# Report on Underwriting Practices

Federal Deposit Insurance Corporation
Andrew C. Hove, Jr., Chairman

## OCTOBER 1997 THROUGH MARCH 1998

### HIGHLIGHTS

- Responses from examiners during the six months ending March 31, 1998, indicated that a greater proportion of banks examined had loosened underwriting practices since the previous examination than had tightened them (6 percent and 5 percent, respectively). About 88 percent of the banks showed no material change in underwriting practices since the previous examination.
- Twenty-five percent of responses characterized the banks' loan growth since the previous examination as "rapid." The demand for loans has resulted from a strong economy plus low interest rates and optimistic consumer expectations.
- Underwriting practices were seen as weaker compared to a year earlier in each of the major loan categories covered in this report, particularly commercial (nonresidential) real estate and construction lending.
- In three of the eight FDIC regions, examiners indicated that a larger proportion of banks had loosened underwriting standards than had tightened them since the last examination.

## *Purpose and Design of the Report*

In early 1995, the FDIC began using an examination questionnaire on risk in current underwriting practices at FDIC-supervised banks. The examiner in charge completes the questionnaire at the conclusion of each bank examination that the FDIC conducts. This systematic collection of 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. These categories are business, commercial (nonresidential) real estate, consumer, agricultural, construction, home equity, and credit card loans. Excluded 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 standards, rating the risk associated with a bank's underwriting practices as above average, average, or below average, and classifying the occurrence of specific risky practices as "frequent enough to warrant notice" or, if more prevalent, "common or standard procedure."

Examiners can use the results from the questionnaire to monitor the underwriting practices of banks over time or within the FDIC regions. But, comparisons across periods or regions must be interpreted cautiously. Because the questionnaire is completed at the conclusion of each bank examination, 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 examination staff. As a result the sample is not random, and the banks sampled during a particular reporting period and within a particular region are not necessarily selected for

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examination for the same reasons as banks during a different period or in another region. Accordingly, time series comparisons should not be interpreted without corroborative data.

## GENERAL UNDERWRITING TRENDS

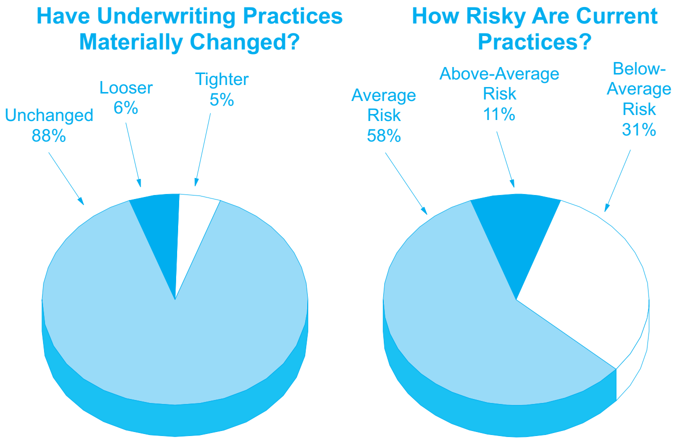
Reports received from examiners during the reporting period October 1, 1997 through March 31, 1998 showed that in almost 12 percent of the 1,212 banks examined, underwriting practices had materially changed since the previous examination. Slightly more than 6 percent of the banks had loosened their underwriting practices, while 5 percent had tightened them. These results are noteworthy: (1) The proportion of banks showing a material change since the previous examination is larger than during any previous reporting period since early 1995, when the questionnaire came into use. (2) For the first time, the proportion of banks showing looser standards is greater than the proportion showing tighter standards.

Changes in the composition of banks examined in each reporting period could contribute to fluctuations in results. However, a comparison of the characteristics of banks examined during two reporting periods, this one and the one a year earlier (the six months ending March 31, 1997), shows that both groups are similar. Moreover, the continuation of the strong economy and the current stable interest-rate environment would not contribute to a weakening in underwriting standards. Thus, we believe that the latest results reflect a true weakening in underwriting practices. Outside support for this conclusion appears in a study released in mid-December 1997 by the Office of the Comptroller of the Currency (OCC), showing a weakening of credit underwriting standards at big banks.[1]

As has usually been the case, the major reason cited by examiners for loosened standards was to achieve loan-growth goals (approximately 70 percent cited this reason). In addition, twenty-five percent of responses characterized the banks' loan growth since the previous examination as "rapid," up from the period a year earlier. The demand for loans has resulted from a strong economy plus low interest rates and optimistic consumer expectations.

