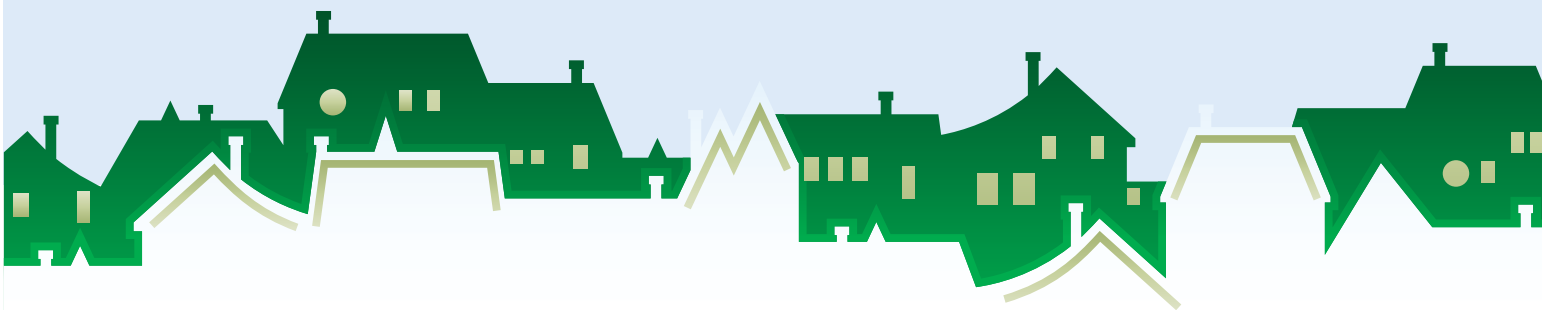


With the addition of hundreds of former OTS employees with extensive experience as regulators of mortgage lenders, the OCC was significantly enhanced in numbers and know-how as it helped confront the nation's ongoing housing difficulties in 2011.



## Section One

# Year in Review—Housing in the Forefront

### Introduction

In fiscal year 2011,<sup>2</sup> the U.S. financial system continued the process of recovery from the economic crisis of 2007 to 2009 while undergoing some of the most sweeping regulatory changes since the Great Depression.

The year was characterized by extreme economic volatility. During the first half, most indicators were positive. Rising corporate profits bolstered investor confidence, sending stock markets broadly higher. As the year wore on, however, the recovery faltered, as persistent high unemployment, rising energy prices, weak consumer spending, and rising public sector debt, both at home and abroad, took their toll.

The persistent weakness in residential real estate markets has slowed the economic recovery. Although home-price declines moderated in most U.S. markets in 2011, the drop in values still left millions of Americans—nearly one in five—owing more than their homes were worth. Homeowners were unable to sell, refinance to take advantage of lower interest rates, or move in search of better jobs. The slumping residential real estate market hurt

the construction-related industries. That in turn weakened banks with the greatest exposures to loan losses in those industries.

Despite the challenging economic environment, the condition and profitability of the national banking industry, supervised by the OCC, improved during 2011. National banks of all sizes, in aggregate, experienced improvements in earnings, asset quality, balance sheet liquidity, and capital. The number of banks with the most serious safety and soundness issues declined for the first time since 2006.

Notwithstanding these positive signs, the level of problem loans that banks must work through remained elevated and continues to require close attention by bank management and supervisors. Persistent weaknesses in commercial and residential real estate markets posed significant challenges for banks with concentrations in these markets. Losses from these exposures continued to be a key factor in the majority of bank failures in 2011: During the 12-month period, a total of 104 banks and federal savings associations, also known as thrifts, failed. Of these, 15 were national banks and nine were federal savings associations.

Implementation of the landmark Dodd–Frank Act was the most



important regulatory development of the year. Dodd–Frank required the OCC and other federal financial regulatory agencies to write hundreds of new regulations and conduct multiple studies that touched on every facet of the financial services industry.

Dodd–Frank also brought important changes to the structure of financial regulation. The act created a new regulatory agency, the CFPB, to regulate the provision of consumer financial products and services, including residential mortgages, across the financial sector. Dodd–Frank eliminated a regulatory agency when it transferred the functions and assets of the OTS to the OCC. Since its creation in 1989, the OTS had served as the regulator of thrifts—the institutions that had long been responsible for most of the nation's mortgage lending. On July 21, 2011, the OCC became the regulator for the more than 600 federal savings associations. The transfer brought to the OCC hundreds of former OTS employees with

<sup>2</sup> Unless otherwise noted, all references to 2011 refer to the fiscal year beginning October 1, 2010, and ending September 30, 2011.



Acting Comptroller John Walsh (second from right) testifies before a congressional subcommittee investigating mortgage foreclosure practices.

extensive experience as regulators of mortgage lenders. The OCC was thus significantly enhanced in numbers and know-how as it helped confront the nation’s ongoing housing difficulties in 2011.

This *Annual Report FY 2011* focuses on four major themes:

- Addressing problems in the nation’s mortgage markets
- Implementing the provisions of Dodd–Frank
- Ensuring the safety and soundness of national banks and federal savings associations
- Enforcing compliance with consumer protection laws and regulations

## Addressing Problems in the Nation’s Mortgage Markets

### Responding to Foreclosure Documentation Problems

The OCC has taken a leadership role in addressing and seeking corrective measures to deficiencies in foreclosure practices that came to light in September 2010. In October 2010, the OCC ordered the eight largest national bank servicers to conduct comprehensive

self-assessments of their foreclosure practices. The OCC demanded prompt action for deficiencies, including, when necessary, re-filing documentation with local courts, correcting weaknesses, and bolstering overall governance of the foreclosure process.<sup>3</sup>

At the same time, the OCC initiated planning for a coordinated horizontal review of 14 large mortgage servicers’ foreclosure processes with the Federal Reserve Board, the FDIC, and the OTS. More than 100 OCC examiners participated in this effort during the fourth quarter of the 2010 calendar year. They reviewed individual foreclosure case files; tested the validity of servicers’ self-assessments and confirmed whether corrective action was taken; determined whether servicers considered alternatives (such as loan modifications) for

<sup>3</sup> Testimony of John Walsh, Acting Comptroller of the Currency, Subcommittee on Housing and Community Opportunity, Committee on Financial Services, U.S. House of Representatives, November 18, 2010, [www.occ.gov](http://www.occ.gov). All citations in this report’s footnotes that refer to the OCC’s Web site can be found on either the News and Issuances page or the Publications page.

troubled borrowers; evaluated the accuracy of servicers’ documents and whether the documents were appropriately reviewed; and assessed whether necessary documents to support legal foreclosure proceedings were provided.<sup>4</sup>

During those reviews, examiners found widespread deficiencies and unsafe and unsound practices. These practices, documented in a report published jointly with the Federal Reserve and OTS, provided the basis for strong comprehensive regulatory action taken in April 2011 against the 14 servicers.

