Audit Report

OIG-08-026

Audit of the Office of the Comptroller of the Currency's Fiscal Years 2007 and 2006 Financial Statements

January 9, 2008

Office of Inspector General

Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

January 9, 2008

MEMORANDUM FOR **JOHN C. DUGAN**
COMPTROLLER OF THE CURRENCY

FROM: Michael Fitzgerald /s/
Director, Financial Audits

SUBJECT: Audit of the Office of the Comptroller of the Currency's Fiscal Years 2007 and 2006 Financial Statements

I am pleased to transmit the attached audited Office of the Comptroller of the Currency (OCC) financial statements for fiscal years 2007 and 2006. Under a contract monitored by the Office of Inspector General, GKA, P.C. (GKA), an independent certified public accounting firm, performed an audit of the financial statements of OCC as of September 30, 2007 and 2006 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. 07-04, *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 Auditor's Report on Financial Statements;
- Independent Auditor's Report on Internal Control over Financial Reporting; and
- Independent Auditor's 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 significant deficiency 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 significant deficiency noted above.

GKA also issued a management letter dated October 31, 2007, discussing a certain matter involving internal control over financial reporting and its operation that was identified during the audit but was not required to be included in the auditor's reports. This letter will be transmitted separately.

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, 2007 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) 927-5789 or a member of your staff may contact Ade Bankole, Manager, Financial Audits at (202) 927-5329.

Attachment

Comptroller of the Currency
Administrator of National Banks

US Department of the Treasury

Office of the Comptroller of the Currency

ANNUAL REPORT

Fiscal Year 2007

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 John C. Dugan before the
Conference on Bank Structure and Competition,
Federal Reserve Bank of Chicago

Contents


COMPTROLLER OF THE CURRENCY
1863

I.

Comptroller's Viewpoint

This year's *Annual Report* reflects the reach – and the strength – of the national banking system and the Office of the Comptroller of the Currency. I am pleased to report that the system remains safe and sound, and fully able to support the needs of its consumer and business customers.

FY 2007 was a year of challenge and accomplishment. Typically, late in an economic cycle, credit problems begin to appear as lenders compete for a smaller base of creditworthy borrowers, and loans made earlier in the cycle begin to show signs of wear. With the United States now in the sixth year of an economic expansion, it is not surprising that such trends became increasingly apparent in 2007.

One of the most significant supervisory issues this year was the continued decline in underwriting standards. Weakened underwriting is often a leading indicator of credit problems, and we are monitoring banks closely for any evidence that relaxed standards are translating into an undue growth in problem loans.

Problem loans did increase in national banks in FY 2007, but they remained very low by historical standards, and supervisory performance ratings remained strong. That's no small achievement, considering the number and severity of economic troubles that emerged during the year. The mortgage market experienced significant difficulties, especially in the subprime area, resulting in increased delinquencies and foreclosures. While the national bank share of problem subprime loans was proportionally smaller than at other lenders, it was significant nevertheless.

The OCC took a number of steps in response. We joined the other federal banking agencies in urging lenders to work with troubled borrowers to modify troubled loans where appropriate, rather than resorting to foreclosure. We also bolstered underwriting and consumer disclosure standards for nontraditional and subprime mortgage products; monitored compliance with regulatory guidance; and supported efforts to obtain flexibility under accounting standards for lenders to restructure mortgages sold to third-party investors. I was especially concerned that we address the widespread acceptance of unverified income in providing subprime credit. So-called "stated-income loans" have allowed too many subprime borrowers to assume more debt than they could afford, and in a market with rising rates and falling home prices, many are now facing foreclosure. I am very pleased that the final subprime guidance we issued provides that stated income should be the exception, not the rule, in underwriting subprime loans.

Commercial real estate concentrations continued to receive our attention. Along with the other agencies, we issued guidance that called on our banks to adopt appropriate risk management policies. The guidance did not set limits on commercial real estate lending, but it did reemphasize that banks with higher CRE concentrations have higher levels of risk, and that they need to have risk management practices and capital commensurate with this increased level of risk. Despite industry apprehension, our implementation of this guidance went smoothly, despite the fact that we began to observe increased CRE losses in the residential sector by the end of the year. This trend in the credit cycle will likely continue in the next year, and commercial real estate lending will very much remain a supervisory focus for the agency.

While commercial real estate lending concentration was primarily an issue for smaller banks, our larger institutions were challenged by leveraged lending. Banks active in this market experienced market liquidity problems in the second half of the year. Skeptical of underwriting standards that had relaxed significantly, investors shrank from purchasing leveraged loans in the quantities they had previously. This unexpectedly forced banks to hold on their balance sheets large volumes of such loans or loan commitments. It also forced them to mark down the values of the loans to reflect the declines in price caused by the lack of market liquidity, resulting in substantial charges to earnings.

We also published guidance – and conducted training – to help banks understand the rules on the Allowance for Loan and Lease Losses (ALLL) – one of the most significant buffers against credit risk. Some national banks have experienced issues with their auditors when they have tried to increase reserves to prudent levels. We have not hesitated to intervene in such cases where we believed the auditor was substituting its judgment for the bank's management in determining reserve adequacy – and we will continue to do so where we believe that is appropriate.

The OCC continues to embrace the concept of risk-based supervision. We spend more time on areas of greater risk to a bank, and conversely, less time on lower risk activities. One promising development has emerged in the area of money laundering and Bank Secrecy Act compliance that has been a great concern to all of us. The OCC developed a Money Laundering Risk (MLR) analysis system that provides more than 1,650 community banks with a concrete tool to help measure anti-money laundering risk. One of our goals is to use the results of the MLR analysis to help focus our BSA compliance resources on the relatively small number of banks where risk is higher, with less intrusive examinations for the vast majority of institutions where risk is low.

Testifying before Congress.

New capital requirements resulting from the Basel II accord will, with respect to the very largest national banks, significantly improve both the alignment of capital with risk and risk management practices. I was very pleased that we were able to issue a final interagency rule, implementing these so-called "advanced approaches" of Basel II, just after the end of the fiscal year. We also plan to issue, at the beginning of 2008, a proposed risk-based capital rule to implement the so-called "standardized approach" as an option for all but the very largest banks. This option is also intended to better align regulatory capital with risk, but in a less costly and complex way than the advanced approaches, for smaller institutions that do not have the complex risk profile of our very largest banks.

As the supervisor of most of the nation's largest banks — including three that each hold over a trillion dollars in assets — the OCC has been heavily involved in international issues for years and has developed a number of approaches to examining banks' international activities.

Of course, risk-based capital is not the only issue at the OCC that has an international focus. Few industries have been more affected by globalization than banking. As the supervisor of most of the nation's largest banks – including three that each hold over a trillion dollars in assets – the OCC has been heavily involved in international issues for years and has developed a number of approaches to examining banks' international activities. For example, our large bank exam teams regularly evaluate international activities and risk exposure, using specialists in such areas as capital markets, credit, and anti-money laundering compliance. Indeed, our London office is fully staffed with such specialists, who are dedicated to evaluating key risks in national banks' European operations.

Reflecting our increased international focus, I agreed in September to serve as chairman of the Joint Forum, an organization that consists of banking, securities, and insurance regulators from many countries around the world. As the lines between these industries have continued to blur, cross-cutting regulatory issues have emerged with more frequency and salience. The Joint Forum provides a unique opportunity to study and address these issues with an exceptionally broad perspective. On behalf of the OCC, I am honored to serve in this new role.

In other international developments, I welcomed the opportunity to visit China last March to strengthen the OCC's longstanding relationship with China's banking supervisor, the China Banking Regulatory Commission, as well as to meet with bankers from our two countries. I observed first hand the remarkable progress that China has made in creating a modern financial system, and I sought to provide useful insight to our Chinese colleagues based on the OCC's considerable experience in supervising both complex and smaller banks.

One of our primary goals this year was not only to expand the store of information available to the consumer, but also to make it more accessible and user-friendly.

While many large national banks have increased their global operations, community banking is still at the heart of the OCC's mission. This year we expanded our outreach efforts to improve our communications with community bankers and directors, assess the effectiveness of our examination process, and identify areas where we can reduce regulatory burden. Our goal is to help community banks devote more of their time and resources to doing what they do best – serving their customers and their communities.

The increased retail orientation of national banks has created a significant shift in the nature of the banking business – and in the OCC's supervisory priorities. Consumer protection is a key element of our mission, and we devote considerable resources to examining national banks for compliance with

Examining a community bank.

consumer protection laws, promoting transparency and improved disclosure of customer information, and helping to resolve consumer complaints.

One of our primary goals this year was not only to expand the store of information available to the consumer, but also to make it more accessible and user-friendly. To that end, we launched a Web site, called HelpWithMyBank.gov, that provides a single reference point for the questions and answers we hear most frequently from consumers about the issues that concern them. It also provides a contact point to file a formal complaint with the OCC's Customer Assistance Group.

Because of the jurisdictional complexities of the U.S. banking system, consumers don't always know which agency supervises their bank, and often complain or pose questions to the wrong supervisor. This customer confusion has cropped up frequently between the OCC and state banking supervisors, and as a result, during this past year the OCC and the Conference of State Bank Supervisors jointly developed a mechanism for expediting the exchange of consumer complaint information between our agency and state banking departments. At the end of fiscal 2007, we had signed agreements with 28 states, which we think will significantly reduce response times for consumers. I am pleased with this progress, but I think we can do more along these lines to make it easier for consumers to get

With the Tuskegee Airmen, Congressman Charles Rangel and OCC Ombudsman Sam Golden.

answers from banking regulators. For that reason, the OCC has asked the Federal Financial Institutions Examination Council, consisting of all the federal banking regulators and representative state banking agencies, to consider additional proposals that would coordinate agency efforts for consumers in other areas, for example, by using a single Web site or call center to route questions and complaints to the appropriate agency.

Meeting with bankers.

Regarding the national bank charter, the Supreme Court issued a seminal decision last year confirming that the banking activities of national banks and their operating subsidiaries are subject to uniform laws established by Congress, not the states. In *Watters* v. *Wachovia,* the court reaffirmed the separate roles of the states and the OCC in regulating the banks that each charters. It also reaffirmed the principle, established earlier by the court in its *Barnett Bank* decision, that states may not significantly burden, curtail, or hinder a national bank's exercise of its powers under the National Bank Act. The *Watters* decision, which ratified the OCC's longstanding position that operating subsidiaries of national banks should not be treated differently from the banks themselves, helped clarify that it is the OCC's responsibility to regulate a national bank's interaction with consumers – a responsibility we take very seriously.

The OCC must be a strong organization if it is to continue to safeguard the interests of a safe and sound national banking system. We continue to invest heavily in technology, training, and development of our people – the OCC's most important resource. But, like all agencies of the federal government – and, indeed, like much of the private sector – the OCC faces demographic challenges that require us to look to the needs of the future. We are continuing to attract large classes of talented college graduates, as well as mid-career industry professionals with specific skills, and we took several important steps this year to improve recruitment, retention, and leadership development. Prominent among them was LeaderTRACK, a management succession development program for senior examiners.

Independent surveys continue to recognize the OCC as an outstanding place to work. In fiscal 2006, *BusinessWeek* included the agency on its list of the 50 best places in the private or public sector to start a career, and last year, the Partnership for Public Service ranked the OCC 4th out of 222 peer agencies in its rankings of best places to work in the federal government. None of this surprises me. As a veteran of just two years at the agency – really just a rookie by OCC standards – I can firmly attest to the exceptionally strong sense of purpose, professionalism, and culture that pervades this organization. What we do and how we do it is a source of great pride to the OCC employees I talk to all around the nation – and it certainly is to me as well. That bodes very well indeed for the future of our agency, and even more important, for the effective regulation of national banks, the financial engines of our economy.

II.

The Comptroller and the Executive Committee

John C. Dugan

29th Comptroller of the Currency

Director of the Federal Deposit Insurance Corporation, Federal Financial Institutions Examination Council, and Neighborhood Reinvestment Corporation. Chairman, Joint Forum. Former Partner, Covington & Burling law firm. Former Assistant Secretary for Domestic Finance, U.S. Department of the Treasury. Former Counsel and Minority General Counsel, U.S. Senate Committee on Banking, Housing, and Urban Affairs.

The Executive Committee

(Front row, left to right) *Senior Deputy Comptroller Douglas W. Roeder, Large Bank Supervision; Chief of Staff and Public Affairs John G. Walsh; Comptroller of the Currency John C. Dugan; Chief Information Officer Jackie Fletcher; Senior Deputy Comptroller Timothy W. Long, Mid-size/Community Bank Supervision.*

(Back row, left to right) *Ombudsman Samuel P. Golden; Senior Deputy Comptroller Mark Levonian, International and Economic Affairs; First Senior Deputy Comptroller and Chief Counsel Julie L. Williams; Senior Deputy Comptroller and Chief Financial Officer Thomas R. Bloom, Office of Management; Senior Deputy Comptroller and Chief National Bank Examiner Emory Wayne Rushton.*

III.

History of the Office of the Comptroller of the Currency

In February 1863, President Lincoln signed the National Currency Act into law, creating a national banking system and "a separate bureau in the Treasury Department," headed by the Comptroller of the Currency, to administer it.

The law was designed to address the country's longstanding need for a uniform national currency and a nationwide system of banks operating under uniform rules, uniform supervision and regulation, and uniformly high standards.

In February 1863, President Lincoln signed the National Currency Act into law, creating a national banking system and "a separate bureau in the Treasury Department," headed by the Comptroller of the Currency, to administer it.

For most of the pre-1863 period, thousands of different bank note varieties were in circulation—some good as gold, some not worth the paper they were printed on. This diverse and irregular paper was a source of inflation and uncertainty, and a barrier to trade and economic growth.

Under the National Currency Act (revised in June 1864 as the National Bank Act), organizers were required to raise substantial capital (previously, many banks had little or no capital) and to invest a portion of that capital in U.S. government bonds, sales of which were lagging at the time. The bonds would be deposited with the Comptroller, who would deliver a proportionate quantity of bank notes of uniform design imprinted with the bank's name. The bonds served as security for the notes; if a national bank was unable to meet its obligations, the bonds were liquidated and the note holders repaid. This ingenious system served the country for many years until national currency was phased out in favor of Federal Reserve notes.

The first Comptroller of the Currency was Hugh McCulloch, a respected Indiana banker. McCulloch staffed the office, developed policies and procedures, promulgated standards of professional conduct for bankers and bank examiners, and worked to refine the legal framework under which national banks still operate today.

Charter number one was issued to the First National Bank of Philadelphia. The First National Bank of Davenport, charter number fifteen, was first to open for business, on June 29, 1863. By 1870, more than 1,600 institutions, including hundreds of former state-chartered banks, had joined the national system, holding well over 50 percent of the country's total bank assets.

The National Bank Act provided extensive enumerated powers and such "incidental powers as shall be necessary to carry on the business of banking." The law required the Comptroller to report directly to Congress on needed improvements in the law, and modifications undertaken over the years have provided national banks with the flexibility to meet changing conditions in the financial marketplace.

The National Currency Act and subsequent laws endowed the Comptroller's Office with considerable operational independence. The Comptroller is appointed by the President to a five-year term. Throughout its history, OCC has been funded by assessments paid by the banks it supervises.


BANK

IV.

Profile

The National Banking System*

National Banks:[1]	1,677
Percentage of Total Number of Commercial Banks:	23
Uninsured National Trust Companies:	78
Federal Branches of Foreign Banks:	49
Assets of National Banks (excluding federal branches):	$7.062 trillion
Percentage of Total U.S. Commercial Banking Assets:	68
Total Insured Deposits:	$4.397 trillion
Employees of National Banks:	1,232,243
Total Investments by National Banks under 12 CFR 24, Community Reinvestment Act:	$4.82 billion

* Based on June 30, 2007, call report data.

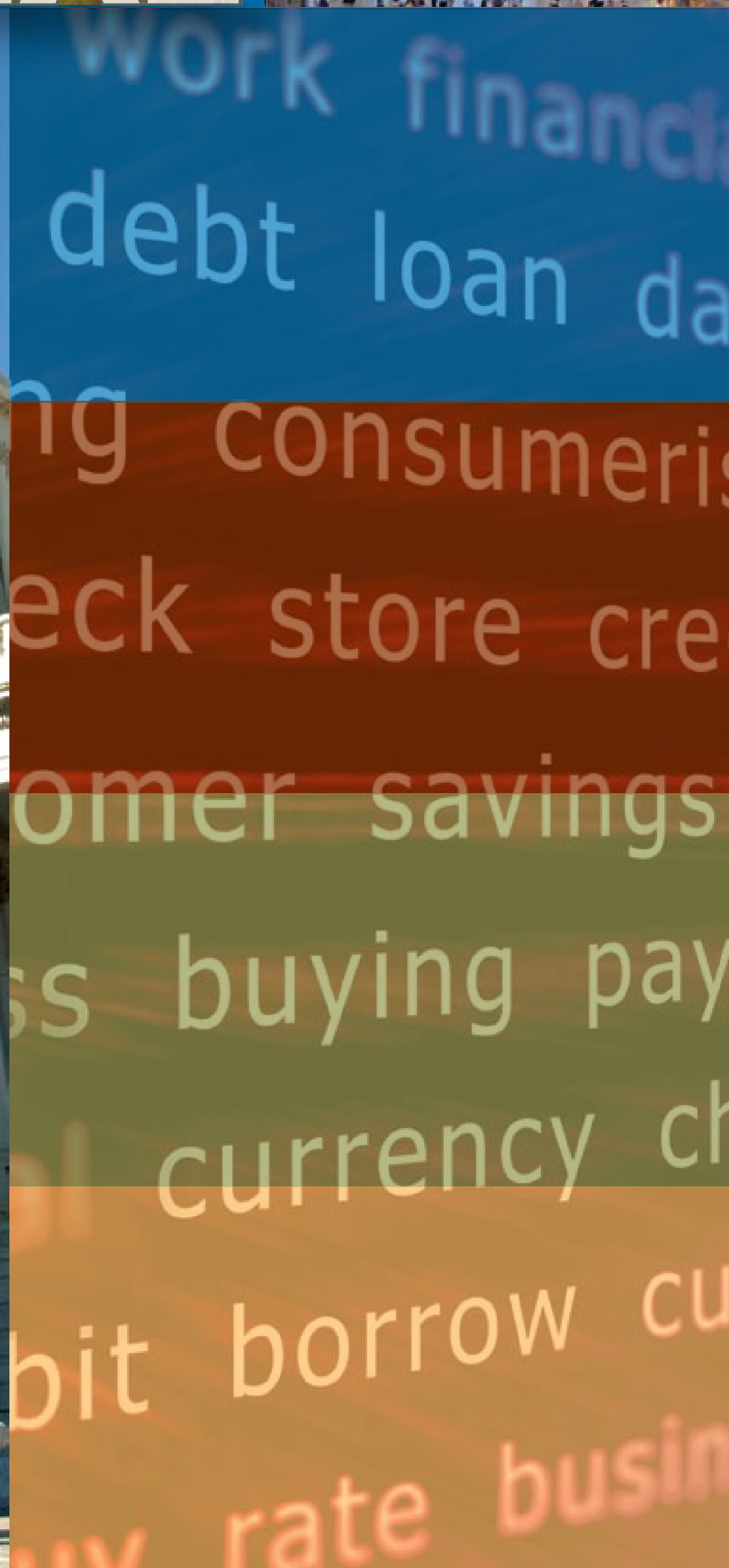
The Office of the Comptroller of the Currency

Total Employees:	3,066
National Bank Examiners:	2,061
Safety and Soundness Examinations Conducted:	1,287
Specialty Examinations Conducted:	897
Consumer Assistance Personnel:	35
Consumer Complaints Processed:	26,967
Total Budget Authority:	$671.2 million
Total Revenue:	$695.4 million
Percentage of Revenue Derived from Assessments:	95.8

[1] National banks are examined every 12 to 18 months, depending on their complexity and risk profile.

NATIONAL

BANK



work financ
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V.

National: Ensuring the Safety and Soundness of the National Banking System

Bank supervision is the OCC's core mission. Our goal is to determine whether a national bank is operating in a safe and sound manner and whether national banks comply with applicable laws and regulations—laws that, among other things, protect consumers, support fair lending, prevent money laundering, protect critical bank and customer information, and promote community reinvestment.

Each national bank's supervisory strategy is customized to its condition and circumstances, and is continually modified as appropriate. When a bank's risk profile or condition changes, the supervisory strategy for that institution changes with it. For example, examiners may decide some banks need more frequent reviews, or they may target specific bank activities that warrant supervisory attention.

The OCC's approach to bank supervision evolved over nearly a century and a half. Soon after the agency was created, its leaders realized that proper supervision required examiners to do more than simply inspect the bank's ledgers. In the 1880s, Comptroller Henry W. Cannon admonished examiners to evaluate the overall competence and prudence of a bank's management, as well as its asset quality. Since that time, the OCC has built on this foundation, focusing not only on how individual loans are underwritten and administered, but also on how bankers assess and manage risks across the institution.

In FY 2007, the OCC continued to implement and strengthen its risk-based approach to bank supervision. Our supervision emphasizes the need for strong risk controls, clearly defined objectives, and a well-developed business strategy. We work to promote effective management and strong corporate governance, ensuring that bankers and directors understand the critical role that each of them plays, and that they have the skills and the tools they need to effectively carry out those roles. The board and management must also ensure that the bank maintains adequate reserves and capital levels to cover both expected and unexpected losses.

In the "national" section of this report, we look at the issues that shaped the OCC's supervisory strategies in FY 2007 and the steps that were taken by the agency to strengthen the national banking system's legal and regulatory framework.

Fostering Better Management of Credit Risk

Reaffirming Credit Quality

National banks face many different forms of risks. None poses greater potential for financial loss than credit risk—the possibility that a loan or investment will not be fully repaid.

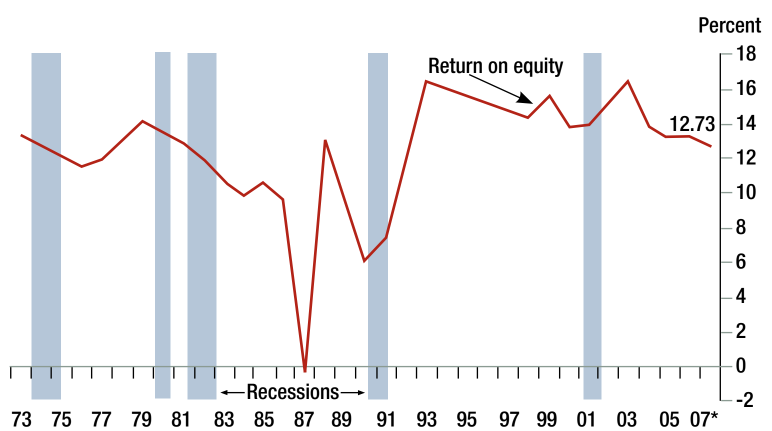
FY 2007 was a year of rising, but still moderate, credit risk. The percentage of loans that were noncurrent rose, and provisions for loan and lease losses increased nearly 90 percent over the 12 months ending June 30, 2007. As a result, national bank earnings were not as strong in the first half of this year as they were last year. Annualized year-to-date return on equity at national banks (as of the second quarter of calendar year 2007) was 12.73 percent—nearly 1 percent lower than it was for 2006. (See chart 1.)

This rise in credit risk was not unexpected. The U.S. economy has been expanding for six years, and it is typical for loans booked early in an economic cycle to show increasing signs of weakness as the expansion matures. Also, loan underwriting standards customarily slip in the later stages of an expansion as lenders compete for a shrinking pool of the most creditworthy borrowers and begin to dip deeper into the risk pool for customers. In recent years, a highly liquid secondary loan market intensified that competition, as did the growth in the number of nonbank lenders, such as mortgage brokers, who packaged and sold loan products to third-party investors. All these factors helped increase credit risk and put pressure on bank earnings.

The dip in earnings must be viewed against the long-term profitability of national banks. National bank earnings have been strong for the past 15 years, and these strong earnings have contributed to healthy capital ratios. In a statement before the House Committee on Financial Services on September 5, 2007, Comptroller Dugan underscored the system's strength, noting that "national banks remain active in major markets and continue to extend credit to corporate and retail customers, including mortgage credit." He pointed out that "the worst problems we have seen in the markets—insufficient liquidity resulting in substantial declines in capital and sometimes in failure—have occurred *outside* the commercial banking system."

