Office of the
Comptroller of the Currency

Semiannual Risk Perspective

From the National Risk Committee

Office of the Comptroller of the Currency
Washington, D.C.
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About This Report

The Office of the Comptroller of the Currency (OCC) charters, regulates, and supervises national banks and federal savings associations (collectively, banks) and licenses, regulates, and supervises the federal branches and agencies of foreign banks. The OCC supervises these banks to ensure they operate in a safe and sound manner, provide fair access to financial services, treat customers fairly and comply with applicable laws and regulations.

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, focusing on those that pose threats to the safety and soundness of banks and their compliance with applicable laws and regulations. This report presents data in four main areas: the operating environment, bank performance, key risk issues, and regulatory actions.

The OCC publishes the report twice a year, drawing on midyear and year-end data. The spring 2016 report reflects bank financial data as of December 31, 2015.

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

Executive Summary

The financial performance of federally chartered banks strengthened in 2015 compared with 2014. Net income for the federal banking system rose 8 percent year-over-year as higher interest income and lower noninterest expenses more than offset an increase in provision expenses. Profitability as measured by return on equity (ROE) remained well below pre-recession levels at large banks, but had almost returned to such levels at small banks. ROE at small banks—those with total assets less than $1 billion—exceeded 10 percent, driven mostly by stronger gains in net interest income and noninterest income. The ROE at large banks was below 10 percent as higher net interest income and lower overhead expenses were partially mitigated by higher provisioning expenses. Broad loan growth continued, with commercial and industrial (C&I), commercial real estate (CRE), and residential real estate as the primary growth drivers. Large banks saw loan growth almost double from 3.6 percent to 5.9 percent in 2015, primarily from growth in loans to nondepository financial institutions and CRE lending. Small banks experienced strong growth primarily in residential and CRE loan portfolios.

This report highlights key risk issues facing the federal banking system. Broadly, the key risk issues remain consistent from the fall 2015 report with strategic, credit, operational, and compliance risk remaining top concerns with interest rate risk warranting continued monitoring. The report discusses how specific aspects of these risks continue to evolve.

Strategic risk remains an ongoing concern. Banks are several years into the risk accumulation phase of the economic cycle. The banking environment continues to evolve, with growing competition among banks, nonbanks, and financial technology firms. Banks are increasingly offering innovative products and services, enabling them to better meet the needs of their customers. While doing so may heighten strategic risk if banks do not use sound risk management practices that align with their overall business strategies, failure to innovate to meet evolving needs or financial services may place a bank at a competitive disadvantage.

Credit risk is increasing because of strong loan growth combined with easing in underwriting standards. More specifically, indirect auto lending and leveraged lending remain concerns, with CRE concentration risk management moving from a monitoring status to an area of additional emphasis. Operational risk remains elevated as banks deal with changing threats to cybersecurity and increasing reliance on third-party relationships. Bank Secrecy Act (BSA) and compliance risk management remain complex areas to manage and continue to pose challenges as banks implement systems to address changes in technology and comply with new rules. Specifically, implementation of the integrated mortgage disclosures under the Truth in Lending Act, which became effective October 3, 2015, is a key risk. Implementation of the new requirements under the amended Military Lending Act (MLA)[1] regulation, which has an effective date of October 3, 2016, was added as a key risk.

The NRC is monitoring these supervisory priorities closely and is implementing appropriate actions to address concerns.

The NRC also is monitoring risks that warrant awareness among bankers and examiners. These risks may develop into broader system-wide issues and may already have raised concern at certain banks. The risks include the following:

[1] 10 USC 987, "Terms of Consumer Credit Extended to Members and Dependents: Limitations." The MLA was amended by sections 661-663 of the National Defense Authorization Act for Fiscal Year 2013, Pub. L. 112-239, 126 Stat. 1785.

- Interest rate risk remains important because of uncertainties about competition for funding. There is also risk from a sharp upward move in funding costs as the sustained period of low interest rates transitions to a period of rising rates.
- Interactions with marketplace lending firms could raise potential compliance, BSA, operational, market, or credit risk issues as more banks engage with firms to purchase, securitize or work in other ways with marketplace lending firms.
- Low energy prices may contribute to a broader economic impact in regions dependent upon oil and gas (O&G) exploration and production.
- Allowance for loan and lease loss (ALLL) levels and methods may not be sufficiently addressing the risks presented by loan growth, easing in underwriting practices, and layering of credit risk.

Key Risk Themes

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

- For small banks, strategic risk primarily includes adequacy of business models, board and management succession, breadth and depth of staff expertise, and the search for new market niches. For large banks, strategic risk stems from adjustments to balance-sheet composition and corporate structures. In both cases, the increased risk taking is intended to enhance near-term net revenues and profits. For large banks, the goal is often to meet investor expectations of "acceptable" ROE rates.
- Heightened lending competition pushes some banks to relax credit structure and terms as these banks adopt growth strategies that target new business segments. Some banks are building concentrations in areas that were problematic in the past credit cycle, while other banks with limited opportunities in their markets are adopting strategies focused on merger, acquisition, or liquidation options.
- Banks are increasingly adopting innovative products, services, and processes in response to the evolving demands for financial services and the entrance of new competitors, such as out-of-market banks and financial technology firms. Doing so often involves assuming unfamiliar risks, an expanded reliance on third-party relationships, and the need to update or acquire new information systems and technology platforms. Banks involved in responsible innovation use new or improved financial products, services, and processes to meet the needs of consumers, businesses, and communities in a manner that is consistent with sound risk management and is aligned with banks' overall business strategies.[2]
- The pace of mergers and acquisitions increased in the past 12 months among banks with less than $20 billion in total assets. This pace is expected to continue in 2016 as banks seek to enhance shareholder or franchise value, gain economies of scale, enhance market penetration, and improve cost efficiencies. Merger and acquisition activity may increase risks in maintaining adequate controls and risk management, management information systems, and operational platforms.
- The ongoing low interest rate environment poses interest rate risk as some banks may reach for yield by extending asset duration. Also, the stability of deposit inflows since the recession is difficult for banks to assess and there is a potential for increased competition for retail deposits as interest rates rise.
- The low interest rate environment may also encourage asset managers to reach for yield on behalf of their clients. While some asset managers have sought yield through direct investments in

[2] *Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective,* March 2016.

alternative and structured products, others have obtained yield by increasing clients' holdings of fixed-income assets with greater duration, credit, and liquidity risk exposures. Similar concerns exist with bank retail non-deposit investment sales programs, where products with increased risk exposures are sold to bank customers through a number of distribution channels.

Growing competitive pressures and continued strong credit risk appetites have led to lower underwriting quality and increased credit risk.

- Banks continue to ease underwriting standards and practices across a variety of credit products as they strive for volume and yield in an increasingly competitive environment. Easing standards are particularly evident in indirect auto, C&I, and CRE lending. Increased risk layering is an additional concern.
- In light of rapid CRE growth, supervisory reviews completed in 2015 raised concerns over the quality of CRE underwriting, portfolio-level stress testing and sufficiency of concentration risk management practices at banks. The OCC has observed an easing of CRE underwriting standards, including less-restrictive loan covenants, extended maturities, longer interest-only payment periods, and limited guarantor requirements as examples of risk layering. Banks are placing greater reliance on loan-to-value ratios to mitigate other structural concessions.
- Continued rapid growth, increasing concentrations, and easing of underwriting standards are increasing indirect auto lending risk.
- Risk management, weak underwriting, and erosion of covenant protection remain supervisory concerns in leveraged lending. Origination of non-pass loans[3] have declined to a de minimis level; however, policies that allow the origination of weakly underwritten loans remain a concern.
- O&G-related loan portfolios experienced significant deterioration in 2015, as the sustained decline in oil prices severely affected borrower cash flows and liquidity. The OCC anticipates increased classified loan volume in 2016, as oil prices are expected to remain low.
- *The Senior Loan Officer Opinion Survey on Bank Lending Practices,* published by the Board of Governors of the Federal Reserve System, has reported a net tightening in underwriting for CRE and C&I loans for the fourth quarter of 2015 and the first quarter of 2016. The OCC has not, however, seen evidence of tightening during supervisory activities to date.
- The appropriateness of ALLL levels and methodologies is increasingly important because of loan growth, easing in underwriting, and layering of credit risk.

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

- Banks and their employees, customers, and third-party relationships remain vulnerable to cyber attacks. A common point of entry into internal systems involves a phishing attack aimed at an employee, customer, or third party. Such an attack may result in cyber criminals gaining access to infrastructure and applications through downloaded malware.
- Recent cyber attacks against interbank networks and wholesale payment systems have demonstrated a range of capabilities, including
  - compromising a financial institution's wholesale payment origination environment; obtaining and misusing valid operator credentials with the authority to create, approve, and submit fraudulent messages.
  - employing sophisticated understanding of funds transfer operations and operational controls.

[3] Non-pass loans are loans that are not "special mention" or classified as substandard or worse.

  - using highly customized malware to disable security logging and reporting, as well as other operational controls to conceal and delay detection of fraudulent transactions.
  - transferring stolen funds across multiple jurisdictions quickly to avoid recovery.
- Banks and other businesses continue to receive extortion demands to be paid in virtual currency in exchange for preventing or stopping distributed denial of service attacks or for the decrypting or return of proprietary information. According to one recent industry report, ransomware samples rose 26 percent to almost 1 million from the third quarter of 2015 to the fourth quarter of 2015.[4]
- Cyber criminals increasingly target businesses, including banks and their customers, using social engineering attacks on bank employees that request expedited wire transfers to pay phony vendor invoices. This scheme, known as business e-mail compromise (BEC), resulted in more than $2.3 billion in losses across all businesses, from October 2013 through February 2016, according to the Federal Bureau of Investigation.[5]
- Cyber attacks continue to target companies that provide cybersecurity risk-mitigation products and services to banks, potentially amplifying the breadth of affected institutions through a common access point.
- In the last several years, the number of reported critical vulnerabilities in widely used technology, such as open-source software, has increased. These vulnerabilities are often difficult to remediate because of the potential effect on significant numbers of third-party and internally developed applications, systems, and services.
- New platforms and technologies, such as virtual currencies, enable anonymity for cyber criminals, including terrorists and other groups seeking to transfer and launder money globally. These methods not only pose substantial challenges for compliance with the Bank Secrecy Act and Anti-Money Laundering (BSA/AML) laws and regulations, but also help cyber criminals raise funds to pay for physical and cyber attacks.
- Business operating models are under increasing pressure as banks seek to launch new products and services directly or through third parties, leverage technology, implement systems to comply with new rules, reduce staffing, outsource critical activities, reengineer business processes, and partner with firms unfamiliar with the bank regulatory environment. Banks may not always adapt risk management and control processes to these changes in business strategy.
- Banks may not adequately incorporate resiliency considerations, including recovery from cyber events, into their overall governance, risk management, and strategic planning processes.
- The number, nature, and complexity of domestic and foreign third-party relationships continue to expand, increasing risk management challenges. This reliance may also present concentration risk.
- Central counterparties (CCP), or central clearinghouses, which are increasingly used to clear financial transactions, can reduce bilateral credit risk and promote transparency and robust risk management practices. An increase in centrally cleared transactions also can, however, increase the concentration of operational, credit, and other risks that require commensurate risk management by the CCPs. Foreign CCP membership may introduce additional risks from differences in rules, requirements, and authorities.

Compliance risk remains high as banks manage BSA/AML risks and implement changes to policies and procedures to comply with new MLA regulations and mortgage lending requirements.

- BSA/AML risks remain high. Criminals can exploit technological developments that also may benefit bank customers. Such developments include enhanced products and greater access to

[4] McAfee Labs Threats Report, p. 39, March 2016.

[5] "FBI (Federal Bureau of Investigation) Warns of Dramatic Increase in Business E-Mail Scams," April 4, 2016.

financial services. Some banks have failed to develop or incorporate appropriate controls as products and services change. In addition, some banks struggle with devoting sufficient resources and maintaining the expertise necessary to effectively manage BSA/AML risks.