The OCC’s 2011 consent orders, taken against the eight national bank servicers and two third-party service providers, require servicers to correct deficiencies regarding compliance, oversight of third parties, management information systems, risk management, and communication with borrowers. They require the establishment of a single point of contact for borrowers and the elimination of dual tracking of mortgages when approved for a trial or permanent modification. Most significantly, the orders require servicers to retain independent consultants to conduct a comprehensive “look back” review of foreclosure actions in process in 2009 and 2010 to determine if errors, misrepresentations, or other deficiencies in the process resulted in financial injury to the borrower. In that independent foreclosure review, the OCC and other federal regulators required servicers to establish

<sup>4</sup> Testimony of Julie L. Williams, First Senior Deputy Comptroller and Chief Counsel, Committee on the Judiciary, U.S. House of Representatives, December 2, 2010, [www.occ.gov](http://www.occ.gov).

a process for eligible borrowers to request a review of their cases, if they think they were financially harmed by improper foreclosure practices. Where financial injury is found, the orders require the servicers to remediate that harm.<sup>5</sup>

These foreclosure actions “fix what is broken, identify and compensate borrowers who suffered financial harm, and ensure a fair and orderly mortgage servicing process going forward,” said Acting Comptroller of the Currency John Walsh.<sup>6</sup>

The independent foreclosure review began in November 2011 and is expected to take several months to complete.

In addition to the joint review and enforcement actions involving the largest mortgage servicers, in June 2011 the OCC directed all other national banks to conduct self-assessments of their mortgage servicing practices. The agency issued supervisory guidance on foreclosure practices applicable to all mortgage servicers under OCC supervision—guidance that emphasized the importance of improved accountability, third-party oversight, and reliable information systems.<sup>7</sup> The OCC issued a similar directive to all federal savings associations in August



The “OCC Mortgage Metrics Report,” prepared quarterly by agency staff, provides valuable data on the performance of U.S. residential mortgages.

2011, after the transfer of the OTS to the OCC.

Homeowners “have the right to expect transparency, accessibility, and fairness from the companies that service their mortgages, and never more than when a borrower is experiencing financial difficulty,” Mr. Walsh said in a speech to the professional association Women in Housing and Finance. “Anything less is unacceptable.”<sup>8</sup>

### Mortgage Metrics

The “OCC Mortgage Metrics Report” is a quarterly publication that, since its debut in June 2008, has provided standardized performance measures for mortgage loans serviced by national banks and federal savings associations. The report quickly became a key tool for bank regulators, lawmakers, and industry analysts seeking a better understanding of home mortgage performance, foreclosure trends, and the effectiveness of loan modifications.

In 2011, the OCC added data organized by state to the report, allowing for a more granular analysis of performance trends, as well as data on the performance of loans held in bank portfolios.

At the end of September 2011, the OCC published its most recent report, covering mortgage performance through the end of the second quarter. The report covered about 63 percent of all first-lien mortgages in the United States, worth \$5.7 trillion in outstanding balances.<sup>9</sup> The data showed that mortgage performance overall had improved from a year earlier but declined slightly from the previous quarter, reflecting seasonal effects, high unemployment, and a slow economic recovery.

The report also showed that servicers continued to process large inventories of delinquent mortgages, with 4 percent of the total portfolio in the process of foreclosure and another 4.9 percent remaining seriously delinquent

<sup>5</sup> Office of the Comptroller of the Currency, “OCC Takes Enforcement Action Against Eight Servicers for Unsafe and Unsound Foreclosure Practices,” news release 2011-47, April 13, 2011, [www.occ.gov](http://www.occ.gov).

<sup>6</sup> Testimony of John Walsh, Acting Comptroller of the Currency, Subcommittee on Housing and Community Opportunity, Committee on Financial Services, U.S. House of Representatives, November 18, 2010, [www.occ.gov](http://www.occ.gov).

<sup>7</sup> Office of the Comptroller of the Currency, “Foreclosure Management,” bulletin 2011-29, June 30, 2011, [www.occ.gov](http://www.occ.gov).

<sup>8</sup> Remarks by John Walsh, Women in Housing and Finance, April 14, 2011, [www.occ.gov](http://www.occ.gov).

<sup>9</sup> Office of the Comptroller of the Currency, “OCC Mortgage Metrics Report,” Second Quarter 2011, [www.occ.gov](http://www.occ.gov).



at the end of the quarter.<sup>10</sup> From January 1, 2010, through the second quarter of 2011, servicers implemented nearly 1.1 million modifications, reducing borrowers' monthly principal and interest payments by more than 25 percent on average.<sup>11</sup>

While home retention options—loan modifications, trial-period plans, and payment plans—can help prevent avoidable foreclosures, they will not work in every case, and completed foreclosures will rise as the large number of foreclosures in process continue to work through the system and servicers exhaust alternatives to foreclosure.

### Real Estate Appraisal and Evaluation Guidelines

Although lenders focus primarily on borrowers' creditworthiness when they consider applications for mortgage loans, they also look at the value of the property pledged to secure the loan as a secondary source of repayment. Professional, independent appraisals are crucial to determining property values.

Since 1994, when federal financial regulatory agencies last published comprehensive supervisory guidance on real estate appraisal requirements, appraisal practices have changed dramatically. Advances in information technology have made the gathering of market information far easier than before. To cut costs and keep up with the demand for their services

in the busy housing markets of the mid-2000s, appraisers increasingly discontinued physical inspections, relying on automated valuation models and the assumption that housing prices would continue to rise. These practices and assumptions contributed to overly optimistic valuations, easy credit, and many home buyers taking on bigger loans than they could afford. Stronger supervisory oversight was needed to restore the independence and integrity of the appraisal process—an essential ingredient in rebuilding confidence in the nation's housing markets.

In response to these issues, the OCC joined the other federal financial regulatory agencies in publishing revised and updated "Interagency Appraisal and Evaluation Guidelines." The guidelines comprise the agencies' recent issuances on appraisal practices and explain minimum supervisory standards for appraisals, including a requirement that lenders select appraisers based on their competence, experience, and knowledge of relevant markets. The guidelines emphasize that lenders must maintain strong internal controls to ensure reliable appraisals and evaluations.<sup>12</sup>

Section 1472 of Dodd–Frank set forth additional requirements to ensure that the appraisals used to underwrite lending decisions are based on appraisers' best professional and independent judgment. An interim final rule, issued by the Federal Reserve Board in October 2010, prohibits appraiser



coercion, forbids appraisers from having financial interest in transactions, and establishes a procedure for identifying violations of these regulations. The rule went into effect on April 1, 2011.

