Report on Underwriting Practices

Federal Deposit Insurance Corporation Donald E. Powell, Chairman

APRIL 2002 THROUGH SEPTEMBER 2002

INTRODUCTION

This *Report on Underwriting Practices* covers the responses submitted during the six months beginning April 1, 2002, and ending September 30, 2002. The number of responses received was 1,201—approximately 22 percent of the number and 29 percent of the assets of all FDIC-supervised banks.

HIGHLIGHTS

- *For the six months ending September 30, 2002, compared with the previous six-month period, examiners noted a small increase in the proportion of banks with medium or high credit risk in their loan portfolios. This continues a trend that started during the period ending September 30, 2001.*
- *For major loan categories, the most notable changes were increases in the risks for underwriting practices in both agricultural and construction lending.*

General Underwriting Trends

Occurrences of risky underwriting practices and the level of overall credit risk either increased or remained the same in the following categories:

- The proportion of banks with medium or high *potential credit risk in their* ***loan portfolios*** inched up from 40 percent to 41 percent.
- The proportion of banks with medium or high *risk in* ***current underwriting practices*** remained the same: 39 percent.
- The proportion of banks that either "frequently" or "commonly"[1] made *loans that resulted in—or contributed to—**concentrations of credit to one borrower or to one industry*** rose from 23 percent to 26 percent.
- The proportion of banks that either "frequently" or "commonly" ***engaged in out-of-area financing*** remained the same: 14 percent.

Occurrences of risky underwriting practices decreased in the following categories:

- The proportion of banks that either "frequently" or "commonly" made *loans in which the bank **failed to adjust loan pricing on different-quality loans to reflect differences in risk*** decreased from 13 percent to 11 percent.
- The proportion of banks that either "frequently" or "commonly" made *loans in which the bank **failed to require a material principal reduction before renewing loans*** edged down from 25 percent to 24 percent.
- The proportion of banks that either "frequently" or "commonly" made *loans in which **actual practices differed from written lending policies*** decreased from 22 percent to 20 percent.

Examiners indicated that 10 percent of FDIC-supervised banks showed a material change in underwriting practices since the previous examination—6 percent had tightened their underwriting practices and 4 percent had loosened them.

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[1] Actual responses are "frequently enough to warrant notice" or, if the risky practice is used more often, "commonly or as standard procedure." See "Purpose and Design of the Report" for definitions of terms.

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Individual Loan Categories

- For banks active in agricultural lending, the proportion of banks showing a "moderate" increase *in the bank's level of **agricultural related carryover debt** since the previous examination* rose from 23 percent to 26 percent.
- The proportion of banks active in agricultural lending that either "frequently" or "commonly" *made loans on the basis of **land values that are not supported by farm operations*** increased from 14 percent to 16 percent.
- The proportion of banks active in construction lending that either "frequently" or "commonly" made ***speculative loans for residential construction projects***[2] increased from 26 percent to 29 percent.
- The proportion of banks active in construction lending that either "frequently" or "commonly" made *loans in which the bank failed to use **realistic appraisal values** relative to the current economic environment and/or to the performance observed on similar credits* increased from 12 percent to 14 percent.
- For banks actively making commercial real estate loans, the proportion of banks that either "frequently" or "commonly" made *commercial real estate loans **without consideration of repayment sources other than the project being funded*** rose from 11 percent to 13 percent.
- The proportion of banks actively making business loans that either "frequently" or "commonly" made *loans to borrowers **who lacked documented financial strength to support such lending*** declined from 23 percent to 21 percent.
- The proportion of banks actively making consumer loans that either "frequently" or "commonly" made loans to ***borrowers who lacked a demonstrable ability to repay*** decreased from 21 percent to 18 percent.

