

Report on Underwriting Practices

Federal Deposit Insurance Corporation



Donna Tanoue, Chairman

APRIL THROUGH SEPTEMBER 1998

HIGHLIGHTS

- *Beginning with this issue*, responses have been weighted to better represent the total population of FDIC-supervised banks (see below, "Purpose and Design of the Report").
- During the six months ending September 30, 1998, the proportion of banks that loosened underwriting practices since the previous examination was slightly higher than the proportion that tightened them (6 percent and 5 percent, respectively).
- There was a slight increase in the potential risk associated with current underwriting practices during the six months ending September 30, 1998 compared with the six months ending March 31, 1998.

Purpose and Design of the Report

In early 1995, the FDIC introduced a supplementary examination questionnaire on current underwriting practices at FDIC-supervised banks. The questionnaire focuses on three topics: material changes in underwriting practices for new loans, the degree of risk in underwriting practices, and underwriting practices for specific categories of loans. These categories are business, consumer, commercial (nonresidential) real estate, agricultural, construction, home equity, and credit card loans. Excluded from the questionnaire are banks specializing in residential real estate loans that do not pose more than normal risk to the bank and banks not actively making any of the above-mentioned types of loans.

Examiners evaluate underwriting practices in terms of FDIC supervisory practices. They are asked to rate the risk associated with a bank's underwriting practices as "above average," "average," or "below average," and to classify the occurrence of specific risky practices as "frequent enough to warrant notice" or, if the risky practice is more prevalent, as "common or standard pro-

cedure." Systematic collection and analysis of questionnaire responses provides an early-warning mechanism for identifying potential lending problems.

The questionnaire is completed at the conclusion of each bank examination the FDIC conducts. Which banks are included during a report period, therefore, depends upon how the FDIC schedules bank examinations. Examination schedules are heavily influenced by the financial condition of a bank, with examinations generally becoming more frequent the poorer a bank's financial condition. In addition, the FDIC shares examination authority of state-chartered non-member banks (those that are not members of the Federal Reserve System) with state bank regulators; and to avoid excessive regulatory burden, the FDIC generally alternates examinations with state regulators (who do not submit questionnaires). Finally, examination schedules are affected by the availability of examination staff. For these reasons the group of banks included in any given report is not randomly selected and, therefore, may not be representative of the population of FDIC-supervised banks.

Beginning with this issue . . .

. . . to partially address the potential bias that examination scheduling might introduce into the report's results, we have statistically weighted the responses. The weights are designed to make questionnaire responses in the aggregate more reflective of the population of FDIC-supervised banks. Simply put, when we compute aggregate questionnaire responses, we give greater weight to FDIC-supervised banks that are "under represented" in the questionnaire (when compared with the population of FDIC-supervised banks) and less weight to "over represented" groups.¹ As a result, responses are more comparable and trend analysis is less subject to bias. **Throughout this report, the percentages reported refer to these weighted responses and represent an estimate of the underwriting practices of all FDIC-supervised banks.** We also wish to point out that the data used to weight responses in this report are subject to slight revisions. Therefore, some of the weighted response rates might be revised in subsequent reports, but we expect no substantive changes.

GENERAL UNDERWRITING TRENDS

Reports received from examiners during the reporting period April 1 through September 30, 1998, showed that slightly more than 6 percent of FDIC-supervised banks had loosened their underwriting practices, while 5 percent had tightened them. During the previous reporting period (October 1, 1997, through March 31, 1998), 6 percent had loosened practices and 4 percent had tightened them.²

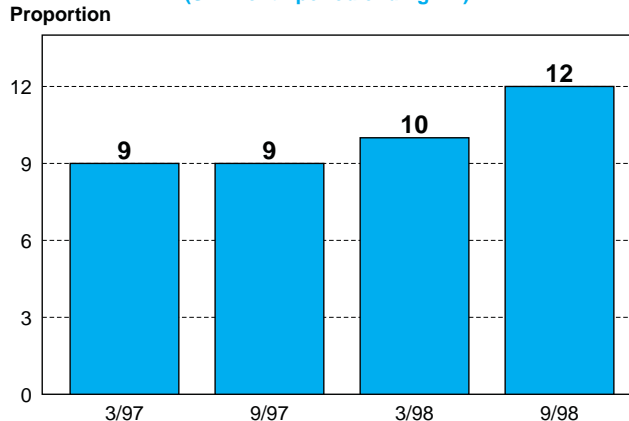
When banks relax underwriting practices, loan-growth goals or increased competition or both have typically been the reasons given by examiners. Loan growth since the previous examination was "rapid" in 20 percent of banks, down from 25 percent during the six-month reporting period ending March 31, 1998.

