



Audit Report



OIG-13-037

SAFETY AND SOUNDNESS: OCC Identification of Emerging Risks

April 9, 2013

Office of
Inspector General

DEPARTMENT OF THE TREASURY

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Abbreviations

BIT	bank information technology
CRE	commercial real estate
DRC	district risk committee
EIC	examiner-in-charge
GBFA	global banking and financial analysis
MBRC	midsize banking risk committee
NRC	national risk committee
OCC	Office of the Comptroller of the Currency
SM	Supervisory Memorandum

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*The Department of the Treasury
Office of Inspector General*

April 9, 2013

Thomas J. Curry
Comptroller of the Currency

This report presents the results of our audit of the Office of the Comptroller of the Currency's (OCC) processes to identify emerging risks to financial institutions' safety and soundness. We included this audit in the *Office of Inspector General Fiscal Year 2011 Annual Plan* based on the results of our material loss reviews of failed institutions where we found that OCC did not always identify and address risks to financial institutions in a timely manner.¹ Additionally, we had not previously reviewed this area of OCC's operation.

Our audit objective was to determine how OCC processes identify emerging risks to financial institutions' safety and soundness and then translate the risks identified into action. We interviewed OCC personnel involved in identifying emerging risks and reviewed relevant OCC documentation. We conducted our audit fieldwork from October 2010 through May 2012. Appendix 1 contains a more detailed description of our objectives, scope, and methodology.

In brief, we found that OCC had processes to identify emerging safety and soundness risks to financial institutions and took actions to address those risks. However, the processes and actions did not

¹ Section 38(k) of the Federal Deposit Insurance Act requires that our office perform a material loss review of a failed institution supervised by OCC whenever the loss to Deposit Insurance Fund is material. The objectives of a material loss review are to determine the causes of the failure; assess the supervision of the institution, including the implementation of the prompt corrective action provisions of section 38; and make recommendations for preventing such a loss in the future. Effective July 21, 2010, section 38(k) defines a loss as material if it exceeds \$200 million for calendar years 2010 and 2011, \$150 million for calendar years 2012 and 2013, and \$50 million for calendar years 2014 and thereafter (with a provision that the threshold can be raised temporarily to \$75 million if certain conditions are met).

prevent the failures of 75 OCC-regulated banks from 2008 through May 2012.² Many of the banks that failed during this timeframe were susceptible to the same risks that gave rise to the bank failures of the 1980's and 1990's, namely weaknesses with bank board of directors or management and high concentrations in commercial real estate (CRE) loans. We noted that OCC issued guidance in September 2011 incorporating lessons learned from the recent failures, including the need to assign adverse ratings related to bank management for poor or missing risk management practices before problems affect a bank's financial condition. With respect to current risks, while concentrations remain a concern, OCC identified reliance on fees and exotic instruments³ as the greatest risk to banks' safety and soundness.⁴ We are recommending that OCC (1) periodically assess the effectiveness of the September 2011 supervisory guidance (Supervisory Memorandum (SM) 2011-5) and (2) ensure that banks and examiners are responding appropriately to identified risks.

Management Response In a written response, which is included as appendix 2, OCC agreed with our recommendations. OCC stated it will periodically assess the effectiveness of the SM 2011-5 guidance and will add explicit statements to its quality assurance conclusion memos that specifically address whether examination staff are adhering to the guidance provided in SM 2011-5. Additionally, OCC stated that it will ensure that identified risks continue to be addressed in the individual supervisory strategy for each institution through its quality control and quality assurance processes.

In its response, OCC also commented that its goal in supervising national banks and federal savings associations is to ensure they operate in a safe, sound, and compliant manner. This goal, however, is not synonymous with a goal of preventing all bank failures. While examiners work diligently to identify potential

² As of May 2012, OCC supervised approximately 2,000 national banks and federal savings associations.

³ Exotic instruments can include nontraditional mortgage loans; hedging products such as prepayment swaps and cash-flow swaps; and complex, unusual and specific derivative contracts that depend on the value of some underlying asset or defined set of assets.