PURPOSE AND DESIGN OF THE REPORT

In early 1995, the FDIC began to require that a supplementary examination questionnaire on current underwriting practices at FDIC-supervised banks be filled out at the end of each FDIC-supervised bank examination. The questionnaire focuses on three topics: material changes in underwriting practices for new loans, the overall degree of risk in underwriting practices for new loans, and the frequency of specific risks in underwriting practices within major categories of loans (business, consumer, commercial real estate, agricultural, construction, home equity, and credit card loans). Examiners are also asked to report whether the institution is active in additional loan categories (unguaranteed portions of Small Business Administration loans, subprime loans, dealer paper loans, low-/no-document business loans, high loan-to-value ratio home equity loans, or any category of loan not mentioned). The systematic collection and analysis of questionnaire responses provides an early-warning mechanism for identifying potential lending problems.

Examiners evaluate underwriting practices in terms of FDIC supervisory practices. **Until October 1, 1998**, examiners were asked to rate the risk associated with a bank's underwriting practices in relative terms: "above average," "average," or "below average." **Beginning October 1, 1998**, examiners began rating the risk associated with a bank's underwriting practices in absolute terms: "low," "medium," or "high."[3] New questions about underwriting practices were also added to the questionnaire. Examiners continue to classify the frequency

[2] Projects without meaningful pre-sale, pre-lease, or take-out commitments.

[3] **Low:** The level of risk imposed on the institution does not warrant notice by bank supervisors even when factors that might offset the risk are ignored. **Medium:** The level of risk should be brought to the attention of bank supervisors. There may or may not be factors that offset the risk imposed on the institution; however, the level of risk raises concerns when considered apart from these offsetting factors. **High:** The level of risk is high and therefore should be brought to the immediate attention of bank supervisors. There may or may not be factors that offset the risk imposed on the institution; however, the level of risk is high when viewed in isolation.

of specific risky underwriting practices as "never or infrequently," "frequently enough to warrant notice," or, if the risky practice is used more often, "commonly or as standard procedure."[4]

The questionnaire is completed at the end of each bank examination the FDIC conducts. Which banks are included during a reporting period, therefore, depends on how the FDIC schedules bank examinations. Examination schedules are heavily influenced by the financial condition of a bank, with the examinations generally becoming more frequent the poorer a bank's financial condition. In addition, the FDIC shares examination authority of state-chartered nonmember banks (those that are not members of the Federal Reserve System) with state bank regulators. To avoid excessive regulatory burden, the FDIC generally alternates examinations with state regulators, and the latter do not fill out 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.

To address the potential bias that examination scheduling might introduce into the report's results, we statistically weight 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 "underrepresented" in the questionnaire (when compared with the population of FDIC-supervised banks) and less weight to "overrepresented" groups.[5] Although these weightings cannot remove all potential bias, they do allow for more meaningful comparisons of results over time. Nevertheless, we advise readers to interpret trends cautiously, for two reasons: (1) the lack of random selection of banks for examination, as noted above, and (2) the small number of responses for some loan categories.

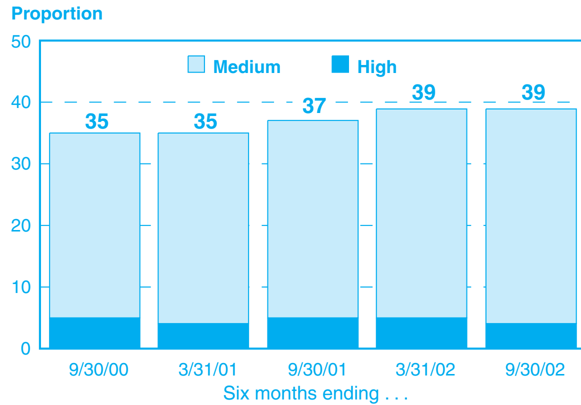
Throughout this report, the proportions presented refer to these weighted responses and are estimates of the underwriting practices of *all* FDIC-supervised banks in the region. In addition, the data used to weight responses in this report are subject to slight revisions, so some of the weighted proportions might be revised in subsequent reports. We expect no substantive changes, however.

[4] **Never or infrequently:** The institution does not engage in the practice, or does so only to an extent that does not warrant notice by bank supervisors. **Frequently enough to warrant notice:** The institution engages in the practice often enough for it to be brought to the attention of bank supervisors. There may or may not be factors that offset the risks the practice imposes on the institution. **Commonly or as standard procedure:** The practice is either common or standard at the institution and therefore should be brought to the attention of bank supervisors. There may or may not be factors that offset the risks the practice imposes on the institution.

