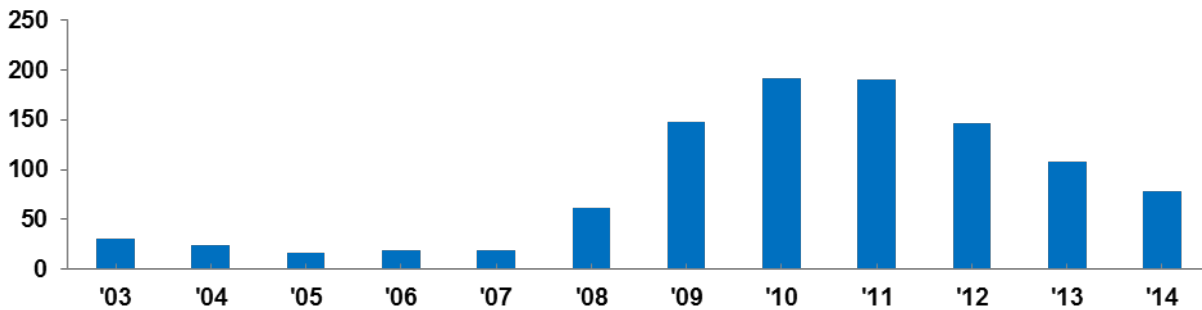
Outliers in reported exposures and NMD assumptions may indicate diversity in balance sheet profiles or unrealistic or incorrect modeling assumptions. The OCC reminds banks of the need to perform sensitivity analysis of NMD assumptions to identify the potential impact of depositor instability. Testing the sensitivity of existing assumptions by applying subtle or significant variations to the repricing or decay rates may be used to analyze the potential impact on capital and earnings if depositors are less stable, or more price sensitive, than expected. As appropriate, strategic planning should include consideration of potential asset-liability management strategies to minimize earnings volatility and capital exposure under different rate scenarios.

## **Part V: Regulatory Actions**

### **Number of Banks Rated 4 or 5 Continues to Decline**

The number of OCC-supervised banks rated 4 or 5 continues to decline after peaking in 2011 (see figure 32). The decline is attributable mainly to positive trends in the institutions resulting from the slowly improving economy and recapitalizations.

**Figure 32: Number of Banks Rated 4 or 5**



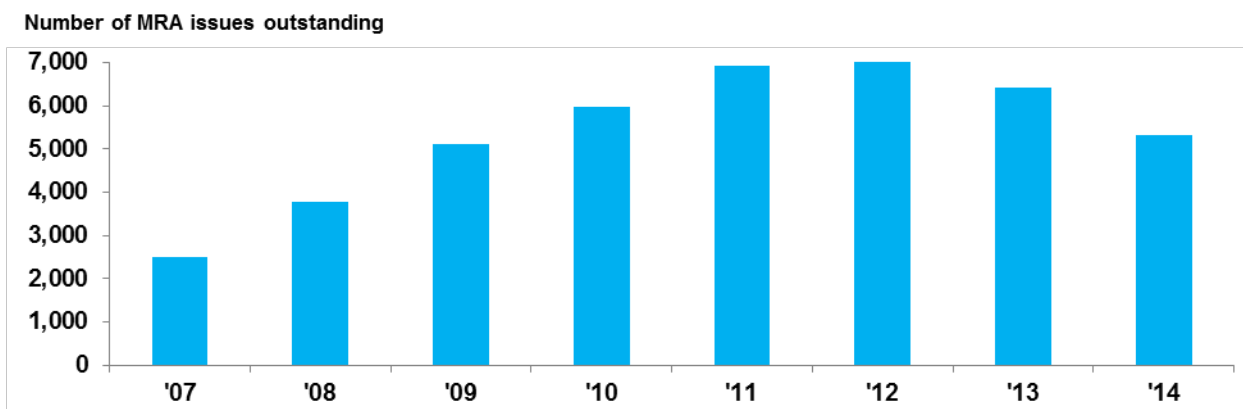
Source: OCC

Note: Data for 2014 are as of June 30. All other data is as of year-end.

### **MRAs Decline**

The OCC uses MRAs in the supervisory process when bank practices deviate from safe and sound banking practices or 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 MRA issues peaked in 2012 and declined through June 30, 2014 (see figure 33).

**Figure 33: Trend in Outstanding MRA Issues**



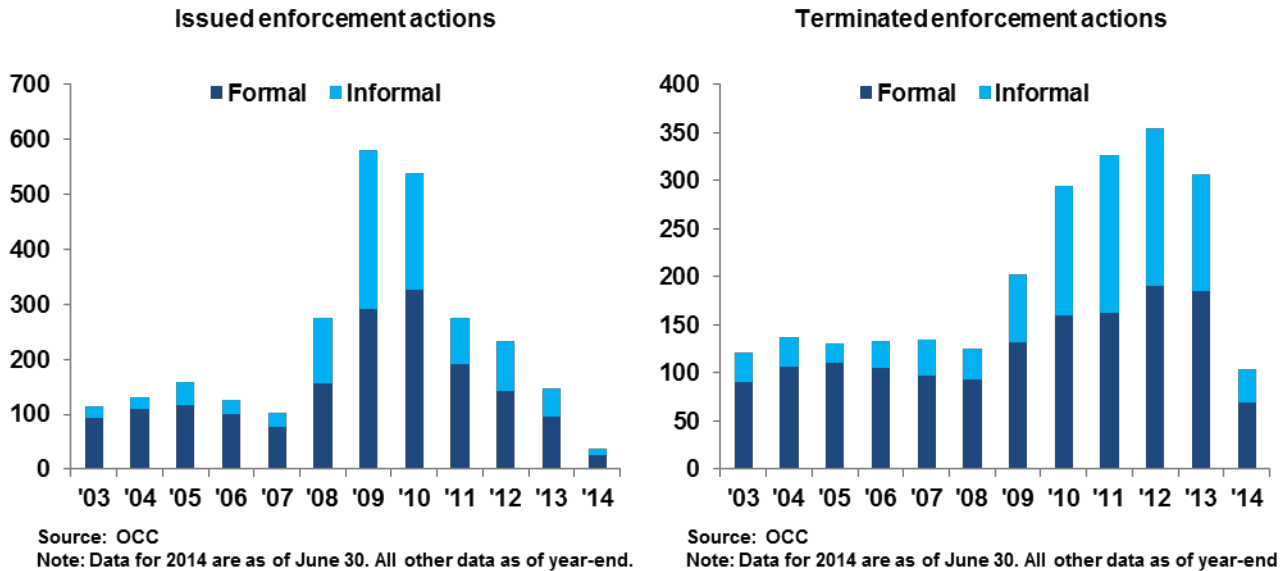
Source: OCC

The order of the top five MRA categories for small banks remains unchanged from the spring 2014 *Semiannual Risk Perspective*. They are credit (30 percent), compliance (13 percent), management (13 percent), IT (9 percent), and audit (8 percent). For large banks, the order of the top five categories also remains unchanged, with MRAs centered in credit risk (27 percent), operational risk (25 percent), consumer compliance (12 percent), BSA/AML (11 percent), and internal controls (10 percent).

## Enforcement Actions Against Banks Continue to Decline in 2014

The OCC uses enforcement actions to address more acute problems or weaknesses requiring corrective measures. Informal enforcement actions include commitment letters, memoranda 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 trend through the first six months is toward fewer enforcement actions against banks for 2014 than in recent years (see figure 34), reflecting the continued overall improvement in the condition of federally chartered banks.

Figure 34: Enforcement Actions Against Banks



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