“The Year in Review”
19th Annual Capital Markets Conference
Federal Reserve Bank of Chicago
December 9, 2013

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Agenda

• Condition of the banking system
• Key Market Events in 2013
• Update on key Dodd-Frank Act rules
  – Volcker Rule
  – Swap Margin Rule
  – Risk Retention Rule
Condition of the Federal Banking System

Third Quarter, 2013
Highlights

- System net income weaker recently due to large one-off items and lower noninterest income

- Weak European economy still faced with lingering structural issues despite calmer market perceptions

- 2014 asset quality reviews and stress tests key factors affecting banking system/financial markets
With data through September, system profitability now tracking at 10% for 2013
National banks and federal thrifts

<table>
<thead>
<tr>
<th></th>
<th>3Q:12</th>
<th>3Q:13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large banks</td>
<td>9.8</td>
<td>9.0</td>
</tr>
<tr>
<td>Midsize</td>
<td>10.0</td>
<td>8.9</td>
</tr>
<tr>
<td>Community</td>
<td>7.7</td>
<td>7.8</td>
</tr>
</tbody>
</table>

Source: Integrated Banking Information System (OCC)

2013 data as of September 30, 2013 (annualized); all other data as of year-end. Sum-of-quarterly net income as a share of 5-quarter trailing average equity. 2008 results are modified with estimates from Y-9 to restore missing data due to purchase accounting treatment of WaMu (3Q:08), Wachovia and NCC (4Q:08). Thrift data not available (not included in chart) prior to 1984.
**System net income has weakened in past two quarters**

**National banks and federal thrifts**

<table>
<thead>
<tr>
<th></th>
<th>System</th>
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<th>Midsize</th>
<th></th>
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<th>Community</th>
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<tbody>
<tr>
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<td>3Q:12</td>
<td>4Q:12</td>
<td>1Q:13</td>
<td>2Q:13</td>
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<td>3Q:12</td>
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<td>3Q:13</td>
<td>3Q:12</td>
<td>2Q:13</td>
<td>3Q:13</td>
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<tr>
<td><strong>Revenues</strong></td>
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</tr>
<tr>
<td>Net interest income</td>
<td>71.8</td>
<td>71.1</td>
<td>70.8</td>
<td>70.3</td>
<td>70.4</td>
<td>5.4</td>
<td>5.4</td>
<td>5.5</td>
<td>5.9</td>
<td>5.8</td>
<td>5.9</td>
</tr>
<tr>
<td>Noninterest income</td>
<td>46.3</td>
<td>46.3</td>
<td>49.1</td>
<td>48.3</td>
<td>42.0</td>
<td>3.8</td>
<td>3.4</td>
<td>2.7</td>
<td>2.5</td>
<td>2.5</td>
<td>2.4</td>
</tr>
<tr>
<td>Realized Sec. G/L</td>
<td>1.7</td>
<td>0.9</td>
<td>1.6</td>
<td>0.9</td>
<td>0.5</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.2</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provisioning</td>
<td>10.8</td>
<td>11.1</td>
<td>8.3</td>
<td>6.1</td>
<td>3.6</td>
<td>0.6</td>
<td>0.3</td>
<td>0.2</td>
<td>0.5</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Noninterest expense</td>
<td>72.1</td>
<td>74.7</td>
<td>70.3</td>
<td>73.4*</td>
<td>73.8</td>
<td>5.7</td>
<td>5.3</td>
<td>5.4</td>
<td>5.9</td>
<td>5.9</td>
<td>6.0</td>
</tr>
<tr>
<td>Income taxes</td>
<td>10.6</td>
<td>9.0</td>
<td>12.8</td>
<td>14.0</td>
<td>11.4</td>
<td>0.9</td>
<td>1.0</td>
<td>0.8</td>
<td>0.5</td>
<td>0.6</td>
<td>0.4</td>
</tr>
<tr>
<td>Net income</td>
<td>26.2</td>
<td>23.4</td>
<td>29.9</td>
<td>25.8*</td>
<td>24.3</td>
<td>2.0</td>
<td>2.1</td>
<td>1.9</td>
<td>1.7</td>
<td>1.6</td>
<td>1.7</td>
</tr>
</tbody>
</table>

* Includes RBS Citizens $3.7 billion goodwill expense.