By historical standards, the loan portfolios of national banks showed low levels of losses and problem assets. Supervisory performance ratings of national banks remained strong (see table 1). This is partly because national banks were proportionally less involved in the increasingly troubled market for subprime mortgages. Still, these troubles offered an object lesson in the importance of sound underwriting. Even before these problems began to emerge, the OCC was reemphasizing the need for national banks to verify the mortgage borrower's capacity to repay and to set aside prudent provisions for losses.

Chart 1: National bank profitability dipped in 2007Q2



Source: Integrated Banking Information System (OCC)

* 2007 data as of June 30, 2007. All other data as of year-end. Shaded areas represent periods of recession.

Commercial real estate portfolios were another focus of credit risk concerns in FY 2007. Growing concentration levels in these portfolios, particularly at mid-size and community banks, raised concerns. The banking supervisory community responded by publishing guidance providing that banks with commercial real estate concentrations should maintain robust risk management systems and should preserve prudent underwriting standards in the face of competitive pressures.

Surveys of Credit Risk

The OCC conducts regular surveys to identify and monitor systemic trends in credit risk and emerging credit risk. In FY 2007, as in previous years, the OCC produced its annual Survey of Credit Underwriting Practices, participated in the interagency Shared National Credit Review, and conducted a series of horizontal reviews of large banks.

Survey of Credit Underwriting Practices

This survey identifies trends in lending standards and credit risk for the most common types of commercial and retail credit products offered by national banks. It assesses how factors such as competition are affecting the pricing and underwriting of loans and whether OCC examiners believe that the inherent credit risk in banks' portfolios is increasing or decreasing.

The 2007 survey, released in October 2007, covered the 12-month period ending March 31, 2007, and included results from the 78 largest national banks, representing more than 85 percent of all outstanding loans in the national banking system.

The survey found that retail and commercial credit underwriting standards eased for a fourth consecutive year, primarily from competitive pressures. The easing that occurred in retail banking was most notable in home equity lending (conventional and

Table 1: Supervisory performance measures, FY 2007

Performance Measures	Target	Actual (9/30/07)[1]
Percentage of national banks that are categorized as well capitalized[2]	95%	*99%*
Percentage of national banks with composite CAMELS rating of 1 or 2[3]	94%	*97%*
Rehabilitated problem national banks as a percentage of the problem national banks one year ago (CAMELS 3, 4, or 5)[4]	40%	*52%*
Percentage of national banks with consumer compliance rating of 1 or 2[5]	94%	*97%*

high loan-to-value loans) and residential real estate lending. Although commercial underwriting standards eased in general, the amount of easing in commercial real estate underwriting declined slightly.

Not all sizes of national banks eased underwriting standards. While large banks continued to do so, especially for leveraged and large corporate products, and mid-size banks eased modestly, the community banks that were included in the survey tightened underwriting standards.

Shared National Credit Review

The Shared National Credit (SNC) review is a joint program of the OCC, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). Published annually (this year on September 25, 2007), the review evaluates the classification of large syndicated loans held by multiple banks. The 2007 review covered approximately 7,700 loans (or 5,265 borrowers) with commitments totaling $2.3 trillion. SNC commitments increased by nearly $401 billion, or 21.4 percent. Although FY 2007's review showed an increase in the volume of criticized commitments, they remained at less than half of their peak dollar level in 2002. Criticized credits were 5 percent of total commitments, about the same rate as in the past three SNC reviews.

This year's review also examined the quality of underwriting of a representative sample of shared credit. This review disclosed a significant increase in underwriting weaknesses, especially in the syndicated leveraged loan market and particularly in non-investment grade or leveraged credit facilities.

Horizontal Reviews of Large Banks

The OCC's Large Bank Supervision Department conducted three horizontal reviews to determine how well large banks are complying with interagency guidance that addressed credit risk. A horizontal review is an examination across a portfolio of banks with similar characteristics. Horizontal reviews offer many benefits, notably the opportunity to exchange best practices and to ensure consistent expectations and supervisory practices across all

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[1] Numbers in italics are estimates.

[2] The Federal Deposit Insurance Act established a system of prompt corrective action that 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.

[3] The composite CAMELS rating reflects the overall condition of a bank. It is based on the Uniform Financial Institutions Rating System. Evaluations are made on Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. Ratings are on a scale of 1 through 5, 1 being best.

[4] The OCC's early intervention can lead to successful remediation of problem banks. More than half of the problem banks on 9/30/2006 were rehabilitated within a year after following the OCC's recommendations for corrective action.

[5] Each bank is assigned a consumer compliance rating based on an evaluation of its present compliance with consumer protection and civil rights statutes and regulations, and the adequacy of its operating systems designed to ensure continuing compliance. Ratings are on a scale of 1 through 5, 1 being the best.

the banks. Typically conducted by experts in the area of focus, horizontal reviews provide an independent assessment. These reviews not only provide the OCC with information on systemic risks, but also afford a quick assessment of how banks are complying with laws, regulations, and other regulatory guidance. They also allow the OCC to focus on higher risk banks and to adjust supervisory strategies and staffing.

In FY 2007, horizontal reviews focused on the guidance on nontraditional mortgages (OCC Bulletin 2006-41, "Nontraditional Mortgage Products: Guidance on Nontraditional Mortgage Product Risks"); the guidance on managing credit risk in home equity lending (OCC Bulletin 2005-22, "Home Equity Lending: Credit Risk Management Guidance"); and the guidance on managing credit card accounts (OCC Bulletin 2003-1, "Credit Card Lending: Account Management and Loss Allowance Guidance").

Helping To Stabilize Mortgage Markets

The OCC has long discouraged abusive and irresponsible lending practices in the national banking system. That's one reason why national banks were relatively less involved in the subprime mortgage market, and why OCC-supervised institutions were not as significantly affected by the setbacks many subprime lenders experienced during FY 2007. Only 10 percent of new subprime loans in 2006 were originated by national banks, and the rate of default among national bank subprime borrowers was significantly lower than that of subprime borrowers generally.

Nevertheless, the OCC has been active in regulatory efforts to address issues in the mortgage markets and to assist troubled subprime borrowers. These latter efforts are discussed in detail in part VIII of this report, "Consumers: Promoting Fairness and Transparency." Throughout 2007, the OCC and the other federal banking regulatory agencies also issued guidance to lenders to encourage arrangements with at-risk borrowers that would enable them to remain in their homes whenever possible.

OCC efforts included:

- Working with individual borrowers seeking information or assistance through the OCC's Customer Assistance Group (CAG).
- Issuing interagency guidelines to lenders regarding underwriting and consumer disclosure practices for nontraditional and subprime mortgage products.
- Monitoring compliance with regulatory guidance and potential adverse affects on bank earnings, liquidity, and capital markets activities.
- Working with community groups and bankers to identify and promote foreclosure prevention strategies.
- Working with the Financial Accounting Standards Board and the Securities and Exchange Commission to clarify how financial institutions and mortgage conduits can modify loan terms of borrowers unable to meet the terms of their original mortgage obligations.
- Working with two nonprofit organizations, NeighborWorks America and the Ad Council, on a series of public service announcements encouraging delinquent mortgage borrowers to get help from their lenders or a trusted housing counselor.

Addressing Concentrations in Commercial Real Estate Lending

Examiners increased their attention on credit risk arising from concentrations in commercial real estate loans in 2007. The emphasis followed the publication in December 2006 of final interagency guidance, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices." The guidance, which was a response to the increasing numbers of small- and medium-sized banks enlarging their portfolios of commercial real estate loans, was especially timely in light of the turmoil in the real estate-related markets in 2007.

The guidance was intended to make sure that banks enhance their risk management systems to accommodate concentrations of such loans, especially if the primary source of repayment for many of the loans is cash flow from real estate collateral. Although the federal banking agencies support the effort to supply credit for business and real estate development, they grew increasingly concerned about the potential effects of such concentrations on earnings and capital if commercial real estate markets were to weaken.

The guidance provided supervisory criteria, including numerical indicators, to help identify commercial real estate loan concentrations that warrant enhanced risk management. The OCC and its examiners emphasized that the criteria do not constitute limits or caps on a bank's ability to make commercial real estate loans.

Hedge funds are private pools of capital that often combine aggressive investment strategies with the use of innovative financial instruments.

Updating the Allowance for Loan and Lease Losses

The federal banking regulatory agencies and National Credit Union Administration (NCUA) published a comprehensive "Interagency Policy Statement on the Allowance for Loan and Lease Losses" (ALLL) in December 2006. This updated guidance came just as many banks were preparing to increase their loss provisions in the first half of 2007.

A valuation reserve charged to a bank's operating income, ALLL is one of the most significant buffers against credit risk. ALLL is the sum of two estimates: 1) estimated credit losses on individually evaluated loans determined to be impaired, and 2) estimated credit losses on the remainder of the loan and lease portfolio. Although maintaining adequate reserves is always important to safety and soundness, it takes on special significance as the credit cycle matures.

Before the latest update, the last comprehensive interagency statement on ALLL had been published in 1993. Much about ALLL policy has changed since then: the banking agencies published significant updates in 1999, 2001, and 2004. The December 2006 statement incorporates those changes.

The statement describes the ALLL-related responsibilities of boards of directors, management, and examiners (including the factors that must be considered when estimating the ALLL), and the objectives and elements of an effective loan review system, including a sound credit-grading system. The agencies issued a series of frequently-asked questions to help institutions apply the guidance (see OCC Bulletin 2006-47, "Allowance for Loan and Lease Losses: Guidance and Frequently Asked Questions on the ALLL").

To ensure that OCC examiners fully understand the guidance, the OCC conducted ALLL training at each of its field offices in FY 2007. The OCC gave ALLL training to large bank examiners throughout the nation in the fall of 2007.

Promoting Better Risk Management of Innovative Markets and Products

Many national banks are leaders in developing new products and services to better serve their customers and compete effectively in today's global economy. But innovation brings risks as well as opportunities, and the OCC expects national banks to have people and systems in place to manage any increased risk they have assumed.

In FY 2007, OCC executives and examiners paid particular attention to large national banks that do business with hedge funds, engage in complex structured finance transactions, and deal in derivatives. They worked to ensure that the banks' risk management systems were capable of controlling the risks of these complex activities.

Doing Business with Hedge Funds

Hedge funds are private pools of capital that often combine aggressive investment strategies with the use of innovative financial instruments. Some large banks provide credit to hedge funds as counterparties in over-the-counter derivatives transactions and by financing transactions such as repurchase agreements.

Doing business with hedge funds presents attractive revenue opportunities for banks, but it also poses heightened credit and price risk. As a result, hedge fund relationships generally are appropriate for only the largest and most sophisticated banks. In February 2007, Comptroller Dugan participated in the President's Working Group on Financial Markets (PWG), which called on highly sophisticated lenders, investors, and counterparties to impose "market discipline" on hedge funds. The group offered guidelines for doing so embodied in the "Agreement among PWG and U.S. Agency Principals on Principles and Guidelines regarding Private Pools of Capital," and OCC examiners expect large national banks to follow those guidelines in 2007 and beyond. Accordingly, banks doing business with hedge funds should carry out appropriate due diligence before entering into a credit relationship with a hedge fund and should establish information flows that enable them to monitor credit exposures effectively.

Dealing in derivatives—instruments whose value is tied to that of underlying securities or other assets—is big business in the banking industry, and the OCC supervises the five largest bank derivatives dealers in the United States.

Comptroller Dugan explained why the PWG chose guidelines over regulation: "When deciding between requirements and guidelines, governments must determine which will have a more positive long-term effect on the markets. The PWG chose guidelines rather than a prescriptive regulatory approach to avoid discouraging financial innovation. But the success of that approach depends on hedge fund investors and creditors exercising appropriate due diligence."

For more on the PWG, see the sidebar "Dugan Sees Growing Role for the President's Working Group on Financial Markets."

Complex Financial Products

Large national banks use and offer an expanding array of complex financial products. The OCC's resident examination staffs at these banks closely monitor the use of these products to ensure that banks have adequate risk management policies and controls in place to govern them.

Certain complex structured finance transactions (CSFTs), such as those that appear designed to achieve questionable tax objectives, pose heightened reputation and legal risk. In January 2007, the federal banking agencies and the Securities and Exchange Commission (SEC) issued the "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Transactions." This final statement describes the types of internal controls and risk management procedures that are needed for financial institutions to identify, manage, and address the heightened risks that may arise from certain CSFTs. OCC examiners require banks engaging in CSFTs to ensure that their risk management systems can identify the elevated risk of CSFTs during new product approval and transaction approval processes and that the banks implement appropriate risk controls.

OCC examiners often work with staff in the OCC's Credit and Market Risk Division and the OCC Law Department's Securities and Corporate Practices Division to determine whether the products or activities in question raise supervisory or legal issues that must be addressed. Before banks use novel derivatives products, for example, the OCC is often required to write legal opinions on their use. (See "Legal Opinions" under "Legal and Regulatory Framework" for more on the legal and regulatory opinions that the OCC issued during the past year.)

Additionally, examiners review a bank's control processes for new derivative products to assess whether the bank can conduct the activity in a safe and sound manner. A bank cannot begin to engage in a novel derivatives activity until the examiner-in-charge (EIC) determines that the bank has a satisfactory risk management and control framework for the product's risks.

Dealing in Derivatives

Dealing in derivatives—instruments whose value is tied to that of underlying securities or other assets—is big business in the banking industry, and the OCC supervises the five largest bank derivatives dealers in the United States. As Comptroller Dugan pointed out in a November 2006 speech to the New York Bankers Association, "such a large and concentrated credit exposure has the potential to affect both markets and systemic stability."

In FY 2007, OCC examiners evaluated the adequacy of the systems used by these bank dealers to monitor and control the collateral with which they mitigate their risk exposures in these transactions. Examiners also worked to determine whether dealer banks were performing adequate stress testing and scenario analysis to measure derivatives' credit and price risk. (Price risk is the possibility that a dealer bank will incur trading losses, especially in market downturns.) Stress testing and scenario analysis allow banks to simulate adverse financial events, helping them to identify potential contagion or "spillover" effects and loss exposures.

To help keep the industry and examiners abreast of derivatives activity, the OCC compiles and issues the *Quarterly Report on Bank Derivatives Activities*, which tracks the volume and trends of derivatives and trading activities within the U.S. commercial banking system.

In FY 2007, the OCC worked with other U.S. and international regulators and major dealers to improve the trade and settlement processing systems that support the global derivatives market. The objective of these efforts is to reduce the level of unconfirmed transactions and make manual processing systems increasingly electronic, decreasing the time it takes to confirm and settle derivatives trans-

Dugan Sees Growing Role for President's Working Group on Financial Markets

A stable financial sector is essential to a well-functioning U.S. economy. Ensuring that public policies are conducive to that stability is the job of the President's Working Group on Financial Markets (PWG), in which the OCC participates.

In February 2007, the PWG released a set of principles and guidelines to guide U.S. financial regulators as they address public policy issues associated with the rapid growth of private pools of capital, including hedge funds. The agreement among the PWG and U.S. agency principals, which concentrates on how to provide investor protection and control systemic risks, serves as a framework for evaluating other market developments.

Chaired by the Secretary of the Treasury, the PWG includes the chairs of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. The PWG has been prominent in addressing a number of high-profile problems facing the financial markets, such as the near collapse of Long-Term Capital Management, a highly leveraged hedge fund, in 1999. That potential collapse posed considerable risk to market stability.

Comptroller Dugan sees an even larger role for the PWG as markets become more global and sophisticated: "When it comes to controlling systemic risks to the U.S. economy and responding to market uncertainty, it's important for the federal government to develop a concerted strategy quickly and to respond with a consistent message," said the Comptroller. "That's what makes the Working Group an essential part of the nation's financial supervisory system."

actions. The result will be more reliable operations systems as derivatives markets continue to grow.

Finalizing New Capital Rules

Capital—the amount by which assets exceed liabilities—is a broad measure of a bank's ability to withstand financial difficulty. Modern risk management systems calculate capital adequacy by weighting bank assets according to their risk.

The OCC, Federal Reserve Board, the FDIC, and OTS worked to finalize the regulatory aspects of risk-based capital in FY 2007. The final rule would implement within the United States the Basel Committee on Banking Supervision's revised capital accord known as Basel II.

The Basel II framework is designed to incorporate information from the advanced risk management and measurement systems used by large banks. In September 2006, the agencies issued for comment a notice of proposed rulemaking to implement Basel II and published revisions to their rules on market risk capital. In February 2007, the agencies sought comment on proposed supervisory guidance for Basel II (OCC Bulletin 2007-10, "Supervisory Guidance Related to Basel II Implementation: Proposed Supervisory Guidance").

When the Basel II proposal was issued, the agencies contemplated that the largest, internationally active U.S. banks ("core banks") would be required to use the Basel II rule. Certain other banks ("opt-in banks") could use the Basel II rule with the permission of their primary federal supervisor. Banks that were neither core banks nor opt-in banks would be subject to an alternative rule. In December 2006, the agencies sought comment on this alternative proposal (see OCC Bulletin 2006-50, "Risk-Based Capital: Domestic Capital Modifications: Notice of Proposed Rulemaking"). The proposal came to be known as Basel 1A.

In July 2007, Comptroller Dugan and the principals of the other three federal banking agencies announced their agreement on how Basel II would be finalized. The agreement included a plan to propose a new standardized approach to replace the proposal known as Basel 1A. Although a standardized approach was part of the original Basel II framework, such an approach had not previously been proposed for U.S. banks. Work to finalize the Basel II rule and to issue this new standardized proposal concluded just after the end of the fiscal year.

Providing Regulatory Relief to National Banks

Regulations are intended to enhance safety and soundness. Yet regulations that impose an excessive compliance burden have the potential to undermine, rather than enhance, the system's viability. That's why the OCC conducts regular reviews of its regulations and continually searches for ways to achieve its regulatory objectives at reduced cost to the institutions it supervises.

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) requires the federal agencies that are members of the Federal Financial Institutions Examination Council (FFIEC) to review their rules every 10 years, to revise rules that are outdated, and to eliminate ones that are unnecessary. The EGRPRA further requires the agencies to submit a report on the review's findings to Congress. Accordingly, in FY 2007, the OCC reviewed its regulations and issued the following proposed and final regulations:

- *18-Month Examination Cycle* (12 CFR 4; 72 *Federal Register* 17798; April 10, 2007). On September 21, 2007, the OCC finalized an interim rule raising the $250 million ceiling for 18-month examinations to $500 million for qualified, well-managed banks. (The general prescript calls for national banks to receive a full-scope, on-site examination at least once during every 12-month period.) The rule, which was finalized by the Federal Reserve Board, the FDIC, and OTS as well, implements section 605 of the Financial Services Regulatory Relief Act of 2006 and related legislation.
- *Regulatory Review Amendments* (74 *Federal Register* 36550; July 3, 2007). The OCC published a proposed rule that would revise several OCC rules to reduce unnecessary regulatory burden, update certain rules, and make certain technical, clarifying, and conforming changes to OCC regulations. This review of OCC regulations, and the resulting notice of proposed rulemaking, is consistent with EGRPRA. The

comment period for this proposed rule closed on September 4, 2007.

- *Lending Limits Pilot Program* (12 CFR 32; 72 *Federal Register* 31441; June 7, 2007). The OCC issued an interim final rule that makes permanent a lending limits pilot program. That program permits a national bank to use a higher lending limit for one- to four-family residential real estate loans, small business loans, and small farm loans if the state where the bank is located allows its state-chartered banks to use a higher lending limit for those types of loans.

The OCC is committed to preventing criminals and terrorists from misusing the financial system and to supporting law enforcement efforts to detect and prosecute criminal activities.

Helping in the Fight against Terrorism and Money Laundering

The OCC is committed to preventing criminals and terrorists from misusing the financial system and to supporting law enforcement efforts to detect and prosecute criminal activities. This work is often carried out in partnership with other federal financial institutions regulatory agencies and the Financial Crimes Enforcement Network (FinCEN).

OCC examiners evaluate each national bank's compliance with Bank Secrecy Act/Anti-Money Laundering (BSA/AML) requirements; when they observe weaknesses, they seek corrective action from the bank. The OCC investigates national banks that fail to meet BSA/AML requirements and takes enforcement actions against them. Such enforcement actions in FY 2007 included:

- A cease and desist order by consent, and a $10 million civil money penalty (CMP) assessed concurrently with a FinCEN CMP assessment, against a bank for violations of the Bank Secrecy Act and its implementing regulation. The enforcement actions were part of coordinated actions with the U.S. Department of Justice, which entered into a Deferred Prosecution Agreement with the bank, and an accompanying $21,600,000 forfeiture in connection with charges that the bank failed to maintain an effective anti-money laundering program. The OCC determined that the bank failed to monitor adequately certain Mexican casa de cambio accounts, to identify suspicious activity and file suspicious activity reports in a timely manner, and to comply with requirements that it improve its processes for identifying and reporting suspicious transactions. The bank's violations resulted in the movement of millions of dollars of suspected proceeds of drug sales through the foreign accounts without detection.

- A cease and desist order by consent and a $500,000 CMP against a federal branch of a foreign bank for failure to meet BSA/AML requirements, including failure to identify suspicious activities and file suspicious activity reports.

- A $250,000 CMP by consent against a bank for failing to meet BSA/AML requirements and for engaging in unsafe or unsound practices in the bank's capital markets division. In addition, the OCC issued cease and desist orders by consent and assessed civil money penalties against three officers.

- A cease and desist order by consent against a bank and civil money penalties against three former bank officers for allegedly causing or permitting violations of law, including failure to meet BSA/AML requirements.

Other BSA/AML activities included:

- Chairing the FFIEC BSA/AML Working Group that coordinates interagency BSA/AML issues.

- Participating in the update of the FFIEC's 2007 *BSA/AML Examination Manual*.

- Issuing the "Interagency Statement on Enforcement of BSA/AML Requirements." The policy promotes consistency among the FFIEC agencies, as well as transparency when taking enforcement decisions.

- Conducting the OCC's 2007 money laundering risk analysis. The analysis provides more than 1,650 community banks with succinct BSA/

AML risk assessment information. This information also enhances the effectiveness of the OCC's BSA/AML supervision.

- Ensuring a high level of technical expertise for OCC examiners through OCC BSA/AML training (classroom and knowledge-sharing calls), FFIEC BSA/AML training, and external training classes and conferences.

- Participating in more than a dozen national and regional industry conferences, including conferences sponsored by the American Banker's Association/American Bar Association (on anti-money laundering enforcement), Florida International Banker's Association, Florida Banker's Association, Banker's Outreach at Kansas State University, and the National Automated Clearing House Association.

- Participating in the U.S. Treasury Department's Private Sector Dialogue outreach program, including the United States–Latin America program in Bogotá, Colombia and the United States–Middle East North Africa (MENA) program in New York City.

- Participating in the Bank Secrecy Act Advisory Group (BSAAG), whose purpose is to develop and implement appropriate policies and procedures for the financial services industry. FinCEN chairs the group on behalf of the Secretary of the Treasury. Made up of regulators, law enforcement officials, and representatives from industries subject to BSA rules, the BSAAG meets semi-annually. Through representative subcommittees, the BSAAG is able to provide regular and meaningful discussion of many aspects of the BSA.

Protecting National Banks against Mismanagement

One of the key responsibilities of national bank examiners is to appraise management's and directors' supervision of a bank and to evaluate the quality of their decision-making processes. Those processes include planning, policymaking, personnel administration, control systems, and management information systems. Although the formality and complexity of these processes differ, all banks must have management capability appropriate to their organizational structure and operational diversity. It is the examiner's job to determine the adequacy of each bank's management processes, to identify problems before they seriously affect the bank's condition, and to ensure that corrective measures are taken.