⁴ According to OCC, after we completed our fieldwork, strategic risks associated with banks' entry into new business products generally posed the greatest risk to banks' safety and soundness.

problems at an early stage so that bank management can take corrective actions, there will always be cases where a bank's strategic and management choices are such that rehabilitation of the bank is not possible. In those situations, OCC's goal is to effect early and least cost resolution of the institution in an orderly manner that minimizes the impact on depositors and customers.

OIG Comment We consider the actions committed to by OCC as responsive to our recommendations. We do recognize that it is not possible to prevent all bank failures. As discussed in our report, the number and quick succession of failures during the recent economic crisis was alarming, especially in light of the fact that OCC had previously identified and dealt with the very same problematic risks and ramifications. A recurring theme in our reviews of bank failures during the crisis was that OCC should have acted sooner to prevent some of the unsafe and unsound management and high concentration practices.

Background

OCC's primary mission is to charter, regulate, and supervise national banks and federal savings associations. It also supervises the federal branches and agencies of foreign banks. OCC's stated goal in supervising banks and federal savings associations is to ensure that they operate in a safe and sound manner and in compliance with laws requiring fair treatment of their customers and fair access to credit and financial products. To accomplish its mission, one of OCC's strategic objectives is to identify emerging risk areas, including those related to operational and technology related vulnerabilities, and adjust supervisory strategies and activities as appropriate.

OCC supervises about 1,400 insured national banks, and in July 2011, pursuant to P.L. 111-203, it assumed regulatory responsibilities for about 640 federal savings associations that had been supervised by the former Office of Thrift Supervision (OTS).

A bank's board of directors and management are responsible for establishing and maintaining effective internal control that meets statutory and regulatory requirements. During an

examination, OCC evaluates a bank's loan policies and risk management systems as part of its overall assessment of the bank's internal control.⁵ If OCC determines that a bank's internal control needs improvement, it may address the weakness with a matter requiring attention (MRA) and/or by downgrading a component or components of the CAMELS rating.⁶ An MRA identifies a bank practice noted during an examination that deviates from sound governance, internal control, and risk management principles, which may adversely affect the bank's earnings or capital, risk profile, or reputation if not addressed. It may also result when the examiner identifies substantive noncompliance with laws and regulations, internal policies or processes, OCC supervisory guidance, or conditions imposed in writing in connection with the approval of any application or other request by a bank.

Results of Audit

OCC Had Processes to Identify Emerging Risks to Financial Institutions' Safety and Soundness

OCC's processes to identify emerging risks included multiple internal committees and other working groups that met regularly to discuss risks to banks' safety and soundness. To address these risks, OCC adjusted supervisory strategies as needed and communicated risk information to OCC examiners and banks.

National Risk Committee (NRC) NRC met quarterly to discuss current and emerging risk issues, coordinated with other supervisory and policy risk groups, and made recommendations for appropriate supervisory responses to risks it identified. NRC members included OCC deputy comptrollers, assistant deputy

⁵ Internal control is the systems, policies, procedures, and processes affected by the board of directors, management, and other personnel to safeguard bank assets, limit or control risks, and achieve a bank's objectives.

⁶ Federal banking agencies use the Uniform Financial Institutions Rating System, or "CAMELS," to assign composite and component ratings to financial institutions. An institution's composite CAMELS rating integrates the ratings from six component areas—capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk. The ratings range from 1 to 5 with 1 being the highest rating and least supervisory concern.

comptrollers, district risk committee chairs, and OCC counsel. NRC prepared quarterly reports called risk radar screens that ranked risks to the national banking system according to level of severity. The radar screen risk categories included credit, operational, reputation, strategic, interest rate, and liquidity. In response to risks it identified, NRC provided additional general guidance to OCC examiners through periodic supervisory communications that highlighted emerging risks, summarized the current business environment, and provided supervision tips on examination issues. For example, a 2006 message highlighted CRE as a significant concentration for community and midsize banks and stressed the need for examiners to do cash flow testing. Another example was a supervision tip issued in 2009 that advised bank examiners on when it was permissible for banks to incur additional expenses on other real estate owned.⁷

Since OCC is now responsible for supervising federal savings associations, OCC officials told us the NRC planned to examine the differences between the risk profiles of federal savings associations relative to community banks, risk management capabilities of federal savings associations, as well as any differences in risk oversight practices between OCC and the former OTS.