[5] Anyone who wishes more information about the weights should contact Virginia Olin, DIR, 202/898-8711.

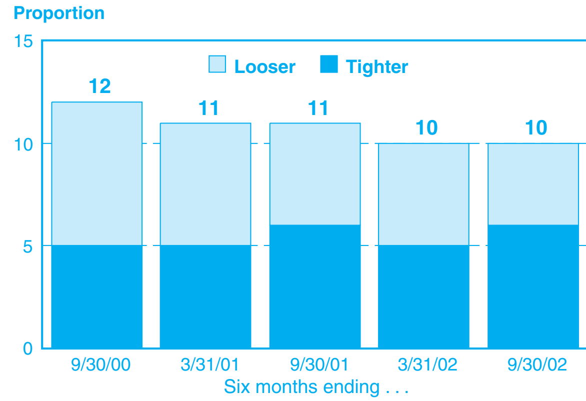
SELECTED CHARTS

Proportion of FDIC-Supervised Banks with "Medium" or "High" Risk Associated with Current Underwriting Practices



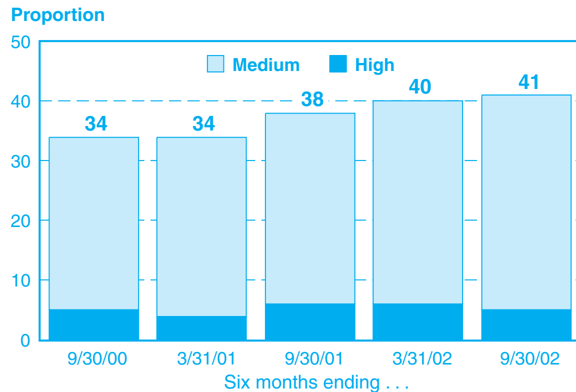
Note: The percentages in the chart may not correspond to the percentages in the table because of rounding.

Proportion of FDIC-Supervised Banks that Materially Changed Underwriting Practices since the Previous Examination, by Direction of Change



Note: The percentages in the chart may not correspond to the percentages in the table because of rounding.

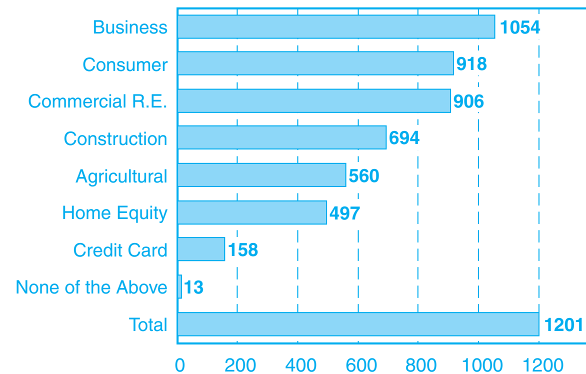
Proportion of FDIC-Supervised Banks with "Medium" or "High" Credit Risk in Their Overall Loan Portfolios



Note: The percentages in the chart may not correspond to the percentages in the table because of rounding.

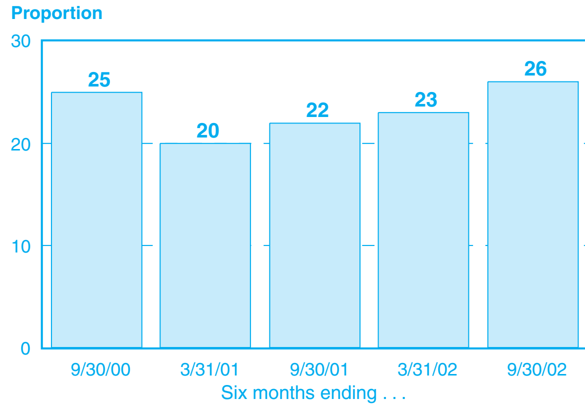
Number of FDIC-Supervised Banks Actively Making Loans, by Loan Type