- Bank decisions to terminate customer relationships because of BSA/AML risk reevaluations may lead to the transfer of these potentially higher-risk customers to banks less experienced in managing associated BSA/AML risks. In addition, if customer terminations result from such reevaluations, this may cause certain customer segments or transactions to move outside of the traditional financial system.
- The amended MLA regulatory requirements generally taking effect on October 3, 2016, for certain types of lending to active duty military personnel and their dependents may pose operational and compliance challenges for banks. Banks need to review the loan products offered to determine whether the new MLA requirements apply and then must implement appropriate policies, procedures and systems to comply with the applicable requirements. Banks continue to face similar change management challenges in also complying with the integrated mortgage disclosure requirements, which apply to loan applications for most closed-end consumer credit transactions secured by real property received on or after October 3, 2015, as well as with other recent amendments to mortgage rules under Regulations Z and X.
- The use of third-party relationships to conduct all or a portion of consumer credit-related product development, implementation, and fulfillment, including MLA and integrated disclosure requirements, can increase compliance risks, including the risk of unfair or deceptive practices.
- Fair lending risks may increase when banks engage third parties to conduct some or all of the loan application or underwriting processes, or to help banks make decisions regarding terms or pricing. Indirect auto lending—an area of significant fair lending risk—is rapidly growing in volume for many banks with simultaneous changes in underwriting standards.
- Banks that offer money market funds (MMF) to customers through fiduciary and custody accounts or through deposit to MMF sweep programs and banks that invest in MMFs may be affected by revisions to the Securities and Exchange Commission's (SEC) rules that become effective in October 2016. The rules[6] establish specific requirements related to net asset value determination, liquidity fees, and redemption gates that vary by MMF types (government, retail, or prime). Banks involved in these activities will likely be affected by compliance, liquidity, operational, and strategic risks related to the SEC's revised rules.

[6] OCC Bulletin 2016-17, "Compliance With SEC (Securities and Exchange Commission) Money Market Fund Rules by Bank Fiduciaries, Deposit Sweep Arrangements, and Bank Investments," May 19, 2016.

OCC Risk Perspective: Outlook by OCC Operating Unit

The outlook for the OCC's Large Bank Supervision and Midsize and Community Bank Supervision operating units remains broadly the same. Compliance and operational risk issues remain leading risk issues at large banks while strategic and credit risk remain the leading issues at midsize and community banks.

Large Bank Supervision

Key risks facing large banks, which contribute to increased strategic and reputation risks, include the following:

- Compliance risk, especially in the area of BSA/AML and implementation of new regulations, because of
  - controls at some banks not keeping pace with higher-risk services and customer relationships.
  - new mortgage-related compliance regulations, which require effective change management strategies around the entire underwriting process.
  - new MLA regulatory requirements.
- Operational risk weaknesses at some banks in controls and oversight of third-party relationships, model risk management, and other high-volume products.
- Credit risks arising from the easing of underwriting standards, a failure to maintain an ALLL commensurate with loan growth, and changes in credit quality in some asset classes, including the O&G sector.
- Cybersecurity from the increasing volume and sophistication of cyber threats and information technology vulnerabilities.
- Governance and enterprise risk management gaps that do not fully align with heightened standards.
- Competition for retail deposits to promote compliance with new regulations that could result in cost of funds pressure.

Midsize and Community Bank Supervision

Key risks facing midsize and community banks, which contribute to strategic and reputation risk include the following:

- Strategic planning and governance risk, as banks implement plans for adapting business models to respond to changing loan demand, low interest rates, and intense competitive pressures, including from nonbanks.
- Credit risk arising from heightened competitive pressures, easing of underwriting standards in high-growth loan products, exposures to O&G-related industries, and expansion into new lending products.
- Operational risk, as banks increase reliance on third-party relationships to provide products and services and perform operational and business functions, as well as the increasing volume and sophistication of cyber threats.
- Compliance risk, especially in the area of BSA/AML and implementation of new regulations, because of
  - controls at some banks not keeping pace with higher-risk services and customer relationships.
  - new mortgage-related compliance regulations, which require effective change management strategies around the entire underwriting process.
  - new MLA regulatory requirements.

- Exposure to interest rate risk resulting from instability in the cost structure of the deposit base, especially at banks with concentrations in longer-term assets, including mortgage-backed securities and loans.
- Board and management succession and retention of key staff.

OCC Supervisory Priorities for the Next 12 Months

The OCC's supervision priorities reflect its risk-based approach. Key risks facing individual banks differ, but the priorities expressed in this section generally reflect the areas of greatest emphasis for the OCC's Large Bank Supervision and Midsize and Community Bank Supervision operating units.

Large Bank Supervision

The OCC developed and is executing a supervisory strategy for each large bank. The strategies prioritize risks and address the OCC's supervisory objectives. The top risk priorities for the next 12 months remain broadly unchanged from fall 2015 and include the following:

- **BSA/AML:** Assessing how effectively BSA/AML programs and controls address money-laundering schemes, the rapid pace of technological change, and overall money-laundering and terrorist financing risks.
- **Compliance:** Developing and implementing plans for assessing compliance with new regulatory requirements. Emphasis is on
  – compliance management for the integrated mortgage disclosure requirements under the Truth in Lending Act of 1968, the Real Estate Settlement Procedures Act of 1974, and their implementing regulations (Regulations Z and X), which went into effect on October 3, 2015.
  – compliance with the amendments to the MLA regulatory requirements, which go into effect on October 3, 2016.
  – continuing to effectively share information and coordinate examinations with the Consumer Financial Protection Bureau to assess overall compliance with consumer laws, regulations, and guidance.
  – determining compliance with the Flood Disaster Protection Act of 1973 and the Servicemembers Civil Relief Act of 2003, focusing on the adequacy of enterprise-wide compliance risk management.
  – compliance with the Community Reinvestment Act and fair lending laws and regulations.
  – assessing banks' effectiveness in identifying and responding to risks posed by new products, services, or terms.
- **Operational risk:** Assessing information security and data protection, model risk management, and third-party risk management. OCC supervisory staff is evaluating bank management plans to respond to increasing operational risk resulting from the introduction of new or revised business products, processes, delivery channels, or third-party relationships.
- **Credit risk management:** Evaluating credit risk management, particularly concentration risk management, credit underwriting practices, loan growth strategies, quality of the bank's loan policies, ALLL methodologies, and stress testing. As part of credit stress testing, examiners assess the spillover effect of continued low oil prices and evaluate the banks' practices for stress testing affected loans.
- **Cyber threats:** Reviewing banks' programs for assessing the evolving cyber threat environment and banks' resilience to cyber attacks. Examiners continue to implement the Federal Financial

Institutions Examination Council's (FFIEC) Cybersecurity Assessment Tool[7] in conjunction with information security and operational risk supervisory activities.
- **Matters requiring attention and enforcement actions:** Ensuring effective, timely, and consistent application of guidance for matters requiring attention (MRA) and enforcement actions (EA). This includes assessing and validating whether requirements for MRAs and EAs are met and ensuring these supervisory actions are closed or terminated timely after completion of those requirements. Examiners-in-charge clearly communicate any additional actions needed to satisfy requirements to bank management.

Midsize and Community Bank Supervision

The OCC developed, and is executing, supervisory strategies for each community and midsize bank. The strategies prioritize risks and address the agency's supervisory objectives. The top priorities for the next 12 months remain broadly unchanged and include the following:

- **Credit risk management:** Evaluating credit risk management, particularly concentration risk management, credit underwriting practices, loan growth strategies, the quality of the bank's loan policies, ALLL methodologies, and stress testing. As part of credit stress testing, examiners assess the spillover effect of continued low oil prices and evaluate the banks' practices for stress testing affected loans.
- **Strategic planning and governance:** Assessing the effectiveness and implementation of business model and strategic changes and reinforcing the importance of sound corporate governance appropriate for bank size, operations, and complexity. A specific focus is determining the adequacy of strategic, capital, and succession planning. Examiners assess whether bank plans are appropriate in light of the risks in new products or services. Examiners also assess bank merger and acquisition processes and procedures, if applicable.
- **Operational risk:** Reviewing the adequacy of operational resiliency to information security, cybersecurity threats, and third-party relationship risk management. Supervisory staff continue to implement the FFIEC's Cybersecurity Assessment Tool.
- **Compliance:** Assessing changes in policies and practices regarding higher-risk customers and determining whether overall BSA/AML program controls are commensurate with the banks' products, services, customers, and geographies. Supervisory staff also assess the banks' effectiveness in complying with consumer laws, regulations, and guidance, including the Truth in Lending Act and the Real Estate Settlement Procedures Act Integrated Disclosures Rule requirements,[8] Community Reinvestment Act, fair lending laws, and preparation for the implementation of the MLA.
- **Interest rate risk:** Evaluating the banks' interest rate risk measurement processes to ensure that banks properly assess vulnerability to changes in interest rates and implements measurement tools to monitor and control this risk. This includes the ability to accurately identify and quantify interest rate risk, with an emphasis on funding pressure that may arise with deposits.
- **MRA and EAs:** Ensuring effective, timely, and consistent application of guidance for MRAs and EAs. This includes assessing and validating that requirements for MRAs and EAs are met and

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[7] The FFIEC developed the Cybersecurity Assessment Tool to help institutions identify their risks and determine their cybersecurity preparedness. See OCC Bulletin 2015-31, "Cybersecurity: FFIEC Cybersecurity Assessment Tool," June 30, 2015.

[8] OCC Bulletin 2015-27, "Consumer Compliance: Revised Interagency Examination Procedures for Consumer Compliance," May 1, 2015.

these supervisory actions are closed or terminated timely. Examiners-in-charge clearly communicate any additional actions needed to satisfy requirements to bank management.

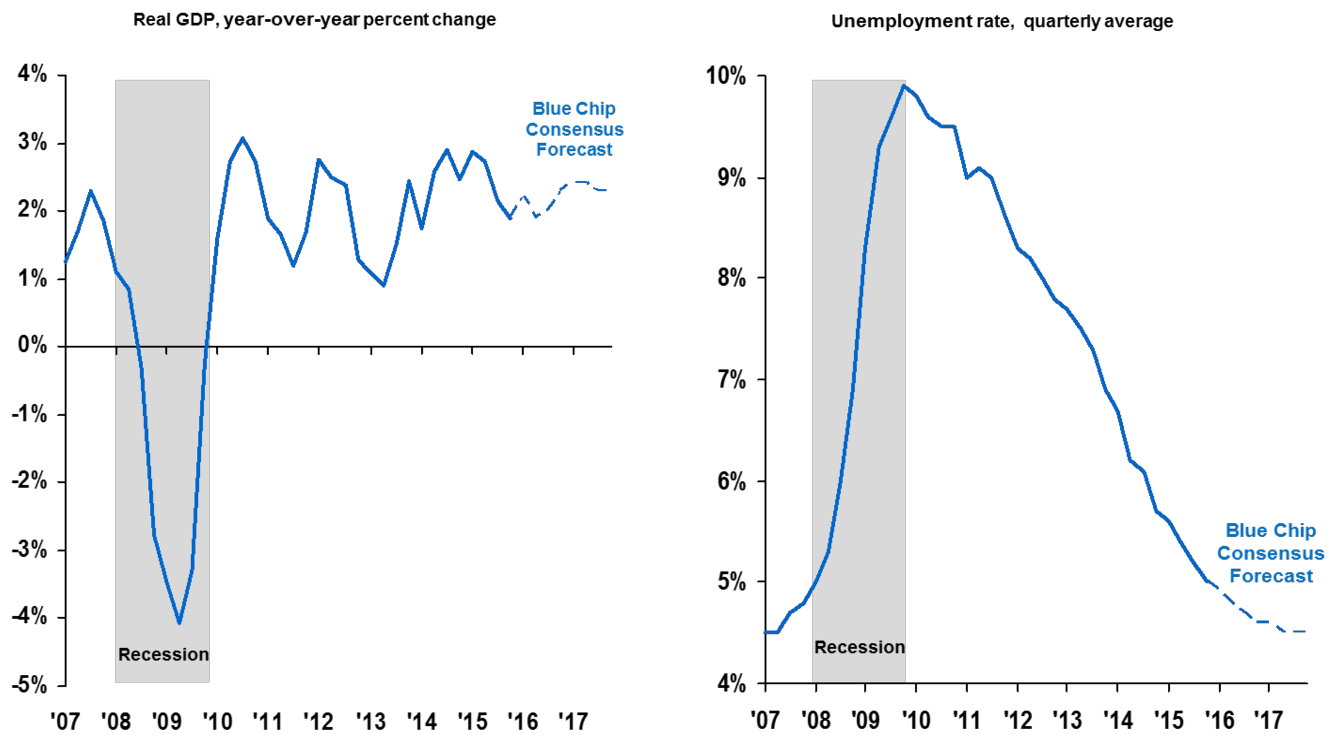
Part I: Operating Environment

U.S. labor markets are improving. With declines in the numbers of the unemployed and underemployed, the U.S. economy is nearer full employment again.[9] Labor force participation rates, however, are not back to pre-recession levels, and real wages have yet to show consistent growth. The housing recovery continues as growth in employment, as well as the continuation of low interest rates, boost housing demand. A key beneficiary has been the multifamily sector, where the large cohort of 20- to 34-year-olds is driving demand. Single-family housing starts, however, remain below normal for this stage of a recovery. Downside economic risks include continued weakness in emerging markets, further strengthening of the dollar, and weakness in capital spending.

