

Report on Underwriting Practices

Federal Deposit Insurance Corporation



Andrew C. Hove, Jr., Chairman

April 1997 through September 1997

Highlights

- Slightly more than 90 percent of the responses received during the period April 1, 1997 through September 30, 1997 from bank examiners showed no material change in underwriting practices since the last examination. Almost 6 percent showed tighter underwriting practices since the prior examination of the banks, and slightly more than 4 percent of the responses indicated that banks loosened underwriting practices.
- Examiners noted “above-average” risk in current underwriting practices for new loans in almost 10 percent of the banks examined. Among those banks, approximately 12 percent also failed to adjust pricing for loan risk, according to examiners.
- Of the 398 banks examined that were actively making construction loans, almost 25 percent funded speculative (unaccompanied by commitments) construction projects “frequently enough to warrant notice”; a little more than 4 percent did so “commonly or as standard procedure.”
- In the Boston and Chicago regions, more of the banks recently examined loosened underwriting standards than tightened them since the last examination.

Purpose and Design of the Report

Beginning in early 1995, the FDIC implemented a questionnaire to report on the riskiness of current underwriting practices at FDIC-supervised banks. The examiner-in-charge completes this questionnaire at the conclusion of each bank examination that the FDIC conducts. This systematic collection of these responses from examinations provides an “early-warning” mechanism for identifying potential lending problems.

The questionnaire focuses on three topics: material changes in underwriting standards for new loans, the degree of risk in current lending practices, and underwriting standards for specific major loan categories. Loan types covered include: business, construction, commercial real estate, consumer, credit card, home equity, and agricultural. Excluded are those banks that either do not make loans that pose more-than-normal risk to the institution or are not active lenders in any of the above-mentioned types of loans.

Examiners evaluate underwriting practices based upon FDIC supervisory standards. Examiners are asked to rate the risk associated with underwriting practices of an institution as above-average, average, or below-average. In addition, examiners are asked to classify the occurrence of specific risky practices as “frequent enough to warrant notice” or, if more prevalent, “commonly or standard procedure.”

Results can be used to monitor underwriting practices of banks within the FDIC regions. Comparisons across regions or different time periods must be interpreted cautiously. As noted, the questionnaire is completed at the conclusion of each bank examination. Thus, the banks included during any given period depend on examination scheduling requirements such as the financial condition of the bank, coordination with state regulators, and the availability of staff. As a result, the sample is not random, and the banks sampled during a reporting period and within a

region are not necessarily selected for examination for the same reasons as banks in another region or during a different period. As such, one cannot draw valid statistical inferences from simple cross-region or cross-time comparisons.

Results: General Underwriting Trends and Practices

Reports received from examiners from April 1, 1997 through September 30, 1997 (reporting period) showed no widespread problems with current underwriting practices for new loans. The proportion of the responses that indicated a material change in underwriting practices since the last examination equaled just under 10 percent. Those citing tighter practices since the last examination totaled close to 6 percent compared with 4 percent reporting looser practices. Both loan growth goals and/or increased competition have typically been reasons given by examiners when banks relax underwriting standards.

- “Above-average” risk in loan administration surfaced in approximately 13 percent of the banks examined.
- Approximately 13 percent of the banks examined made new loans that resulted in high concentrations of loans to one borrower or to one industry “frequently enough to warrant notice”; and almost 7 percent of the banks examined made such loans “commonly or as standard procedure.”
- Almost 6 percent “commonly” failed to require a material principal reduction before renewing term loans.

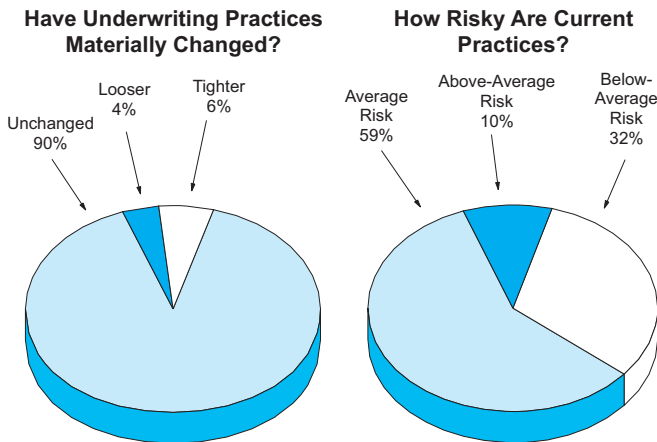
Individual Loan Types

In the questionnaire, examiners are requested to indicate the loan types that are a significant portion of the bank's new lending and were reviewed during the examination. Note that banks may be actively lending in more than one loan type. Reports filed during the reporting period showed 69 percent of the 1,233 banks examined were active business lenders, and 56 percent were actively making consumer loans. The proportions for other loan types are shown below.

