Audit Report

OIG-07-020

Audit of the Office of the Comptroller of the Currency's Fiscal Years 2006 and 2005 Financial Statements

December 12, 2006

Office of Inspector General

Department of the Treasury

OCC has made every effort to make their documents accessible;
for a MS Word text-only version of the OCC Annual Report, Fiscal Year 2006**,** see:

http://www.occ.treas.gov/annrpt/2006%20Annual%20ReportWordFINAL.doc

for more information, see OCC's Accessibility.htm

OFFICE OF
INSPECTOR GENERAL

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

December 12, 2006

MEMORANDUM FOR JOHN C. DUGAN
COMPTROLLER OF THE CURRENCY

FROM: Joel A. Grover
Deputy Assistant Inspector General
for Financial Management and Information Technology Audits

SUBJECT: Audit of the Office of the Comptroller of the Currency's Fiscal Years 2006 and 2005 Financial Statements

I am pleased to transmit the attached audited Office of the Comptroller of the Currency (OCC) financial statements for fiscal years 2006 and 2005. Under a contract monitored by the Office of Inspector General, Gardiner Kamya & Associates, PC (GKA), an independent certified public accounting firm, performed an audit of the financial statements of OCC as of September 30, 2006 and 2005, and for the years then ended. The contract required that the audit be performed in accordance with generally accepted government auditing standards; applicable provisions of Office of Management and Budget Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements;* and the *GAO/PCIE Financial Audit Manual*.

The following reports, prepared by GKA, are incorporated in the attachment:

- Independent Auditors' Report on Financial Statements;
- Independent Auditors' Report on Internal Control over Financial Reporting; and
- Independent Auditors' Report on Compliance with Laws and Regulations

In its audit, GKA found that the financial statements were fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. However, GKA's Report on Internal Control over Financial Reporting contained one reportable condition related to information technology general controls over OCC's financial systems, which was not considered a material weakness. Further, GKA found no instances of reportable noncompliance with laws and regulations, exclusive of the *Federal Financial Management Improvement Act of 1996 (FFMIA)*, tested. However, GKA's tests of *FFMIA* Section 803(a) requirements disclosed one instance in which OCC's financial management systems did not substantially comply with federal financial management system requirements, which is related to the reportable condition noted above.

In connection with the contract, we reviewed GKA's reports and related documentation and inquired of its representatives. Our review, as differentiated from an audit in accordance with generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on the financial statements or conclusions about the effectiveness of internal control or compliance with laws and regulations. GKA is responsible for the attached auditors' reports dated October 31, 2006 and the conclusions expressed in the reports. However, our review disclosed no instances where GKA did not comply, in all material respects, with generally accepted government auditing standards.

Should you have any questions, please contact me at (202) 927-5400 or a member of your staff may contact Mike Fitzgerald, Director, Financial Audits at (202) 927-5789.

Attachment

Comptroller of the Currency
Administrator of National Banks
US Department of the Treasury

Office of the Comptroller of the Currency

ANNUAL REPORT

Fiscal Y

Ensuring a Safe and Sound
National Banking System
For All Americans

The mission of the Office of the Comptroller of the Currency is, and always has been, supervision. We supervise all types of banks in all parts of the country, from the smallest community banks to the trillion dollar “megabanks,” from “ag” banks to credit card banks, and from federal branches of foreign banks to one-branch banks that do their business close to home.

—Comptroller Dugan before the
Conference on Bank Structure and Competition,
Federal Reserve Bank of Chicago, May 19, 2006

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We are living in a time of great uncertainty and constant change, but I am confident that we are prepared to evolve with the market, meet new challenges, and respond to emergencies—just as the OCC has done throughout its 143-year history.

I. Comptroller's Viewpoint

I am pleased to report that the national banking system not only remained strong throughout fiscal year (FY) 2006, but that both the OCC and the system are well equipped to meet the challenges that lie ahead.

This was the second consecutive year in which no national bank failed. Capital was strong and earnings increased, driven by strong growth in noninterest income. Healthy loan growth helped compensate for narrowing net interest margins. Losses and delinquencies were minimal. In short, the picture at year-end was quite positive.

Yet as supervisors, it is our job to worry about what comes next. Are we at the stage of the credit cycle where risks in the system begin to increase because of less favorable macroeconomic conditions, increased competition, and weaker underwriting standards? What must we be doing to prepare the banking system and the OCC for the challenges ahead?

What must we be doing to prepare the banking system and the OCC for the challenges ahead?

A great deal of our work during the year focused squarely on these questions. The interagency Shared National Credit review, a detailed assessment of large syndicated loans to major corporate borrowers, provided one important "snapshot" of national trends in credit quality. The review found only small increases in the number of criticized and classified commitments—and those increases were measured against 2005 levels, which were the lowest in six years. As positive as those results were, they did not answer the question of whether that small drop in credit quality portends a change in direction, or merely a small fluctuation around a high and stable level of credit quality in the syndicated loan market.

Of greater concern to me was the evidence of credit trends provided by the OCC's *Survey of Credit Underwriting Practices*, a detailed review of lending standards across 18 commercial and retail product lines, based on the professional judgment of examiners-in-charge at the 73 largest national banks. The 2006 survey results indicated that loan standards in both commercial and retail lending had eased for a third consecutive year under pressure from competition and optimistic expectations for loan volume, yield, and market share. The evidence included thinner pricing, reduced amortization, weaker covenants and controls, pervasive structural concessions in such terms as tenor and guarantor requirements, and increased exceptions to lending policies.

In commercial lending, the most pronounced slippage occurred in leveraged lending and large corporate loans. Commercial real estate also showed continued signs of net easing that, in combination with the increased concentrations in commercial real estate loans, heightened concerns in that area. In retail lending, there was significant easing in residential mortgage and home equity lending standards: longer interest-only periods, higher allowable debt-to-income and loan-to-value ratios, and greater volumes of loans with reduced documentation requirements. Significantly, this weakening of standards came at a time when prices in the previously red-hot housing market were leveling off and, in many local and regional markets, actually declining. Although these market trends would normally trigger tighter lending standards, all evidence suggested that standards were continuing to loosen because of intensifying competition among lenders for a shrinking pool of buyers.

Strong capital is a key element of any risk management regime—and the bulwark of a safe and sound banking system.

The evidence emerging from our analysis revealed symptoms that have historically been reliable predictors of future problems in the banking industry, if not addressed. Our challenge was to ensure that national banks managed this risk in an effective and timely way, while credit quality, loan loss reserves, and the economy remain strong.

It was with that objective in mind that the OCC addressed a broad range of risks facing the national banking system during FY 2006.

As the fiscal year drew to a close, the bank, thrift, and credit union regulatory agencies published guidance addressing nontraditional residential mortgages. At a time of rising house prices in many parts of the country, some lenders introduced options that, for a limited period, allow borrowers to forego regular principal payments ("interest-only" loans) or even to waive a portion of the interest due, resulting in negative amortization. Although these products clearly can benefit some consumers, we are concerned that banks may not properly manage the risks they entail, especially in an environment of rising interest rates and softening real estate markets. Our guidance therefore cautions banks to assess a borrower's ability to repay the loan at the fully amortized rate and to ensure that the borrower understands the terms and risks of the product before purchase.

Similar concerns lay behind this year's proposed guidance on commercial real estate (CRE) concentrations. The guidance does not take the position that CRE concentrations are inherently unsafe and unsound, or that hard limits should be set on such activities. Instead, it concludes that CRE concentrations pose special risk that can and must be managed effectively through appropriate management controls, including strong information systems.

Strong capital is a key element of any risk management regime—and the bulwark of a safe and sound banking system. A year marked by significant progress in the arduous process of writing, refining, testing, and critiquing the Basel II capital rules culminated in the long-awaited release of a Notice of Proposed Rulemaking that was issued for public comment. I am committed to continuing to work closely with all concerned parties to ensure that the Basel II capital rule that emerges from this process is one that deserves widespread support.

We undertook lower-profile, but no less important, initiatives throughout the year that further strengthen risk management in the national banking system. Our Community Bank Directors Workshop program offered a selection of one-day classes on such subjects as credit risk, compliance risk, and the OCC's risk assessment process. In February, more than 400 senior bank managers, academics, vendors, and regulators attended an OCC-sponsored conference on risk modeling, reflecting the growing importance of these sophisticated statistical tools in making underwriting decisions, managing and pricing accounts, and mitigating losses.

The banking system played an increasingly important role in safeguarding our nation's physical security. The OCC takes very seriously its responsibility to enforce the Bank Secrecy Act in a manner that is rigorous, consistent, measured, and fair. To help bankers better understand their responsibilities under the law and our supervisory procedures, we continued an ambitious industry outreach program and issued clarifying supervisory guidance. We also added a new director for Bank Secrecy Act (BSA) and Anti-Money Laundering (AML) Compliance and increased the number of BSA/AML experts in our headquarters office, which substantially augmented the OCC's existing expertise in this critical area.

Protecting the rights of bank consumers is one of our agency's fundamental obligations.

During fiscal year 2006, recovery began in earnest from the massive damage wrought by hurricanes Katrina, Rita, and Wilma on the Gulf Coast. National banks are playing a crucial role in that effort, beginning with the recovery of many local banks from damage sustained during the storms. During my several trips to the region, I was impressed by the way that banks have put competitive considerations aside and worked together to keep vital services flowing to citizens of the affected communities.

OCC staff members did their part, too. They worked with our banks to address the many regulatory issues raised by the storms and encouraged bank officials to work with their customers to help see them through the financial difficulties many of them faced. They also established relationships with community organizations and helped coordinate our outreach efforts to local citizens and governmental bodies. They helped mobilize the financial and intellectual resources of out-of-town bankers, many of whom attended an interagency banker forum held in New Orleans in March—as I did.

The OCC's commitment to community development is an around-the-country proposition. I saw the fruits of the partnerships between national banks and community-based organizations during my visits to neighborhoods in Chicago, Los Angeles, and Washington, D.C., during FY 2006. Small business formation and assistance, housing construction and renovation, financial literacy and foreclosure abatement programs—the range and vitality of community development initiatives undertaken with the support of national banks—are truly impressive.

Several regulatory initiatives during the fiscal year promise to make these partnerships even more successful. For example, we provided guidance on how small- and minority-owned business contracts that enhance the effectiveness of a bank's small business loan program may be considered favorably in the bank's Community Reinvestment Act evaluation. We also proposed that Congress approve legislation increasing the community development lending authority available to national banks under Part 24 of our regulations, and that measure was adopted and signed into law.

Under Part 24, national banks may make an investment in a minority-owned bank or thrift. The OCC is committed to supporting these institutions. Our outreach efforts this year resulted in constructive dialogue between minority-bank CEOs and OCC's senior executives, and helped us better understand the special issues they face.

Under Part 24, national banks may make an investment in a minority-owned bank or thrift. The OCC is committed to supporting these institutions.

Protecting the rights of bank consumers is one of our agency's fundamental obligations. In FY 2006, we expanded the capabilities of our Customer Assistance Group (CAG), located in Houston. A report this year by the Government Accountability Office (GAO) gave CAG high marks for the way information obtained from consumers is incorporated in the examination process. The GAO report also contained suggestions for improving the quality of service CAG provides to consumers—suggestions that we are in the process of implementing.

The national bank charter continued to be a vibrant vehicle for conducting the business of banking. This is reflected in the growth of the national banking system: assets under OCC supervision grew from $5.9 trillion to $6.5 trillion during the fiscal year, representing 67 percent of all U.S. commercial bank assets.

In a long-awaited decision, *Wachovia* v. *Schmidt,* the U.S. Supreme Court unanimously upheld the OCC's position that a national bank is a citizen of the one state in which its main office is located. This seemingly arcane issue is one of significant practical importance because it enhances the ability of national banks to have their cases heard in federal courts.

Important legal principles affecting national banks continue to be litigated, including the extent to which state laws are preempted by federal law under the National Bank Act, and the scope of the OCC's exclusive "visitorial" authority over national banks (the authority to examine, supervise, regulate, and sanction national banks). One issue, the question of whether state laws apply to national banks' operating subsidiaries to the same extent as they apply to the parent bank itself, will be considered by the Supreme Court in late 2006, and should be decided in 2007. This case, *Watters* v. *Wachovia Bank, N.A.,* arose from state efforts to regulate and require state licenses of mortgage banking operating subsidiaries of several large national banks. The OCC believes that if state law is inapplicable to a national bank because of federal preemption, the state law also would be inapplicable to the bank's operating subsidiary because the operating subsidiary is a federally authorized means through which the bank exercises its federally authorized powers.

Information security, long a focus of attention for the OCC, emerged as a critical issue during the year, as security breaches at some government agencies, including the loss of laptop computers, raised the visibility of this problem. A break-in at the OCC's Phoenix office exposed vulnerabilities even where security is high. In response to these developments, the OCC launched an end-to-end security review from which we expect to emerge with a strengthened security infrastructure fully capable of confronting the world of network linkages, high-speed transmission, and mass storage of easily portable electronic data that our supervisory work requires.

I have said to OCC staff that it is my responsibility to make sure that on my last day in office, the OCC is stronger than it was on my first. To achieve that goal, we must build staff resources and expertise that are equal to the growth in the size and complexity of the national banks we supervise. Our success depends on the supervisory staff that implements OCC policies: nearly 3,000 examiners, attorneys, economists, information technology experts, and other professionals and support staff. Directly or indirectly, they are responsible for the examination and supervision of the more than 1,800 national banks, federal branches of foreign banks, and uninsured national trust companies. Our front-line examiners serve as the OCC's face to the banking industry.

Recruitment, retention, and training are thus essential to the future of our organization and our ability to perform our important mission.

During the last year, we have focused intently on our organizational and human resource capabilities and requirements. The challenge we face is embedded in the OCC's changing demographics: fully 30 percent of our current employees and 50 percent of our managers will be eligible to retire in the next five years. Recruitment, retention, and training are thus essential to the future of our organization and our ability to perform our important mission.

During the last year, we have made unprecedented strides in recruitment and hiring of examination staff, bringing aboard 162 new college hires and 37 mid-career hires from industry and other agencies. We have also made great strides in assessing the agency's skill requirements and laying plans for the training programs needed to meet them. This is an advantageous moment to be tackling these challenges. The current sound condition of the national banking system allows us to focus on our personnel needs in a measured and orderly way. We are also well positioned by the OCC's own financial health, which is discussed elsewhere in this *Annual Report,* and our growing reputation as a workplace of excellence.

The OCC placed sixth among more than 170 peer agencies and bureaus in a survey of "The Best Places to Work in the Federal Government." Also, *BusinessWeek* magazine named us among the 50 best places in America to start a career. These results are not only a matter of organizational pride, but also an asset of considerable value to us as we work to recruit and retain the best qualified individuals to fill our evolving personnel needs.

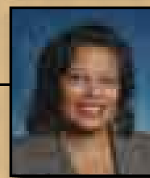
We are living in a time of great uncertainty and constant change, but I am confident that we are prepared to evolve with the market, meet new challenges, and respond to emergencies—just as the OCC has done throughout its 143-year history.

John C. Dugan
Comptroller of the Currency
October 2006

John C. Dugan
Comptroller of the Currency

Thomas R. Bloom
Senior Deputy Comptroller
and Chief Financial Officer

Jeffrey A. Brown
Senior Deputy Comptroller
for International and Economic Affairs



Jackie Fletcher
Chief Information Officer

Samuel P. Golden
Ombudsman

Timothy W. Long
Senior Deputy Comptroller
for Mid-Size/Community Bank
Supervision

Mark A. Nishan
Executive Officer for Leadership,
Learning, and Workplace Fairness

Douglas W. Roeder
Senior Deputy Comptroller
for Large Bank Supervision

Emory Wayne Rushton
Senior Deputy Comptroller
and Chief National Bank Examiner

John G. Walsh
Chief of Staff and Public Affairs

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel

Headquarters
Data Center
District Offices
Field Offices
Field Office Satellite Office
Ombudsman Office

II. Agency History and Profile

President Abraham Lincoln established the Office of the Comptroller of the Currency (OCC) by signing the National Currency Act of 1863, which empowered the fledgling bureau to organize a system of nationally chartered banks and administer a uniform national currency that generated badly needed revenue during the Civil War.

The currency-related duties of the OCC, a bureau of the Department of the Treasury, ended after the Banking Act of 1935 retired national bank currency in favor of Federal Reserve notes, but the agency continues to supervise, regulate, and charter national banks.

Much has changed during the OCC's history. Examiners once painstakingly counted all of a bank's cash during an examination and faithfully recorded each national bank's "resources" and liabilities in the annual *Report of the Comptroller of the Currency*. In later years, examiners encoded telegraph messages to headquarters using a pocket-sized "Cipher Code" book for reference.

What has not changed during the past 143 years is the OCC's steadfast dedication to ensuring a safe, sound, and fair national banking system for all Americans.

Today, the OCC supervises more than 1,750 national banks, more than 80 uninsured national trust companies, and 49 federal branches of foreign banks in the United States.

National banks represent only about a quarter of the commercial banks nationwide, but they hold about two-thirds—$6.4 trillion—of the nation's total commercial banking assets. Including federal branches and uninsured national trust companies, total assets under OCC supervision are nearly $6.5 trillion.

The OCC has nearly 3,000 employees, including almost 2,000 bank examiners.

John C. Dugan is the 29th Comptroller of the Currency and the chief officer of the OCC. An 11-member Executive Committee, comprised of senior agency officials who lead major business units, advises the Comptroller.

The OCC operates entirely free of taxpayer dollars. Semiannual assessments on national banks account for about 97 percent of the OCC's operating budget. The agency also receives interest income from investments in U.S. Treasury securities, licensing fees, and other fees.

The agency is headquartered in Washington, D.C., and maintains a number of offices throughout the country, including a data center in Maryland, an Office of the Ombudsman in Houston, and district offices in Chicago, Dallas, Denver, and New York City. The agency also has 52 field offices and 25 satellite locations that give it a full-time presence in two-thirds of the states, as well as examiner teams that are resident full-time in the 22 largest national banks. An office in London facilitates the supervision of international activities of national banks.

III. Operations and Accomplishments

The Office of the Comptroller of the Currency supervises institutions representing 67 percent of the nation's banking assets, ranging from small agricultural banks in the farm belt to the largest banks in the world—including some with more than a trillion dollars in assets.

Large bank supervision is accomplished in part through teams of experienced examiners assigned full-time to individual institutions. They are supported by all of the resources a national regulator can bring to the task, including a strong legal staff and experts in a variety of risk areas, such as capital markets, bank technology, credit risk, and compliance. In addition, Ph.D. economists—the OCC's "quants"— work with national bank examiners to evaluate the complex models banks use to manage risk.

The national banking industry is diverse, competitive, and constantly changing, requiring the OCC to evolve with the industry.

Community institutions, the economic backbone of America's communities, represent by far the largest number of banks supervised by the OCC. The OCC has a network of field offices that examine these smaller banks in every state in the country. Each field office oversees a portfolio of banks, and the examiners are frequently on the road, traveling from bank to bank for examinations.

In between are mid-size national banks that have outgrown the community bank category and share some attributes with large banks. This bank segment draws examiners from Large Bank Supervision as well as the ranks of community bank examiners. Mid-size banks are key training grounds for examiners who typically start their careers in community banks, then can move into specialized fields in large banks as their expertise grows.

In addition, the OCC supervises credit card banks, uninsured national trust companies, and federal branches of foreign banks.

The national banking industry is diverse, competitive, and constantly changing, requiring the OCC to evolve with the industry. The keys to the OCC's success as a banking regulator are the dedicated and highly skilled professionals who work for the agency. To ensure that the agency has the skills to keep pace with an evolving industry and to ensure continued strong leadership as the baby boom generation reaches retirement, the OCC has made top priorities of staff recruitment, retention, training, and the development of a new generation of leaders.

Fiscal Year 2006 Highlights

- Issued Interagency Guidance on Nontraditional Mortgage Products, which addressed issues raised by interest-only and payment-option mortgage loans.
- Published the revised Federal Financial Institutions Examination Council (FFIEC) *Bank Secrecy Act/ Anti-Money Laundering (BSA/AML) Examination Manual* to provide bankers and bank examiners with comprehensive guidance and resources about requirements and the agencies' expectations.
- Exceeded recruiting goals by hiring 162 entry-level bank examiners, adding to a highly qualified and diverse pool of talent. Also brought aboard a record number of mid-career banking specialists.
- Proposed legislation passed by Congress to raise the limit on banks' investments in urban revitalization and rural redevelopment.
- Hosted a forum in New Orleans with other banking agencies titled "The Future of Banking on the Gulf Coast: Helping Banks and Thrifts Rebuild Communities." Bank executives from the Gulf Coast region and elsewhere discussed the challenges facing banks and thrifts affected by hurricanes Katrina and Rita and strategies for meeting the needs of local communities.
- Filed "friend of the court" briefs in cases that affirmed federal preemption of state law restriction of national bank activities.
- Issued for comment the interagency notice of proposed rulemaking to implement the Basel Committee on Banking Supervision's new capital accord (Basel II) for large, internationally active banks and an interagency notice of proposed rulemaking on changes to the agencies' risk-based capital standards for market risk.
- Fully implemented supervision by risk for both large and community national banks. Effective supervision tailored examinations to risks presented, addressing safety and soundness issues, and applicable specialty areas. There were no national bank failures and many of the problem banks at the beginning of the year returned to sound condition. Overall, the national banking system remained in safe and sound condition, with adequate capital and earnings to support future operations.
- Completed the annual Shared National Credit review that covered 7,009 facilities (or 4,833 borrowers) with commitments totaling $1.9 trillion, in coordination with the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS).
- Initiated more than 30 process improvement studies since beginning such studies in FY 2005. Such projects have saved the OCC $1.3 million, enabled redirection of staff to higher priority needs, allowed the agency to deploy new regulatory requirements more efficiently, and met internal customers' expectations with service delivery.

Strategic Goals

The OCC pursues four strategic goals to achieve its mission:

- A safe and sound national banking system.
- Fair access to financial services and fair treatment of bank customers.
- A flexible legal and regulatory framework that enables the national banking system to provide a full, competitive array of financial services.
- An expert, highly motivated, and diverse workforce that makes effective use of OCC resources.

Here are the major operations of the OCC and the most significant accomplishments that the agency has achieved under each of the four strategic goals during FY 2006.

Strategic Goal I: A safe and sound national banking system

The OCC examines banks to ensure that each national bank operates in a safe and sound manner and complies with applicable laws, rules, and regulations. The agency also analyzes and monitors systemic risk and market trends in the national banking system, the financial services industry, and the economic and regulatory environments.

The agency continuously supervises six categories of institutions—large banks, mid-size banks, community banks, credit card banks, uninsured national trust companies, and federal branches of foreign banks—and develops supervisory strategies based on each bank's risk profile and condition. Each strategy outlines the examinations and off-site analyses that will be completed during the supervisory cycle. To carry out this objective, the OCC employs nearly 2,000 bank examiners, based in offices throughout the United States.

In FY 2006, the OCC's supervisory strategies focused on Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance, credit quality, risk management practices, audit, internal controls, integrity of financial statements, reliance on noninterest income, and other areas. Supervision also concentrated on outsourcing and vendor activities; interest rate risk models and controls; liquidity and investment portfolio practices and holdings; concentration risk; Basel II implementation; allowance for loan and lease losses methodology and adequacy; and corporate governance. Many of these issues will continue to be areas of emphasis in FY 2007 strategies.

OCC's National Risk Committee regularly briefs the Comptroller and the Executive Committee on material and emerging risks facing the national banking system, evolving business practices, and financial market issues. Risk assessment and strategies to mitigate identified risks are significant areas of focus for Executive Committee members.

When necessary, the OCC employs a range of enforcement options to help national banks correct identified problems. These options range from advice to informal and formal enforcement actions. Agency officials determine the best course of action in each particular case based on the facts of that case and reasoned judgment about how to address problems most effectively. Informal enforcement actions include commitment letters and memorandums of understanding, which often are effective in correcting problems. At the next level, formal enforcement actions include specific, formal agreements signed by a bank's board of directors and the OCC. Cease-and-desist orders are similar to formal agreements and may be enforced through assessment of civil money penalties. Cease-and-desist orders may also be enforced by a request in federal district court for injunctive relief.

