

# **Semiannual Risk Perspective**

From the National Risk Committee

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

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

The OCC's National Risk Committee (NRC) monitors the condition of the federal banking system. The NRC also monitors emerging threats to the system's safety and soundness and ability to provide fair access and to treat customers fairly. NRC members include senior agency officials who supervise banks of all sizes, as well as officials from the law, policy, accounting, and economics departments. The NRC meets quarterly and issues guidance to examiners that provides perspective on industry trends and highlights issues requiring attention.

The OCC's *Semiannual Risk Perspective* addresses key issues facing banks, focusing on those that pose threats to the safety and soundness of banks and their compliance with applicable laws and regulations. This report presents data in four main areas: the operating environment, bank performance, trends in key risks, and supervisory actions.

The OCC publishes the report twice a year, drawing on midyear and year-end data. The fall 2017 report reflects bank financial data as of June 30, 2017.

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

## **Executive Summary**

The financial performance of the federal banking system improved for the first six months of 2017 compared with the same period in 2016. Capital and liquidity are near historic highs and have improved dramatically since the crisis. The federal banking system return on equity (ROE) improved to 10 percent through the second quarter of 2017, up from 9.6 percent a year earlier. Similarly, net income increased 11.6 percent, boosted by growth in net interest income and lower provision expense. Net interest income grew 8.9 percent in the first half of 2017 compared with a year earlier, as net interest margins expanded at both large and small banks. The earnings performance at the smallest banks, those with total assets of \$100 million or less, lagged behind other banks. Loan growth slowed for the federal banking system in the first half of 2017 but remained stable for banks with total assets less than \$1 billion.

This report highlights key risks facing the federal banking system that the NRC monitors closely. While the banking sector remains relatively stable, many of the key risks are consistent with the spring 2017 *Semiannual Risk Perspective*. The current operating environment presents strategic risk for many banks in increasingly diverse ways. Thus, this report emphasizes the need for vigilance by bank management at this point in the economic cycle. Banks continue to face competitive pressure to increase lending, enhance efficiencies, innovate products and services, embrace new technologies, or merge with another institution. Key risks raise concerns about credit, operational, and compliance risks and include

- incremental easing in commercial credit underwriting practices.
- increasing complexity of cybersecurity threats.
- increasing concentrations in third-party service providers for some critical operations.
- ongoing challenges in complying with Bank Secrecy Act (BSA) requirements.
- challenges in consumer compliance risk management for banks due to the increasing complexity in consumer compliance regulations.

The NRC monitors other risks that have the potential to develop into system-wide issues and that warrant awareness among bankers and examiners. These risks include

- weaknesses in the governance of product sales, delivery, and service result in elevated levels of operational risk for some banks.
- increasing concentrations of commercial real estate (CRE) loans highlight the need for sound risk management processes and the effectiveness in managing concentration risk for some banks.
- potential for renewed declines in prices for grain crops, livestock, and dairy may compound three years of declining prices and increasing debt for agriculture borrowers and their ability to service debt.
- new requirements under the amended regulation implementing the Military Lending Act (MLA) and pending changes to the data collection and processing rules for the Home Mortgage Disclosure Act (HMDA) may result in further challenges to compliance change management processes.
- the current expected credit losses standard for which implementation begins in 2020 may pose operational and strategic risk to some banks when measuring and assessing the collectability of financial assets.

Changes since the spring 2017 *Semiannual Risk Perspective* include characterization of CRE concentrations; governance of sales, delivery, and service; and compliance with the MLA from key risks to issues warranting monitoring. Because strategic risk is multifaceted and comprises several risk

areas, and thus is better assessed in those areas, strategic risk is no longer reflected as a stand-alone issue in the *Semiannual Risk Perspective*.

### ***Key Risk Themes***

**Asset quality remains strong, and overall underwriting is acceptable. Nonetheless, the credit environment continues to be influenced by strong competition, tighter spreads, and slowing loan growth. These factors are driving incremental easing in underwriting practices and increasing concentrations in select loan portfolios—leading to heightened risk if the economy weakens or markets tighten quickly.**

- The credit market continues to be influenced by strong competition, particularly from non-bank lenders, and heightened asset valuations. In addition, the long economic recovery and expansion may collectively increase lender complacency. In this environment, lenders need to focus on maintaining sound credit standards within risk tolerances and understanding the potential credit risks that may be exposed under less benign economic conditions.
- The vast majority of banks continue to maintain satisfactory underwriting policies and practices, and operate within bank-approved risk tolerances. The volume of loans with eased terms or structures continues to increase, however, principally to meet competition and maintain customers. Weaker underwriting heightens the risk of credit quality problems when conditions deteriorate.
- Traditional commercial credit quality metrics, such as delinquencies, nonperforming loans, and net charge-offs, reflected improvement in the first half of 2017. These metrics remain better than historical averages and are at levels near or better than any quarter since the 1980s.
- Retail loan delinquencies remain relatively low but have increased off of record low levels, particularly for auto loan and credit card exposures.
- After expanding 25 percent from 2014–2016, commercial loan growth moderated in the first half of 2017 but remains above gross domestic product (GDP) growth. CRE lending and loans to a broad array of nondepository financial institutions (e.g., investment firms, mortgage companies, and finance companies) have been key drivers of the growth.
- Overall delinquencies for agricultural loans remain low but are increasing. Farm cash income is projected to increase modestly in 2017 after declining for the last three years because of lower agricultural commodity prices. Renewed declines in farm cash income could result in credit quality deterioration for banks with significant concentrations in agricultural lending.
- Increased credit risk, whether incurred through loan growth and weaker underwriting terms, or increased concentrations, needs to be thoroughly assessed and qualitatively incorporated into capital or allowance for loan and lease losses analyses, as appropriate.

***Operational risk remains elevated as banks adapt business models, transform technology and operating processes, and respond to increasing cybersecurity threats.***

- The speed and sophistication of cybersecurity threats are increasing. Banks continually face threats seeking to exploit bank personnel, processes, and technology. These threats target large quantities of personally identifiable information and proprietary intellectual property and facilitate fraud and misappropriation of funds at the retail and wholesale levels.
- Phishing is a primary method for breaching data systems and often leads to other malicious activity, such as installing ransomware, compromising internal systems to effect payments, or conducting espionage. Effective user awareness campaigns and training help prevent phishing attacks. Timely and thorough software patch and system update management, strong risk-based authentication, employee training, and effective network segmentation can prevent further damage if intrusions succeed.

- The number, nature, and complexity of third-party relationships continue to expand, increasing risk management challenges for banks. Financial technology companies providing innovative financial products and services introduce opportunities, as well as potential risk, for banks.
- Consolidation among larger service providers has increased third-party concentration risk, in which a limited number of providers service large segments of the banking industry for certain products and services. Operational events at these larger service providers can potentially affect wide segments of the financial industry.
- The volume of products and services and the complexity of end-to-end processes for delivery in larger, complex banks are key drivers influencing the current level of operational risk. Insufficient monitoring and limited internal testing have failed to detect product and service delivery disruptions, resulting in slowed responses by banks and prolonged impact to customers. This condition is especially true of banks with legacy or disparate management information systems and risk management programs that may be ineffective.