¹To compute weights, we post-stratified the population of FDIC-supervised banks into groups, or "post-strata," with an eye toward grouping banks with similar examination frequencies together. Specifically, the three characteristics used to define the post-strata were two asset size groups, eight FDIC regions, and three safety-and-soundness risk ratings.

For more information about the weights, please contact Virginia Olin, FDIC, 202/898-8711.

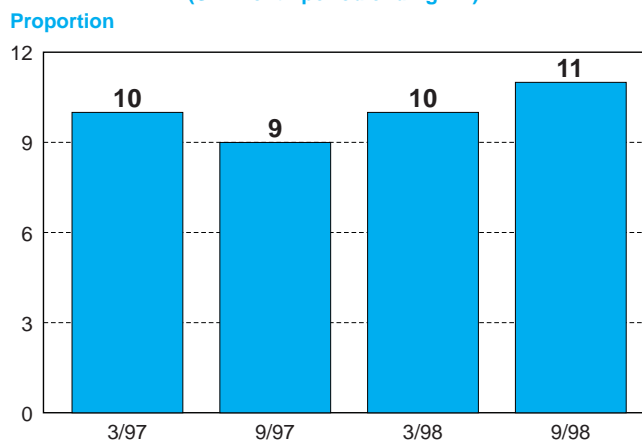
²The past response rates reported here are also weighted.

General Underwriting Practices
Proportion of FDIC-Supervised Banks Having "Above Average" Risk in Current Underwriting Practices (Six-month period ending . . .)



When questioned about the banks' underwriting practices for new lending and loan administration, examiners were slightly more concerned during the six months ending September 30, 1998, than during the previous reporting period. For example, the percent of FDIC-supervised banks with "above-average" risk in current underwriting practices crept up to 12 percent compared with 10 percent during the previous six-month reporting period ending March 31, 1998.

General Underwriting Practices
Proportion of FDIC-Supervised Banks Having "Above Average" Risk in Their Overall Loan Portfolio (Six-month period ending . . .)



Other findings for FDIC-supervised banks showed:

- 11 percent were reported to have “above-average” risk in their current loan portfolios, up from 10 percent during the previous reporting period.
- Approximately 13 percent were reported to have “above-average” risk in loan administration (up from 11 percent reported during the previous reporting period).
- Approximately 8 percent “commonly or as standard procedure” made loans that resulted in high concentrations of loans to one borrower or to one industry (up from 7 percent reported during the previous reporting period).
- Six percent had written lending policies that differed “substantially” from actual practices (up from 4 percent during the previous reporting period).
- Five percent failed to require a material reduction in principal before renewing term loans “commonly or as standard procedure” (down from 6 percent during the previous reporting period).

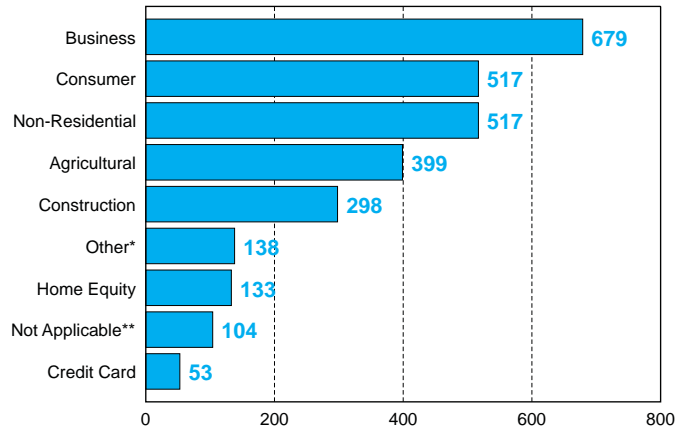
While examiners reported increased concern about general underwriting practices, concern about underwriting practices within individual loan categories remained about the same or decreased. Comments received from examiners indicated two likely reasons for this divergence. First, while the questionnaire covers key underwriting practices within loan categories, there are other underwriting practices not specifically addressed. Second, increased uncertainty about the economy might have contributed to increased risk in underwriting practices overall, even though most specific underwriting practices did not change.