Supervisory Guidance

During FY 2006, the OCC issued the following supervisory guidance, policies, and examination handbooks on issues and risks affecting national banks:

- *Nontraditional Mortgage Products.* American home buyers now have more financing options than ever before. They can choose from a menu of mortgage products that offers an array of maturities, interest rates, and payment plans. A rapid increase in home prices in some markets and other forces have led to increased popularity of mortgage products in recent years, allowing borrowers to defer repayment of principal and, sometimes, interest. Although such products, often referred to as nontraditional mortgages, can benefit some consumers, they can pose additional risks that bankers and borrowers must understand. In 2006, the OCC, FRB, FDIC, OTS, and National Credit Union Administration (NCUA) issued Interagency Guidance on Nontraditional Mortgage Products. The guidance instructed banks to offer the consumer loan terms and underwriting standards consistent with prudent lending practices and clear and balanced information about a product's relative risk and benefits before the product choice is made. To assist financial institutions in implementing the guidance, the agencies published for comment examples of consumer information that reflect the recommended practices. (OCC Bulletins 2006–41, 42, and 43)
- *Guidelines for Identifying and Managing Commercial Real Estate Concentrations.* In recent years a growing number of financial institutions have developed high and increasing concentrations of commercial real estate (CRE) loans on their balance sheets. These

concentrations can make institutions vulnerable to cyclical commercial real estate markets. In response to this development, the OCC, FRB, FDIC, and OTS issued for comment proposed guidance that reinforces the agencies' regulations and guidelines for safe and sound real estate lending programs. The proposal also set forth thresholds for the agencies to use in assessing whether an institution had a CRE concentration and would be expected to employ more robust risk management practices. The agencies are reviewing the comments received on the proposed guidance and expect to issue final guidelines in FY 2007. (OCC Bulletin 2006–2).

- *Risk Management Guidance for Automated Clearing House Activities.* Advances in technology have brought about significant changes in the nature and volume of automated clearing house (ACH) activity. The ACH system is a nationwide electronic payment system used by businesses, governments, and consumers for cost savings and convenience. Common ACH transactions include direct deposit of payrolls and government benefit checks and direct payments of mortgages and loans. Increasingly, the ACH system is also used for nonrecurring consumer transactions for the purchases of goods and services. In light of these developments, the OCC issued guidance to bankers and examiners on the risks that banks may incur when originating, receiving, or processing ACH transactions and on the key components of an effective ACH risk management program. (OCC Bulletin 2006–39)
- *Sound Practices for Managing Complex, Structured Finance Activities.* Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers, and investors in more efficient ways. Various financial derivatives, asset-backed securities with customized cash flows, and specialized finance conduits that manage pools of assets have become an essential part of U.S. and international capital markets. The OCC, FRB, FDIC, OTS, and the Securities and Exchange Commission (SEC) issued revised guidance for comment to assist institutions in identifying, evaluating, managing, and addressing the risks of complex, structured financial transactions. (OCC Bulletin 2006–22)
- *Guidance and Examination Procedures on Community Reinvestment Act (CRA) Activities.* The OCC, FRB, and FDIC updated examination procedures based on FY 2005 revisions to their CRA regulations. (OCC Bulletins 2006–6, 16, 17, 21, and 29)
- *Advisory on Unsafe and Unsound Limitation of Liability Clauses in External Audit Engagement Letters.* A properly conducted audit provides an independent and objective view of the reliability of a financial institution's financial statements. Limits on an external auditor's liability could weaken the auditor's objectivity, impartiality, and performance. In response to an increase in the types and frequency of such provisions in financial institutions' external audit engagement letters, the OCC, FRB, FDIC, OTS, and NCUA issued a joint advisory to financial institutions to alert them not to enter into arrangements that include certain limitations that the agencies deem to be unsafe and unsound. (OCC Bulletin 2006–7)
- *Disaster Preparedness.* When the prospect of an avian flu pandemic surfaced in FY 2006, the OCC led the interagency development of an advisory to raise industry awareness of the threat and of the need to plan for possible business disruptions of long durations and wide geographic impact. The OCC and other FFIEC agencies also issued a booklet, "Lessons Learned from Hurricane Katrina: Preparing Your Institution for a Catastrophic Event" to document the knowledge gleaned from the financial industry's responses to the devastation from the hurricane. (OCC Bulletins 2006–12 and 26)
- *Gift Card Disclosures.* In August, the OCC issued guidance to national banks and examiners on issues associated with gift cards. The guidance focused on the need for national banks that issue gift cards to ensure that purchasers and recipients are fully informed of the product's terms and conditions. The OCC noted that gift cards present special challenges because providing disclosures to a purchaser may not suffice to inform the gift card recipient about the product. The OCC guidance urged national bank gift card issuers to provide critical information to recipients as well as purchasers. The OCC also advised national banks to avoid certain practices that could be misleading to consumers, for example, advertising a gift card with "no expiration date" if recurring fees could consume the card balance. (OCC Bulletin 2006–34)

Modernizing Regulatory Risk-Based Capital Standards

Bank capital serves as a buffer against anticipated and unexpected losses. Risk-based capital standards are designed so that if banks take on greater risk, they must hold more capital. The current risk-based capital framework, implemented in 1989, relies on a very crude distinction between risks. The OCC is working with the FRB, FDIC, and OTS to ensure that regulatory capital requirements better reflect the risks facing the banking industry.

The agencies' capital reform efforts for the largest and most complex banks are focused on the U.S. implementation of the Basel Committee on Banking Supervision's revised capital accord, known as Basel II. The Basel II framework is designed to provide a more risk-sensitive capital process that incorporates information from advanced risk management and measurement systems used by large banks. In September, the agencies issued for comment the interagency notice of proposed rulemaking to implement Basel II, an interagency notice of proposed rulemaking on changes to the risk-based capital standards for market risk, and proposed supervisory reporting templates to collect key data required under the proposed Basel II framework and revised market risk standards. The agencies also continued to work on supervisory guidance that outlines those portions of the risk measurement and management systems that banks subject to the Basel II framework would need to meet.

The Basel II framework is not appropriate for all banks in the United States. Many of those banks need meaningful, but simpler, improvements in their risk-based capital requirements to align capital more closely with risk. To address this need, the agencies issued an advance notice of proposed rulemaking in October 2005 that sought comment on possible changes to improve the agencies' current capital rules for non–Basel II banks. The agencies have reviewed those comments and are proposing modifications to their rules. Publication of the proposed rule, known as Basel 1A, is anticipated in early 2007.

Bank Secrecy Act/Anti-Money Laundering

Early in FY 2006, the OCC launched a comprehensive set of initiatives to ensure that its BSA/AML supervision is not only effective, but also measured and fair. "The post–9/11 world is profoundly different in many ways from what it used to be, and that is certainly true in the BSA area," Comptroller Dugan said in a speech in November 2005. "Whether we like it or not, the traditional concerns of BSA—disrupting the money flow of the drug trade and other illicit activity—have been joined with concerns about combating the financing of terrorism."

Highlights include:

- Published the FFIEC's revised *BSA/AML Examination Manual* in July 2006. The FFIEC, assisted by the Financial Crimes Enforcement Network (FinCEN), reorganized and updated the manual to reflect recent changes to the BSA/AML regulations. The manual also offers updated supervisory guidance for examiners when conducting risk-focused compliance examinations related to BSA/AML and the Office of Foreign Assets Control (OFAC). (OCC Bulletin 2006–33)
- Completed BSA/USA PATRIOT Act (USPA) examinations for mid-size banks.
- Completed BSA/USPA compliance reviews for 90 percent of non-high-risk community banks. The agency completed these reviews for all large banks and high-risk community banks in FY 2005.
- Developed a national pool of BSA/AML examiners, including 20 OCC employees who earned Certified Anti-Money Laundering Specialist credentials as of June 2006.
- Delivered BSA/AML training to all examiners-in-charge in Large Bank Supervision and most compliance specialists.
- Doubled the number of classes in the OCC's updated BSA/AML internal training program for examiners. During these eight classes in FY 2006, the agency trained 187 examiners to recognize potential money laundering risks, understand high-risk products and services, and assess the adequacy of a bank's policies and procedures.
- Completed BSA/AML training for all examiners in the Mid-Size/Community Bank Supervision program and all examiners performing BSA/AML work in the Large Bank Supervision program who had not completed such training in the past two years.
- Served as a member of the interagency working group that published the *U.S. Money Laundering Threat Assessment*, which is the first government-wide analysis of money laundering in the United States.
- Served as a member of the interagency working group that provided significant assistance to the Financial Action Task Force (FATF) in its Mutual Evaluation of the Anti-Money Laundering and Combating the Financing of Terrorism Regime of the United States.

BSA/AML Enforcement
OCC is committed to ensuring that banks have adequate and effective BSA/AML programs in place. The agency is also committed to balanced supervisory discretion by taking supervisory actions fairly and consistently.

The OCC investigates national banks that fail to meet BSA/AML requirements and brings enforcement actions against them. Banks must implement adequate BSA compliance programs in accordance with OCC regulations, establish procedures to identify and monitor high-risk accounts, and report suspicious transactions. The OCC coordinates with other regulators and law enforcement authorities to ensure such compliance and detect, track, and prevent attempts by terrorists and other criminals to use the national banking system for their activities.

The OCC brought enforcement actions against several banks for inadequate BSA/AML compliance programs, ordering them to develop and implement internal controls, conduct audits, designate BSA compliance officers, and conduct employee training programs. For example:

- A federal branch agreed to the OCC assessment of a $3 million civil money penalty (CMP) for deficiencies in its internal controls, particularly in the area of BSA/AML compliance.
- The OCC issued a cease-and-desist order by consent against a bank for failing to have an adequate BSA compliance program and for failing to take appropriate action to determine the risk level of its customer base.
- The OCC issued a cease-and-desist order by consent against a bank with a large number of high-risk accounts for failing to implement an adequate system of internal controls to identify and monitor those accounts, and for failing to implement adequate testing of its BSA/AML compliance.
- The OCC issued a cease-and-desist order by consent against a bank for failing to have an adequate BSA compliance program. The order required the bank to adhere to a strategic plan, which would be terminated in the event of the sale, merger, or liquidation of the bank.
- The OCC issued a cease-and-desist order by consent against a bank for an inadequate BSA/AML program and for failing on multiple occasions to file suspicious activity reports. In addition, the bank's former President and Chief Executive Officer (CEO) agreed to the OCC's prohibition and cease-and-desist orders, and a $100,000 CMP for allegedly issuing and concealing millions of dollars' worth of unsafe or unsound loan guarantees. The cease-and-desist order required the former President to make restitution of $407,000 to the bank, to reimburse the bank $100,000 for expenses, and to indemnify the bank for half of any judgments against it related to the worthless guarantees.
- The OCC issued a cease-and-desist order by consent against a bank for failure to correct previously identified deficiencies in its BSA/AML program.
- The OCC issued a cease-and-desist order by consent against a federal branch for deficiencies in its BSA/AML program, including inadequate internal controls over its wire pouch activities and demand deposits, and lack of independent testing. The bank had previously been subject to formal enforcement action for BSA/AML deficiencies.

Enforcement

In addition to BSA/AML enforcement, the OCC takes other formal and informal enforcement actions to support prompt detection and mitigation of problems before they affect a bank's viability, and to ensure orderly resolution of troubled banks. These actions address violations of laws, rules, and regulations, unsafe or unsound banking practices, and noncompliance with policies or procedures by national banks, their insiders, and other affiliated parties.

During FY 2006, formal enforcement actions included temporary cease-and-desist orders, final cease-and-desist orders, removal or prohibition orders, CMPs, and formal agreements. The agency also took informal actions, including supervisory letters, memorandums of understanding, and letters of reprimand. In addition, the OCC's Fast Track Enforcement Program helped ensure that bank insiders and employees who committed criminal acts involving banks, but who were not being criminally prosecuted, were banned from working in the banking system. Table 1 summarizes enforcement actions taken in FY 2006.

Enforcement Actions against Banks and Bank Insiders
The OCC brought these actions to detect and mitigate problems at banks that could affect their viability. The agency also took action against bank insiders and other institution-affiliated parties when practices, conduct, or breaches caused, or could have caused, harm to a bank, or resulted in financial gain or other benefit for the insider.

- The OCC issued a prohibition order by consent and assessed a $100,000 CMP against a former bank President accused of causing the bank to make unauthorized payments for personal expenses totaling at least $388,000 for himself and his family. The former President made restitution of the unauthorized payments before the OCC's action.
- The OCC issued a prohibition order by consent against a former bank President accused of causing the bank to make loans significantly exceeding its legal lending limit (which led to closure of the bank), creating false bank records, and engaging in a fraudulent wire transaction. The OCC's supervisory office also assisted the Assistant U.S. Attorney for the Western District of Wisconsin in criminal proceedings. The judge in that case ordered the former bank President to serve nine years in prison and pay $13.4 million in restitution to the bank.
- The OCC issued a prohibition order by consent and assessed a $25,000 CMP against a former bank Senior Vice President accused of embezzling about $700,000, which he repaid to the bank in full, plus $21,500 in related bank costs, before the OCC's action.

- Following the issuance of a cease-and-desist order against a bank for violations of law and regulation and for problems in its lending program, the bank's Chairman and CEO agreed to the OCC's assessment of a $5,000 CMP against him for alleged violations of laws governing legal lending limits, insider loans, and affiliate transactions. The OCC issued a second cease-and-desist order by consent and assessed a $20,000 CMP against the bank for failing to maintain adequate and accurate records, and for filing inaccurate reports on the bank's condition.
- The OCC issued prohibition orders by consent and assessed CMPs of $5,000 each against two former senior bank officers accused of embezzling bank funds and for assisting other executive officers' misconduct. The OCC also assessed CMPs ranging from $7,500 to $10,000 against four bank directors for inadequate oversight of the bank's affairs and for the bank's failure to comply with a 2002 OCC formal agreement. The bank has been purchased by another financial institution. Further enforcement actions are pending.

Actions to Enforce Federal Standards for Mortgage Lending

A mortgage lending subsidiary of a national bank engaged in a pattern of submitting loans to the U.S. Department of Housing and Urban Development (HUD) for Federal Housing Administration insurance without proper review and certification by appropriate underwriters, as required by HUD. The subsidiary agreed to pay approximately $6.8 million to HUD in restitution, agreed not to submit insurance claims on certain FHA loans, and was assessed a $6.25 million CMP.

Enforcement Investigations and the Right to Financial Privacy Act

The U.S. District Court for the Northern District of Texas ruled in favor of the OCC in a case involving enforcement of an OCC subpoena challenged under the Right to Financial Privacy Act (RFPA). The court found that the OCC's investigation of the plaintiff (a bank officer) for nonpayment of wire transfer fees was conducted pursuant to the OCC's statutory authority and necessarily qualified as a "legitimate law enforcement inquiry" for RFPA purposes. The OCC was thereby allowed access to the bank officer's personal financial records held at a non-national bank, the court said. The court rejected the bank officer's argument that the OCC must cite a specific violation of law to comply with RFPA requirements. *Abrams* v. *OCC,* No. 3:05–CV–2242–L (N.D. Tex. August 3, 2006)

Actions Involving Flood Insurance

The OCC continued to review the compliance of national banks with federal regulations requiring flood insurance for certain properties located in special flood hazard areas that secure loans by national banks. The OCC assessed CMPs totaling $32,900 against six banks for violating flood insurance requirements in FY 2006.

Table 1: Enforcement Actions, FY 2006

Type of enforcement action	FY 2006	
	Against banks	Against institution-affiliated parties
Cease-and-desist orders	13	9
Temporary cease-and-desist orders	2	0
12 USC 1818 civil money penalties	6	41
12 USC 1818 civil money penalties amount assessed	$9,495,000	$693,500
Flood insurance civil money penalties	6	0
Flood insurance civil money penalties amount assessed	$ 32,900	0
Restitution orders	1	12
Amount of restitution ordered	$6,800,000	$545,604
Formal agreements	27	0
Memorandums of understanding	16	0
Commitment letters	7	0
Suspension orders	0	0
Letters of reprimand	0	41
12 USC 1818 removal/prohibition orders	0	42
12 USC 1829 prohibitions	0	232
Total enforcement actions	**78**	**377**

Hurricane Katrina: OCC Helps Banks and Customers Rebound

> *"It is clear that we have a long road ahead before the region returns to normal, but however great the task, the OCC staff and national bankers I spoke to are ready to play their part."*
>
> —Comptroller Dugan

At 3:00 a.m. on the morning before Hurricane Katrina made landfall along the Louisiana and Mississippi coasts, a local bank executive sent an e-mail to his examiner-in-charge. He and his employees were "up to our ears in alligators," he said, and they had begun executing contingency plans. The region had been through hurricanes before, but this one was going to be different.

The unprecedented magnitude and duration of Hurricane Katrina caused major losses that exceeded the scope of disaster response plans. A second hit from Hurricane Rita three weeks later created an unimaginable situation for area banks, examination teams, and their families.

Many banks had to evacuate twice and execute two separate contingency plans. More than 600 employees of Whitney Bank evacuated from New Orleans to Houston only to move again to avoid Rita's wrath. Hibernia Bank, now part of Capital One, evacuated more than 1,400 employees. OCC employees and their families also fled. Many lost much; some lost everything.

In the days and months after the storms, the financial industry and its regulators showed strength and resilience. Alongside bankers and other federal regulators, OCC employees supported citizens, communities, and banks throughout the region.

"I'm very proud of the way our banks and our team members reacted," Comptroller of the Currency John C. Dugan said. "OCC and the other federal and state bank regulators have often been held up as examples of government at its best."

As chairman of the FFIEC, a group of federal banking regulators, the Comptroller played a central role in shaping interagency responses to the disaster.

Reaching Customers and Taking Care of People

Although realistic and well-rehearsed plans for recovery and continuity can help organizations to manage crises, Katrina showed that institutions must improvise, adapt, and overcome obstacles as events unfold. After Katrina, financial institutions adapted procedures to facilitate check cashing for non-customers, shared limited workspace, and worked cooperatively in new ways to meet customer and community needs.

Immediately after the storm, the OCC publicly encouraged national banks to consider helping affected customers by giving them extra time to make loan payments, restructuring their debts, and easing credit terms for new loans.

OCC examiners also acted as facilitators between their banks and other federal agencies. For example, when the flow of mail slowed to a trickle after the storms, the OCC set up meetings between bankers and representatives of the U.S. Postal Service. Over the weeks, the decline in calls to federal regulators signaled progress.

As banks began to reopen offices and resume operations, reconstituting bank staffs presented significant challenges. In response to these challenges, banks moved their back-office operations out of storm-damaged areas, changed operating hours to accommodate employees who were putting their lives back together, and offered pay increases to entice new employees, as well as encourage former employees to return. In one large bank, 90 percent of the loan processing staff had not come back to work a year after the storms. While some employees could return sooner than others, commutes were difficult for months.

Re-establishing communication with customers also presented a significant challenge. More than a million people from the Gulf Coast were displaced and spread across the nation, making it nearly impossible for lenders to locate many customers. While regulators encouraged lenders to work with storm victims, lenders could not assess or meet customers' needs without direct contact.

To help solve this problem, the FFIEC sponsored a public service advertising campaign reaching out to encourage hurricane victims to contact their lenders. The radio and print spots began in mid-January and reached an audience of more than 4.7 million people in fewer than 90 days.

The FFIEC later collected valuable hurricane-related lessons from regulators and industry professionals, and documented them in "Lessons Learned from Katrina: Preparing Your Institution for a Catastrophic Event."

The OCC to Employees: "Whatever you need"

The OCC also responded to the needs of its employees and their families who were directly affected by the storm. Like other hurricane victims, OCC families were uprooted by the storms, their homes and lifestyles destroyed. The agency immediately put employees displaced by the storm on travel status, providing them with lodging, a daily stipend, access to cash advances, and other benefits. On a personal level, employees took up collections and made donations to support one another.

The agency explored and authorized alternative work arrangements to help employees return to work from new locations. The OCC also provided equipment, such as wireless handheld devices and laptop computers, to help displaced employees reconnect.

"Getting back to work was important to all of us, so we could return to some semblance of normalcy," said Mary Reeves, an OCC national bank examiner displaced by the storms. "I'll never forget what the agency did for us: 'Whatever you need,' they said."

Enabling a Rebuilt Gulf Coast

A year after Katrina, rebuilding the Gulf Coast has only begun. Banks and other financial institutions play critical roles in that effort. Early in the process, Comptroller Dugan took a direct and personal interest in coordinating activities to support the region.

"Nothing can prepare you for a drive that takes you past mile after mile of uprooted trees, abandoned cars, and concrete foundations that mark the spots where homes once stood," the Comptroller said after his first visit to the region. "It is clear that we have a long road ahead before the region returns to normal, but however great the task, the OCC staff and national bankers I spoke to are ready to play their part."

As FFIEC chairman, Comptroller Dugan immediately called for a special interagency working group to coordinate and monitor activities supporting the region. This coordination helped the FFIEC provide broad and flexible guidance giving financial institutions more leeway to meet the needs of their communities.

In October 2005, regulators announced exceptions to regulatory requirements for appraisals in areas affected by hurricanes Katrina and Rita. Waiving the requirements for appraisals allowed speedier granting of loans for recovery from the disasters. In that same month, the OCC announced a partnership with Operation HOPE, Inc., to provide bank customers with information about accounts, lost financial records, ATM cards, direct deposits, how to contact a national bank branch, and other matters.

In December 2005, the agency expanded its presence by establishing an additional OCC Community Affairs Officer in the region to work with national banks, community groups, government organizations, and others who are rebuilding the area.

The federal agencies issued guidance in February 2006 to allow financial institutions to receive Community Reinvestment Act credit for activities that revitalize and stabilize designated disaster areas even though the lender may be based outside that area. The guidance also stated that national banks could receive positive consideration for activities benefiting people who had been displaced by the hurricanes and perhaps had relocated to other states.

In March 2006, regulators hosted a forum, "The Future of Banking on the Gulf Coast: Helping Banks and Thrifts Rebuild Communities." This forum brought community groups, the federal regulatory agency leaders, and lenders together to discuss the challenges facing communities, banks, and thrifts operating in areas affected by the hurricanes.

OCC examiners in New Orleans reported additional signs of progress this past summer. On August 7, the Capital One building began operating without any external generator power. From the air, observers could see that the blue dots of tarped roofs were slowly disappearing. Shops were opening on streets that were once underwater, and the first "Lucky Dog" hot dog carts returned to Jackson Square.

Hurricane Katrina was only one of the natural disasters that hit the country in 2005. Its scope and impact tested the resolve of federal regulators and the financial services industry. OCC employees and bankers passed that test and showed their mettle, finding creative and meaningful ways to meet customers' needs as they restored financial services in the flood-torn region.

Bank Performance

Here are some of the ways the OCC analyzes national bank performance and responds to bank inquiries and appeals of agency decisions and actions.

National Banks with Composite CAMELS Rating of 1 or 2

Bank regulatory agencies use a composite rating known as CAMELS (**C**apital adequacy, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk) to determine the overall condition of banks. The rating, which provides a framework for evaluating significant financial, operational and compliance factors, has a scale of 1 through 5, in which 1 is best. CAMELS ratings are assigned at the completion of every supervisory cycle or when a significant event leads to a change in CAMELS components. In FY 2006, 95 percent of national banks received a CAMELS rating of either 1 or 2, showing the overall strength of the national banking system and the U.S. economy.

Rehabilitated National Banks

Although problem banks sometimes reach a point beyond which rehabilitation is no longer feasible, OCC's early identification of, and intervention with, problem banks can lead to their successful rehabilitation. The OCC proposes corrective actions to improve operations at problem banks. As a result, 46 percent of banks with composite CAMELS ratings of 3, 4, or 5 in FY 2005 improved their ratings to either 1 or 2 in FY 2006. This is an improvement from 44 percent in FY 2005 and 40 percent in FY 2004.

Shared National Credit Modernization

The Shared National Credit (SNC) program is a collaborative review and assessment by the OCC, FRB, FDIC, and OTS of the largest and most complex loans that are shared by multiple financial institutions. The 2006 SNC review, which covered 7,009 loan facilities with commitments totaling $1.9 trillion, found that overall SNC credit quality was good. But the review noted a small increase in the level of adversely rated credits. The bulk of this increase was associated with credits held by nonbank entities, while problem loans at regulated institutions—most notably those with insured deposits—grew slightly. The review also found a continued easing of credit underwriting standards in the syndicated market in general, particularly in non-investment-grade, or leveraged-credit, facilities.

In FY 2006, the OCC assumed the lead of an interagency modernization initiative to standardize and expand the data collection process to improve the effectiveness of reviews. The initiative will continue in FY 2007.

Well-Capitalized National Banks

The Federal Deposit Insurance Act classifies insured depository institutions into five categories (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized) based on their capital levels relative to their risks. At the fiscal year-end, 99 percent of national banks were categorized as well capitalized. National banks' capital has remained at this high level for the past several years.