Responses Received 4/1/02–9/30/02



Agricultural Loans

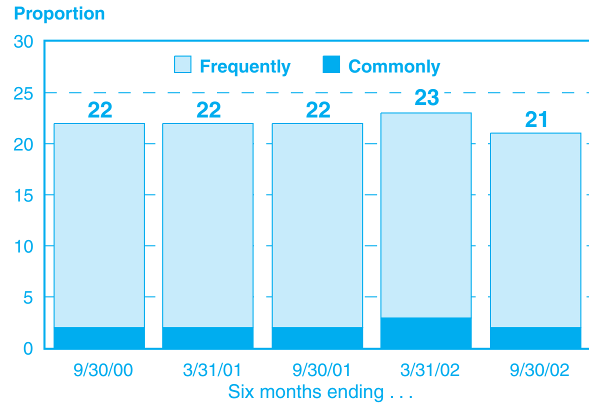
Proportion of FDIC-Supervised Banks Showing a "Moderate" Increase in Carryover Debt



Business Loans

Loans Made to Borrowers Who Lacked Documented Financial Strength to Support Such Lending

(Proportion of FDIC-supervised banks making such loans either "frequently" or "commonly")

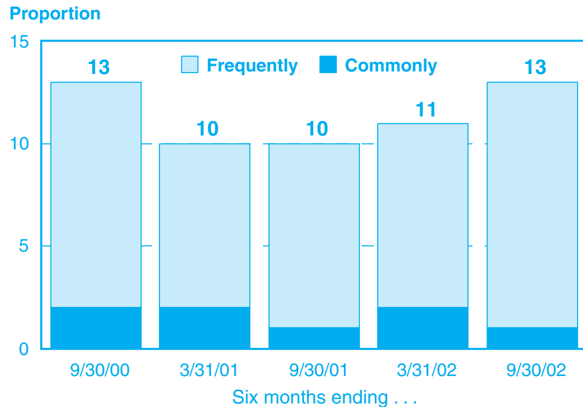


Note: The percentages in the chart may not correspond to the percentages in the table because of rounding.

Commercial Real Estate

Loans Made without Consideration of Repayment Sources Other than the Project Being Funded

(Proportion of FDIC-supervised banks making such loans either "frequently" or "commonly")

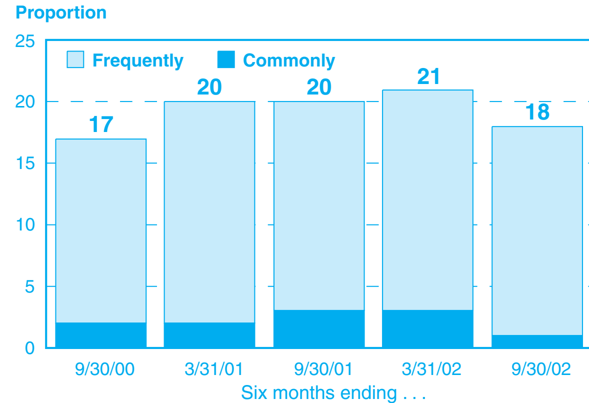


Note: The percentages in the chart may not correspond to the percentages in the table because of rounding.

Consumer Loans

Loans Made to Borrowers Who Lacked Demonstrable Ability to Repay

(Proportion of FDIC-supervised banks making such loans either "frequently" or "commonly")



Note: The percentages in the chart may not correspond to the percentages in the table because of rounding.