Despite an increase in the proportion of banks loosening standards, examiners continued to report no widespread problems in underwriting practices for new lending overall. Examiners did indicate "above-average" risk in underwriting practices for new loans in 11 percent of the banks examined, but this was up only slightly from the period a year earlier. Of that 11 percent, 21 percent (or 27 banks) also "commonly" failed to adjust price for loan risk. In addition, 11 percent of all banks examined were reported to have "above-average" risk in their current loan portfolios—a proportion essentially unchanged from the period a year earlier.

**Current Underwriting Practices**
PERCENT OF RESPONSES RECEIVED: 10/97 - 3/98


Have Underwriting Practices Materially Changed?
How Risky Are Current Practices?

Other findings are the following:

- "Above-average" risk in loan administration surfaced in approximately 13 percent of the banks examined (about the same as was reported during the period a year earlier).
- Approximately 7 percent of banks examined "commonly" made loans that resulted in high concentrations of loans to one borrower or to one industry (up slightly from the period a year earlier). Most of the banks examined are small, community-based banks and tend to lend mainly to people or industries dominant in the area.

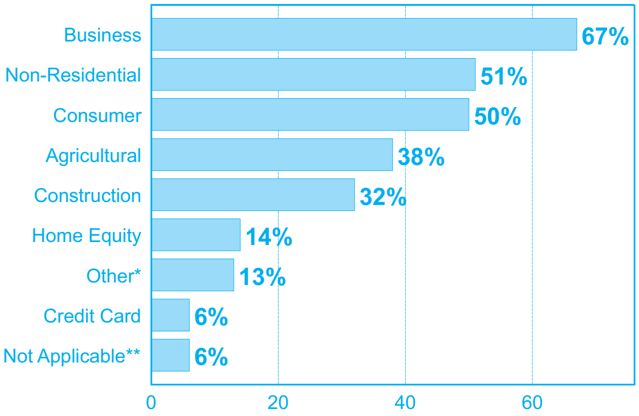
[1] This study, the *1997 Survey of Credit Underwriting Practices*, can be obtained from the OCC (phone: 202/874-5770).

- Six percent of banks examined “commonly” failed to require a material reduction in principal before renewing term loans (essentially unchanged from the period a year earlier).
- In 5 percent of the banks examined, the written lending policies differed “substantially” from actual practices (up slightly from the period a year earlier).

## INDIVIDUAL LOAN TYPES

The questionnaire asks examiners to indicate the types of loans that are a significant portion of the bank's new lending and that were reviewed during the examination. Note that banks may be actively lending in more than one loan type. Responses during this reporting period showed that 67 percent of the 1,212 banks examined were active business lenders; 51 percent were actively making commercial (nonresidential) real estate loans; and 6 percent were not active in any of the major loan categories covered. The proportions for other loan types are shown in the accompanying chart.

**Banks Actively Making Loans by Loan Type**
**PERCENT OF RESPONSES RECEIVED: 10/97 - 3/98**



**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.

Examiners showed greater concerns than in prior reports for underwriting practices in each loan category.

### *Business Loans.*

In business lending, the borrower's financial strength and source of repayment are important criteria for soundness in underwriting standards. With asset-based loans, monitoring the collateral pledged is also critical. Of the 806 banks examined during the reporting period that were active in business lending, approximately two-thirds (or 520) made asset-based loans. Among the 806 banks actively making business loans,

- Almost 21 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.”
- Slightly less than 17 percent made business loans without a clear and reasonably predictable repayment source “frequently enough to warrant notice.” Two percent did so “commonly.”
- Of the 520 banks making asset-based loans, approximately 19 percent failed to monitor the collateral pledged “frequently enough to warrant notice”; another 3 percent “commonly” failed to monitor.

Almost all of these proportions were up substantially from the period a year earlier.