***Compliance risk remains elevated as banks continue to manage money laundering risks in an increasingly complex risk environment. Implementing changes to policies and procedures to comply with amended consumer protection requirements tests bank compliance risk and change management processes.***

- The challenge for banks to comply with BSA requirements persists due to dynamism of money laundering and terrorism-financing methods. Also, bank offerings using new or evolving delivery channels may increase customer convenience and access to financial products and services, but banks need to maintain a focus on refining or updating BSA compliance programs to address any vulnerabilities created by these new offerings, which criminals can exploit.
- In addition, BSA and anti-money laundering (AML) compliance risk management systems may not keep pace with evolving risks, constraints on resources, changes in business models, and an increasingly complex risk environment.
- New and amended regulations strain bank change management processes and compliance management systems, which increases operational, compliance, and reputation risks. These changes include the integrated mortgage disclosures under the Truth in Lending Act (TILA) and the Real Estate Settlement Procedures Act (RESPA), as well as the new requirements under the amended regulations implementing the HMDA and the MLA.
- Many banks face difficulties validating processes and systems that rely on software, automated tools, disclosure forms, and third-party relationships to process loan applications, create and distribute disclosures, and underwrite and close loans. Sound risk management practices should include maintaining processes and systems that are sufficient to identify covered borrowers and loan products, producing accurate calculations and required disclosures, and incorporating other required protections.
- Some banks have difficulty fully and accurately implementing the significant system and operational changes necessary for the integrated mortgage disclosure forms—Loan Estimate and Closing Disclosure—required for most mortgage loans secured by real property since October 3, 2015. Banks need consumer compliance risk management and audit functions sufficient to promote ongoing compliance with the regulation.

## **Part I: Operating Environment**

The financial condition of banks broadly continues to improve. Bank earnings are increasing because of improved net interest margins, the quality and quantity of bank capital is strong, and liquidity remains widely available. Credit quality also remains strong, with net charge-off rates below their 25-year averages for all major loan categories. Bank earnings continue to be supported by favorable economic conditions, although at a slower rate than historical economic expansions. The unemployment rate has declined below its pre-recession level, but wage growth and inflation have been slow to increase. Interest rates and market volatility remain at or near historical lows. Equity markets across emerging, developing, and developed economies have performed well over the last year.

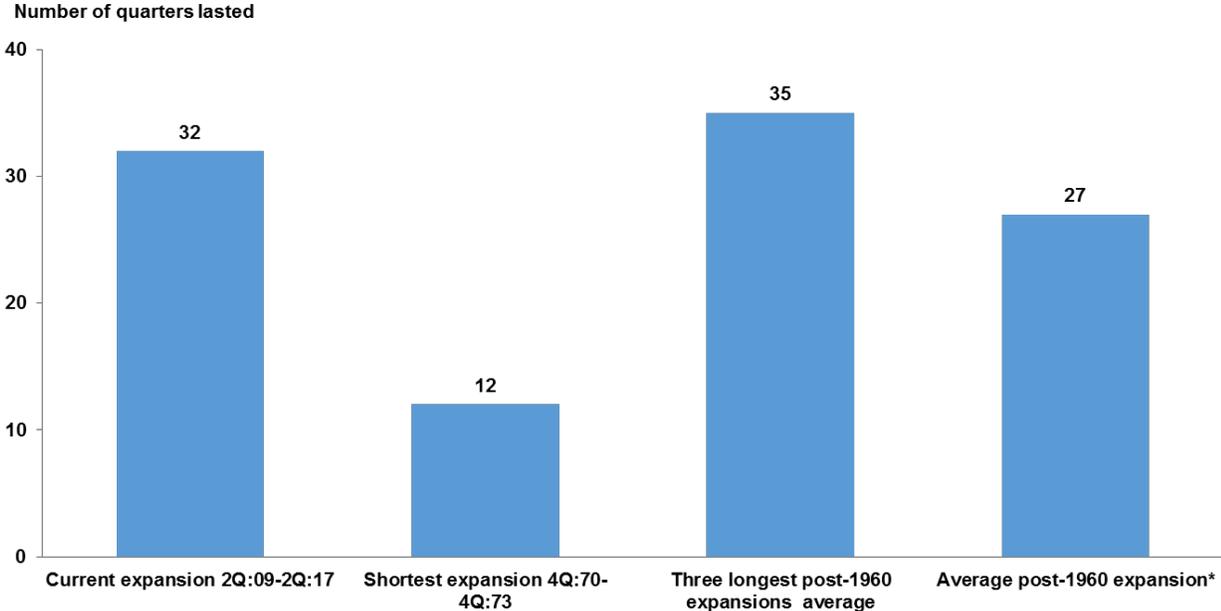
While conditions are positive in many respects, banks should guard against complacency. The operating environment for banks continues to be affected by a broad range of macroeconomic trends and events, regulatory changes, and potential geopolitical issues that affect risk levels. Banks are confronted with strong competition for commercial and retail lending products from bank and nonbank competitors. This competition and a desire for growth contribute to easing in underwriting and a risk that sound pricing structures relative to risk practices are being compromised. Valuations for many asset classes are at or near historical highs. There is growing concern by some market participants that valuations for some asset classes are growing faster than can be supported by underlying fundamental drivers. In addition, the low interest rate environment continues to pressure some banks to reach for return by extending credit and liquidity risk exposures, lengthening asset duration, and investing in alternative and structured products. These challenges contribute to strategic, credit, liquidity, and operational risks that warrant close attention to sound strategic planning and monitoring for operating within established risk tolerances of the institutions.

### **U.S. Economic Expansion Likely to Continue Through 2018**

U.S. real GDP growth rebounded to a 3.2 percent annualized rate and unemployment declined to an average of 4.3 percent in the third quarter of 2017. The pace of business spending on equipment doubled to a nearly 9 percent annual rate of growth. Regionally, hiring picked up in commodity-dependent areas and cooled in technology-reliant states in the west. Even with the expansion in its eighth year, the consensus forecast is for expansion through at least next year. Short- and medium-term risks to the outlook include potential monetary and fiscal policy changes in the United States and economic and geopolitical risks abroad. Long-term risks include slow wage and productivity growth, which would weaken the national standard of living.

While the current economic expansion is aging, it is generally shocks or imbalances, such as excessive leverage in the commercial or consumer sector, and not length of the expansion that precipitates a recession. The current expansion has lasted 32 quarters, slightly longer than the 27-quarter average for the previous six expansions since 1960 (see figure 1). The major expansions of the 1960s, 1980s, and 1990s lasted 35 quarters on average, so there is precedent for the current expansion to last longer. The consensus forecast expects annual real GDP growth to be between 2 and 2.5 percent in 2017 and 2018.