When directing management and directors to take these measures, examiners generally use the supervisory process to obtain the requisite responses. They issue reports, attend board meetings, participate in on-site activities, obtain commitment letters, and sign memorandums of understanding. However, when problems are serious and well-documented, formal administrative action may be warranted to address violations of laws, rules, and regulations; unsafe or unsound banking practices and breaches of fiduciary duty; and noncompliance with OCC directives or orders by national banks, their insiders, and other affiliated parties.

In combating mismanagement during FY 2007, the OCC took such formal enforcement actions as temporary cease and desist orders, final cease and desist orders, removal or prohibition orders, CMPs, and formal agreements. Documents relating to OCC enforcement actions can be found at www.occ.gov/EnforcementActions.

Enforcement Actions against Bank Insiders and Third Parties

Actions against insiders included cease and desist orders, restitution orders, and the assessment of CMPs. Insiders were the subject of these actions for misrepresenting and omitting material fact in regulatory filings, self-dealing, abusing overdraft protection, and misappropriating bank funds. The violations involved nominee loan schemes, improper fee waivers, improper extensions of credit, improper use of bank premises, improper practices in construction or acquisition of bank premises, failure to properly administer loans, abuses of expense procedures, fraudulent trade advance loans, and participation in adjusted price trades.

Actions involving third parties included issuance of a cease and desist order and assessment of a $300,000 CMP against an auditing firm for reckless conduct when auditing the 1998 financial statements of the former First National Bank of Keystone (a failed national bank in West Virginia).

The Comptroller has stayed the enforcement action while the auditing firm appeals the action.

In another action, a law firm and an attorney of the firm signed agreements with the OCC governing their representation of insured depository institution clients and agreed to pay CMPs. In a separate agreement, the law firm agreed to pay more than $7 million to the FDIC as the receiver for a failed bank. Although the OCC discovered evidence to suggest that the bank's officers had engaged in fraudulent transactions to hide bank losses, the law firm hired by the bank to investigate the matter issued reports clearing the officers of wrongdoing. The chairman and two other bank officers were subsequently charged and convicted of criminal offenses, and were incarcerated.

The OCC's Fast Track Enforcement Program used information from Suspicious Activity Reports to pursue prohibition or other enforcement actions when bank insiders and other institution-affiliated parties committed criminal acts or acts of significant wrongdoing involving banks, but no criminal action was taken.

Table 2 summarizes enforcement actions taken in FY 2007.

Strengthening the Legal and Regulatory Framework

Litigation

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

In *Watters* v. *Wachovia* [Supreme Court Docket Number 05-1342], the U.S. Supreme Court issued a seminal decision on the question of federal preemption and national bank powers. The issue before the Court was whether Michigan and Linda Watters, its Commissioner of Financial and Insurance Services, could require a mortgage operating subsidiary of a national bank, Wachovia Bank, N.A. (Wachovia), to register with and pay fees to the state. Michigan acknowledged that it would not have had the power to impose these requirements on Wachovia itself.

The Supreme Court's decision on April 17, 2007 in favor of Wachovia confirmed the findings of several federal district courts and federal courts of appeal that state laws must treat operating subsidiaries as if they were the national banks themselves. Basing its opinion on its *Barnett* decision of 1996, the Court reaffirmed the principle of preemption,

Table 2: Enforcement actions, FY 2007

Enforcement Actions, FY 2007	Against Banks	Against Institution-Affiliated Parties
Cease and Desist Orders	8	25
Temporary Cease and Desist Orders	1	0
12 USC 1818 Civil Money Penalties	4	65
12 USC 1818 Civil Money Penalties Amount Assessed	$10,755,000	$2,231,000
Flood Insurance Civil Money Penalties	10	0
Flood Insurance Civil Money Penalties Amount Assessed	$629,369	$0
Restitution Orders	0	4
Amount of Restitution Ordered	$0	$567,655
Formal Agreements	20	0
Memoranda of Understanding	9	0
Commitment Letters	1	0
Suspension Orders	0	1
Letters of Reprimand	0	8
12 USC 1818 Removal/Prohibition Orders	0	37
12 USC 1829 Prohibitions	0	108
Total Enforcement Actions	53	248

holding that state law may not significantly burden, curtail, or hinder a national bank's exercise of its powers under the National Bank Act.

The *Watters* case was one of four cases in which U.S. courts of appeal 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 enforcement authority over national bank mortgage subsidiaries. After issuing its ruling in the Michigan case, the Supreme Court denied petitions for Supreme Court review filed by Connecticut and Maryland.

In a related pending case, the Second Circuit Court of Appeals is considering a federal district court decision enjoining the exercise of State Attorney General visitorial authority and other state authorities over national banks.

Legal Opinions

When a national bank contemplates engaging in a certain activity, but is not certain whether it has the legal ability to do so, it may ask the OCC Law Department for its opinion on the matter. If the OCC determines that an activity is permissible, an individual national bank may engage in the activ-

The *Watters* Decision Clears the Air

The Supreme Court's decision in *Watters* v. *Wachovia* will have little direct effect on bank supervision. Courts will continue to view duplicative examination, supervision, and regulation of national banks by the states as preemption-triggering burdens. And national banks will continue to be subject to state laws of general application, provided those laws do not conflict with the provisions or purposes of the National Bank Act. But the Court's decision, which ratified the OCC's view that operating subsidiaries should not be treated differently than the bank itself, resolves a related supervisory dispute that had been raised in several lower court cases.

Central (if implicit) to the case was this question: Who has the supervisory authority to ensure that the customers of national banks and their operating subsidiaries are treated fairly? Is it the states or the OCC? If the answer to that question was not clear before the *Watters* decision was handed down, it is now.

The Court's decision begins by describing the OCC's responsibilities as "oversee[ing] the operations of national banks and their interactions with the customers." That's a defining phrase— ". . . and their interactions with the customers"—because it clarifies that the OCC is the supervisor accountable for how national banks treat their customers.

And the OCC takes that accountability very seriously. The agency is committed not only to ensuring the safety and soundness of national banks, but also to enforcing strong protections for national banks' customers. The OCC views these dual commitments as consistent and complementary, and we have devoted considerable resources to ensuring that banks' consumer practices are as sound as their finances.

For more on the OCC's commitment to consumer protection, see the "Consumers" section of this report.

ity, subject to supervisory judgment that it has the capability to do so in a safe and sound manner. Legally supportable and safe and sound expansion of national bank activities enhances the national banking system's competitiveness in the modern financial marketplace.

Legal opinions issued in FY 2007 addressed issues relating to national bank custody activities, investments, lending, and derivatives. Banks engaging in permissible derivatives activities must have adequate risk management systems, risk measurement systems, and controls, and must meet any other supervisory requirements relevant to the particular proposal.

Among approved investments was a noncontrolling investment in a company that offers fraud prevention, identity verification, credential validation, and payment/deposit risk services to financial institutions and other companies in the financial industry.

The OCC, along with the other federal financial institution regulators, issued a joint opinion concluding that the Bank Merger Act does not apply to a financial institution's acquisition of a portfolio of credit card accounts from another financial institution that includes a small amount of credit balances. The full text of legal opinions issued by the OCC in FY 2007 can be found at www.occ.gov/law/guidance.htm.

Licensing Decisions

The OCC made several significant licensing decisions in FY 2007 involving national bank business realignments and acquisitions. In addition, the OCC completed bank chartering studies that will result in streamlined regulatory requirements, process improvements, reduced costs and barriers, and enhanced value of the national bank charter for bank organizers.

Table 3: Licensing and customer service performance measures, FY 2007

Performance Measures	Target	Actual
Percentage of licensing applications and notices filed electronically	40%	38%
Percentage of licensing applications and notices completed within established time frames	95%	96%
Average survey rating of the overall licensing services provided by OCC	≤ 1.5	1.2

Table 4: Corporate application activity, FY 2006 and FY 2007

	Applications received		FY 2007 Decisions			
	FY 2006	FY 2007	Approved	Conditionally Approved[4]	Denied	Total*
Branches	1,872	1,673	1,724	4	0	1,729
Capital / Sub Debt	167	135	66	3	0	71
Change in Bank Control	9	8	2	0	0	6
Charters	47	32	3	27	0	30
Conversions[1]	15	25	6	5	0	11
Federal Branches	3	1	0	0	0	0
Fiduciary Powers	30	6	4	0	0	4
Mergers[2]	62	49	40	0	0	0
Relocations	274	277	256	1	0	257
Reorganizations	123	108	81	13	0	94
Stock appraisals	0	2	0	0	0	0
Subsidiaries[3]	27	14	21	10	0	31
12 CFR 5.53 Change in Assets	3	4	0	4	0	4
LTD NB Upgrade	5	2	0	1	0	1
Total	2,637	2,336	2,203	68	0	2,278

[1] Conversions to national bank charters.

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

[3] This count does not include 93 After-the-Fact notices received in FY 2006 and 81 After-the-Fact notices received in FY 2007.

[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.

* Total includes alternative decisions or no objections.

Table 5: OCC licensing actions and timeliness, FY 2006 and FY 2007

		FY 2006			FY 2007		
			Within Target			Within Target	
Application Type	Target time frames in days[1]	Number of Decisions	Number	%	Number of Decisions	Number	%
Branches	45 / 60	1,790	1,721	96	1,729	1,690	98
Capital / Sub Debt	30 / 45	55	48	87	71	59	83
Change in Bank Control	NA /60	8	8	100	6	6	100
Charters [2]		34	21	62	30	13	43
Conversions	30 / 90	12	9	75	11	8	73
Federal Branches	na/120	2	1	50	0	0	0
Fiduciary Powers	30 / 45	14	9	64	4	3	75
Mergers	45 / 60	64	54	84	40	36	90
Relocations	45 / 60	271	267	99	257	251	98
Reorganizations	45 / 60	132	100	76	94	84	89
Stock Appraisals	NA /90	2	2	100	0	0	0
Subsidiaries	NA	35	35	100	31	31	100
12 CFR 5.53 Change in Assets	NA/60	5	4	80	4	2	50
LTD NB Upgrade [3]		1	0	0	1	0	0
Total		2,425	2,279	94	2,278	2,183	96

Note: Most decisions (98 percent in 2006 and 99 percent 2007) 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.

[3] Ibid. 2.

Table 6: Change in Bank Control Act,[1] FY 2003–FY 2007

Year	Received	Acted On	Not Disapproved	Disapproved	Withdrawn
2007	6	6	0	0	0
2006	9	8	4	0	4
2005	17	17	17	0	0
2004	16	14 [2]	13	0	0
2003	16	10	9	1	0

[1] Notices processed with disposition.

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

Table 7: List of applications presenting Community Reinvestment Act issues decided, FY 2007

Bank, City, State	Interpretations and Actions	Document Number
JPMorgan Chase Bank, NA	October 2006	CRA Decision No. 136
HSBC Trust Company (Delaware), National Association, Wilmington, DE	October 2006	CRA Decision No. 137
City National Bank, Beverly Hills, CA	May 2007	CRA Decision No. 138
COFSB National Association, McLean, VA	May 2007	CRA Decision No. 139
Rabobank, NA, El Centro, CA	June 2007	CRA Decision No. 140

Working To Address the Needs of Minority Banks

The OCC has long been committed to expanding opportunities for minority-owned national banks (MONBs). In 2007, the agency took several steps toward increasing outreach and support to promote that goal.

First, the OCC established an interdepartmental Minority National Bank Working Group to address hot topics and emerging issues that pertain to MONBs. Headed by Mid-Size/Community Bank Supervision, the group developed two surveys that assessed the breadth and quality of the agency's efforts to support MONBs. The surveys should help the OCC to enhance its education, outreach, and technical assistance as well as improve the agency's strategies aimed at helping MONBs operate in a safe and sound manner, serve the banking needs of their communities, and preserve their minority-owned status.

Also in FY 2007, the OCC improved its communication and outreach with minority banks and trade associations. Among the recent MONB-related information produced and disseminated are the agency's print and online versions of the Winter 2006-2007 *Community Developments* newsletter, "Minority-Owned Banks—Making a Difference in Their Communities." This issue of the newsletter appears on the OCC's Web site at http://www.occ.gov/cdd/commfoc.htm and in the Community Affairs section of the National Banknet, the OCC's extranet for national banks.

The OCC also participated in several conferences throughout FY 2007. It co-hosted the Minority Depository Institution Interagency National Conference, where Chief of Staff John Walsh discussed opportunities and requirements under the Community Reinvestment Act and discussed the OCC's efforts to support minority banking and its supervision. OCC managers and staff participated in other 2007 events largely attended by minority bank CEOs, including the Annual Conference and the Legislative and Regulatory Conference of the National Bankers Association. "Increased dialogue with the minority banking community," said Glenda Cross, Senior Advisor for External Outreach and Minority Affairs, "has helped the OCC not only better understand the unique characteristics of minority-owned banks, but also to establish and share with its bank supervision staff best practices for working effectively with MONBs."

EVENTS

September 2006	**The OCC and other federal banking agencies issue final guidance on nontraditional mortgage products.**
October 2006	**The OCC and other federal banking agencies inform consumers about nontraditional mortgage loans.** The booklet "Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?" features a glossary of lending terms, a mortgage shopping worksheet, and a list of additional sources of information.
November 2006	**The OCC hosts a meeting of directors of Large Banks to promote communications and enhance corporate governance.**
December 2006	**The OCC, Federal Reserve (FRB), and FDIC issue guidance on concentrations in commercial real estate lending.** The OTS issued separate but parallel guidance.
	The OCC and other federal banking agencies provide guidance and FAQs to bankers and examiners on the allowance for loan and lease losses.
January 2007	**The OCC, FRB, FDIC, OTS and SEC issue statement on complex structured financial transactions.**
February 2007	**The OCC, FRB, FDIC, and OTS seek comment on proposed supervisory guidance for the implementation of the Basel II advanced measurement approaches.**
March 2007	**The OCC and other federal banking agencies seek comment on the subprime mortgage lending statement.** The proposal addresses concerns that subprime borrowers may not fully understand the risks and consequences of obtaining subprime mortgages.
April 2007	**Supreme Court renders its decision in *Watters* v. *Wachovia.***
	The OCC, the other federal banking regulators, and the U.S. Department of Housing and Urban Development issue statement encouraging institutions to work with mortgage borrowers.
May 2007	**Comptroller Dugan expresses concern over "stated income" subprime loans.**
June 2007	**Comptroller Dugan in testimony before the House Financial Services Committee announces new cooperative initiative with state agencies that aims to curb abuses by mortgage brokers.**
	Comptroller Dugan unveils public service announcements encouraging delinquent borrowers to contact lenders for help to avoid foreclosure.
	OCC releases report highlighting best practices of loan servicers to prevent foreclosures.
	OCC and other federal banking regulators issued final statement on subprime mortgage lending.
July 2007	**OCC publishes interim final rule amending 12 CFR 32, which governs lending limits.** The revision allows national banks higher lending limits if state-chartered banks in the same locale are allowed higher limits.
	OCC, FRB, FDIC, and OTS issue final rule amending regulations on management interlocks.
	Federal banking agencies issue statement on enforcement of Bank Secrecy Act/anti-money laundering requirements. The statement aims to provide greater consistency in BSA enforcement among the agencies.
	OCC, FRB, FDIC, and OTS reach agreement on implementation of Basel II.
August 2007	**Federal banking agencies propose illustrations of consumer information to support their statement on subprime mortgage lending.**
	Financial regulatory agencies issue a revised BSA/AML manual.
September 2007	**OCC brings together chief risk officers of Large Banks to discuss trends in credit markets.**
	OCC, the other federal banking agencies, and the Conference of State Bank Supervisors issue statement on loss mitigation strategies for servicers of residential mortgage loans.
	Comptroller Dugan tells House committee that the National Banking System remains safe and sound despite challenging credit and mortgage markets.
	Results of the annual Shared National Credit review show an increase in criticized commitments but satisfactory overall credit quality.

INTERNATIONAL

VI.

International: National Banks and OCC Supervision in a Global Economy

Few industries have been more affected by globalization than banking. Spurred by opportunities in both the developed world and emerging markets, U.S. banks are rapidly expanding their international presence through mergers, strategic investments, and organic growth. Greater economic integration and financial market innovations, as well as the largely favorable global economic conditions of recent years, have fueled this development. Advancements in technology continue to improve banks' ability to manage larger operations at lower costs and from more locations, including geographically remote areas. The general trend toward deregulation contributes to this international expansion by lowering barriers to competition and permitting foreign bank entry into local markets.

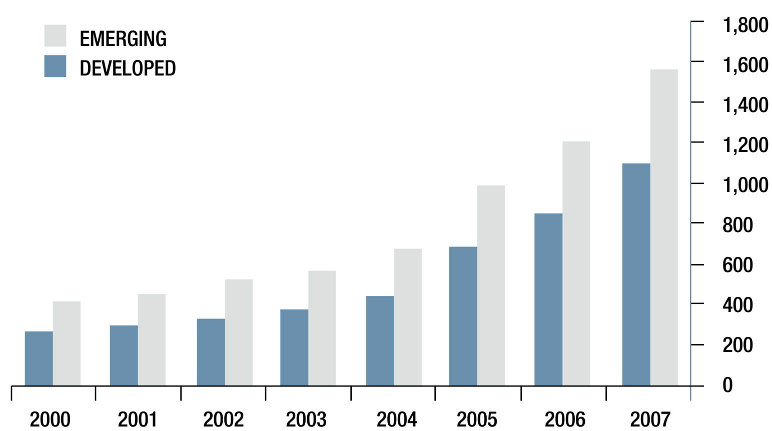
The international efforts of bank supervisors to promote best practices also affect the international reach of globally active banks. These efforts have ranged from promoting strong capital frameworks to fostering standards for effective banking supervision. As a result, they tend to raise standards and promote a level playing field for cross-border banking.

The following sections discuss the size, composition, and growth of national bank foreign exposures. The discussion then turns to the complementary roles played by OCC in assessing international risks and supervising international exposures of the national banking system.

National Banks' International Exposures

U.S. national banks, with their expanded global reach, are an important part of the international financial system. U.S. national banks' direct foreign outstanding claims were $1.6 trillion as of the second quarter 2007, an increase of 174 percent since 2003, in part because of conversions to a national charter. These claims are made up of cross-border and foreign office claims. In addition, banks had $406 billion in unused foreign commitments, while the notional value of credit derivatives sold totaled $1.9 trillion as of the second quarter 2007. These large and growing numbers make the international environment increasingly important to the OCC.

Chart 2: National bank direct outstandings are rising in developed and emerging markets ($ billions)



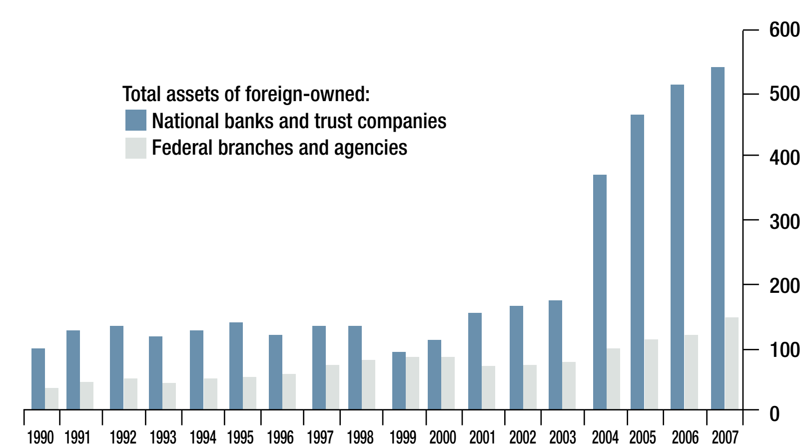
Source: Country Exposure Report (FFIEC 009). Note: yearly data reflects 2nd quarter. Direct outstandings include cross-border and foreign office claims. Data for offshore centers are not included.

Internationally active national banks offer an array of products and services, ranging from consumer credit loans to complex capital market instruments. International exposures in the national banking system fall primarily into three groups: large money-center banks, which provide a full range of products and services through an extensive international network of branches and affiliates; other banks, which serve the international financing needs of their domestic, corporate clients; and small banks with close geographic ties to Latin America, Asia, or the Middle-East.

While the majority of exposures and growth has been to developed countries, such as the United Kingdom and Germany, exposures to emerging market (EM) countries also rose in FY 2007, to a total of $469 billion. The expansion in both the developed and emerging markets is projected to continue, particularly among the largest internationally active U.S. banks.

Growth in emerging market exposures has been broad based, with double digit growth not only in the increasingly dominant economies of Brazil, Russia, India, and China (BRIC), but also in such markets as Korea, Turkey, Chile, and Poland. U.S. national banks are pursuing varied strategies to expand in these countries to take advantage of economic growth and rising income levels. U.S. banks are engaged in a wide variety of business lines in the EM countries. Their businesses have expanded beyond traditional commercial and industrial (C&I) lending. A retail credit culture is developing in many countries, such as in India, Brazil, and China, with more individuals using credit to purchase consumer goods and automobiles.

Chart 3: Foreign-owned national bank assets increasing



Source: Federal Reserve Board. Data as of June 30, 2007. All other data as of year end.

Outsourcing to third-party servicers has increased substantially across the global market in recent years. Software development and maintenance, which have been the predominant services, are leveling off, while marked growth has been noted for business processing outsourcing involving asset management and capital market services. As services grow in diversity, so do the countries involved. India, Canada, the Philippines, and the United Kingdom still host the bulk of independent third-party service providers, while emerging countries, such as China, Brazil, Mexico, and Korea, have increasing numbers of service agreements.

OCC's International Focus

The OCC provides comprehensive supervision relating to the international activities of national banks. The OCC's examination staff regularly evaluates bank activities and risk exposure in this area. In large banks, the OCC has examination staff dedicated to providing supervision on an ongoing basis and specialists in such areas as capital markets, credit, and anti-money laundering who evaluate risk and the quality of bank management across the enterprise. Enterprise risk management incorporates activities that occur overseas—for example, evaluating international vendor activities in the assessment of vendor-service risk management.

Since 1974, the OCC's London Office has been dedicated to evaluating the key risks present in the U.S. national banks' European operations. Top issues facing these banks focus on governance, complex and structured product expansion, major technology initiatives, and compliance with new European directives. OCC large bank examination teams evaluate international activity and exposure in countries where business activity is significant, including emerging market countries in Asia and Latin America.

The OCC supervises 49 federal branches and agencies of foreign banks, from such countries as Austria, Canada, and China. This foreign bank portfolio, with combined assets of $142 billion, is supervised by the OCC's New York field office located in the Northeastern District Office. The principal business focus of these institutions is generally wholesale-oriented, inasmuch as they provide credit facilities, and capital markets and funding activities to U.S. and home country customers. In addition, the OCC supervises 35 foreign-owned national banks and trust companies with aggregate assets of $535 billion. This group, led by large, globally active British, Japanese, Canadian, and Dutch financial institutions, offers a mix of retail, wholesale, and private banking products.

The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters with a view to enhance understanding of key supervisory issues and to improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, and by developing guidelines and supervisory standards.

The Joint Forum was established under the aegis of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and the International Association of Insurance Supervisors to deal with issues common to the banking, securities, and insurance sectors, including the regulation of financial conglomerates.

Supporting International Risk Supervision

The OCC analyzes global and country risks affecting U.S. banks, collaborates with foreign counterparts to develop international banking policy, establishes relationships with foreign supervisors, negotiates protocols for exchanging information, and provides technical assistance to foreign supervisors.

International Analysis

International risk analyses target issues of emerging importance, such as global financial liquidity conditions and retail lending trends in emerging economies. Scenario analysis and stress-testing are areas of ongoing research. Specialized research into topics, such as global demographic developments and their implications for banking, is also undertaken. These analyses assist the OCC in evaluating factors affecting the condition of the national banking system, and contribute to developing OCC policy and to discussions with other federal bank regulators and foreign supervisors.

International Policy Development

With the increased relevance of the international policy environment to the OCC and the internationally active national banks it supervises, and the trend toward establishment of globally consistent supervisory standards, the agency has devoted increased attention to international policy-setting groups. In addition to its longstanding involvement in the Basel Committee on Banking Supervision, Comptroller Dugan's appointment in September 2007 as Chairman of the Joint Forum has placed the OCC in an even stronger position to influence the direction of global supervisory policy.