### Credit-Risk Retention

Section 941 of Dodd–Frank charged federal financial regulatory agencies with formulating rules that required lenders to retain a 5 percent interest in any assets not held on their books, while authorizing exemptions for loans with the lowest credit risk, particularly QRMs. But the law left many complicated issues to be resolved by regulation, including the level and structure of risk to be retained and the definition of a QRM. Overlaying these issues is potential concern about how the final rules might affect the cost and availability of credit at a time when mortgage loans are already hard to acquire for many borrowers.

<sup>10</sup> Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report," Second Quarter 2011, table 7, [www.occ.gov](http://www.occ.gov).

<sup>11</sup> Office of the Comptroller of the Currency, "OCC Mortgage Metrics Report," Second Quarter 2011, tables 2 and 24, [www.occ.gov](http://www.occ.gov).

<sup>12</sup> Office of the Comptroller of the Currency, et al., "Interagency Appraisal and Evaluation Guidelines," December 2, 2010, [www.occ.gov](http://www.occ.gov).

In interagency discussions leading up to the proposed rules, the OCC emphasized several key principles.

First, the rules had to provide sufficient flexibility to allow the securitization markets to function in a manner that both facilitates the flow of credit to consumers and investors and protects investors. To that end, the proposed rules released for comment on March 31, 2011, offered firms that securitize assets five possible options for handling risk retention, consistent with the Dodd–Frank goal of restoring confidence in the quality of asset-backed securities.<sup>13</sup>

Second, the rules had to be balanced, setting the bar for QRMs neither too high nor too low. The agencies were intent that the requirement not be taken as a new (and highly restrictive) national mortgage standard but rather as the special case the law intended it to be.<sup>14</sup>

Third, the OCC emphasized that the rules must be uniform among the involved agencies and across the institutions they regulate. The proposals that emerged from interagency deliberations provide a single, straightforward set of federal requirements on securitization—risk retention, structure, and disclosure—that applies to all markets, all products, and all securitizers.



President Obama discusses Dodd–Frank implementation issues with senior administration officials. Acting Comptroller John Walsh is at the far left.

Finally, the OCC believed that careful and extensive public review, which is always essential in the rule-making process, was especially important when the rules under consideration had extensive implications for credit availability. Thus, the agencies actively solicited comment on a host of issues and, when the number of public comments far exceeded expectations, extended the comment deadline from June 2011 to August 2011. The final rules are expected to be released in fiscal year 2012.<sup>15</sup>

### Implementing Dodd–Frank Integrating the OCC and the OTS

On July 21, 2011, a key provision of Dodd–Frank was fulfilled when most of the OTS’s assets and personnel officially transferred to the OCC and federal thrifts were brought under OCC regulation and supervision. The OTS integration was the culmination of months

of intensive effort to unify rules, systems, and processes to ensure a timely and seamless transition for OTS employees and OTS-supervised institutions.<sup>16</sup>

To accomplish these goals, Senior Deputy Comptroller and Chief Financial Officer Thomas R. Bloom led an OCC working group that collaborated with counterparts from the OTS, the Federal Reserve (which became responsible for the holding companies of thrifts), and the FDIC (which assumed supervisory responsibility for state-chartered thrifts). In January 2011, the agencies delivered to Congress a “Joint Implementation Plan” spelling out how the agencies would accomplish the job. The plan was updated in April 2011.<sup>17</sup>

<sup>13</sup> Office of the Comptroller of the Currency, et al., “Credit Risk Retention,” proposed rule, March 31, 2011, [www.occ.gov](http://www.occ.gov).

<sup>14</sup> Statement of John Walsh, Federal Deposit Insurance Corporation Board of Directors, March 29, 2011, [www.occ.gov](http://www.occ.gov).

<sup>15</sup> Testimony of Julie L. Williams, Subcommittee on Capital Markets and Government Sponsored Entities, Financial Services Committee, U.S. House of Representatives, April 14, 2011, [www.occ.gov](http://www.occ.gov); Office of the Comptroller of the Currency, et al., “Credit Risk Retention,” proposed rule, June 7, 2011, [www.occ.gov](http://www.occ.gov).

<sup>16</sup> See “Records Integration and Freedom of Information Act” and “Policy Integration Project” in the “OCC Profiles” section of this report for a more detailed look at how the two agencies dealt with some of the challenges of reconciling infrastructure and back-office functions.

<sup>17</sup> Board of Governors of the Federal Reserve System, et al., “Joint Implementation Plan, 301-326 of the Dodd–Frank Wall Street Reform and Consumer Protection Act,” January 2011 (revised April 2011), [www.occ.gov](http://www.occ.gov).



OCC and OTS examiners collaborate to promote effective supervision of national banks and federal savings associations.

The OCC launched an extensive internal communication campaign to smooth the integration of the two agencies, which, while previously operating under different statutory regimes, had similar missions but varying policies and procedures. Automated bulletin boards allowed for the exchange of questions and answers, and group events gave the OTS and OCC staffs opportunities to meet. Like the majority of OCC examiners, most OTS employees would work in the OCC’s Midsize and Community Bank Supervision Department. Over many months, Senior Deputy Comptroller Jennifer C. Kelly, the OCC executive in charge of that department, and her team prepared the groundwork for the transition and conducted a series of meetings and conference calls with OTS employees to explain, among other things, how the OCC intended to use and develop their skills.

Under the leadership of Timothy T. Ward, a veteran OTS executive whom the OCC had named Deputy Comptroller for Thrift

Supervision,<sup>18</sup> the agencies developed a staffing plan that integrated the supervision of thrifts into the existing OCC structure, developed examination plans and supervisory strategies for former OTS-supervised institutions, and created a number of new manage-

ment positions. The plan, which was tested in a series of pilot examinations in the OCC’s Central District between January 2011 and April 2011, called for OTS and OCC examiners to be deployed without regard to whether the institution in question was a national bank or a thrift. The pilot helped the agencies identify and address conflicts and gaps in examination documentation procedures, training and certification, and automated supervisory systems.