Figure 1: Age of Economic Expansion



Source: Bureau of Economic Analysis, OCC Economics calculation

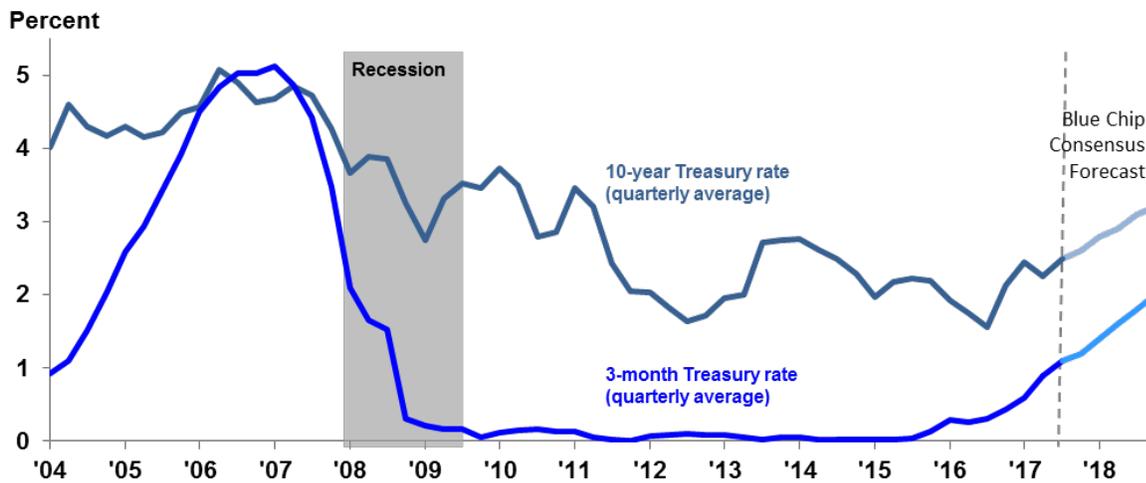
Note: Asterisk (\*) represents third quarter of 1980 through the third quarter of 1981 and current expansion excluded.

Currently, there are no significant economy-wide imbalances in growth or inflation. Wage gains are modest, and core inflation remains below the Board of Governors of the Federal Reserve’s target. Unforeseen shocks could, however, disrupt the expansion, and banks should monitor economic conditions and consider the potential impact of alternative negative scenarios.

## Short- and Long-Term Interest Rates Expected to Rise

Interest rates are likely to rise, since the economy is near full employment. With the unemployment rate at a 16-year low, wage growth and inflation are likely to pick up. The Federal Reserve is expected to begin to shrink its balance sheet in the fourth quarter of 2017 and continue to increase the Federal Funds rate. The reduction of the Federal Reserve’s balance sheet is expected to modestly increase long-term rates, but the effect on bank margins is uncertain. Market participants expect a 30-basis-point rise in longer-dated Treasury rates and a much larger increase in the short-term Federal Funds rate, flattening the yield curve. Although higher rates are generally positive for bank margins, a flatter yield curve usually is not. A flatter yield curve could complicate the margin outlook for banks if the curve flattens at a pace or magnitude beyond current expectations. The Blue Chip Consensus Forecast is that the three-month Treasury bill rate will hit 2 percent by the end of 2018, with the 10-year Treasury bond rate slightly above 3 percent (see figure 2).

Figure 2: Short- and Long-Term Interest Rate Measures

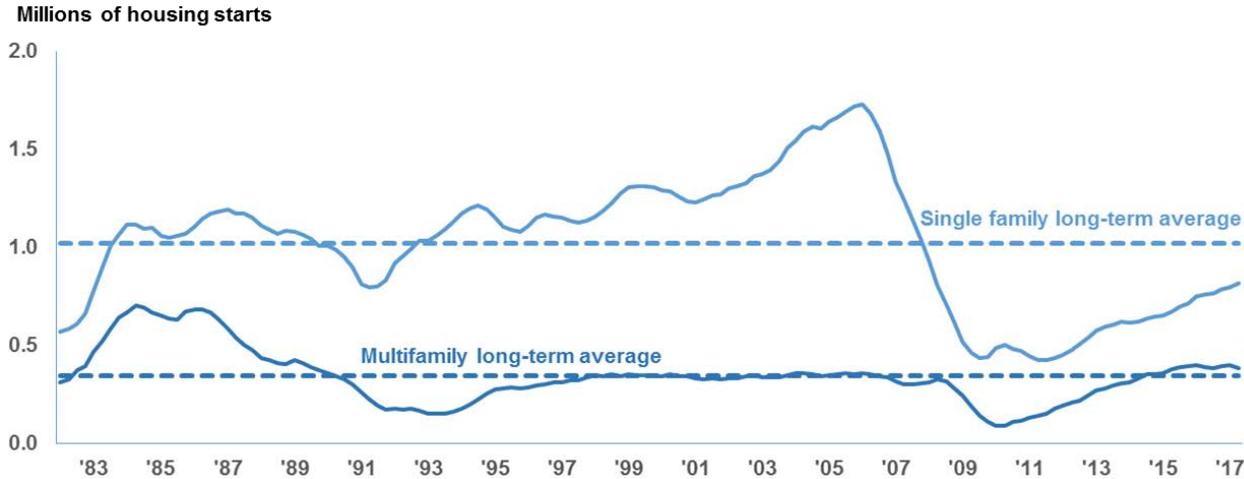


Source: Federal Reserve, Blue Chip Indicators (July 2017); historical data through the second quarter of 2017

### Housing Construction Is Increasing

Housing construction continues to increase but remains below average and weighted more toward multifamily than the historical average (see figure 3). The greater focus on multifamily construction by builders is in response to the decade-long decline in the homeownership rate and growth in the nation’s key renter cohort (adults aged 20-34). Multifamily starts historically average 25 percent of total starts but comprised 32 percent of housing starts over the last year. Although single-family starts continue to increase, they are still 20 percent below their historical average.