The OCC played an important role in the comprehensive revision of the Basel Capital Standards, known as Basel II, published in June 2006, and in the revision of the Basel Committee Core Principles for Effective Banking Supervision in late 2006. This work required the OCC to collaborate with other U.S. regulators in forging a common U.S. policy view that helps inform international discussions. Serving on international policy-setting groups also enables the OCC to promote sound supervisory standards worldwide and to foster policies that help promote competitive equality for globally active financial institutions across markets.

The OCC has an ongoing interest in the development of international financial policy generally and especially in areas like Europe where national banks' activities and exposures are concentrated. The European Union's (EU) policy agenda on banking is influenced by such groups as the Basel Committee, the Joint Forum, and the Financial Action Task Force (FATF). Through OCC's participation in these international groups, as well as through its relationships with the European Commission and the Committee of European Bank Supervisors (CEBS), the OCC is kept abreast of developments that may affect the operations of national banks.

External Supervisory Relations

The OCC maintains a wide range of relationships, formal and informal, with foreign supervisors across the globe. These relationships enable the OCC to facilitate the exchange of supervisory information about internationally active banks and enter into information-exchange arrangements. During regular meetings, the OCC and foreign supervisors exchange important supervisory and economic information. These working relationships will become even more important as the new Basel II regime is adopted by large, globally active banks operating across national jurisdictions. The OCC conducts bilateral meetings based on the level of current or prospective national bank activity in the host country, regional importance, federal branch activity in the United States, and the need to address issues of supervisory concern. For instance, in 2007 the OCC held bilateral meetings with China, Brazil, India, and Mexico to discuss regulatory changes, anti-money laundering, Basel II capital standards, and domestic and international banking activities. OCC participated in conferences, such as those of the Southeast Asian Central Banks (SEACEN) Research and Training Centre and the Caribbean Group of Banking Supervisors, which provide a forum to exchange supervisory practices. In addition, the OCC provided support to Treasury's Financial Services Working Group (FSWG) dialogue with Japan and China.

FATF—The Financial Action Task Force is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing.

OCC staff members also periodically participate in international banking conferences, which allow them to communicate directly with international bankers, discuss issues of supervisory importance, and better understand bankers' views and concerns.

SEACEN—The Southeast Asian Central Banks is an organization of Southeast Asian Central Bankers that reviews monetary, banking, and economic developments in the region and facilitates supervisory cooperation and training among its members.

Sharing Information with Foreign Supervisors

Sharing arrangements and the actual exchange of information between supervisors is important in advancing effective consolidated supervision. The OCC is permitted to disclose information to foreign supervisors if the disclosure is appropriate, does not prejudice the interest of the United States, and is accompanied by a confidentiality agreement (to the extent necessary) [12 USC 3109]. Formal information-sharing arrangements, while not legally binding documents, set out the types of information that may be shared, the parameters as to how shared information will be safeguarded, and how it will be used, as well as notification procedures for examining cross-border institutions. The arrangements can facilitate a more expedited process for exchanging information.

Such arrangements, however, are not always required. The OCC may share, and has shared, information with supervisors when no formal arrangement is in place. In such cases, the OCC may provide information along with stipulations about its use and confidentiality, or the OCC may require the supervisor to provide a written agreement regarding use and confidentiality.

OCC often assists foreign supervisors in meeting their supervisory objectives by responding to their requests for:

- Background information on prospective managers.
- Information on a bank's financial condition and examination findings.
- Authorization to perform examinations as home country supervisor of national bank operations overseas.

In addition, the OCC will make a foreign supervisor aware of significant concerns (*e.g.,* an enforcement action) that arise regarding a bank under the foreign supervisor's jurisdiction.

Foreign Technical Assistance

In providing foreign technical assistance (FTA), the OCC helps foreign supervisors to develop, improve, and refine their supervisory systems. The goal is to elevate supervisory standards and provide competitive equality for internationally active banks. At the same time, the program increases the international expertise of OCC employees and helps to enhance the global reputation of the agency.

The FTA program offers training courses to foreign bank supervisors, provides internships, and supports the assistance projects of regional supervisory bodies, the U.S. Department of the Treasury, the International Monetary Fund (IMF), and World Bank, and regional supervisory bodies. In 2007, approximately 72 supervisors from 29 countries took part in OCC international schools for Anti-Money Laundering/Combating the Financing of Terrorism, Operational Risk, and Problem Bank Supervision. Also, OCC instructors assisted training efforts of regional supervisory bodies and the IMF. They served as instructors for the following training: Operational Risk (Partnership for Financial Excellence in Middle East–North Africa); Anti-Money Laundering and Countering the Financing of Terrorism (Arab Monetary Fund/IMF); Economic Stress Testing (SEACEN); and Pillar II Implementation of the Basel Capital Standards (Partnership for Financial Excellence in Middle East–North Africa).

At the request of foreign supervisors, the OCC provides developmental assignments to foreign interns. The OCC hosted interns last year from Korea, Singapore, and China with internships that ranged from two months to one year. Russia, Austria, Egypt, and Lebanon each sent small teams to join OCC on bank examinations for two to three weeks each.

The OCC also receives requests for exam-related assistance from foreign supervisors. OCC examiners who participate in the FTA cadre are selected to assist foreign bank supervisors for a variety of international programs and projects. In 2007, OCC examiners assisted foreign supervisors with anti-money laundering and problem bank issues.

The OCC and China

The OCC has a long-standing relationship with China's banking supervisor, the China Banking Regulatory Commission (CBRC), and its predecessor, the People's Bank of China (PBOC). This supervisory relationship has been cultivated over the years through various programs including formal bilateral meetings and the OCC's international intern program.

Since 2006, the OCC, in cooperation with the other U.S. federal banking regulators, has held formal bilateral meetings with the CBRC on banking supervisory practices and the operating environment. In September 2007, the OCC hosted a bilateral meeting in Washington, D.C., attended by representatives of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

The CBRC is an active participant in the OCC's international intern program. CBRC interns have spent from two to six months at the OCC learning about its examination approaches and practices. They have participated in onsite examinations and learned about supervisory data collection and analyses, supervisory information technology, and banking laws and regulations, among other things. In 2008, the OCC will host two CBRC interns and will provide them with insight into the supervision of bank financing in rural communities and into OCC's economic and industry research, as it relates to supervising the national banking system.

China—U.S. Bank Supervisory Relationship Nurtured by Dugan Visit

In March, Comptroller Dugan visited China to meet with members of the Chinese bank regulation community, as well as executives of U.S. national banks operating in China. Senior Deputy Comptroller for International and Economic Affairs Mark Levonian and Senior International Advisor Susan Hopkins accompanied him.

The trip was designed to gain first-hand knowledge of China's banking operating environment, and to promote supervisory cooperation with the OCC's counterpart, the China Banking Regulatory Commission (CBRC).

The Comptroller met in Beijing with CBRC Chairman Liu Mingkang to discuss issues of common interest, such as global liquidity, real estate markets, universal banking, and the implementation of Basel II. In a speech to the CBRC staff, the Comptroller spoke about the challenges of financial innovation, a topic particularly relevant to China's rapidly changing banking and bank regulation system.

"While each regulator faces certain challenges that are unique, other challenges are shared by all," he said in his speech. "The candid exchange of experiences and approaches is likely to make all of us more effective."

Rural finance, a top priority of Chinese financial system reform, is one such challenge. In an effort to gain a deeper appreciation of rural Chinese financial conditions, Comptroller Dugan visited Shaanxi province, in the country's heartland. While in Shaanxi, he met with the management of a rural credit cooperative, as well as the owner of a local corn starch manufacturing plant in a village served by the cooperative.

Comptroller Dugan believes that effective supervision of U.S. branches of Chinese banks depends on effective communication with home country supervisors and home country management. The only U.S. branches of Chinese banks in operation are federal branches supervised by the OCC (Bank of China and Bank of Communications). During his meetings with Chinese regulators and bankers, the Comptroller discussed Chinese banks' U.S. expansion plans.

A visit to Shanghai enabled the Comptroller to meet personally with executives of U.S. national banks operating in China. They told him that while China still has a long way to go in reforming its financial system, the overall direction of reform is positive. They agreed that the Chinese financial system might not be ready for fast-paced, more radical changes, such as deregulation of interest rates or the removal of foreign exchange controls.

"As China's economy rapidly expands, its banking and bank regulatory system will continue to adapt to the demands of modernization," said Comptroller Dugan. "It is in both our interests for them to continue their significant progress toward first-class, risk-based supervision. Our visit was part of our ongoing effort to do just that."

EVENTS

October 2006	OCC Signs Statement of Cooperation with Australian Prudential Regulation Authority
May 2007	OCC Holds Anti-Money Laundering and Anti-Terrorism Financing School for Foreign Bank Supervisors
August 2007	Foreign Bank Supervisors Attend OCC Operational Risk School
September 2007	OCC Sponsors and Hosts Second United States–China Banking Supervisors Conference
	OCC Attends Meeting of G–10 Governors and Heads of Supervision
	OCC Problem Bank Supervision School Offers Instructions to Foreign Bank Supervisors
	Comptroller Dugan Named Chairman of Joint Forum, a group of senior financial regulators from the United States, Canada, Europe, Japan, and Australia

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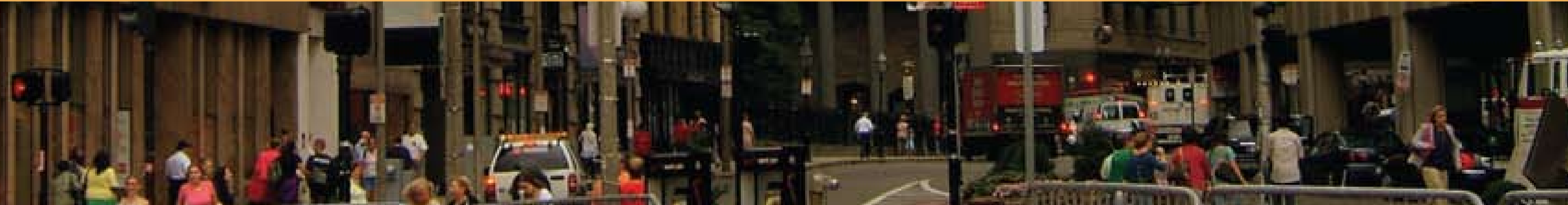

VII.

Communities: The Bedrock of a Strong National Economy

Community banks, central to the health and development of the U.S. economy, are a mainstay of the supervisory mission of the Office of the Comptroller of the Currency. Nearly 1,700, or over 90 percent of banks in the national banking system, are community banks. More than 600 of those banks hold less than $100 million in assets. Approximately two-thirds of the OCC staff and the majority of the agency's annual budget are devoted to community banking.

Locally owned, locally managed, and locally focused, community banks provide the credit and personalized service that drive local economies. Small businesses receive 35 percent of their commercial bank loans from community banks. The OCC recognizes the critical role of local banks, and has a supervisory structure and approach to support this component of the financial services industry.

The community bank perspective plays an important part in all areas of OCC supervision—in its Large Bank program, in mid-size and credit card banks, and in formulating supervisory policy.

One way OCC extends this support is in our evaluation of proposals to open new community banks or expand existing ones. Soundly conceived charter proposals aid the community, and the OCC welcomes the opportunity to work with organizers to ensure that their proposed national banks, when approved and opened, will succeed.

Relationship banking is the key business model for many smaller institutions. This model is driven by local ownership and direction, an emphasis on local decision-making, relating to customers on an individual basis, and exercising personal judgment on credit issues. The needs of the community, and individuals within that community, are the focus of bank management.

The OCC, too, takes a relationship approach to the supervision of community banks. The OCC has 68 supervisory offices around the country, staffed by people who live and work in those communities. The agency's management structure, with only three levels between the community bank examiner-in-charge and the Comptroller, promotes rapid, focused decision-making. With few exceptions, supervisory decisions are made locally by OCC staff who know and understand the bankers they supervise.

The relationship between community banking and the OCC goes back to the very beginning of the agency's history, and continues to be central to its identity. "The truth is that OCC has almost 1,400 examiners out there who live, shop, vote, raise families, and have a personal interest in the economy of their state and region," Comptroller Dugan said.

Community Banks and Examinations: Setting Standards for Safety

The OCC examines community banks every 12 to 18 months using a risk-based, continuous supervisory process. In the course of its ongoing supervision, OCC examiners review the adequacy of a bank's policies, systems, and controls relative to the character and complexity of a bank's business, and evaluate whether the bank's activities are being carried out in compliance with applicable consumer protection laws and regulations. Examiners typically sample individual loans and other transactions to validate their assessment of the bank's systems, controls, and legal compliance. Depending on the bank's risk profile and other supervisory information, including consumer complaints, examiners may target their reviews to a particular loan product, business line, or operating unit.

Communication is continuous, and includes formal and informal meetings as well as reports of examination and other written material. The written materials detail findings from the ongoing supervision and targeted reviews. Violations of law or regulation, nonconformity with supervisory guidance, and other significant problems typically are detailed as "matters requiring attention" (MRA). Examiners obtain management's commitment to correct these deficiencies and track these MRAs until resolution. OCC examiners expect MRAs to be corrected promptly, and without further action by the OCC. Failure by bank management to do so can lead to formal enforcement action.

The supervisory process can be especially effective in addressing problems early, before they become more widespread. In many instances, banks consult with OCC examiners about their plans before implementing them, so that any issues can be raised and addressed before missteps are taken. Examiners often are able to address potential consumer protection and safety and soundness issues proactively with management through this ongoing supervision process.

OCC Measures Effectiveness of Supervisory Process

The OCC assesses the effectiveness of the supervisory process through an examination questionnaire, administered by its Office of the Ombudsman. The questionnaire is provided to all national banks at the conclusion of their 12- or 18-month supervisory cycle. The questionnaire is designed to gather direct and timely feedback from bankers on the OCC's supervisory program.

The national bank appeals process is another method of feedback. It addresses 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 2007, the Ombudsman's office received a total of 21 informal, formal and substantive inquiries and more than 100 general inquiries.

OCC Outreach and Education: Creating a New Bank Director Workshop

The OCC launched a new offering in April 2007 in its series of community bank director workshops. The workshop, titled "A New Director's Challenge: Mastering the Basics," is designed to appeal to directors with less than three years of experience, as well as to longer tenured directors who would like to review the fundamental requirements of their position. This two-day workshop combines lectures, discussions, and exercises on such subjects as understanding the regulatory structure, creating effective boards, identifying effective board processes, operating in a regulatory environment, overseeing the audit function, working with examiners and the report of examination, understanding the Uniform Bank Performance Report, and managing bank information.

This workshop joins three other programs devoted to the core of the community bank supervision process: Risk Assessment, Credit Risk, and Compliance Risk. These workshops are offered around the country throughout the year and are geared primarily to outside directors of national community banks with assets of less than $1 billion. Management directors also find the workshops beneficial. Space is limited to 50 participants, so that open and constructive dialogue can take place.

Banks Help Meet Community Needs

The mutually supportive benefits of relationship banking can extend indirectly to activities that may not be obvious to bank customers. When flooding occurred this year in Wisconsin, Minnesota, Illinois, and Ohio, the OCC encouraged national banks to reach out to affected customers. The agency encouraged them to consider alternatives that may include:

- Extending the terms of loan repayment.

Comptroller Dugan and Chief of Staff Walsh Participate in a Community Bank Examination

Downtown Newton, Iowa, about 170 miles east of Omaha, looks like a lot of other small American towns. The bank occupies one corner of the square, the courthouse is in the middle, and you can park at a meter for l0 cents an hour. They don't get too many people from Washington out here, and certainly not many federal agency heads.

But for one week in May 2007, Comptroller of the Currency John Dugan and Chief of Staff John Walsh accompanied an OCC exam team—which included a group of OCC examiner-trainees—for a hands-on introduction to community bank examination procedures. It was an interesting week for the visitors and for the staff at the First National Bank of Newton, a $75 million institution.

The Comptroller had emphasized that he wanted to be a contributor—not just an observer. And so, with an experienced examiner at his side, the Comptroller reviewed the bank's wire transfers for Bank Secrecy Act compliance, participated in the loan review process, and helped enter exam findings into the OCC's databases. He met with the bank's president to elicit his views on the examination process. The Comptroller and Walsh then met with each member of the OCC exam team to discuss supervisory strategies and review the exam findings.

On the final day, the Comptroller and Walsh attended the team's 90-minute exit meeting where examiners discussed their conclusions and recommendations with bank management and the board of directors.

The Comptroller was impressed. "I really enjoyed working with the exam staff and observing just how competent and professional our examiners are at what they do," he said. "I was pleased to observe our commitment to rigorous 'real world' training of our newest hires—who by the way performed very well despite the extra scrutiny from their Washington visitors . . . Thanks to the entire team, my first bank exam was an experience I'll never forget," the Comptroller said.

- Restructuring certain borrower's debt obligations.
- Easing credit terms for new loans to certain borrowers.

The OCC suggested measures that could help borrowers recover their financial strength and position them to repay their debts. When these recovery efforts work, they can contribute to the health of the community and the long-term interests of the bank and its customers.

The OCC's District Community Affairs Officers (DCAOs), located in nine cities throughout the country, serve as a resource to national banks. These community development experts provide consultations to national banks seeking clarification on Community Reinvestment Act (CRA) qualified lending, investment, and service activities. They assist with the identification of state, local, and community-based partnerships to promote community development. They can assist national banks seeking to form a Community Development Corporation or lending consortia, and offer assistance with Part 24 Community Development investment filings.

Working individually and in partnership with their peers at the other federal financial regulators, DCAOs provide group training for bank CRA officers interested in obtaining up-to-date information on assessing community needs, forming meaningful partnerships with community groups, and creating a bank's individualized CRA performance context. The training forums facilitated by DCAOs allow access to regulatory training as well as an opportunity for national bank officers to learn from the best practices of their peers and engage in case study exercises.

The best national bankers see themselves as community resources, especially for small businesses that are often in need of financial and technical support available nowhere else. Many banks use collaborative forums involving their government and community development organization partners to learn about the credit and other needs of small businesses and to develop ways of reaching those that need assistance. In that connection, these banks engage in extensive training of their own personnel, so that they can provide the level of support that small business customers require.

The OCC works closely with national banks and community organizations to bring financing and retail services to underserved communities and consumers. We conduct one-on-one consultations with lenders and organizers to assist in identifying opportunities and resources to support community development finance, sponsor conferences and workshops to promote the exchange of ideas and information, and produce publications and Web-based resources on innovative approaches banks have used to provide community development financing and retail financial services to underserved populations.

Comptroller Brings Supervisory Message to Communities

Since taking office in August 2005, Comptroller Dugan has logged thousands of miles meeting personally with national bankers all across America, learning first-hand about the issues that concern them and about the work they do. To actually see the fruits of bankers' investment in time, energy, and capital, however, the Comptroller and OCC staff travel into the nation's streets and towns, where creative partnerships between national banks and community development organizations are changing lives for the better every day.

In November 2006, the Comptroller toured community development projects in the revitalized East Liberty neighborhood of Pittsburgh, the birthplace of what is now NeighborWorks America (NWA). NWA is a network of nearly 250 local community organizations that brings together residents, business leaders, financial institutions, government officials, and volunteers in support of community revitalization projects across the country. The Comptroller and principals of the other federal regulatory agencies serve on its board of directors.

The East Liberty neighborhood is bolstered by public welfare investments. The Comptroller met with members of the Pittsburgh Community Reinvestment Group (PCRG) who have led the effort to fund and implement these projects. As a result of

OCC Facilitates Solutions to a Branch Closing Dilemma

In response to the announced closing of several branches of national banks in the Philadelphia area, the OCC Community Affairs division sponsored three community meetings that offered bank customers a forum for their concerns and fresh hope of obtaining alternative banking facilities. The meetings were conducted under the auspices of the Waters Amendment of the Riegle–Neal Act of 1994, which requires the bank regulatory agencies to convene meetings of community leaders and other interested persons to discuss the feasibility of obtaining alternative banking facilities and services under such circumstances.

The meetings took place in North Philadelphia, Coatesville, and Linwood, Pennsylvania.

Nearly 100 private citizens sat alongside representatives of banks, thrifts, and credit unions in a joint OCC-sponsored effort to explore the credit needs of the residents and ways to alleviate the impact of branch closings.

“Many people in town walk to their bank,” said Carolyn Johnson, Executive Director for Community Impact Legal Services in Philadelphia, during the Coatesville session. “It was a concern of mine that these people would not have access to [the bank] any longer . . . and this limits their choices.”

Joyce Taylor, the Executive Director of the Chester County Assistance Office, noted that customers on public assistance often cash their checks at that bank branch, where the assistance office has an account. Most do not have bank accounts, so people rely on cashing their checks at the bank, free of charge.

Barry Wides, OCC Deputy Comptroller for Community Affairs, raised the possibility that other financial institutions would be willing to accommodate people affected by the closing. “What I have seen before is that financial institutions will agree to take customers at no charge and hope they might gain them as a customer.” The meeting led to discussion of several such possibilities, as well as consideration of the community’s larger financial needs for low-cost checking and deposit accounts, opportunities to refinance predatory loans, financial education, and one-on-one counseling for homeowners to help them avoid aggressive predatory lenders.

such support, development in the East Liberty area has already attracted more than $200 million and created more than 400 jobs. PCRG is now turning to financial education and foreclosure counseling programs to ensure that residents can sustain these investments and their benefits to the community.

Also in FY 2007, the Comptroller on two occasions visited the nonprofit East Los Angeles Community Union (TELACU), which has approved more than $2 million in small business loans each year since 1999, in cooperation with contributing national banks. The NeighborWorks America affiliate, Neighborhood Housing Services of LA, has reinvested more than $63 million to improve housing, create homeownership opportunities, and prevent predatory lending with the support of its bank partners.

Several community development projects are the result of national bank financing through low-income housing tax credits and new markets tax cred-

OCC Staff Join the Comptroller in Improving D.C. Affordable Housing Complex

On June 2, Comptroller Dugan led more than 20 volunteers from the OCC in landscaping an affordable housing complex in the Brentwood neighborhood of Northeast Washington, D.C.

As part of National NeighborWorks' Week 2007, the event represented just one of hundreds of similar projects held throughout the country involving thousands of volunteers. At this project, OCC staff, their families, and friends worked alongside residents to improve the grounds surrounding the Unity Gardens Condominiums, which Manna, Inc., another member of NeighborWorks America, recently renovated. The event also marked the 25th year that Manna, Inc., has worked to help hundreds of low-income homebuyers purchase their first homes.

"The event was about making a difference in our community," said Comptroller Dugan. "As a D.C. native, I'm proud to participate in such a worthwhile effort to support my community, and I share the personal commitment that OCC volunteers, community residents, and Manna staff demonstrated."

In 25 years, Manna has produced more than 850 affordable homes under its programs, which have accumulated more than $50 million in equity for program participants. The Unity Gardens Condominiums project combines housing development and design with human service programs to promote homeownership through pre-purchase counseling, asset-building, and job training.

Each year the Comptroller and OCC staff members volunteer in a NeighborWorks' Week project to make a difference in the local community and demonstrate the agency's commitment to community reinvestment and redevelopment. Many projects have resulted from Community Reinvestment Act credits and have involved community reinvestments from national banks or their community development corporations.

its using the public welfare investment authority. The Comptroller said, "These investments support critically needed urban revitalization, rural redevelopment, and job creation. They do so in a manner that not only benefits the communities served, but also enjoys a solid track record of profitability and safety and soundness."

These accomplishments, and the need for additional resources, led the OCC to support an increase in the level of bank investments permitted under the Part 24 public welfare investment authority, from 10 percent to 15 percent of a bank's capital and surplus. This increase, which was authorized by Congress in the Financial Services Regulatory Relief Act of 2006, opens the door to substantial new private investment, as banks work together with their community partners to revitalize and stabilize communities and promote the public welfare.

New market tax credit financing was used recently to renovate a former department store, vacant for more than 20 years, and located in a downtown commercial district. A nonprofit developer received a senior loan of $11.3 million and a subordinated loan of $2.8 million from a national bank-owned community development entity to restore an approximately 140,000-square-foot building as a business incubator that will include space for a biotechnology life sciences facility. The project will add laboratory and custom-designed space to accommodate high-tech, biotechnology, and biomedical business start-ups and ultimately house as many as 65 start-up companies at one time. The tenants and incubator "graduates" have combined annual sales of $127 million as of 2004 (the most recent year for which data are available). The businesses are projected to have created jobs for 775 people by 2007.