National Bank Appeals

The national bank appeals process is an avenue for the OCC and national banks to address disagreements arising from the supervisory process that cannot be resolved through informal discussions. National banks may appeal OCC decisions and actions to the Office of the Ombudsman. With the consent of the Comptroller, the Ombudsman can stay a pending decision or action until the appeal is resolved. In FY 2006, the Ombudsman's office received about 90 substantive appeal-related inquiries, informal appeals, and formal appeals. Separate from the appeals process, banks may provide confidential feedback at the end of each supervisory cycle on the OCC supervisory process by completing an examination questionnaire administered by the Ombudsman's office.

Table 2: Performance Measures, FY 2006

Performance Measures	Target	Actual
Percentage of national banks with composite CAMELS rating of 1 or 2	90%	**95%**
Rehabilitated problem national banks as a percentage of the problem national banks in FY 2005	40%	**46%**
Percentage of national banks that are categorized as well capitalized	95%	**99%**

Quantitative Risk Models Provide New Insights for Bank Supervision

An explosion of computing power is making a major impact on banking by putting abstract economic models onto personal computers and into banks of all sizes.

Computer modeling to perform complex risk analysis has grown rapidly from small beginnings a dozen years ago to a central role in the national banking system.

Even smaller banks are now using computer models to manage areas of business, such as loan underwriting, credit risk, and asset-liability management. In large banks, the modeling that began in derivatives eventually spread to all lines of business.

To gauge the effectiveness of increasingly pervasive modeling, the OCC employs quantitative modeling experts, who work with members of examination teams in large banks.

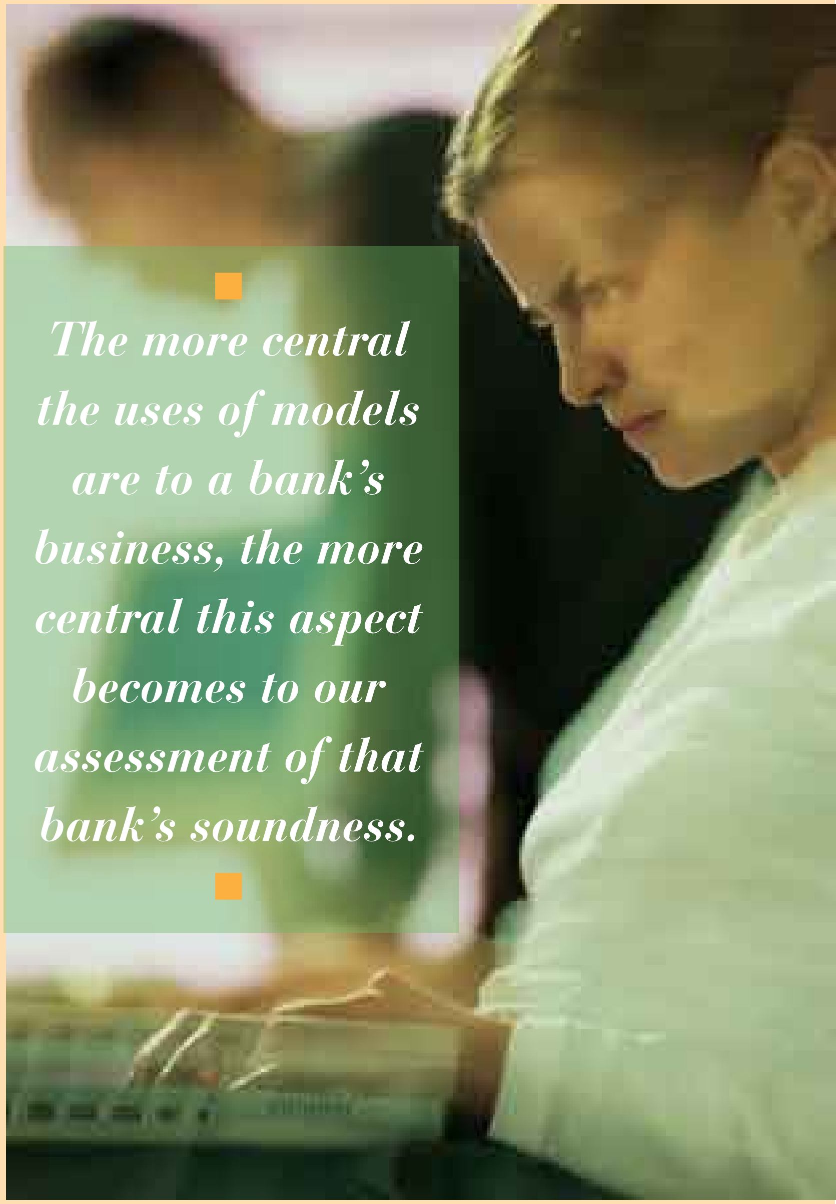
What began as a two-person shop in 1994 has grown into a 30-person Risk Analysis Division (RAD), working hand-in-glove with examiners to assess the safety and soundness of national banks' quality controls for computer risk analysis modeling and to assess national banks' fair lending performance.

These experts not only help examiners evaluate the modeling activities of banks, but offer expert advice on best practices in quantitative modeling. The OCC modeling experts have also been busy assessing the quantitative risk systems that would provide inputs for banks to use under the proposed Basel II capital rule.

The agency has sponsored two conferences on computer modeling. The first, on how to build credit rating-and-scoring models, featured experts from the industry and the OCC.

At a follow-up conference in February 2006, OCC experts provided guidance on how to validate those models and develop quality controls to make sure they work as intended. Interest in the conference ran high and organizers had to limit the number of attendees to 400.

"If a bank relies on models in ways that are integral to its business processes, then the soundness of the organization is likely to depend on the validity of those models," Comptroller Dugan told the audience of bankers and officials of other regulatory agencies during the conference luncheon speech. "Models and validation become integral to the way we supervise the bank, making model validation very much our concern. The more central the uses of models are to a bank's business, the more central this aspect becomes to our assessment of that bank's soundness."



> *The more central the uses of models are to a bank's business, the more central this aspect becomes to our assessment of that bank's soundness.*

Although the OCC has supervised federally chartered banks since the creation of the national banking system more than 140 years ago, its supervision is anything but old-fashioned. The RAD team is only one example of how the world-class expertise of the OCC workforce positions the agency well for its next century of challenges.

Partnership and Outreach

The OCC maintains ties to other financial regulators and the banking industry.

Industry Outreach
Industry outreach programs are key vehicles for the Comptroller and other senior OCC officials to exchange information with bank executives and trade association representatives. The Comptroller is a frequent speaker at major industry conferences and events.

The OCC offers programs and conferences to provide information to bankers and bank directors on emerging issues and regulatory requirements. Periodic seminars are offered on the Web and by telephone so bankers can hear agency experts discuss their experiences and regulatory expectations, and can directly ask the experts questions.

The OCC, other federal banking agencies, FinCEN, and OFAC hosted four well-attended conference calls for examiners and bankers about the revised FFIEC *BSA/AML Examination Manual.* More than 10,000 callers listened and participated in an extensive question-and-answer session.

Another 2006 highlight was a program covering "The New CRA Perspective for You and Your Bank." Approximately 2,000 listeners participated from more than 400 sites.

The OCC sponsors programs each year to foster dialogue between the Comptroller and groups of chief executive officers of national banks. Discussion focuses on the nuts and bolts of OCC supervision, economic and community development trends, and broad issues of public policy. In 2006, the agency hosted about 240 CEOs at programs in Tampa, Dallas, Chicago, Los Angeles, and New York City.

The OCC also conducted 15 workshops for about 750 community bank directors that addressed topics such as credit risk, compliance risk, and the OCC's risk assessment process.

Working with Other Financial Regulators
The dynamic and global nature of today's financial services industry presents issues that cut across regulatory and legal boundaries. Banks, securities, and insurance firms participate actively in the credit and capital markets and are often counterparties to each other's transactions; electronic payment systems span the globe; and national banks have offices and customers in countries throughout the world.

Primarily through the FFIEC, the OCC works with the other federal financial agencies (FRB, FDIC, OTS, and NCUA) to coordinate supervisory policies, regulations, regulatory reporting requirements, and examiner training. The agencies also coordinate to supervise institutions that are subject to multiple regulators and perform joint examinations when necessary. Joint supervisory programs include the FFIEC's examination program for multi-regional data processing servicers and the SNC program.

The OCC also works with the SEC on issues such as securities, brokerage, accounting, and disclosure, and with the Federal Trade Commission (FTC) on consumer protection and privacy. In particular the OCC worked with the SEC in developing its "Reg B" rule to define when bank securities activities will be regulated as brokerage. The OCC has agreements with 49 state insurance departments and the District of Columbia to share information about insurance-related supervision and consumer complaints.

The OCC is a member of the administration's Financial and Banking Infrastructure Information Committee (FBIIC) and works with FBIIC, the Department of Homeland Security, and other agencies to combat money laundering and terrorist financing, and to prepare the nation's financial sector for catastrophic events.

The OCC is a member of the National Interagency Bank Fraud Working Group and the Bank Secrecy Act Advisory Group to combat fraud and money laundering in the financial services industry. These groups include representatives of the Department of Justice, the FBI, other law enforcement agencies, the Treasury Department, FinCEN, and the federal banking agencies.

The globalization of the financial marketplace has accentuated the need for OCC to work with financial supervisors around the world. This coordination takes place through formal supervisory groups, such as the Basel Committee on Banking Supervision, the Financial Action Task Force, and the Joint Forum of banking, securities, and insurance regulators. It also occurs through direct meetings and agreements with foreign bank regulators. In addition, the OCC provides technical assistance and classroom training for foreign supervisors across the globe to strengthen their domestic supervisory programs.

As noted throughout this report, the OCC continued to work with other regulators during the fiscal year to respond to emerging risks and issues facing the industry.

The Globalization of Banking

In Cairo, OCC officials joined bankers and bank supervisors from North Africa and the Middle East to discuss anti-money laundering issues. In Washington, Russian bank supervisors met with OCC officials about recruiting, commissioning, and retaining bank examiners.

In Turkey, OCC officials met with Turkish supervisors to establish a program for Turkish examiners to attend OCC conferences to enhance their skills and strengthen the collaborative relationship on banking supervisory and analytical issues.

Banking is becoming an increasingly global enterprise, especially for the largest national banks, and as banking has become more international, so has the OCC.

As banking has become more international, so has the OCC.

"The increasing global integration of economic and financial markets and ever-expanding breadth and complexity of operations of banks heighten the importance of regular and effective communication with our international counterparts," said Nancy Wentzler, Deputy Comptroller for Global Banking.

OCC has developed excellent relationships over the years with many international bank supervisors. For example, the OCC has a valuable working relationship with the China Banking Regulatory Commission, sharing analytical tools, early warning techniques, supervisory procedures for complex products, methods to assess and provide better incentives for management and corporate governance, techniques for improved data structure and management, and programs for general employee training and performance evaluation.

The OCC also collaborates regularly with the Reserve Bank of India to exchange ideas and supervisory information. More recently, the OCC actively participated in shaping the annual banking supervisory program for the South East Asian Central Banks (SEACEN) and held seminars on stress testing techniques for this group and for bank supervisors in Latin America.

Under the agency's Foreign Technical Assistance program, the OCC establishes, builds, and maintains relationships with foreign supervisory organizations to improve bank supervision around the world.

The program increases the international expertise of OCC employees, provides a platform for OCC to present its supervisory philosophy and views to the international supervisory community, and enhances the global reputation of the agency.

"We have a good reputation around the world for supervising banks," noted Jeffrey A. Brown, Senior Deputy Comptroller for International and Economic Affairs.

In FY 2006, OCC examiners taught one-week schools in Egypt on problem bank supervision; in Colombia, Kuwait, and Egypt on evaluating bank management; in Turkey on credit risk management; and in Malaysia on economic stress testing.

The OCC also hosted interns last year from Japan, Korea, Singapore, and China. Turkey and Lebanon each sent a small team to join OCC examiners on bank examinations.

International Exchanges

The Foreign Technical Assistance program is just one example of the OCC's participation in the international financial arena.

OCC officials also meet with foreign supervisors about bank activities in foreign countries or other issues of supervisory concern. In 2006, OCC officials met with banking supervisors from India, China, Brazil, Russia, and Canada to discuss anti-money laundering, Basel II capital requirements, regulatory changes, and other issues.

These international exchanges help OCC officials measure the "country risks" that internationally active national banks encounter doing business overseas.

International collaboration on the Basel II capital accord has provided an important forum for banking supervisors from across the world to interact, exchange information about common issues, lay groundwork for information-sharing agreements, and set principles for cross-border supervision.

These information exchanges are also more important than ever to combat the global threat from terrorism by blocking the country-to-country flow of financing for terrorist enterprises. A bank can no longer be sure of avoiding supervisory scrutiny by moving assets from one nation to another.

As the banking world shrinks and international contacts among banking supervisors become commonplace, banking regulation around the globe is trending toward greater similarity. For example, supervisory authorities around the world are following the lead of U.S. bank regulators by increasingly emphasizing supervision-by-risk policies and procedures.

Although the U.S. national banking industry is enjoying excellent health, the Comptroller likes to point out that the OCC's job is to "see around corners," to look beyond the good times for signs of trouble and spot problems early before they can grow. As OCC officials develop and refine contingency plans for the possibility of a confluence of downward economic trends, they must now look not only in this country, but also beyond U.S. shores to a global system of banking.

Strategic Goal II: Fair access to financial services and fair treatment of bank customers

The OCC has a fundamental responsibility to ensure compliance with fair lending laws, the Community Reinvestment Act, and other consumer laws and regulations.

The OCC also strongly supports the community development efforts of national banks. Recognizing the importance of bank investment in America's communities, the Comptroller successfully urged Congress to increase the authority of banks and thrifts to invest in projects that provide housing, community services, and jobs for low- and moderate-income communities and families across the nation.

The Comptroller pressed for adoption of this provision in meetings with lawmakers, banker groups, and community organizations. He also visited community development projects to draw attention to the benefits of the program. These investments have a solid record of profitability and have fostered $16 billion in such investments by national banks in all 50 states in the last decade.

The agency publishes periodic *Community Development Insights* papers on products, services, and initiatives related to community development and consumer banking.

The OCC continued its work with the other federal banking agencies in FY 2006 to improve privacy notices that banks are required to send to their customers. Simple, easy-to-understand language—not tangled legalese in fine print—is the goal. In March, the agencies released "Evolution of a Prototype Financial Privacy Notice," a report summarizing research on making these notices easier for consumers to understand. The agencies have also commissioned the use of focus groups and one-on-one interviews with consumers to test samples of such notices.

During FY 2006, the OCC and other federal banking agencies not only issued examination procedures for assessing how banks complied with 2005 revisions to Community Reinvestment Act regulations, but also:

- Issued interagency questions and answers about the revisions.
- Updated lists of distressed or underserved non-metropolitan, middle-income geographic areas where bank revitalization or stabilization activities would receive CRA consideration.
- Updated median family income levels used in CRA performance evaluations.

Federal banking agencies joined HUD in releasing updated answers to questions regarding 2005 home loan data to be disclosed under the Home Mortgage Disclosure Act. The OCC also updated its consumer compliance booklet, "Fair Lending Examination Procedures."

Identity Theft and Information Integrity

Identity theft and the accuracy of consumer information reported to, and used by, credit bureaus also were major concerns to consumers, bankers, and regulators. In July 2006, the OCC, other FFIEC-member agencies, and the FTC issued proposed rules to require financial institutions and creditors to develop and implement identity theft prevention programs. The proposal included guidelines about patterns, practices, and activities that signal risks of identity theft. The agencies also published for comment proposed procedures to enhance the accuracy and integrity of information furnished to consumer reporting agencies.

The security of banks' systems and operations is essential to maintaining the privacy of customer information. In FY 2006, the FFIEC issued a revised "Information Security Booklet" that describes how a bank should protect the systems and facilities that process and maintain information. The revisions include updated information on authentication, monitoring programs, and software trustworthiness.

The OCC issued prohibition orders and, in several cases, ordered restitution or assessed CMPs against bank employees in six cases. These cases involved losses to bank customers because of identity theft committed by bank employees, or by third parties who received confidential customer information from bank employees.

Consumer Compliance Ratings

To ensure fair access to financial services and fair treatment of bank customers, the OCC evaluates banks' compliance with consumer laws and regulations. Bank regulatory agencies use the Uniform Interagency Consumer Compliance Rating System to provide a general framework for assimilating and evaluating significant consumer compliance factors at a bank. Each bank receives a consumer compliance rating based on an evaluation of its compliance with consumer protection and civil rights statutes and regulations, and the adequacy of its systems for continued compliance. Ratings are on a scale of 1 through 5, in increasing order of supervisory concern. National banks continued to show strong compliance in FY 2006 with consumer protection regulations, with 94 percent earning a consumer compliance rating of either 1 or 2.

Fair Treatment of Bank Customers

The OCC has a long history of responding aggressively in cases when it finds business practices that are predatory, abusive, unfair, or deceptive.

The OCC entered into a formal agreement in November 2005 with a national bank and its mortgage lending subsidiary requiring the bank to establish a $14 million fund to reimburse consumers harmed by the lack of appropriate controls in the bank's mortgage lending operations. Consumers entitled to restitution had: (1) paid origination fees and/or interest rates substantially different from those indicated on good faith estimates; (2) not had their creditworthiness adequately considered; (3) held subsidized loans that were refinanced with higher-cost loans, which did not appear to provide the consumers with a tangible benefit; or (4) applied for mortgage loans and were denied after receiving "preapproved" direct mail solicitations.

The agreement also required the bank to:

- Ensure that its advertising materials adequately disclosed limitations or conditions on various products and complied with the Truth in Lending Act.
- Develop a detailed consumer program for compliance with the FTC Act, the Real Estate Settlement Procedures Act, the OCC's Part 30 Guidelines, and the OCC's other issuances regarding abusive, predatory, unfair, or deceptive practices.
- Provide disclosures to consumers explaining certain product options.
- Adopt a compliance audit program.
- Develop a staffing plan to ensure a sufficient number of adequately trained personnel to support compliance and audit functions.

Customer Assistance Group

The OCC Customer Assistance Group (CAG) in Houston assists consumers who have questions or complaints about national banks or their operating subsidiaries. CAG refers complaints to the agency's law department if they (1) allege or raise concerns about possible unfair or deceptive practices, predatory lending practices, or fair lending law violations or other discriminatory practices; and (2) involve possible violations of consumer protection laws, or inconsistencies with OCC regulations or guidance.

CAG published a brochure in Spanish to assist Spanish-speaking bank customers.

Upon request from Congress, the Government Accountability Office (GAO) conducted an assessment of CAG in FY 2006. The GAO subsequently released a favorable report, noting that the OCC handles more complaints than any other federal banking agency.

The report also noted that OCC's bank examiners use consumer complaint information collected by CAG to plan or adjust examinations. CAG employees and OCC examiners regularly discuss specific complaints and complaint numbers for individual banks, and they coordinate in communicating consumer-related issues to bank officials.

"We are very proud of the work of our Customer Assistance Group," Comptroller Dugan said after the report's release. "Not only does the CAG assist customers with questions or complaints, but it helps national banks improve their customer service and it provides invaluable feedback that helps our examiners focus on problem areas."

The OCC is implementing three improvements recommended by the report: that the OCC measure customer satisfaction; revise the way it measures and reports on timeliness in resolving customer complaints; and find better ways to inform the public, state officials, and others about the OCC's role in handling consumer questions and complaints.

CAG Focuses on Quality Service for Consumers

Over the last 12 months, nearly 70,000 telephone conversations began the same way: "Hello, thank you for calling the Office of the Comptroller of the Currency's Customer Assistance Group. How can I help you today?"
At one end of the phone line, a customer had turned to the OCC for help. On the other end, a member of OCC's Customer Assistance Group responded.

While the volume of calls, e-mails, and written inquiries is large, the specialists who staff CAG's Houston facility never seem to tire of the work.

Serving consumers is "just where I get my kicks," said Rayburn Johnson, a 20-year OCC veteran with seven years experience in customer assistance. "It's what I was called to do in this life."

Added OCC Ombudsman Samuel P. Golden, whose office operates the CAG in Houston: "Customer service is not difficult if your heart is in it."

> Thank you for the prompt attention your agency gave the matter In addition not only was my issue taken seriously by your agency, but you [also] kept me informed of the progress.
>
> *—Daniel M.*

> Thank you very much for getting involved in my case about the bank unfairly raising my credit card interest rate. They have now corrected the problem and there is no question it is only because your organization became involved. Thank you again, you are so important to the "little guy" in these situations.
>
> *—John D.*

Callers' emotions vary, but the quality of service from CAG team members remains constant. "It's about trying to help as much as you can," said Vonda King, a Customer Assistance Specialist.
"Lots of times, folks just want to tell you the whole story and that's part of the process," Mr. Johnson added.

During the year, the OCC improved CAG service by expanding its hours. Under "Project Daylight," CAG now operates from 9 a.m. to 5 p.m. CST. Hours will soon expand further to 7 a.m. to 7 p.m.
Just as important, Project Daylight also initiated a tiered-service approach. That means call-center operators field initial calls, answer basic questions, and take basic information. More complex questions,

unique issues, and Spanish-language inquiries, however, can be referred to more experienced OCC staff members.

"I really like this new approach," said Alicia Loya, Customer Assistance Specialist. "It gives us more time to speak with customers."

Having an Impact

The CAG team views every complaint as an opportunity, according to Deputy Ombudsman Craig D. Stone. Some calls are an opportunity to educate consumers about applicable banking laws and to advise them of their rights. Other calls involve researching complaints about billing, credit card terms, checking accounts, mortgage loans, and other retail banking matters.

In the 12-month period ending in August 2006, the CAG team facilitated the return of nearly $7 million to consumers and, in the last five years, nearly $30 million. The vast majority of those cases involved less than $200. In many cases, good will—not bank errors—prompted the return of funds.

"At the end of the day, there's a lot of satisfaction because the consumers appreciate the effort," said Howard Greene, a CAG Customer Assistance Specialist.

Improving the Supervisory Process

Although customer service is its primary mission, the CAG team also evaluates the data gained through the volume of calls for insights on improving the OCC's bank supervisory process.

Analyses of the numbers of calls and categories of those calls point to areas of focus for bank examiners, such as compliance and managing the risks to bank reputation, according to Ombudsman Golden.

"Our systems give us the capability to look at data over time and identify trends and issues by product or banking regulation," he said.

Over the past few years, several important pieces of bank guidance originated from complaint data, including guidance related to predatory lending, unfair or deceptive practices, credit card rates, and overdraft protection.

Through this complaint analysis and follow-up action, the OCC leverages its authority as the primary regulator of national banks to achieve its goals of ensuring the safety and soundness of the financial system, while ensuring equal access and fair treatment for bank customers.

My sincere thanks to you for achieving in a week, what I was unable to accomplish in almost a year. For you and [your] staff, please accept my deepest appreciation for the fine work you do everyday for others like me.

—Sally B.

The Comptroller saw firsthand how banks can make a positive impact on communities when he visited Chicago's West Side in May to tour housing and community development projects that are contributing to the economic well-being of neighborhoods.

Community Affairs

The OCC is a strong supporter of national banks' investments to revitalize neighborhoods and highly values its relationships with community groups and organizations dedicated to community development.

Throughout the fiscal year, OCC officials met with community groups and consumer organizations on issues of interest, including credit card fees and disclosures, nontraditional mortgages, fair lending, electronic check cashing fees, and predatory appraisals.

The Comptroller saw firsthand how banks can make a positive impact on communities when he visited Chicago's West Side in May to tour housing and community development projects that are contributing to the economic well-being of neighborhoods. The OCC's authority to approve national banks' investments in community development projects comes from a provision in federal law known as "Part 24."

"The trip highlighted in a very visible way the important role that national bank Part 24 public welfare investment authority plays in local communities," Mr. Dugan said at the end of that tour. "Community-based organizations have partnered with national banks in a number of key projects in the Near West Side to create affordable housing using low-income housing tax credits in which banks are major investors."

The Comptroller and members of his family also joined other OCC employees and their families in sprucing up apartments for families participating in a NeighborWorks America housing program in Northeast Washington, D.C.

The OCC produces publications to help banks meet their obligations under the CRA. Agency officials also held more than 300 consultations with bank executives during the year on strategies for fulfilling those obligations.

Other agency publications provide information about bank-owned community development corporations, financial literacy, hurricane recovery assistance, rural economic development, and low-income housing tax credits.

The OCC also produces an electronic newsletter with information about agency work in the area of fair treatment and fair access to financial services.