INDIVIDUAL LOAN CATEGORIES

The questionnaire asks examiners to indicate the types of loans that were a significant portion of the bank's new lending and were reviewed during the examination. Responses during this reporting period show that 679 of the 1,104 banks examined were active business lenders; 517 banks were actively making consumer loans (excluding credit cards); and 517 banks were actively making commercial (nonresidential) real estate loans. The number for other loan categories is shown in the accompanying chart.

Compared with a year earlier, examiners showed increased concern about underwriting practices for new lending in each loan category, but compared with the previous six-month reporting period ending March 31, 1998, concern remained about the same or decreased.

Number of Banks Actively Making Loans by Loan Type
Responses Received: 4/98 - 9/98



*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.

Business Loans

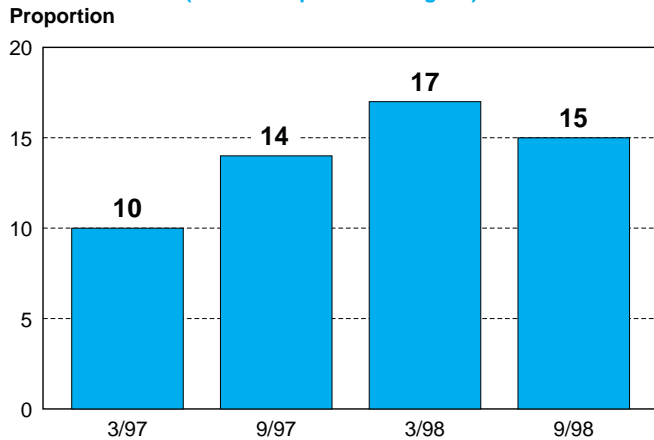
Examiners review underwriting practices for business loans to ensure that each borrower's financial strength and source of repayment are taken into account. With asset-based loans, examiners review practices to verify that the bank monitors the collateral pledged. Among the FDIC-supervised banks actively making business loans,

- Almost 19 percent made business loans to borrowers who lacked documented financial strength to support such lending “frequently enough to warrant notice.” An additional 3 percent did so “commonly or as standard procedure.”
- Slightly under 13 percent made business loans without a clear and reasonably predictable repayment source “frequently enough to warrant notice.” Two percent did so “commonly or as standard procedure.”
- Of the banks making asset-based loans, 14 percent failed to monitor the collateral pledged “frequently enough to warrant notice”; another 2 percent “commonly or as standard procedure” failed to monitor.

All but one of these percentages (the percentage of banks “commonly” making business loans with-

out a clear and reasonably predictable repayment source) was lower than the percentages reported during the previous reporting period.

Business Loans
Loans Made Without Clear and Predictable Repayment Source
(Six-month period ending . . .)



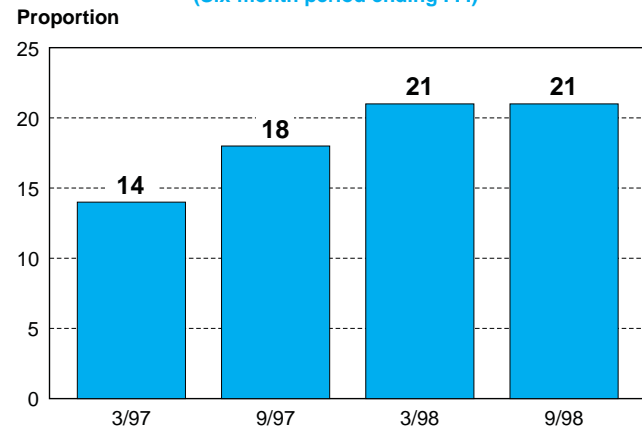
Proportion of FDIC-supervised banks making such loans either "frequently enough to warrant notice" or "commonly."

Consumer Loans (Excluding Credit Card Lending)

Among the FDIC-supervised banks actively making consumer loans (excluding credit card lending), concern about underwriting practices remained about the same compared with the previous reporting period. For example,

- Approximately 16 percent were considered to have made loans to borrowers who lack a demonstrable ability to repay "frequently enough to warrant notice"; an additional 5 percent were cited for lending in this manner "commonly or

Consumer Loans
Loans Made to Borrowers Who Lack Demonstrable Ability to Repay
(Six-month period ending . . .)



Proportion of FDIC-supervised banks making such loans either "frequently enough to warrant notice" or "commonly."