Additionally, OCC officials told us that in November 2011, OCC distributed its first *Semiannual Risk Perspective Report* to examiners and, on a more limited basis, to bankers. The report included the NRC's views of existing or emerging threats to the banking system along with supporting data and analysis. According to OCC, the report was designed to foster dialog within the industry and between bankers and examiners on emerging risks. In July 2012, OCC published its Spring 2012 *Semiannual Risk Perspective Report* and made it available to the public on its website.

District Risk Committees (DRC) and Midsize Banking Risk Committee (MBRC) served as communication links to NRC. There were four DRCs – central, northeastern, southern, and western –

⁷ Other real estate owned are real properties that an insured depository institution acquired that do not constitute its facilities. Such properties include real estate acquired in full or partial satisfaction of a debt previously contracted (e.g., through foreclosure on a mortgage) and are subject to specific holding periods, disposition requirements, and appraisal requirements.

representing each of the OCC district offices. DRC members typically included a combination of district associate- and assistant-deputy comptrollers, senior thrift advisors, analysts, field examiners, and lead experts in commercial credit, asset management, retail credit, compliance, bank information technology (BIT), and capital markets. MBRC addressed risks that were specific to midsize banks.⁸ MBRC members included the associate- and assistant deputy comptrollers for midsize banks and lead experts in the areas of commercial credit, asset management, retail credit, compliance, BIT, capital markets and enterprise governance/operational risk.

The DRCs met on a quarterly basis and issued radar screens to inform district management of existing and potential risks, as well as to propose action to NRC for addressing those risks. Although the DRCs did not issue official OCC examiner guidance, the committees communicated to examiners how to address risks through the issuance of job aids and emerging risk alerts. For example, in May 2009, the southern DRC issued an emerging risk alert titled Property Tax Loans to examiners highlighting the risks associated with bank loans for property taxes owed.⁹ The DRCs also alerted banks to existing and potential risks in the banking industry. For example, in December 2010, the western DRC sent a letter to banks with concentrations in agriculture loans stating that agricultural-related lending posed a significant systemic risk in the district. The letter reminded those banks, among other things, that they needed to have board-approved policies specific to agricultural lending that established risk tolerances and limits in detail and underwriting guidance by product type. Similarly, MBRC provided supervisory risk radar screens for midsize banks and periodically conducted roundtables with midsize bankers regarding risk areas. For example, in October 2010, the MRBC conducted a 2-day roundtable on retail credit.

Other Committees OCC had three additional committees that met to discuss existing and emerging risks: the National Commercial

⁸ Midsize banks generally include companies with national bank assets totaling between \$10 billion and \$50 billion, either in a single charter or aggregated among several charters.

⁹ According to the risk alert, property tax loans have a high level of credit risk. These loans are made to borrowers to address tax liens that resulted from nonpayment of taxes.

Credit Committee, the National Retail Credit Committee, and the Committee on Consumer Issues. These committees met quarterly to discuss existing and emerging trends in the credit and consumer protection areas within the national banking system and advised the NRC on related risks and trends.

Large Bank (LB) Network Groups Established to identify and communicate emerging risks and provide supervisory strategy guidance to examiners in OCC's Large Bank Supervision program,¹⁰ there were eight LB network groups: commercial credit, retail credit, mortgage banking, capital markets, BIT, compliance, asset management, and operational risk. Membership in the network groups was open to all large bank supervision examiners; an examiner-in-charge from the OCC's Large Bank program sponsored each group. The network groups issued annual supervisory strategy guidance that alerted examiners to systemic and emerging risks and recommended supervisory strategies to address those risks. For example, the commercial credit network group issued supervisory strategy guidance that outlined risk issues examiners should consider during large bank examinations in fiscal year 2011, including high-risk income-producing CRE lending, credit underwriting, and allowance for credit losses. The guidance the network groups provided might outline a series of emerging risks that would be relevant for all large bank teams or it might only be relevant to a segment of the large bank population.