The pilot examination program also provided federally chartered thrifts with a greater understanding of the OCC’s approach to supervision. Related initiatives included publishing a brochure titled “The OCC’s Approach to Supervision” and a series of letters to thrift institutions from Acting Comptroller Walsh that provided updates on the integration process.<sup>19</sup> The agency also held a series of 17 informational seminars with executives of thrifts around the country,

<sup>18</sup> Dodd–Frank created the position of Deputy Comptroller for Thrift Supervision.

<sup>19</sup> See “Outreach to Thrifts” in the “OCC Profiles” section of this report.

which provided an opportunity, as Northeastern District Deputy Comptroller Toney M. Bland told one group, “to establish and encourage ongoing two-way communication, address your concerns, and give you our commitment to provide value-added supervision.”<sup>20</sup>

To make the changes necessary to bring regulations into conformity with Dodd–Frank, integrate rules on similar topics, and implement other needed revisions, on July 20, 2011, the OCC issued a final rule implementing several provisions of the Dodd–Frank Act. Provisions included changes to facilitate the transfer of functions from the OTS and revisions to the OCC’s rules on preemption and visitorial powers. The revised rules

- eliminated preemption for operating subsidiaries of national banks and operating subsidiaries of federal thrift institutions.
- applied to federal thrifts the same preemption standard—that is, a conflict preemption



Timothy T. Ward, the OCC’s Deputy Comptroller for Thrift Supervision, and a thrift executive discuss the agency’s supervisory approach.

<sup>20</sup> See “Outreach to Thrifts” in the “OCC Profiles” section of this report.



standard and not an occupation of the field standard—as applies to national banks, and applied to federal thrifts the visitorial powers standard applicable to national banks.

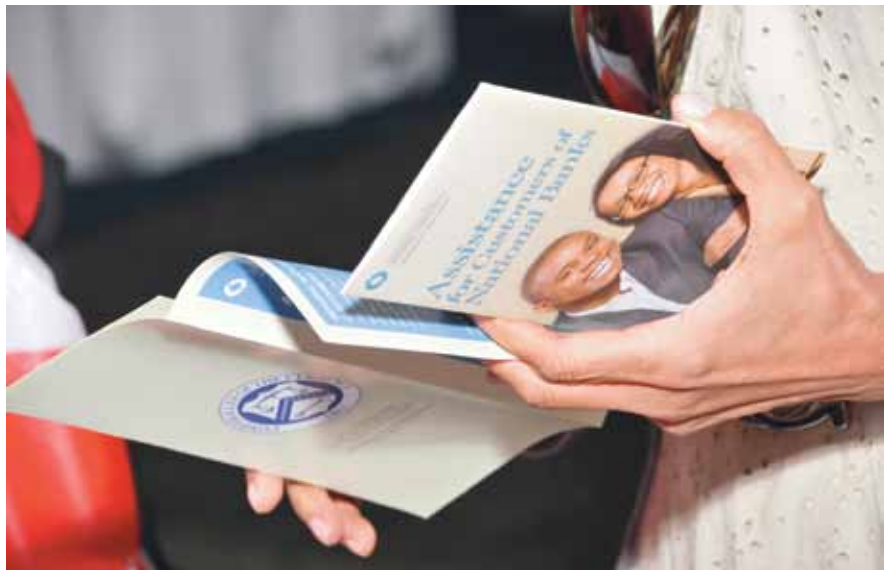
- eliminated ambiguity concerning the preemption standards in OCC regulations by removing language from OCC rules that provides that state laws that “obstruct, impair, or condition” a national bank’s powers are preempted.
- revised the OCC’s visitorial powers rule to conform to the Supreme Court’s *Cuomo* decision, recognizing the ability of state attorneys general to bring enforcement actions in court to enforce applicable laws against national banks as authorized by such laws.<sup>21</sup>

On July 21, 2011, the OCC became the sole federal regulator of 642 federal savings associations and home to 670 former OTS employees. In addition, the OCC was given the authority to prescribe regulations for all federal savings associations. The OCC will be working to integrate sets of rules on similar topics and review stand-alone rules for clarity and consistency through 2013.

### Creating the CFPB

The transfer date for OTS integration, July 21, 2011, was also the creation date of the CFPB, which was given rule-making authority that was previously the province of other federal regulatory agencies,

<sup>21</sup> Office of the Comptroller of the Currency, “Notice of Proposed Rulemaking,” bulletin 2011-20, June 1, 2011, [www.occ.gov](http://www.occ.gov); “Office of Thrift Supervision Integration; Dodd–Frank Act Implementation,” final rule, 76 Fed. Reg. 140 (July 21, 2011), [www.gpoaccess.gov](http://www.gpoaccess.gov).



The OCC’s publications disseminate valuable information to consumers regarding financial products and services.

such as the OCC, for specified federal consumer financial laws under Dodd–Frank. To ensure compliance with those laws, Dodd–Frank also granted the CFPB authority to supervise banks holding more than \$10 billion in assets.

OCC Deputy Comptroller for Large Banks Delora Jee headed an OCC committee that coordinated with the CFPB to ensure a smooth transition. The OCC consulted extensively with CFPB staff on issues ranging from procurement processes to examination techniques, contributing six full-time staff members with diverse and essential institutional expertise.

Congress envisioned that the CFPB would draw staff from the agencies that were transferring responsibilities to it. By agreement with the OCC, the CFPB solicited expressions of interest from OCC employees interested in joining the bureau, in particular those employees working in “transfer-process functions” such as compliance examination, enforcement and

interpretation of consumer financial law, and consumer education. The bureau subsequently made employment offers to individuals who met its needs.<sup>22</sup>

The mission of the OCC’s Houston-based Customer Assistance Group, with its sophisticated consumer complaint processing capability, aligns directly with the new bureau’s mission.<sup>23</sup> The CFPB will process consumer complaints related to the large financial companies over which it has supervisory authority. The OCC will continue to process questions and complaints concerning consumer issues within the jurisdiction of the OCC through the Customer Assistance Group and will continue to send mis-directed complaints it receives to the appropriate federal or

<sup>22</sup> Consumer Financial Protection Bureau, “Developing Our Human Capital,” Annual Report to Congress, July 21, 2011, [www.consumerfinance.gov](http://www.consumerfinance.gov).

<sup>23</sup> For more on the Customer Assistance Group, see the *Annual Report FY 2009*, 44, [www.occ.gov](http://www.occ.gov).





The Financial Stability Oversight Council addresses systemic risks to the U.S. banking system.

state regulator. In addition, the Customer Assistance Group will process complaints involving national banks and federal savings associations with more than \$10 billion in assets on behalf of the CFPB, while the CFPB builds its capacity to handle complaints. Under this approach, the CFPB will begin by handling credit card-related complaints involving national banks and federal savings associations with assets greater than \$10 billion and will expand its complaint process to other products and services offered as the new bureau builds that capacity through March 2012.