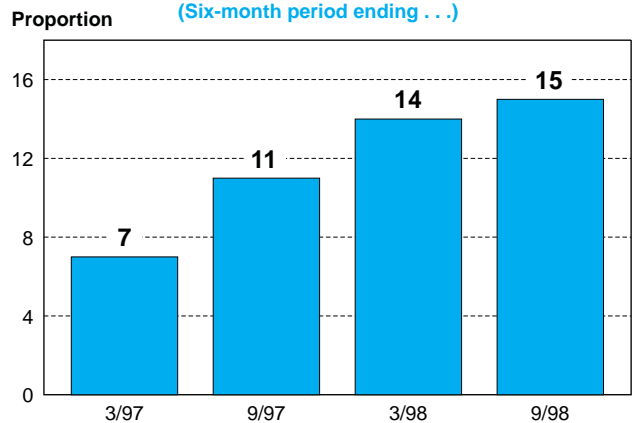
as standard procedure." (During the previous reporting period, the comparable figures were 18 percent and 3 percent, respectively.)

- Slightly more than 13 percent made consumer loans without adequate collateral protection "frequently enough to warrant notice"; an additional 4 percent made loans lacking collateral protection "commonly or as standard procedure" (compared with 14 percent and 3 percent, respectively, during the previous reporting period).

Commercial (Nonresidential) Real Estate Loans

In commercial real estate lending, examiners review underwriting practices to ensure that the income generated from the property is not the only source of repayment. Because future income is uncertain, sound underwriting practices generally require alternative sources of repayment. Of the FDIC-supervised banks that were active in commercial real estate,

Commercial (Nonresidential) Real Estate Loans Made with No Consideration of Repayment Source Other than the Project Being Funded
(Six-month period ending . . .)



Proportion of FDIC-supervised banks making such loans either "frequently enough to warrant notice" or "commonly."

- Thirteen percent made short-term commercial real estate loans with minimal amortization and large balloon payments "frequently enough to warrant notice" (down from 15 percent during the previous reporting period). Another 3 percent (down from 4 percent during the previous reporting period) did so "commonly or as standard procedure."
- Approximately 12 percent failed to consider repayment sources other than the project being

funded “frequently enough to warrant notice” (down from 13 percent during the previous reporting period). Almost 3 percent (up from 1 percent previously) failed to consider alternative sources of repayment “commonly or as standard procedure.”

- Seven percent made interest-only, extended-amortization, or negative-amortization permanent commercial real estate loans “frequently enough to warrant notice” (up from 6 percent during the previous reporting period), but 0 percent did so “commonly or as standard procedure” (down from 1 percent previously).

Agricultural Loans

Examiners saw few problems with underwriting practices for agricultural loans. They did, however, continue to monitor the extent to which banks' agricultural loan portfolios were tied to major crops affected by the Federal Agriculture Improvement and Reform Act of 1996.³ Twenty-eight percent of FDIC-supervised banks active in agricultural lending — up from 27 percent during the previous reporting period — had portfolios tied to crops affected by the phaseouts “enough to warrant notice.” And 21 percent — compared with 14 percent previously — were affected by the phaseouts “substantially.” Further, 13 percent made agricultural loans using unrealistic cash flow projections “frequently enough to warrant notice.” An additional 3 percent did so “commonly or as standard procedure” (compared to 9 percent and 3 percent, respectively, previously).

Construction Loans

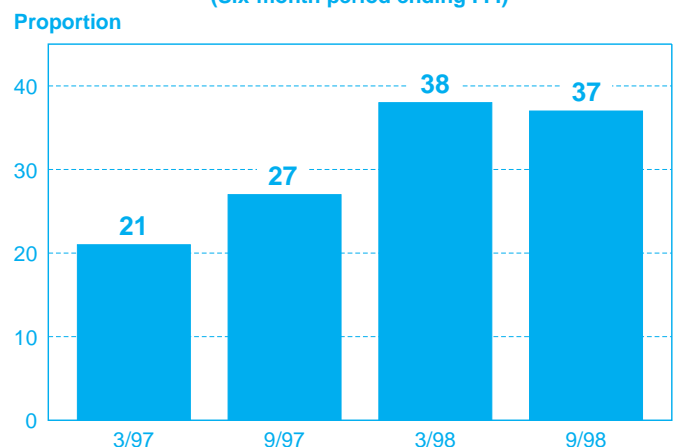
Examiners review underwriting practices for construction lending to ensure that these loans are covered by commitments either for the sale or lease of the property or for the refinancing of the property by another lender. Moreover, sound policy also requires that the lender consider sources of repayment other than the project being funded (unless the bank has set loan terms, such as collateral, pricing, and loan-to-value ratios, which fully mitigate the need to consider an outside source of repayment).