Global Banking and Financial Analysis (GBFA) Group Comprised of OCC economists, the GBFA group performed various types of analysis, such as modeling and stress testing using historical bank data, and presented its findings to NRC. One example of a GBFA group report was the annual Global Outlook, which identified what it believed were the most important domestic and international economic and financial risks, and provided estimates of the potential consequences to national banks under scenarios that reflected those risks. In addition, in June 2006, GBFA gave a presentation to NRC titled "Condition of the Banking Industry" that described the rapid increase in CRE loan concentrations in community and midsize banks during the first quarter of 2006. The

¹⁰ Large banks include the largest national banking companies, with assets of more than \$50 billion, which generally are involved in the most complex activities and operate over wide geographic areas.

presentation pointed out that heavy reliance on CRE in the past resulted in serious problems, such as in the northeast in the early 1990s.

Interagency Collaboration OCC officials told us that the risk committees and groups described above collaborated with other regulatory agencies such as the Board of Governors of the Federal Reserve System (FRB) and Federal Deposit Insurance Corporation (FDIC) to identify emerging risks to national banks. Additionally, pursuant to P.L. 111-203, the Financial Stability Oversight Council (FSOC) was created to share collective accountability for identifying risks and responding to emerging threats to financial stability. The Comptroller of the Currency is a voting member of FSOC and senior OCC staff are involved in FSOC's Systemic Risk and other operating committees.

OCC's Processes and Actions Did Not Prevent Bank Failures

As stated above, OCC's goal in supervising banks and federal savings associations is to ensure that they operate in a safe and sound manner. OCC-regulated banks that failed from 2008 through May 2012 were determined to be transacting business in an unsafe or unsound condition, and thus OCC recommended they be closed and FDIC be appointed receiver.

Although OCC had a number of established committees and working groups set up to identify and respond to emerging risks to financial institutions, OCC's processes and actions did not prevent the failure of 75 OCC-supervised institutions. Additionally, many of the banks that failed during the period we reviewed were adversely affected by the same risks OCC identified as causes of the many bank failures that occurred during the 1980s and 1990s: management-related weaknesses such as inadequate policies and risk management systems, and excessive concentrations in CRE loans.

Regarding the bank failures in the 1980's, a June 1988 OCC study *Bank Failure – An Evaluation of the Factors Contributing to the Failure of National Banks* found that the primary causes of failures

during that period were (1) inadequate loan policies, problem loan identification systems, and systems to ensure compliance with internal policies and banking law; (2) bank directors' or management's overly aggressive behavior resulting in imprudent lending practices, such as unwarranted concentrations of credit to one industry and excessive loan growth; and (3) insider abuse and fraud involving directors, senior management, or principal shareholders. Additionally, OCC's *Quarterly Journal* published in June 1999 stated that the primary cause of bank failures in the late 1980's and early 1990's was excessive concentrations of real estate loans, and that this was a lesson that bankers and regulators were determined not to forget.¹¹

Over the years, OCC has issued guidance to banks and examiners on asset concentration risk.¹² As early as 1990, OCC's examination handbook emphasized the need to maintain a high-level of supervision over credit concentrations. OCC Bulletin 1995-7, *Identifying Credit Concentrations*, stated that banks with significant exposure to risks of concentrations of credit or those not adequately managing concentration risks require capital in excess of regulatory minimums. Interagency guidance on CRE concentration risk management issued in 2006 included risk management practices that a bank should employ when it has CRE concentrations and stated that banks may be identified for further supervisory analysis if total CRE lending is above 300 percent of risk-based capital.¹³

From January 2008 through May 2012, 75 OCC-regulated banks failed. This number represents 68 national banks and 7 federal

¹¹ The last issue published March 2007, the *Quarterly Journal* served as a record for significant actions and policies of the OCC.

¹² OCC defines a concentration asset as a type of asset that represents 25 percent or more of a bank's risk-based capital.

¹³ In December 2006, OCC, FRB, and FDIC jointly published *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (Guidance). The Guidance reminded institutions that strong risk management practices and appropriate levels of capital are important elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans. The Guidance did not establish specific CRE lending limits; rather, it promoted sound risk management practices and appropriate levels of capital to enable institutions to continue to pursue CRE lending in a safe and sound manner. The sophistication of an institution's CRE risk management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the institution.