Source: Integrated Banking Information System (OCC)

Data are merger-adjusted and held constant for institutions in continuous operation from 1Q:06 to 3Q:13 and use the current supervision designations.
System 3Q noninterest income decline driven by servicing revenue, loan sale losses and trading
National banks and federal thrifts

Noninterest income, $ billions

Reflects “London Whale” losses

Source: Integrated Banking Information System (OCC)
Data are merger-adjusted and held constant for institutions in continuous operation from 1Q:06 to 3Q:13.
Large one-off items at two banks behind recent uptick in system noninterest expenses

National banks and federal thrifts

Noninterest expense, $ billions

- Goodwill & Impairment losses
- Other noninterest expense
- Salaries
- Premises

Source: Integrated Banking Information System (OCC)

Data are merger-adjusted and held constant for institutions in continuous operation from 1Q:06 to 3Q:13.
System provisions are back to record low shares of both total loans and pre-provision net revenue.

National banks and federal thrifts

Provisions to loans, %

Provisions to PPNR, %

Source: Integrated Banking Information System (OCC)

* 2013 data as of September 30, 2013 (annualized). PPNR is net interest income plus noninterest income minus noninterest expense.
System reserve coverage ratio and provisions as a share of charge-offs also at long-term lows
National banks and federal thrifts

Reserves to noncurrent loans, %
Provisions to net charge-offs, %

Source: Integrated Banking Information System (OCC)

* 2013 data as of September 30, 2013 (annualized).
System net charge-off rate below average for most loan types in 3Q; HELOCs at average

National banks and federal thrifts

Net charge-off rates, percent annualized

Post-2007 quarterly peak

Post-1990 quarterly avg

Historical peak 3Q:92

Current share of loans*:

<table>
<thead>
<tr>
<th>Category</th>
<th>3Q:11</th>
<th>3Q:12</th>
<th>3Q:13</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>2</td>
<td>21</td>
<td>8</td>
</tr>
<tr>
<td>Construct</td>
<td>9</td>
<td>25</td>
<td>9</td>
</tr>
<tr>
<td>1-4 fam</td>
<td>11</td>
<td>8</td>
<td>21</td>
</tr>
<tr>
<td>HELOC</td>
<td>9</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>Nonres mortg</td>
<td>25</td>
<td>9</td>
<td>11</td>
</tr>
<tr>
<td>C &amp; I</td>
<td>9</td>
<td>25</td>
<td>11</td>
</tr>
<tr>
<td>Installment</td>
<td>21</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>Credit card</td>
<td>8</td>
<td>11</td>
<td>9</td>
</tr>
</tbody>
</table>

Source: Integrated Banking Information System (OCC)

Not all detail loan categories are shown.
European Economic Update

- European financial market fears have quieted, but fundamental economic imbalances remain

- ECB asset quality review (AQR) and stress tests are key issue for Euro area in 2014

- Bank need to bolster capital ratios may continue to limit credit growth, slowing recovery
  - Weak Europe will continue to weigh on US (and global) growth
  - Reaction to stress tests could upset US financial markets
ECB actions quelled immediate risk of a Eurozone collapse, but structural problems remain

Sources: Sentix investor survey; Merrill Lynch

Bond spreads are monthly data through October 2013 (last data point is November 18, 2013). Long-term refinancing operations (LTROs) and Outright Monetary Transactions announcement (OMT) are policies by the European Central Bank designed to ensure adequate financial market liquidity to the Eurozone economy.
Structural challenges remain in government debt, particularly for Spain

General government gross debt, percent of GDP
- France
- Germany
- Italy
- Spain
- Maastricht Treaty

General government primary balance, percent of GDP

Sources: Haver Analytics, IABC estimates for 2013
Europe’s economy is very weak and could remain so for some time, dragging down global growth.