Community Banks and the Global Economy

Today, even small community banks find themselves drawn inexorably into the global economy—a trend that offers opportunities and challenges for them, as it does for their customers. Small community banks—those of $100 million in assets or less—are probably not as affected by the trend toward globalization as larger institutions. But their roles, like the lives of their customers, *are* changing.

Community banks are adjusting to tighter margins and tougher competition. For example, over the past 10 years, commercial real estate loans doubled in community and mid-size banks. Some of these loans went to Americans who were starting businesses to serve rising immigrant populations—populations who went on to borrow and start businesses of their own. Community banks added foreign-language-speaking personnel to serve the new clientele from foreign countries; some of these bank employees became founders of the minority-owned national banks that are the pride of their communities—and the country—today. In this way community national banks not only promote the well-being of their customers, but also that of the entire national economy.

EVENTS

January 2007	OCC Releases CRA Evaluations for 36 National Banks
February 2007	Comptroller Dugan Hosts Workshop for New Community Bank Directors in Washington, D.C.
March 2007	OCC Publishes Newsletter Highlighting Community Development Venture Capital Investment Opportunities
April 2007	Comptroller of the Currency Hosts Community Bank Directors Workshop on Compliance Risk in Tulsa, Oklahoma
May 2007	Agencies Release List of Distressed or Underserved Nonmetropolitan Middle-Income Geographies
	OCC Volunteers Help to Improve an Affordable Housing Property in Northeast Washington, D.C.
June 2007	Comptroller of the Currency Hosts Community Bank Directors Workshops in Houston, Texas
	Agencies Release Proposed Revisions to Interagency Questions and Answers Regarding Community Reinvestment
July 2007	Comptroller of the Currency Makes Statement Regarding Community Reinvestment Act Questions and Answers
	OCC Chief of Staff Addresses Minority-Owned Financial Institutions
	Comptroller Distributes Booklet to Help Banks Fight Child Pornography
August 2007	Comptroller of the Currency Hosts Community Bank Directors Workshop on Compliance Risk in Lexington, Kentucky
September 2007	Comptroller of the Currency Hosts Community Bank Directors Workshops on Credit Risk in Grapevine, Texas

CONSUMER


VEGETABLES
WE DELIVER
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UNITED STATES
e-business
Los Angeles
MEXICO
shift
CD DE MEXICO
GUATEMALA

VIII.

Consumers: Promoting Fairness and Transparency

A generation ago, commercial banks were not the leading suppliers of financial services to retail customers. But times have changed. Today's national banks are leaders in the delivery of the innovative products and services consumers rely on to achieve their financial goals and to function effectively in our increasingly complex global economy.

Retail banking itself has assumed an increasingly global dimension, reflecting not only the diversity of our nation's population, but also the growing presence of Americans living, traveling, working, and using financial services abroad.

As retail banking has grown in importance, so has consumer protection become a more prominent part of the OCC's mission. The OCC pursues this mission in three distinct but interrelated ways. First, we promote consumer protection through our supervisory program. In that connection, we develop consumer protection standards, conduct rigorous examinations of national banks to ensure that they are complying with all applicable consumer protection laws and regulations, and take enforcement actions when we are unable to achieve compliance by other means.

Second, the agency seeks to promote transparency in the financial system by getting more and better information into the hands of consumers, whether from national banks or the OCC itself.

Finally, the OCC assists consumers by maintaining a state-of-the-art process for addressing their bank-related complaints.

In each of these ways, we work to maintain high standards of customer service in the national banking system; help consumers better understand their rights and responsibilities as bank customers; and coordinate our efforts with other financial regulatory agencies to promote seamlessness and efficiency in addressing consumer needs.

The increasing importance of retail banking to the national banking system, its customers, and the economy whose health they support combined to make FY 2007 a year of important initiatives by the OCC in each of these areas.

Consumer Protection through Bank Supervision

Nontraditional and Subprime Mortgage Guidance

Changes in housing finance represent a good illustration of the changes that have taken place in the retail financial services landscape. A variety of complex mortgage products have become available, through a wide variety of providers. Indeed, a homebuyer's mortgage process may take place today entirely outside traditional channels: the borrower may use an independent mortgage broker to arrange his or her loan, which is then packaged through a Wall Street conduit and sold to a third party investor who may or may not reside in the United States.

While these changes have expanded access and choice for consumers seeking a mortgage, they have also resulted in less desirable outcomes. Some consumers have obtained mortgages on terms they may not have fully understood or that they cannot afford. There has also been a rise in mortgage fraud.

Some nontraditional mortgage (NTM) products, designed to help borrowers cope with rising home prices, involved relaxed underwriting standards that increased risk for both borrowers and lenders. The OCC carefully monitored developments in this segment of the market, and in 2005 initiated a process that resulted in the release of interagency guidance on NTM products, which took effect on October 4, 2006.

The guidance addressed the need for financial institutions to provide timely, clear, and balanced consumer information about NTM products, including information about the possible adverse consequences of these loans, such as payment shock and negative amortization. It stipulates that this information should be provided to consumers when they are shopping for a loan—that is, when that information is most likely to be of greatest practical value. In addition, the guidance provides that information concerning choices in payment options should be provided to the consumer with every monthly statement on a payment option adjustable-rate mortgage (ARM).

The OCC also worked with the other federal banking agencies to provide guidance on certain types of subprime mortgage loans, including the so-called "2-28" and "3-27" hybrid ARM products. This guidance was issued on June 29, 2007. It describes prudent safety and soundness and consumer protection standards that institutions should follow to ensure borrowers can afford to repay the loans they obtain. These standards include a fully indexed, fully amortized qualification for borrowers and cautions on risk-layering features, including an expectation that stated income and reduced documentation should be accepted only if there are documented mitigating factors that clearly minimize the need for verification of a borrower's repayment capacity.

Both the subprime guidance and the nontraditional mortgage guidance apply only to federally regulated financial institutions and their affiliates. Yet, because the majority of NTMs and subprime mortgages are originated by lenders and brokers regulated exclusively by the states, the Comptroller has stressed the need for state authorities to enact standards comparable to that in the federal guidance, and has applauded efforts by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators to encourage states' adoption of these guidelines.

Mitigating the Impact of Mortgage-Market Turmoil

Although they originated a relatively small share of subprime mortgages, national banks and their customers have been affected by problems in the mortgage markets.

One area in which the agency took an active role was in encouraging more timely and constructive contact between troubled borrowers and their lenders. Understandably, borrowers having trouble making their mortgage payments are often reluctant to talk about it. Yet we know that such reticence tends only to make the matter worse. For those who fall behind, or think they are likely to fall behind, it is important to reach out and make contact with their lenders and mortgage servicers as soon as possible, so that alternative arrangements can be discussed before it is too late.

To address this need for greater openness and communication, the OCC took two important steps. With the help of a partnership with NeighborWorks America and the Ad Council, we reached out to borrowers, releasing two public service announcements aimed at encouraging delinquent borrowers to contact lenders for help to avoid foreclosure. These audio and video ads, targeted at areas where delinquencies are on the increase, call viewers' attention to a toll-free hotline staffed by housing counselors from agencies approved by the U.S. Department of Housing and Urban Development.

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Another initiative involved outreach to mortgage servicers. In June the OCC published a report on best practices in the loan servicing sector, designed to improve the quality and timeliness of the contact with delinquent mortgage borrowers. The OCC's report, *Foreclosure Prevention: Improving Contact with Borrowers*, highlighted the growing role of partnerships between lenders and nonprofit third parties to provide counseling services to at-risk homeowners and reported on the strategies being employed successfully around the country to establish contact, reduce financial hardship on borrowers, and reduce losses for lenders.

In conjunction with both federal and state financial regulatory agencies, the OCC in April issued a release reminding banks that they are not required under existing regulations and accounting standards to foreclose immediately when a borrower falls behind on payments. The release pointed to the potential benefits for lenders when they make alternative arrangements, such as modifying loan terms or moving borrowers from variable-rate to fixed rate loans. Such restructuring, the release pointed out, not only offers lenders the possibility of returning troubled loans to performing status, but may also qualify banks for favorable consideration under the Community Reinvestment Act.

The kind of restructuring that can be beneficial in dealing with troubled borrowers is no longer as simple as it was when originators and servicers tended to hold those loans in portfolio to maturity, however. Today, it is far more common for both prime and subprime mortgages to be bundled into securities, which are typically resold to investors in the secondary market. To help address this increasing complexity, the banking agencies, in a statement issued in September 2007, encouraged servicers to use the authority that may exist under securitization governing documents to take appropriate steps when an increased risk of default by a borrower is identified, and to explore, when appropriate, a loss mitigation strategy that avoids foreclosures. Such strategies may include deferring payments, extending maturities, or converting adjustable-rate loans into fixed-rates. But whatever solution is adopted, the guidance emphasizes that it be an *affordable* solution.

Dugan Receives "Making-the-Difference" Award from Credit Counseling Foundation

Citing his commitment to financial literacy and education, the National Foundation for Credit Counseling gave its annual "Making-the-Difference" Award to Comptroller Dugan.

Comptroller Dugan used the occasion of the award presentation to express his concern about the growing number of Americans facing the threat of foreclosure, especially those holding subprime mortgages. Although national banks are relatively less involved in that segment of the mortgage market, the OCC has been a leader in developing strategies to bring at-risk borrowers together with lenders and housing counselors. The agency has been creative in gathering new ideas and developing regulatory incentives for lenders to restructure loans so that people falling behind on their payments can stay in their homes.

In his acceptance speech, Comptroller Dugan hailed the work of organizations such as the Center for Foreclosure Solutions, which was established with the help of contributions from national banks, as well as Fannie Mae, Freddie Mac, and others. He challenged lenders and loan servicers that are not federally regulated to "make similar contributions to assist borrowers to avoid foreclosure wherever feasible."

"It is not enough to *achieve* home ownership," Dugan concluded. "We—all of us operating in our respective roles—have to work hard to *sustain* home ownership."

Protecting Consumer Privacy

Helping to protect bank customers against identity theft and unauthorized access to sensitive customer information is a high priority for the OCC and the banking community. The OCC was an active member of the President's Identity Theft Task Force, helping to craft a strategic plan to improve the federal government's efforts in preventing, detecting, and prosecuting identity theft.

Through the examination process, the OCC monitors national banks' compliance with applicable security and privacy laws, regulations, and supervisory guidelines. During the past year, an area of focus has been banks' compliance with the interagency guidance on "Authentication in an Internet Banking Environment." Evidence shows that national banks have taken positive steps to strengthen their authentication processes and improve the security posture of their Internet and electronic banking environments. Indeed, the introduction of more robust measures to authenticate customers has already led to an appreciable decline in the number of successful hacker attacks on national banks and on the fraudulent use of information obtained through phishing.

When national banks violate applicable rules and regulations safeguarding consumer privacy, the OCC takes action. For example, we collaborated with a county prosecutor to obtain prohibition orders against bank employees who were paid by a third party to gather confidential information on selected bank customers. The third party, in turn, sold the confidential customer information to law firms for collection purposes.

As a result of OCC guidance, supervision, and enforcement actions, customers have reason to feel more secure that their confidential financial information is being adequately safeguarded in the national banking system.

Fair Lending

The OCC has a strong commitment to ensuring that national banks comply with fair lending laws and that consumers who seek credit from national banks are evaluated based on legitimate, non-discriminatory factors. Because of the importance the OCC places on ensuring that national banks comply with fair lending laws and regulations, our examination guidance directs examiners to assess fair-lending risk during each supervisory cycle. While regular risk assessments serve as the cornerstone for setting a fair-lending supervisory strategy for each national bank, this process is complemented by an annual fair-lending screening process that helps to identify banks that may have high potential for fair-lending risks.

A strong examination regimen is crucial to maintaining the integrity of our fair lending program, and we took several actions to ensure that our supervisory guidance and examination procedures remain effective and up to date. For example, new procedures addressed provisions in the Fair Credit Reporting Act that generally prohibit creditors from obtaining and using medical information in connection with any determination of a consumer's eligibility for credit. We also updated our procedures to reflect changes made to the regulation that address concerns about the uniformity and adequacy of information provided to consumers when they overdraw their deposit accounts. These procedures prohibit misleading advertisements, and impose new disclosure requirements about fees and other terms for overdraft services.

Consumer Protection through Public Information

A free flow of information has always been at the heart of a well-functioning financial system, and the OCC has long been committed—both through its own public communications programs and its initiatives to improve bank disclosures—to increasing the quality of the information available to bank customers. Only with clear and complete information can consumers be expected to understand their rights and responsibilities and to make the best financial decisions in their own interests. Well-founded decisions, in turn, promote healthy competition among financial providers—competition that promotes efficiency, high service standards, and reduced costs to bank customers. And, as Comptroller Dugan noted in testimony before a subcommittee of the House Financial Services Committee in June, by exposing unsavory and abusive business practices to the glare of public scrutiny and criticism, public information also helps to expose and root out those practices, making providers "think long and hard about the costs of such practices before implementing them."

OCC Initiatives To Improve Bank Disclosures

In order for them to achieve their fundamental purposes, bank disclosures must meet minimum standards of timeliness, completeness, and clarity. Yet disclosures have often fallen short in one or more of these areas. They typically arrive in multiple pages of small print, in language that the average consumer is likely to find difficult to comprehend. In some cases, disclosures do not adequately describe all relevant practices and do not present the information that consumers need for making informed choices in a straightforward and useful manner.

"My take on all this is that there is plainly a state of disequilibrium when it comes to consumer protection for credit cards," Comptroller Dugan said. "The system needs fixing."

Credit card disclosures highlighted these deficiencies. Considerable controversy has come to surround credit card marketing and account management practices. This is partly the result of Americans' growing reliance on this unique form of unsecured credit, and partly because of the ways issuers have gone about managing the risk that increased exposure entails. Full and clear disclosure is crucial if cardholders understand the terms of their credit contract and the terms being offered by competiting credit card banks to make well-informed credit choices.

Credit card disclosures have often fallen short of these demands. Although credit card terms, marketing, and account management practices have changed dramatically, disclosure requirements, as mandated by Federal Reserve Regulation Z, have not. As a result, innovative credit card practices—in particular, such practices as "universal default" and "double cycle billing"—have been especially difficult for consumers to understand, since they are not addressed in the current disclosure regime. Clearly, those rules need updating.

The Federal Reserve's Truth in Lending initiative is focusing on the form as well as the content of bank disclosures. Pioneering work in that area came to partial fruition in FY 2007 when the agencies issued a rule on consumer privacy disclosures. That release marked a major step in an important process to determine through controlled research, using consumer focus groups, how to construct a model prototype privacy notice that would effectively present the information required by the Gramm-Leach-Bliley Act on how financial service providers protect, use, and share personal information. This research yielded data on the language and design of a prototype disclosure form that people found easy to read, understand, and use. With the help of the feedback from consumers, industry groups, and others that we solicited in FY 2007, the participating agencies—which include the Federal Reserve, the Commodity Futures Trading Commission, the FDIC, the Federal Trade Commission, NCUA, the Securities and Exchange Commission, and the OTS, as well as the OCC—are a step closer to implementing this standardized disclosure notice.

Yet even credit card disclosures that meet the highest standards of clarity and timeliness may offer small consolation to consumers if the card's policies do not provide a real choice in the face of a disclosed rate hike on a balance that is too large to pay off or if the customer lacks options for rolling over the balance to another credit card lender.

That's why Comptroller Dugan, in a September 27, 2007 speech, urged the Federal Reserve to include among the contemplated changes to its Truth in Lending rules a provision that would allow consumers 45 days to "opt out" of an increase in the interest rate on a credit card, unless the increase resulted from the consumer's own failure to make required payment on that card. Under the proposed provision, consumers would be free to keep the outstanding balance at the old rate, with a requirement to pay off the balance or roll it over to another card within a reasonable period. This approach would help address one of the practices consumers find most objectionable: so-called "retroactive" pricing. "My take on all this is that there is plainly a state of disequilibrium when it comes to consumer protection for credit cards," Comptroller Dugan said. "The system needs fixing." The OCC's new proposal is an important step in that direction.

OCC Public Information Initiatives

People who believe they are at risk of losing their homes are particularly vulnerable to predatory lenders who exploit that fear. A rise in financial fraud directed toward at-risk borrowers led the OCC to take steps to raise public awareness of the schemes that seem to proliferate in difficult times. For example, we issued one in a series of Consumer Alerts in response to consumers who received solicitations about so-called "Community Reinvestment Act" loans, purportedly entitling certain homeowners to cash grants or equity disbursements. A September 2007 alert catalogued a whole range of programs designed to entrap borrowers into paying money up-front, ostensibly to eliminate debt. Borrowers have been told they can wipe out their debts by claiming a non-existent arbitration award, by asserting that a contract or note is illegal and therefore not binding, or by drawing on a spurious federal government "trust account." What these and other schemes described in the alert have in common is that borrowers who fall for them inevitably wind up in a deeper hole than before.

When financial fraud surfaces, the OCC acts to root it out, both by supervising banks rigorously and by alerting consumers before they become its victims. One form of fraud in which there was a marked increase in 2007 involved cashier's checks.

OCC Acts To Root Out Mortgage Fraud

At a time of turmoil in mortgage lending, it is particularly important that market participants play by the rules. One case that led to an OCC enforcement action involved two employees of a bank's mortgage subsidiary allegedly involved in a scheme with a land developer to find buyers for the developer's properties.

A loan officer and his wife, both mortgage processors, allegedly submitted false and misleading loan applications to the bank to obtain mortgages for 64 low-income first-time homebuyers to buy homes from the developer. Many of the borrowers received mortgages for which they would not have otherwise qualified. The loan officer also allegedly submitted a number of Federal Housing Administration housing counseling forms, falsely representing that the prospective buyers had received counseling designed to prepare them for home ownership, to qualify the loans for a reduced interest rates. In fact, none of the buyers received such counseling.

The mortgage processor allegedly prepared a U.S. Department of Housing and Urban Development Addendum to each loan application and certified that the information supporting the addendum was accurate and obtained from the buyer when she and the loan officer knew that much of the information was false and had been obtained from the land developer. The loan officer received approximately $20,000 in increased commissions and bonuses from the bank and kickbacks of $500 for each loan approved. When borrowers defaulted, the bank incurred loan losses of approximately $1 million. The OCC issued a prohibition order against the loan officer, required him to pay $460,375 in restitution to the bank, and assessed a $100,000 civil money penalty. The mortgage processor consented to a prohibition order and a $20,000 CMP.

Individuals receive notification that they have won a foreign lottery or have been designated the beneficiary of someone's estate, and that the proceeds will be passed along as soon as fees or taxes are paid. A cashier's check is provided to cover those charges, and the individual is asked to deposit the check and then wire the required amount, invariably to a foreign country, once the check clears. Or, in another common scam, an individual sells something on the Internet and receives a cashier's check that is greater than the purchase price. The seller is instructed to deposit the check and wire the excess once it clears, keeping some of the amount to "compensate" for his or her trouble.

What scammers seek to exploit in these cases is the lag between the time that funds are made available after the check is deposited and the time that it takes to ascertain whether that check is legitimate or fraudulent. Under Federal Reserve Regulation CC, banks must make funds available the following day when they are drawn on a cashier's check. By contrast, wire transfers are instantaneous and irreversible, and depositors who have wired good funds to fraudsters only to be informed later that the cashier's check that they deposited was fraudulent are usually out the money.

The OCC attacked this emerging problem on two fronts. A supervisory bulletin to bankers alerted them to the risks associated with fraudulent cashier's checks and offered recommendations for managing these risks and protecting their customers. The agency also issued a Consumer Advisory that received widespread notice in media stories on the problem.

Sounding the alarm about financial fraud was only one way that the OCC delivered on its commitment to transparency and a more literate financial consumer in 2007. Our main effort went into placing into consumers' hands—either through OCC distribution or through improved disclosures by the banks we supervise—better and more complete information about bank policies, products, and services.

At the start of the 2006 holiday season, for example, the OCC issued a release reminding consumers to consider the terms and conditions that apply to gift cards—an increasingly popular option for gift-givers. But some cards come hedged with conditions, including inactivity fees and expiration dates that can erode the cards' value. To avoid unpleasant surprises, our release suggested that consumers consult either the disclosure statements that accompany cards or the offerer itself to determine what conditions, if any, might apply to the gift card. To ensure consumers get this important information, the OCC prepared and distributed audio and print announcements that ran 965 times in 38 states, reaching a potential audience of 87 million people.

Gift cards and even credit cards are simple products compared to today's mortgage loans. Some homeowners who took out interest-only or payment-option loans two or three years ago, thinking only about the initially low monthly payment, may have received an expensive and depressing education in the realities of the mortgage marketplace. For example, some borrowers have learned the hard way the meaning of such terms as "negative amortization." The challenge is to ensure that before borrowers enter into such commitments, they *do* understand this terminology and have carefully considered whether these products are right for them.

To aid them in making these decisions, the federal banking agencies published a new brochure on the subject. *Interest-Only Mortgage Payments and Payment-Option ARMs—Are They for You?* contains a glossary of lending terms, a mortgage shopping worksheet, and a list of additional information sources. It stresses the importance of understanding the risks and benefits of these nontraditional mortgage products, and urges borrowers to be realistic in assessing their ability to face the "payment shock" that can result when these loans readjust. By providing this information—and the agencies made it widely available to consumer groups, financial institutions, agencies, and other organizations—the OCC hopes to enable mortgage shoppers to make sound financial decisions that will keep them safely in their homes.

Thorny questions can arise even over conventional fixed rate, 30-year mortgages, and, with the multitude of products, providers, and regulatory authorities that characterize our modern banking system, it can be difficult for consumers to know where to turn with their questions. It was to answer that need—to provide a one-stop, central clearinghouse where consumers can search comprehensively for reliable information—that the OCC launched HelpWithMyBank.gov. This Web site, which was widely hailed by consumer groups for its user-friendly interface, offers an extensive list of questions and answers, drawn from the actual experience of the OCC's customer complaint specialists—people who speak to thousands of national bank customers each year. The agency assembled the most common questions, organized them by topic—"bank accounts," "loans and credit cards," "insurance," and "other topics"—and provided short, easy-to-understand answers, along with links and references for further information. The agency also provided a list of national banks and their operating subsidiaries, a list of OCC consumer advisories, and an option that allows the user to generate a formal complaint to the OCC.

Consumers Help Themselves with a Click

There's never been a single spot for consumers to turn to when they had a general question about how banks process checks and overdrafts, what to do in the event they lose a credit card, how to deal with a problem of identity theft, or what to do when confronted with a host of other banking issues. But with the launch of the OCC's HelpWithMyBank.gov, that has changed.

"We created HelpWithMyBank.gov with national bank customers in mind," Comptroller Dugan said. "Our goal was to build a site that makes it easier for people to get answers and submit concerns about their bank because we are committed to ensuring fair access to financial services and equal treatment for national bank customers."

While targeted to national bank customers, the site answers many questions common to consumers of all financial services companies and provides useful information about contacting regulators of institutions other than national banks.

"HelpWithMyBank.gov presents information in straightforward, easy-to-use terms. It lets consumers answer questions online that previously required a phone call to the OCC Customer Assistance Group," said OCC's Ombudsman Samuel P. Golden.

The launch concluded six months of work and more than a year of planning. The site is one of the agency's steps in creating more accessible services for consumers. "The OCC will continue to enhance HelpWithMyBank.gov with information and features," said Comptroller Dugan. Future enhancements include an online complaint submission process, enhanced "Frequently Asked Questions" functions, and a referral process to share complaints with other regulators to ensure that consumers' concerns reach the right agency.

Consumer Protection through Complaint Resolution

The third pillar of the OCC's approach to consumer protection rests on a state-of-the-art consumer complaint resolution process. FY 2007 was a year of refinement in that process, as the OCC addressed a frequent source of frustration for consumers who were unsure just where their bank-related complaint needed to be lodged.