savings associations supervised by the former OTS until July 2011. As of May 2012, we completed reviews of 60 of these failed banks (57 national banks and 3 federal savings associations). We concluded that 57 of the 60 banks (54 national banks and 3 federal savings associations) failed due to real estate loan concentrations, board of directors or management weaknesses, or both.¹⁴ Examples of these board and management weaknesses included inadequate controls over loan administration and overly aggressive growth strategies. In September 2011, we issued a joint report with FDIC and FRB Offices of Inspector General that evaluated regulators' use of Prompt Regulatory Action during the recent financial crisis. That report also discussed the similarities between the bank failures from 2008 to 2011 and those that failed in the 1980's and 1990's.^{15,16}

As noted above, OCC identified the same risks to banks as a result of the bank failures from the 1980s and 1990s, and its examination handbook provided guidance for addressing them. Furthermore, as discussed above, the GBFA group notified NRC in June 2006 that concentrations in CRE were increasing and that similar conditions caused serious problems for CRE-focused banks in the early 1990s. OCC officials stated that the agency's goals are (1) to identify a bank's problems early when there may still be time to rehabilitate the bank and (2) when that is not possible, to seek early/orderly resolution through a sale/merger or other actions to minimize losses to the FDIC's Deposit Insurance Fund and disruption to customers, communities, and the larger financial sector.

While it is not possible to prevent all failures, the number and quick succession of failures during the recent economic crisis was alarming, especially in light of the fact that OCC had previously

¹⁴ Our reviews for eight banks that failed between February 2012 and May 2012 had not been completed as of May 2012, and seven bank failures did not require a review by our office.

¹⁵ *Evaluation of Prompt Regulatory Action Implementation* (OIG-CA-11-008), September 30, 2011.

¹⁶ The report noted that the aggregate estimated losses to the Deposit Insurance Fund during the period 2008 to 2011 for failed banks supervised by the four federal banking agencies was \$82.4 billion or 28.8 percent of bank assets, as of May 2011. The individual estimated losses and loss rates were for OCC, \$9.5 billion and 22.2 percent, respectively; for OTS, \$28.2 billion and 27.5 percent, respectively; for FDIC, \$38.9 billion and 31.0 percent, respectively; and for FRB, \$5.8 billion and 28.9 percent, respectively.

identified and dealt with the very same problematic risks and ramifications. Although OCC's examination handbook provided guidance on how to address these risks, a recurring theme in our reviews of bank failures during the crisis was that OCC should have acted sooner to prevent some of the unsafe and unsound management and high concentration practices.

According to OCC, it did take steps to address increasing CRE concentrations in community and midsize banks. These actions included (1) a series of targeted examinations at banks that were at significant risk due to the nature and scope of their CRE activities, (2) the development of tools that bankers could use to stress test certain types of acquisition and development CRE transactions, and (3) additional supervisory guidance and nationwide teleconferences on CRE lending issues.

In September 2011, OCC issued a supervisory memorandum to examiners, drawing upon lessons learned from the recent financial crisis. SM 2011-5, Examiner Guidance on Using the Risk Assessment System (RAS) was intended to enhance examiners' use and communication of the RAS. The RAS is a tool used by examiners to identify, communicate, and affect appropriate responses to the buildup of risks or deficiencies in risk management systems at OCC-supervised institutions. Regarding follow through on corrective actions related to risk management systems, the memorandum notes that too often, the CAMELS management component rating reflected banks' management and board of directors' cooperation and commitment to correct deficiencies without demonstrated performance. The memorandum goes on to state that the management component rating should focus on actions and results, rather than commitments. Finally, the memorandum states that assigning an adverse rating to the management component based on poor or missing practices, *before* problems are evident in a bank's financial condition, is one of the tenets of sound and forward-looking supervision and an important lesson learned from the recent financial crisis. We believe the guidance in September 2011 is on target with respect to its renewed emphasis on the management component being a leading indicator. That said, it is too soon to tell how effective the guidance and its implementation will impact banks' risk management practices going forward.

Current Risks to Financial Institutions' Safety and Soundness Identified by OCC

According to NRC's April 2012 risk radar screen, the greatest risk to banks' safety and soundness was their reliance on fees and exotic instruments,¹⁷ which OCC categorized as a strategic risk as low interest rates and a weak credit demand environment have decreased net interest margins.¹⁸ To address this risk, during its examinations, OCC plans to evaluate reliance on fee income as part of the concentration of risk assessment, and OCC is encouraging banks with revenue concentrations to consider diversification options. OCC also plans to evaluate bank strategic plans for changing business models and introduction of significant new products and services. Furthermore, OCC plans to assess investment portfolio activity.