Examiners expressed the most concern about agricultural lending. In particular, examiners were anxious about agricultural banks having portfolios tied closely to crops affected by The Federal Agriculture Improvement and Reform Act of 1996 (FAIR). (See the section on agricul-

Current Underwriting Practices

PERCENT OF RESPONSES RECEIVED: 4/97 - 9/97

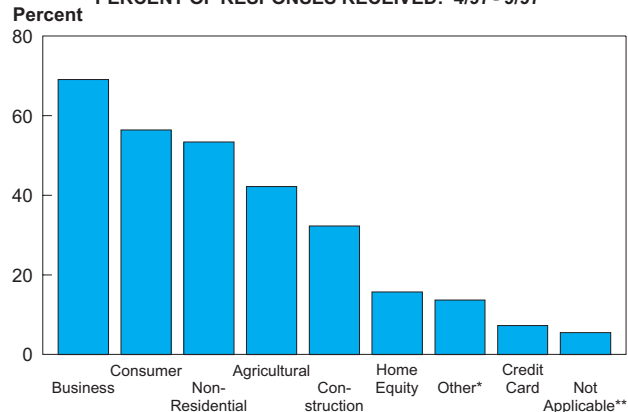


Examiners indicated “above-average” risk in underwriting practices for new loans in almost 10 percent of the banks examined nationwide. Of the banks characterized as having “above-average” risk, approximately 12 percent also “commonly” failed to adjust price for loan risk.

Additional information from responses received during the reporting period indicated:

Banks Actively Making Loans by Loan Type

PERCENT OF RESPONSES RECEIVED: 4/97 - 9/97



*Loans not specified that pose more-than-normal risk to the institution.

**Mainly residential loans that do not pose more-than-normal risk to the institution.

tural lending.) Construction lending received the second highest level of deficiencies. In this case, examiners were concerned about the frequency of speculative lending.

Business Loans. The borrower's financial strength and repayment source are important criteria in sound underwriting standards for business lending. For asset-based loans, the monitoring of the collateral pledged is also critical. For the reporting period, of the 852 banks examined and active in business lending approximately two-thirds made asset-based loans.

- Of the banks actively making business loans, over 19 percent loaned to borrowers who lacked documented financial strength “frequently enough to warrant notice”; an additional 2 percent did so “commonly or as standard procedure.”
- Over 13 percent of business lenders made business loans without a clear and reasonably predictable repayment source “frequently enough to warrant notice,” with only 1 percent categorized as doing so “commonly or as standard procedure.”
- Approximately 18 percent of the 571 banks making asset-based loans failed to monitor the collateral pledged “frequently enough to warrant notice”; only nine banks failed to monitor “commonly or as standard procedure.”

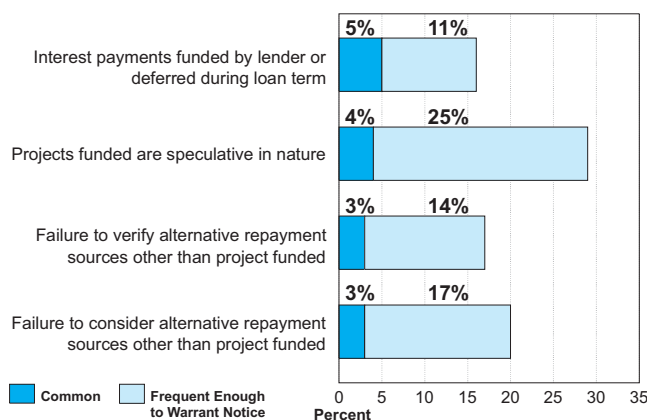
Construction Loans. Typically, developers receive funds to repay construction loans only upon completion of projects. Thus, an important concern for examiners is that the majority of a lender’s development loans be covered by commitments for either the sale or lease of the property or refinancing by another lender. Also, sound policy requires that repayment sources other than the project being funded be considered. Responses received from the 398 banks examined actively making construction loans during the reporting period yielded the following:

- Almost 25 percent of the banks examined funded speculative (unaccompanied by

commitments) construction projects “frequently enough to warrant notice”; a little more than 4 percent did so “commonly or as standard procedure.”