The OCC helped to organize and participated in the first of several regional conferences on the "unbanked"—consumers who have no accounts or loans with banks. The OCC and other financial regulators also sponsored a National Reinvestment Conference that brought together experts on strategies for revitalizing distressed communities. More than 500 bankers, government officials, and community representatives attended.

The OCC participates in the interagency Financial Literacy and Education Commission (FLEC) established to improve financial literacy and education in the U.S. In FY 2006, FLEC issued a strategy paper and launched MyMoney.gov, a Web site dedicated to teaching Americans the basics of financial education.

Strategic Goal III: A flexible legal and regulatory framework that enables the national banking system to provide a full, competitive array of financial services

The national bank charter is a unique and powerful instrument for carrying on the competitive business of banking. This charter offers national banks a legal framework that enables them to compete effectively and meet the evolving business needs of their customers, under a flexible and responsive system of supervision.

To set the bounds of activities permissible under the charter, the OCC establishes regulations, policies, operating guidance, and interpretations that set standards for the national banking system, define acceptable banking practices, provide guidance on risks and responsibilities facing national banks, and prohibit or restrict banking practices deemed imprudent or unsafe. The OCC also represents and defends its regulatory authorities and interpretations in administrative, judicial, and congressional hearings.

Legal and Regulatory Opinions

In response to inquiries from national banks, the OCC writes legal and regulatory opinions on a wide variety of banking-related topics, including the following:

Regulatory Capital

Regulatory capital requirements include risk-based capital, in which risk weights are assigned to specific types of assets and off-balance-sheet items to ensure that banks have adequate capital levels.

- The OCC issued several opinions addressing the appropriate factors to apply in calculating risk-based capital for multipurpose loan commitments, structured second mortgages, and securities lending transactions. OCC Interpretive Letters No. 1049 (January 17, 2006), No. 1057 (June 14, 2005), No. 1058 (April 20, 2005), and No. 1066 (November 8, 2005)

Investments

- Complex Structure with Indirect Credit Default Swap Index Exposure. OCC Interpretive Letter No. 1047 (December 20, 2005)

Derivatives

These permissible derivatives activities are subject to supervisory nonobjection based on the adequacy of the national bank's risk management and measurement systems and controls and other supervisory considerations relevant to the particular proposal. Derivatives and hedging provide banks and their customers with a mechanism to reduce risks associated with financial holdings and transactions.

- *Hedging.* National banks may purchase and hold below-investment-grade debt to hedge the counterparty credit risk exposures arising from the bank's derivatives activities, and to hedge risks arising from permissible customer-driven derivative transactions. OCC Interpretive Letter No. 1051 (February 15, 2006)
- *Customer-Driven Derivative Transactions.* National banks may engage in certain customer-driven derivative transactions based on a number of underlying commodities, such as frozen juice concentrate, polypropylene, and cardboard products. The agency issued a more comprehensive opinion in July 2006 identifying 11 categories of reference assets indices. OCC Interpretive Letters No. 1064 (July 13, 2006), No. 1039 (September 13, 2005), No.1056 (March 29, 2006), No. 1059 (April 13, 2006), No. 1060 (April 26, 2006), No. 1063 (June 1, 2006), and No. 1065 (July 24, 2006)

Bank Premises

- *Retail, Office, Lodging, and Residential Space.* A bank may hold, as permissible bank premises under 12 USC 29, a building containing retail and office space and commercial facilities for lodging out-of-town bank visitors, provided that the lodging space is operated by an independent, third-party company. Office and lodging space not used by the bank may be made available to the general public. The building may also include a certain number of residential condominiums that will be sold to the public by an unaffiliated real estate broker, because such mixed use is necessary for the project to be economically viable in the market where it is located. OCC Interpretive Letter No. 1044 (December 5, 2005). The rationale for this letter was further explained in OCC Interpretive Letter No. 1053 (January 31, 2006)
- *Lodging for Out-of-Town Bank Visitors.* A bank may hold, as permissible bank premises under 12 USC 29, commercial facilities for lodging out-of-town bank visitors, provided that the lodging space is operated by an independent, third-party company. Excess lodging space may be made available to the general public. OCC Interpretive Letter No. 1045 (December 5, 2005). The rationale for this letter was further explained in OCC Interpretive Letter No. 1053 (January 31, 2006)

Interstate Branching

- *Branching by Out-of-State Industrial Loan Companies.* Laws recently enacted in some states prohibit or restrict branching by out-of-state industrial loan companies. Those laws have the effect of defeating those states' laws that previously permitted interstate de novo branching into those states by banks generally. Therefore, the OCC, FDIC, and the FRB concluded that they cannot approve the establishment of de novo branches in such states by any out-of-state bank. OCC Interpretive Letter No. 1068 (July 28, 2006)

Lending

- *Wind Energy Project Financing.* A national bank may provide financing for a wind energy project by making an equity investment in the project. Because the transaction is structured to be the functional equivalent of a secured financing, it is permissible under 12 USC 371 and consistent with the purposes of 12 USC 29. Structuring the transaction in this manner permits the bank to capture tax benefits enacted to promote the flow of capital to renewable sources of energy. OCC Interpretive Letter No. 1048 (December 21, 2005). The rationale for this letter was further explained in OCC Interpretive Letter No. 1048a (February 27, 2006) and Interpretive Letter No. 1053 (January 31, 2006).

Litigation

The OCC was a party to, or prepared "friend of the court" briefs for, several cases that affirmed federal preemption of state law restricting national bank activities, including:

- *Four decisions upheld on appeal that federal law preempts state law restrictions on the activities of national bank mortgage operating subsidiaries.* U.S. courts of appeal for four circuits have upheld decisions by district courts in California, Connecticut, Maryland, and Michigan that granted national banks declaratory and injunctive relief in suits challenging states' efforts to license and exercise visitorial powers over the operating subsidiaries of national banks. In each case, the U.S. courts of appeal affirmed district court decisions that the National Bank Act and OCC regulations preempt state licensing and enforcement authority over the real estate lending activities of national bank operating subsidiaries. Connecticut and Michigan have asked the U.S. Supreme Court to review the decisions of the Second and Sixth Circuits, respectively. The Supreme Court granted Michigan's request for review of the Sixth Circuit's decision and is expected to issue a decision in that case in early 2007.[1]

- *Federal district court rules that the New York state attorney general may not enforce subpoena for mortgage loan records of national banks to enforce state fair lending statute.* The U.S. District Court for the Southern District of New York issued two decisions on October 12, 2005, in response to separate suits by the New York Clearing House Association and the OCC. These suits challenged the authority of the New York state attorney general to demand mortgage loan records of national banks and their operating subsidiaries as part of an investigation into real estate lending. In the first decision, the Court granted declaratory and injunctive relief to the OCC. This decision enjoined the New York attorney general from: 1) issuing subpoenas or demanding inspection of the books and records of any national banks for his investigation into residential lending practices, 2) instituting any enforcement actions to compel compliance with existing information demands, and 3) instituting actions in court to enforce state fair lending laws.[2] In the second decision, the Court granted the same injunctive relief granted in *Comptroller of the Currency* v. *Spitzer* and further enjoined the New York attorney general from instituting a parens patriae action to enforce the federal Fair Housing Act.[3] An appeal of both decisions is pending in the Second Circuit Court of Appeals.

- *Supreme Court rules that each national bank is a citizen of a single state.* The Supreme Court issued a decision on January 16, 2006, holding that a national bank is a citizen of the one state in which it maintains its main office, under the National Bank Act. The Supreme Court's decision reversed a decision by the Fourth Circuit Court of Appeals that had interpreted 28 USC 1348, containing the special jurisdiction provision for national banks, as providing that a national bank is a citizen of each state in which the bank has a branch or other physical presence.[4]

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[1] *Wachovia Bank, N.A.* v. *Burke,* 414 F.3d 305 (2nd Cir.) *petition for cert. filed;* 74 U.S.L.W. 3223 (U.S. September 30, 2005) (No. 05-431); *Wells Fargo Bank, N.A.* v. *Boutris,* 419 F.3d 949 (9th Cir. 2005); *Wachovia Bank, N.A.* v. *Watters*, 431 F.3d 556 (6th Cir. 2005), *cert. granted* 75 U.S.L.W. 3019 (U.S. June 19, 2006) (No. 05-1342); and *Nat'l City Bank of Ind.* v. *Turnbaugh,*____F.3d _____ (4th Cir. 2006).

[2] *Comptroller of the Currency* v. *Spitzer,* 396 F.Supp.2d 383 (S.D.N.Y. 2005) *appeal docketed* (November 8, 2005).

[3] *Clearing House Association, LLC* v. *Spitzer,* 394 F.Supp.2d 620 (S.D.N.Y. 2005), *appeal docketed,* No. 05-5996 (2nd Cir. November 8, 2005).

[4] In earlier decisions, the Seventh and Fifth Circuits had interpreted 28 USC 1348 as providing that national banks, in parity with state banks, are citizens of at most two states: the state where the bank has its main office, and the state where the bank has its principal place of business. *Wachovia* v. *Schmidt,* ____ U.S. ____, 126 S.Ct. 941, 74 U.S.L.W. 4085 (2006).

- *Fair Credit Reporting Act preempts California statute that restricts information-sharing among affiliates.* The Ninth Circuit Court of Appeals held that the Fair Credit Reporting Act preempts those provisions of the California Financial Information Privacy Act (commonly known as SB1) that condition or prohibit affiliates from sharing information bearing on a consumer's creditworthiness, credit standing, credit capacity, character, or other factor used to establish the consumer's eligibility for credit or insurance. The appeals court directed the district court to determine whether any part of the state statute survived preemption and was severable.[5] On remand, the district court concluded that no part of the state law's affiliate-sharing prohibitions survives and that the statute was not severable.[6]

Rulemakings

Significant rulemakings completed in FY 2006 included:

- *Fair Credit Reporting Medical Information Regulations (12 CFR 41) 70 FR 70664 (November 22, 2005).* The OCC and other financial regulators issued a final rule to implement a provision of the Fair and Accurate Credit Transactions Act of 2003 (FACT Act) pertaining to the use of medical information in determining eligibility for credit. As authorized by the statute, the final rule creates exceptions to the FACT Act's general prohibition on creditors obtaining or using medical information for any determination of the consumer's eligibility for credit. The exception permits creditors to obtain or use medical information for credit eligibility determinations under certain circumstances. The rule also creates other, limited exceptions to permit affiliates to share medical information without becoming consumer-reporting agencies for purposes of the Fair Credit Reporting Act.
- *One-Year Post-Employment Restrictions for Senior Examiners (12 CFR 4) 70 FR 69637 (November 15, 2005).* This final rule, issued jointly with the FRB, the FDIC, and the OTS, implements a section of the Intelligence Reform and Terrorism Prevention Act of 2004. For one year after leaving federal service, an examiner who served as the senior examiner in a national bank for at least two months of the preceding 12 months is barred from accepting compensation as an employee, officer, director, or consultant in that national bank or a company (including a bank holding company) that controls that bank. For violations, the act requires the OCC to seek removal from the relevant bank of the former examiner or a prohibition order for up to five years. The OCC also may seek a CMP of up to $250,000.
- *Risk-Based Capital—Securities Borrowing Transactions: Final Rule (12 CFR 3) 71 FR 8932 (February 23, 2006).* The OCC, FRB, FDIC, and OTS issued a final rule applying to banks that are subject to a separate capital charge for market risk under risk-based capital rules. The rule permits the banks to include in risk-weighted assets an amount based on the difference between the amount of cash collateral posted and the market value of the borrowed security, subject to certain conditions. Because of changes in the final rule, banks borrowing securities from counterparties that are not exempted from U.S. federal bankruptcy treatment or receivership law may receive this capital treatment.

Licensing

The OCC grants national bank charters and approves the establishment or expansion of banking activities of existing national banks. The *Comptroller's Licensing Manual* outlines OCC procedures for handling licensing applications; the agency revised six booklets from the manual in FY 2006.

The OCC has several initiatives to evaluate and enhance its licensing programs, including a quality control program to improve procedures for processing bank applications for branches and de novo charters.

Licensing Decisions
The OCC made several significant licensing decisions in FY 2006:

- Conditional approval was given for several types of applications imposing a "significant deviation" condition. This condition requires the bank to notify the supervisory office at least 60 days before making a significant change or deviation to its business plan. OCC Conditional Approvals No. 705, 712, 714, 716, and 717
- The OCC approved an operating subsidiary to offer services for customers to engage in capital gains tax-deferred exchanges of business and investment property under the Internal Revenue Code. Such transactions are called like-kind exchanges. OCC Conditional Approval No. 706 (October 6, 2005)
- The OCC approved a limited federal branch to be located in Florida. A limited federal branch is a branch of a foreign bank that can accept deposits from foreign states

[5] *American Bankers Ass'n* v. *Gould,* 412 F.3d 1081 (9th Cir. 2005).

[6] *ABA* v. *Lockyer,* 2005 WL 2452798 (E.D. Cal. October 5, 2005), appeal docketed No. 05-517163 (9th Cir. November 9, 2005).

or individuals, but not U.S. citizens or corporations. OCC Conditional Approval No. 727 (January 3, 2006)

- A bank received approval to establish a wholly owned operating subsidiary to provide Internet access, including dial-up Internet service provider (ISP) service, to its customers and nonbank customers as part of its package of Internet banking services. It may not sell ISP services to new nonbank customers unless it demonstrates compliance with 12 CFR 7.5004 and obtains the OCC's prior approval. OCC Conditional Approval No. 733 (February 16, 2006)

- The OCC approved the expansion of a limited bank charter to a full-service charter. Such requests to expand powers are infrequent and are evaluated in a similar manner as an application for a de novo charter. OCC Conditional Approval No. 707 (October 14, 2005)

Table 3: Corporate Application Activity, FY 2005 and 2006

	Applications received		*FY 2006 Decisions*			
			Approved	**Conditionally approved[4]**	**Denied**	**Total**
	FY 2005	**FY 2006**				
Branches	1,645	1,872	1783	2	2	1,790
Capital/sub debt	141	167	50	5	0	55
Change in Bank Control	17	9	4	0	0	8
Charters	26	47	4	30	0	34
Conversions[1]	15	15	5	7	0	12
Federal branches	2	3	0	2	0	2
Fiduciary powers	22	30	13	1	0	14
Mergers[2]	69	62	61	3	0	64
Relocations	259	274	269	0	0	271
Reorganizations	116	123	122	10	0	132
Stock appraisals	2	0	0	0	0	2
Subsidiaries[3]	23	27	30	4	0	35
12 CFR 5.53 Change in Assets	4	3	0	5	0	5
LTD NB upgrade	NA	5	0	1	0	1
Total	2,341	2,637	2,341	70	2	2,425

[1] Conversions are conversions to national bank charters.

[2] Mergers include failure transactions when the national bank is the resulting institution.

[3] This count does not include 128 After-the-Fact notices received in FY 2005 and 93 After-the-Fact notices received in FY 2006.

[4] On April 14, 2000, the Licensing department issued guidance imposing special conditional approval for all bank charters requiring the OCC to be notified before a significant deviation or change in the operating plan during the first three years of operation.

Table 4: OCC Licensing Actions and Timeliness, FY 2005 and 2006

	FY 2005				*FY 2006*		
			Within Target			Within target	
Application type	Target time frames in days[1]	Number of decisions	Number	%	Number of decisions	Number	%
Branches	45 / 60	1,550	1,519	98	1,790	1,721	96
Capital / sub debt	30 / 45	57	48	84	55	48	87
Change in Bank Control	NA / 60	17	17	100	8	8	100
Charters[2]	See footnote 2	20	17	85	34	21	62
Conversions	30 / 90	16	7	44	12	9	75
Federal branches	NA / 120	0	0	NA	2	1	50
Fiduciary powers	30 / 45	11	6	55	14	9	64
Mergers	45 / 60	63	53	84	64	54	84
Relocations	45 / 60	242	237	98	271	267	99
Reorganizations	45 / 60	107	88	82	132	100	76
Stock appraisals	NA / 90	0	0	NA	2	2	100
Subsidiaries	30 / 60	43	43	10	35	35	100
12 CFR 5.53 Change in Assets	NA / 60	2	1	50	5	4	80
LTD NB upgrade[2]	See footnote 2	0	0	NA	1	0	0
Total	NA	2,128	2,036	96	2,425	2,279	94

Note: Most decisions (99 percent in 2005 and 98 percent 2006) were decided in the district offices and Large Bank Licensing under delegated authority. Decisions include approvals, conditional approvals, and denials.

[1] Those filings that qualify for the "expedited review" process are subject to the shorter of the time frames listed. The longer time frame is the standard benchmark for more complex applications. New time frames commenced in 1997 with the adoption of the revised Part 5. The target time frame may be extended if the OCC needs additional information to reach a decision, permits additional time for public comment, or processes a group of related filings as one transaction.

[2] For independent charter applications, the target time frame is 120 days. For holding-company-sponsored applications, the target time frame is 45 days for applications eligible for expedited review, and 90 days for all others.

Table 5: Change in Bank Control Act[1] CY 2002–FY 2006

Year	*Received*	*Acted On*	*Not Disapproved*	*Disapproved*	*Withdrawn*
FY 2006	9	8	4	0	4
FY 2005	17	17	17	0	0
FY 2004	16	14[2]	13	0	0
FY 2003*	16	10	9	1	0
CY 2002	10	10	9	1	0

* Reporting changed from calendar year to fiscal year, starting October 1, 2002 (FY 2003).

[1] Notices processed with disposition.

[2] Includes one notice with no activity. The OCC considered it abandoned.

Change in Bank Control

The OCC administers the Change in Bank Control Act (CBCA) to prevent adverse effects from anti-competitive mergers, acquisitions, consolidations, or other business combinations; inadequate financial support; or unsuitable management of national banks. The OCC reviews each CBCA notice and disapproves transactions that could have serious harmful effects. When the notice raises fundamental supervisory or other issues that cannot be mitigated through an agreement, the OCC disapproves the proposal. The OCC is coordinating with Federal Reserve banks on CBCA applications so the OCC can seek certain safeguards from acquiring holding companies of national banks.

The OCC received adverse comments from the public and subsequently rendered decisions on the following 10 CRA-covered applications during the year.

Table 6: Applications Decided That Presented Community Reinvestment Act Issues, FY 2006

Bank, City, State	Interpretations and Actions	Document Number
Citibank, NA, New York, NY	October 2005	CRA Decision No. 126
Associated Bank, NA, Green Bay, WI	November 2005	CRA Decision No. 127
JPMorgan Chase Bank, NA, Columbus, OH	December 2005	CRA Decision No. 128
HSBC Bank Nevada, NA, Las Vegas, NV	November 2005	CRA Decision No. 129
NBT Bank, NA, Norwich, NY	January 2006	CRA Decision No. 130
TD Banknorth, NA, Portland, ME	December 2005	CRA Decision No. 131
Harris, NA, Chicago, IL	February 2006	CRA Decision No. 132
Huntington National Bank, Columbus, OH	February 2006	CRA Decision No. 133
Rabobank, NA, EL Centro, CA	May 2006	CRA Decision No. 134
Trustmark National Bank, Jackson, MS	September 2006	CRA Decision No. 135

Regulatory Efficiency

The OCC and the other FFIEC-member agencies have participated in a comprehensive multi-year review of the agencies' regulations, as required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA). The purpose of the review is to identify and, as appropriate, eliminate unnecessary regulations. In FY 2006, the agencies completed the process of publishing their regulations in the *Federal Register* for public comment and concluded a series of outreach meetings in conjunction with the requests for written comment. As required by the statute, the agencies plan to submit a report to Congress in FY 2007 on the results of their review. In addition, the OCC is considering what revisions to its regulations are appropriate in light of the results of the EGRPRA review.

On October 13, 2006, the President signed into law the Financial Services Regulatory Relief Act. This legislation contains provisions that contribute to the reduction of unnecessary regulatory burden for national banks, including provisions that:

- Simplify national banks' statutory authority to pay dividends and reduce capital.
- Increase, from $250 million to $500 million, the asset-size threshold enabling banks that are well capitalized, well managed, and satisfy certain other statutory requirements to have a full-scope, on-site examination once every 18 months, rather than once every 12 months.
- Clarify that a bank does not waive any applicable privilege if it discloses information to a federal, state, or foreign bank supervisor as part of a supervisory or regulatory process. (The bank may not assert that privilege against its supervisor, however.)
- Require the OCC and certain other federal agencies to develop jointly a proposed model for a more user-friendly privacy disclosure notice.

Strategic Goal IV: An expert, highly motivated, and diverse workforce that makes effective use of OCC resources

The OCC pursued an array of management initiatives in FY 2006 to achieve its goals for human capital, security, process improvement, and technology.

Human Capital

The OCC supervises a remarkably diverse group of institutions, ranging from small community banks to the world's largest financial institutions. To carry out the agency's supervisory mission, the Comptroller and the Executive Committee have made a top priority of maintaining a diverse, highly skilled, and strategically deployed workforce.

In response to challenges posed by impending civil service retirements and the need to foster the evolution of the agency's future leadership team, the OCC has mounted a broad initiative to recruit, retain, and develop employees with the necessary skills and qualities. *BusinessWeek* magazine recognized the quality of the OCC work environment during this fiscal year by naming the OCC one of the "50 best places to launch a career."

In executing its comprehensive strategy, the agency is recruiting both highly experienced and entry-level employees, and shifting internal expertise to where it is needed most. During the fiscal year, the OCC hired an unprecedented number of industry specialists for Large Bank Supervision. These specialists are seasoned experts from banks and elsewhere in the financial world who want to steer their career paths toward public service. By continually introducing new expertise to its workforce, the OCC enjoys the benefits of a stream of fresh ideas that keep the OCC at the forefront of the banking industry. Most of these highly experienced new employees work in key financial centers, such as New York and Charlotte.

After hiring employees, the agency moves its focus to training and retaining them. On large bank teams, the OCC recently established a program for bringing the newly hired industry specialists on board, assigning a highly skilled advisor to each of them, teaching them about the culture and policies of the agency, providing regular feedback on performance, and soliciting their comments on their initial experiences at the OCC.

Internal recruitment in FY 2006 concentrated on redeploying examiner expertise to the supervision policy group led by the Chief National Bank Examiner and to large banks in high-cost cities. To attract internal candidates, the OCC emphasized the importance of these assignments to career advancement and provided incentives, including relocation bonuses, mortgage subsidies, financial assistance for renters, and transitional cost-of-living reimbursements.

The OCC also continued its nationwide program to recruit and train entry-level bank examiners. Building on the relationships reestablished three years ago with colleges across the nation, the agency competed for the best talent and hired 162 entry-level examiners in FY 2006. This pool of examiners was distinctive not only for the high quality of the individuals hired, but for the diversity of the pool as a whole. Fifty-one percent of these new examiners are women and 29 percent are minorities.

Since the inception of this program in 2003, the agency has brought aboard about 430 entry-level examiners. The agency also instituted an aggressive retention program to keep these new employees after their critical first five years, when many examiners make a decision about whether to continue their careers with the OCC.

For an examiner out of college, a near-term goal is to pass the Uniform Commission Examination to become a National Bank Examiner, a title that carries high credibility at the OCC and throughout the financial industry. Once the OCC instills basic skills in a new bank examiner, the emphasis often turns toward identifying and developing skills in key specialty areas. This skill development feeds the pipeline from community bank supervision to jobs in large banks or Headquarters.

The agency's Committee on Bank Supervision, made up of three Senior Deputy Comptrollers, is undertaking a major project centered on those key specialty skills: Asset Management, Bank Information Technology, Capital Markets, Compliance, Commercial Lending, Retail Lending, Mortgage Banking, and Operational Risk. A project team of managers and subject matter experts from those eight critical business lines developed a Specialty Skills Assessment framework that, when fully implemented, will help bank supervision managers identify resource needs and available expertise with greater precision. That will allow the agency to maximize its use of existing resources and to develop strategic plans to meet future staffing needs.

FY 2006 also marked the establishment of the Office of Leadership, Learning, and Workplace Fairness (LLWF), which supports OCC's commitment to equal employment opportunity, succession planning, and high-quality learning.

The OCC has strengthened its leadership programs, recognizing that strong leaders are the key to maintaining the strategic direction of the agency and effective bank supervision in the future. The agency built a leadership development framework and wrote a strategic plan for a comprehensive program to train current and future leaders. This program includes a leadership development advisory board, five pilot leadership development courses focusing on key competencies, an executive coaching program, and a manager forum to enhance knowledge-sharing, learning, and skill development.