Figure 3: Trend in Housing Starts

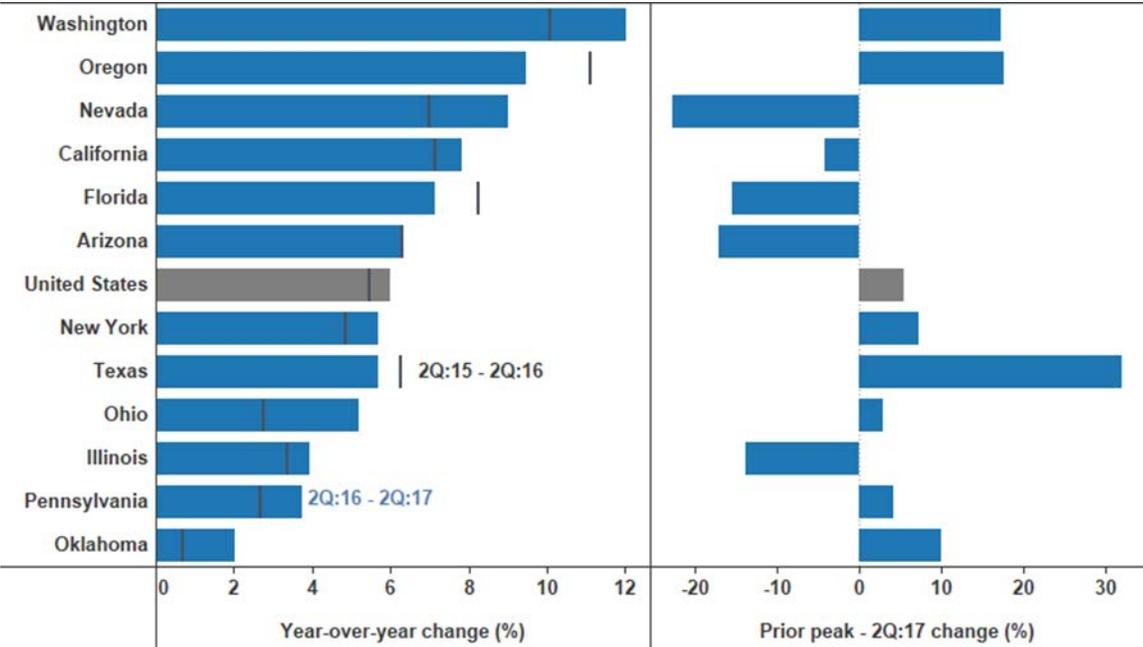


Source: U.S. Census Bureau, Moody's Analytics. Data are as of the second quarter of 2017 (seasonally adjusted in millions, four-quarter moving average)

### Home Price Appreciation Continues in Most States

The U.S. average existing home price rose 6 percent over the year through the second quarter of 2017, after increasing 5.4 percent over the previous year (see figure 4). Continued economic growth, low interest rates, and a limited supply of homes for sale contributed to faster price growth. Home prices remain below their peaks, however, in the states that saw the greatest appreciation during the last housing boom—more than 20 percent below the peak in Nevada and more than 10 percent below the peak in Arizona, Florida, and Illinois.

Figure 4: States With Highest Percentage Change in Home Prices



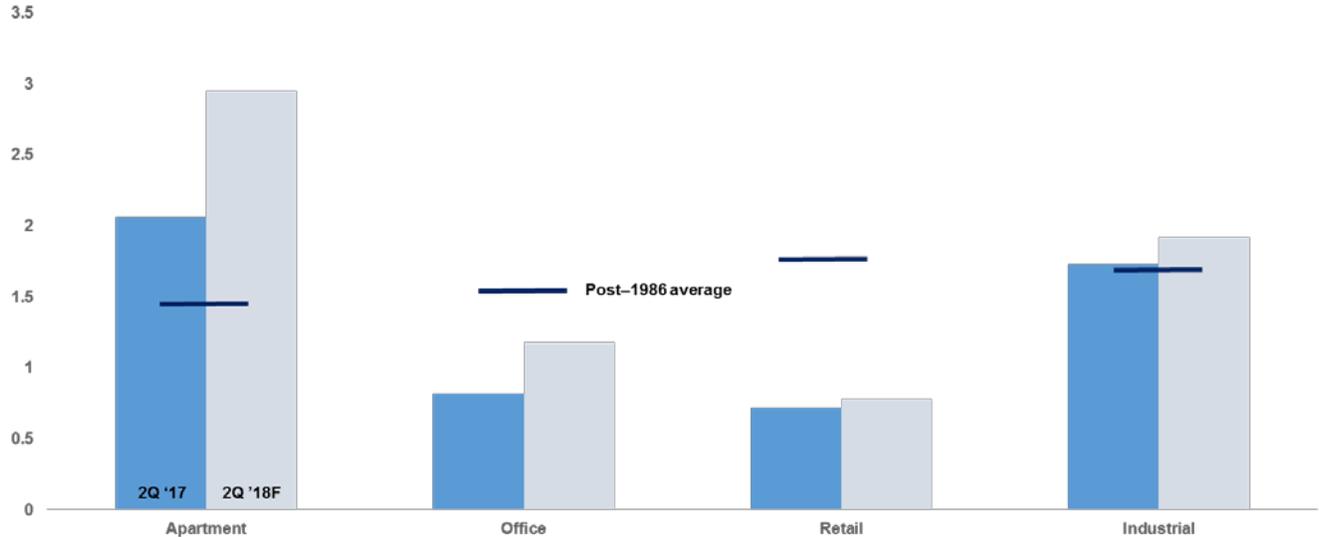
Source: Black Knight (updated August 2017); represents prices of non-distressed transactions

Note: In the left graph, the bars represent the percentage change from 2Q:16 to 2Q:17. The solid line denotes the percentage change for 2Q:15 to 2Q:16.

### Multifamily Supply Growth Remains Strong

Supply growth in the multifamily property sector was stronger than supply growth in the office, retail, or industrial property sectors over the period from the second quarter of 2016 to the second quarter of 2017. The multifamily sector was the only property type with supply growth over the last year that was significantly above its long-term average. Supply growth over the last year in office and retail property types was well below long-term averages, while supply growth in the industrial property type matched its long-term average. Looking ahead, multifamily supply growth is forecast to accelerate over the coming year, from the second quarter of 2017 to the second quarter of 2018, by close to 100 basis points, bringing forecast growth to double its long-term average (see figure 5). The wave of new supply, centered in luxury apartments, will increase pressure on vacancies and rent growth in the metropolitan areas that have added the most new supply.

Figure 5: Year-Over-Year Percentage CRE Supply Growth

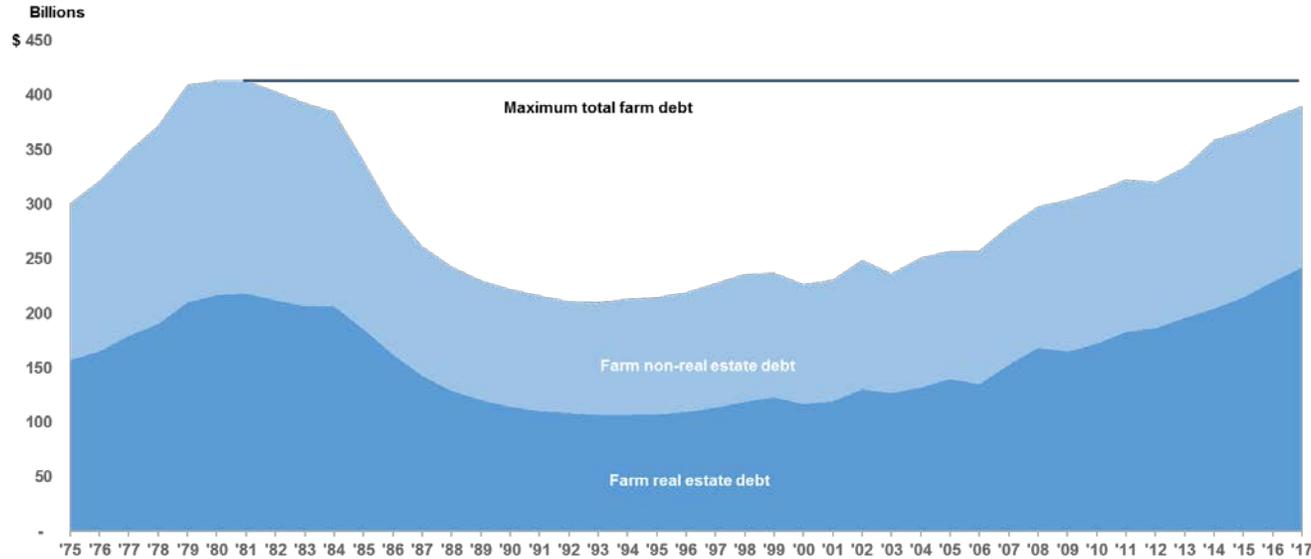


Source: CoStar Portfolio Strategy with historical data through the second quarter of 2017, and baseline forecast updated August 2017