U.S. Economic Expansion to Continue Through 2017

Real gross domestic product (GDP) increased 2 percent between the fourth quarter of 2014 and the fourth quarter of 2015 (see figure 1). Despite a slowdown in U.S. growth in fourth quarter of 2015, economic fundamentals, including consumer and government spending, suggest moderate expansion in 2016. The unemployment rate fell to 5 percent in 2015, with total employment up 2 percent from a year ago. The consensus of private sector forecasters is for the economic expansion to continue through 2017.[10]

Figure 1: GDP and Unemployment Trends



Source: Bureau of Economic Analysis, Bureau of Labor Statistics/Haver Analytics, Blue Chip Indicators (March 2016)

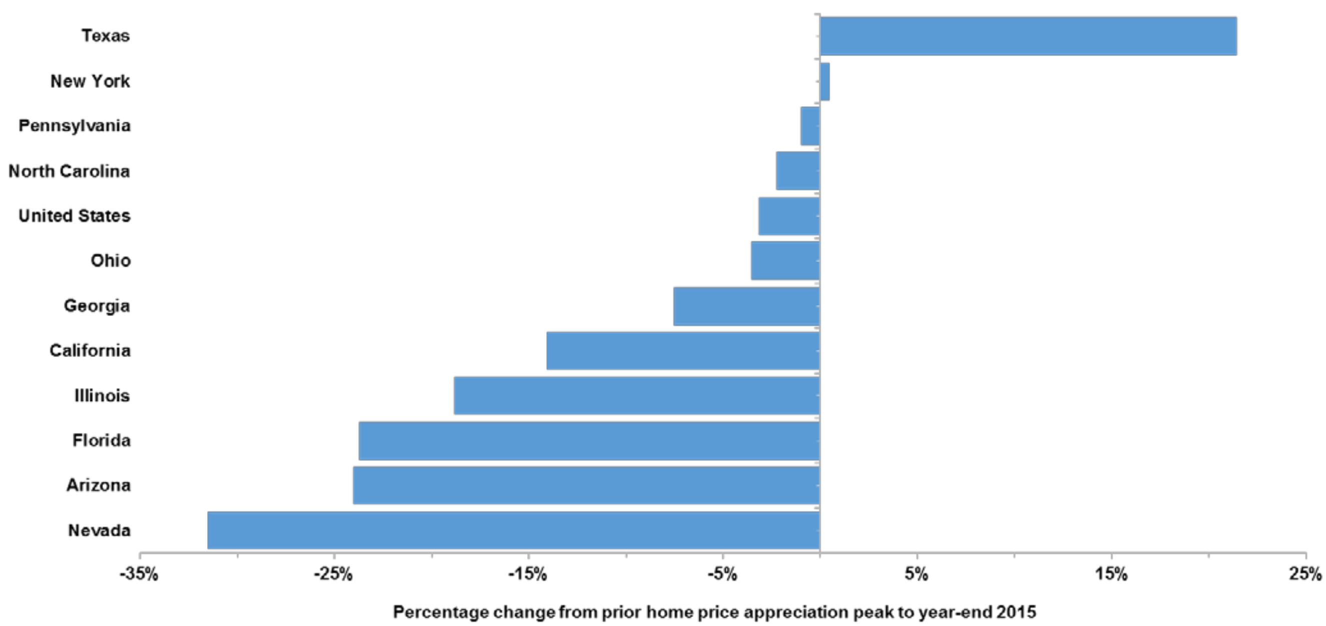
[9] Bureau of Economic Analysis, Moody's Analytics.

[10] Blue Chip Economic Forecast.

Home Price Appreciation Increasing But Many States Still Below Pre-Recession Peaks

Home prices increased modestly in 2015 in most states, but home prices remain below their pre-recession peaks in about one-half of all states. Nevada, Arizona, and Florida are still more than 20 percent below their housing boom price peaks (see figure 2). The U.S. average existing home price increased 5.2 percent year-over-year in 2015; this increase represents an acceleration in price appreciation from 2014’s 4.4 percent increase. Continued economic growth, low interest rates, and a limited supply of homes for sale contributed to these price gains.

Figure 2: Percentage Change in Home Price Appreciation From Pre-Recession Peak to Fourth Quarter 2015



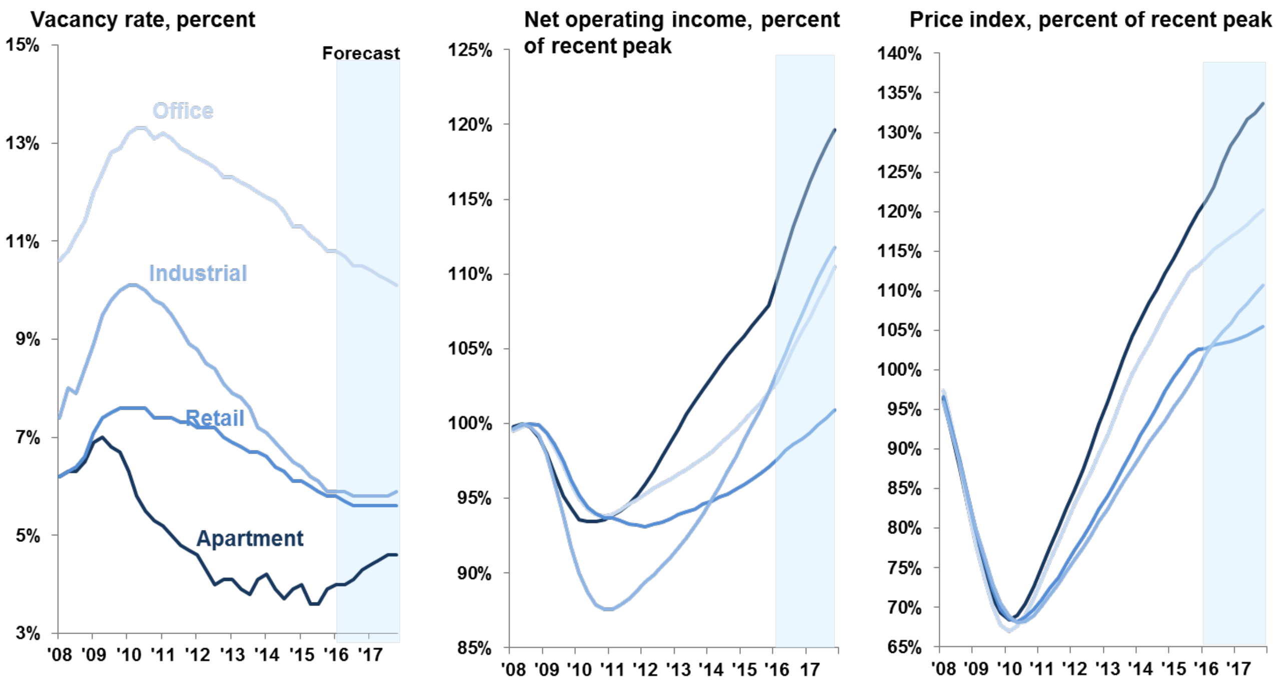
Source: Black Knight Financial Services.

CRE Outlook Is Mixed

Apartments are at a more advanced stage of the vacancy rate cycle than other commercial property types (see figure 3) and could see rising vacancy rates sooner than other property types. Because of booming new apartment construction, the national apartment vacancy rate, which fluctuated within a narrow range in the past two years, is expected to increase by nearly 1 percentage point over the next two years. Markets with the most new construction will likely see apartment vacancy rates rise by more than 1 percent and will experience slower rent and net operating income growth. Construction of other types of commercial properties has been, and is likely to remain, more limited. Consequently, the national vacancy rates for office, industrial, and retail space declined steadily in the past two years and, unlike apartments, are expected to decline further in the next two years.

The pace of growth in CRE property values is forecast to slow.[11] In the past two years, strong market fundamentals and low interest rates made CRE a relatively attractive investment, especially for foreign investors with limited prospects in their home markets; in response, investors rapidly bid up property prices, particularly in major U.S. markets most attractive to foreign investors. In the next two years, higher interest rates will raise borrowing costs for both domestic and foreign investors and could dampen the pace of price growth for commercial properties.

Figure 3: CRE Vacancy Rates



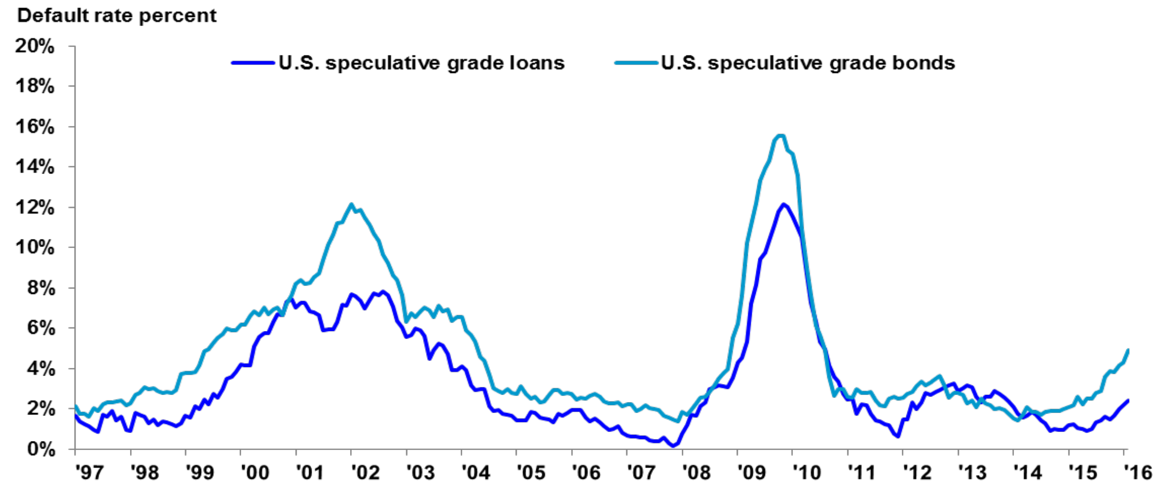
Source: CoStar Group; fourth quarter 2015 baseline forecast for 54 tier 1 markets.

[11] CoStar Group provides information, analytics, and online marketplaces to the CRE industry.

U.S. Speculative Grade Default Rate Trending Higher

The U.S. speculative grade default rate for bonds and loans moved higher in 2015 and year-to-date 2016 (see figure 4). Firms primarily in the metals and mining and O&G sectors led defaults. The forecast for 2016 calls for continued increases in the default rate for bonds and loans.[12]

Figure 4: Trend in Default Rates for Speculative Grade Bonds and Loans

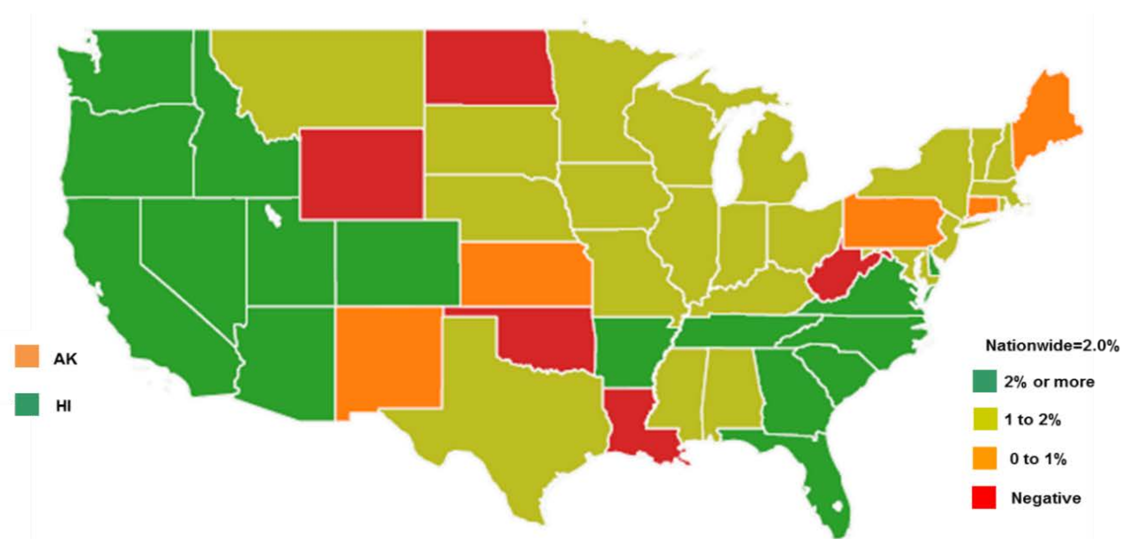


Source: Moody's Investor Service.