### Financial Stability Oversight Council

Section 111 of Dodd–Frank created the FSOC to assess overall risks to the financial system and coordinate corrective action when systemic risks were identified. The council consists of 10 voting members, one from each of nine federal financial regulatory agencies and an independent member with insurance expertise. On October 1, 2010, Acting Comptroller Walsh represented the OCC at the FSOC’s inaugural meeting, presided over by Treasury Secretary Timothy

F. Geithner. The FSOC adopted organizational bylaws and issued a notice of proposed rulemaking bolstering supervision for certain nonbank financial companies. The council also commenced a study of section 619 of Dodd–Frank, the “Volcker rule,” which restricts U.S. financial companies from engaging in most kinds of trading using their own funds, otherwise known as proprietary trading.<sup>24</sup>

Rather than create a new permanent bureaucracy at the FSOC, Dodd–Frank envisioned that experts drawn from member agencies would compose the FSOC’s committees and working groups. The OCC’s Chief National Bank Examiner is a member of the council’s deputies’ committee, which provides broad oversight and direction on the activities of FSOC’s various operating committees. OCC staff members serve on the council’s committee on systemic risk and on subcommittees on institutions and markets, which play a major role in the FSOC’s analysis of emerging threats to financial stability. The OCC assigned experts to five standing committees that support the FSOC’s work in designating

systemically important nonbank financial companies; payment, clearing, and settlement activities; heightened prudential standards; orderly liquidation authority and resolution plans; and data collection and analysis. Additionally, OCC attorneys participated in the FSOC’s informal legal staff working group, which provides the council with legal guidance.<sup>25</sup>

### Dodd–Frank and Basel III

Capital is the bulwark of the banking business, a bank’s backstop against loss and insolvency. In the aftermath of the financial crisis, financial institutions were under heavy pressure to build capital to protect themselves against future downturns. While much of this pressure came from financial markets, regulation and supervision also encouraged, and in some cases required, higher bank capital. In revising capital policy in 2011, regulators were tasked with finding the right balance between ensuring safety and soundness and supporting a healthy level of credit availability.

<sup>24</sup> Testimony of John Walsh, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 17, 2011, [www.occ.gov](http://www.occ.gov).

<sup>25</sup> Testimony of Timothy W. Long, Senior Deputy Comptroller for Bank Supervision Policy and Chief National Bank Examiner, Subcommittee on Oversight and Investigations, Financial Services Committee, U.S. House of Representatives, April 14, 2011, [www.occ.gov](http://www.occ.gov).

The Basel Committee on Banking Supervision, of which the OCC is a member, brings bank supervisors from around the world together to promote consistent and high-quality supervision. In December 2010, the committee adopted a new international framework focused on strengthening global capital and liquidity requirements for internationally active banks. This framework—known as Basel III—requires increases in both the amount and quality of regulatory capital relative to banks’ risks, including a greater reliance on common equity. Basel III requires banks to hold substantially more liquidity in the form of short-term, low-risk assets and to increase their reliance on more stable long-term debt and core deposits. Basel III introduces other significant enhancements designed to ensure that all material risks confronting financial companies—especially risks held in trading portfolios and the risks posed by complex structured financial products that proved to be most problematic during the crisis—are appropriately reflected in regulatory capital requirements. The OCC was active in the development of these enhanced standards.<sup>26</sup>

Dodd–Frank contains provisions that also aim to enhance the capital and liquidity standards of U.S. financial companies. Among them are sections 115(a) and 115(b), which authorize the FSOC to make recommendations to the Federal Reserve on prudential standards

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<sup>26</sup> Bank for International Settlements, Basel Committee on Banking Supervision, “Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems,” December 16, 2010 (revised June 2011), [www.bis.org](http://www.bis.org).



Newly commissioned national bank examiners take the oath of office.

for risk-based capital, leverage limits, and liquidity requirements at systemically important non-bank financial companies. Section 171(b) of Dodd–Frank also deals with risk-based capital, requiring the banking agencies to develop minimum risk-based capital rules, not only for commercial banks but also for nonbank financial companies supervised by the Federal Reserve. Other sections set minimum capital floors for large banks. The final rule, published by the banking agencies on June 28, 2011, implemented this minimum capital requirement.<sup>27</sup>

Although provisions of Dodd–Frank and Basel III share the goal of raising the amount and the quality of bank capital, they differ in important respects, and these differences raise questions that the U.S. federal banking agencies must address as they move forward with implementation. These issues include such questions as, what should count as capital? To which institutions should the standards apply? How much risk is inherent in the various asset classes that

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<sup>27</sup> Testimony of John Walsh, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, February 17, 2011, [www.occ.gov](http://www.occ.gov).

banks hold on their books? How much capital must be held in each instance? In the new fiscal year, U.S. regulators will weigh the costs and benefits of adopting a single set of Basel III-compatible standards for all U.S. banks.<sup>28</sup>

### Ensuring Safety and Soundness

As government agencies begin to implement Dodd–Frank, the ultimate impact on the financial institutions that are subject to its new rules and structures will be significant. Given the changing regulatory environment for national banks and federal savings associations, and with the outlook for the economy still uncertain, the OCC’s core mission of protecting safety and soundness is more important than ever.<sup>29</sup>

The OCC takes a differentiated approach to its bank supervisory activities, providing supervision tailored to the distinctive needs of national banks and federal savings associations of varying sizes and

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<sup>28</sup> Remarks by John Walsh, Exchequer Club, January 19, 2011, [www.occ.gov](http://www.occ.gov).

<sup>29</sup> Remarks by John Walsh, Independent Community Bankers of America, March 23, 2011, [www.occ.gov](http://www.occ.gov).



levels of complexity. Institutions in the OCC's Large Bank Supervision program have businesses that cover the broadest geographic span and encompass a wide range of financial products and services. Large and midsize banks receive constant monitoring by teams of resident examiners, many of them specialists in such areas as asset management, commercial credit, retail credit, compliance, capital markets, information technology, mortgage banking, and operational risk. This full-time, on-site presence helps bank examiners develop a close understanding of the banks' risk taking and risk management; identify the most significant risks; and determine the adequacy of bank systems and controls to measure, monitor, and manage these risks.

Community-based institutions constitute the vast majority of the more than 2,000 national banks and federal savings associations under the OCC's jurisdiction. These institutions receive risk-based supervision by examiners who are typically members of the communities in which the banks they supervise do business. These examiners have firsthand familiarity with local economic conditions,

while the OCC's national network of field, satellite, and district offices provides insight into larger economic, financial, and regulatory trends that affect banks of all sizes. This combination of local presence and national per-

spective adds significant value to OCC supervision.