The OCC's Customer Assistance Group, or CAG, is centralized in Houston, Texas, under the direction of the agency's Ombudsman. The OCC has invested heavily in sophisticated technology and in the people who staff the CAG. CAG managers have an average of 25 years of regulatory or industry experience, and CAG staff has an average of 10 years of experience. This means that callers with complex questions can reach competent, experienced professionals. And they can reach them during a newly expanded, 12-hour business day.

We further increased our complaint-handling efficiency by bringing additional banking organizations on to CAGNet, our Web-based government-to-business consumer complaint delivery application. Currently, almost 90 percent of our complaint volume travels over CAGNet.

Case loads in FY 2007 reflected a slight decline compared to the previous year. As shown in table 8, we handled about 67,000 cases, of which nearly 29,000 were complaints (as compared to inquiries). The result was more than $8 million in relief for national bank customers. This adds to the total of more than $30 million of such relief over the last five years.

CAG's contribution to consumer protection doesn't end with the resolution of consumer complaints. The OCC is unique in the way we use the information obtained and analyzed by CAG in support of our bank supervisory activities. Through an internal, Web-based system called CAGWizard, analysts extract complaint data, sort and analyze the

Comptroller Showcases OCC Consumer Complaint Process

Thousands of Americans have had their complaints against national banks resolved through the OCC's Customer Assistance Group (CAG) in Houston, Texas. But not many of them know how it happens or how the process actually works.

To provide an audience of Washington insiders with a look at the lifecycle of a consumer complaint, Comptroller Dugan walked them through it, in a January speech before a joint meeting of the Exchequer Club and Women in Housing and Finance. Comptroller Dugan began by talking about the OCC's commitment to the people and technology that are so essential to CAG's effectiveness.

He then walked the audience through a hypothetical case. Using the OCC's "Remedy" software, Dugan demonstrated how the complaint was ushered by the OCC to the bank for a resolution.

The Comptroller emphasized that the value of the CAG process goes beyond helping consumers. The OCC uses that data in various ways to inform the supervisory process. The data is analyzed and made accessible to OCC examiners, schedulers, policymakers, attorneys, and others. And CAG staff uses it to provide feedback to banks on practices that need improvement.

information, and generate custom reports that bank examiners use regularly in their examination of individual banks. To inform the OCC's supervisory strategies and policies, we use complaint trends for individual products, such as home mortgages and credit cards. This data enables us to better time and focus examinations, target areas of potential concern, develop annual risk assessments of banks, and formulate supervisory guidance. And when we see individual complaints or patterns of complaints that could indicate inappropriate or unfair and deceptive practices, OCC lawyers are called in.

Complaint Sharing

Many of the complaints received by CAG concern institutions not regulated by the OCC. Our sister agencies at the federal and state level have also had to deal with a significant number of misdirected complaints. In general, their response has been the same as ours: to come up with ad hoc procedures for getting these complaints into the hands of the appropriate regulatory agency. Last year alone, the OCC referred more than10,000 complaints to other regulators and received nearly12,000 referrals concerning national banks from other agencies. But that process takes time, it is sometimes constrained by privacy restrictions, and it has afforded few systematic opportunities to follow up on the disposition of complaints that have been referred.

That's why the OCC took the initiative to develop procedures for the exchange of consumer complaint information with state banking departments. In November 2006, this initiative bore fruit. The OCC reached an agreement with the Conference of State Bank Supervisors (CSBS) on a model Memorandum of Understanding (MOU) designed to ensure that misdirected complaints are sent to the appropriate agency and that agencies can track the status of a referred complaint and resolve it in a more efficient manner. Two weeks later, New York became the first state to sign the MOU, thus endorsing the principle that the burden should not be on consumers to know which agency regulates their financial institution. Since then, 27 others states, plus Puerto Rico, have signed the MOU.

This is one example of interagency cooperation in which consumers—and their confidence in a fair and open bank system—are the true winners.

Table 8: Consumer complaint caseload, FY 2007

FY 2007 Cases

Complaints	28,870
Inquiries	38,199
Total Cases	67,069

Complaints Generating Compensation or Reimbursement

No. of Complaints	7,589
Amount Returned	$8,071,848

EVENTS

November 2006	**OCC–Conference of State Bank Supervisors Memorandum of Understanding on Consumer Complaint-Sharing**
January 2007	**OCC Alert on Cashier's Check Fraud**
March 2007	**Interagency Rule on Consumer Privacy Notices**
April 2007	**Comptroller Dugan Receives Financial Literacy and Education Award**
June 2007	**Banking Agencies Issue Statement on Subprime Mortgage Lending**
July 2007	**HelpWithMyBank.gov Goes Live**
September 2007	**Banking Agencies Tell Lenders to Work with At-Risk Borrowers**

IX.

On Making the OCC a Great Workplace

In Pursuit of Excellence

The OCC supervises a diverse group of institutions, ranging from small community banks to the world's largest financial institutions. To provide the best workforce to supervise and administer the national banking system, the Comptroller and the Executive Committee have continued to emphasize the importance of maintaining a diverse, highly skilled, motivated, and well-placed workforce—its most valuable asset.

Yet the OCC and its workforce face the same demographic pressures that confront employers across the nation. The baby boom generation is reaching retirement age. Over the next five years, 32 percent of OCC's current workforce, 30 percent of its national bank examiners, and 50 percent of its managers will be eligible for retirement. The potential impact could be most pronounced in the Large Bank Supervision area, which has a particularly experienced, senior-level workforce.

Anticipating such retirements and recognizing the need to foster the development 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—at the entry level as well as at the senior level.

These programs are having a positive effect. In its 2007 issue of *The Best Places To Work in the Federal Government,* the Partnership for Public Service ranked the OCC fourth overall out of 222 subcomponents of large federal agencies. In

the "best of class" rankings, the agency also tied for second in strategic management and fourth for pay and benefits. The rankings were based on the Partnership for Public Service's and the American University Institute for the Study of Public Policy Implementation's analysis of the Office of Personnel Management's (OPM) 2006 Federal Human Capital Survey of overall employee engagement and workplace environment, as well as 2003 demographic data.

In the "best of class" rankings, the agency also tied for second in strategic management and fourth for pay and benefits.

This independent rating speaks well of the OCC's efforts to attract and retain staff. It promises even better results for the future as newer programs enable the organization to continue to attract "the best and the brightest."

Recruitment and Retention

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. Highly experienced new employees with an interest in public service come from banks and elsewhere in the financial world. A large proportion of entry-level employees are recruited on college campuses and must meet rigorous hiring criteria.

After hiring employees, the agency focuses on training and retaining them. The OCC recently established a program for acclimating its industry hires by assigning an experienced advisor to work with each of them, teaching them about the culture and policies of the agency, providing regular feedback on performance, and then soliciting their comments on their initial experiences at the OCC.

Internal recruitment in FY 2007 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, particularly metropolitan New York City. 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. A special package of compensation incentives was announced in April 2007 to recruit and retain OCC employees with the experience, skills, and talent necessary to meet the agency's critical mission needs in the greater New York metropolitan area. These were augmented and expanded in September 2007 to include Washington, D.C., and San Francisco.

The OCC also continued its nationwide program to recruit and train entry-level bank examiners. Building on the relationships nurtured in recent years with colleges across the nation, the agency was able to compete for the best talent and hired 151 entry-level examiners in FY 2007. This pool of examiners was distinctive not only for its high quality, but for its diversity. Since the inception of this hiring program in 2003, the agency has brought aboard about 580 entry-level examiners. Of these new examiners 52 percent are women and 35 percent are minorities.

The agency instituted an aggressive retention program to keep these new employees during their critical first five years, when many examiners decide whether or not to continue their careers with the OCC. The success of OCC's world-class examiner recruitment and training programs was recognized last year by *BusinessWeek* magazine, which rated the OCC's workplace as one of the "50 best places to launch a career."

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Finally, the agency has continued its strategic efforts to improve its ability to attract and retain staff with strong quantitative and analytical skills, particularly through external hiring. In FY 2007, the OCC received direct-hire authority from the Office of Personnel Management to hire quantitative modelers for the Risk Analysis Division. The Risk Analysis Division is a specialized group of economists and mathematicians who use statistical methods and models to analyze the risks affecting banks, and who evaluate the quantitative models used increasingly within banks for valuation and other business decisions. These modeling experts work on-site at national banks with OCC examiners to evaluate risk measurement systems and models.

Developing a Highly Skilled Workforce

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 enormous prestige at the OCC and throughout the financial industry. Once the examiner develops the basic skills, the emphasis often turns toward developing that examiner's expertise in key specialty areas. This skill development feeds the pipeline from community bank supervision to jobs in large bank supervision or in Headquarters.

OCC is committed to ensuring that its employees have the knowledge and skills necessary to meet its supervisory and organizational challenges. These educational needs are supported through internal courses (more than 200 sessions per year), interagency training, and externally provided courses. The agency's Committee on Bank Supervision, made up of three Senior Deputy Comptrollers, began implementation of a major project centered on eight key specialty skills: the new Specialty Skills Assessment Program. An Examiner Development Advisory Group has been established for each specialty area: asset management, bank information technology, capital markets, compliance, commercial lending, retail lending, mortgage banking, and operational risk. These groups monitor how identified industry risks affect commissioned examiner development and assess examiner training and development offerings to determine gaps and recommend enhancements.

Effective leadership is also critical for the agency to successfully accomplish its mission. OCC implemented a comprehensive array of leadership development offerings that included executive coaching, classroom training, new managers' orientation, manager forums, and on-line reference tools. In addition, OCC initiated a project to develop an agency-wide leadership development competency framework. To ensure that the leadership development program is aligned with the needs of the agency, an advisory group—the Leadership Development Advisory Board—was formed, made up of leaders from each OCC department. In FY 2007, the LeaderTRACK management development program was implemented for experienced examiners, to help ensure that the bank supervision area, as Comptroller Dugan stated, "has a steady and deep pipeline of qualified employees to meet its future needs."

Equal Opportunity and Workplace Fairness

In its continual search for workplace improvement, the OCC maintains a commitment to equal opportunity and workplace fairness. In FY 2007, this commitment took the following forms:

- Presenting a forum on dispute prevention and alternative dispute resolution at the OCC Manager's Conference.
- Establishing a field advisory position to ensure that OCC employees in the field have more localized access to alternative dispute resolution services.
- Providing a wide array of internal conflict management resources and dispute resolution options.
- Working with the National Treasury Employees Union to meet the agency's legal obligations, as well as to enhance workplace fairness.
- Investing in the certification of an internal cadre of instructors to deliver training designed to enhance the communication and conflict management skills of the workforce.
- Supporting diversity through the four active affinity groups—special-interest organizations of employees who meet to discuss workplace issues and communicate with agency leaders to improve operations, personnel management, and employee effectiveness.

Technology

The OCC is committed to providing its employees with the high-quality tools they need to achieve the agency's goals. OCC information technology specialists develop enterprise information strategies, policies, and standards; oversee information technology investments; and create a secure and efficient information management environment.

Among FY 2007's key technology projects was the WISDM document management system for large bank examinations. Bank examiners and their managers will use the new system to develop, store, search, and share examination documents.

The OCC is also engaged in overhauling its print-based process to produce mission-critical publications, such as bank examination handbooks. The new technology will improve the content delivery of agency information for bank examiners, other OCC employees, national banks, and the public.

Considerable resources are being devoted to bring the OCC's employee intranet, public Web site, and National BankNet, an OCC site exclusively for national bankers, to state-of-the-art status.

Information Technology 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. In FY 2007 the Information Security Office within Information Technology Services developed and implemented a full certification and accreditation program. The program assessed the risk of OCC major applications and general support systems. The OCC also used guidance provided by the Treasury Department to update its "IT Security Policy Handbook."

The OCC also developed a Plan of Actions and Milestones program to track all IT security-related remediations. The program is also used to track findings and recommendations provided by various IT security reviews conducted under the Treasury Department's Office of the Chief Information Officer. The OCC also reduced considerably its inventory of major information systems.

The OCC's emergency management program prepares the agency to respond to emergencies that disrupt normal operations. The program ensures that the necessary plans, resources, and training are in place to deal effectively with the full spectrum of emergencies the OCC could face in today's threat environment. The OCC tested its Continuity of Operations Plan (COOP) during FY 2007 by participating in the Treasury-wide Forward Challenge '07 exercise, and updated its policies and procedures to include a comprehensive pandemic response plan.

Process Improvement

The OCC continually reviewed internal programs to improve their effectiveness and productivity. During the fiscal year, the agency:

- Reengineered its processes for new employees to facilitate and expedite processing and personnel security clearances.
- Reengineered its employee relocation process to reduce processing costs and simplify the process for employees.
- Implemented a "Quick Wins" program in the Office of Management that encourages participation by all staff in innovation and continuous improvement in operations. Program suggestions have resulted in more than $200,000 in annual savings.
- Reengineered its pre-exit clearance when staff members leave the OCC to ensure protection of sensitive bank information and documents, ensure protection of OCC assets, and minimize other risks when an employee departs.

For some reengineering projects, the OCC uses the Lean Six Sigma methodology, also used by many of the larger banks OCC regulates, 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 45 of these projects have produced approximately $3.3 million in annual savings and allowed the OCC to make more effective use of its employees.

Improving Enterprise-Wide Governance

After careful deliberation on how to better align OCC's strategic planning, quality management, and business process improvement activities with its strategic objectives and legal governance responsibilities, the Comptroller established the Enterprise-wide Governance (EG) unit in 2007.

As the Comptroller's governance support unit, EG links OCC's enterprise-wide risk management priorities to its results-oriented strategic planning process. By doing so, strategic performance goals and accompanying risk management responsibilities can be formally evaluated, in an integrated way, on a regular basis.

The restructuring involved reviewing public sector governance standards and requirements, examining OCC's corporate governance experiences over the last four decades, and benchmarking agency efforts to governance structures in other public and private sector institutions.

EG will assist the Comptroller and the Executive Committee by administering a set of governance support activities that assure:

- Strategic goals, objectives, and strategies are updated, and progress is being measured.
- Quality management programs for all major agency business processes are tested.
- OCC complies with applicable federal sector governance laws, regulations, and standards.

The EG unit also serves as liaison to the Treasury Office of the Inspector General, the Government Accountability Office, and the Office of Management and Budget.


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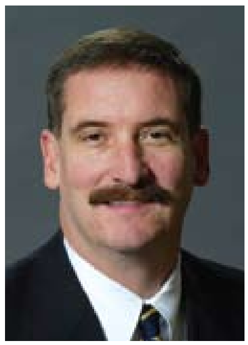
BUSINESS STRATEGY FOR MARCH

X.

Financial Management Discussion and Analysis

Letter from the Chief Financial Officer



I am pleased to present the OCC's financial statements as an integral part of the FY 2007 *Annual Report.* I am also pleased to report that for FY 2007 our independent auditors rendered an unqualified opinion with no material internal control weaknesses. The OCC's commitment to effective financial management and a strong internal control environment continues to be my highest priority.

Internal controls were strengthened last year as a result of OCC's implementation of Appendix A to Circular A-123—Management's Responsibility for Internal Controls (A-123). Now in its second year, our program is beginning to mature and yield the expected benefits of a robust internal control environment. Some of these benefits include a stronger culture of control and accountability for safeguarding OCC assets. OCC's Financial Management staff documents our financial processes, performs a risk assessment of all significant financial statement line items, and tests all critical processes. There were no material internal control weaknesses noted as a result of the testing, and where appropriate we have developed plans of corrective action to strengthen our internal controls. Additionally, plans of corrective action from the prior year have been completed.

The OCC is committed to maintaining strong controls and taking appropriate measures as required to ensure that we comply with federal security standards. An end-to-end security control review was conducted this year to identify potential internal control issues related to information technology (IT) and physical security. IT security controls related to our financial systems have been enhanced, however, our efforts continue as we address the challenges presented in this important area of our operations.

I would also like to provide a brief update on the Office of Management's Lean Six Sigma program. This program is designed to re-engineer and improve burdensome administrative processes throughout the OCC. Additionally, the program is intended to continually increase the quality of services delivered to our workforce, increase overall administrative productivity, and optimize or decrease total overhead cost. This year, 20 administrative projects were completed in Bank Supervision, the Ombudsman's Office, and the Office of Management with savings of approximately $1.7 million as reported in the Office of Management Balanced Scorecard. Key projects this year included Procurement, Recruiting and Hiring, Financial Reporting, and the Employee Relocation process.

Turning to the financial condition of the agency, OCC budgetary expenses continue to reflect the growing complexity of the national banking system and the overall increase in assets supervised by the OCC. As noted earlier in our annual report, the OCC currently supervises 68 percent of all U.S. commercial banking assets, a 19.3 percent increase from the levels of assets supervised as recently as FY 2004. The increase in bank assets supervised has required the OCC to respond with corresponding growth in bank examination staff, IT infrastructure, and office space. Although these are the primary cost drivers, because over 50 percent of our staff travel to conduct bank examinations, we have been affected by the overall increase in fuel, air travel, and hotel costs.

Currently, bank assessment revenue has adequately addressed the increase in operating costs. Since we receive no federal appropriation and must fund our operations primarily from these revenues, we review our cost performance on a continual basis. Last year, the OCC implemented an efficiency performance measure that examines the OCC costs relative to every $100,000 in assets regulated. In FY 2007 the estimated cost is $8.89, higher than last year's cost of $8.57, but this is 7 percent less than our target of $9.55. However, efficient regulation may not always translate into effective regulation. Therefore our focus from a cost perspective has been, and always will be, to ensure that the OCC uses resource levels that successfully achieve its mission to maintain the safety and soundness of the national banking system. The results of other significant agency performance measures can be found in section XIII to the *Annual Report.*

The Budget and Finance Subcommittee, which I chair, continues to closely monitor the overall financial condition of the OCC. This past year, the subcommittee continued its focus on the agency's investment activities. The subcommittee oversees the agency investment portfolio and on a quarterly basis reviews the activity and strategy of the investment committee. The subcommittee also has been actively involved in addressing the office space needs that have arisen as a result of the growth in staff. Office space will continue to be on the agenda of the subcommittee as we approach the expiration of the lease on our current headquarters location in Washington, D.C. To avoid an increase in bank assessments, each year the OCC has prudently reserved its excess bank assessment revenue, so that funds will be available to address this long-term need.

Though FY 2007 has been a year of significant achievement, the core values associated with our responsibility to oversee OCC financial operations continues to motivate us to seek out the latest trends and best practices associated with financial management. In closing, I would like to repeat my commitment from last year—to ensure that 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

Historical Perspective

In FY 2006, the Office of Management's Financial Management department (FM) focused on its commitment to customer service, stewardship, and continual process improvement. Using the balanced scorecard (BSC) to measure progress toward key business goals, FM made significant progress in FY 2006. The department's efforts were focused on implementing stringent new internal control requirements for federal agencies, carrying out several business process improvement efforts, adopting a new organizational structure to align units for efficiency and customer service, and continuing leadership development and employee engagement as measured by the Gallup employee engagement survey.

Strategic Focus

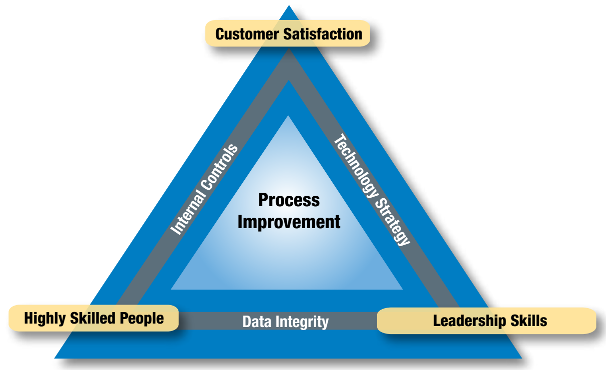
This year, FM continued to manage for results and use widely recognized best practices, such as the balanced scorecard and Lean Six Sigma. FM's strategic focus in FY 2007 has been to improve and strengthen internal controls across the department, while improving business processes and financial systems, and optimizing costs in the delivery of products and services. FM continued to focus this year on staff and leadership development, and on increasing employee engagement.

Strategic Goals

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

- An engaged workforce that is 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.
- Optimized costs in delivering products and services.

Chart 4: FM operating strategy



FM Operating Strategy

The FM operating strategy is shown in Chart 4. The strategy focuses on FM's most important business objectives, which include developing a robust process improvement program to ensure that continual improvement is an integral component of the organizational culture. As part of the department's efforts to achieve continual improvement and improve management of financial systems, FM used Lean Six Sigma as the chosen tool for business process improvement. Additional major accomplishments include improved efficiencies from the redesigned process for collecting semi-annual assessments from national banks, implementation of improvements to financial systems, continuing refinements to the department's internal control program, ongoing employee and leadership development efforts, and continued reduction of FM costs as a percentage of OCC planned operating costs.

FM secured benchmarking data for major department functional areas, and will launch an effort to benchmark operations against other entities that are known for adopting best practices. These data will be used to identify opportunities for process improvement and adopting metrics for BSC initiatives. Managers and team leaders have begun preparing recurring trend analyses to ensure that FM is anticipating and preparing for changes in the arena of federal financial management. The FM department began a new initiative to improve and ensure consistently high quality in communications with customers. FM continued to concentrate on employee development through specific training and developmental assignments for staff at all levels. The department focused again this year on developing strong leadership skills and on increasing employee engagement.

The FM Balanced Scorecard

The FM Balanced Scorecard covers performance measures and initiatives from four perspectives: customer, financial, internal processes, and learning and growth.

The customer perspective ensures that FM identifies its customers and understands their needs and expectations. FM measures performance on how well FM products and services meet those customer needs and expectations. During FY 2007, FM carried out a customer service action plan to ensure that the voice of the customer is integrated into all FM products and services. Using valuable input received from OCC customers through the 2006 annual customer satisfaction survey, FM engaged in ongoing dialogue with key customers and significantly improved the delivery of guidance and information on the agency's intranet. In August 2007, 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 customer-focused initiatives in FY 2008 and beyond.

The financial perspective ensures that FM is using the OCC's financial resources to support the OCC'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 2007, FM met its goal of maintaining operating costs at less than 1.7 percent of OCC planned operating costs. This was a decline from 1.9 percent in FY 2006.

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 2007 operating and strategic business strategies, FM processes that had known inefficiencies, especially for customers, received the most attention and effort this year. FM carried out several Lean Six Sigma business process reengineering projects for key areas, such as time and attendance reporting and travel voucher processing and auditing.

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 those skills are fully developed. In addition to each unit of FM working on Gallup Q12 employee engagement survey action plans, FM ensured that key vacancies were filled during FY 2007, and continued focusing on developing the next generation of leaders.

Looking Forward

FM will continue to focus on achieving its strategic business goals, to measure progress using the balanced scorecard, and to concentrate its efforts on continual process improvement using Lean Six Sigma as its primary tool. The department will continue to benchmark performance through key business metrics. Recognizing that financial management and financial reporting are much more than the mechanics of transaction processing and financial statement preparation, the department will continue to explore the latest business models, such as e-commerce and digitization. Finally, the department will focus on modernizing internal controls and ensuring that the agency is up-to-date with the current guidance in financial management and accounting policies.

Financial Highlights

Overview

The OCC received an unqualified opinion on its FY 2007 and FY 2006 financial statements. The financial statements include a Balance Sheet and Statements of Net Cost, Changes in Net Position, and Budgetary Resources. The financial statements and footnotes are presented on a comparative basis, providing financial information for FYs 2007 and 2006. These financial statements, which were prepared from the OCC's accounting records in conformity with the U.S. generally accepted accounting principles (GAAP) for federal agencies, summarize the OCC's financial activity and position. The financial statements, footnotes and auditor's opinion appear in Sections XI and XII of the *Annual Report.* A summary of the OCC's financial activities in FY 2007 and 2006 is presented as follows.

Assets

The OCC's assets include both "entity" and "non-entity" assets. Entity assets belong to the agency and are used to fund the OCC's operations. The OCC earns revenue through the collection of assessments from national banks, and from other income, including interest on investments in U.S. Treasury securities. Non-entity assets are assets that are held by the OCC on behalf of another federal agency or other third party. The OCC's non-entity assets are comprised of civil money penalties due to the federal government through court-enforced legal actions. Once collected, these amounts are transferred to the General Fund of the Treasury.