Employment in Oil-Producing States Has Slipped

U.S. oil companies have idled 70 percent of their drilling rigs, sharply reduced capital spending, and cut 100,000 extraction and field service jobs in response to the sustained decline in oil prices in 2015. These reductions spilled over from the O&G sector into other parts of local economies, including machinery manufacturing and transportation. In these industries, jobs grew nationally in 2015 but fell in oil-producing states (see figure 5).

Figure 5: Percentage Change in Employment: Fourth Quarter 2014 to Fourth Quarter 2015



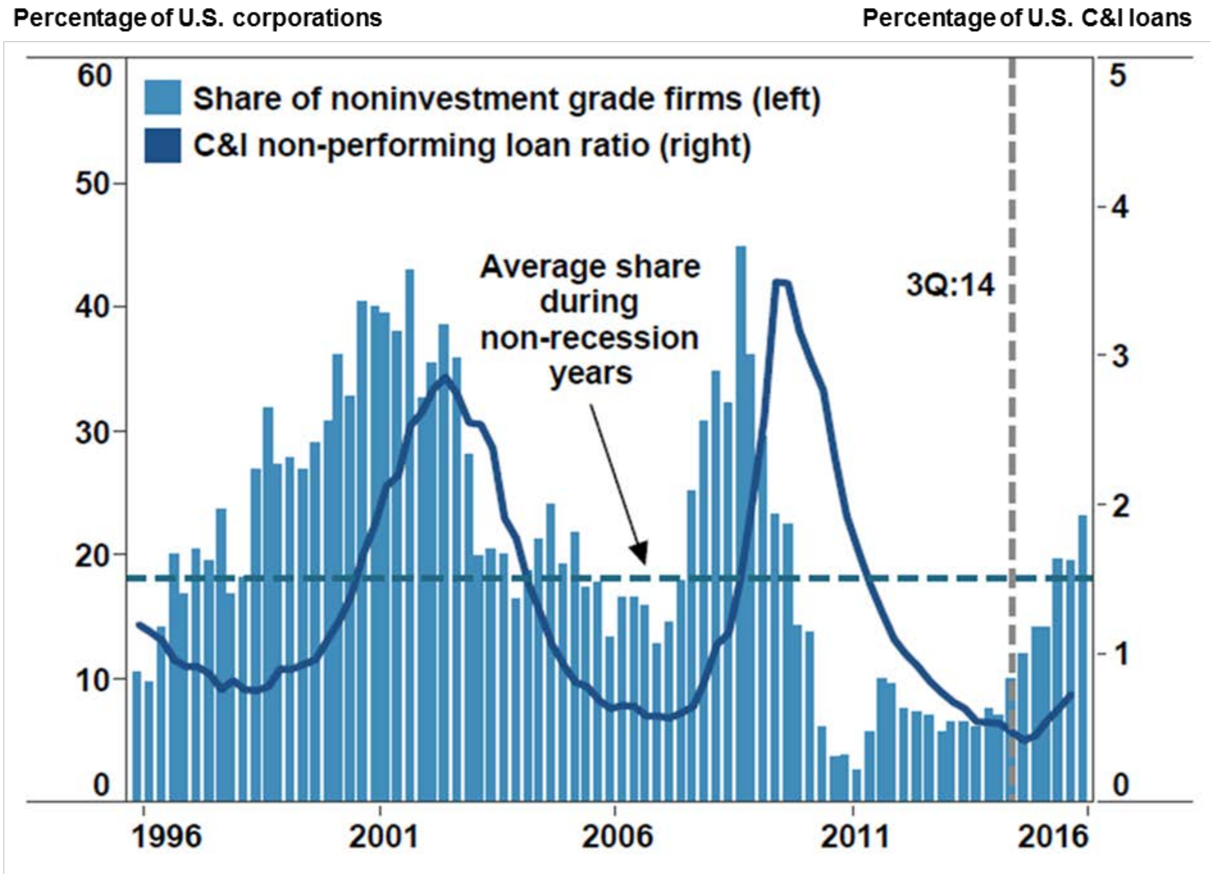
Source: Bureau of Labor Statistics (data updated March 2016)

[12] Moody's Investor Service.

Commercial Credit Quality Is Declining

The share of U.S. corporations with a one-year probability of default of 2 percent or more, roughly equal to a noninvestment grade rating, has risen from 10 to 23 percent since late 2014, as corporate financial and equity performance has weakened (see figure 6). While this rise is significant, 23 percent is only slightly above the average during nonrecession years. The deterioration is broad based, but most evident in the mining and energy sectors. The probability of default trend is a leading indicator of potential future issues with nonperforming loans.

Figure 6: Share of Firms Projected as Noninvestment Grade Rises



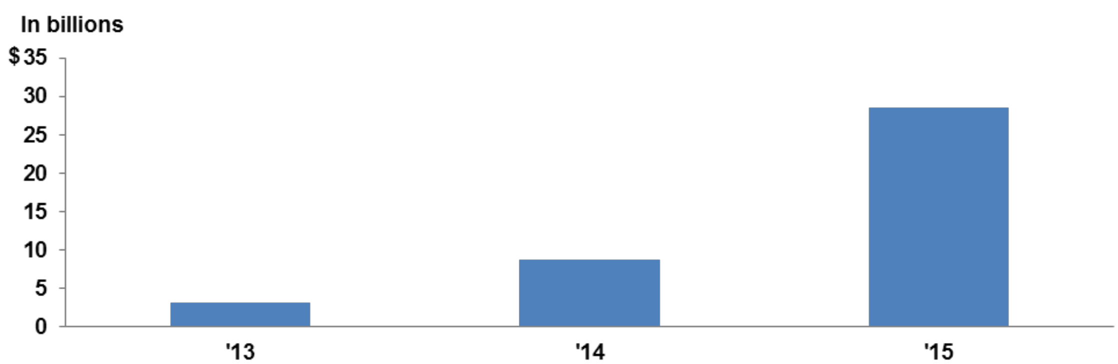
Sources: Kamakura (data through March 2016), Integrated Bank Information System (OCC).
Note: Kamakura probabilities of default exclude firms in banking, government, and real estate sectors.

Marketplace Lending Is Expanding

U.S. marketplace lending platforms reported rapid growth in 2015, with an estimated $28.6 billion in loans originated (see figure 7). Marketplace lenders are nonbank lenders that rely heavily on online marketing and underwriting platforms. Though they provide some small business credit, marketplace lenders primarily target refinancing opportunities in unsecured consumer lending. Marketplace lending currently represents a small portion of the $3.6 trillion consumer lending sector. Whole loan sales to institutional investors, in particular, have become an increasingly important source of cost-effective funding for marketplace lenders. More recently, some marketplace lenders have experienced challenges in managing costs, credit performance, and loan delivery as institutional investor interest has diminished. About $6.6 billion in asset-backed securities supported by marketplace loans were originated in 2015, contributing to a cumulative $8.2 billion in such asset-backed securities to date.

As more banks engage in strategic partnerships, purchase loans, securitize, or work in other ways with marketplace lending firms, banks face potential compliance, BSA/AML, operational, and market risk issues. The OCC strongly encourages responsible innovation that provides fair access to financial services and fair treatment of consumers. Banks involved in responsible innovation should assess the benefit to consumers and businesses (including their own operational efficiencies), and should likewise recognize the need for sound risk management to oversee and control heightened risks. Banks may refer to OCC guidance on strategic planning, evaluating new products and services, using models, operational risk, compliance risk, credit risk, cybersecurity, managing third-party relationships, and appropriate classification of acquired assets for information on supervisory expectations when exploring potential partnerships or other relationships with marketplace lenders. Also, the U.S. Department of the Treasury issued a white paper that highlights recommendations and identifies potential trends that will require ongoing monitoring.[13]

Figure 7: Growth in U.S. Marketplace Lending



Source: *Breaking New Ground: The Americas Alternative Finance Benchmarking Report*, (April 2016)
All data are as of year-end.

[13] *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016.

Part II: Bank Performance

Strong Revenue Gains Led by Loan Growth

Profitability Increases in 2015

Banks reported improved net income in 2015, albeit on higher total assets (see table 1). Banks with more than $10 billion in total assets and those with less than $1 billion in total assets reported growth in net income of 8.3 percent and 12.9 percent, respectively. At banks with more than $10 billion in total assets, revenue growth was driven by increased net interest income from stronger total loan growth. Alongside stronger loan growth, full-year loan loss provisions rose for the first time in several years, but were offset by lower total noninterest expenses. Banks with total assets between $1 billion and $10 billion reported a decline in net income in 2015 because of lower revenue, slightly higher provisioning expense, and slightly higher noninterest expense.

Table 1: Trends in Bank Net Income

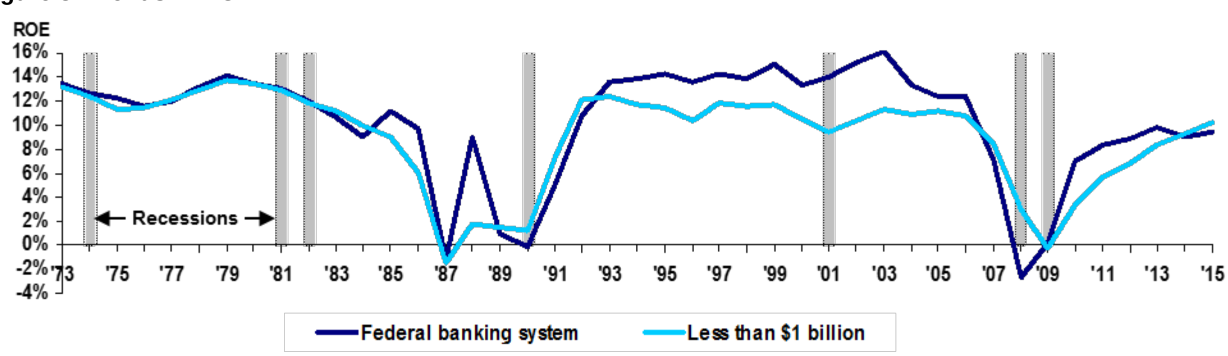
	Total assets greater than $10 billion			Total assets between $1 billion and $10 billion			Total assets less than $1 billion		
	2013	2014	2015	2013	2014	2015	2013	2014	2015
Total assets in billions	9,397.7	9,918.7	10,080.5	424.2	426.0	453.9	273.5	284.2	294.6
Year-to-date revenues in $ billions									
Net interest income	260.3	262.0	266.8	13.7	13.6	13.6	8.7	9.0	9.4
Noninterest income	171.6	165.9	167.0	5.9	6.2	6.0	5.4	5.6	6.2
Year-to-date expenses in $ billions									
Provisioning	21.8	20.9	26.4	0.6	0.5	0.6	0.5	0.3	0.3
Noninterest expense	263.0	266.5	258.1	12.6	12.5	12.6	10.2	10.3	10.9
Net income	100.9	95.9	103.9	4.9	5.0	4.7	2.8	3.1	3.5

Source: Integrated Banking Information System (OCC).
Note: Data as of year-end, merger-adjusted, and held constant for institutions in operation from the first quarter of 2010 to the fourth quarter of 2015.

Return on Equity Strongest in Small Banks

System-wide ROE remains below 10 percent and has yet to return to pre-recession levels (see figure 8). ROE across the federal banking system is gradually improving, but the distribution is uneven, with fewer than half of banks seeing an improvement in ROE. In 2015, ROE at banks with less than $1 billion in total assets surpassed the system ROE and returned close to its pre-recession level.