### Farm Debt Nearing 1980s Peak

After three consecutive years of decline, farm sector profits are forecast to modestly increase in 2017. During the last three years, farmers took on more debt to cover expenses. Total inflation-adjusted farm debt estimated for 2017 is 6 percent below the peak reached during the 1980s agricultural bust. Today’s debt is more heavily weighted toward debt collateralized with real estate, which is 11 percent above its prior peak (see figure 6). With interest rates historically low, the high level of debt is not as much of a burden as it was in the early 1980s, when annual interest rates were in double digits. Although the farm debt service ratio has risen over the last three years, it remains manageable and well below the peak level it reached in 1981.

Figure 6: Trend in Farm Debt



Source: U.S. Department of Agriculture

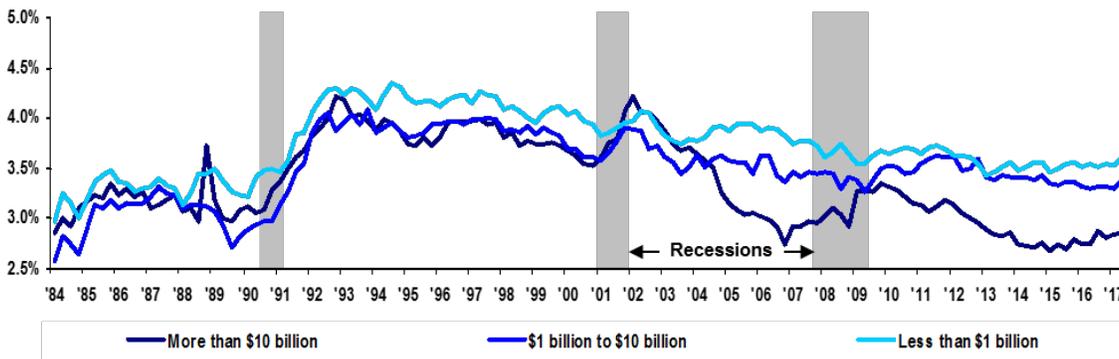
## **Part II: Bank Performance**

### **Revenue Growth Driven by Higher Loan Volumes**

#### **Net Interest Margins Have Increased**

Net interest margins have increased at banks of all sizes, ending a period of margin compression (see figure 7). Noticeable improvement in net interest margins enabled banks to report the largest net interest income gain since 2010. Bank net interest margins have benefitted from steadily rising loan volumes and increasing interest rates. However, margins remain historically low for many banks and are likely to remain under pressure for those with extended asset maturities or with low loan growth.

**Figure 7: Net Interest Margin as a Percentage of Earning Assets**



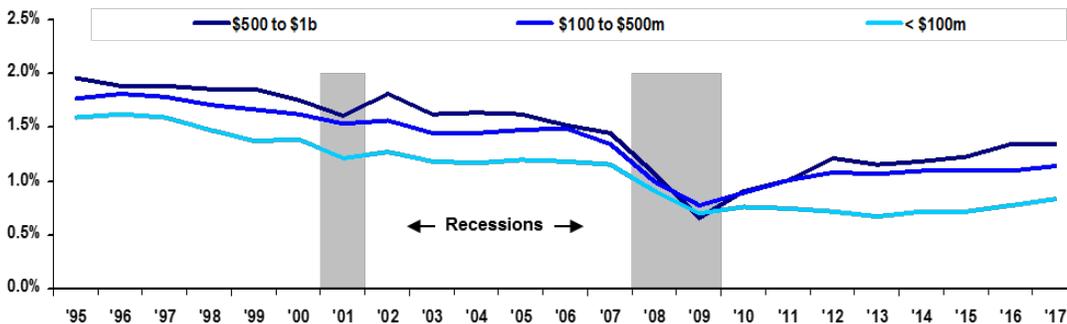
Source: Integrated Banking Information System (OCC)

Note: Data are quarterly through June 2017. Data exclude credit card and trust banks.

#### **Profitability Slow to Recover at Smallest Banks**

Median pre-tax return on assets (ROA) improved by 17 basis points from the crisis low point for the smallest banks and is about 60 percent of its 1994–2006 pre-crisis average (see figure 8). In contrast, median pre-tax ROA improved by 36 basis points for banks with total assets of \$100 million to \$500 million and 68 basis points for banks with total assets of \$500 million to \$1 billion, leaving these banks only one-third to one-fourth below their pre-crisis averages. This divergence in profitability improvement is driven by lower margins, slower loan growth, and higher operating costs relative to assets at the smallest banks.

**Figure 8: Median Percentage Pre-Tax Return on Assets**



Source: Integrated Banking Information System (OCC)

Note: Annual data through 2016. Data for 2017 are as of June 30. Bank data exclude federal savings associations and credit card and trust banks.