TABULAR RESULTS FROM THE REPORT ON UNDERWRITING PRACTICES

Percent of Respondents

		(Weighted) Six-Month Period Ending: 9/00	3/01	9/01	3/02	9/02
GENERAL UNDERWRITING PRACTICES						
Have the institution's underwriting practices materially changed since the last examination:	Yes	11.6	11.6	10.8	9.2	10.4
	No	88.4	88.4	89.2	90.8	89.6
If practices have materially changed, are they:[1]	Substantially tighter	1.4	1.2	1.5	0.8	1.8
	Moderately tighter	3.6	3.9	4.5	3.8	4.5
	Moderately looser	4.7	5.2	3.3	2.7	2.7
	Substantially looser	1.8	1.2	1.6	1.9	1.5
How would you characterize the risk associated with loan growth and/or significant changes in lending activities since the last examination:	Low	52.5	51.3	49.8	52.0	54.6
	Medium	29.3	31.2	31.8	30.6	30.5
	High	4.8	3.3	4.4	4.8	3.5
	Insignificant	13.4	14.2	14.1	12.6	11.4
RISK IN CURRENT PRACTICES						
How would you characterize the potential risk associated with the institution's current UW practices:	Low	65.3	64.7	63.3	60.7	61.2
	Medium	30.2	31.2	31.8	33.8	35.0
	High	4.6	4.2	4.9	5.5	3.8
How would you characterize the potential credit risk of the institution's overall loan portfolio:	Low	66.1	65.6	62.6	59.6	59.1
	Medium	29.1	30.1	31.8	34.2	35.7
	High	4.7	4.3	5.6	6.2	5.2
How would you characterize the potential risk in underwriting practices associated with loan participations purchased by the institution:	Low	78.8	74.5	76.2	73.1	73.0
	Medium	19.2	23.6	22.4	25.7	25.3
	High	2.1	2.0	1.4	1.2	1.6
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	77.0	79.4	76.9	76.9	74.5
	Frequently enough to warrant notice	16.3	14.3	15.5	15.6	19.3
	Commonly or standard procedure	6.7	6.4	7.6	7.5	6.2
To what extent is the institution currently engaged in out-of-area financing:	Never or infrequently	85.9	84.6	85.1	86.4	86.2
	Frequently enough to warrant notice	11.3	12.7	13.0	10.5	12.0
	Commonly or standard procedure	2.9	2.7	1.9	3.1	1.8
How would you characterize the risk associated with loan administration:	Low	62.1	63.4	60.0	58.4	61.4
	Medium	32.3	31.0	34.0	35.5	33.8
	High	5.6	5.6	6.0	6.1	4.8
To what degree does the institution fail to adjust its loan pricing on different quality loans to reflect differences in risk:[2]	Never or infrequently	87.6	87.6	89.6	87.3	88.7
	Frequently enough to warrant notice	10.2	10.0	8.1	10.3	9.6
	Commonly or standard procedure	2.3	2.4	2.3	2.4	1.7
To what extent does the institution fail to require a material principal reduction before renewing term loans:[2]	Never or infrequently	77.4	78.6	76.2	75.1	76.0
	Frequently enough to warrant notice	19.3	18.8	19.8	21.5	21.3
	Commonly or standard procedure	3.3	2.7	4.0	3.4	2.8
To what extent do the institution's written lending policies differ from actual practices:	Never or infrequently	74.1	77.6	77.0	77.6	80.5
	Frequently enough to warrant notice	22.2	18.7	20.0	18.8	16.6
	Commonly or standard procedure	3.7	3.7	2.9	3.6	2.9
BUSINESS LOANS						
To what extent does the institution make business loans without a clear and reasonably predictable repayment source:	Never or infrequently	85.1	86.4	84.5	84.8	85.8
	Frequently enough to warrant notice	13.8	12.4	14.2	12.6	12.4
	Commonly or standard procedure	1.1	1.2	1.4	2.6	1.8
To what extent does the institution make business loans to borrowers who lack documented financial strength to support such lending:	Never or infrequently	77.9	78.4	77.9	77.0	79.6
	Frequently enough to warrant notice	20.2	19.8	20.2	20.2	18.8
	Commonly or standard procedure	1.9	1.8	1.9	2.8	1.6
With respect to asset-based business loans, to what extent does the institution fail to monitor collateral:	Never or infrequently	79.2	80.0	77.1	76.0	77.5
	Frequently enough to warrant notice	19.4	16.8	19.1	21.8	20.1
	Commonly or standard procedure	1.4	3.2	3.8	2.2	2.4
CONSTRUCTION LOANS						
To what extent is the institution funding residential construction projects on a speculative basis (i.e., without meaningful pre-sale, pre-lease or take-out commitments):	Never or infrequently	NA	NA	NA	73.6	71.3
	Frequently enough to warrant notice	NA	NA	NA	20.9	22.8
	Commonly or standard procedure	NA	NA	NA	5.5	5.9
To what extent is the institution funding commercial real estate development projects on a speculative basis (i.e., without meaningful pre-sale, pre-lease or take-out commitments):	Never or infrequently	NA	NA	NA	87.4	85.9
	Frequently enough to warrant notice	NA	NA	NA	11.6	12.2
	Commonly or standard procedure	NA	NA	NA	1.0	1.9
To what extent are construction loans made without consideration of repayment sources other than the project being funded:	Never or infrequently	87.4	86.7	87.4	88.5	88.2
	Frequently enough to warrant notice	10.7	10.8	10.6	10.3	10.2
	Commonly or standard procedure	2.0	2.5	2.0	1.2	1.6
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	87.5	87.4	86.9	87.3	84.8
	Frequently enough to warrant notice	10.6	10.5	10.8	10.9	13.0
	Commonly or standard procedure	1.9	2.1	2.3	1.8	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	87.7	88.3	88.2	88.5	86.3
	Frequently enough to warrant notice	10.8	10.6	10.2	10.9	12.8
	Commonly or standard procedure	1.5	1.1	1.6	0.6	0.8