As of September 30, 2007, total assets of $881.5 million increased by $114.3 million or 14.9 percent from the level at September 30, 2006. This increase is primarily attributable to the changes in investments and accrued interest. The increase of $105.1 million in investments and accrued interest was attributed to a rise in assessment collections during FY 2007. Chart 5 shows the composition of the OCC's assets.

Liabilities

The OCC's liabilities represent the resources due to others or held for future recognition and are largely comprised of deferred revenue, accrued liabilities, and accounts payable. Deferred revenue represents the unearned portion of semi-annual assessments that have been collected but not yet earned. The OCC records a custodial liability for the net amount of enforcement-related receivables. Upon collection, these amounts are transferred to the General Fund of the Treasury.

As of September 30, 2007, total liabilities of $277.9 million increased by a net of $29.0 million, or 11.7 percent, over the level on September 30, 2006. The increase of $12.0 million in deferred revenue was due to a rise in assessment collections during FY 2007. The increase of $13.0 million in accounts payable and accrued liabilities was due primarily to an increase in payroll and employee benefits over last year. Chart 6 illustrates the composition of the OCC's liabilities.

Net Position

The OCC's net position of $603.6 million as of September 30, 2007, and $518.4 million as of September 30, 2006, represent the cumulative net excess of the OCC's revenues over its cost of operations since inception. This represents an increase of $85.2 million, or 16.4 percent. The majority of this increase is directly related to increases in assessment revenue. The net position is presented on both the Balance Sheet and the Statement of Changes in Net Position.

Chart 5: Composition of FY 2007 and FY 2006 assets (in millions)

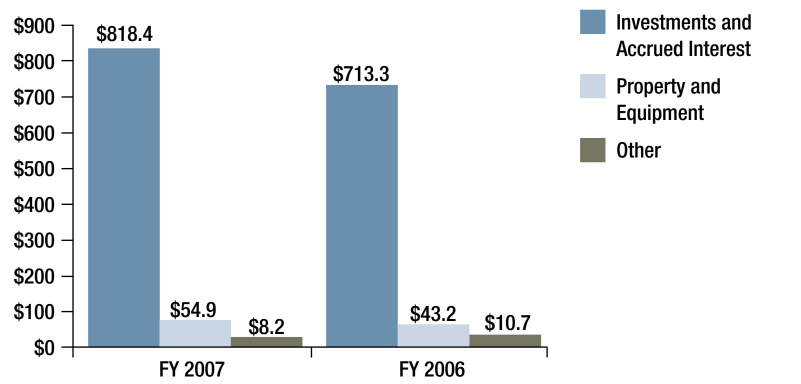


Chart 6: Composition of FY 2007 and FY 2006 liabilities (in millions)

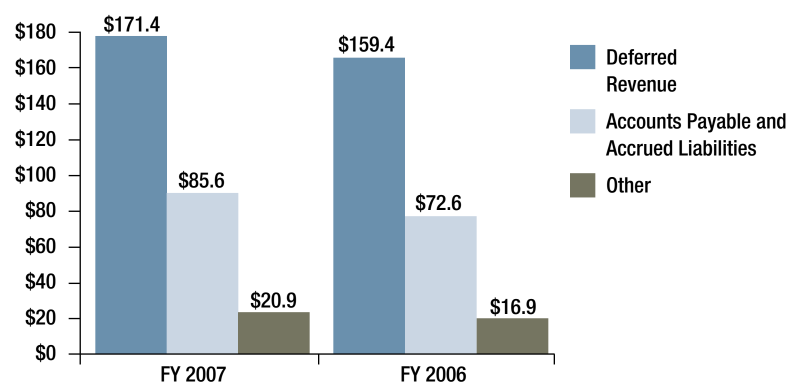
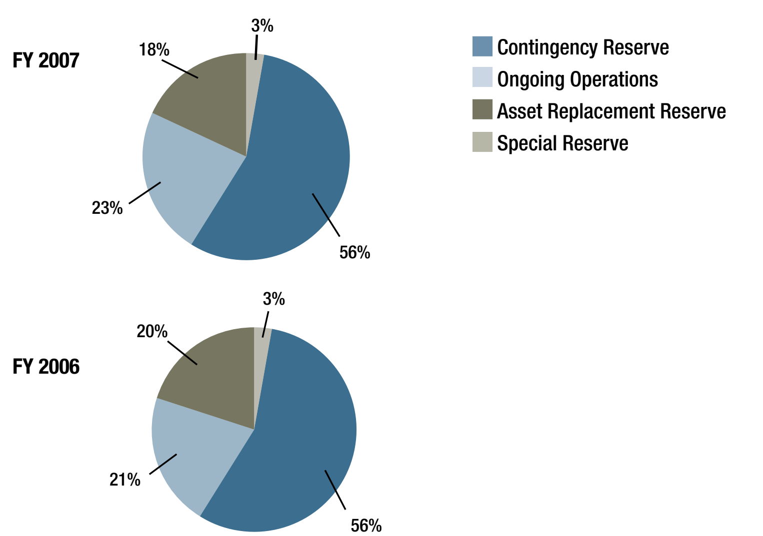


Chart 7: Composition of FY 2007 and FY 2006 net position



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 ongoing operations to cover undelivered orders, the consumption of assets, and capital investments. Chart 7 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 replacement 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.

Revenues and Costs

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 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 2007 was $671.2 million, which represents an increase of $91.8 million, or 15.8 percent, over the $579.4 million budget in FY 2006.

Total FY 2007 revenue of $695.4 million reflects a $61.8 million, or 9.8 percent, increase over FY 2006 revenues of $633.6 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. Table 9 depicts the components of total revenue for FY 2007 and FY 2006.

Table 9: Components of total revenue, FY 2007 and FY 2006 (in millions)

	FY 2007	FY 2006	Change
Assessments	$666.0	$609.5	$56.5
Investment Income	$26.6	$20.5	$6.1
Other[1]	$2.8	$3.6	($0.8)
Total Revenue	$695.4	$633.6	$61.8

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

Bank Assets and Assessment Revenue

Total assets (including federal branches) under OCC supervision increased during FY 2007 from $6.5 trillion in FY 2006 to $7.2 trillion; of this total, 86.3 percent ($6.2 trillion) is attributable to large national banks. Large banks' share of total OCC assessment revenue remains at almost 67.5 percent, followed by mid-size and community banks 29.4 percent, and federal branches 3.1 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 2007. Chart 8 shows the composition of national bank assets by large banks, mid-size banks, community banks, and federal branches for FY 2007 and FY 2006.

Investments

The book value of the OCC's portfolio on September 30, 2007 was $814.3 million, compared to $709.6 million a year earlier. The OCC invests available funds in non-marketable U.S. Treasury securities issued through the Department of Treasury's Bureau of Public Debt in accordance with the provisions of 12 USC 481 and 12 USC 192. The increase in investments of $104.7 million during the fiscal year reflects the investment of increased assessment revenue and the interest on investments held in the portfolio. The portfolio earned an annual yield for 2007 of 4.4 percent. The OCC calculates annual portfolio yield by dividing the total interest earned during the year by the average ending monthly book value of investments.

Cost of Operations

The OCC's net cost of operations is reported on the Statements of Net Cost and the Statements of Changes in Net Position. The OCC uses an activity-based time reporting system to allocate costs among 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 Statements of Net Cost present the full cost of operating the OCC's three major program areas (supervise, regulate, and charter national banks) for the years ended September 30, 2007, and 2006. Chart 9 illustrates the breakdown of costs of operations for FY 2007 and FY 2006.

The full cost presented in the Statements of Net Cost includes contributions made by the OPM on behalf of the OCC to cover the cost of the Federal Employees Retirement System and Civil Service Retirement System retirement plans, totaling $26.4 million in FY 2007 and $24.5 million in FY 2006. The total program cost increased by $62.5 million, primarily due to increases in pay and benefits, resulting from a 5.1 percent increase to full time equivalents of 2,956.6 in FY 2007 from 2,812.3 in FY 2006 and additions to or improvements in benefit programs in FY 2007. Additional contributing factors include increases to contractual services supporting maintenance and non-capitalized IT investments and imputed costs.

The full cost is reduced by earned revenues to arrive at net cost. Earned revenues increased by $61.8 million because of a rise in bank assessments earned during FY 2007. The increases in assessments are a direct result of the addition of new charters and increases in bank assets of existing charters. The influx of assets into the national banking system has increased the OCC assessment revenue. Correspondingly, the costs of supervising the national banks have risen because of the increasing size and complexity of national bank assets.

Chart 8: Composition of national bank assets as of June 30, 2007 and FY 2006 (in billions)

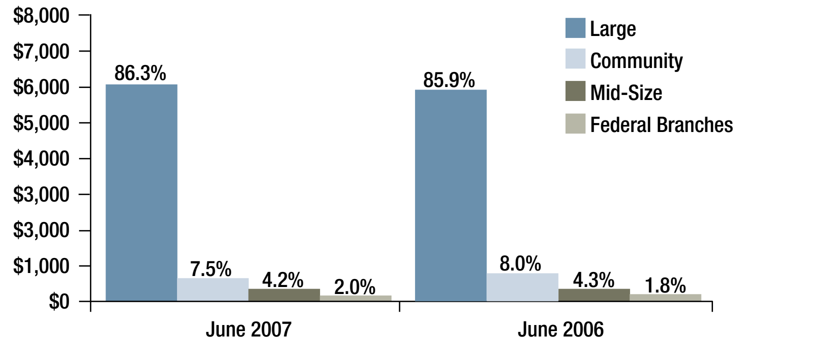
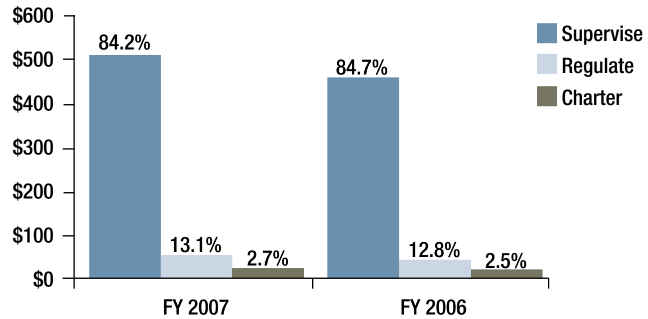


Chart 9: Costs of operations by major program, FY 2007 and FY 2006 (in millions)



Budgetary Resources

As discussed above, the OCC receives the majority of its funding from assessment revenue earned and investment income. The Statement of Budgetary Resources, designed primarily for appropriated fund activities, presents 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 $633.9 million or 94.4 percent of its FY 2007 budget of $671.2 million, with the remaining funding being applied to its asset replacement and contingency reserves.

XI.

Financial Statements and Notes

Financial Statements

Office of the Comptroller of the Currency
Balance Sheets
As of September 30, 2007 and 2006

	FY 2007	Restated FY 2006
Assets		
Intragovernmental:		
Fund balance with Treasury	$ 6,762,090	$ 9,104,809
Investments and related interest (Note 2)	818,361,022	713,281,888
Advances and prepayments	82,904	-
Total intragovernmental	**825,206,016**	**722,386,697**
Cash	11,944	12,256
Accounts receivable, net	1,347,977	1,626,336
Property and equipment, net (Note 3)	54,882,947	43,165,142
Advances and prepayments	24,193	39,031
Total assets	**$ 881,473,077**	**$ 767,229,462**
Liabilities		
Intragovernmental:		
Accounts payable and other accrued liabilities	$ 2,019,543	$ 1,894,147
Total intragovernmental	**2,019,543**	**1,894,147**
Accounts payable	7,251,284	10,005,032
Accrued payroll and benefits	22,677,144	13,902,932
Accrued annual leave	29,996,291	27,533,285
Other accrued liabilities	23,671,832	19,129,317
Deferred revenue	171,380,008	159,421,459
Other actuarial liabilities (Note 5)	20,882,737	16,986,832
Total liabilities	**277,878,839**	**248,873,004**
Net position (Note 6)	**603,594,238**	**518,356,458**
Total liabilities and net position	**$ 881,473,077**	**$ 767,229,462**

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, 2007 and 2006

	FY 2007	FY 2006
Program Costs		
Supervise National Banks		
Intragovernmental	$ 74,331,808	$ 68,025,152
With the public	462,006,442	418,553,951
Subtotal - Supervise National Banks	**$ 536,338,250**	**$ 486,579,103**
Regulate National Banks		
Intragovernmental	$ 11,790,685	$ 10,459,084
With the public	71,519,547	62,743,342
Subtotal - Regulate National Banks	**$ 83,310,232**	**$ 73,202,426**
Charter National Banks		
Intragovernmental	$ 2,462,667	$ 2,119,060
With the public	14,513,285	12,267,183
Subtotal - Charter National Banks	**$ 16,975,952**	**$ 14,386,243**
Total Program Costs (Note 7)	**$ 636,624,434**	**$ 574,167,772**
Less: Earned revenues not attributed to programs	(695,443,263)	(633,598,176)
Net Cost of Operations	**$ (58,818,829)**	**$ (59,430,404)**

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

Financial Statements *(continued)*

Office of the Comptroller of the Currency
Statements of Changes in Net Position
For the Years Ended September 30, 2007 and 2006

	FY 2007	FY 2006
Beginning Balances	$ 518,356,458	$ 434,421,291
Other Financing Sources:		
Imputed financing sources (Note 8)	26,418,951	24,504,763
Net Cost of Operations	58,818,829	59,430,404
Net Change	85,237,780	83,935,167
Ending Balances	**$ 603,594,238**	**$ 518,356,458**

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, 2007 and 2006

		FY 2007		FY 2006
Budgetary Resources				
Unobligated balance, brought forward, October 1	$	597,772,320	$	506,623,014
Spending authority from offsetting collections				
Earned				
Collected		707,929,667		649,009,263
Receivable from Federal sources		392,256		(1,034,307)
Subtotal		708,321,923		647,974,956
Total Budgetary Resources	**$**	**1,306,094,243**	**$**	**1,154,597,970**
Status of Budgetary Resources				
Obligations incurred	$	638,433,261	$	556,825,650
Unobligated balance available		667,660,982		597,772,320
Total Status of Budgetary Resources	**$**	**1,306,094,243**	**$**	**1,154,597,970**
Change in Obligated Balance				
Obligated balance, net, beginning of period				
Unpaid obligations brought forward, October 1	$	117,900,706	$	98,950,249
Uncollected customer payments from Federal sources, October 1		(3,644,462)		(4,678,768)
Total unpaid obligated balance, net		114,256,244		94,271,481
Obligations incurred		638,433,261		556,825,650
Gross outlays		(604,612,639)		(537,875,194)
Change in uncollected customer payments from Federal sources		(392,256)		1,034,307
Obligated balance, net, end of period				
Unpaid obligations		151,721,328		117,900,706
Uncollected customer payments from Federal sources		(4,036,718)		(3,644,462)
Obligated balance, net, end of period		147,684,610		114,256,244
Net outlays				
Gross outlays	$	604,612,639	$	537,875,194
Offsetting collections		(707,929,667)		(649,009,263)
Net Outlays	**$**	**(103,317,028)**	**$**	**(111,134,069)**

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

Notes to the Financial Statements

Note 1—Significant Accounting Policies

A. Reporting Entity

The OCC was created as a bureau within the U.S. Department of the Treasury by an act of Congress in 1863. The mission of OCC was 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 financial statements report on OCC's three major programs: supervise, regulate, and charter national banks. These programs support OCC's overall mission by ensuring the safety and soundness of the national banking system, fostering a flexible legal and regulatory framework that enables the national banking system to provide a full, competitive array of financial services, and promoting fair access to financial services and fair treatment of bank customers.

B. Basis of Accounting and Presentation

The accompanying financial statements present the operations of the OCC and custodial activities managed on behalf of the U.S. government. The OCC's financial statements are prepared from its accounting records in conformity with the generally accepted accounting principles (GAAP) in the United States.

The OCC's financial statements consist of Balance Sheets, and the Statements of Net Cost, Changes in Net Position, and Budgetary Resources. These financial statements are presented on a comparative basis providing information for FYs 2007 and 2006. In previous years, the OCC's financial statements also included the Statements of Custodial Activity. However, as the amounts for FY 2006 and FY 2007 are immaterial, these statements have been eliminated from the FY 2007 presentation. Should amounts become material in the future the Statements of Custodial Activity will be included in the OCC's financial statement presentation at that time. The OCC's financial information is included in the Department of the Treasury's consolidated financial statements. Transactions and balances among the OCC and other Treasury entities are eliminated from the Treasury consolidated financial statements.

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.

In accordance with federal 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.

Throughout these financial statements, intragovernmental assets, liabilities, earned revenues, and costs have been classified according to the entity responsible for these transactions. Intragovernmental assets and liabilities are defined as those occurring within or between other federal entities. Intragovernmental earned revenues are collections or accruals of revenue from other federal entities, and intragovernmental costs are payments or accruals of expenditures to other federal entities.

C. Revenues and Other Financing Sources

The OCC's revenue is derived primarily from assessments and fees paid by national banks and income on investments in U.S. Treasury 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.

D. Earmarked Funds

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 Federal Accounting Standards Advisory Board (FASAB) Statements of Federal Financial Accounting Standards (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds*, all of the OCC's revenue meets this criterion and constitutes an earmarked fund.

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 the U.S. Treasury are both parts of the federal government, the corresponding assets and liabilities offset one another 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.

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.

E. 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 non-marketable U.S. Treasury securities (Note 2). In accordance with SFFAS No. 1, *Accounting for Selected Assets and Liabilities,* the OCC has the positive intent and ability to hold these securities until maturity.

The OCC's Statements of Budgetary Resources reflect the status of its Fund Balance with Treasury. It consists of the unobligated balance amount of $667.7 million at September 30, 2007 and $597.8 million at September 30, 2006, which is included in the OCC's net investment balance of $808.6 million for FY 2007 and $702.9 million for FY 2006, and the obligated balances not yet disbursed (*e.g.,* undelivered orders) of $147.7 million for FY 2007 and $114.3 million for FY 2006. These balances reflect the budgetary authority remaining for disbursements against current or future obligations.

F. Accounts Receivable

As presented in the OCC's Balance Sheets, Accounts Receivable represent monies owed for services and goods provided. Also included are civil money penalty (CMP) amounts that, when collected, are transferred to the Treasury General Fund. CMP collections totaled $12.7 million at September 30, 2007, of which $12.3 million have been transferred to Treasury, and $3.9 million at September 30, 2006 of which $3.7 million had been transferred as of September 30, 2006. If applicable, accounts receivable from the public are reduced by an allowance for loss on doubtful accounts. In accordance with SFFAS No. 1, *Accounting for Selected Assets and Liabilities,* the OCC updates its allowance for loss on accounts receivable account annually or as needed to reflect the most current estimate of accounts that are most likely uncollectible.

The OCC's practice has been to reserve 50 percent of outstanding receivable balances between 180 and 365 days delinquent and 100 percent for outstanding balances greater than 365 days delinquent. Since CMPs are not debts due the OCC, the amount outstanding does not enter into the calculation for the allowance. In addition, debts owed by other government entities and interest receivable on investments in U.S. Treasury securities are considered collectible, and therefore also do not enter into the calculation for the allowance. The balance in the OCC's allowance for loss on accounts receivable account was $2,374 at September 30, 2007 and $52,645 at September 30, 2006.

G. Advances and Prepayments

Payments in advance for receipt of goods and services are recognized as advances or prepayments and are reported as assets on the Balance Sheet. In FY 2007, OCC participated in a simplified acquisition pilot with the Department of Interior's GovWorks, resulting in an outstanding intragovernmental balance of $82,904.

H. Property and Equipment

Property, equipment, and internal use software (Note 3) are accounted for in accordance with SFFAS No. 6, *Accounting for Property, Plant, and Equipment,* and SFFAS No. 10, *Accounting for Internal Use Software.*

I. Liabilities

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 No. 5, *Accounting for Liabilities of the Federal Government*. In accordance with SFFAS No. 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.

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 report date. The unearned portions are classified as deferred revenue.

The custodial liability amount of $1.2 million recognized represents the amount of net accounts receivable that, when collected, will be deposited to the Treasury General Fund. Included in the custodial liability are amounts collected for fines, CMPs, and related interest assessments.

The SFFAS No. 12, *Recognition of Contingent Liabilities Arising from Litigation*, defines a contingency as an existing condition, situation, or set of circumstances that involves an uncertainty as to possible gain or loss. The uncertainty will be resolved when one or more future events occur or fail to occur. The OCC recognizes contingencies as liabilities when past events or exchange transactions occur, a future loss is probable, and the loss amount can be reasonably estimated. For FY 2006 and FY 2007, the OCC neither identified nor recognized any such contingent liabilities.

J. Employment Benefits

Retirement Plan
OCC employees are eligible to participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS), depending on when they were hired by the federal government. Pursuant to the enactment of Public Law 99-335 which established the FERS, most employees hired after December 31, 1983, are automatically covered by FERS and Social Security. Employees hired prior to January 1, 1984, are covered by CSRS, with the exception of those who, during the election period, joined the FERS.

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 1.0 percent of base pay to this account. In addition, the OCC matches employee contributions up to an additional 4.0 percent of pay, for a maximum OCC contribution amounting to 5.0 percent of base pay.

OCC 401(k) Plan
In addition to the Federal Thrift Savings Plan, employees can elect to contribute up to 10.0 percent of their base pay in the OCC 401(k) Plan administered by Prudential Financial Incorporated, subject to Internal Revenue regulations. Currently, the OCC contributes a fixed 2.0 percent of the base pay to the plan for all qualified employees, regardless of whether they contribute to the plan or not. In ad-

dition, the OCC will match an additional 1.0 percent employee contribution, for a maximum OCC contribution of 3.0 percent of base pay. In both FY 2006 and FY 2007, the OCC funded a special lump sum contribution of $1,000 to be deposited in the 401(k) accounts of all permanent employees. The OCC contracted with an independent public accounting firm to perform an audit of the plan and related financial statements for the year ended December 31, 2006. The financial statements for the plan received an unqualified opinion.

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.

K. Restatements and Reclassification

In previous years, the OCC disclosed in the notes to the financial statements, CMPs due the federal government through court-enforced legal actions. For FY 2007, to more closely align its presentation with that of the Department of the Treasury's, the OCC has included these restricted, non-entity assets in its financial statements. As a result, the OCC's financial statements for FY 2006 have been restated as well. Both the "Accounts receivable, net" and the "Accounts payable and other accrued liabilities" lines on the Balance Sheet are impacted by the amount of outstanding CMPs at September 30, 2006, which totaled $1,619,114. There is no impact on Net Position.

In addition, the amounts in OCC's FY 2006 financial statements have been reclassified to more accurately reflect actuarial Federal Employees' Compensation Act (FECA) liability amounts as required by SFFAS No. 5, *Accounting for Liabilities of the Federal Government*. Amounts were previously included on the Balance Sheet as "Accrued payroll and other employee benefits." Actuarial FECA liability amounts at September 30, 2006, totaled $4,147,544 and are presented on the Balance Sheet as "Other actuarial liabilities" in accordance with fiscal year-end reporting requirements previously issued to all federal agencies by the Financial Management Service bureau of the Department of the Treasury.

L. Effects of Recent Accounting Pronouncements

Presentation of the OCC's financial statement disclosures was affected by the publication of SFFAS No. 27, *Identifying and Reporting Earmarked Funds.* All of the OCC's sources of revenue are characteristic of earmarked funds as outlined in SFFAS No. 27.

The OCC's benefits program includes a Postretirement Life Insurance Plan, a defined benefit program not typically offered within the federal government and therefore not addressed by accounting standards issued by the Federal Accounting Standards Advisory Board. For this program, the OCC follows Financial Accounting Standards Board Statement of Financial Accounting Standard (SFAS) No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. As a result, the OCC implemented SFAS 158, *Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans* in FY 2007. This standard requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its Statement of Financial Position and to recognize changes in that funded status in the year in which the changes occur. Implementation of this standard resulted in an increase to the OCC's liability for the funded portion in the amount of $3.1 million (Note 5), in accordance with the current actuarial estimate.