Figure 8: Trends in ROE

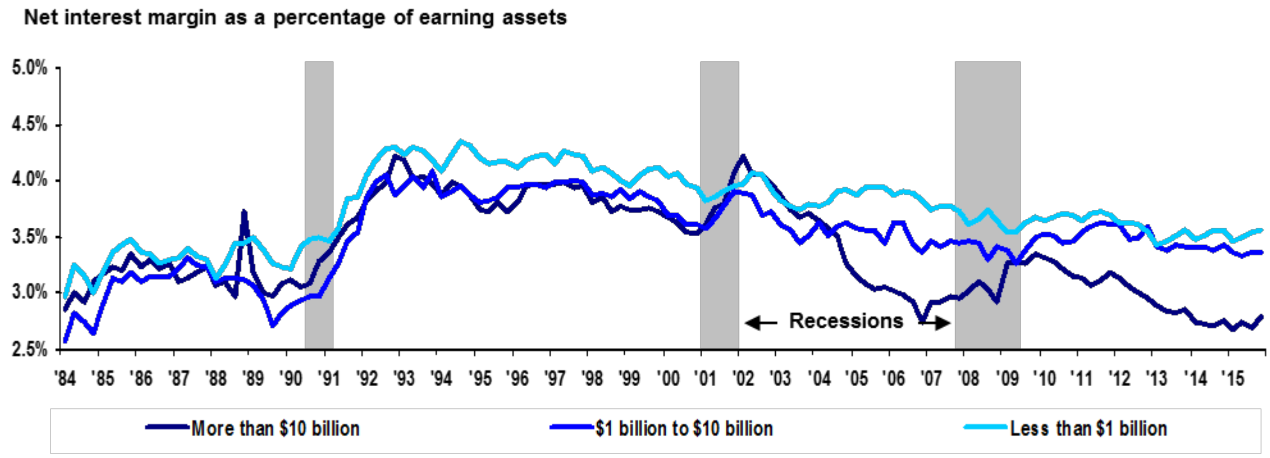


Source: Integrated Banking Information System (OCC).
Note: Annual data through year-end 2015. 2008 results are the sum of quarterly net income and include estimates from Y-9 to restore income eliminated due to purchase accounting treatment of Countrywide (2Q:08), Washington Mutual (3Q:08), Wachovia, National City, and Downey (4Q:08). Data on federal savings associations are not available prior to 1984.

Net Interest Margins Remain Under Pressure

While banks reported strong increases in revenues and net income because of increased net interest income, margin pressures continued (see figure 9). Banks increased net interest income despite ongoing margin pressures due to increased loan volume. The decline in net interest margin was broad-based, with more than two-thirds of banks seeing a decline in the past year.

Figure 9: Trends in Net Interest Margin



Source: Integrated Banking Information System (OCC).
Note: Quarterly data through the fourth quarter of 2015. Data excludes credit card and trust banks.

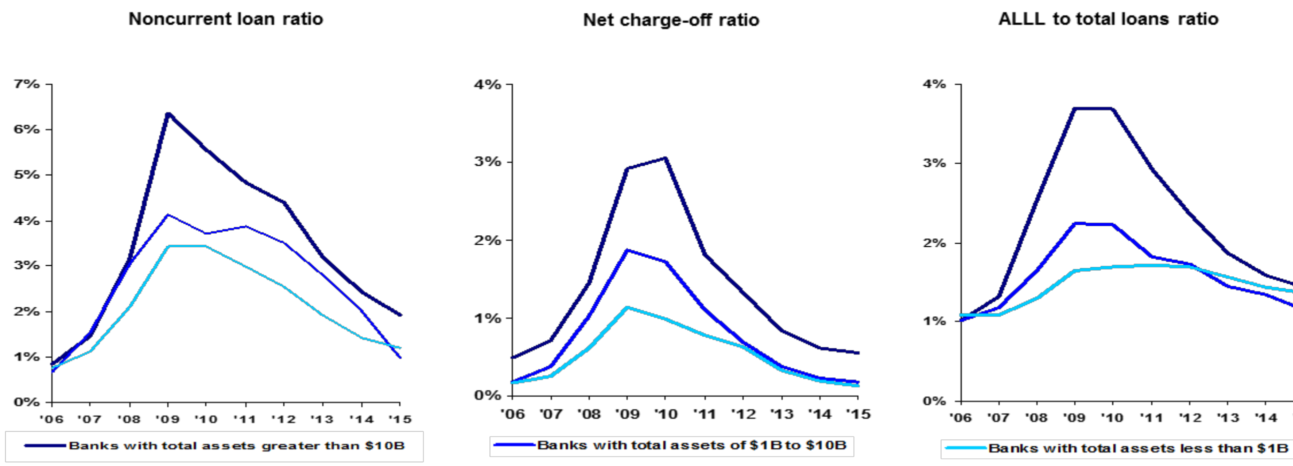
Part III: Trends in Risk Exposure

A. Commercial Credit Risk Is Building, Although Loan Quality Metrics Are Near Pre-Recession Lows

Credit Performance Metrics Flatten in 2015

Lagging credit quality performance metrics mostly improved in 2015 (see figure 10). Total noncurrent loans—those 90 days or more past due or on nonaccrual—declined for large and small banks, though improvement in the ratio for banks with total assets greater than $10 billion lags. Net charge-off ratios have returned to near 2006 levels. The ALLL as a percentage of total loans appears to be stabilizing above its pre-recession level for banks with total assets of more than $10 billion or less than $1 billion.

Figure 10: Credit Cycle Analysis



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

Easing of Underwriting Standards and Loan Growth Driving Increasing Credit Risk

With increasing demand for commercial loans, low interest rates, and plentiful market liquidity, competition among banks for commercial loans remains strong. Supervisory examinations and industry surveys, including the OCC's annual *Survey of Credit Underwriting Practices Report*, continue to find evidence of easing underwriting standards and practices in commercial lending as lenders strive for volume and yield.

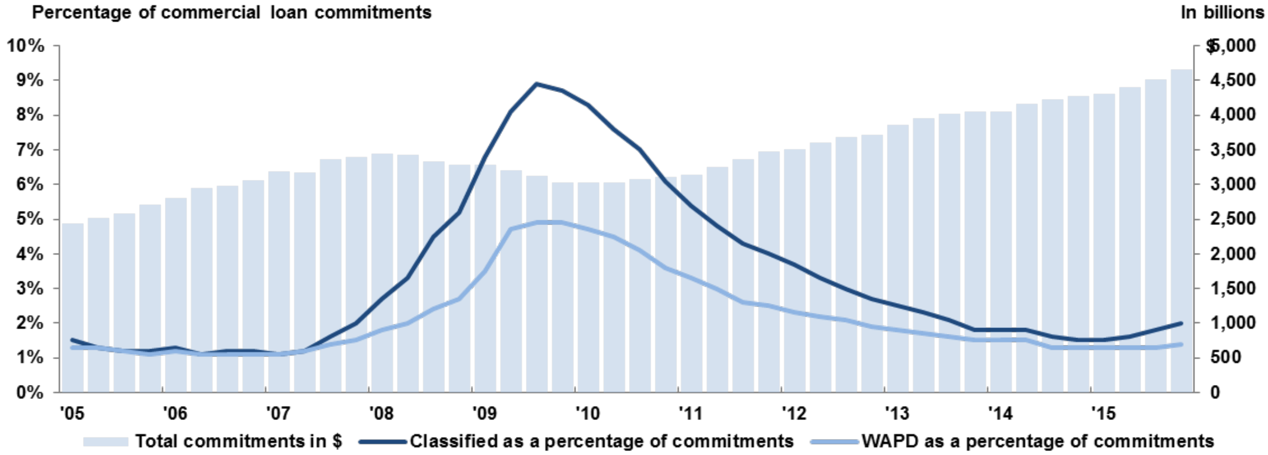
Credit concentrations have increased in banks of all sizes, year-over-year. Concentrations are primarily in CRE loans, particularly multifamily, as well as financial services and energy-related industries. Concerns over easing underwriting standards coupled with these concentrations require bankers to evaluate concentration risk management thoroughly. Strong growth rates and strategic initiatives in these loan portfolios could cause the buildup of excessive and poorly managed credit risk in the federal banking system.

For loans included in the OCC's Credit Analytics data system,[14] the weighted-average probability of default for 2015 ended at 1.4 percent, and the ratio of classified commitments to total commitments ended at 2.0 percent. These ratios compared with 1.3 percent and 1.5 percent, respectively, at the end

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

of 2014 (see figure 11). Classified commitments ended 2015 at 8.5 percent of aggregate tier 1 capital plus the ALLL, which was an increase from 6.4 percent at year-end 2014 and reflected a significant increase in classified O&G-related loans.

Figure 11: Commercial Loan Trends for Select Banks

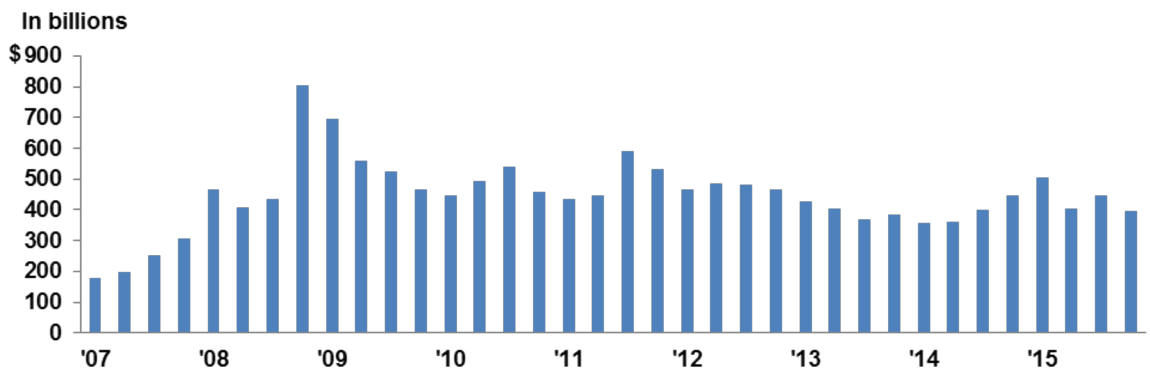


Source: OCC Credit Analytics.
Note: WAPD = weighted-average probability of default to commitments.

Risk in Counterparty Credit Exposure Changing

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. NCCE fell by $50 billion (11 percent) in the fourth quarter of 2015 from the third quarter of 2015 (see figure 12).

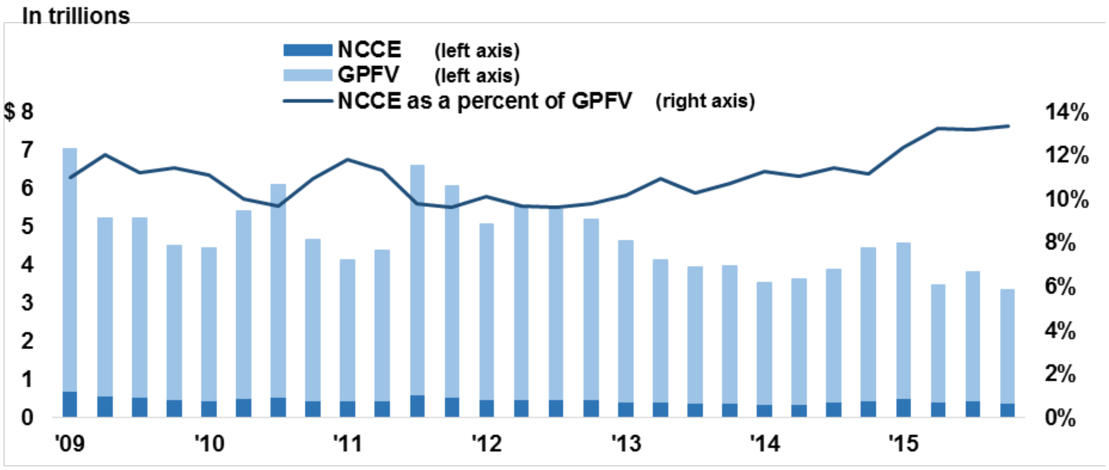
Figure 12: Trend in Counterparty Credit Exposure in Derivatives



Source: Integrated Banking Information System (OCC).

Banks measure their gross positive fair values (i.e., counterparty owes bank) and gross negative fair values (i.e., bank owes counterparty) against each counterparty. Legally enforceable netting arrangements allow banks to net the two measures, resulting in NCCE. For perspective, this "netting benefit" has allowed banks to collapse their gross positive fair values by approximately 80 to 90 percent in the past few years (see figure 13).

Figure 13: Net Current Credit Exposure as a Percentage of Gross Positive Fair Value



Source: Integrated Banking Information System (OCC)

Since the financial crisis, changes in the architecture of the derivatives markets have contributed to a significant reduction in derivative-related counterparty credit risk. The percentage of derivative transactions cleared through CCPs has substantially increased while the exchange of high-quality financial collateral between bilateral counterparties on non-cleared transactions has also expanded.