The OCC also introduced the "LeaderTRACK" program during the fiscal year to manage succession and prepare leaders for bank supervision. The program, which will be piloted for 18 months beginning in FY 2007, offers six participants a series of assignments with significant managerial and supervisory roles.

BusinessWeek magazine cited the OCC as a great place to begin a career.

For its employees to have the knowledge and skills to meet agency challenges, OCC delivered its training in FY 2006 through hundreds of classes and events. The OCC's online learning management system continues to be the primary vehicle to administer, track, and report on internal training for employees.

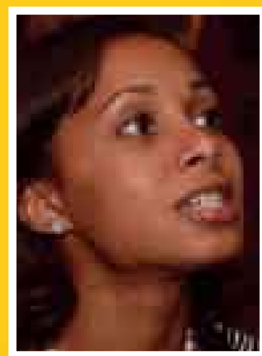
A fair workplace helps to ensure that OCC will retain the talent it needs to meet the demands of supervising the national banking system. OCC continued its commitment to a fair workplace by:

- Conducting online briefings about employees' rights under employment discrimination laws, the "No Fear Act," and whistleblower protection.
- Adding facilitation to its menu of alternative dispute resolution options and training a cadre of facilitators.
- Participating in the Federally Employed Women's conference and the Equal Employment Opportunity (EEO) Commission's national conference.
- Making a presentation on workplace fairness and the future of EEO during OCC's four district conferences for employees.

The OCC has continued to demonstrate its commitment to workplace diversity by supporting four affinity groups, which are special-interest organizations of employees who meet to discuss workplace issues and communicate with agency leaders to improve agency operations, personnel management, and employee effectiveness.

For the OCC, meeting the challenge of hiring, retaining, and developing a highly effective workforce is imperative, now and for the future.


OCC



OCC's Workforce of the Future

Green and blue lines on charts tell a compelling story in an annual "State of the Workforce" presentation for the Comptroller and the Executive Committee.

The story is about significant challenges—and significant opportunities—that have prompted agency leaders to design and execute a detailed strategy for hiring, retaining, and developing employees for the workforce of the future to supervise the national banking system.

The charts show a shrinking pool of potential successors to OCC supervisors who retire over the next several years, a sharp increase in recent years of bank examiners over age 50, and a sharp drop of examiners in their thirties.

The challenge is to prepare for the succession to OCC leadership. The opportunities are for all employees who are poised and eager for advancement.

To John G. Walsh, Chief of Staff and Public Affairs, the message of opportunity is clear for employees who are beginning their careers with the OCC. "Look at the place and think about what you'd like to do," he said. "Chances are, you'll be able to do it."

Baby Boomers Retiring

The agency is subject to the same demographic trends facing employers across the nation. The baby boom generation has reached retirement age. "OCC is essentially in the same boat as everyone else," noted Pat Pointer, Deputy Comptroller for Workforce Effectiveness.

Yet, as she also pointed out, the OCC has unique flexibilities and resources to meet the challenge and is moving with dispatch to develop future agency leaders.

In five years, almost a third of the OCC workforce will be eligible for retirement. The potential impact is most acute in Large Bank Supervision, which has a highly experienced, senior-level workforce.

Changes in Hiring

Aside from nationwide demographics, trends unique to the U.S. banking industry have influenced the makeup of the labor force of the OCC and other federal banking regulators.

Although national bank assets have climbed steadily in the last decade, the number of national banks declined as the industry consolidated. Since 1993, those assets have doubled, while the number of national banks dropped by almost half. Spurred by the reduction in bank numbers, the OCC cut its workforce in the mid-1990s by almost one-third. When hiring resumed in 1997, it centered on seasoned experts from the banking industry. The agency resumed hiring entry-level examiners in 1999 but the emphasis on experience continued until 2003. Since then, more than 80 percent of new OCC employees have been at the entry level.

These hiring patterns have contributed to the composition of an OCC workforce that has two-and-a-half times as many examiners over age 40 as under age 40.

Retirement-eligible baby boomers might be more apt than workers in earlier generations to stay on the job beyond retirement age. At the OCC, employees stay on the job for an average of three years past retirement eligibility. Still, the situation has created the imperative for the OCC to establish initiatives to develop the next class of agency leaders.

Although many of these leaders will no doubt continue to come from the more seasoned portion of the workforce, the rise in retirement eligibility also provides an incentive for younger employees to remain at the OCC to pursue expanded career opportunities. These workers may be more mobile and less likely than older colleagues to remain with a single employer for their entire careers, but opportunities to grow toward leadership roles are keys to retaining them.

Younger workers must be able to see a promising future. At the OCC, the expected decline in the average age of supervisors in coming years spells a surge of opportunity.

Information Security and Emergency Preparedness

Ensuring the security of sensitive information entrusted to the custody of the OCC is critical to performing the agency's mission safely and effectively.

The OCC has multiple layers of security to protect the integrity of sensitive information and to prevent unauthorized access to that information. To evaluate the effectiveness of those security controls and recommend improvements, the agency hired an external consultant in late FY 2006 to conduct an end-to-end security review. As the evaluation proceeds, the OCC will consider and implement recommended changes immediately. The project will conclude during the second quarter of FY 2007.

The agency took several other steps during the fiscal year to improve its information security environment. These included:

- Continuing the information security awareness training program for all employees and contractors.
- Completing vulnerability assessments of the OCC computer network.
- Improving the OCC network infrastructure to detect unauthorized access from outside the OCC network, to detect unauthorized behavior inside the network, and to analyze security incidents after the fact.
- Working with other bank regulatory agencies to implement cost-effective approaches to exchanging encrypted e-mail with banks and each other.
- Implementing an integrated personal identity verification process to comply with federal requirements.
- Implementing digital fingerprinting systems, document verification software, and a system to exchange secure information on a real-time basis with the Office of Personnel Management.

The OCC's emergency management program prepares the agency for emergencies that disrupt operations. The OCC tested its Continuity of Operations Plan (COOP) during FY 2006, participated in the government-wide Forward Challenge '06, and updated its strategies for maintaining management capability and using internal communications in an emergency.

Process Improvement

Programs are continually reviewed to minimize burden on the OCC and national banks, and to improve their effectiveness and productivity. During the fiscal year, the OCC:

- Reengineered its processes for collecting assessments from banks to reduce effort by national banks and the agency's financial staff.
- Developed the Office of Management's "OM At-A-Glance" on the OCC intranet to reduce time staff spends finding information about salaries, benefits, travel, and other administrative matters.
- Received delegated authority for investigating EEO complaints and implemented a cost-effective program to ensure compliance during EEO investigations.

For some reengineering projects, the OCC uses a methodology for analyzing its business processes to improve quality and efficiency. This approach improves those business processes, eliminates waste, reduces the burden of compliance with statutory and regulatory requirements, and delivers more value to customers. Since FY 2005, more than 30 of these projects have produced $1.3 million in savings and allowed the OCC to make more effective use of its employees.

Technology

The OCC provides timely, high-quality technology solutions to its employees. The agency's information technology professionals develop enterprise information strategies, policies, and standards; oversee information technology investments; and create a secure and efficient information management environment.

Throughout its history, OCC has dealt primarily with information about banks and the national banking system. The agency has made significant investments in several vital projects that are under way to apply the latest technology to manage this information in ways not possible in the past.

The most wide-ranging of these projects will automate information management in examinations of large national banks. Bank examiners and their managers will use the new system to develop exam documents collaboratively, store documents securely, search for information effectively, and share documents easily.

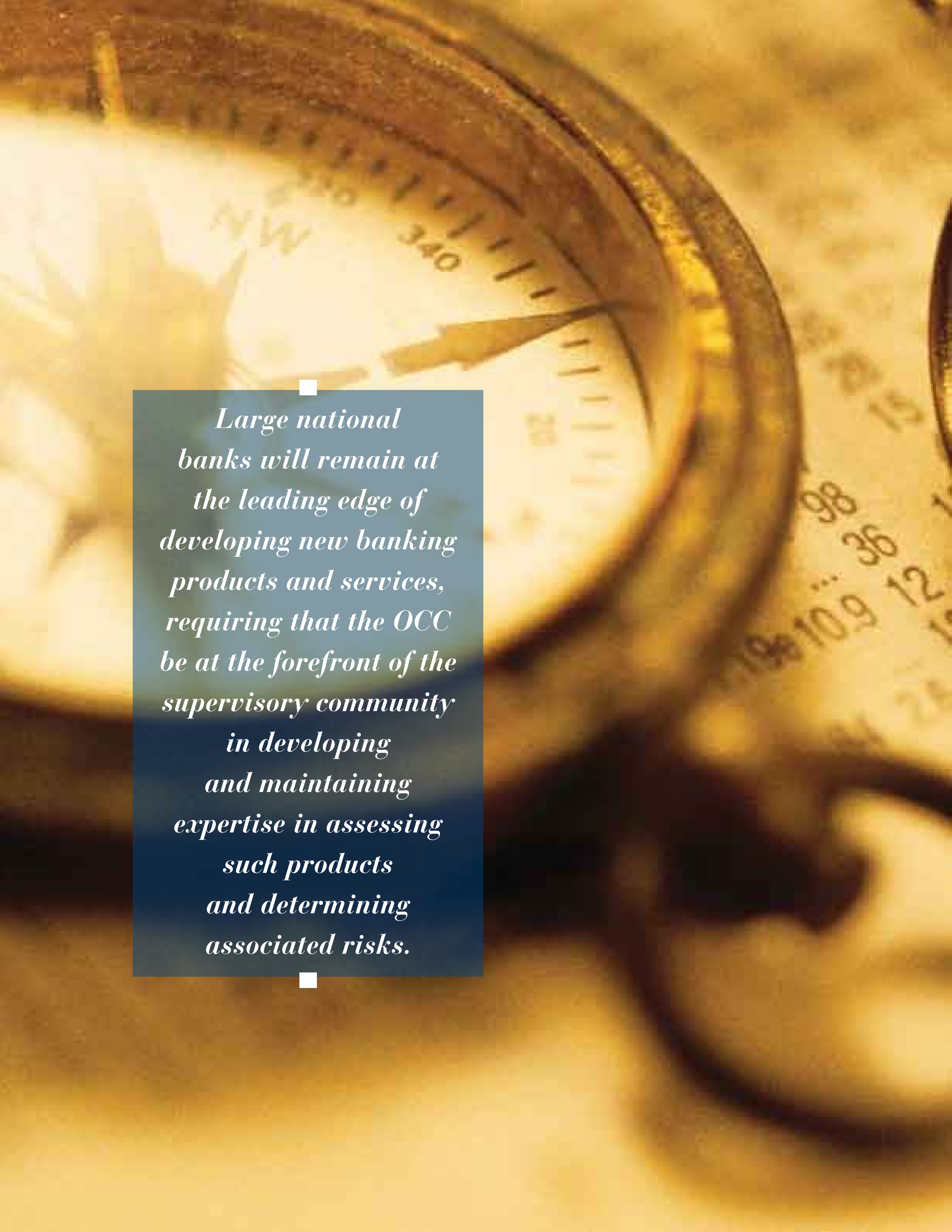
Another large project is building an electronic system for OCC employees to receive, process, and monitor licensing applications that banks file online for activities such as establishing branches, relocating offices, and obtaining charters to become national banks.

Two other projects are teaming up to improve important agency information—and the delivery of that information—for bank examiners, other OCC employees, national banks, and members of the public. One of them is overhauling the agency's outmoded, print-based publishing process to produce mission-critical publications, such as bank examination handbooks, that are more timely, accessible, and searchable. The other is redeveloping the OCC's employee intranet, public Web site, and National BankNet, a private site for bankers, into state-of-the-art Web sites.

Underpinning each of these projects is an initiative to develop a secure electronic repository to store the agency's essential records. Each of the projects will be sending records to this electronic records management system for safekeeping.

To enhance its ability to manage these crucial projects, the agency established program management offices in two of its major business units—the Office of Management and Large Bank Supervision. These offices provide expertise in project management, planning, and implementation to ensure that technology solutions meet business unit requirements.

The Comptroller and Chief of Staff tour the OCC Data Center in Maryland.



Large national banks will remain at the leading edge of developing new banking products and services, requiring that the OCC be at the forefront of the supervisory community in developing and maintaining expertise in assessing such products and determining associated risks.

IV. Looking Ahead

To meet demands on OCC resources from large, highly complex national banks and from a nationwide network of offices serving community banks, the OCC must set bank supervision priorities that maximize efficiency in using and allocating resources. Attracting and retaining qualified new employees, developing and maintaining OCC staff expertise, embracing and supporting the OCC's diversity initiatives, and enhancing the OCC's leadership skills will continue to be priorities for the agency.

Large national banks will remain at the leading edge of developing new banking products and services, requiring that the OCC be at the forefront of the supervisory community in developing and maintaining expertise in assessing such products and determining associated risks. The OCC and national banks must interact effectively with one another, with other federal regulators, and with international regulators. Concerns about regulatory burden, especially among community bankers, will accentuate the need to ensure that the OCC's policies and expectations for its lines of business are balanced, clear, and appropriately implemented. BSA/AML, consumer disclosures, and Home Mortgage Disclosure Act reporting will continue to require OCC resources and responses.

The OCC will be operating in a new legislative environment in FY 2007, with leadership changes in the Congress, including in the two committees with oversight of the agency. OCC officials also will be watching for the Supreme Court's decision in *Watters* v. *Wachovia*, a case that involves the extent to which states may exercise authority over national bank mortgage lending activities conducted in operating subsidiaries.

To continue to strengthen its workforce, the agency plans to hire 70 entry-level bank examiners in early FY 2007. They will begin on-the-job training and join field offices by mid-year.

The agency will maintain its focus on internal information security as its end-to-end security review unfolds, and OCC officials evaluate findings and implement improvements. The agency will also continue to focus on assisting consumers, as the hours of operation of its Customer Assistance Group further expand for answering questions and receiving complaints from customers of national banks.

Uncertainties in the financial and commodities markets and in the global political landscape are likely to continue and may result in a more volatile operating environment for the banking industry. Continued loosening of standards for credit underwriting and pricing, and the increased involvement of hedge funds in syndicated bank loans, heighten concerns about credit quality and may escalate problem credits and losses in the event of unfavorable market developments. Slowdowns in housing, construction, and real estate development may adversely affect banks' balance sheets and earnings streams. Many banks and over-leveraged consumers remain vulnerable if interest rates rise. Pressures on net interest margins are likely to continue. Merger and acquisition activity has fostered a growing concentration of banking assets in the largest national banks and reduced the number of major dealers in key money market and derivatives markets.

Risks facing the banking industry and the OCC are increasingly interdependent, cutting across traditional disciplines and business lines. Operational and compliance risks are becoming more prominent, and traditional distinctions between credit and capital markets activities and risk management tools are eroding. Corporate governance, accounting, compliance, and customer information security continue to be high-visibility issues for the banking industry and for large, publicly traded banks in particular, accentuating the need for strong corporate governance, accounting transparency, internal controls, and audit and compliance programs.

The rapid pace of financial innovation and growing concentrations—both within individual bank's portfolios and across industry segments—pose additional challenges and require improved risk management and information systems. Quantitative risk measurement systems will continue to become more prominent in banks' risk management processes.

The Comptroller, the Executive Committee, and other agency officials will continue to monitor these risks closely in FY 2007 and to develop and refine strategies for the agency's workforce to address them through supervisory and regulatory programs of onsite supervision, timely examination and policy guidance, and balanced regulatory actions. The OCC also will work with other international, federal, and state supervisors to respond to the myriad of cross-cutting issues that face the financial services industry.

The OCC will continue its efforts to ensure fair access to financial services and fair treatment of bank customers through its consumer compliance supervisory activities, community development programs, and outreach efforts.

We expect to deploy our financial assets to increase staffing levels, increase staff expertise through hiring experienced employees and training, investing in sophisicated enterprise-wide system solutions, and making long-overdue upgrades to our technical infrastructure.

V. Financial Management

Letter from the CFO

I am pleased to present the OCC's financial statements for the FY 2006 Annual Report. I am also pleased to note that for FY 2006 our independent auditors rendered an unqualified opinion with no material internal control weaknesses. The OCC's commitment to effective financial management continues to be my highest priority, as the following key initiatives show:

- *Implementation of OMB Circular A-123—Management's Responsibility for Internal Control (A-123).* During the past year we completed our A-123 implementation. The Financial Management staff documented our financial processes, performed a risk assessment, and tested all of our critical processes. The testing showed no material internal control weaknesses, and we have developed plans to strengthen our internal controls. A communications strategy is an essential element in our A-123 program. We sent regular messages to OCC employees highlighting this effort and reminding them of their responsibilities to maintain an effective internal control environment. Though significant resources were required, we firmly established a stronger internal control environment. I look forward to the evolving benefits that this process will offer.
- *Migration of OCC Financial Platform to the Bureau of Public Debt (BPD).* OCC has signed a letter of intent to migrate its financial and acquisition systems to the Administrative Resource Center (ARC) at BPD. This decision will enhance financial reporting and yield long-term financial benefits from the expertise of an established service provider. The expected conversion to the new platform is October 2007.
- *Financial Management Restructuring.* After analyzing the organization of the Financial Management department, we determined that structural changes would serve the financial needs of the OCC more effectively and efficiently. Highlights of the restructuring include consolidation of accounting processes into two groups, one focused on operational accounting and the other on financial accounting. We also created an internal control unit focused on A-123 and process reengineering.

I would also like to update you on the continued success of our process reengineering initiatives. After embracing the Lean Six Sigma methodology, the Office of Management turned its focus to reengineering core processes in FY 2006. We completed 15 new reengineering projects during the fiscal year. Because Lean Six Sigma stresses the "voice of the customer," internal customer participation in these projects has been vital for success. As measured by the Office of Management "balanced scorecard," the OCC has saved approximately $1.3 million through these efforts since FY 2005, but more importantly, our processes more efficiently address the needs of the OCC.

The Budget and Finance Subcommittee, which I chair, had a full agenda during the past year. Responsible for managing the financial performance of the agency, the subcommittee continued to oversee the budgeting process and made key recommendations to establish the direction of the FY 2007 budget. The goal of the subcommittee is to ensure that the budget is not only prudent, but also links directly with the agency's strategic goals and objectives. The subcommittee also serves as an investment review board for non-information-technology investments, such as leasing arrangements. One area of subcommittee focus was the OCC's need for additional office space to accommodate increased staffing levels. The panel reviewed and analyzed options and recommended an office space plan that is being implemented.

Finally, I would like to take a few moments to review the overall financial condition of the OCC. In FY 2006, the OCC has seen an increase in its balance-sheet assets, reflecting the overall growth of assets in the national banking system. As the agency responds to that growth through its primary programs, we expect to deploy our financial assets to increase staffing levels, increase staff expertise through hiring experienced employees and training, investing in sophisticated enterprise-wide system solutions, and making long-overdue upgrades to our technical infrastructure. These investments are designed to maintain our strong regulatory presence.

While FY 2006 has been a year of significant accomplishments, we do not intend to rest on our laurels. We plan to continue to meet our financial responsibilities and contribute to the overall strength of financial management in the federal government. In closing, I would like to repeat my commitment from last year—to ensure we have the finest people and resources dedicated to managing and monitoring the effective and efficient use of agency resources.

Thomas R. Bloom, Chief Financial Officer

Financial Management Discussion and Analysis

Historical Perspective

In FY 2006, the Office of Management's Financial Management department (FM) employed an operating strategy focused on achieving and maintaining data integrity across its organization. During the previous year, FM began improving its business processes and further refining the department's alignment with strategic goals through the use of the "balanced scorecard." The scorecard measures performance and initiatives in four operational areas. As a result of these efforts, the department began FY 2006 in a much stronger position to provide consistently reliable information to OCC decision-makers for managing their programs effectively, and the department was poised to meet the agency's emerging needs.

Strategic Focus

Last year, Financial Management continued to demonstrate its commitment to customer service, stewardship, and continuous improvement. Managing for results and using widely recognized best practices, such as the "balanced scorecard" and business process improvement, FM made significant progress toward achieving key business goals. The department's strategic focus has been to prepare for implementing new systems for financial management and acquisitions, and to meet significant new internal control requirements for federal agencies. The department adopted a new organizational structure, ensuring that units are better aligned for efficient processes and valued customer service. FM has focused heavily on staff and leadership development, and on increasing employee engagement as measured through the Gallup employee engagement survey.

Goal for Financial Management

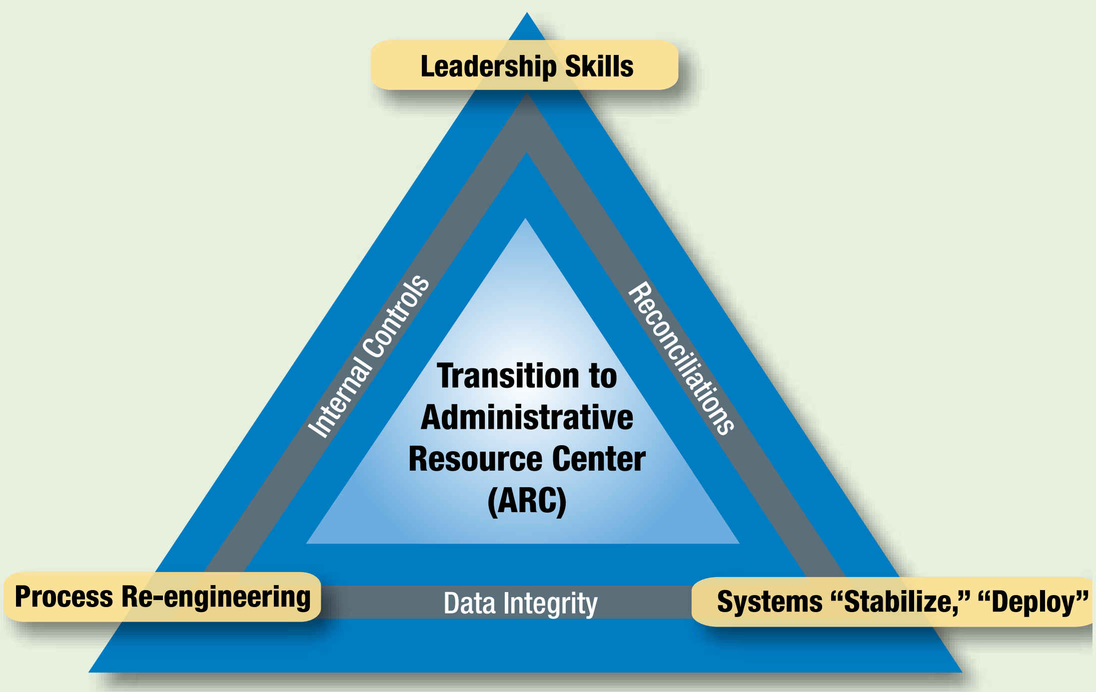
The goal for FM is to be an efficient organization that reflects:

- An engaged workforce committed to the business strategy of operational excellence.
- A solid understanding of customer needs and expectations.
- Efficient processes that take advantage of system capabilities.
- A focus on developing staff competencies for the evolving organization.
- An effective management of projects and programs.

Operating Strategy

The FM operating strategy for FY 2006 is shown in Figure 1. The strategy emphasized FM's most important business objectives. Business process improvement will be used throughout the department's preparation for implementing the new systems for financial management and acquisitions

Figure 1: FY 2006 FM Operating Strategy



that are scheduled for deployment in early FY 2008. FM fully adopted the new process documentation and internal control testing requirements outlined in OMB Circular A-123, Appendix A, "Internal Control over Financial Reporting," and has begun to refine its internal control program to ensure that it is effective in all FM business processes. Implementing the requirements of Circular A-123 required significant participation and support from staff and management across all FM units. This first year effort required a proactive approach that included visible senior management support, a strong communication strategy throughout the agency, and the on-going involvement of a strong agency governance team. The comprehensive assessment resulted in the Comptroller's ability to provide reasonable assurance that the OCC has effective internal controls over financial reporting.

Additional major accomplishments include the use of the redesigned process for collecting annual OCC operating funds from the national banks and negotiating more than 7 percent, or approximately $5 million, in contractual savings for annual contracts awarded.

The FM organization was restructured this year to ensure that responsibilities are aligned to enhance efficiency, facilitate implementation of new automated systems, and improve customer-service delivery. FM concentrated on employee development through specific training and developmental assignments for staff at all levels.

The Balanced Scorecard
The FM "balanced scorecard" measures performance and initiatives from these four perspectives:

- Customer
- Financial management
- Internal processes
- Learning and growth

The customer perspective ensures that FM's products and services reflect an accurate identification of its customers and their needs. During FY 2006, FM carried out a customer service action plan to ensure that the "voice of the customer" was integrated into all FM products and services. Using valuable input received from OCC customers through the 2005 annual customer satisfaction survey, FM engaged in on-going dialogue with key customers and is working to improve the delivery of guidance and information on the agency's intranet. In August 2006, FM participated again in the annual OM OCC-wide customer satisfaction survey. FM management and staff will use the results of this year's survey to plan FY 2007 and later customer-focused initiatives.