[1] Prior to October 1, 1998, responses were either "tighter" or "looser."
[2] Prior to October 1998, responses were "rarely," "to some degree," or "commonly."

TABULAR RESULTS FROM THE REPORT ON UNDERWRITING PRACTICES

Percent of Respondents

		Weighted Six-Month Period Ending:				
		9/00	3/01	9/01	3/02	9/02
CONSTRUCTION LOANS *(cont.)*						
To what extent does the institution fund, or defer, interest payments during the term of its commercial construction loans:	Never or infrequently	85.2	83.5	85.2	80.4	81.0
	Frequently enough to warrant notice	9.6	8.8	8.9	11.2	11.2
	Commonly or standard procedure	5.2	7.8	5.9	8.4	7.9
To what extent does the institution fund 100% of the cost of construction and land, with no cash equity on the part of the borrower/developer:	Never or infrequently	87.7	87.5	87.8	87.0	87.8
	Frequently enough to warrant notice	11.0	8.8	9.5	10.8	10.9
	Commonly or standard procedure	1.4	3.8	2.7	2.2	1.3
NONRESIDENTIAL LOANS						
To what extent are commercial real estate loans made without consideration of repayment sources other than the project being funded:	Never or infrequently	87.7	90.3	89.9	88.9	87.4
	Frequently enough to warrant notice	10.6	8.2	8.8	9.5	11.6
	Commonly or standard procedure	1.7	1.5	1.3	1.6	1.0
To what extent does the institution make interest-only, extended amortization, or negative amortization permanent commercial real estate loans:	Never or infrequently	92.5	94.0	93.2	92.2	91.1
	Frequently enough to warrant notice	6.8	5.1	6.0	7.4	8.3
	Commonly or standard procedure	0.7	0.9	0.8	0.3	0.6
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	82.2	84.8	86.4	82.4	82.9
	Frequently enough to warrant notice	15.0	11.4	11.2	14.1	14.0
	Commonly or standard procedure	2.9	3.8	2.4	3.5	3.1
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	88.7	90.9	90.7	89.4	90.1
	Frequently enough to warrant notice	10.1	8.5	8.4	9.9	9.1
	Commonly or standard procedure	1.2	0.6	0.9	0.7	0.8
HOME EQUITY LOANS						
To what extent does the institution make home equity loans that push mortgage indebtedness above 90 percent of collateral value:	Never or infrequently	86.6	90.5	88.8	89.3	88.3
	Frequently enough to warrant notice	9.9	7.7	10.3	10.0	10.1
	Commonly or standard procedure	3.5	1.8	0.9	0.8	1.6
To what extent does the institution qualify borrowers for home equity credit based on initially-discounted loan rates:	Never or infrequently	97.3	98.7	98.4	98.7	98.0
	Frequently enough to warrant notice	2.1	1.1	1.6	0.6	1.4
	Commonly or standard procedure	0.7	0.2	0.0	0.7	0.6
AGRICULTURAL LOANS						
To what extent does the institution make agricultural loans on the basis of land values that cannot be supported by farm operations:	Never or infrequently	87.3	90.1	85.5	86.4	84.5
	Frequently enough to warrant notice	11.6	8.0	13.2	12.0	14.9
	Commonly or standard procedure	1.1	2.0	1.3	1.7	0.6
To what extent are agricultural loans being made based on unrealistic cash flow projections:	Never or infrequently	89.5	88.8	84.8	86.4	86.5