Banks collect variation margin from their counterparties to secure their NCCE. Collateralization of banks' NCCE has increased steadily in recent years. From 2009 to the fourth quarter of 2015, banks' collateralization of their NCCE increased from 60 percent to about 90 percent. Collateral posted is typically in the form of cash or very high-quality liquid financial instruments. The swaps margin rule, which becomes effective in September 2016, will introduce the addition of initial margin collateralization for most transactions. Initial margin is designed to shield the recipient from adverse market moves between an event of counterparty default and settlement. Many market participants have already adopted more stringent collateralization regimes in anticipation of the margin rule.

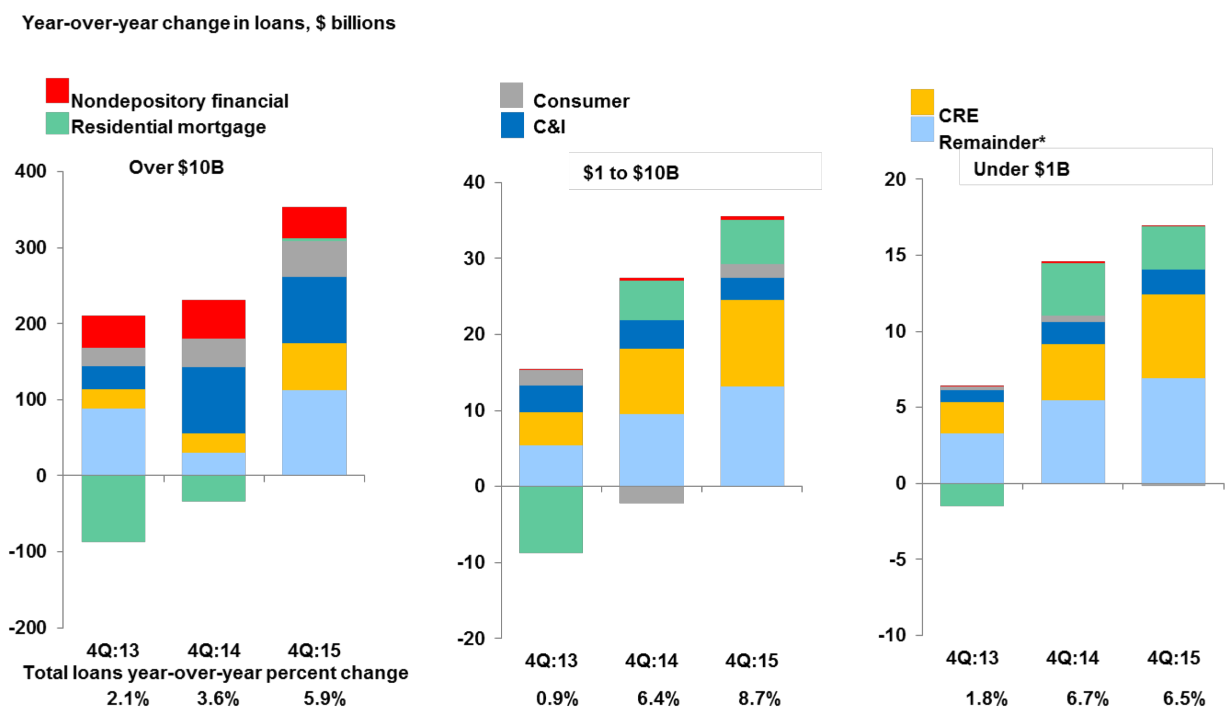
Central clearing mandates in the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 and similar mandates by other regulatory authorities lead to significant increases in the types and volumes of derivatives transactions that are cleared through CCPs. Central clearing reduces bilateral credit exposures and often leads to increased transparency and improved risk management practices. At the point of novation in a centrally cleared transaction, each of the original counterparties faces the CCP as counterparty rather than each other. While this change reduces bilateral credit risk, in the event that a clearing member defaults CCPs have the ability to allocate credit losses based on CCP membership rules. Typically, once the defaulting member's resources (such as initial margin and guaranty fund contributions) are exhausted, a CCP then contributes a limited amount of its own capital to absorb the loss, followed by a process that mutualizes losses among nondefaulting members. Because of the risk of mutualized losses, banks that are, or wish to become, CCP members should implement effective risk management processes and conduct robust initial and ongoing due diligence to determine whether the CCP has appropriate risk management controls in place. On an ongoing basis, banks need to measure and monitor their exposures to each CCP and limit their exposures in a manner consistent with OCC regulations, guidance, and interpretive letters.

B. Loan Growth

Loan Growth Centered in Commercial and Residential Real Estate

Banks of all sizes reported stronger total loan growth in 2015, led by year-over-year growth of 8.7 percent at banks with total assets between $1 billion and $10 billion (see figure 14). Loan growth for these banks centered in CRE, or the sum of construction, nonresidential mortgage, multifamily, and residential mortgage lending. Banks with less than $1 billion in total assets reported 6.5 percent growth in total loans year-over-year, also driven by CRE and residential mortgage lending. The overall growth rate for banks with more than $10 billion in total assets lagged behind that of small banks at 5.9 percent. This growth pace was a strong improvement from several prior years below the 20-year average rate for this group—the result of an end to residential mortgage runoff at the large banks. CRE, C&I, loans to nondepository financial[15] institutions, and consumer lending remained noticeable contributors to loan growth at large banks last year.

Figure 14: Year-Over-Year Loan Growth Composition



Source: Integrated Banking Information System (OCC).
Note: Data are merger adjusted for institutions in continuous operation between 1Q:10 and 4Q:15. CRE includes commercial mortgages and construction loans.
***Remainder includes agricultural loans, loans to governments, banks, municipalities, etc.**

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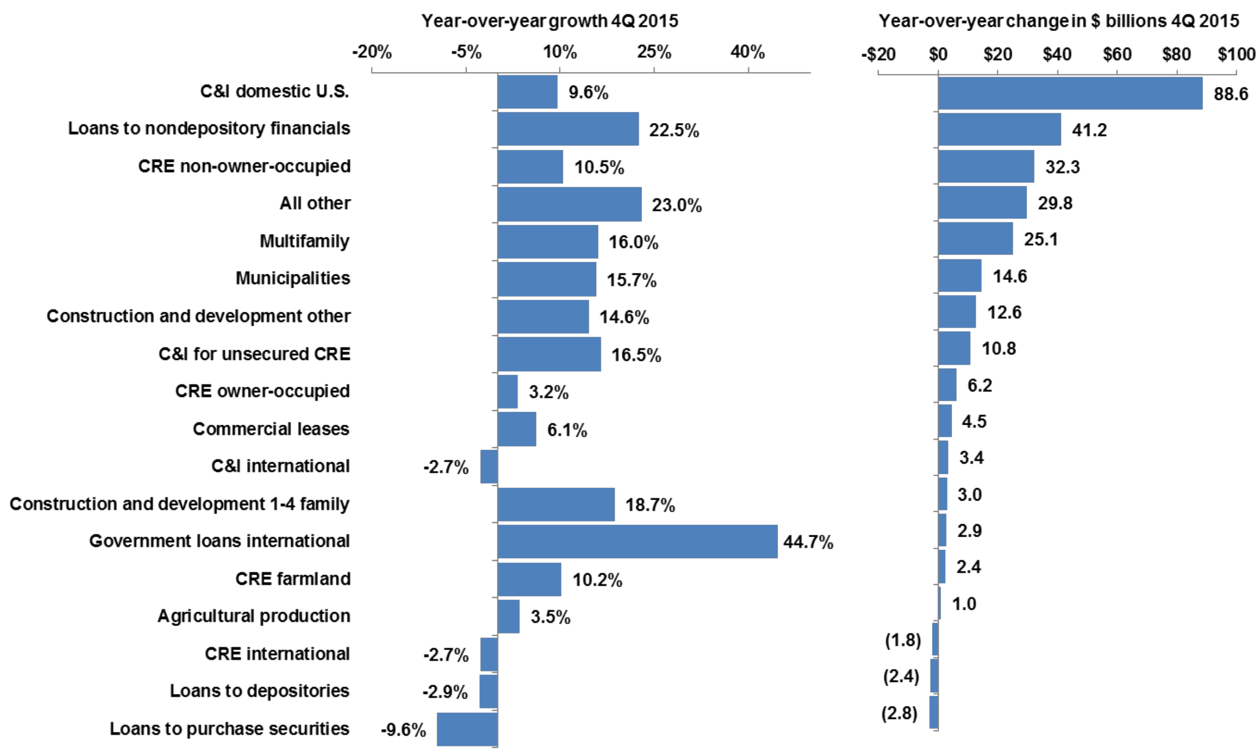
[15] Loans to nondepository financial institutions generally include (1) loans to real estate investment trusts and to mortgage companies that specialize in mortgage loan originations and warehousing, or in mortgage loan servicing; (2) loans to holding companies of other depository institutions; (3)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

Commercial Loan Growth Led by C&I, Nondepository Financials, and Real Estate

Total commercial loan commitments, including standby letters of credit, continued a steady increase through the end of 2015. Funded commercial commitments (loans) increased 9.7 percent year-over-year through December 31, 2015. Growth was concentrated in domestic C&I loans (9.6 percent), loans to nondepository financial institutions (22.5 percent), and multifamily loans (16 percent) (see figure 15). Construction lending also increased for single-family housing and other construction and land development. In the past three years, loans to nondepository financial institutions have increased by more than 150 percent, and are now the fourth-largest commercial category reported in the quarterly Consolidated Reports of Condition and Income (call report), compared with the 11th-largest at mid-2012. Loans to municipal governments are another area of strong growth, up by 15.7 percent in 2015 and by more than 56 percent in the past three years.

Figure 15: Commercial Loan Balances and Year-Over-Year Growth



Source: Integrated Banking Information System (OCC).

Part IV: Key Risk Issues

A. Operational Risk Remains Elevated

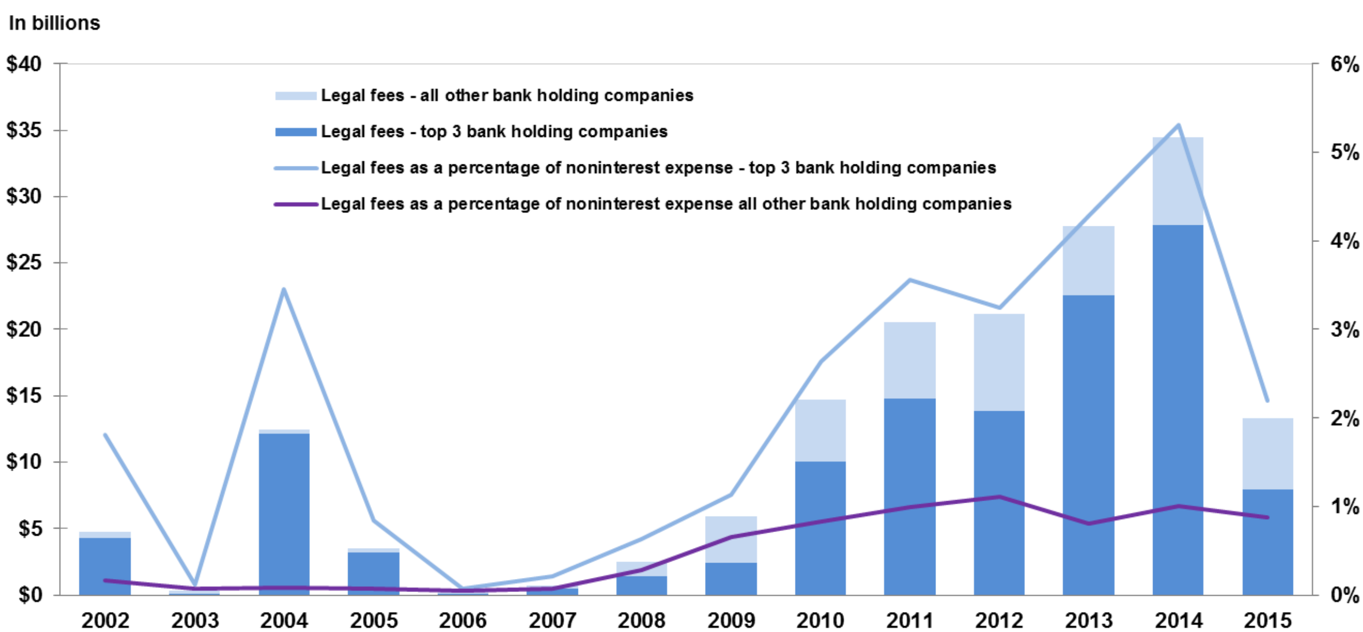
Operational Risk Concentrated in Largest Banks, Increasing in Small Banks

Operational risk is elevated for a number of reasons. These reasons include the amount and pace of change, greater interconnectedness and dependencies with business affiliates, increased reliance on third parties to provide products and services, and increased sophistication of cyber threats and other pervasive technology vulnerabilities. While high operational risk has been primarily concentrated in the largest banks, it is increasing among small banks.