The financial management perspective ensures that FM is using the OCC's financial resources to support the agency's overall strategic financial goals and objectives. It serves as a mechanism to help FM use financial resources to produce the best value for the OCC. In FY 2006, FM met the target of maintaining its costs at or below 1.9 percent of total planned OCC operating costs, even with the increased costs of its expanded responsibilities for OMB A-123.

The internal processes perspective ensures that FM focuses on improving the processes that are most critical to achieving its business goals. As reflected in the FY 2006 operating and strategic business strategies, FM devoted the most attention and effort this fiscal year to processes that had known inefficiencies or would be significantly affected by the implementation of a new system for financial management and acquisitions. FM carried out several business process reengineering projects for key areas, such as acquisitions and file planning, contract closeouts, federal records retention scheduling, and file room management.

The learning and growth perspective ensures that FM identifies the critical staff skills needed to achieve its business goals and that management works with staff to ensure that those skills are fully developed. Each unit of FM worked on action plans in response to the Gallup employee engagement survey. FM hired several new employees during FY 2006 and began focusing on developing the next generation of leaders. The department also augmented its workforce by hiring several undergraduate and graduate-level financial interns, who introduced fresh perspectives and the latest learning in various disciplines to the work environment.

Future Focus

Financial Management will continue to focus on achieving strategic business goals and on measuring progress by using the "balanced scorecard" and business process improvement. The department will benchmark performance through key business metrics. The department will continue to explore the latest business models, such as outsourcing and e-commerce, and will focus on modernizing internal controls, ensuring that the agency is up-to-date with the current guidance in financial management policies.

Funding Sources and Uses

Funding Sources
The OCC does not receive appropriations. The OCC's operations are funded primarily by assessments collected from national banks and other income, including interest on investments in U.S. Treasury securities. The Comptroller, in

Table 7: Components of Total Revenue, FY 2006 and 2005 (in millions)

	FY 2006	FY 2005	Change
Assessments	$609.5	$557.8	$51.7
Investment Income	$20.5	$17.0	$3.5
Other[1]	$3.6	$2.9	$0.7
Total Revenue	$633.6	$577.7	$55.9

[1] Other sources of revenue include bank licensing fees, revenue received from the sale of publications, and other miscellaneous sources.

accordance with 12 USC 482, establishes budget authority for a given fiscal year. The total budget authority available for use by the OCC in FY 2006 was $579.4 million, which represents an increase of $60 million, or 11.6 percent, over the $519.4 million budget in FY 2005.

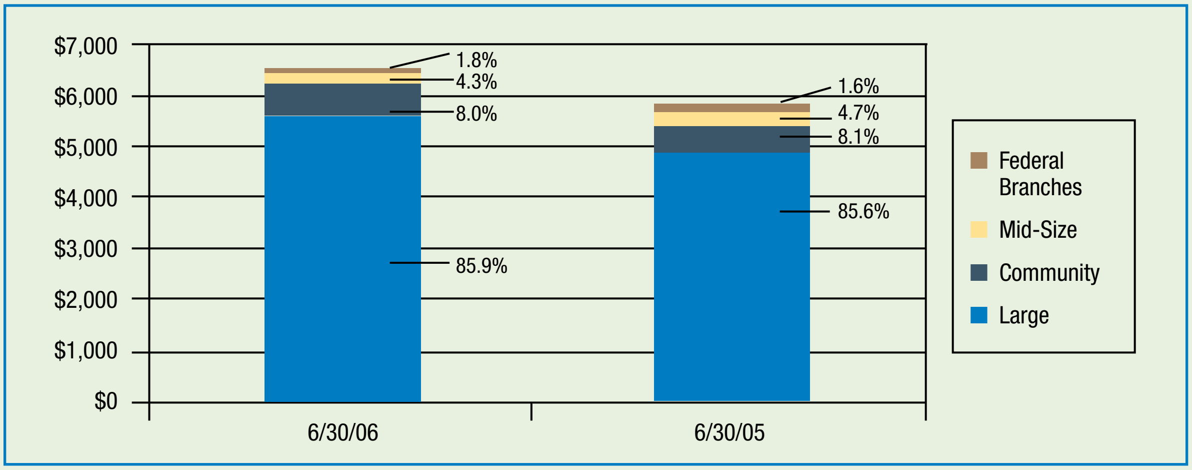
Total FY 2006 revenue of $633.6 million is a $55.9 million, or 9.7 percent, increase over FY 2005 revenues of $577.7 million. The increase is primarily attributed to a rise in bank assessment revenue stemming from the overall increase in the assets of the national banking system and the growth of investment income from an expanded investment portfolio in a rising interest-rate environment. Table 7 depicts the components of total revenue for FY 2006 and FY 2005.

Investment income is earned on investments in U.S. Treasury securities. The OCC increased its investments by $102.3 million during the fiscal year by investing its increased assessment revenue and earning interest. The book value of the OCC's portfolio on September 30, 2006 was $709.6 million, compared to $607.3 million a year earlier. The portfolio earned an annual yield for 2006 of 3.94 percent. The OCC's annual portfolio yield is calculated by dividing the total interest earned during the year by the average ending monthly book value of investments.

Bank Assets and Assessment Revenue

Total assets under OCC supervision increased during FY 2006 from $5.9 trillion to $6.5 trillion; of this total, 86 percent ($5.6 trillion) is attributable to large national banks. Large banks' share of total OCC assessment revenue remains at almost 70 percent, followed by community banks 19 percent, mid-size banks 8 percent, and federal branches 3 percent. Strong national bank asset growth combined with the movement of assets into the national banking system resulted in the higher total assets of national banks in FY 2006. Figure 2 shows the composition of national bank assets by large banks, mid-size banks, community banks, and federal branches for FY 2006 and FY 2005.

Figure 2: Composition of National Bank Assets as of June 30, 2006 and 2005 (in billions)



Funding Uses

The OCC classifies its funding uses as pay, discretionary, and fixed. Pay encompasses payroll-related costs; discretionary reflects all other funding uses, such as contractual services, travel, training, and capital projects; and fixed primarily includes rent, utilities, and office maintenance. In FY 2006, the OCC's total funds used were $553.0 million, an increase of 10.6 percent over the FY 2005 level. Of the total funds used in FY 2006, $370.6 million was categorized as pay, $146.3 million as discretionary, and $36.1 million as fixed. The OCC's operations are service-intensive; therefore, the majority of funds are used for pay. The OCC experienced a $17.8 million increase in non-pay funds used primarily for training, travel, relocations, contractual services and the capital investment program. Figure 3 depicts the uses of the OCC's funding for FYs 2006 and 2005.

While the influx of assets into the national banking system has increased assessment revenue, corresponding costs of supervising the increased asset base, along with the increased complexity of those assets also have risen, a trend expected to continue. Supervision costs during FY 2006 related to staffing, training, and travel increased by $60.5 million, or 14.4 percent, compared with FY 2005.

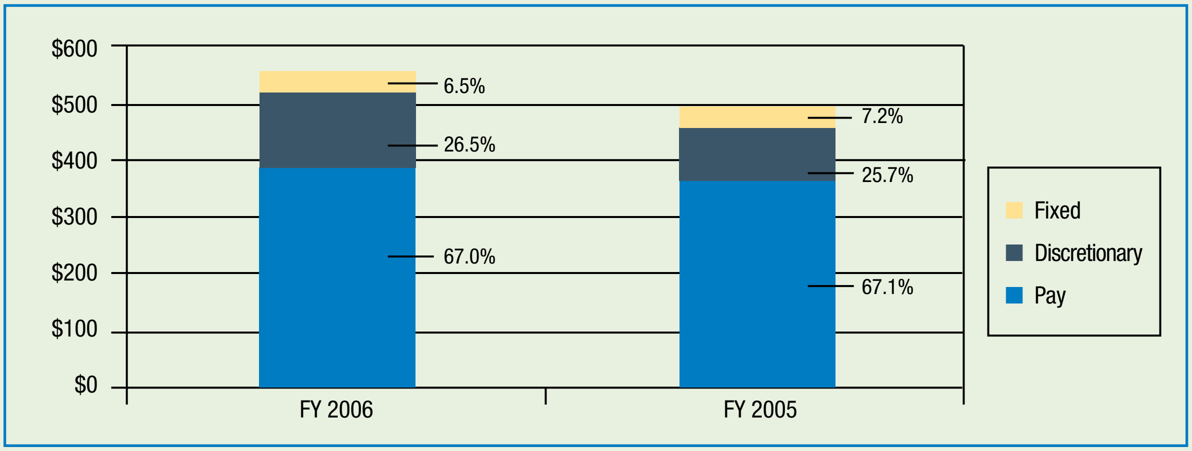
Financial Review

The OCC received an unqualified opinion on its FY 2006 and FY 2005 financial statements. The financial statements include Balance Sheets and Statements of Net Cost, Changes in Net Position, Budgetary Resources, Financing, and Custodial Activities. The financial statements and notes are presented on a comparative basis, providing financial information for FYs 2006 and 2005. These financial statements summarize the OCC's financial activity and position. Highlights of information presented on the financial statements follow.

Balance Sheets

The Balance Sheets, as of September 30, 2006 and 2005, present the resources that are owned by the OCC and available for use (assets), the resources due to others or held for future recognition (liabilities), and the resources that comprise the residual (net position). For clarity in presentation, assets and liabilities are differentiated between those resulting from transactions between the OCC and other federal entities (intragovernmental) and transactions between the OCC and nonfederal entities (with the public).

Figure 3: FY 2006 and 2005 Funding Uses (in millions)



Composition of OCC Assets

The Balance Sheets show that total assets as of September 30, 2006, increased by $104.3 million or 15.8 percent from their level at September 30, 2005, which is primarily attributable to the changes in investments and accrued interest. The increase of $101.3 million in investments and accrued interest was attributed to a rise in assessment collections during FY 2006. Figure 4 shows the composition of the OCC's assets.

Composition of OCC Liabilities

Total liabilities, as of September 30, 2006, increased by a net of $20.3 million, or 9.0 percent, over their level on September 30, 2005. The OCC's liabilities are largely comprised of deferred revenue, accrued liabilities, and accounts payable. Deferred revenue represents the unearned portion of semiannual assessments that have been collected but not yet earned. The increase of $12.8 million in deferred revenue was due to a rise in assessment collections during FY 2006. The increase of $6.1 million in accounts payable and accrued liabilities was due primarily to an increase in payroll and employee benefits over last year and to disbursement timing differences. Figure 5 illustrates the composition of the OCC's liabilities.

Figure 4: Composition of FY 2006 and FY 2005 Assets (in millions)

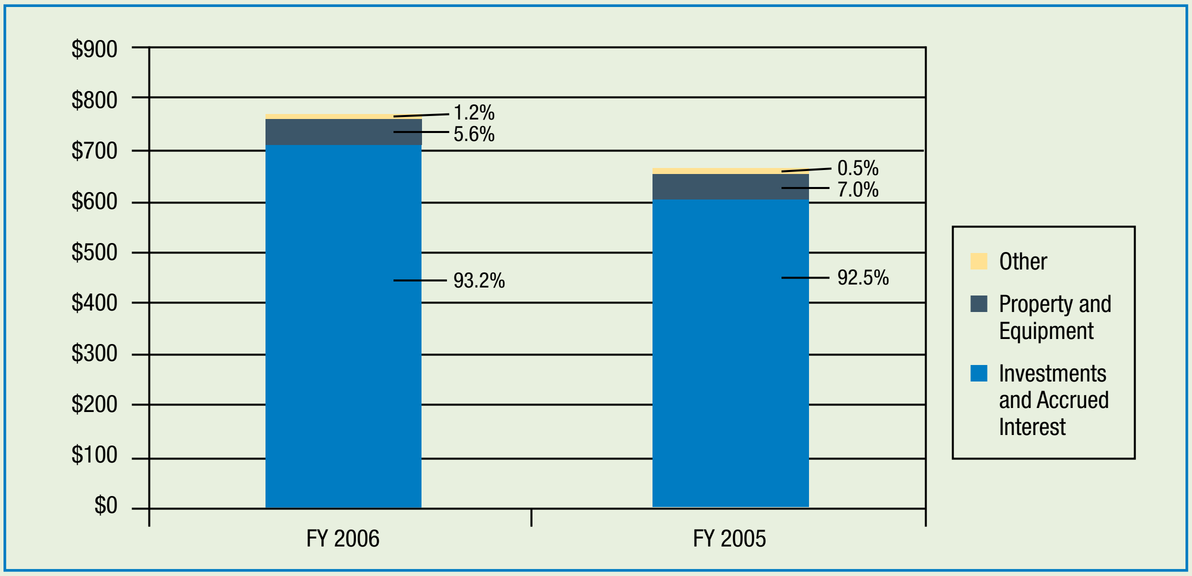
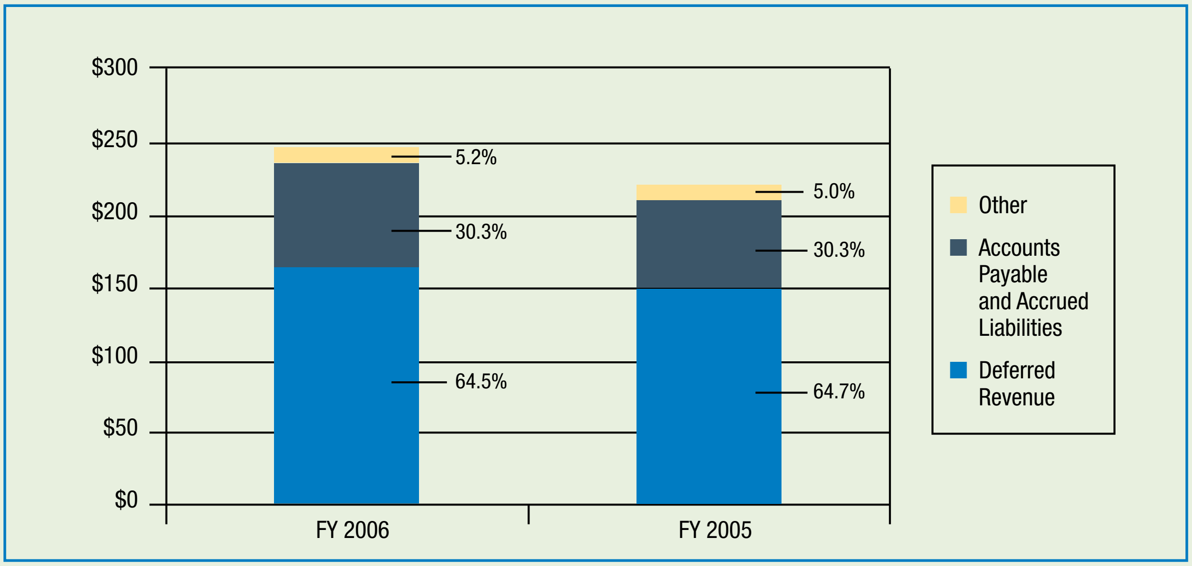


Figure 5: Composition of FY 2006 and 2005 Liabilities (in millions)



Composition of OCC Net Position

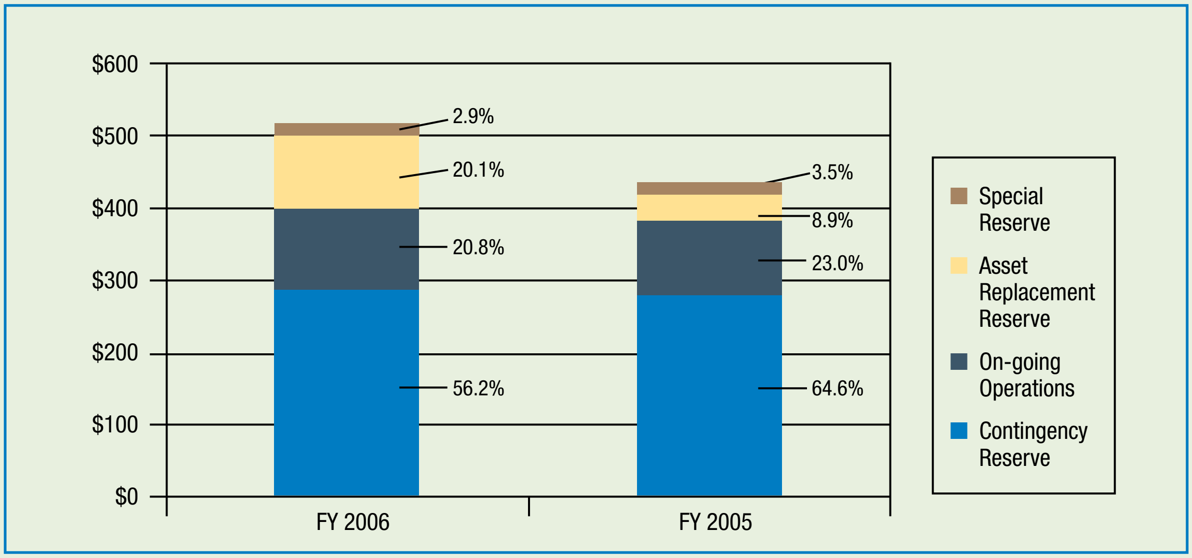
The OCC's net position of $518.4 million as of September 30, 2006, and $434.4 million as of September 30, 2005, represent the cumulative net excess of the OCC's revenues over its cost of operations since inception. This represents an increase of $84.0 million, or 19.3 percent. The majority of this increase is directly related to increases in assessment revenue, which has been allocated to the OCC's asset replacement reserve.

The net position is presented on both the Balance Sheets and the Statements of Changes in Net Position. As discussed in the next section, the OCC reserves a significant portion of its net position to supplement resources made available to fund the OCC's annual budget and to cover foreseeable but rare events. The OCC also earmarks funds for on-going operations to cover undelivered orders, the consumption of assets, and capital investments. Figure 6 shows the composition of the OCC's net position.

Reserves

The establishment of financial reserves is integral to the effective stewardship of the OCC's resources, particularly because the agency does not receive congressional appropriations. The contingency reserve is for foreseeable but rare events that are beyond the control of the OCC, such as a major change in the national banking system or for instance, a fire, flood, or significant impairment to the OCC's information technology network that interferes with the OCC's ability to accomplish its mission. The asset replacement reserve is for the replacement of IT equipment, leasehold improvements, and furniture replacements for future years. The target level in the replacement reserve is established annually based on the gross value of existing property and equipment plus a growth rate factor and a margin for market cost adjustments. The Special Reserve reduces the effect of unforecasted shortfalls, or unbudgeted and unanticipated requirements.

Figure 6: Composition of FY 2006 and 2005 Net Position (in millions)



Statements of Net Cost

The Statements of Net Cost present the full cost of operating the OCC's programs for the years ended September 30, 2006, and 2005. The net cost of operations is reported on the Statements of Net Cost, the Statements of Changes in Net Position, and on the Statements of Financing. The OCC uses an activity-based time allocation process to allocate costs between the programs. Costs are further differentiated between those resulting from transactions between the OCC and other federal entities (intragovernmental) and transactions between the OCC and non-federal entities (with the public). The full cost includes contributions made by the Office of Personnel Management (OPM) on behalf of the OCC to cover the cost of the Federal Employees Retirement System (FERS) and Civil Service Retirement System (CSRS) plans, totaling \$24.5 million in FY 2006 and \$22.9 million in FY 2005. The full program cost increased by \$72.5 million, primarily due to increases in pay and benefits, resulting from increases to full-time equivalents to 2,827.4 in FY 2006, from 2,680.9 in FY 2005, and additions to or improvements in benefit programs in FY 2006. Additional contributing factors include increases to contractual services supporting maintenance and non-capitalized IT investments, loss on the write-off of internal use software assets, and imputed costs. The full cost is reduced by earned revenues to arrive at net cost. Earned revenues increased by \$55.9 million because of a rise in assessments collected during FY 2006. The increases in assessments are a direct result of the addition of new charters and increases in bank assets of existing charters.

Statements of Changes in Net Position

The Statements of Changes in Net Position present the change in the OCC's net position resulting from the net cost of the OCC's operations and financing sources other than exchange revenues for the years ended September 30, 2006, and 2005. Imputed financing from costs absorbed by others increased by \$1.6 million. The OCC's financing source resulted from a contribution of \$24.5 million in FY 2006 and \$22.9 million in FY 2005 by the OPM toward the OCC's FERS and CSRS retirement plans.

Statements of Budgetary Resources

The Statements of Budgetary Resources, designed primarily for appropriated fund activities, present the budgetary resources available to the OCC for the year, the status of these resources at the end of the year, and the net outlay of budgetary resources at the end of the year. The OCC, which is a non-appropriated agency, executed \$553.0 million or 95.4 percent of its FY 2006 budget of \$579.4 million, with the remaining funding being applied to its asset replacement and contingency reserves.

Statements of Financing

The Statements of Financing demonstrate the relationship between the OCC's proprietary (net cost of operations) and budgetary accounting (net obligations) information. For FY 2006, the statements show \$66.6 million in excess resources available to finance activities, a net decrease of \$18.5 million over September 30, 2005. This net decrease resulted from a \$52.8 million increase in resources available netted against the increase of \$69.7 million in resources used (obligations incurred) and the \$1.6 million increase in imputed financing. The increase in net resources available is due primarily to increased assessments and imputed financing, while the increase in resources used results primarily from various office space and IT investments as well as pay and employee benefits.

Statements of Custodial Activities

The Statements of Custodial Activities identify revenues collected by the OCC on behalf of others. These revenues result primarily from CMPs that are assessed through court-enforced legal actions against a national bank and/or its officers. CMP collections are transferred to the Department of the Treasury's General Fund.

Audits and Program Analyses

Enhanced OCC's Effectiveness through Audits and Program Analyses

The OCC's management control program involves OCC's major programs and all Executive Committee members. OCC relies in part on the work of the GAO, OIG, and independent auditors for an assessment of OCC's annual statement of assurance. Internally, OCC relies on a two-tier, enterprise-level assurance framework.

The first tier is the general requirement that all Executive Committee-level department heads establish satisfactory quality assurance programs in their respective areas of responsibility and annually certify their level of assurance. Executive Committee members design quality assurance processes that are tailored to their operations and work best for them. However, those quality assurance program frameworks must provide reasonable assurance to those department heads that:

- OCC programs are achieving their intended results.
- Resources are aligned with our mission and strategic plan.
- Resources are protected from waste, fraud, and abuse.
- Laws and regulations that apply to OCC operations are being followed.
- Reliable and timely management information systems support decisions.

The Executive Committee members must provide annual written certifications on these five areas to the Comptroller.

The Program and Management Accountability (P&MA) office administers the second tier of the enterprise-level assurance framework—validation, testing, and analysis.

To ensure that identified weaknesses are responded to appropriately, the Executive Committee's Audit Subcommittee provides a forum for monitoring progress, resolving problems, and developing consensus recommendations on issues that arise from the Executive Committee member self-assessments, quality assurance activities, and audits.

For FY 2006, P&MA completed six reviews and has two under way. In addition, the unit administered management control self-assessments from OCC line managers and senior managers.

Audit and program analysis during the year continued to enhance the effectiveness of the OCC workforce and strengthen its organization performance and corporate governance. With guidance provided by the chief of staff and the Audit Subcommittee, this year's initiatives included:

- *Matters requiring attention (MRA) diligence:* Assessed examiner diligence with matters requiring attention (contrasted the operational use of MRA against the standards that apply).
- *Pay flexibility:* Concluded that all Executive Committee areas are using some of OCC's pay flexibility tools for recruiting or retention. Recommended Workforce Effectiveness report pay flexibility usage semiannually to the Executive Committee.
- *Supervision of novel bank activities authorized by Licensing:* Completed a review of a sample of large banks and mid-size/community banks.
- *Implementation of internal controls:* Completed assessing test results of OCC's internal controls, under a requirement from the Office of Management and Budget for federal agencies to establish and maintain effective internal controls over financial reporting, and to submit an annual assurance statement on the effectiveness of those controls.
- *Review of OCC's exit interview process:* Provided findings to management on opportunities to improve the usefulness of exit interviews.
- *Safeguarding personal employee information:* Completed phase 1 of the project to collect best-practice information from private and public sector organizations.

In addition, the unit assisted business units with process improvement projects involving: Web content, external outreach to bankers, records management, and communications processes.