	Frequently enough to warrant notice	9.8	9.8	13.6	12.0	12.3
	Commonly or standard procedure	0.7	1.4	1.6	1.6	1.3
How would you characterize the change in the level of the institution's agricultural related carryover debt since the last examination:	Sharp decline	1.9	1.6	1.5	2.0	1.1
	Moderate decline	13.7	14.0	11.9	9.4	10.2
	No change	58.4	63.4	63.2	64.1	60.7
	Moderate increase	25.1	19.7	21.9	22.6	26.3
	Sharp increase	1.0	1.3	1.5	1.8	1.7
CONSUMER LOANS						
To what extent does the institution make 'secured' consumer loans without adequate collateral protection:	Never or infrequently	86.3	85.4	85.5	83.4	84.7
	Frequently enough to warrant notice	11.9	13.1	12.0	14.2	13.9
	Commonly or standard procedure	1.8	1.6	2.6	2.5	1.4
To what extent does the institution make consumer loans to borrowers who lack demonstrable ability to repay:	Never or infrequently	82.4	80.0	80.0	79.1	81.6
	Frequently enough to warrant notice	15.4	17.5	16.8	18.0	17.0
	Commonly or standard procedure	2.2	2.4	3.2	3.0	1.4
CREDIT CARD LOANS						
Have the institution's underwriting practices for new credit card loans materially changed since the last examination:	Yes	2.1	2.5	5.2	6.4	6.0
	No	97.9	97.5	94.8	93.6	94.0
Are underwriting practices for new credit cards:[1]	Substantially tighter	1.2	1.4	1.1	0.6	2.2
	Moderately tighter	0.5	1.1	2.9	3.8	3.0
	Moderately looser	0.0	0.0	1.2	1.3	0.0
	Substantially looser	0.3	0.0	0.0	0.7	0.8
How would you characterize the level of risk associated with the institution's current underwriting practices for new credit card loans:	Low	78.5	77.7	79.2	74.5	72.6
	Medium	20.0	21.5	20.3	24.0	25.0
	High	1.5	0.9	0.5	1.5	2.4
How would you characterize the level of risk associated with the institution's credit card portfolio:	Low	78.3	75.5	77.2	74.2	73.0
	Medium	19.8	21.9	21.9	23.6	23.4
	High	1.8	2.7	0.9	2.2	3.6
For credit card loans in the institution's portfolio with risk characterized as high, to what degree does the institution fail to adjust its loan pricing to account for this risk:	Never or infrequently	60.0	74.7	50.0	80.8	48.9
	Frequently enough to warrant notice	40.0	0.0	50.0	0.0	0.0
	Commonly or standard procedure	0.0	25.3	0.0	19.2	51.1

[1] Prior to October 1, 1998, responses were either "tighter" or "looser."

Federal Deposit Insurance Corporation
Washington, DC 20429-9990

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Attention:
Chief Executive Officer

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

- Coverage: 1,201 FDIC-supervised banks.
- Period: Reports filed between April 1, 2002, and September 30, 2002.
- Charter types: 100 percent of the examined banks during this period were state-chartered commercial banks.
- Size distribution of banks: assets of $1 billion or greater, 5 percent; assets between $300 million and $1 billion, 14 percent; assets between $25 million and $300 million, 71 percent; assets less than $25 million, 10 percent.

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.