³Whereas previous laws allowed traditional subsidies tied to prices and limits on production, this law allowed declining payments to farmers until the year 2002 for certain crops.

Of the FDIC-supervised banks active in construction lending,

- Thirty percent funded speculative construction projects (that is, those unaccompanied by commitments) “frequently enough to warrant notice” (down from 31 percent during the previous reporting period); a little more than 7 percent did so “commonly or as standard procedure” (unchanged from that reported during the previous reporting period).
- Further, 23 percent made construction loans without considering sources of repayment other than the project being funded “frequently enough to warrant notice” (up from 19 percent previously). Approximately 3 percent did so “commonly or as standard procedure” (down from 5 percent previously).
- In addition, 14 percent required alternative sources of repayment but failed to verify the quality of these sources “frequently enough to warrant notice”; an additional 2 percent failed to verify the quality of these sources “commonly or as standard procedure.” (Both percentages were lower than those reported previously.)
- Fourteen percent funded, or deferred, interest payments during the loan term “frequently enough to warrant notice”; an additional 6 percent did so “commonly or as standard procedure.” (Both percentages were essentially unchanged from those reported previously.)

Construction Loans
Loans Made on a Speculative Basis
(Six-month period ending . . .)



Proportion of FDIC-supervised banks making such loans either “frequently enough to warrant notice” or “commonly.”

Results from the Report on Underwriting Practices
Percent of respondents

		WEIGHTED				
		6-month period ending:				
		9/96	3/97	9/97	3/98	9/98
Have the institution's underwriting practices materially changed since the last examination:	Yes	9.7%	8.1%	9.0%	10.7%	11.7%
	No	90.3	91.9	91.0	89.3	88.3
If practices have materially changed, are they:	Tighter	4.7	5.3	4.8	4.4	5.3
	Looser	4.9	2.8	4.2	6.4	6.3
How would you characterize the institution's recent loan growth since the last examination:	Zero or Negative	NA	14.7	11.9	11.2	14.9
	Moderate	NA	66.3	66.3	64.0	64.9
	Rapid	NA	19.1	21.8	24.8	20.2
How would you characterize the potential risk associated with the institution's current underwriting practices:	Below Average	25.3	28.8	33.2	32.6	27.0
	Average	63.6	62.5	58.3	57.0	61.5
	Above average	11.1	8.7	8.5	10.4	11.5
How would you characterize the potential credit risk of the institution's overall loan portfolio:	Below average	38.5	35.7	39.5	40.6	32.8
	Average	50.5	54.8	51.8	49.7	56.0
	Above average	11.0	9.5	8.8	9.6	11.3
To what extent has recent lending been made in amounts that resulted in—or contributed to—concentrations of credit to one borrower or industry:	Never or infrequently	86.1	85.4	81.1	79.1	77.7
	Frequently enough to warrant notice	9.1	9.5	12.5	13.9	14.5
	Commonly or standard procedure	4.8	5.2	6.4	7.0	7.8
How would you characterize the risk associated with loan administration:	Below average	32.3	31.1	33.9	35.7	30.7