Three audit reports issued by the U.S. Government Accountability Office (GAO) during the year addressed various aspects of the OCC's preemption and visitorial powers rulemaking. Congress asked GAO to look at the rulemaking process, the OCC's assistance to consumers, and the applicability of state consumer protection laws to national banks. The OCC implemented the GAO's suggestions to improve the rulemaking process, and we are in the process of implementing GAO's recommendations to improve outreach to consumers and to clarify the applicability of state consumer protection laws to national banks.

Both the GAO and the Treasury Department Office of Inspector General (OIG) issued reports to the OCC that contained recommendations for improving bank supervision for compliance with laws and regulations focused on anti-money laundering and the deterrence of terrorist financing activities. The OIG also recommended improvements to systems security and disaster recovery.

OCC is required to implement controls and periodically submit information to the Department of the Treasury in support of various department-wide compliance initiatives. Specific examples include compliance under FISMA (Federal Information Security Management Act of 2002), IPIA (Improper Payments Information Act), the Erroneous Payments Recovery Act of 2002, and GPRA (Government Performance and Results Act). The OCC continues to monitor its performance under these acts and has been responsive to each related data call from the Department of the Treasury.

Assurance Statement

The Office of the Comptroller of the Currency (OCC) has made a conscientious effort during fiscal year (FY) 2006 to meet the internal control requirements of the Federal Managers' Financial Integrity Act (FMFIA), the Federal Financial Management Improvement Act (FFMIA), and Office of Management and Budget (OMB) Circular A-123.

OCC systems of management control are designed to ensure that:

a) Programs achieve their intended results;
b) Resources are used in accordance with the agency's mission;
c) Programs and resources are protected from waste, fraud, and mismanagement;
d) Laws and regulations are followed;
e) Controls are sufficient to minimize improper or erroneous payments;
f) Performance information is reliable;
g) Systems security is in substantial compliance with relevant requirements;
h) Continuity of operations planning in critical areas is sufficient to reduce risk to reasonable levels; and
i) Financial management systems are in compliance with Federal financial systems standards, *i.e.*, FMFIA Section 4 and FFMIA.

I am providing reasonable assurance that the above listed management control objectives were achieved by the OCC without material weakness during FY 2006. Specifically, this assurance is provided relative to Sections 2 and 4 of the Federal Managers' Financial Integrity Act (FMFIA). However, control deficiencies in our financial management systems were identified by external auditors requiring improvements in information technology controls, and the Inspector General criticized certain network and information security practices. Accordingly, I am reporting a lack of substantial compliance with the requirements imposed by the Federal Financial Management Improvement Act (FFMIA). As discussed below, these areas are receiving heightened management attention, and plans of corrective action have been developed for resolving both by mid-year 2007.

The OCC also conducted its assessment of the effectiveness of internal control over financial reporting, which includes the safeguarding of assets and compliance with applicable laws and regulations, in accordance with the requirements of Appendix A of OMB Circular A-123. Based on the results of this evaluation, the OCC can provide reasonable assurance that its internal control over financial reporting as of June 30, 2006, was operating effectively, and no material weaknesses were found in the design or operation of the internal control over financial reporting.

Reportable Condition
External auditors found that the OCC needs to improve its information technology (IT) controls over financial management systems. Specifically, they identified IT deficiencies related to security program planning and management, service continuity, and selected access controls.

These deficiencies are based on a certification and accreditation methodology that was found to be inconsistent with the latest National Institute of Standards and Technology guidance. A revised methodology will allow OCC to identify appropriate access controls consistent with sensitivity ratings.

Other access control deficiencies are due to a lack of clear policy and procedures for confirming employee awareness training, acknowledgement of information systems responsibilities, and management of computer system accounts.

Additionally, certain security settings were not configured properly, and there is no process to promptly detect and remove unauthorized personal and public domain software. A plan of corrective actions has been developed to address all of these issues by March 31, 2007.

Other Control Deficiency
I am also bringing to your attention physical and computer security issues that are receiving heightened management attention. These internal control deficiencies do not rise to the level of materiality, and we are not aware of any management control weakness or non-conformance that significantly impairs our ability to fulfill our mission, or otherwise significantly weakens established safeguards against waste, fraud, or mismanagement.

On June 24, 2006, a breach of multiple layers of physical security at our Phoenix Field Office resulted in the theft of two server hard drives and a router. OCC took the appropriate steps to contain and control the incident. Subsequently, but unrelated to the Phoenix incident, OCC also received Office of the Inspector General audit findings critical of certain OCC network and information security practices. Where possible, device or software specific vulnerabilities cited in the report have been corrected. In other cases, a plan of corrective actions has been developed to address these issues by June 30, 2007.

These actions highlight the risks facing the agency in safeguarding sensitive information. I have initiated a comprehensive end-to-end review of our physical and computer security processes and procedures to identify opportunities to improve and further strengthen our management controls in this area. The evaluation will be completed in the first half of FY 2007.

Analytical Basis of Assurance Statement

OCC evaluated its management controls in accordance with the FY 2006 Secretary's Assurance Statement Guidance of July 19, 2006, signed by Richard Holcomb, Deputy Chief Financial Officer, and also considered the following guidance:

- Office of Management and Budget (OMB) Circular A-123, Management Accountability and Control;
- OMB Circular A-127, Financial Management Systems;
- OMB Circular A-130, Management of Federal Information Systems Resources; and
- Treasury Directive 40-04, Treasury Internal Control Program.

Information considered in our control assessment included the following:

- FMFIA certifications submitted by each Executive Committee member;
- OCC's risk assessment analysis for FY 2006;
- Results of internal control testing under OMB Circular A-123, Appendix A;
- Executive Committee descriptions of business unit quality assurance programs;
- Results of internal audits and reviews;
- Results of control self-assessments completed by OCC managers in FY 2006;
- Audit reports and evaluations issued by the Government Accountability Office and the Office of the Inspector General;
- Completion of risk assessment materials related to the Improper Payments Information Act by our Deputy Chief Financial Officer, which was submitted to the Department in May 2006;
- Program information submitted by OCC's Chief Information Security Officer, Deputy Chief Financial Officer, and Office of Critical Infrastructure Protection and Security;
- Completion of GAO's Core Financial System Requirements Checklist;
- Unqualified and timely audit opinion on FY 2005 financial statements; and
- CPA's Gardiner, Kamya and Associates' status report of October 20, 2006 on the FY 2006 financial statement audit.

John C. Dugan
Comptroller of the Currency

GARDINER KAMYA
& ASSOCIATES, PC

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Independent Auditors' Report on Financial Statements

The Inspector General, Department of the Treasury, and
the Comptroller of the Currency:

We have audited the accompanying balance sheets of the Office of the Comptroller of the Currency (OCC) as of September 30, 2006 and 2005, and the related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity for the years then ended. These financial statements are the responsibility of the management of OCC. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the Office of Management and Budget Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements.* Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the OCC as of September 30, 2006 and 2005, and its net costs, changes in net position, budgetary resources, the reconciliation of budgetary obligations to net costs, and custodial activities for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The information in Sections II through V of OCC's fiscal year 2006 Annual Report is not a required part of the financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and accordingly, we express no opinion on it.

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Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The information included in Sections I and VII of OCC's fiscal year 2006 Annual Report is presented for purposes of additional analysis and is not a required part of the financial statements. We did not audit this information and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued reports dated October 31, 2006, on our consideration of the OCC's internal control over financial reporting, and on our tests of its compliance with certain provisions of applicable laws, regulations and contracts. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards*, and these reports should be read in conjunction with this report in considering the results of our audits.

October 31, 2006

Independent Auditors' Report on Internal Control over Financial Reporting

The Inspector General, Department of the Treasury, and
the Comptroller of the Currency:

We have audited the balance sheets of the Office of the Comptroller of the Currency (OCC) as of September 30, 2006 and 2005, and the related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity for the years then ended, and have issued our report thereon dated October 31, 2006. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements.*

In planning and performing our audits, we considered the OCC's internal controls over financial reporting by obtaining an understanding of the OCC's internal controls, determined whether internal controls had been placed in operation, assessed control risk, and performed tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives describes in OMB Bulletin No. 06-03 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audits was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion on internal control over financial reporting.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention that, in our judgment, should be communicated because they represent significant deficiencies in the design or operation in internal control, which could adversely affect OCC's ability to meet the objectives of internal control. Material weaknesses are reportable conditions in which the design or operation of the internal control does not reduce to a relatively low level the risk that errors, fraud or noncompliance in amounts that would be material in relation to the financial statements being audited, or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements due to error or fraud may occur and not be detected. However, we noted a certain matter discussed in Exhibit 1

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involving the internal control over financial reporting and its operation that we consider to be a reportable condition. However, this reportable condition is not believed to be a material weakness.

Finally, with respect to internal control related to performance measures determined by management to be key and reported in Sections III and VII of the OCC's fiscal year 2006 Annual Report, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions and determined whether they have been placed in operation, as required by OMB Bulletin No. 06-03. Our procedures were not designed to provide assurance on internal controls over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

This report is intended solely for the information and use of the OCC's management, the Department of the Treasury Office of Inspector General, OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is available as a matter of public record.

October 31, 2006

EXHIBIT 1

REPORTABLE CONDITION

Improvements Needed in Information Technology General Controls over OCC's Financial Systems.

In our fiscal year 2005 audit, we identified weaknesses in the area of security program planning and management and access controls. We reported these weaknesses to management in a separate letter. Since these weaknesses were identified, OCC has made significant progress by devoting the necessary resources for resolving these weaknesses within its information technology (IT) environment as evidenced in OCC's Plan of Actions and Milestones (POAM) and our verification of correction of prior year issues. However in our review this year, we noted certain weaknesses in OCC's IT general controls. These weaknesses related to the entity-wide security program planning and management, access controls, service continuity, and application software development and change control and are summarized below.

Entity-Wide Security Program Planning and Management

Entity-wide security program planning and management provides a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of the entity's computer-related controls. We noted that OCC's (a) procedures for risk assessment, (b) fiscal management security plan, and (c) Certification and Accreditation methodology related to its Fiscal Management System need improvement. In addition, OCC lacked an updated General Support System Risk Assessment, and a Memorandum of Understanding (MOU) or Interconnection Security Agreement (ISA) with external entities it shared data with or whose systems were interconnected with OCC systems. We also noted that new employees were not always given security awareness training before granting access to information resources and that OCC does not require all employees to sign Non-Disclosure agreements. As a result, OCC was vulnerable to the loss of integrity and confidentiality of its financial data.

Access Controls

Access controls limit or detect access to computer resources (data, programs, equipment and facilities), thereby protecting these resources against unauthorized modification, loss and disclosure. We noted that OCC does not have (a) security parameters (i.e. password configuration) for certain systems identified during the audit, (b) adequate documentation to support the recent change in the sensitivity rating for the Fiscal Management System, and (c) adequate account management procedures for managing information system accounts. We also noted that OCC could not provide signed Employee Acknowledgement of Information Systems Responsibility (EAISR) forms for a sample of new employees. These access control weaknesses may diminish the reliability of computerized data and increase the risk of destruction or inappropriate disclosure of information.

Service Continuity

Service continuity controls ensure that when unexpected events occur, critical operations continue without interruption or are promptly resumed and critical and sensitive data are protected. We noted that (a) OCC has not developed and implemented a Business Impact Analysis (BIA) for its Fiscal Management System as part of its contingency planning activities, (b) the current OCC Contingency Plan, which is currently in development, for the Fiscal Management System does not meet the requirements of NIST Special Publication 800-34, and (c) testing of off-site storage backup tapes are not regularly performed. We also noted that the offsite storage facility currently used for storing backup tapes associated with the Fiscal Management System, is subject to the potential risk of being affected by the same natural disaster as the main Fiscal Management System application process facility because of their close proximity to each other. As a result, OCC may be unable to implement effective contingency procedures for the Financial Management System in the event of a disaster or disruption in processing.

Application Software Development and Change Control

Application software development and change controls prevent unauthorized programs or modifications to an existing program from being implemented. We noted that OCC has not implemented a mechanism for promptly detecting and removing unauthorized software from OCC systems (desktops). The lack of monitoring of OCC systems for the use of unauthorized software could result in the introduction of non-approved software in OCC's networking environment, which could negatively impact processing operations, introduce harmful viruses, and/or cause the loss of data.

RECOMMENDATIONS:

We recommend that the Chief Information Officer ensure that OCC:

1. Documents its risk assessment activities in a form that will make them verifiable and in accordance with NIST Special Publication 800-30.
2. Adheres to its current plans for finalizing the security plans for the Fiscal Management System and Network Infrastructure Security Plans and their corresponding certifications and accreditations in accordance with NIST Special publications 800-18 and 800-37.
3. Finalizes its MOUs and ISAs with the National Finance Center, Federal Deposit Insurance Corporation and Federal Reserve Board.
4. Continues implementing its new processes to ensure that new employees complete their initial Security Awareness Training in a timely manner.
5. Requires all new employees and contractors to complete and sign all access agreements (e.g. Non-Disclosure Agreements).
6. Implements password configuration settings for certain systems identified during the audit in accordance with NIST Special Publication 800-12.

7. Continues its effort to improve documentation for "security impact ratings" of its Federal Information Security Management Act (FISMA) systems in accordance with NIST Special Publication 800-60, Volume 1.
8. Develops and implements a policy that requires user accounts to be disabled and removed when they are no longer needed in accordance with NIST Special Publication 800-53.
9. Requires employees to sign the EAISR forms in a timely manner in accordance with OCC Information Security Handbook, Section 3.3, and maintains adequate documentation of signed forms.
10. Develops and implements a BIA for its Fiscal Management System in accordance with NIST Special Publication 800-34.
11. Completes the Contingency Plan that is currently under development in accordance with NIST Special Publication 800-34.
12. Develops and implements a policy for regular testing of off-site storage backup tapes.
13. Expands the existing offsite tape storage contract to include a secondary rotation of tapes on a regular basis to a remote facility, if it is cost-beneficial, in accordance with NIST Special Publication 800-34, Section 3.4.1.
14. Develops and implements a process for the active and systematic detection, notification, and prompt removal of unauthorized personal and public domain software in accordance with NIST Special Publication 800-53.

MANAGEMENT RESPONSE:
OCC management concurs with the reportable condition that is described in this report. Corrective actions are underway to address each recommendation and they are confident that they will be able to rectify these deficiencies before the next annual report cycle is completed.

GARDINER KAMYA
& ASSOCIATES, PC

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Independent Auditors' Report on Compliance with Laws and Regulations

The Inspector General, Department of the Treasury, and
the Comptroller of the Currency:

We have audited the balance sheets of the Office of the Comptroller of the Currency (OCC) as of September 30, 2006 and 2005, and the related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity, for the years then ended, and have issued our report thereon dated October 31, 2006. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and, Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*.

The management of the OCC is responsible for complying with laws, regulations and contracts applicable to the OCC. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the OCC's compliance with certain provisions of laws, regulations and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 06-03, including certain requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations and contracts applicable to the OCC. However, our objective was not to provide an opinion on overall compliance with laws, regulations and contracts. Accordingly, we do not express such an opinion.

The results of our tests of compliance with laws, regulations and contracts described in the preceding paragraph, exclusive of FFMIA, disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 06-03.

Under FFMIA, we are required to report whether the OCC's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

The results of our tests of FFMIA Section 803(a) requirements disclosed one instance in which OCC's financial management systems did not substantially comply with federal financial management system requirements related to information technology general controls, which is

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described in Exhibit 1 of our Report on Internal Control over Financial Reporting dated October 31, 2006.

The results of our tests disclosed no instances in which OCC's financial management systems did not substantially comply with applicable Federal accounting standards and the United States Government Standard General Ledger at the transaction level.

This report is intended solely for the information and use of the OCC's management, the Department of the Treasury Office of Inspector General, OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is available as a matter of public record.

October 31, 2006

VI. Financial Statements and Notes

Office of the Comptroller of the Currency
Balance Sheets
As of September 30, 2006 and 2005

		FY 2006		FY 2005
Assets				
Intragovernmental:				
Fund balance with Treasury	$	9,104,809	$	1,724,161
Investments and related interest (Note 3)		713,281,888		611,975,767
Accounts receivable		-		13,300
Total intragovernmental		**722,386,697**		**613,713,228**
Cash		12,256		12,584
Accounts receivable, net		7,222		270,556
Property and equipment, net (Note 4)		43,165,142		46,190,939
Advances and prepayments		39,031		1,145,419
Total assets	**$**	**765,610,348**	**$**	**661,332,726**
Liabilities				
Intragovernmental:				
Other accrued liabilities	$	275,033	$	1,405,550
Total intragovernmental		**275,033**		**1,405,550**
Accounts payable		10,005,032		7,960,357
Accrued payroll and other employee benefits		18,050,476		17,555,891
Accrued annual leave		27,533,285		24,942,021
Other accrued liabilities		19,129,317		17,030,393
Deferred revenue		159,421,459		146,664,373
Post retirement benefits (Note 6)		12,839,288		11,352,850
Total liabilities		**247,253,890**		**226,911,435**
Net position (Note 7)		**518,356,458**		**434,421,291**
Total liabilities and net position	**$**	**765,610,348**	**$**	**661,332,726**

The accompanying notes are an integral part of these financial statements.

Office of the Comptroller of the Currency
Statements of Net Cost
For the Years Ended September 30, 2006 and 2005

		FY 2006		FY 2005
Program Costs				
Supervise National Banks				
Intragovernmental	$	68,025,152	$	57,553,452
With the public		418,553,951		362,769,983
Subtotal - Supervise National Banks	**$**	**486,579,103**	**$**	**420,323,435**
Regulate National Banks				
Intragovernmental	$	10,459,084	$	9,279,718
With the public		62,743,342		56,650,420
Subtotal - Regulate National Banks	**$**	**73,202,426**	**$**	**65,930,138**
Charter National Banks				
Intragovernmental	$	2,119,060	$	2,232,906
With the public		12,267,183		13,228,352
Subtotal - Charter National Banks	**$**	**14,386,243**	**$**	**15,461,258**
Total Program Costs	**$**	**574,167,772**	**$**	**501,714,831**
Less: Earned revenues not attributed to programs		(633,598,176)		(577,742,644)
Net Cost of Operations	**$**	**(59,430,404)**	**$**	**(76,027,813)**

The accompanying notes are an integral part of these financial statements.

Office of the Comptroller of the Currency
Statements of Changes in Net Position
For the Years Ended September 30, 2006 and 2005

	FY 2006	FY 2005
Beginning Balances	$ 434,421,291	$ 335,459,615
Other Financing Sources:		
Imputed financing from costs absorbed by others (Note 6)	24,504,763	22,933,863
Net Cost of Operations	59,430,404	76,027,813
Net Change	83,935,167	98,961,676
Ending Balances	**$ 518,356,458**	**$ 434,421,291**

The accompanying notes are an integral part of these financial statements.

Office of the Comptroller of the Currency
Statements of Budgetary Resources
For the Years Ended September 30, 2006 and 2005

		FY 2006		FY 2005
Budgetary Resources:				
Unobligated balance:				
Beginning of period	$	506,623,014	$	398,535,082
Spending authority from offsetting collections:				
Earned				
Collected		649,009,263		596,213,085
Receivable from Federal sources		(1,034,307)		(1,011,814)
Subtotal		647,974,956		595,201,271
Total Budgetary Resources	**$**	**1,154,597,970**	**$**	**993,736,353**
Status of Budgetary Resources				
Obligations incurred	$	556,825,650	$	487,113,339
Unobligated balance available		597,772,320		506,623,014
Total Status of Budgetary Resources	**$**	**1,154,597,970**	**$**	**993,736,353**
Relationship of Obligations to Outlays				
Obligated balance, net, beginning of period		94,271,481		80,658,172
Obligated balance, net, end of period:				
Accounts receivable		(3,644,462)		(4,678,768)
Undelivered orders		30,068,275		18,703,188
Accounts payable and accruals, net of assessments refunds		87,832,431		80,247,061
Outlays:				
Disbursements	$	537,875,194	$	474,511,844
Collections		(649,009,263)		(596,213,085)
Net Outlays	**$**	**(111,134,069)**	**$**	**(121,701,241)**

The accompanying notes are an integral part of these financial statements.

Office of the Comptroller of the Currency
Statements of Financing
For the Years Ended September 30, 2006 and 2005

	FY 2006	FY 2005
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
Obligations incurred	$ 556,825,650	$ 487,113,339
Less: Spending authority from offsetting collections	(647,974,956)	(595,201,271)
Net obligations	(91,149,306)	(108,087,932)
Other Resources		
Imputed financing from costs absorbed by others (Note 6)	24,504,763	22,933,863
Total resources used to finance activities	**(66,644,543)**	**(85,154,069)**
Resources Used to Finance Items not Part of the Net Cost of Operations:		
Change in budgetary resources obligated for goods, services and benefits ordered but not yet provided	(10,258,699)	(2,278,023)
Resources that finance the acquisition of assets	(13,105,666)	(17,874,784)
Other resources or adjustments to net obligated resources that do not affect net cost of operations	263,333	(158,355)
Total resources used to finance items not part of the net cost of operations	**(23,101,032)**	**(20,311,162)**
Total resources used to finance the net cost of operations	**(89,745,575)**	**(105,465,231)**
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Periods:		
Change in deferred revenue	12,757,084	21,648,766
Total components that will require or generate resources in future periods	12,757,084	21,648,766
Components not Requiring or Generating Resources:		
Depreciation and amortization	12,147,307	11,203,799
Net (increase) decrease in bond premium	1,426,622	(4,043,186)
Other	3,984,158	628,039
Total components that will not require or generate resources	17,558,087	7,788,652
Total components of net cost of operations that will not require or generate resources in the current period	**30,315,171**	**29,437,418**
Net Cost of Operations	**$ (59,430,404)**	**$ (76,027,813)**

The accompanying notes are an integral part of these financial statements.

Office of the Comptroller of the Currency
Statements of Custodial Activity
For the Years Ended September 30, 2006 and 2005

	FY 2006	FY 2005
Revenue Activity:		
Sources of Cash Collections		
Civil Money Penalties	$ 4,127,008	$ 31,264,157
Accrual Adjustments	(104,325)	234,072
Total Custodial Revenue	4,022,683	31,498,229
Disposition of Custodial Revenue		
Transferred to Treasury	(3,870,483)	(31,117,164)
(Increase)/Decrease in Amounts Yet to be Transferred	(152,200)	(381,065)
Total Disposition for Custodial Revenue	(4,022,683)	(31,498,229)
Net Custodial Activity	**$ -**	**$ -**

The accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements

Note 1—Organization

The OCC was created as a bureau within the U.S. Department of the Treasury by an act of Congress in 1863. The OCC was created to establish and regulate a system of federally chartered national banks. The National Currency Act of 1863, rewritten and reenacted as the National Bank Act of 1864, authorized the OCC to supervise national banks and to regulate the lending and investment activities of federally chartered institutions.

The OCC's revenue is derived primarily from assessments and fees paid by national banks and income on investments in U.S. government securities. The OCC does not receive congressional appropriations to fund any of its operations. Therefore, the OCC does not have any unexpended appropriations.

By federal statute 12 USC 481, the OCC's funds are maintained in a U.S. government trust revolving fund. The funds remain available to cover the annual costs of the OCC's operations in accordance with policies established by the Comptroller.

Note 2—Significant Accounting Policies

2A. Basis of Accounting

(1) The OCC's financial statements are prepared from its accounting records in conformity with the generally accepted accounting principles (GAAP) in the United States of America. The financial statements consist of Balance Sheets, and the Statements of Net Cost, Changes in Net Position, Budgetary Resources, Financing, and Custodial Activity. These financial statements are presented on a comparative basis providing information for FYs 2006 and 2005.

(2) The financial statements reflect both the accrual and budgetary bases of accounting. Under the accrual method, revenues are recognized when earned, and expenses are recognized when a liability is incurred, without regard to cash receipt or payment. The budgetary method recognizes the obligation of funds according to legal requirements, which in many cases, is made prior to the occurrence of an accrual-based transaction. Budgetary accounting is essential for compliance with legal constraints and controls over the use of federal funds.

(3) In accordance with GAAP, the preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Such estimates and assumptions could change in the future as more information becomes known, which could affect the amounts reported and disclosed herein.

2B. Revenues and Other Financing Sources

(4) The OCC's revenue is derived primarily from assessments and fees paid by national banks and income on investments in U.S. government securities. The OCC does not receive congressional appropriations to fund any of its operations. Therefore, the OCC does not have any unexpended appropriations.