Another significant risk noted on the April 2012 radar screen was the fallout from weak mortgage underwriting from 2004 to 2006. That is, the massive volumes of loan foreclosures, modifications, and loss rates have caused operational issues in mortgage servicers processing these loans, as well as an increase in credit costs. To address this risk, and as a result of findings from a horizontal review of major residential mortgage servicers, OCC issued consent orders to the 14 largest mortgage servicers in April 2011. The consent orders required the banks to, among other things; create compliance programs to ensure that mortgage servicing and foreclosure operations comply with all applicable legal requirements and OCC supervisory guidance. OCC was monitoring compliance with the consent orders and planned to test certain order requirements during 2012 and 2013. As separate audits, we are reviewing OCC's monitoring of the consent orders and amended consent orders.¹⁹

¹⁷ It should be noted that OCC identified the risk of exotic instruments before the May 2012 disclosure by JPMorgan Chase of its losses associated with certain hedging activities. We initiated an audit of OCC's supervision of national bank trading activities with a focus initially on its supervision of JPMorgan Chase.

¹⁸ According to OCC, after we completed our fieldwork, strategic risks associated with banks' entry into new business products generally posed the greatest risk to banks' safety and soundness.

¹⁹ In January 2013, OCC negotiated a change to the terms of the April 2011 consent orders with 10 of the 12 servicers under OCC supervision. OCC issued amended consent orders for these servicers in February 2013.

Losses associated with CRE lending continued to be on NRC's supervisory risk radar screen as of April 2012 although the risk was assessed at a lower level than it had been. To address the continued risk, OCC updated its handbook on concentrations of credit as of December 2011. Also, in July 2012, OCC issued interagency supervisory guidance on stress testing for banks with more than \$10 billion in total consolidated assets. The guidance, which became effective in July 2012, highlights the importance of stress testing as an ongoing risk management practice that supports a bank's forward-looking assessment of its risks. Finally, in October 2012, OCC developed a portfolio level stress-testing tool for income producing CRE and guidance on stress testing for examiners and community bankers.

Recommendations

We recommend that the Comptroller of the Currency:

1. Periodically assess the effectiveness of the September 2011 guidance to ensure, among other things, examination staff are assigning CAMELS management component ratings based on actions and results, rather than commitments, and that adverse ratings are appropriately assigned for poor or missing practices identified in examinations.

Management Response

OCC agreed and will periodically assess the effectiveness of the SM 2011-5 guidance to ensure, among other things, examination staff are assigning CAMELS management component ratings based on actions and results, rather than commitments, and that adverse ratings are appropriately assigned for poor or missing practices identified in examinations.

OCC will also add explicit statements to its quality assurance conclusion memos that specifically address whether examination staff are adhering to the guidance provided in SM 2011-5, and are assigning CAMELS management component ratings based on actions and results, rather than

commitments, and whether adverse ratings are appropriately assigned for poor or missing practices identified in examinations. Currently these steps are taken, however not explicitly stated in their conclusion memos. In addition, OCC will continue to discuss key messages from SM 2011-5 and the Midsize and Community Bank Supervision (MCBS) MRA Reference Guide with staff.

OIG Comment

OCC's corrective actions are responsive to our recommendation.

2. Ensure that banks and examiners are responding appropriately to risks identified including, but not limited to over-reliance on fees and exotic instruments, as well as risks that are identified in the future.

Management Response

OCC agreed with this recommendation and will ensure that identified risks continue to be addressed in the individual supervisory strategy for each institution through their quality control and quality assurance processes. OCC will continue to refine its ability to use data obtained from the Consolidated Reports of Condition and Income²⁰ to ensure risks such as over-reliance on fee income are being identified and are receiving appropriate supervisory attention.

OIG Comment

OCC's corrective actions are responsive to our recommendation.

²⁰ Auditor note: A quarterly report of income and financial condition that banks file with their regulatory agency. The contents of this report include consolidated detailed financial information on assets, liabilities, capital, and loans to executive officers, as well as income, expenses, and changes in capital accounts.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the audit. If you wish to discuss the report, you may contact me at (202) 927-0384 or Theresa Cameron, Audit Manager, at (202) 927-1011. Major contributors to this report are listed in appendix 3.