Given the continued weakness in the economic environment, credit risk and credit-risk management continue to be a major focus of OCC supervisory activities in all banks. Examiners pay particular attention to the quality of systems for rating credit risk and identifying problem loans; the adequacy of loan-loss reserves in light of deteriorating credit quality; and the effectiveness of loan work-out strategies. They look for sound policies and structures for managing interest rate risk and liquidity risk, based on diversified funding sources and realistic plans for contingency funding. Recognizing that effective risk management policies require a supportive risk management culture, they evaluate the role of a bank's board of directors and senior managers in promoting those policies. In the case of community banks, examiners emphasize the importance of identifying potential concentrations in key portfolios, such as commercial real estate, to identify problems before they surface. The OCC's findings are communicated directly to the bank's leaders.

## Guidance on Model Risk Management

In recent years, the largest, most complex national banks have placed increasing reliance on sophisticated quantitative models to conduct many parts of their business. And the use of models is not limited to the largest banks; banks of all sizes use models to manage risk, price products, and make many fundamental business decisions.

The OCC recognizes the benefits that such models provide. The OCC has long emphasized, however, that the use of models also carries risk, and the potential for model-related financial loss, reputational damage, or poor decisions must be managed as a risk, just as any other source of risk would be addressed within banks' overall risk-management structures.

These key principles are reflected in "Supervisory Guidance on Model Risk Management," which was released by the OCC and the Federal Reserve in April 2011. The guidance, which builds on the OCC's 2000 guidance on model validation, articulates the elements of a sound program for managing model risk and provides guidance to OCC examiners and the banks they supervise on prudent model risk-management policies, procedures, practices, and standards.<sup>30</sup>

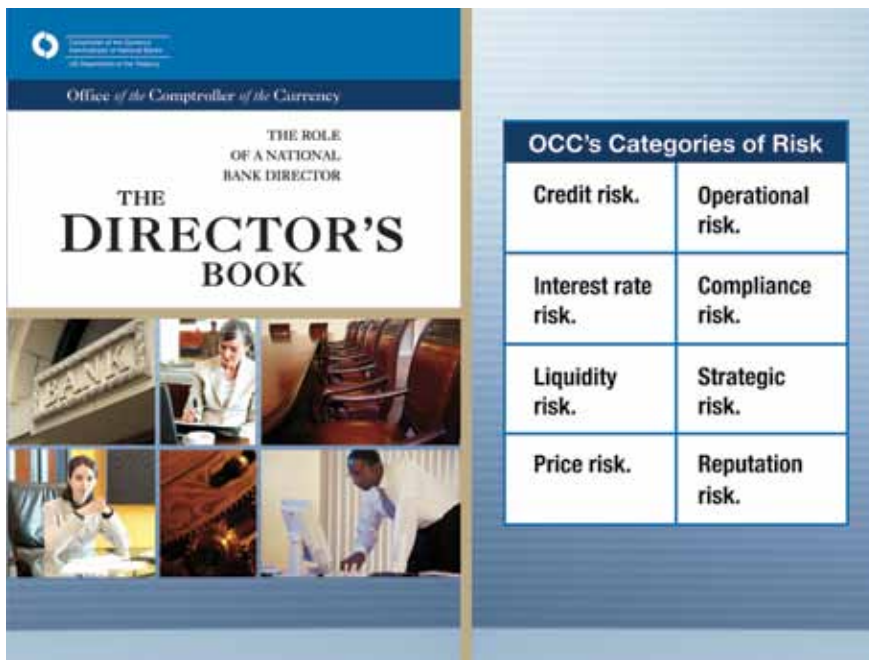
## Stress Testing

Beginning in February 2009, in connection with the Supervisory Capital Assessment Program, the

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<sup>30</sup> Office of the Comptroller of the Currency, "Supervisory Guidance on Model Risk Management," bulletin 2011-12, April 4, 2011, [www.occ.gov](http://www.occ.gov).





OCC and the Federal Reserve worked with 19 large bank holding companies to carry out stress tests that assessed the ability of these companies to absorb significantly worse than expected losses and still continue to provide credit to the economy. The stress testing program was widely viewed as a turning point in resolving the financial crisis.<sup>31</sup> Regulators learned much from that experience, which highlighted the value of regularly conducting rigorous, credible tests to assess the potential impact of stressful economic events on the financial condition of banks.

In June 2011, the OCC, the FDIC, and the Federal Reserve released for comment guidance that provides an overview of how large banking organizations should develop a structure for stress-testing programs and why such programs are crucial for managing

<sup>31</sup> Office of the Comptroller of the Currency, *Annual Report FY 2009*, 11–12, [www.occ.gov](http://www.occ.gov).

credit risk and liquidity risk. The proposed guidance also cites the importance of strong internal governance and controls in an effective stress-testing framework.<sup>32</sup> The OCC continues to coordinate with the Federal Reserve on implementing stress-testing requirements under section 165(i) of Dodd–Frank.

### Derivatives Trading and Guidance on Counterparty Risk Management

After a steep multiyear decline, the market for derivatives rebounded in 2011, as large banks and their customers sought to hedge against risks and market volatility. The derivatives market is the province of large banks: The five largest commercial banks held 96 percent of the total notional amount of

<sup>32</sup> Office of the Comptroller of the Currency, “Agencies Seek Comment on Stress Testing Guidance,” news release 2011-67, June 9, 2011, [www.occ.gov](http://www.occ.gov).

derivatives contracts, and the top 25 banks held 100 percent.<sup>33</sup>

Interagency guidance on counterparty credit-risk management, released in July 2011, addressed weaknesses in the management of these risks, which became apparent during the financial crisis.<sup>34</sup> These weaknesses included shortcomings in the timeliness and accuracy of assessing banks’ aggregate exposures to a counterparty and inadequate measures of correlation risks across counterparties. The interagency guidance addressed these weaknesses by emphasizing prudent oversight by banks’ boards of directors and senior managers and by developing metrics to measure counterparty exposure and the likelihood of deterioration or default.

### Survey of Credit Underwriting Practices

In June 2011, the OCC released its 17th annual survey of trends in lending standards and credit risk for the most common types of commercial and retail credit offered by national banks. The “2011 Survey of Credit Underwriting Practices” highlighted how various factors, such as competition among financial providers and the performance of the broader economy, affect the way banks price and underwrite loans, and whether the OCC

<sup>33</sup> Office of the Comptroller of the Currency, “OCC Reports Second Quarter Trading Revenue of \$7.4 Billion,” news release 2011-118, September 16, 2011, [www.occ.gov](http://www.occ.gov).