### Unemployment Rates

<table>
<thead>
<tr>
<th></th>
<th>10-yr Avg</th>
<th>Sep 2013</th>
<th>Change since Jan. 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>8.1</td>
<td>5.2</td>
<td>1/3rd lower</td>
</tr>
<tr>
<td>France</td>
<td>9.4</td>
<td>11.1</td>
<td>Up by 1/2</td>
</tr>
<tr>
<td>Italy</td>
<td>8.2</td>
<td>12.5</td>
<td>Double</td>
</tr>
<tr>
<td>Spain</td>
<td>15.6</td>
<td>26.6</td>
<td>Up 3 fold</td>
</tr>
<tr>
<td>Euro Area</td>
<td>9.5</td>
<td>12.2</td>
<td>2/3rds higher</td>
</tr>
</tbody>
</table>

### Real GDP

<table>
<thead>
<tr>
<th>Region</th>
<th>Yr-yr % chg</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td></td>
</tr>
<tr>
<td>Euro Area</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td></td>
</tr>
<tr>
<td>US</td>
<td></td>
</tr>
</tbody>
</table>

Source: Haver Analytics
Core EA banking system exposure to Italy and Spain has declined, but still high share of capital.

Exposures are on ultimate risk basis (borrower location).

Sources: SNL; BIS
Real GDP and unemployment trends in largest European countries

Real GDP, Index 1Q:2008=100

Unemployment, Index Jan. 2008=100

Source: Haver Analytics
Real GDP are quarterly data through 2013Q3. Unemployment are monthly data through September 2013.
Key Market Events in 2013
Key Events in 2013

- Bubble trouble?
- Taper tease
- Banks, write your checks!
- Reserve releases redux
- Vanishing Volatility and VaR
- Municipal malaise
- Operational risk revival
- Mortgage business blues
- CFTC saga and cross-border disorder
- Fiscal follies
- Bitcoin??
Bubble Trouble?

- US stocks have hit new highs; home prices have rebounded sharply

![S&P 500 graph](#)

- Analysts beginning to worry about “bubble” conditions in both markets
- And then there’s the leveraged loan market
  - Rising leverage, fewer covenants

S&P 500 is up 25.16% in 2013, after rising 13.4% in 2012. Major European equity markets are also up strongly this year. Only markets down are Brazil and Mexico.
Surprise! RE prices are rising rapidly, which could lead to a deterioration in credit underwriting standards. Press articles note this rebound, and emphasize it is from investors paying cash.

Source: Bloomberg
Leverage multiples exceed pre-crisis levels.

Banking agencies have responded by issuing guidance on leveraged lending.

Cov-lite deals highest on record. Investors are “chasing” weakly underwritten deals.

Source: S&P LCD 11/14/2013
The volume of dividend recap/stock purchase loans is higher than pre-crisis levels. This trend suggests lenders and investors are increasingly agnostic as to the purpose of debt, even when returning cash to private equity sponsors through dividends that the firms lack the free cash flow to pay out of operations.
Taper Tease

- In a Q&A session on 5-22-13, FRB Chairman Bernanke hinted that QE purchases could slow
  - “If we see continued improvement, and we have confidence that that is going to be sustained, in the next few meetings we could take a step down in our pace of purchases”
- Comments kicked off a “real world” interest rate risk stress test

- Interest rate risk remains a significant supervisory concern
  - Rates have been very low for a long time; bond portfolios have increased and are more negatively convex; low dealer inventories may mean difficulty selling MBS
Banks, Write Your Checks!

- Dollar Libor fines
  - Receivers: CFTC, DOJ, UK FSA, Swiss FMSA, and Openbaar Ministerie
  - Payers: ICAP $87.4M, RBS $612M, UBS $1.52B, Barclays $454M
- National Mortgage Settlement
  - Servicers Ally, BAC, Citi, JPM & Wells Fargo
  - $25B, divided into 3 tranches
    - $17B to fund national commitment to foreclosure relief efforts
    - $3B to fund national commitment to underwater mortgage refinance program
    - $5B to fund payments to 49 states and the federal government
- GSE “put backs”
  - BAC $14.8B, JPM $1.1B, WFC $869M, Citi $395M
- JPM Settlements
  - London “whale” $920M
  - RMBS settlement with DOJ: $4B to help struggling homeowners; $9B to settle civil claims
- EC fined large banks $2.3 billion for violating anti trust laws and participating in cartels for Yen Libor and Euribor
Comptroller Curry has been jawboning the banking industry about reserve releases. While it's normal to have releases after a credit crisis, the magnitude of the releases is a bit of a concern. Not a sustainable source of earnings and indicates weak earnings quality. Data is YTD 9-30-13.
Low volatility is a catalyst for future risk. Does anyone think bank risk positions have fallen as much as VaR measures suggest?