Jeffrey Dye /s/
Director, Banking Audits

Our objective was to determine the Office of the Comptroller of the Currency's (OCC) processes in place to identify emerging risks to financial institutions' safety and soundness and translate the risks identified into action.

To accomplish these objectives, we performed the following activities.

- Interviewed OCC officials and personnel working on committees or other groups whose goal is to identify emerging risks.
- Collected and reviewed OCC documents produced by these committees or groups, such as risk radar screens, supervisory strategy guidance documents, OCC bulletins, and the results of OCC studies.
- Analyzed causes of failure of OCC regulated institutions from 2008 to May 2012, and compared to causes identified by OCC of bank failures during the 1980's and 1990's.

We performed our audit fieldwork from October 2010 through May 2012.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.



MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Jeffrey Dye, Director of Banking Audits

From: Thomas J. Curry, Comptroller of the Currency

Date: March 20, 2013

A handwritten signature in black ink, appearing to read 'Tom Curry', written over the 'From' line.

Subject: Response to Draft Report – OCC Identification of Emerging Risks

We have received and reviewed your draft report concerning the Office of the Comptroller of the Currency's (OCC) processes to identify emerging risks to financial institutions' safety and soundness. You also sought to determine how the OCC translates the risks identified into action.

You concluded that OCC had processes to identify emerging safety and soundness risks to financial institutions and took actions to address those risks. You also concluded that OCC's processes and actions did not prevent bank failures.

As your report states, the OCC's goal in supervising national banks and federal savings associations is to ensure that they operate in a safe and sound manner and in compliance with applicable laws and regulations. This is not, however, synonymous with a goal of preventing all bank failures. While our examiners work diligently to identify potential problems at an early stage so that bank management can take corrective actions, there will always be cases where a bank's strategic and management choices are such that rehabilitation of the bank is not possible. In those situations our goal is to effect early and least cost resolution of the institution in an orderly manner that minimizes the impact on depositors and customers.

We continuously look for ways to improve the effectiveness of our supervision and as your report discusses, we have taken a number of steps to better identify and respond to the buildup of risks within individual institutions and across the banking system. Your report includes two recommendations that we agree to implement to strengthen these actions.

First, you recommend that OCC periodically assess the effectiveness of the September 2011 guidance Supervisory Memo 2011-5 to ensure, among other things, examination staff are assigning CAMELS management component ratings based on actions and results, rather than commitments, and that adverse ratings are appropriately assigned for poor or missing practices identified in examinations.

We agree and will periodically assess the effectiveness of the SM 2011-5 guidance to ensure, among other things, examination staff are assigning CAMELS management component ratings

Appendix 2
Management Comments

based on actions and results, rather than commitments, and that adverse ratings are appropriately assigned for poor or missing practices identified in examinations.

We will also add explicit statements to our quality assurance conclusion memos that specifically address whether examination staff are adhering to the guidance provided in SM 2011-5, Examiner Guidance on Using the Risk Assessment System (RAS), and are assigning CAMELS management component ratings based on actions and results, rather than commitments, and whether adverse ratings are appropriately assigned for poor or missing practices identified in examinations. Currently these steps are taken, however not explicitly stated in our conclusion memos. In addition, we will continue to discuss key messages from SM 2011-5 and the MCBS MRA Reference Guide with staff.

Second, you recommend that OCC ensure that banks and examiners are responding appropriately to risks identified including, but not limited to, over-reliance on fees and exotic instruments, as well as risks that are identified in the future.

We also agree with this recommendation and will ensure that identified risks continue to be addressed in the individual supervisory strategy for each institution through our quality control and quality assurance processes. We will continue to refine our ability to use data obtained from the Consolidated Reports of Condition and Income to ensure risks such as over-reliance on fee income are being identified and are receiving appropriate supervisory attention.

Thank you for the opportunity to review and comment on your draft report. If you have questions or need additional information, please contact Jennifer Kelly, Senior Deputy Comptroller for Midsize and Community Bank Supervision, at 202-649-5420.

Appendix 3
Major Contributors to This Report

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