- Further, in 17 percent of the banks examined, examiners reported that banks made construction loans without consideration of repayment sources other than the project being funded “frequently enough to warrant notice.” However, only 12 banks did so “commonly or as standard procedure.” Additionally, for loans on which alternative repayment sources had been required, examiners reported that 17 percent of the banks failed to verify the quality of these sources either “frequently enough to warrant notice” or “commonly or as standard procedure.”
- For institutions making construction loans, 11 percent funded, or deferred, interest payments during the loan term “frequently enough to warrant notice”; an additional 5 percent did so “commonly or as standard procedure.”

Key Construction Loan Practices
PERCENT OF RESPONSES RECEIVED: 4/97- 9/97



Commercial Real Estate Loans. In commercial real estate lending, the income generated from the property is the primary source of repayment. However, because future income is subject to uncertainty, sound underwriting practices generally require alternative sources of repayment. Responses received during the reporting period

from the 659 banks examined and active in commercial real estate lending showed:

- Slightly under 11 percent of the banks examined failed to consider alternative repayment sources other than the project being funded “frequently enough to warrant notice.” Only nine banks actively making commercial real estate loans practiced this lending “commonly or as standard procedure.”
- Approximately 14 percent of the institutions examined made short-term commercial real estate loans with minimal amortization and large balloon payments “frequently enough to warrant notice.” Another 3 percent were characterized as making these loans “commonly or as standard procedure.”

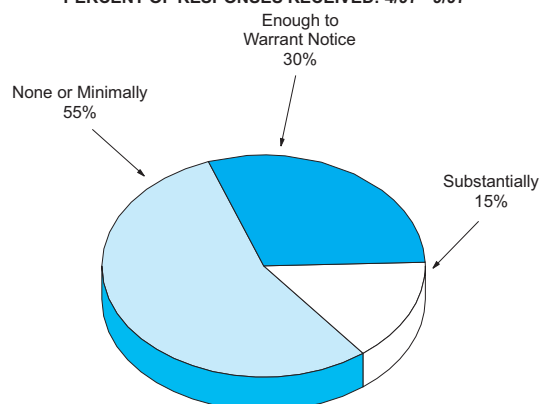
Agricultural Credits. Examiners are asked to determine the extent to which banks' agricultural loan portfolios are tied to major crops affected by the FAIR, which was signed into public law in April 1996. Traditional crop subsidies for wheat, feed grains, rice, and cotton that were originally tied to prices and limits on production are replaced with fixed but declining payments to farmers until the year 2002. The dependence of farmers on farm subsidy programs could make them more vulnerable to any program cuts and affect their ability to repay loans.

During the reporting period, 520 of the banks examined were active agricultural lenders. Results indicated that the approaching declining payments to farmers remain a problem. In fact, more examiners were concerned about this issue than any other deficiency in the underwriting report. However, the potential severity of this phaseout to the banking industry depends on how both farmers and banks adapt to the new legislation.

- Thirty percent of the examiners noted that the banks examined have portfolios tied to crops affected by the phaseout “enough to warrant notice”; an additional 15 percent of the banks examined have portfolios tied “substantially.”

Agricultural Banks with Loan Portfolios Subject to Farm Bill

PERCENT OF RESPONSES RECEIVED: 4/97 - 9/97



- Examiners also noted a “moderate” increase in the volume of loans carried over from the previous season in approximately 14 percent of the banks examined; an additional 2 percent showed a “sharp” increase.

Consumer Loans (Excluding Credit Card Lending). Responses received during the reporting period from the 695 banks active in consumer lending showed the following:

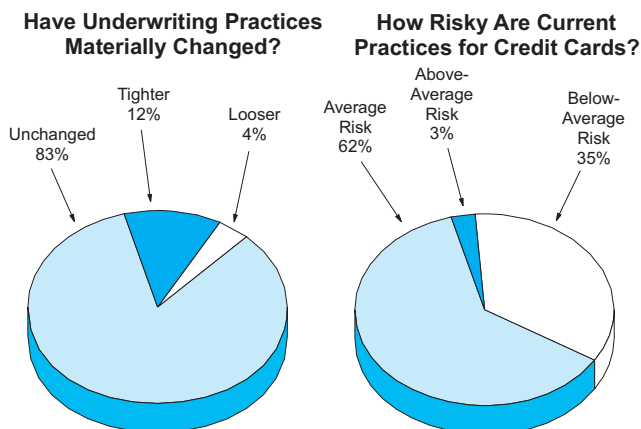
- Fifteen percent of the banks made consumer loans without adequate collateral protection “frequently enough to warrant notice”; an additional 3 percent made loans lacking collateral protection “commonly or as standard procedure.”
- Some institutions made loans to borrowers who lack a demonstrable ability to repay. Approximately 16 percent of the banks examined were noted for making these loans “frequently enough to warrant notice”; and an additional 3 percent were cited for lending in this manner “commonly or as standard procedure.”