	Average	53.5	57.4	54.3	52.9	56.2
	Above average	14.2	11.4	11.7	11.4	13.1
To what degree does the institution fail to adjust its loan pricing on different quality loans to reflect differences in risk:	Rarely	68.0	69.8	68.3	72.1	73.0
	To some degree	27.7	26.1	26.6	23.4	22.3
	Commonly	4.4	4.2	5.1	4.6	4.7
To what extent does the institution's written lending policies differ from actual practices:	Identical or minimal difference	85.4	76.6	75.8	72.5	71.5
	Moderately different	11.8	20.4	21.1	23.1	22.7
	Substantially different	2.9	3.1	3.1	4.4	5.8
To what extent does the institution fail to require a material principal reduction before renewing term loans:	Rarely	NA	58.6	60.9	63.1	62.5
	To some degree	NA	35.4	33.9	31.3	32.7
	Commonly	NA	5.9	5.2	5.6	4.8
To what extent does the institution make business loans without a clear and reasonably predictable repayment source:	Never or infrequently	89.9	90.2	85.9	82.6	85.1
	Frequently enough to warrant notice	9.3	9.2	13.0	15.6	12.6
	Commonly or standard procedure	0.7	0.7	1.1	1.8	2.3
To what extent does the institution make business loans to borrowers who lack documented financial strength to support such lending:	Never or infrequently	93.7	89.0	79.8	76.7	78.6
	Frequently enough to warrant notice	5.8	10.3	18.8	20.6	18.9
	Commonly or standard procedure	0.4	0.7	1.4	2.7	2.5
With respect to asset-based business loans, to what extent does the institution fail to monitor collateral:	Never or infrequently	NA	85.8	81.5	79.0	83.6
	Frequently enough to warrant notice	NA	9.4	17.2	18.0	14.4
	Commonly or standard procedure	NA	4.8	1.4	3.0	2.0
To what extent is the institution funding construction projects on a speculative basis (i.e., without meaningful pre-sale, pre-lease or take-out commitments):	Never or infrequently	89.6	79.2	72.6	62.2	63.2
	Frequently enough to warrant notice	8.3	17.3	23.8	30.6	29.7
	Commonly or standard procedure	2.2	3.5	3.7	7.2	7.2
To what extent are construction loans made without consideration of repayment sources other than the project being funded:	Never or infrequently	92.5	89.3	81.3	76.4	74.3
	Frequently enough to warrant notice	7.0	10.0	16.1	18.7	22.6
	Commonly or standard procedure	0.5	0.7	2.5	5.0	3.1
When alternative repayment sources are required, to what extent does the institution fail to take appropriate steps to verify the quality of these sources:	Never or infrequently	91.2	91.0	84.0	79.1	83.6
	Frequently enough to warrant notice	5.4	7.6	13.8	16.7	14.1
	Commonly or standard procedure	3.4	1.4	2.2	4.1	2.2
To what extent does the institution fail to use realistic appraisal values relative to the current economic environment and/or to the performance observed on similar credits:	Never or infrequently	94.9	93.0	90.2	86.0	86.0
	Frequently enough to warrant notice	4.7	6.4	9.2	12.2	11.8
	Commonly or standard procedure	0.3	0.6	0.6	1.8	2.2
To what extent does the institution fund, or defer, interest payments during the term of its commercial construction loans:	Never or infrequently	94.0	89.2	85.7	80.3	79.8
	Frequently enough to warrant notice	4.2	5.9	10.6	13.9	14.4
	Commonly or standard procedure	1.8	4.9	3.7	5.8	5.8