<sup>34</sup> Office of the Comptroller of the Currency, “Agencies Issue Guidance on Counterparty Credit Risk Management,” news release 2011-88, July 5, 2011, [www.occ.gov](http://www.occ.gov).



believes that the inherent credit risk in bank portfolios is increasing or decreasing.<sup>35</sup>

The 2011 survey included examiner assessments of credit underwriting standards at 54 of the largest national banks—those with assets of \$3 billion or more. The survey encompassed loans as of December 31, 2010, totaling \$4.2 trillion, or 94 percent of total loans in the national banking system at the time.

The 2011 survey contained positive news. A majority of examiners surveyed said credit risk embedded in bank portfolios was stable or improving. Examiners reported easing of underwriting standards for most types of loans to businesses, as banks responded to intensified competition and took advantage of more readily available funding to gain new customers and market share.

The retail portion of the market, however, was a different story. Most of the national banks surveyed were still working through losses sustained on credit cards, home equity loans, and residential

real estate. That residue, combined with persistent unemployment, woes in the housing market, and uncertainties in the consumer economy, led most banks to maintain, or even tighten, credit underwriting standards.

In short, the 2011 survey revealed an industry still recovering from the financial crisis but making significant strides toward regaining its confidence and capacity to support U.S. business and consumers through prudent lending.

While the easing of underwriting standards is normal and a healthy sign of economic stabilization, the OCC warned national banks that the pace of eased standards for certain loan products, most notably leveraged loans, was disconcerting and warranted closer attention by bankers. The OCC carefully monitors the institutions under its supervision to ensure that appropriate underwriting standards are maintained as lending activity continues to revive.

### Shared National Credit Program

A similar picture of an industry in transition emerged in the annual Shared National Credit Program review, which the OCC conducts with the Federal Reserve and the FDIC. A shared national credit is any loan of \$20 million or more that is shared by three or more federally supervised institutions. The program began in 1977 to promote consistent analysis of shared national credits. The 2011 review covered \$910 billion, nearly a third of all such credits in the shared national credit portfolio.

A substantial backlog of poorly underwritten loans, mostly from 2006 and 2007, continued to dampen the outlook for the shared national credits portfolio. Indeed, almost 60 percent of the criticized assets (loans rated “special mention,” substandard, doubtful, or loss) originated in those two years. The fact that shared national credits were up only negligibly—less than 1 percent—from the year before reflected the slow recovery of the U.S. economy.

Nonetheless, the overall credit quality of the reviewed loans improved in 2011 for the second year in a row. Loans rated as doubtful or loss, the two weakest categories, fell by 50 percent to \$24 billion. Classified assets declined 30 percent, representing 9 percent of the total portfolio, compared with 12 percent in 2010.<sup>36</sup>

### Incentive-Based Compensation Practices

Section 956 of Dodd–Frank requires federal financial regulatory agencies to regulate incentive compensation arrangements at the financial institutions under their supervision. Specifically, the law instructs the agencies to prohibit incentive-based payment arrangements that provide “excessive compensation or could lead to material financial loss” for financial institutions.

Accordingly, in March 2011, the agencies issued a proposed rule that required banks to identify and

<sup>35</sup> Office of the Comptroller of the Currency, “2011 Survey of Credit Underwriting Practices,” [www.occ.gov](http://www.occ.gov); Board of Governors of the Federal Reserve System and Office of the Comptroller of the Currency, “Supervisory Guidance on Model Risk Management,” April 4, 2011, [www.occ.gov](http://www.occ.gov).

<sup>36</sup> Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, “Shared National Credits Program, 2011 Review,” August 2011, [www.occ.gov](http://www.occ.gov).

## Consumer Advisories and Public Service Announcements

The OCC issued two consumer advisories in 2011 that were widely publicized through OCC public service announcements.

For families in danger of losing their homes, the threat of foreclosure can engender fear and desperation. Unscrupulous criminals view such situations as opportunities to prey on vulnerable homeowners. Scam tactics vary, as the OCC's consumer advisory titled "Avoiding Mortgage Modification Scams and Foreclosure Rescue Scams" points out.

The culprits might ask for a large up-front cash payment—always a red flag—to negotiate a settlement with lenders. They might encourage troubled borrowers to file for bankruptcy, or stop communicating with lenders, or take advantage of an imaginary government assistance program, or, perhaps worst of all, sign over their property to a third-party, with the promise of more affordable financing to come. Do that, the OCC warns, and the next step could be an eviction notice.

How can a consumer avoid these traps? Awareness is the first step. The OCC's public service announcement describes false promises and enticements that should make people in need of mortgage assistance run in the opposite direction. What they should do instead, the OCC advises, is to call a toll-free number that provides access to a housing counselor approved by the

U.S. Department of Housing and Urban Development. The advice is free, and there are no strings attached.<sup>37</sup>

As technology evolves and adapts, so do the criminals who try to exploit it.

As another OCC consumer advisory explains, one of the latest and most sophisticated frauds is card skimming—tampering with automated teller machines (ATM) or other cash machines to steal information that criminals can use to loot bank accounts.

In card skimming, a bank customer makes a routine ATM deposit or withdrawal and does not notice that a "skimmer," which reads and transmits card information, is installed on the ATM. Sometimes a remote camera is installed, too, enabling criminals to record keystrokes and steal customers' pass codes. Often, customers only discover tampering when their bank accounts have been wiped out.

The consumer advisory offers tips on how to avoid skimming. These include walking away from an ATM if someone is watching nearby; checking the card slot to be sure it is an integral part of the cash machine; and examining card statements for unauthorized withdrawals and immediately reporting anything suspicious to the financial institution.<sup>38</sup>

In personal finance, as in so many aspects of people's lives, technology brings benefits. But using it safely requires vigilance.

<sup>37</sup> Office of the Comptroller of the Currency, "Avoiding Mortgage Modification Scams and Foreclosure Rescue Scams," consumer advisory 2011-1, February 24, 2011, [www.occ.gov](http://www.occ.gov).