Credit Card Loans. Approximately 8 percent of the banks examined were active credit card lenders. Of those institutions, three were credit card specialty banks. (None of these three were cited with “above-average” risk in current underwriting practices for new credit card loans.) The

remaining institutions were not major players in credit card lending, holding, on average, less than 1 percent of their total assets in such credits.

- Slightly more than 83 percent of all banks examined that were active in credit card loans showed stable underwriting practices for new credit card lending. Just over 12 percent indicated that underwriting practices had tightened compared with more than 4 percent showing looser practices.
- Almost 98 percent of responses indicated “average” or “below-average” risk in underwriting practices for new credit card loans.

Current Credit Card Underwriting Practices
PERCENT OF RESPONSES RECEIVED: 4/97 - 9/97

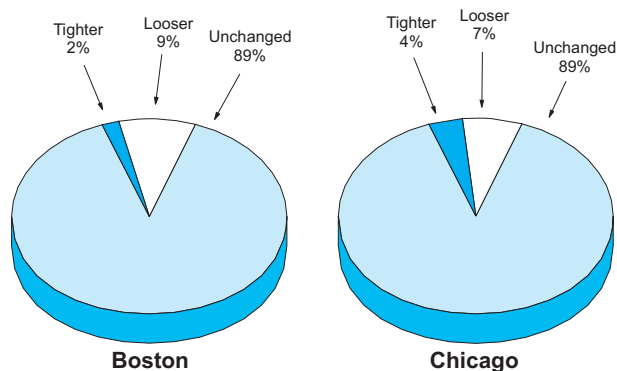


Home Equity Loans. Reports on the underwriting of home equity loans continued to reveal few deficiencies among the approximately 193 institutions actively making such loans.

Regional Results: General Underwriting Trends

Responses received during the reporting period in the Boston and Chicago regions indicated that a larger proportion of banks loosened underwriting standards than tightened standards since the last examination. Of the 64 banks examined in the Boston region during the reporting period, 9 percent loosened underwriting practices since the last examination compared with only 2 percent tightening standards. Slightly more than 7 percent of the 235 banks examined in the Chicago

Have Underwriting Practices Materially Changed in Boston and Chicago?
PERCENT OF RESPONSES RECEIVED: 4/97 - 9/97



region loosened standards compared with almost 4 percent tightening standards.

Highlights in general underwriting practices in the Boston region include:

- In existing loan portfolios, examiners noted “above-average” risk in almost 11 percent of the banks examined.
- Examiners noted “above-average” risk in underwriting practices for new loans in 9 percent of the banks examined.
- “Above-average” risk in loan administration appeared in approximately 9 percent of the responses.

For the Chicago region:

- Approximately 11 percent of the banks examined made new loans that resulted in high concentrations of loans to one borrower or to one industry “frequently enough to warrant notice”; and almost 6 percent of the banks examined made such loans “commonly or as standard procedure.”
- More than 16 percent of the banks examined had “above-average” risk in loan administration.
- Also, more than 12 percent of the banks examined showed “above-average” risk in underwriting practices for new loans, and slightly more than 11 percent of the banks examined showed “above-average” risk in existing loan portfolios.

Characteristics of the Banks Examined in the Report

- Coverage: 1,233 FDIC-supervised depository institutions.
- Time period: Reports filed between April 1, 1997 and September 30, 1997.
- Charter types: 92 percent of the institutions are state-chartered commercial banks, 8 percent are state-chartered savings banks, and less than 1 percent (2 banks) are branches of foreign banks on U.S. soil.
- Size distribution of institutions: 4 percent have over \$1 billion in assets, 29 percent have assets greater than \$100 million but less than \$1 billion, and 67 percent have assets less than \$100 million.
- Proportion of FDIC-regulated banks covered (as of June 30, 1997): 25 percent of assets and 20 percent of institutions.

Objectives of the Report on Underwriting Practices

- To identify:
 - material changes in underwriting standards since the last examination;
 - overall riskiness of new lending practices; and
 - specific risks in underwriting practices for major loan categories.
- To track emerging issues in the underwriting of new loans.
- To provide an “early-warning” mechanism for identifying potential problems.