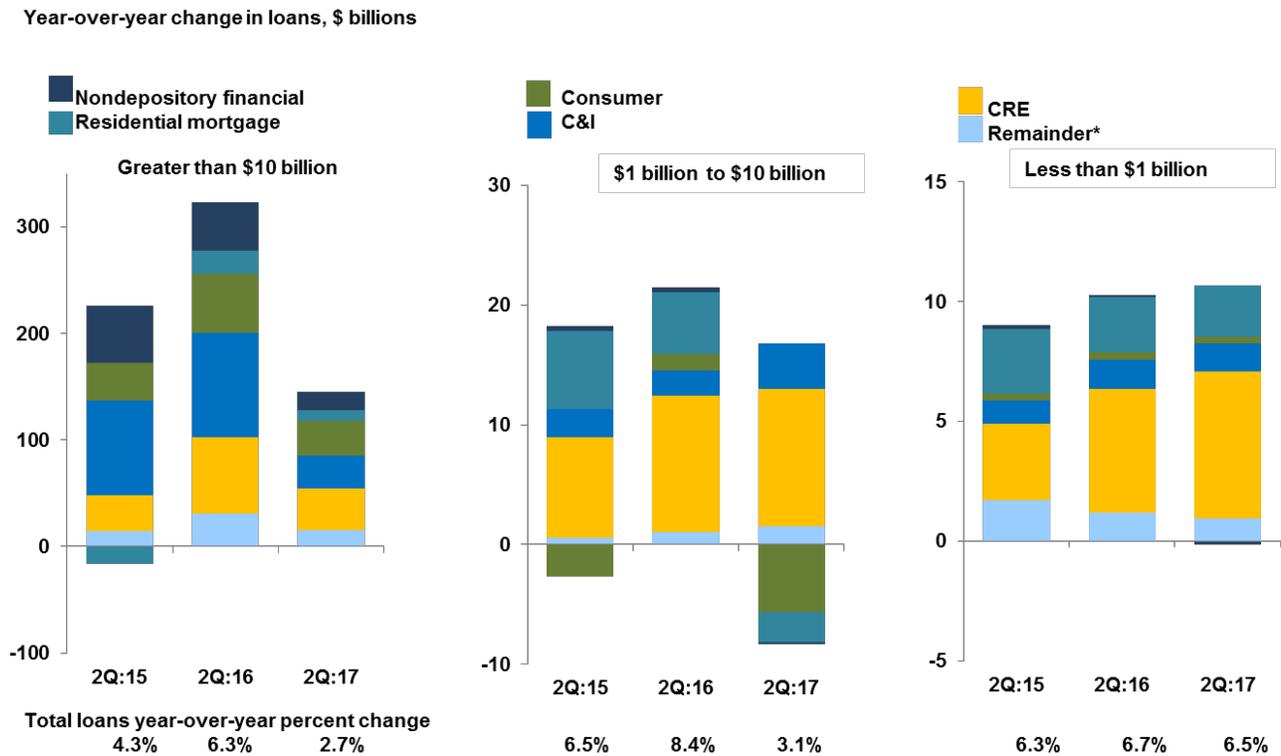
**Part III: Trends in Key Risks**

**A. Loan Growth and Easing Underwriting Practices**

**CRE Continues to Drive Loan Growth in Small Banks**

While loan growth for banks with total assets greater than \$10 billion slowed year-over-year in the second quarter of 2017, the smallest cohort of banks show growth (see figure 9). Loan growth for banks with total assets of less than \$1 billion remains consistent with prior periods and was centered in CRE. Banks with total assets between \$1 billion and \$10 billion show slower total loan growth because of a decline in consumer and residential mortgage loans, but relatively consistent growth in commercial and industrial (C&I) and CRE compared with the same period in 2016.

**Figure 9: Year-Over-Year Loan Growth**



Source: Integrated Banking Information System (OCC)

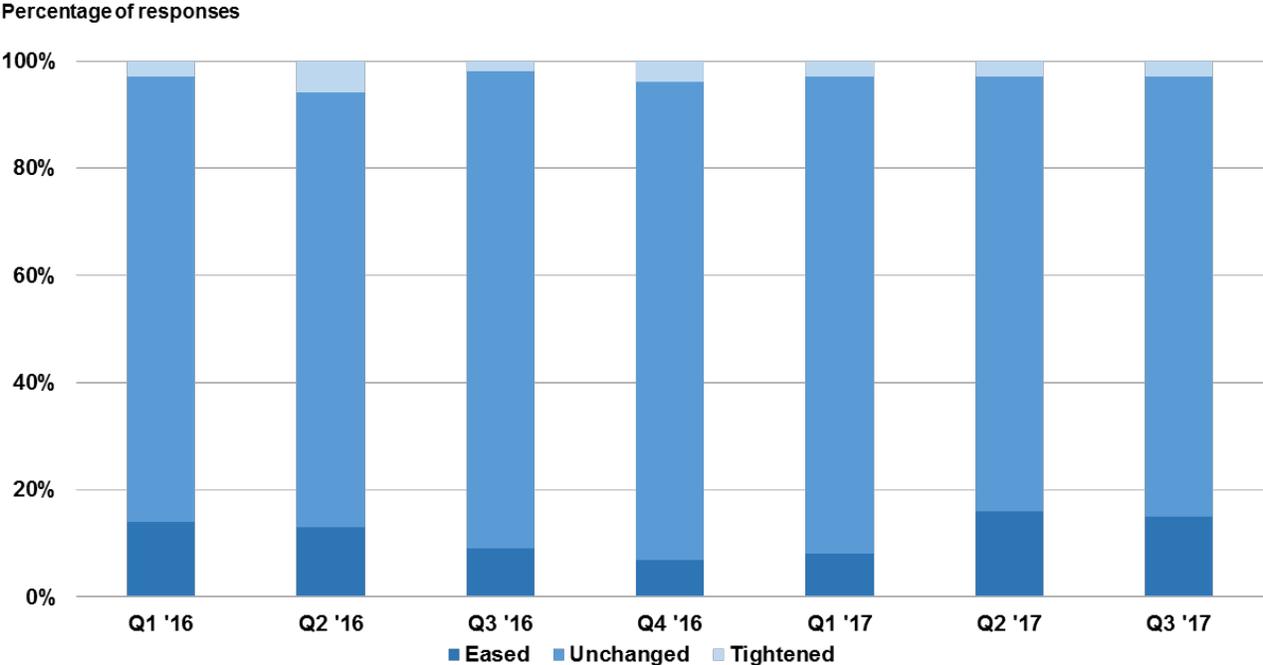
Note: Data are merger adjusted for institutions in continuous operation between the first quarter of 2010 and the second quarter of 2017. CRE includes commercial mortgages and construction loans.

\* The "Remainder" category includes agricultural loans, loans to governments, banks, and municipalities, etc.

### Examiners Report Continued Easing in Underwriting Practices

Credit underwriting assessments completed by OCC examiners indicate that banks continue to ease practices on net, a trend that began in 2013 after a period of substantial tightening following the recession. In each quarter since the first quarter of 2016, the percent of banks assessed as having eased their underwriting practices exceeds the percent that were viewed as having tightened underwriting (figure 10). This incremental easing is being influenced by banks' desire for loan growth amid a very competitive credit market. Nonetheless, examiners still report that the vast majority of banks are operating within their credit risk appetite and are maintaining satisfactory underwriting practices.

Figure 10: Assessment of Direction of Credit Underwriting Practices



Source: OCC

## ***B. Operational Risk Remains Elevated Because of Increasing Cyber Threats and Use of Third-Party Service Providers***

### **Severity of Cyber Threats Is Increasing**

Cyber threats are increasing in speed and sophistication. These threats target vulnerabilities that could expose large quantities of personally identifiable information and proprietary intellectual property and facilitate misappropriation of funds at the retail and wholesale level. Cyber criminals continue to innovate and aggressively pursue personal information.

Phishing is a primary method of breaching data systems. Phishing deceives people into opening files or clicking links in messages (e.g., emails, instant messages, or social media posts). A related form of social engineering, known as “watering holes,” involves infecting websites frequently visited by targeted people. The malicious code on watering holes passes malware to visitors. The malware helps cyber criminals gather information or access corporate networks. Such methods are frequently the primary entry mechanism to perpetrate other malicious activity, such as loading ransomware onto bank computers, accessing confidential information, compromising internal systems to affect payments, or conducting espionage.

Use of unpatched or unsupported software and hardware by banks and their service providers is a key risk that can expose data or enable breaches. Out-of-date or unsupported software often contains vulnerabilities that can lead to breaches. A sound systems development life cycle requiring regular maintenance and system updates is important to protect against these weaknesses.

It is important for banks to have a well-established and tested response plan if a cyber breach occurs. Bank management should clearly designate appropriate personnel for key response mechanisms, which include public affairs, operations, legal, service providers, law enforcement, and other government entities.