If a bank is comfortable taking $100 million in VaR risk, that $100 million is now equivalent to what used to be a much higher risk level.
Municipal Malaise

- In 2010, Meredith Whitney predicted “hundreds of billions of dollars in municipal defaults”
  - Led to 29 straight weeks of investor withdraws from muni funds
  - Anticipated wave of defaults did not occur, and the muni market rebounded strongly
- In summer of 2012, two California municipalities (Stockton and San Bernardino)
- SEC issued an investor bulletin to help educate investors about assessing credit risks they face when purchasing municipal bonds ($3.7 trillion market)
- Detroit filed for Chapter 9 protections 7-18-13, the largest municipality bankruptcy ($18B in LT debt) on record
- Key issue: are public employee pensions ordinary debts or specially protected?
  - Federal bankruptcy judge formally declared Detroit BK, and ruled that pensioners are not entitled to special protections, despite state constitutional provision
- The municipal bankruptcies highlight the severe underfunding of public PFs
  - Use high discount rates that aren’t reflective of their asset returns, to PV liabilities
  - Not likely a near-term threat to financial stability, but judicial ruling could lead to further BKs
  - Banks have large and growing municipal bond holdings
Municipal Holdings Sharply Higher

Bank Muni Bond Holdings

<table>
<thead>
<tr>
<th>Billions</th>
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<tbody>
<tr>
<td>YE2008</td>
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<tr>
<td>YE2009</td>
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<td>YE2010</td>
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<td>YE2011</td>
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<td>YE2012</td>
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<tr>
<td>1Q2013</td>
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<tr>
<td>2Q2012</td>
</tr>
<tr>
<td>3Q2013</td>
</tr>
</tbody>
</table>

- FV Held to Maturity
- FV Available for Sale
Operational Risk Revival

- Bank supervisors have always believed that credit and liquidity risks are the areas of most concern
- OCC now says Operational Risk is the greatest risk banks face
  - Technology failures
    - Flash crash (2010)
    - Facebook IPO (2012): dysfunction in Nasdaq systems delayed trading
    - Knight Capital (2012): $440M trading loss triggered from unintended orders due to software malfunction
    - Goldman Sachs (2013): erroneous orders on equity options
    - Nasdaq (2013): trading halt due to processor outage
  - Natural disasters
    - Superstorm Sandy
  - Cyber attacks
    - DDoS attacks overload a targeted computer server with e-mail traffic; hacking attacks
    - JPM and Regions both experienced DDoS-related intermittent outages
Mortgage Business Blues

- Under Basel III, “sin bucket” items are limited, in aggregate, to 15% of common equity tier 1 (CET1) Capital
  - Deferred Tax Assets
  - Mortgage servicing rights
  - Investments in significant unconsolidated financial institutions
- Each item is individually limited to 10% of CET1
- Any amounts over the limit become $ for $ deductions from CET1
- The rules apply to Advanced Approaches banks 1-1-14, although there is a transition period
  - Effective 1-1-15 for all other banks
- Banks are responding by trying to sell MSRs; buyers are non-banks
  - Ocwen, Nationstar and Walter Investment (REIT) now hold nearly $1T of unpaid balances in MSRs, out of a nearly $10T market
- Beyond the MSR problem, the rise in rates in 2013 has reduced mortgage originations, cutting into bank profits
  - As of Q3, smaller mortgage players held a 60% market share of the origination market, up from 39% in 2009. Smaller players are estimated to have gained 6 percentage points of market share in Q3 alone.
  - WF reported a 16% drop in MB revenue, to $7.2B, thru Q3
  - BAC reported a 43% decline to $3B
CFTC Cross-Border Disorder