In the area of cyber risk particularly, banks and other businesses are continuing to be attacked through BEC. BEC is a sophisticated scheme that initially involved criminals forging payment requests for legitimate vendors and directing the funds to the cyber criminal's account. For example, public reports indicate that BEC schemes are evolving to include digital impersonation of chief executive officers. These criminals then e-mail internal accounting and human resources offices and request copies of employee W-2 information to facilitate additional fraud and identity theft. Total losses internationally from BEC schemes have exceeded $2 billion from 17,642 victims from October 2013 through February 2016.

In addition to cyber-related and other fraud losses, legal fees and settlements offer a measure of the financial impact of operational loss events to the banking industry. Aggregate legal fees and settlements reached a 10-year high in 2014, though the total decreased in 2015 (see figure 16). Several of the largest banks incurred significant regulatory penalties and large legal settlements arising from the 2008 financial crisis.

Figure 16: Trends in Legal Fees and Settlements



Source: FR Y-9C Reports; quarterly data annualized.
Note: Data are as of year-end.

B. Compliance Risk Remains High

Increased BSA/AML Risk Observed in New Offerings and Strategies

Under the current legal framework, banks have significant responsibility for protecting the national security of the financial system of the United States. BSA/AML risk is increasing. Technological developments in enhanced delivery platforms for bank products may create new vulnerabilities to criminal activity. More traditional concerns—such as trade-based money laundering and bulk cash smuggling, including via armored car service and funnel account activity—also continue to present risks to banks.

Some banks have reevaluated client BSA/AML risk profiles and limited activities or closed accounts of certain customers. Typically, reevaluations have led banks to terminate some of their foreign customer relationships because of concerns about the host country's ability to supervise AML risk and doubts that the potential financial benefits of the relationship would offset the costs of managing the associated BSA compliance risk. Displacement of customers from large banks may result in higher-risk customers moving to smaller and less sophisticated banks—banks that potentially have less experience managing the associated BSA/AML risks. This displacement also may result in the financial exclusion of some customers from banking services, and transactions that would have taken place subject to regulatory oversight may be undertaken with less scrutiny in a non-regulated context.

As a general matter, the OCC does not direct banks to open, close, or maintain individual accounts, nor does the agency encourage banks to engage in the termination of entire categories of customer accounts without regard to the risks presented by an individual customer or the bank's ability to manage the risk. The OCC expects banks to assess the risks posed by individual customers on a case-by-case basis and implement controls to manage the relationships commensurate with these risks. The decision to exit a line of business or to terminate a banking relationship with a customer resides solely with the bank, not with the OCC. Banks must make their own choices about whether to enter into or maintain a business relationship based on their unique business objectives, their own evaluation of the risks associated with the particular products or services, and their own capacity to effectively manage those risks. By understanding the risks associated with their domestic and foreign customers and the jurisdictions in which they operate, banks are better able to make determinations regarding how to address those risks.

Military Lending Act

On July 22, 2015, the U.S. Department of Defense published its final rule amending 32 CFR 232, the implementing regulation of the MLA. The amended MLA regulation affects all banks that extend consumer credit, as described in this section, to members of the U.S. armed forces on active duty and their dependents (collectively, covered borrowers) as of October 3, 2016. The compliance date for credit card accounts is October 3, 2017, unless the Secretary of Defense provides an additional extension of up to one year. The Department of Defense estimates that 238 million transactions each year will be subject to the disclosure requirements of the regulation.[16]

The amended regulation expands coverage of the MLA requirements to all consumer credit covered under the Truth in Lending Act and Regulation Z (12 CFR 1026), except for residential mortgages (including purchases, initial construction, refinances, home equity loans and lines of credit, and reverse mortgages) and purchase money loans secured by motor vehicles or personal property. The regulation prohibits a military annual percentage rate (MAPR) greater than 36 percent and limits certain practices and loan terms in connection with extensions of consumer credit to covered borrowers. Additionally, the regulation requires creditors to provide certain written and oral disclosures to covered borrowers. Prudent change management is imperative to prepare for timely compliance with the new regulatory requirements. Banks need to ensure that their processes and systems are sufficient to identify covered borrowers and loan products, accurately calculate the MAPR, provide required disclosures, and incorporate other required limitations and protections. Many banks rely on software, automated tools, disclosure forms, and other third-party relationships to process loan applications, create and distribute disclosures, underwrite loans, and close loans. Banks need to manage their third-party relationships to ensure that operational and compliance risks associated with the regulatory amendments are addressed appropriately.

Truth in Lending and Real Estate Settlement Procedures Act Integrated Disclosure/Know Before You Owe Rule

Since October 3, 2015, new mortgage disclosure forms—the Loan Estimate and the Closing Disclosure—have been required for most mortgage loans secured by real property. To comply with the new integrated rules, individual banks and the mortgage industry as a whole have needed to make significant systems and operational changes. The implementation process required extensive coordination with third parties, and there were numerous reports of issues relating to third-party readiness. Many banks also have dedicated substantial resources to understanding the rules, adapting systems, and training personnel. Full implementation of the rules, however, continues to pose operational and compliance risks and challenges. In recognition of the scope and scale of changes needed to achieve effective compliance, the OCC's fiscal year 2017 examination strategies incorporate assessing compliance with the rules as well as banks' compliance management systems and overall compliance efforts.

[16] 80 Fed. Reg. 43560, 43595 (2015).

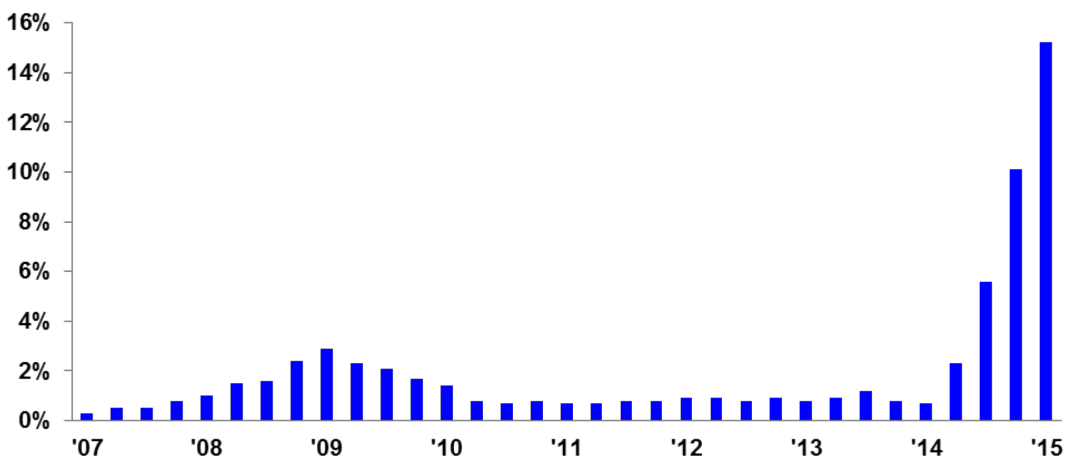
C. Strong Loan Growth Building Concentrations of Credit

Substantial Deterioration in Quality of Loans to Oil and Gas Upstream Businesses Including Services

Classified loans in the O&G extraction sector increased to 15.2 percent of commitments at year-end 2015 compared with 0.7 percent a year ago (see figure 17). Classified volume increased by $24 billion since 2014, and represents 2.4 percent of aggregate tier 1 capital plus the ALLL. Special mention loans also increased in 2015 to $15 billion, or 9 percent of commitments but are still a low 1.4 percent of tier 1 capital plus the ALLL. Further downgrades and higher levels of classified loans are expected in 2016, driven by continued low commodity price levels and borrower cash flow declines that further impair liquidity and the ability to service debt. This ongoing deterioration requires further provisioning at some banks.

The O&G extraction industry commitments were $167.6 billion at year-end 2015, down $9.2 billion from year-end 2014, and represented only 3.6 percent of total commercial commitments in the Credit Analytics data and 15.7 percent of tier 1 capital plus the ALLL. The OCC has communicated concerns in this market to the financial industry for two years and will continue to focus on O&G exposures, with additional targeted examinations scheduled in 2016 for institutions with significant portfolios.

Figure 17: Classified Commitments as a Percentage of Total Commitments for the O&G Extraction Sector



Source: OCC Credit Analytics.

CRE Growth Raises Importance of Concentration Risk Management

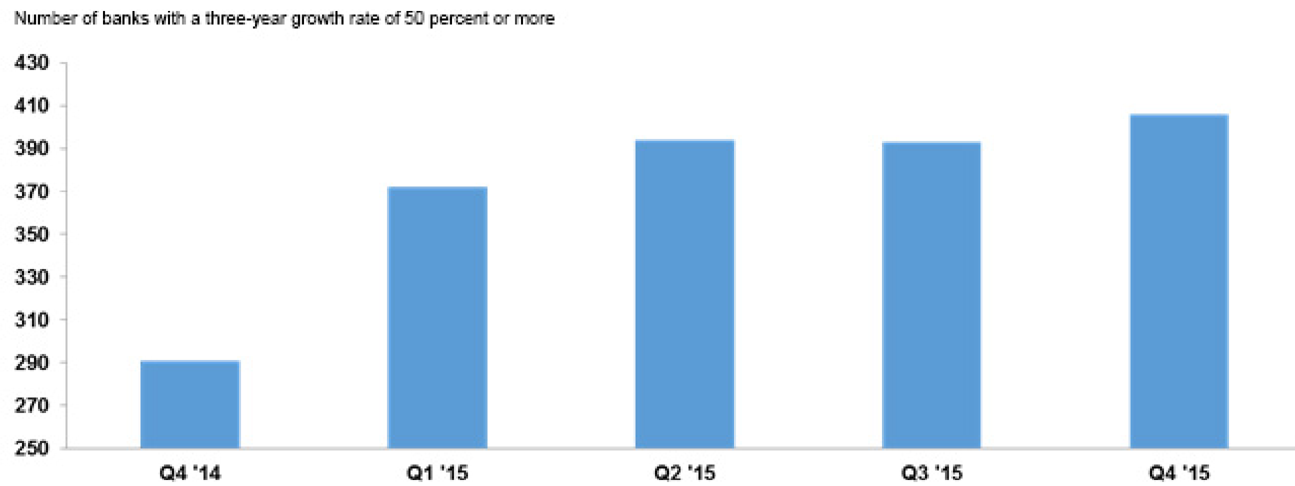
CRE loans increased more than 13 percent in 2015 following a 7.4 percent increase in 2014 as banks exhibited a strong risk appetite for this type of lending. Through the end of 2015, many banks saw robust growth in their CRE portfolios, as defined by the interagency CRE guidance,[17] with 406 banks experiencing three-year growth rates of 50 percent or more as of year-end 2015, compared with 291 banks reaching that level just four quarters earlier (see figure 18). With the continuation of favorable market fundamentals, the OCC expects additional growth in 2016. Moreover, this growth has been

[17] OCC Bulletin 2006-46, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices," (December 6, 2006) defines CRE as the sum of non-owner-occupied nonresidential loans secured by CRE, construction and land development loans, loans secured by multifamily residential property, and C&I loans with a CRE purpose not secured by real estate.

accompanied by weaker underwriting standards and examiner-identified weaknesses in concentration risk management practices in many banks with growing portfolios.

In response to the significant growth and risk management concerns, the OCC joined the other federal banking regulators in issuing a statement on prudent CRE lending in December 2015.[18] The interagency statement reminds financial institutions of existing regulatory guidance for CRE lending activity through economic cycles, noting the need to implement prudent CRE risk management practices and to maintain capital levels commensurate with the level and nature of an institution's concentration risk.