NA – Not available

Results from the Report on Underwriting Practices (continued)
Percent of respondents

		WEIGHTED				
		9/96	6-month period ending:			9/98
		3/97	9/97	3/98		
To what extent are commercial real estate loans made without consideration of repayment sources other than the project being funded:	Infrequently	93.5%	92.9%	89.5%	86.1%	85.1%
	Frequently enough to warrant notice	6.1	7.0	9.6	12.5	12.3
	Commonly or standard procedure	0.4	0.2	0.9	1.4	2.6
To what extent does the institution make interest-only, extended amortization, or negative amortization permanent commercial real estate loans:	Never or infrequently	95.9	95.8	93.6	93.0	92.8
	Frequently enough to warrant notice	4.0	3.6	6.1	6.3	7.2
	Commonly or standard procedure	0.2	0.5	0.2	0.7	0.0
To what extent does the institution make short-term commercial real estate loans (Mini-perms) with minimal amortization terms and large balloon payments at maturity:	Never or infrequently	90.7	87.9	84.7	80.6	84.7
	Frequently enough to warrant notice	7.7	9.8	12.5	15.0	12.7
	Commonly or standard procedure	1.6	2.3	2.8	4.4	2.7
To what extent does the institution fail to use realistic appraisal values relative to the current economic environment and/or to the performance observed on similar credits:	Never or infrequently	95.1	95.3	91.8	90.0	89.6
	Frequently enough to warrant notice	4.7	4.3	7.5	9.2	9.9
	Commonly or standard procedure	0.3	0.4	0.7	0.8	0.6
To what extent does the institution make home equity loans that push mortgage indebtedness above 90 percent of collateral value:	Never or infrequently	96.3	92.7	88.0	88.1	86.8
	Frequently enough to warrant notice	3.1	5.0	7.9	9.9	11.5
	Commonly or standard procedure	0.7	2.3	4.1	2.0	1.7
To what extent does the institution calculate equity for home equity loans based on recent escalation in home prices:	Never or infrequently	97.5	95.7	90.3	82.2	79.8
	Frequently enough to warrant notice	2.1	4.1	8.0	16.4	12.3
	Commonly or standard procedure	0.3	0.3	1.7	1.5	7.9
To what extent does the institution qualify borrowers for home equity credit based on initially-discounted loan rates:	Never or infrequently	99.0	99.1	97.1	99.0	98.3
	Frequently enough to warrant notice	0.6	0.8	1.6	1.0	1.7
	Commonly or standard procedure	0.3	0.2	1.4	0.0	0.0
To what extent does the institution make agricultural loans based on artificially-inflated land values:	Never or infrequently	98.3	98.7	96.2	96.4	96.1
	Frequently enough to warrant notice	1.7	1.3	3.3	3.2	3.7
	Commonly or standard procedure	0.0	0.0	0.5	0.4	0.3
To what extent is the institution's agricultural loan portfolio tied to major crops affected by the phase out of farm subsidies:	None or minimally	59.9	66.2	54.9	59.2	51.2
	Enough to warrant notice	36.3	27.0	30.3	27.1	27.7
	Substantially	3.8	6.9	14.8	13.7	21.1
To what extent are agricultural loans being made based on unrealistic cash flow projections:	Never or infrequently	91.2	93.0	89.3	88.1	84.3
	Frequently enough to warrant notice	7.2	6.1	8.7	9.4	12.6
	Commonly or standard procedure	1.6	0.9	2.0	2.5	3.1
How would you characterize the change in the level of the institution's agricultural related carryover debt since the 1st examination:	Sharp decline	NA	2.5	4.7	2.4	0.8
	Moderate decline	NA	26.1	30.3	25.5	17.6
	No change	NA	51.1	50.1	60.5	55.8
	Moderate increase	NA	18.7	13.5	10.4	23.5
	Sharp increase	NA	1.6	1.5	1.2	2.4
To what extent does the institution make consumer loans without adequate collateral protection:	Never or infrequently	91.5	86.4	82.4	83.0	82.6
	Frequently enough to warrant notice	6.6	11.6	14.7	14.2	13.5
	Commonly or standard procedure	1.9	2.0	3.0	2.8	3.9
To what extent does the institution make consumer loans to borrowers who lack demonstrable ability to repay:	Never or infrequently	90.5	85.8	82.3	78.9	79.5
	Frequently enough to warrant notice	8.1	12.9	15.6	18.0	16.0
	Commonly or standard procedure	1.4	1.3	2.2	3.1	4.5
If the institution's underwriting practices for new credit card loans have materially changed since the last examination, are they:	Not applicable	95.1	89.9	82.0	84.3	89.1
	Tighter	2.5	7.6	14.0	13.7	9.4
	Looser	2.4	2.6	3.9	2.0	1.5
How would you characterize the level of risk associated with the institution's current underwriting practices for new credit card loans:	Below Average	29.0	24.6	34.2	22.9	27.9
	Average	70.0	71.8	63.8	73.8	67.5
	Above average	1.1	3.6	1.9	3.4	4.7
How would you characterize the level of risk associated with the institution's credit card portfolio:	Below Average	23.6	23.1	29.2	27.2	27.0
	Average	73.5	70.6	63.0	70.0	65.8
	Above average	2.9	6.3	7.7	2.8	7.2

NA – Not available



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Attention:
Chief Executive Officer

**Characteristics of Banks Examined in the
*Report on Underwriting Practices***

- Coverage: 1,104 FDIC-supervised banks.
- Period: Reports filed between April 1 and September 30, 1998.
- Charter types: state-chartered commercial banks, 91 percent; state-chartered savings banks, 9 percent; branches of foreign banks on U.S. soil, less than 1 percent (3 banks).
- Size distribution of banks: assets of \$1 billion or greater, 4 percent; assets between \$300 million and \$1 billion, 9 percent; assets between \$25 million and \$300 million, 69 percent; assets less than \$25 million, 18 percent.
- Proportion of all FDIC-supervised banks (as of June 30, 1998): 21 percent of assets and 18 percent of the number of banks.

The Report on Underwriting Practices seeks

- To identify (1) material changes in underwriting practices, (2) overall risk in new lending practices, and (3) specific risks in underwriting practices for major loan categories.
- To track emerging issues in underwriting practices of new loans.
- To provide an early-warning mechanism for identifying potential problems.