Companies that provide information technology products and services or are otherwise part of the supply chain, including those that allow remote access and system management, are increasingly targeted for cybercrime and espionage. When exploited, these third parties provide back doors into client businesses’ operations. This trend coincides with many of the large breaches that have occurred throughout the last year.

Recent successful breaches were the result of poor authentication schemes that allowed for stolen customer data, large movements of funds, and increased reputation risk from exposing sensitive information. Millions of compromised credentials have been sold online and are being used to gain access to sensitive accounts. As part of a layered security approach, it is important for banks to implement strong authentication and management of privileged and high-value user access (e.g., system administrators, staff capable of moving funds, or board members and executives with access to sensitive corporate information).

### **Use of Third-Party Service Providers Is Increasing, and Critical Operations Are Increasingly Concentrated in a Few Large Service Providers**

Third-party risk management remains a supervisory focus. While the number of concerns relating to banks’ third-party risk management practices is declining as banks implement more effective processes to address supervisory concerns, banks’ increasing use of third-party service providers and the

emergence of new products and services offered through financial technology companies or other industry collaborations warrant heightened supervisory focus.

Many banks have become increasingly reliant on third-party service providers to support their key operations. Consolidation has increased among significant service providers, as has consolidation in the financial services industry. This consolidation of service providers has increased reliance on a smaller group of third parties providing critical applications and resulted in large numbers of banks, especially community banks, relying on a small number of service providers.

In addition, examiners have identified instances of concentrations of third-party service providers for specialized services, such as merchant card processing, denial-of-service mitigation, trust accounting systems securities settlements and custody, and other specific product or market service. Banks benefit through use of these service providers by achieving greater economies of scale and having access to technical resources that allow them to better manage operations than an institution could do individually. Increased use of a limited number of third-party service providers can also, however, create concentrated points of failure resulting in systemic risk to the financial services sector that banks can address through appropriate due diligence and ongoing oversight.

### ***C. Compliance Risk Remains Elevated***

#### **New Technology Offerings and Evolving Criminal Methods Result in High BSA/AML Compliance Risk**

Banks continue to face challenges in complying with BSA requirements because money laundering and terrorism-financing methods are dynamic. Bank offerings based on new technological platforms may increase access to financial products and services and provide convenience to customers, but may also create vulnerabilities that criminals can exploit as vehicles for money laundering.

BSA/AML compliance risk management remains an area of emphasis as banks are challenged with adopting risk management systems that can keep pace with evolving risks, constraints on resources, changes in business models, and an increasingly complex risk environment. The OCC expects banks to be aware of regulatory changes, including the Financial Crimes Enforcement Network's Beneficial Ownership/Customer Due Diligence regulation, which has an implementation date of May 2018, and to ensure that its processes comply with the new regulatory requirements including the appropriate system changes, training, quality assurance, independent testing, and controls. New Office of Foreign Assets Control sanctions as well as additional requirements in existing sanctions programs also require attention and system updates. While the number of enforcement actions (EA) issued since 2014 has declined, several banks remain under EAs or have matters requiring attention (MRA) to correct deficient practices related to their BSA/AML compliance programs.

#### **Amendments to Regulations Pose Challenges in Change Management**

New or amended consumer protection regulations pose challenges to bank change management processes and increase operational, compliance, and reputation risk exposure. These changes include the integrated mortgage disclosure requirements under the TILA and RESPA, as well as the new requirements under the amended regulations implementing the HMDA and MLA.

The majority of OCC-supervised institutions have mortgage products that will be subject to the new integrated disclosure requirements under TILA and RESPA. As of June 30, 2016, 61 percent of OCC-supervised institutions are HMDA reporters and subject to the rule. The actual percentage of OCC-supervised institutions subject to the integrated disclosure rule is larger, as HMDA reporters do not include certain small, rural banks that offer mortgage products that are subject to the integrated disclosure requirements.

The integrated disclosure requirements establish specific calculations and impose narrow tolerances for fees, payment streams, and timing. Even after the October 2015 effective date of these amendments, the OCC continues to identify instances where banks have not fully implemented these requirements, thus increasing the potential risk of violations of law and consumer harm. Common supervisory concerns include accuracy of loan estimates and closing disclosures and inaccurate timing and tolerance violations. Violations of the integrated disclosure requirements can result in reimbursements and rescissions. Noncompliance could also result in statutory damages, civil liability, and reputation risks. Such concerns highlight the complexity of these amendments and change management and compliance management system challenges that banks face.

Changes to the HMDA require banks to significantly enhance their data collection and reporting systems in 2017 and 2018 to meet their compliance obligations. For HMDA data collected in 2017, covered banks are required to update their submission processes before the deadline in March 2018 in order to use a new platform and specifications issued by the Consumer Financial Protection Bureau.

For all covered applications on which action is taken on or after January 1, 2018, covered banks must collect information related to 110 data points, as compared with the 36 data points required for applications decided before 2018. Data collected in 2018 must be submitted by March 2019. The Bureau's recent announcement that it intends to engage in rulemaking to reconsider various aspects of the 2015 HMDA Rule may result in further HMDA-reporting change management by banks.

The amended MLA regulation expands specific protections provided to service members and their families and covers a wider range of credit products. The types of charges that must be counted toward the military annual percentage rate limit of 36 percent are more inclusive than the "finance charges" counted toward the annual percentage rate under Regulation Z. The amendments have the potential for significant compliance, credit, and reputation risk exposure in OCC-supervised banks. Risks include violations of MLA requirements and the potential for voiding the credit agreement if the military annual percentage rate exceeds the 36 percent limit.

### **Some Compliance Management Systems Lag Behind Evolving Compliance Risks**

Bank internal quality assurance and risk assessment processes for supporting compliance management systems and the ability to maintain sufficient compliance expertise to manage the additional risks and complexities remain a concern. Banks are expected to have consumer compliance risk management systems commensurate with the risk inherent in their products and services. In some banks, these systems have not kept pace with the increasing complexity of the regulatory and risk environments in which they operate. In addition to significant changes to regulations, banks also face heightened regulatory and public scrutiny of consumer protection activities. Increased compliance costs and resulting pressures on earnings, mergers and acquisitions, entry into new products and service areas, and increasing use of third parties for compliance management purposes place additional demands on already strained compliance risk management systems.

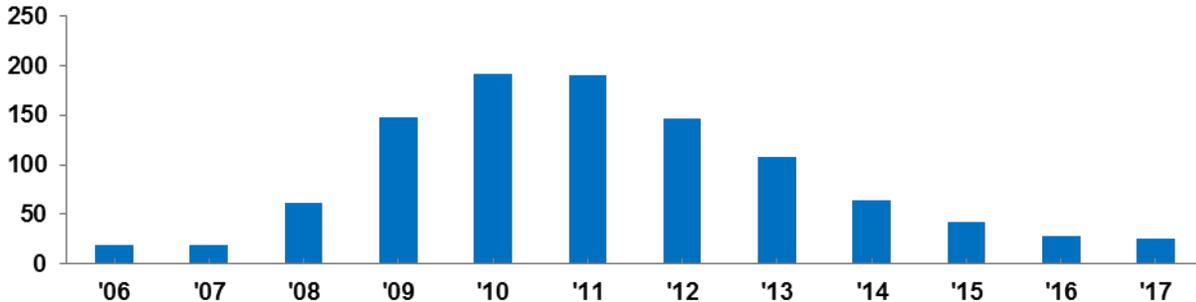
With finite resources to effectively support the volume and frequency of regulatory changes and manage existing compliance programs, banks have increasing operational and compliance risk exposure. Management needs to ensure that it identifies and understands the risk exposure associated with these resource challenges and addresses them appropriately. Failure to do so could have negative impacts on the effectiveness of compliance risk management systems to ensure regulatory compliance and fair treatment of customers. As banks consider outsourcing compliance management activities, management should conduct sound due diligence and maintain sufficient oversight when relying on third parties to provide or service bank products.