### *Commercial (Nonresidential) 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 uncertain, sound underwriting practices generally require alternative sources of repayment. Of the 612 banks examined during the reporting period that were active in commercial real estate,

- Fifteen percent made short-term commercial real estate loans with minimal amortization and large balloon payments “frequently enough to warrant notice.” Another 5 percent were characterized as making these loans “commonly or as standard procedure.”
- Approximately 13 percent failed to consider repayment sources other than the project being funded “frequently enough to warrant notice.” Only eight banks (1 percent) actively making commercial real estate loans “commonly”

failed to consider alternative sources of repayment.

These proportions were up slightly from the period a year earlier.

## *Consumer Loans (Excluding Credit Card Lending).*

In some of the 604 banks examined during this reporting period that were active in consumer lending, underwriting standards weakened slightly from the period a year earlier:

- Approximately 19 percent were considered to have made loans to borrowers who lack a demonstrable ability to repay "frequently enough to warrant notice"; an additional 3 percent were cited for lending in this manner "commonly or as standard procedure."
- Fifteen percent 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."

## *Agricultural Loans.*

Examiners continued 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. The 464 responses during the reporting period from examiners in banks that were active agricultural lenders indicated that 27 percent—about the same as during the period a year earlier—were reported to have portfolios tied to crops affected by the phaseouts "enough to warrant notice." And, 15 percent—compared with 7 percent in the period a year earlier—were affected by the phaseouts "substantially."

## *Construction Loans.*

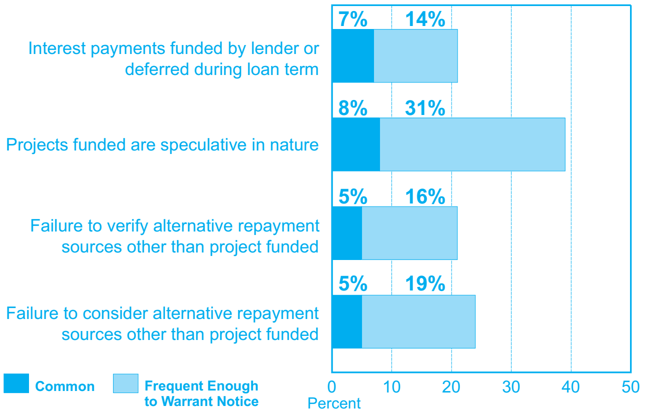
Typically, developers receive funds to repay construction loans only upon completion of projects. Thus, an important concern for examiners is that the majority of a lender's development loans be covered by commitments for either the sale or lease of the property or for the refinancing of the property by another lender. Moreover, sound policy 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, that fully mitigate the need to consider an outside source of repayment.)

Of the 387 banks that actively made construction loans,

- Thirty-one percent funded speculative construction projects (i.e., those unaccompanied by commitments) "frequently enough to warrant notice"; a little less than 8 percent did so "commonly or as standard procedure."
- Further, 19 percent were reported to have made construction loans without consideration of sources of repayment other than the project being funded "frequently enough to warrant notice." Approximately 5 percent did so "commonly or as standard procedure."
- In addition, 16 percent had required alternative sources of repayment but failed to verify the quality of these sources "frequently enough to warrant notice"; an additional 5 percent "commonly" failed to verify the quality of these sources.
- Fourteen percent of the banks funded, or deferred, interest payments during the loan term

### Key Construction Loan Practices

PERCENT OF RESPONSES RECEIVED: 10/97 - 3/98



"frequently enough to warrant notice"; an additional 7 percent did so "commonly or as standard procedure."

Each of these proportions was up substantially from the period a year earlier.

## *Home Equity Loans.*

Of the banks examined during the reporting period, 14 percent were actively making home equity loans. As with lending in the other major loan types, examiners noted a troubling trend.

- Fifteen percent of the 168 banks actively making home equity loans calculated the equity on the basis of recent escalation in home prices "frequently enough to warrant notice." Another 1 percent did so "commonly or as standard procedure." These proportions—higher than during the period a year earlier—probably reflect the recent escalation in home prices.