(5) By federal statute 12 USC 481, the OCC's funds are maintained in a U.S. government trust revolving fund. The funds remain available to cover the annual costs of the OCC's operations in accordance with policies established by the Comptroller.

(6) The OCC collects CMPs due to the federal government that are assessed through court-enforced legal actions against a national bank and/or its officers. Outstanding CMPs at September 30, 2006, and 2005, amounted to $1,619,114 and $1,514,789, respectively.

2C. Earmarked Funds

(7) Earmarked funds are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities, benefits, or purposes, and must be accounted for separately from the government's general revenues. In accordance with SFFAS 27, Earmarked Funds, all of the OCC's revenue meets this criteria and constitutes an earmarked fund.

(8) The federal government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds. Treasury securities are an asset to the OCC and a liability to the U.S. Treasury. Because the OCC and U.S. Treasury are both parts of the government, these assets and liabilities offset each other from the standpoint of the government as a whole. For this reason, they do not represent an asset or a liability in the U.S. government-wide financial statements.

(9) Treasury securities provide the OCC with authority to draw upon the U.S. Treasury to make future payments or expenditures. When the OCC requires redemption of these securities to make expenditures, the government finances those expenditures out of accumulated cash balances, by raising taxes or other receipts, by borrowing from the public or repaying less debt, or by curtailing other expenditures. This is the same way that the government finances all other expenditures.

2D. Basis of Consolidation

The OCC's financial statement amounts are included in the consolidated financial statements of the U.S. Department of the Treasury (Treasury). Transactions and balances among the OCC and other Treasury entities are eliminated from the Treasury consolidated financial statements.

2E. Fund Balance with Treasury

The OCC's cash receipts and disbursements are processed by the U.S. Treasury. Sufficient funds are maintained in a U.S. government trust revolving fund and are available to pay current liabilities. The OCC invests available funds in U.S. government securities (Note 3). In accordance with SFFAS 1, *Accounting for Selected Assets and Liabilities,* the OCC has the ability and the intent to hold its government securities until maturity. Accordingly the OCC accounts for its government securities at acquisition cost adjusted for amortized premium or discount.

2F. Accounts Receivable

Accounts Receivable represent monies owed to the OCC for services and goods provided. If applicable, Accounts Receivable from the public are reduced by an Allowance for Doubtful Accounts. In accordance with SFFAS 1, the OCC updates its allowance for doubtful accounts annually or as needed to reflect the most current estimate of accounts that are more likely than not to be uncollectible.

2G. Property and Equipment

Property, equipment, and internal use software (Note 4) are accounted for in accordance with SFFAS 6, *Accounting for Property, Plant, and Equipment,* and SFFAS 10, *Accounting for Internal Use Software.*

2H. Liabilities

(10) Liabilities represent the amounts owing or accruing under contractual or other arrangements governing the transactions, including operating expenses incurred but not yet paid. Payments are made in a timely manner in accordance with the Prompt Payment Act. Interest penalties are paid when payments are late. Discounts are taken when cost effective, and the invoice is paid within the discount period. The OCC accounts for liabilities in accordance with SFFAS 5, *Accounting for Liabilities of the Federal Government.* In accordance with SFFAS 5, annual leave is accrued and funded by the OCC as it is earned, and the accrual is reduced as leave is taken or paid. Each year, the balance in the accrued annual leave account is adjusted to reflect current pay rates. Sick leave and other types of leave are expended as taken.

(11) The OCC's activities are primarily financed by assessments on assets held by national banks and the federal branches of foreign banks. These assessments are due March 31 and September 30 of each year based on asset balances as of call reports dated December 31 and June 30, respectively. Assessments are paid in mid-cycle and are recognized as earned revenue on a straight-line basis over the six months following the call date. The unearned portions are reduced accordingly.

2I. Effects of Recent Accounting Pronouncements

Presentation of the OCC's financial statement disclosures was affected by the publication of SFFAS 27, *Earmarked Funds.* All of the OCC's sources of revenue are characteristic of earmarked funds as outlined in SFFAS 27. Accordingly, Significant Accounting Policies Note 2C and its subparagraphs include the appropriate disclosures effective for FY 2006.

Note 3—Investments and Related Interest

Investments are U.S. Treasury securities stated at amortized cost and the related accrued interest. The OCC plans to hold these investments until maturity. Premiums and discounts are amortized over the term of the investment using the straight-line method, which approximates the effective yield method. The fair market value of investment securities was $703,712,750 at September 30, 2006, and $603,096,812 at September 30, 2005.

Investments and Related Interest Receivable

	FY 2006	FY 2005
Par Value	$ 705,164,000	$ 600,379,000
Net Unamortized Discount/Premium	4,473,426	6,931,298
Net Unamortized Value	709,637,426	607,310,298
Interest Receivable	3,644,462	4,665,469
Total	**$ 713,281,888**	**$ 611,975,767**

FY 2006 Investment Portfolio

Maturity	Par Value	Coupon Rate
Overnight	$ 327,164,000	5.030%
During 2006	30,000,000	3.500%
During 2007	30,000,000	4.380%
	50,000,000	3.250%
	30,000,000	3.000%
During 2008	30,000,000	2.630%
	21,000,000	3.380%
During 2009	21,000,000	3.880%
	35,000,000	3.500%
During 2010	35,000,000	5.750%
During 2011	32,000,000	5.000%
	32,000,000	5.000%
During 2012	32,000,000	4.880%
Total	**$ 705,164,000**	

FY 2005 Investment Portfolio

Maturity		Par Value	Coupon Rate
Overnight	$	218,379,000	3.460%
During 2006		29,000,000	5.750%
		25,000,000	6.875%
During 2007		30,000,000	3.500%
		30,000,000	4.375%
During 2008		30,000,000	3.000%
		30,000,000	2.625%
During 2009		21,000,000	3.375%
		21,000,000	3.875%
During 2010		35,000,000	3.500%
		35,000,000	5.750%
During 2011		64,000,000	5.000%
During 2012		32,000,000	4.875%
Total	**$**	**600,379,000**	

Note 4—Property and Equipment, net

Property and equipment purchased at a cost greater than or equal to the noted thresholds below with useful lives of five years or more are capitalized at cost and depreciated or amortized, as applicable. Leasehold improvements are amortized on a straight-line basis over the lesser of the terms of the related leases or their estimated useful lives. All other property and equipment are depreciated or amortized, as applicable, on a straight-line basis over their estimated useful lives. During FY 2006, a comprehensive review of the Internal Use Software program, internal controls, and assets was accomplished to validate the proper identification, capture, and capitalization or expensing of costs related to software development. Significant development costs were subsequently expensed, along with an impaired software asset written off during FY 2006. The tables presented below summarize property and equipment balances as of September 30, 2006, and 2005.

FY 2006 Property and Equipment, net

Class of Assets	Capitalization Threshold/	Useful Life		Cost		Accumulated Depreciation		Net Book Value
Leasehold Improvements	$ 50,000	5-20	$	27,794,731	$	(20,971,319)	$	6,823,412
Equipment	$ 50,000	5-10		20,615,740		(12,885,585)		7,730,155
Furniture and Fixtures	$ 50,000	5-10		1,336,778		(1,035,196)		301,582
Internal Use Software	$500,000	5		38,631,354		(20,764,024)		17,867,330
Internal Use Software-Dev	$500,000	N/A		9,298,819		-		9,298,819
Leasehold Improvements-Dev	$ 50,000	N/A		1,143,844		-		1,143,844
Total			**$**	**98,821,266**	**$**	**(55,656,124)**	**$**	**43,165,142**

FY 2005 Property and Equipment, net

Class of Assets	Capitalization Threshold/	Useful Life		Cost		Accumulated Depreciation		Net Book Value
Leasehold Improvements	$ 50,000	5-20	$	26,429,648	$	(19,271,689)	$	7,157,959
Equipment	$ 50,000	5-10		15,075,850		(9,379,463)		5,696,387
Furniture and Fixtures	$ 50,000	5-10		1,336,778		(971,877)		364,901
Internal Use Software	$500,000	5		31,383,723		(14,199,259)		17,184,464
Internal Use Software-Dev	$500,000	N/A		15,317,047		-		15,317,047
Leasehold Improvements-Dev	$ 50,000	N/A		470,181		-		470,181
Total			**$**	**90,013,227**	**$**	**(43,822,288)**	**$**	**46,190,939**

Note 5—Leases

The OCC leases office space for headquarters operations in Washington, D.C., and for district and field operations. The lease agreements expire at various dates. In FY 2006, the OCC entered into a 54-month occupancy agreement with the General Services Administration for headquarters expansion and a 2-year lease for temporary office space for the headquarters staff. These leases are treated as operating leases. As part of the extensive A-123 review of internal controls and processes, all OCC leases were reviewed and tested, and it was determined that all leases are properly classified as operating leases.

FY 2006 Future Lease Payments

Year		Amount
2007	$	25,665,528
2008		25,887,021
2009		24,739,474
2010		24,060,079
2011		18,921,229
2012 and beyond		18,905,173
Total	**$**	**138,178,504**

FY 2005 Future Lease Payments

Year		Amount
2006	$	22,789,699
2007		24,954,737
2008		23,774,977
2009		22,589,732
2010		21,751,178
2011 and beyond		34,436,469
Total	**$**	**150,296,792**

Note 6—Retirement Plans and Other Benefits

Retirement

OCC employees are eligible to participate in one of two retirement plans. Employees hired prior to January 1, 1984, are covered by the CSRS, unless they elected to join the FERS and Social Security during the election period. Employees hired after December 31, 1983, are automatically covered by FERS and Social Security. The distribution of the OCC's workforce by retirement plan is 72 percent FERS and 27 percent CSRS. The remaining 1 percent of employees qualifies only for Social Security benefits. For employees covered by CSRS, the OCC contributes 7 percent of their adjusted base pay to the plan. OCC contributions to CSRS were $6,942,291 in FY 2006 and $6,219,879 in FY 2005. For employees covered by FERS, the OCC contributes 11.2 percent of their adjusted base pay. OCC contributions totaled $19,368,843 in FY 2006 and $17,001,247 in FY 2005.

Furthermore, OPM contributed an additional $24,504,763 toward these retirement plans during FY 2006, and $22,933,863 in FY 2005. The OCC recognized these contributions as "Imputed costs absorbed by others" and an offset in equal amount to "Imputed financing from costs absorbed by others" as a result of not having to reimburse OPM.

The OCC does not report in its financial statements information pertaining to the retirement plans covering its employees. Reporting amounts, such as plan assets, accumulated plan benefits, or unfunded liabilities, if any, are presently the responsibility of the OPM.

Other Benefits

Thrift Savings Plan

OCC employees are eligible to participate in the Federal Thrift Savings Plan (TSP). For those employees under FERS, a TSP account is automatically established, and the OCC contributes a mandatory 1 percent of adjusted base pay to this account. In addition, the OCC matches employee contributions up to an additional 4 percent of pay, for a maximum OCC contribution amounting to 5 percent of adjusted base pay. Employees under CSRS may participate in the TSP, but do not receive the automatic (1 percent) and matching employer contributions. TSP contributions by the OCC totaled $7,633,767 in FY 2006 and $6,890,694 in FY 2005. The OCC also contributed a total of $14,495,366 for Social Security and Medicare benefits for all eligible employees in FY 2006, and $12,632,597 in FY 2005.

OCC 401(k) Plan

Employees can elect to contribute up to 10 percent of their adjusted base pay in the OCC 401(k) Plan, subject to Internal Revenue regulations. Prudential Financial Incorporated administers the plan. Currently, the OCC contributes a fixed 2 percent of the adjusted base pay to the plan for all qualified employees, regardless of whether they contribute to the plan or not. In addition, the OCC matches the first 1 percent of an employee's contribution to the Plan, for a total agency contribution of 3 percent. Approximately 2,503 employees receive the maximum of 3 percent contribution and 383 employees benefit from the basic 2 percent contribution. In both FY 2005 and FY 2006, the OCC funded a special lump sum contribution of $1,000 to be deposited in the 401(k) accounts of all permanent employees. The total cost of the OCC's employer biweekly and special lump sum contributions plus associated administration fees amounted to $10,840,966 during FY 2006, and $9,227,442 in FY 2005. The OCC contracted with the independent audit firm of Clifton, Gunderson, LLP to perform an audit of the plan and related financial statements for the year ended December 31, 2005. The financial statements for the plan received an unqualified opinion.

Post-Retirement Life Insurance

The OCC sponsors a life insurance benefit plan for current and retired employees. This plan is a defined benefit plan. Premium payments made during FY 2006 totaled $297,121 and $289,348 in FY 2005.

The weighted-average discount rate used in determining the accumulated post-retirement benefit obligation was 5.75 percent. Gains or losses due to changes in actuarial assumptions are amortized over the service life of the plan.

Federal Employees Health Benefits and Federal Employees Group Life Insurance

Employees and retirees of the OCC are eligible to participate in Federal Employees Health Benefits (FEHB) and Federal Employees Group Life Insurance (FEGLI) plans that involve a cost sharing of bi-weekly coverage premiums by employee and employer. Both of these employee benefit plans are administered by OPM. Total OCC contributions for active employees who participate in the FEHB plans were $17,088,453 for FY 2006, and $14,567,345 for FY 2005. OCC contributions for active employees who participate in the FEGLI plan were $256,700 for FY 2006, and $213,267 for FY 2005.

Federal Employees' Compensation Act

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered federal civilian employees injured on the job, employees who have incurred a work-related occupational disease, and beneficiaries of employees whose death is attributable to a job-related injury or occupational disease. Claims incurred for benefits for OCC employees under FECA are administered by the U.S. Department of Labor (DOL) and later billed to the OCC. The OCC accrued $4,316,129 of workers' compensation costs as of September 30, 2006, and $5,260,569 as of September 30, 2005. These amounts include unbilled costs of $168,585 in FY 2006 and $280,603 in FY 2005 and an actuarial estimated liability of $4,147,544 in FY 2006 and $4,979,966 in FY 2005 based on calculations provided by the DOL at year-end.

Accrued Post-Retirement Benefit Cost and Net Periodic Post-Retirement Benefit Cost

Component		FY 2006		FY 2005
Accumulated Post-Retirement Benefit Obligation	$	(17,354,262)	$	(16,272,887)
Unrecognized Transition Obligation		1,037,034		1,209,871
Unrecognized Net Gain		3,477,940		3,710,166
Total	**$**	**(12,839,288)**	**$**	**(11,352,850)**
Service Cost	$	583,972	$	509,425
Interest Cost		923,884		844,237
Amortization of Transition Obligation		172,837		172,837
Amortization of Unrecognized Loss		273,864		186,069
Total	**$**	**1,954,557**	**$**	**1,712,568**

Note 7—Net Position

The OCC sets aside a portion of its net position as contingency, asset replacement, and special reserves to be used at the discretion of the Comptroller. In addition, funds are set aside to cover the cost of on-going operations.

The contingency reserve supports the OCC's ability to accomplish its mission in the case of foreseeable but rare events. Foreseeable but rare events are beyond the control of the OCC, such as a major change in the national banking system or for instance, a fire, flood, or significant impairment of its information technology systems.

The asset replacement reserve funds the replacement of IT equipment, leasehold improvements, and furniture replacements for future years. The target level in the replacement reserve is established annually based on the gross value of existing property and equipment plus a growth rate factor and a margin for market cost adjustments.

The special reserve supplements revenue from assessments and other sources that are made available to fund the OCC's annual budget. The special reserve reduces the effect on operations of unforecasted revenue shortfalls or unbudgeted and unanticipated requirements or opportunities.

Net Position Availability

Components		FY 2006		FY 2005
Contingency Reserve	$	291,689,618	$	280,828,551
Asset Replacement Reserve		104,000,000		38,709,695
Special Reserve		15,000,000		15,000,000
Earmarked for On-going Operations:				
Undelivered Orders		30,068,275		18,703,188
Consumption of Assets		49,930,100		55,488,907
Capital Investments		27,668,465		25,690,950
Net Position	**$**	**518,356,458**	**$**	**434,421,291**

Note 8—Expenses by Budget Object Classification

The following table illustrates the OCC's costs by major budget object class for FYs 2006 and 2005.

Budget Object Class		FY 2006		FY 2005
Personnel Compensation	$	282,267,100	$	256,653,020
Personnel Benefits		94,091,970		85,542,831
Benefits to Former Employees		191,232		626,059
Travel and Transportation of Persons		35,570,767		31,160,567
Travel and Transportation of Things		1,992,797		1,446,824
Rent, Communication, and Utilities		34,417,329		33,530,892
Printing and Reproduction		880,900		859,851
Other Contractual Services		70,932,468		44,696,702
Supplies and Materials		5,236,152		3,382,594
Equipment		5,247,447		5,452,810
Land and Structures - Leasehold Improvements		2,281,116		3,521,380
Insurance Claims and Indemnities		422,267		75,601
Depreciation		12,147,306		11,203,799
Loss on Asset Disposal		3,984,158		628,038
Imputed Costs		24,504,763		22,933,863
Total	**$**	**574,167,772**	**$**	**501,714,831**

VII. Appendices

Appendix A—FY 2006 Performance Measures and Results

The OCC's FY 2006 performance measures, workload indicators, customer service standards, and results are presented below.

Strategic Goal	Performance Measure Workload Indicator Customer Service Standard	FY 2003	FY 2004	FY 2005	FY 2006	
					Target	Actual [1]
I. A safe and sound national banking system						
	Percentage of national banks with composite CAMELS rating of 1 or 2	94%	94%	94%	90%	***95%***
	Rehabilitated problem national banks as a percentage of the problem national banks one year ago (CAMELS 3, 4 or 5)	32%	40%	44%	40%	***46%***
	Percentage of national banks that are categorized as well capitalized	99%	99%	99%	95%	***99%***
	Percentage of critically undercapitalized banks on which responsible action is taken within 90 calendar days after they become critically undercapitalized	100%	100%	N/A [2]	100%	100%
	Average survey response that the report of examination clearly communicated examination findings, significant issues and the corrective actions management needed to take [3]	1.26	1.30	1.28	$\leq$ 1.75	1.30
II. Fair access to financial services and fair treatment of bank customers						
	Percentage of national banks with consumer compliance rating of 1 or 2	96%	96%	94%	94%	***94%***
	Percentage of qualified intermediate small banks to which the OCC offers to provide consultation on the Community Reinvestment Act and community development opportunities	100%	100%	100%	100%	100%
	Percentage of consumer complaints closed within 60 calendar days of receipt [4]	N/A	N/A	N/A	Baseline	36%
	Number of consumer complaints opened/closed during the fiscal year [4]	N/A N/A	N/A N/A	N/A N/A	Baseline Baseline	31,827 32,945
III. A flexible legal and regulatory framework that enables the national banking system to provide a full, competitive array of financial services						
	Percentage of external legal opinions issued within established time frames	87%	87%	86%	86%	89%
	Number of external legal opinions issued during the fiscal year	92	119	119	120	70
	Percentage of licensing applications and notices filed electronically	8%	34%	38%	40%	36% [5]
	Number of licensing applications and notices filed electronically during the fiscal year	182	893	1,256	1,600	1,367
	Percentage of licensing applications and notices completed within established time frames	97%	96%	96%	95%	94% [6]
	Number of licensing applications and notices completed during the fiscal year	1,918	2,477	2,128	2,000	2,425
	Average survey rating of the overall licensing services provided by OCC [7]	1.14	1.20	1.19	$\leq$ 1.5	1.2

Strategic Goal	Performance Measure Workload Indicator Customer Service Standard	FY 2003	FY 2004	FY 2005	FY 2006 Target	FY 2006 Actual [1]
IV. An expert, highly motivated, and diverse workforce that makes effective use of OCC resources						
	Total OCC costs relative to every $100,000 in bank assets regulated	N/A	N/A	N/A	Baseline	***$8.84***

[1] FY 2006 performance numbers shown in bold italics are estimates. Some performance data is obtained from quarterly call reports from banks. The September 30, 2006 call reports are not due until 30 or 45 days after the end of the period. Additionally, examinations concluded late in the fiscal year are not finalized for another 30 to 60 days. As a result, complete fiscal year data is not yet available, therefore, estimates have been reported.
[2] There were no critically undercapitalized national banks in FY 2005.
[3] The examination survey is based on a five-point scale, in which 1 indicates complete agreement and 5 indicates complete disagreement.
[4] In FY 2006 OCC revised reporting on the consumer complaints measure and related workload indicators to exclude inquiries and appeals at the recommendation of the General Accountability Office. As such, prior year reporting is no longer presented because the data is not comparable and FY 2006 is shown as the baseline year.
[5] The OCC did not meet the target of receiving 40 percent of all licensing application and notice filings electronically (36 percent actual) because of the unexpected filing of 208 branch applications from a single national bank that preferred paper filings over electronic filings. These 208 branch application filings contributed to a 40 percent increase in branch application filings for the district licensing unit responsible for this bank, compared with branch application filings during the previous year.
[6] This year, several applications that initially appeared to be routine in nature required additional processing time due to unique circumstances that became apparent in the course of application review, for example, branch applications with historical preservation issues. This caused the OCC performance on this measure to be marginally below target.
[7] The licensing survey is based on a five-point scale, in which 1 indicates outstanding and 5 indicates significantly deficient.

Appendix B—Financial Performance Measures

The following is a discussion of OCC's financial performance measures and the results achieved during FY 2006.

Prompt Payment

The Prompt Payment Act and the OMB Circular A-125 require agencies to make payments on time, pay interest penalties when payments are late, and take discounts only when payments are made on or before the discount date. The OMB's goal is a prompt payment rate of greater than 98 percent. The OCC's prompt pay rate was 99.9 percent in FY 2006 as compared to 99.6 percent in FY 2005. In FY 2006, the OCC was offered 96 vendor discounts for a total of $63,176. The OCC took 92 percent of the discounts offered saving a total of $57,809. Table 9 summarizes the OCC's prompt payment performance for FYs 2006 and 2005.

Table 8: Prompt Payment Performance, FY 2006 and 2005

	FY 2006 Amount	FY 2005 Amount	FY 2006 Number	FY 2005 Number
Invoices paid	$114,074,064	$81,266,691	28,869	22,472
Invoices paid late	$698,940	$2,247,318	36	81
Interest penalties paid	$221	$1,198	23	53

Electronic Funds Transfer

The use of Electronic Funds Transfer (EFT) rather than a paper check for payments provides greater control over payment timing and reduces payment cost. During FY 2006, the OCC continued to maximize the use of payment mechanisms as required by the Debt Collection Improvement Act of 1996. Table 10 summarizes EFT usage for FYs 2006 and 2005.

Table 9: Electronic Funds Transfer Performance, FY 2006 and 2005

	FY 2006	FY 2005
Vendor payments	99.6%	99.5%
Employee payments	100.0%	100.0%

Erroneous Payments

The erroneous payments program meets the criteria of IPIA to support the Department of the Treasury's strategic goal, "Ensure Professionalism, Excellence, Integrity and Accountability in the Management and Conduct of the Department of the Treasury." The OCC analyzed payments (excluding payroll) made during FY 2006 and identified 89 erroneous payments totaling $140,120. Erroneous payments are identified and monitored daily to ensure prompt recovery. The underlying causes and contributing factors are identified quickly, and control measures are implemented to prevent additional erroneous payments. The OCC corrected and recovered all erroneous payments made during the year.

Methodology for Identifying Improper Payments
The OCC conducts both pre-payment reviews and post-payment audits to identify improper or erroneous payments. The OCC conducts a 100 percent pre-payment review of all supplier invoices and payment files prior to transmission to Treasury. As part of its sensitive payments program, the OCC conducts a 100 percent pre-payment review of executive and international travel vouchers and relocation payments, thereby helping to prevent erroneous payments. The OCC uses a sampling approach to audit travel vouchers and data-mining techniques to detect potential erroneous payments for post-payment audit activities. Immediately upon their identification, the OCC initiates collection activity to ensure recovery of funds. Also, the OCC is conducting a business process improvement review of the non-payroll process to bring about efficiencies and to determine the need for additional controls.

Based on the analyses, the OCC has concluded that erroneous payments do not exceed the Treasury threshold, which is both 2.5 percent of non-payroll payments and $10 million. The OCC is compliant with the Erroneous Payments and Recovery Act of 2001 and the IPIA.

Other Significant Financial Management Measures
The OCC continued to meet the Treasury-mandated monthly 3-day close requirement throughout FY 2006. Financial Management reconciled all accounts each month, completing 98.4 percent within 7 workdays, supporting the delivery of the monthly Financial Status Reports to management within 8 workdays. In addition, the OCC's delinquency rate for individually billed government travel cards continued to be less than 1 percent of the total balance outstanding.

VIII. Index

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