- CFTC has issued 67 final rules, orders and guidance documents
  - In a rush to fix many shortcomings, CFTC staff has issued over 130 exemptions and no-action letters.
- Registration frustration and aggregation aggravation
  - Swap dealing activity over past 12 months > $8B ($25M if special entity CP)
  - Cross border guidance provides that non-U.S. persons may have to register as swap dealers if their transactions with U.S. persons and with non-U.S. persons are guaranteed by U.S. financial entities
- Clearing-Reality is here
  - Phased implementation ended in October
- Continued cross border confusion
  - “Risk knows no geographic boundaries”
  - Last week, ISDA, SIFMA and IIB sued CFTC
    - Argued CFTC did not comply with APA and CEA by issuing cross border regs in guidance form rather than a formal rule. Also argued no cost-benefit analysis
- US Person Definition
  - Foreign branches of U.S. Banks are U.S. Persons
  - Non-U.S. Affiliates of U.S. Banks are not U.S. Persons, even if they are guaranteed
  - Certain banks that conduct derivatives from branches (vs. affiliates) have to restructure their business model
- Substituted compliance
- Footnote 88
  - requires any platform to register as a SEF if it allows more than one participant to trade swaps with more than one other participant, regardless of whether the swaps trading on the platform have been mandated for clearing by the CFTC
  - Sweeps away belief that those platforms don’t have to register with the CFTC
Update on Dodd-Frank Act Rulemakings
Volcker Rule

- Holiday greetings from the banking agencies, CFTC and SEC!
  - 75 page rule in a document that will be nearly 1,000 pages!

- Prop Trading
  - Engaging as principal for the trading account in purchase/sale of any security, derivative, commodity future, or option on any such instruments
    - Does not cover loans, spot FX or currency, and spot commodities
  - Trading account:
    - Buy/sell instrument for purpose of short-term resale or to benefit from short-term price movements
    - Market risk rule account
  - Trading account exclusions
    - Repos, liquidity management, derivatives clearing, DPC, etc.
  - Compliance program includes CEO attestation
  - Covered funds
Volcker Rule (Cont’d)

- Market Making Activities
  - Trading activities separated into market maker inventory and financial exposures

- Risk Mitigating Hedging
  - Must demonstrably reduce or otherwise significantly mitigate specific identifiable risks (no “macro” hedging)
  - Must not give rise to significant new risks that are not hedged

- Government Securities
  - US banks can prop trade US gov’t securities
  - US affiliates of foreign banks can prop trade in their home country debt
  - Foreign banks or securities dealers controlled by a US banking entity may prop trade in their home country debt
Swap Margin Rule

- US prudential supervisors released a proposed rule in 2011, and are now working to complete a final rule implementing the WGMR framework.
- What’s new and/or what you need to know:
  - Initial and variation margin requirements will be applicable on trades involving all financial firms and systemically important non-financial firms.
    - VM requirements begin 12-1-15.
    - IM requirements start same day, but are phased in based on volume of non-cleared derivatives, starting at €3T:
      - Gross exchange of IM; no netting.
      - Very limited rehypothecation rights, so significant liquidity impact.
    - Banks will post IM to hedge funds.
    - IM and VM will not apply to sovereigns or corporate end-users.
  - Initial margin will be subject to a threshold of up to €50M; no VM T/H.
  - BCBS and IOSO to set up a Monitoring Group to evaluate margin standards in 2014.
Risk Retention Rule

- In August, agencies re-proposed an NPR to implement Section 941 of the DFA, the so-called risk retention rule.
- Key aspects of the re-proposal:
  - Eliminates the premium capture cash reserve account (PCCRA) provisions that would have taken the first losses on a mortgage bond issued under the rule and replaces them with a fair value, rather than a par value, calculation.
  - Aligns the definition of a qualified residential mortgage (QRM) with the CFPB’s Qualified Mortgage (QM) rule.
  - Agencies seek comment on another option called QRM Plus, which includes a down payment requirement with QM (at least 30% down payment).
    - Addresses the criticism that QRM = QM neuters the risk retention requirement.
  - Sunset provision terminates the prohibition on sale/hedging of the required risk retention after seasoning period.
  - L-Shaped risk retention permits sponsors to hold any combination of vertical and horizontal first loss interests, rather than only on a 50-50 basis.
  - For CMBS, allows the risk retention requirement to be satisfied through retention by up to two third-party “B-piece buyers” of a residual “B-piece” equal to at least 5% of the fair value of all ABS interests issued by the issuing entity.