Figure 18: Number of Banks With a Three-Year CRE Growth Rate of 50 Percent or More

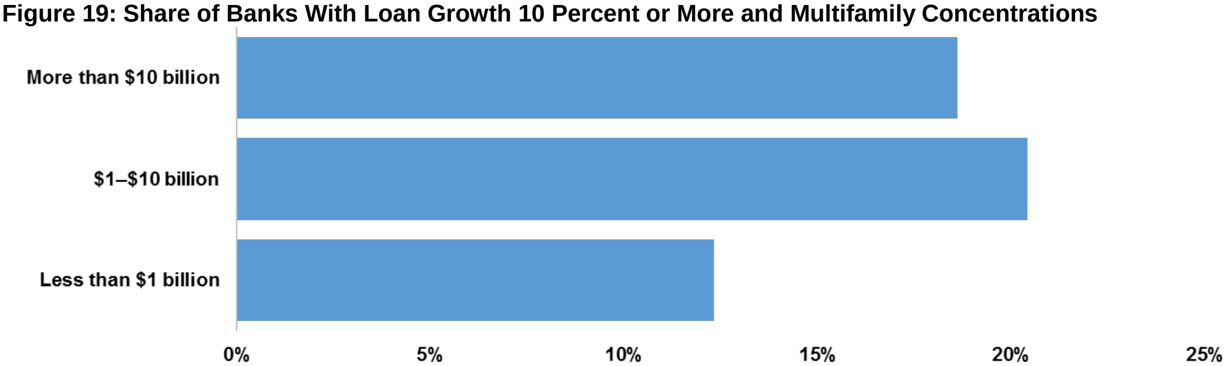


Source: Integrated Banking Information System (OCC).
Note: Data are quarterly from the fourth quarter of 2014 through the fourth quarter of 2015.

Multifamily Concentrations Higher in Banks With Total Assets More Than $1 Billion

Multifamily lending continues to grow across all banks, but particularly in banks with total assets of greater than $1 billion. While multifamily lending comprises a relatively small share of total bank lending, it is a significant concentration (25 percent or more of capital) and a fast-growing loan category for more than one in seven banks with growth of 10 percent or more (see figure 19).

Figure 19: Share of Banks With Loan Growth 10 Percent or More and Multifamily Concentrations



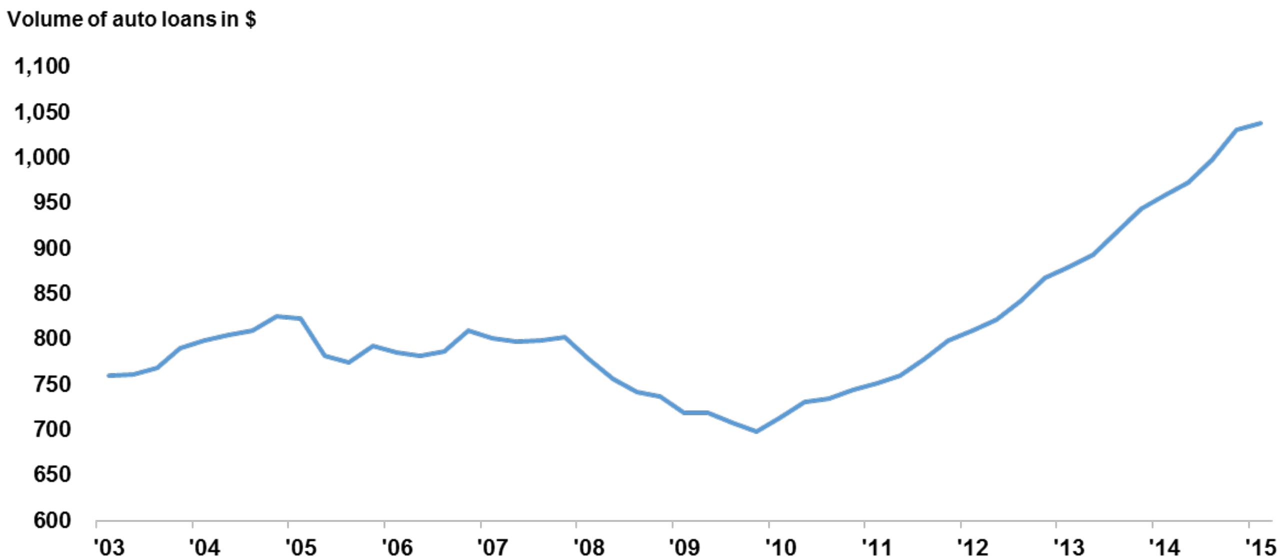
Source: Integrated Banking Information System (OCC)

[18] OCC Bulletin 2015-51, "Real Estate Lending: Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending," December 18, 2015.

Risks in Auto Lending Continue to Grow

Auto lending risk is increasing because of notable and unprecedented growth across all types of lenders (see figure 20). Recently, delinquencies on auto loans have begun to increase and used car values have started to decline. As banks have competed for market share, some banks have responded with less stringent underwriting standards, or both, for direct and indirect auto loans. In addition to the easing of underwriting standards and potential layering of risks (higher loan-to-value ratios combined with longer terms), concentrations in auto loans have been increasing. These factors create the potential for increasing levels of embedded credit risk in auto loan portfolios. The elevated risk results in higher probable credit losses and may warrant additional provisions to the ALLL or higher capital allocations. Supervisory work to date has noted that some banks' risk management practices have not kept pace with the growth and increasing risk in these portfolios.

Figure 20: Trends in Automobile Loan Volumes



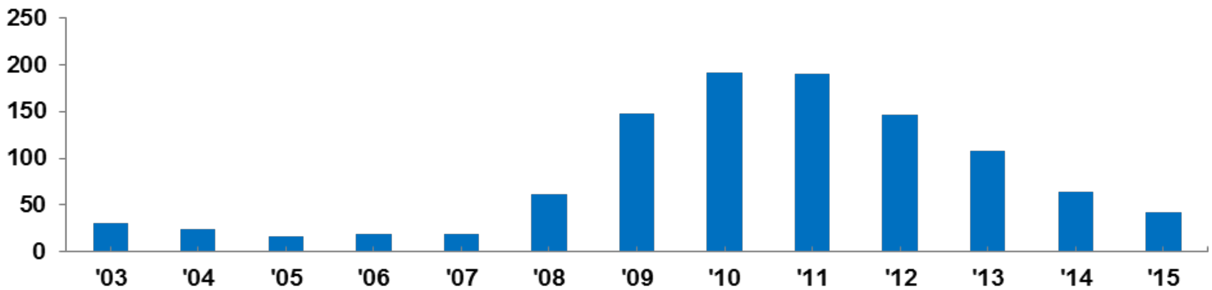
Source: Board of Governors of the Federal Reserve System.

Part V: Regulatory Actions

Number of Banks Rated 4 or 5 Continues to Decline

The number of OCC-supervised banks rated 4 or 5 declined by 34 percent in 2015 after peaking in 2010 and 2011, but remains above levels immediately preceding the recession (see figure 21). This decline is attributable to positive trends in the overall condition and risk management practices of OCC-supervised banks and mergers and acquisition activity.

Figure 21: Number of Banks Rated 4 or 5

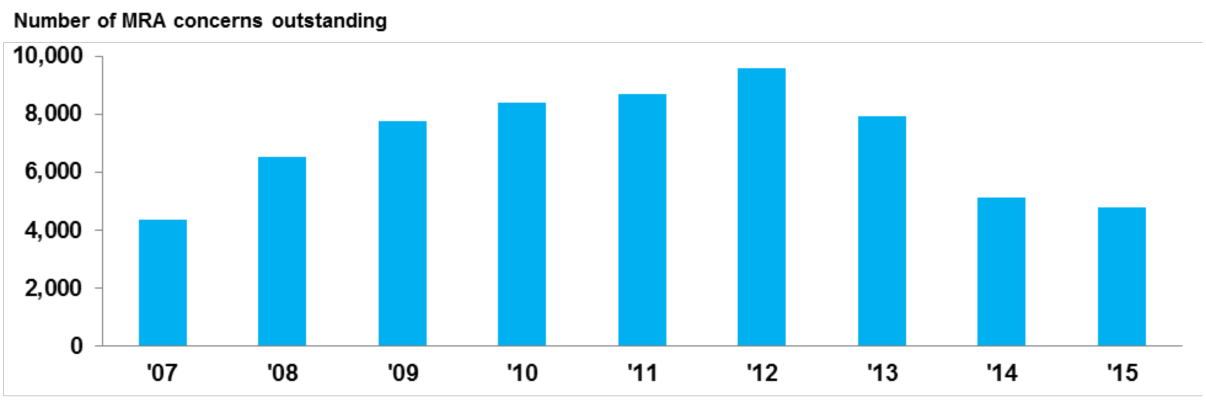


Source: OCC.
Note: All data are as of year-end.

Outstanding MRA Concerns Decline Slightly

The OCC communicates supervisory concerns to a bank's board of directors and management in the form of MRAs. Supervisory concerns include practices that deviate from safe and sound banking practices or sound risk management principles.[19] Such deviations, if not addressed appropriately, could affect a bank's earnings, capital, risk profile, compliance, or reputation and could lead to EAs. The number of outstanding MRAs peaked in 2012 and has declined consistently through year-end 2015 (see figure 22).

Figure 22: Trends in Outstanding MRA Concerns



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

The top five MRA categories for small banks were credit (38 percent), enterprise governance (16 percent), bank information technology (12 percent), BSA/AML (8 percent), and capital markets

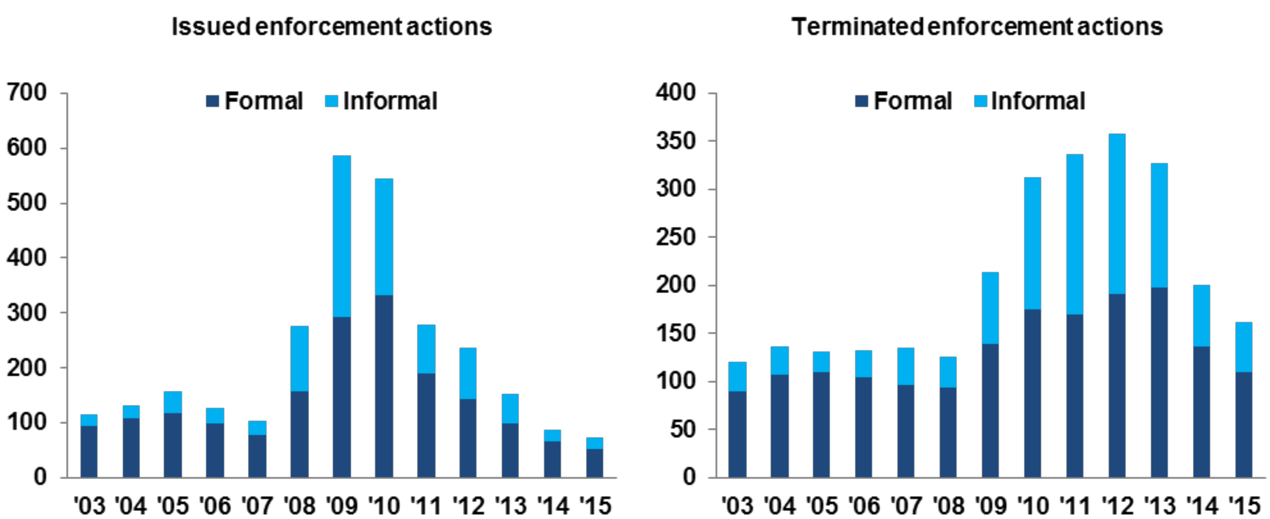
[19] OCC Bulletin 2014-52, "Matters Requiring Attention: Updated Guidance," October 30, 2014.

(7 percent). For large banks, the top five MRA categories were credit (24 percent), BSA/AML (14 percent), capital markets (14 percent), bank information technology (10 percent), and enterprise governance (10 percent).

Enforcement Actions Against Banks Continue to Decline

The OCC uses EAs to address more acute problems or weaknesses requiring corrective measures. Informal EAs include commitment letters, memorandums of understanding, and approved safety and soundness plans. Formal EAs are disclosed to the public and include cease-and-desist orders, capital directives, and formal agreements. Generally, the OCC may take formal EAs for violations of law, rules, or regulations; unsafe or unsound practices; violations of final orders or of conditions imposed in writing; and for institution-affiliated parties' breaches of fiduciary duty. The number of EAs issued by the OCC against banks has steadily declined since 2012 (see figure 23), reflecting overall improvement in banks' financial conditions and risk management practices. Even so, compliance or operational failures have resulted in a number of recent EAs. These remedial EAs addressed a lack of appropriate governance, oversight, and risk management systems and controls. In addition, in 2015 the OCC assessed significant civil money penalties for serious violations of law and unsafe or unsound practices. As with new issuances, the number of terminated (resolved) EAs has declined since 2012.

Figure 23: OCC Enforcement Actions Against Banks



Source: OCC.
Note: Data are as of year-end.

Source: OCC.
Note: Data are as of year-end.

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