Note 2—Investments and Related Interest

The OCC invests available funds in non-marketable U.S. Treasury securities and has the positive intent and ability to hold all U.S. Treasury securities to maturity. It does not maintain any available for sale or trading securities. The OCC's objective is to manage risk by diversifying the OCC's portfolio across maturities within established parameters. Diversifying maturities of the individual securities is meant to help manage the inherent risk of interest rate fluctuations. As part of its investment strategy, the OCC evaluates, at least annually, performance benchmarks with objectives and holdings comparable to those within the OCC's investment portfolio.

Investments are stated at amortized cost and the related accrued interest. Premiums and discounts are amortized over the term of the investment using the effective yield method. The fair market value of investment securities was $815.9 million at September 30, 2007, and $703.7 million at September 30, 2006. The total return on the OCC's portfolio, which includes income from interest and the change in the market value of the securities held in the portfolio during the reporting period, was 6.2 percent and 3.5 percent, respectively. The overall portfolio earned an annual yield of 4.4 percent for FY 2007 and 4.0 percent for FY 2006.

The yield-to-maturity on the non-overnight portion of the OCC's investment portfolio ranged from 2.9 percent to 4.9 percent in FY 2007, and from 2.4 percent to 4.9 percent in FY 2006.

FY 2007 Investments and Related Interest

Intragovernmental Securities	Cost	Amortization Method	Amortized (Premium)/ Discount	Investment, Net	Market Value Disclosure
Non-Marketable Market Based	$ 815,967,809	Effective Yield	(1,643,505)	814,324,304	$ 815,902,463
Accrued Interest	4,036,718		0	4,036,718	4,036,718
Total Intragovernmental Interest	**$ 820,004,527**		**(1,643,505)**	**818,361,022**	**$ 819,939,181**

FY 2006 Investments and Related Interest

Intragovernmental Securities	Cost	Amortization Method	Amortized (Premium)/ Discount	Investment, Net	Market Value Disclosure
Non-Marketable Market Based	$ 712,871,813	Effective Yield	(3,234,387)	709,637,426	$ 703,712,750
Accrued Interest	3,644,462		0	3,644,462	3,644,462
Total Intragovernmental Interest	**$ 716,516,275**		**(3,234,387)**	**712,281,888**	**$ 707,357,212**

Note 3—Property and Equipment, net

Property and equipment purchased at a cost greater than or equal to the thresholds noted on the following charts with useful lives of three 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. The following tables summarize property and equipment balances as of September 30, 2007, and 2006.

FY 2007 Property and Equipment, net

Class of Assets	Capitalization Threshold/ Useful Life		Cost	Accumulated Depreciation	Net Book Value
Leasehold Improvements	$ 50,000	5-20	$ 28,480,815	$ (21,989,589)	$ 6,491,226
Equipment	$ 50,000	3-10	26,941,592	(18,213,271)	8,728,321
Internal Use Software	$500,000	5	39,922,748	(27,290,315)	12,632,433
Internal Use Software-Dev	$500,000	N/A	22,583,709	-	22,583,709
Leasehold Improvements-Dev	$ 50,000	N/A	4,447,258	-	4,447,258
Total			**$ 122,376,122**	**$ (67,493,175)**	**$ 54,882,947**

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	3-10	21,952,518	(13,920,781)	8,031,737
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**

Note 4—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 2007, the OCC entered into 60-month occupancy agreements in various locations throughout the continental United States as current leases expire. These leases are treated as operating leases. All annual lease costs under the operating leases are included in the Statements of Net Cost.

FY 2007 Future Lease Payments

Year	Amount
2008	$ 29,064,300
2009	28,735,823
2010	27,189,128
2011	21,338,482
2012	9,068,922
2013 and beyond	18,780,610
Total	**$ 134,177,265**

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**

Note 5—Other Actuarial Liabilities

OCC's other actuarial liabilities are reported on the Balance Sheets and include the components as shown in the following table.

Actuarial Liabilities

Component	FY 2007	FY 2006
Federal Employee's Compensation Act (FECA)	$ 3,418,308	$ 4,147,544
Postretirement Life Insurance Benefits	17,464,429	12,839,288
Total Other Actuarial Liabilities	**$ 20,882,737**	**$ 16,986,832**

Federal Employees Compensation Act

The FECA provides income and medical cost protection to cover 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 covered under FECA are administered by the U.S. Department of Labor and later billed to the OCC. The FY 2007 present value of these estimated outflows are calculated using a discount rate of 4.9 percent in the first year and 5.1 percent in subsequent years.

Postretirement Life Insurance Benefits

The OCC sponsors a life insurance benefit plan for current and retired employees. This plan is a defined benefit plan. The following table sets forth the plan's funded status reconciled with the actuarial liability.

Accrued Postretirement Benefit Liability and Net Periodic Postretirement Benefit Cost

Liability Component	FY 2007	FY 2006
Accumulated Postretirement Benefit Obligation	$ 17,464,429	$ 17,354,262
Unrecognized Transition Obligation	(864,197)	(1,037,034)
Unrecognized Net Gain	(2,279,106)	(3,477,940)
SFAS 158 Funded Status Adjustment	3,143,303	0
Total Postretirement Benefit Liability	**$ 17,464,429**	**$ 12,839,288**
Cost Component		
Service Cost	$ 598,961	$ 583,972
Interest Cost	967,799	923,884
Amortization of Transition Obligation	172,837	172,837
Amortization of Unrecognized Loss	148,431	273,864
Total Postretirement Benefit Cost	**$ 1,888,028**	**$ 1,954,557**

The actuarial cost method used to determine costs for the retirement plans is the Projected Unit Credit method, a benefit valuation method, according to SFAS No. 87, *Employers Accounting for Pensions*. The weighted-average discount rate used in determining the accumulated postretirement benefit obligation was 6.0 percent. Gains or losses due to changes in actuarial assumptions are amortized over the service life of the plan. The actuarial assumptions and methods used in calculating actuarial amounts comply with the requirements for postretirement benefits other than pensions as set forth in SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* and for health benefit plans as set forth in AICPA Statement of Position 92-6.

Net periodic postretirement benefit costs for life insurance provisions under the plan include the components as shown in the previous table. The total benefit expenses are recognized as program costs in the Statements of Net Cost.

Note 6—Net Position

Net Position represents the net result of operations since inception, and includes cumulative amounts related to investments in capitalized assets. The OCC is affected by the publication of SFFAS No. 27, *Identifying and Reporting Earmarked Funds.* All of the OCC's revenues and financing sources constitute earmarked funds.

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 ongoing 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 for 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 2007	FY 2006
Contingency Reserve	$ 340,256,659	$ 291,689,618
Asset Replacement Reserve	111,200,000	104,000,000
Special Reserve	15,000,000	15,000,000
Set Aside for Ongoing Operations:		
Undelivered Orders	50,972,975	30,068,275
Consumption of Assets	60,742,789	49,930,100
Capital Investments	25,421,815	27,668,465
Net Position	**$ 603,594,238**	**$ 518,356,458**

Note 7—Total Program Costs

The following table illustrates the OCC's operating expenses for FY 2007 and FY 2006.

Operating Expenses

Expense Category	FY 2007	FY 2006
Personnel Compensation and Benefits	$ 423,596,167	$ 376,550,302
Contractual Services	77,945,521	71,813,368
Travel and Transportation of Persons and Things	41,099,328	37,563,564
Rent, Communicaton, and Utilities	36,486,810	34,417,329
Imputed Costs	26,418,951	24,504,763
Depreciation	12,112,108	12,147,306
Other	18,965,549	17,171,140
Total	**$ 636,624,434**	**$ 574,167,772**

Note 8—Imputed Costs and Financing Sources

In accordance with SFFAS No. 5, *Liabilities of the Federal Government*, federal agencies must recognize the portion of employees' pension and other retirement benefits to be paid by the OPM trust funds. These amounts are recorded as imputed costs and imputed financing for other agencies. OPM provides federal agencies with cost factors for the computation of current year imputed costs. These cost factors are multiplied by the current year salary or number of employees, as applicable, to provide an estimate of the imputed financing that the OPM trust funds will provide for each agency.

The imputed costs categories for FY 2007 and FY 2006 are listed as follows. These imputed costs are included on the Statements of Net Cost. The financing sources absorbed by OPM are reflected on the Statements of Changes in Net Position and in Note 9, Reconciliation of Net Cost of Operations to Budget.

Imputed Costs Absorbed by OPM

Component	FY 2007	FY 2006
Retirement	$ 10,971,155	$ 10,756,713
Federal Employees Health Benefits	15,417,724	13,720,896
Federal Employees Group Lfe Insurance	30,072	27,154
Total Imputed Costs Covered by Others	**$ 26,418,951**	**$ 24,504,763**

Note 9—Reconciliation of Net Cost of Operations to Budget

The reconciliation of Net Cost of Operations to Budget demonstrates the relationship between OCC's proprietary (net cost of operations) and budgetary accounting (net obligations) information. For FY 2007, the following table shows $43.5 million in excess resources available to finance activities, a net decrease of $23.1 million over September 30, 2006. This net decrease resulted from a $60.3 million increase in resources available netted against the increase of $81.6 million in resources used (obligations incurred) and the $1.9 million increase in imputed financing. The increase in net resources available is primarily because of increased assessments, while the increase in resources used results from various office space and IT investments as well as salary and employee benefits.

Reconciliation of Net Cost of Operations to Budget

	FY 2007	FY 2006
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
Obligations incurred	$ 638,433,261	$ 556,825,650
Less: Spending authority from offsetting collections	(708,321,923)	(647,974,956)
Net obligations	(69,888,662)	(91,149,306)
Other Resources		
Imputed financing sources (Note 8)	26,418,951	24,504,763
Total resources used to finance activities	**(43,469,711)**	**(66,644,543)**
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	(16,455,629)	(10,258,699)
Resources that finance the acquisition of assets	(24,244,583)	(13,105,666)
Other resources or adjustments to net obligated resources that do not affect net cost of operations	(107,415)	263,333
Total resources used to finance items not part of the net cost of operations	**(40,807,627)**	**(23,101,032)**
Total resources used to finance the net cost of operations	**$ (84,277,338)**	**$ (89,745,575)**
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	11,958,547	12,757,084
Total components that will require or generate resources in future periods	11,958,547	12,757,084
Components not Requiring or Generating Resources:		
Depreciation and amortization	12,112,109	12,147,307
Net decrease in bond premium	973,181	1,426,622
Other	414,672	3,984,158
Total components that will not require or generate resources	13,499,962	17,558,087
Total components of net cost of operations that will not require or generate resources in the current period	**25,458,509**	**30,315,171**
Net Cost of Operations	**$ (58,818,829)**	**$ (59,430,404)**

XII.

Independent Auditor's Reports

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Independent Auditor's Report on Financial Statements

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, 2007 and 2006, and the related statements of net cost, changes in net position and budgetary resources 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 applicable provisions of Office of Management and Budget Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements.* Those standards require that we plan and perform the audits 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, 2007 and 2006, and its net costs, changes in net position, and budgetary resources for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As more fully described in Note 1, OCC has restated its Balance Sheet as of September 30, 2006 to include Civil Monetary Penalties due to the Federal government to more closely align its presentation with that of the Department of the Treasury's financial statement presentation.

The information in Sections III through X of OCC's fiscal year 2007 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 we express no opinion on it.

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, II, and XIII of OCC's fiscal year 2007 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 we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued reports dated October 31, 2007, 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 should be read in conjunction with this report in considering the results of our audits.

GKA, P.C.

October 31, 2007

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Independent Auditor's Report on Internal Control over Financial Reporting

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

We have audited the balance sheet and the related statements of net cost, changes in net position, and budgetary resources, hereinafter referred to as "financial statements" of the Office of the Comptroller of the Currency (OCC) as of and for the year ended September 30, 2007, and have issued our report thereon dated October 31, 2007. We conducted our audit 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 applicable provisions of Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements.*

In planning and performing our audit, we considered the OCC's internal control over financial reporting by obtaining an understanding of the design effectiveness of OCC's internal control, determined whether these 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 described in OMB Bulletin No. 07-04 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 audit was not to provide an opinion on internal control over financial reporting. Consequently, we do not provide an opinion on internal control over financial reporting.

Our consideration of the internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily disclose all deficiencies in internal control over financial reporting that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. Under standards issued by the American Institute of Certified Public Accountants, a control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the OCC's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles, such that there is more than a remote likelihood that a misstatement of the OCC's financial statements that is more than inconsequential will not be prevented or detected by the OCC's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the OCC's internal control. We noted a certain matter discussed in Exhibit 1 involving the internal control over financial reporting and its operation that we consider to be a significant deficiency. However, we do not believe this significant deficiency is a material weakness.

We also noted another matter involving the internal control and its operation that we reported to management of OCC in a separate letter dated October 31, 2007.

Finally, with respect to internal control related to performance measures determined by management to be key and reported in Section III through X and XIII of the OCC's fiscal year 2007 Annual Report, we obtained an understanding of the design of internal control relating to the existence and completeness assertions and determined whether they have been placed in operation, as required by OMB Bulletin No. 07-04. Our procedures were not designed to provide an opinion on internal control 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 Management of the OCC, the Department of the Treasury Office of Inspector General, the Government Accountability Office, OMB, and the U.S. Congress, and is not intended to be, and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

GKA, P.C.

October 31, 2007

Exhibit 1: Significant Deficiency—
Improvements Needed in Information Technology General Controls over OCC's Financial Systems.

Improvements Needed in Information Technology General Controls over OCC's Financial Systems. (Repeat Condition)

In our fiscal year (FY) 2006 audit, we identified weaknesses in the areas of entity-wide security program planning and management, access controls, service continuity, and application software development and change control**.** We reported these weaknesses to management in our report on internal control over financial reporting (report). Since these weaknesses were identified, OCC has made progress by devoting the resources for resolving these weaknesses within its information technology (IT) environment as evidenced by OCC's Plan of Actions and Milestones (POAM) and our verification of correction of many of the prior year issues. However, in our review this year we noted certain weaknesses in OCC's IT general controls. These weaknesses are summarized below. Detailed findings and related recommendations will be provided to management in a separate Sensitive But Unclassified management report dated October 31, 2007.

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. As a result of our FY 2007 audit, we concluded that OCC needs to strengthen its controls over implementation of requirements pertaining to the administration of the security awareness training; recordkeeping of users' access agreements; completion of exit process for terminated employees; and testing and updating its computer incident response capability.

Access Controls

Access controls limit and/or detect access to computer resources (data, programs, equipment, and facilities). This protects these resources against unauthorized modification, loss and disclosure. During our FY 2007 audit, we determined that OCC needs to strengthen its controls over implementation of requirements pertaining to the password configuration setting for one of its systems; revoking unnecessary access accounts; and recordkeeping of management approval and recertification of access to sensitive areas.

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. As a result of our FY 2007 audit, we determined that OCC needs to strengthen its controls over implementation of requirements pertaining to the performance of a cost-benefit analysis to support its selection of an off-site storage close to the main processing facility; maintenance of consistency between Contingency Planning documents; finalizing the Information Technology Recovery Plan (ITRP); development of a formal emergency response training program for Data Center personnel; and mitigation of the risk associated with the overheating of the Data Center telecommunication room until the planned air conditioner installation takes place.

System Software

System software is a set of programs designed to operate and control the processing activities of computer equipment. Controls are aimed at reducing exposure to security vulnerabilities. In FY 2007, we determined that: OCC needs to strengthen its controls over proper approval and recordkeeping of access authorization forms for domain or system administrators; consider upgrading to a newer version of PeopleSoft that will run on a server that has better security for server authenticated accounts; and update $MART Database production server with software for which the vendors provide support.

Application Software Development and Change Control

Application software development and change controls prevent unauthorized programs or modifications to an existing program from being implemented. Our FY 2007 audit revealed that OCC needs to fully implement the necessary Microsoft Systems Management Server capabilities to automatically and promptly detect and remove unauthorized personal and public domain software from OCC systems (desktops).

MANAGEMENT'S RESPONSE

OCC's management concurs with the significant deficiency described in this report. Corrective actions are underway to address each recommendation and management is confident that they will be able to rectify these deficiencies before the next annual report cycle is completed.

OCC's response has not been subjected to the auditing procedures applied in the audit of the financial statements and accordingly, we express no opinion on it.

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Independent Auditor's 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 and the related statements of net cost, changes in net position, and budgetary resources, hereinafter referred to as "financial statements" of the Office of the Comptroller of the Currency (OCC) as of and for the years ended September 30, 2007 and 2006, and have issued our report thereon dated October 31, 2007. 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 applicable provisions of Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*.

The management of the OCC is responsible for complying with laws and regulations applicable to the OCC. As part of obtaining reasonable assurance about whether the OCC's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and 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. 07-04, 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* or OMB Bulletin No. 07-04.

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.

Member of the American Institute of Certified Public Accountants

The results of our tests disclosed one instance in which the OCC's financial management systems did not substantially comply with federal financial management system requirements related to information technology general controls, which is described in Exhibit 1 of our Report on Internal Control over Financial Reporting dated October 31, 2007.

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 Management of the OCC, the Department of the Treasury Office of Inspector General, the Government Accountability Office, OMB, and U.S. Congress and is not intended to be, and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

GKA, P.C.

October 31, 2007

XIII.

Other Accompanying Information

Performance Measures and Results

The OCC's FY 2007 performance measures, workload indicators, customer service standards, and results are presented as follows.

Table 10: Performance measures, FY 2004–FY 2007

Strategic Goal	Performance Measure Workload Indicator Customer Service Standard	FY 2004	FY 2005	FY 2006	FY 2007 Target	FY 2007 Actual[1]
I. A safe and sound national banking system						
	Percentage of national banks with composite CAMELS rating of 1 or 2	94%	94%	95%	94%	***96%***
	Rehabilitated problem national banks as a percentage of the problem national banks one year ago (CAMELS 3, 4 or 5)	40%	44%	46%	40%	***52%***
	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%	N/A[2]	100%	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]	1.30	1.28	1.30	< 1.75	1.32
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%	94%	94%	94%	***97%***
	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	36%	80%	18%
	Number of consumer complaints opened/closed during the fiscal year[5]	N/A N/A	N/A N/A	31,827 32,925	38,000 36,000	33,655 26,245

[1] FY 2007 performance numbers shown in bold italics are estimates. Some performance data is obtained from quarterly call reports from banks. The September 30, 2007 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. While the number of consumer complaints opened during FY 2007 increased, the rate was less than projected. Performance numbers for FY 2007 are consistent with the performance numbers reported for the final two quarters for FY 2006.

[5] See note 4 above.

Table 10: Performance measures, FY 2004–FY 2007 *(continued)*

Strategic Goal	Performance Measure Workload Indicator Customer Service Standard	FY 2004	FY 2005	FY 2006	FY 2007 Target	FY 2007 Actual[1]
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%	86%	89%	86%	96%
	Number of external legal opinions issued during the fiscal year	119	119	70	120	81[6]
	Percentage of licensing applications and notices filed electronically	34%	38%	36%	40%	38%[7]
	Number of licensing applications and notices filed electronically during the fiscal year	893	1,256	1,367	1,600	1,261[8]
	Percentage of licensing applications and notices completed within established time frames	96%	96%	94%	95%	96%
	Number of licensing applications and notices completed during the fiscal year	2,477	2,128	2,425	2,000	2,278
	Average survey rating of the overall licensing services provided by OCC[9]	1.20	1.19	1.2	< 1.5	1.2
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	$8.57	$9.55	***$8.89***

[6] For FY 2007 the number of external legal opinions issued during the fiscal year is below target because legal opinions are initiated externally by banks requesting interpretations from the OCC, and the OCC can only base projections on past history and anticipated activity.

[7] The OCC did not meet the target of receiving 40 percent of all licensing application and notice filings electronically (38 percent actual) because most of our large volume application filers have already become regular electronic filers. Rate of adoption by new electronic filers has leveled off. Lower volume filers are reluctant to adopt a new system that they are not likely to use frequently.

[8] The number of total licensing filings has declined from the previous FY. Correspondingly, the number of electronic filings has also declined, but the percentage of electronic filings has increased from the previous FY.

[9] The licensing survey is based on a five-point scale, in which 1 indicates outstanding and 5 indicates significantly deficient.

Improper Payments Information Act

The Improper Payments Information Act of 2002 (IPIA), as implemented by the Office of Management and Budget, requires federal agencies to review all program and activities annually and identify those that may be susceptible to significant erroneous payments. The OCC analyzed payments (excluding payroll) made during FY 2007 and identified 78 erroneous payments requiring adjustments totaling $272,570. 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. Table 11 summarizes the OCC's erroneous payments for FYs 2007 and 2006.

Table 11: Erroneous payments, FY 2007 and 2006

	FY 2007	FY 2006
Number of payments	78	89
Dollar value of adjustments	$272,570	$141,120

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.

Audits

Two audit reports issued by the U.S. Government Accountability Office (GAO) during the year resulted in recommendations designed to improve OCC service to the entities it oversees. GAO recommended that the OCC add more transparency and overcome impediments in the rulemaking process for implementation of the Basel II risk-based capital framework. GAO also suggested that the OCC could do more to address the needs of minority-owned financial institutions and recommended that the OCC measure the effectiveness of its program regularly.

Disaster preparedness was the common theme for other reports issued by the GAO and the Treasury Department Office of the Inspector General (OIG). GAO expressed concern that institutions supervised by the OCC had not planned sufficiently for the possibility of a pandemic. Also the OIG noted that the OCC could further strengthen its ability to assess risks to community banks during emergencies, such as hurricanes Katrina and Rita.

Corrective actions are planned and are well under way.

Assurance Statement

The Office of the Comptroller of the Currency (OCC) has made a conscientious effort during fiscal year (FY) 2007 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 2007. Specifically, this assurance is provided relative to Sections 2 and 4 of the Federal Managers' Financial Integrity Act (FMFIA).

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, 2007 was operating effectively, and no material weaknesses were found in the design or operation of the internal control over financial reporting.

OCC continues to address financial management systems deficiencies identified by external auditors in FY 2006 and FY 2007. Accordingly, I am reporting a lack of substantial compliance with the requirements imposed by the Federal Financial Management Improvement Act (FFMIA).

Significant Control Deficiency

In FY 2006 and FY 2007, external auditors found that the OCC needed to improve its IT controls over financial management systems. Specifically, they identified IT deficiencies related to security program planning, service continuity, selected access and change controls, and system software administration. The FY 2007 financial audit continues, but external auditors have noted that OCC has made significant progress. The OCC certification and accreditation program is now compliant with NIST and OMB standards; interconnection security agreements have been developed and approved; security awareness procedures have been improved; and, system security plans have been completed. This area continues to warrant management attention, and a plan of corrective actions is in place to address these issues during FY 2008.

Other Control Deficiency

In FY 2006, I also brought to your attention physical and computer security issues that were receiving heightened management attention. These issues highlighted the risks facing the agency in safeguarding sensitive information. I 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 was completed in July 2007 and resulted in recommendations for improvement. A project task force has developed an implementation plan to address these recommendations.

Analytical Basis of Assurance Statement

OCC evaluated its management controls in accordance with the FY 2007 Secretary's Assurance Statement Guidance of July 12, 2007, signed by Richard Holcomb, Deputy Chief Financial Officer, and also considered the following guidance:

- OMB Circular A-123, Management Accountability and Control;
- OMB Circular A-127, Financial Management Systems;
- OMB Circular A-130, Management of Federal Information Resources; and
- Treasury Directive 40-04, Treasury Internal (Management) 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 2007;
- Results of internal control testing under OMB Circular A-123, Appendix A;
- Executive Committee descriptions of business unit quality management programs;
- Results of internal audits and reviews;
- Results of control self-assessments completed by OCC managers in FY 2007;
- 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 2007;
- 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 2006 financial statements; and
- Gardiner, Kamya and Associates' status report of October 19, 2007, on the FY 2007 financial statement audit.

John C. Dugan
Comptroller of the Currency
November 1, 2007

XIV.

Index

A

B

C

D

E

F

Q

R

S

T

U

W

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