<sup>38</sup> Office of the Comptroller of the Currency, "Avoiding 'Card Skimming' at ATMs and Other Money Machines," consumer advisory 2011-2, June 1, 2011, [www.occ.gov](http://www.occ.gov).



eliminate incentive compensation arrangements that encouraged inappropriate risks and risk taking by their employees. The proposed rule required institutions with more than \$1 billion in assets to implement formal policies and procedures governing incentive compensation arrangements and to submit an annual report to their federal regulator describing that structure. Larger institutions (with more than \$50 billion in assets) would have to defer at least 50 percent of the incentive compensation of certain bank officers for three years, with the ultimate payment adjusted to reflect any losses.<sup>39</sup>

### Internet Authentication Practices

In October 2005, the federal banking agencies issued guidance titled “Authentication in an Internet Banking Environment,” which discussed risk management expectations regarding fraud prevention and safeguarding customer information. Since that time, online threats to financial institutions and their customers have grown in size and sophistication. Therefore, in June 2011, the agencies released supplemental guidance to reinforce the risk management framework and update their expectations regarding customer authentication, layered security, and other controls in an increasingly hostile online environment.

The supplemental guidance requires banks to perform periodic risk assessments of their controls,

assessing new and evolving threats to the security of online accounts and taking the necessary steps to strengthen and enhance those controls. OCC examiners will continue to assess the adequacy of banks’ controls, including any remediation plans, as part of their ongoing supervision and the enhanced expectations outlined in the supplementary guidance.<sup>40</sup>

### Enforcing Compliance With Consumer Protection Laws and Regulations

The OCC is dedicated to protecting consumers and enforcing consumer protection laws. Although Dodd–Frank transferred authority to the CFPB for supervising most areas of consumer compliance at banks and federal savings associations with more than \$10 billion in assets, the OCC retains exclusive authority to supervise for compliance with the Bank Secrecy Act, the Community Reinvestment Act, and flood insurance rules, among other regulations. The OCC continues to provide comprehensive compliance supervision at the more than 1,900 community banks and federal savings associations under its jurisdiction.

It is the OCC’s unwavering commitment that all bank customers should be treated fairly, that they have access to credit and other basic banking services, and that the terms and conditions of the products and services provided by national banks and federal savings

associations are communicated to consumers transparently and honestly.

In 2011, the OCC’s examiners, especially compliance specialists, monitored bank products and practices across the industry. When questionable practices at national banks or federal savings associations came to light, bank managers were instructed to correct them. When supervisory intervention proved inadequate, the OCC has not hesitated to take legally binding enforcement action.

In disputes involving consumers and their banks, the OCC’s Customer Assistance Group, which operates under the agency’s independent Office of the Ombudsman, is an important resource. Between 2006 and 2010, the Customer Assistance Group processed nearly 150,000 written complaints and fielded 115,000 telephone inquiries, providing consumers with needed information and assistance in dispute resolution.<sup>41</sup>

The OCC communicates directly with consumers by issuing consumer advisories and public service announcements, which appear in local newspapers and other media. And the agency conducts an extensive bilingual outreach program, using Spanish-language multimedia and print publications to bring vital information to consumers’ attention and help them make wise financial decisions.

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<sup>39</sup> Office of the Comptroller of the Currency, “Agencies Seek Comment on Proposed Rule on Incentive Compensation,” news release 2011-37, March 30, 2011, [www.occ.gov](http://www.occ.gov).

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<sup>40</sup> Office of the Comptroller of the Currency, “Authentication in an Internet Banking Environment,” bulletin 2011-26, June 28, 2011, [www.occ.gov](http://www.occ.gov).

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<sup>41</sup> Office of the Comptroller of the Currency, “Report From the Office of the Ombudsman, 2006–2010 Highlights,” June 2011, [www.occ.gov](http://www.occ.gov).

## Supervisory Guidance on Prepaid Access Programs

Prepaid access devices, which enable consumers to handle their money electronically, are among the fastest growing segments of the payment sector. These devices, which include reloadable cards, payroll cards, government benefit cards, retail gift cards, mobile phones with banking applications, and Web sites, allow consumers to add, store, spend, and withdraw funds from many sources.

Because prepaid access devices provide anonymous access to funds through electronic channels, criminals can take advantage of them to commit fraud and money laundering. Banks, therefore, must manage these products with extreme care.

New supervisory guidance issued by the OCC encourages national banks to develop and implement comprehensive risk management programs to ensure that prepaid access devices are safe from

thieves and terrorists. The guidance cautions banks that entrusting the operation of these devices to unsupervised third parties does not absolve the originating institutions from resulting damages or from responsibility for comprehensive risk management.<sup>42</sup>

## Enforcement Actions

The OCC's actions against national banks and third-party service providers in connection with foreclosure processing deficiencies described on page 8 of this report also benefited consumers. A summary of OCC enforcement actions in 2011 is presented on page 41.

In other instances in which the OCC took action to protect consumers from unfair and abusive banking practices, a substantial civil money penalty was imposed on a national bank relating to the marketing and sale of a credit protection product by its auto finance subsidiary. The OCC found that this practice involved materially false, deceptive, or otherwise

misleading practices in violation of the Federal Trade Commission Act.<sup>43</sup>

Another case involved a national bank whose new customers were automatically enrolled in its overdraft program 30 days after opening their accounts. Any time an account was overdrawn, a fee was imposed. If the account stayed overdrawn for more than seven days, there was an additional fee. The OCC found that these terms, which made it impossible for some customers to escape from their overdrawn status, were not properly advertised in the bank's brochures.<sup>44</sup>

The OCC imposed a consent order that levied a \$1 million civil penalty against the bank and required it to establish a fund of at least \$32 million to reimburse consumers who were harmed by practices deemed unfair and deceptive. The OCC also ordered the bank to improve its corporate governance and revamp its overdraft program to ensure that such abuses did not occur again.<sup>45</sup>

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<sup>42</sup> Office of the Comptroller of the Currency, "OCC Issues Guidance on Prepaid Access," news release 2011-83, June 29, 2011, [www.occ.gov](http://www.occ.gov); Office of the Comptroller of the Currency, "Prepaid Access Programs: Risk Management Guidance and Sound Practices," bulletin 2011-27, June 28, 2011, [www.occ.gov](http://www.occ.gov).

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<sup>43</sup> Office of the Comptroller of the Currency, "OCC Assesses Civil Money Penalty Against JPMorgan Chase Bank, N.A.," news release 2011-70, June 15, 2011, [www.occ.gov](http://www.occ.gov).

<sup>44</sup> Office of the Comptroller of the Currency, "In the Matter of Woodforest National Bank: Consent Order for a Civil Money Penalty," October 8, 2010, [www.occ.gov](http://www.occ.gov).

<sup>45</sup> Office of the Comptroller of the Currency, "Agreement by and Between Woodforest National Bank, The Woodlands, Texas, and The Comptroller of the Currency," October 8, 2010, [www.occ.gov](http://www.occ.gov).