## *Credit Card Loans.*

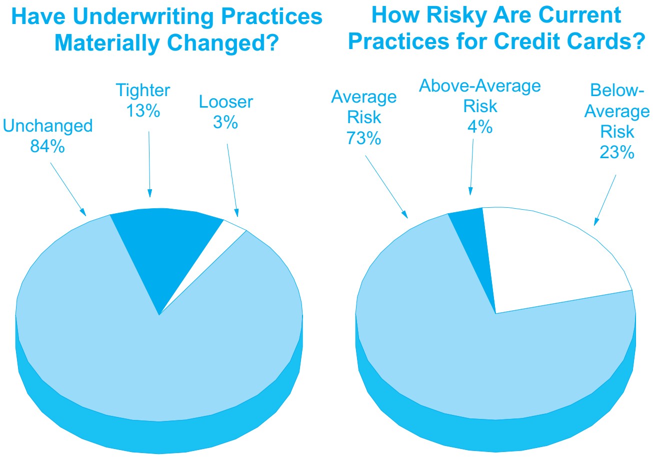
Slightly more than 6 percent (or 77 banks) were active in credit card lending. Of these, 5 are credit card specialty banks (according to examiners, all of these banks showed "average" risk in current underwriting practices for new credit card loans). The 72 remaining banks are not major players in credit card lending, holding slightly more than 1 percent of their total assets, on average, in such credits.

- Of the 77 banks that were active in credit card loans, 84 percent showed unchanged underwriting practices for new credit card lending, 13 percent (10 banks) showed tighter practices, and 3 percent (2 banks) showed looser practices. Interestingly, the proportion showing tighter practices was substantially above what it was in the period a year earlier, while the proportion with loosening standards was unchanged.

- Of the banks examined, 96 percent showed "average" or "below-average" risk in underwriting practices for new credit card loans—unchanged from the period a year earlier.

**Current Credit Card Underwriting Practices**

**PERCENT OF RESPONSES RECEIVED: 10/97 - 3/98**



**Have Underwriting Practices Materially Changed?**

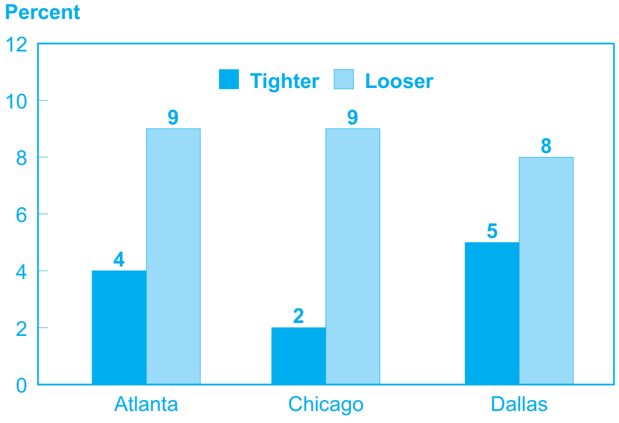
**How Risky Are Current Practices for Credit Cards?**

## *REGIONAL DIFFERENCES: GENERAL UNDERWRITING TRENDS*

In three of the eight FDIC regions, responses indicated that the proportion of banks with looser underwriting standards since the previous examination was larger than the proportion with tighter standards. Of the 134 banks examined in the Atlanta region, the figures were 9 percent (looser) and 4 percent (tighter). Of the 202 banks examined in the Chicago region, the figures were a little more than 9 percent (looser) and about 2 percent (tighter). Finally, in the Dallas region, 130 banks were examined and 8 percent had loosened their standards while 5 percent had tightened them.

**FDIC Regions with Looser Underwriting Practices Since the Last Examination**

**PERCENT OF RESPONSES RECEIVED: 10/97 - 3/98**



## Characteristics of the Banks Examined in the Examination Supplement on Current Underwriting Standards

- Coverage: 1,212 FDIC-supervised depository banks.
- Period: Reports filed between October 1, 1997, and March 31, 1998.
- Charter types: state-chartered commercial banks, 93 percent; state-chartered savings banks, 7 percent; branches of foreign banks on U.S. soil, less than 1 percent (4 banks).
- Size distribution of banks: assets of $1 billion or greater, 3 percent; assets between $300 million and $1 billion, 7 percent; assets between $25 million and $300 million, 72 percent; assets less than $25 million, 17 percent.
- Proportion of all FDIC-supervised banks (as of December 31, 1997): 22 percent of assets and 20 percent of the number of banks.

## Objectives of the Report on Underwriting Practices

- To identify (1) material changes in underwriting standards since the previous examination, (2) overall risk in new lending practices, and (3) 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.