## **Part IV: Supervisory Actions**

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

The number of OCC-supervised banks with composite ratings of 4 or 5 has declined by 11 percent since year-end 2016, but the number remains slightly above levels immediately preceding the recession (see figure 11). The number is now the lowest since 2007. The decline since the peak in 2010 is attributable to a variety of factors, including merger and acquisition activity; failures or liquidations; or upgrades resulting from recapitalizations and improvements in risk management.

**Figure 11: Number of Banks Rated 4 or 5**



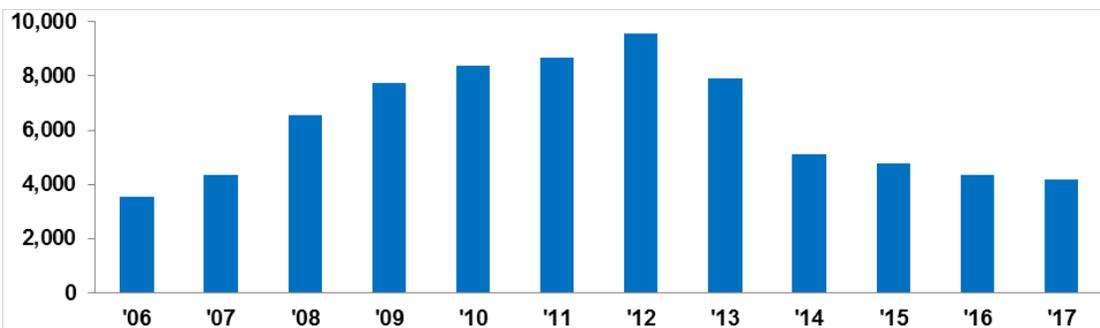
Source: OCC

Note: Data for 2017 are as of June 30. All other data are as of year-end.

### **Outstanding MRA Concerns Continue to Decline**

The OCC communicates supervisory concerns to a bank’s board and management in the form of MRAs. Supervisory concerns include practices that deviate from sound governance, internal control, or risk management principles.<sup>1</sup> Such deviations, if not addressed appropriately, could adversely affect a bank’s condition or risk profile, result in violations of laws or regulations, resulting in EAs. The number of outstanding MRAs peaked in 2012 and has declined steadily through June 30, 2017, to the lowest level since 2006 (see figure 12). MRAs have declined 2.7 percent since year-end 2016.

**Figure 12: Number of MRA Concerns Outstanding**



Source: OCC

Note: Data for 2017 are as of June 30. All other data are as of year-end.

As of June 30, 2017, the top three MRA categories based on primary risk area for community and midsize banks were operational (38 percent), credit (32 percent), and compliance (18 percent). For large banks, the top three MRA categories based on primary risk area were compliance (36 percent),

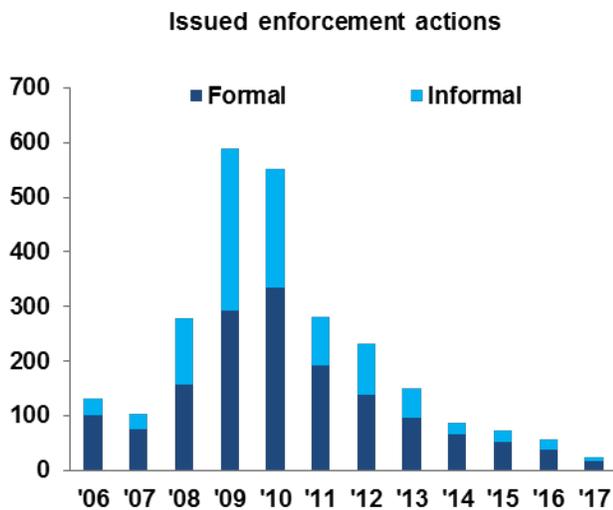
<sup>1</sup> OCC Bulletin 2014-52, “Matters Requiring Attention: Updated Guidance,” October 30, 2014.

operational (35 percent), and credit (18 percent). The OCC revised its MRA concern reporting framework in January 2017. Accordingly, these examination categories will not be comparable to issues discussed in *Semiannual Risk Perspective* reports prior to that date.

### Enforcement Actions Against Banks Continue to Decline

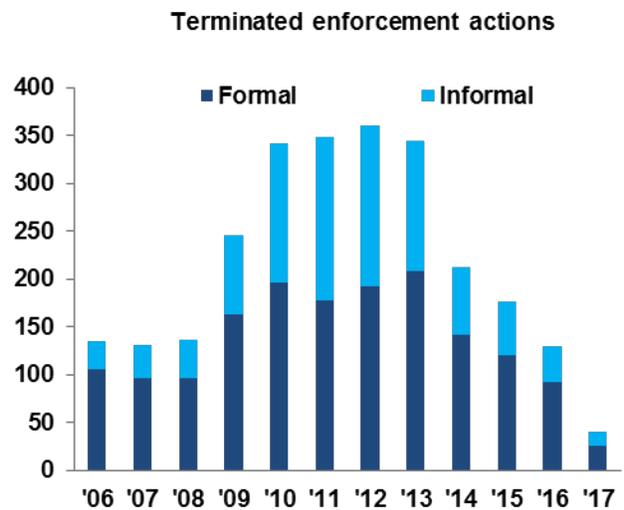
The OCC uses EAs to address more acute problems or weaknesses requiring corrective action. Informal EAs include commitment letters, memorandums of understanding, and notices of deficiency issued under 12 CFR 30. Formal EAs are disclosed to the public and include cease-and-desist orders, consent orders, capital directives, prompt corrective action directives, civil money penalties, and formal agreements. Generally, the OCC may take EAs for violations of laws or regulations; unsafe or unsound practices; or violations of final orders, conditions imposed in writing, or written agreements entered into with the OCC. The number of EAs issued by the OCC against banks has steadily declined since peaking in 2009 (see figure 13), reflecting overall improvement in banks’ financial conditions and risk management practices. Even so, compliance or operational failures have resulted in a number of recent EAs. These EAs addressed a lack of appropriate governance, oversight, and risk management systems and controls. As with new issuances, the number of terminated (resolved) EAs has declined since 2012.

Figure 13: OCC Enforcement Actions Against Banks



Source: OCC

Note: Data for 2017 are as of June 30.  
All other data are as of year-end.



Source: OCC

Note: Data for 2017 are as of June 30.  
All other data are as of year-end.

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