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The Level of Risk in Bank Portfolios Continues to Rise, OCC Reports in Annual Underwriting Survey

WASHINGTON -- The OCC's sixth annual Survey of Credit Underwriting Practices found that the level of credit risk embedded in bank portfolios continues to rise and that loan standards for very large syndicated loans have eased. The survey also found that standards for home equity lending have eased for the sixth consecutive year.

"We remain quite concerned about the high levels of 'embedded' credit risk on the books of some banks as a result of relaxed underwriting and risk selections in prior years," said John D. Hawke, Jr., Comptroller of the Currency. "We are also apprehensive about the continued growth of various types of highly-leveraged and sub-prime lending in the system, and the frequency with which these activities are being undertaken without adequate analysis and risk management systems at some banks."

Although there has been some modest tightening in standards for commercial loans, and standards for retail loans were essentially unchanged after some tightening last year, the embedded risk in portfolios remains high because of the higher level of risks that banks took on in previous years. "It takes time for risk to work its way through a loan portfolio," said David D. Gibbons, Deputy Comptroller for Credit Risk.

"This year's Shared National Credit results are confirming the higher risk that has been building in loan portfolios for some time," Mr. Gibbons said. Shared National Credits are loans of more than \$20 million shared by three or more banks. This is the second straight year that both the dollar volume and the percentage of problem credits have increased. Adversely rated -- classified and special mention -- shared credits went from \$45 billion in 1998 to \$100 billion in 2000 and the percent of these loans more than doubled from 2.5 percent in 1998 to 5.1 percent in 2000.

The OCC will continue bank examination efforts designed to identify and communicate the increased risks associated with loans with underwriting and other weaknesses to bank management and boards of directors. "These regulatory efforts have had the salutary effect of incrementally tightening standards more than they otherwise would have been tightened during this continued positive economy," Mr. Gibbons said. "However, the heightened risk in bank portfolios will not wane based on the modest tightening done to date." He cited trends in

underwriting and risk selection standards as characteristic of the competitive and earnings pressure facing banks today, and a strong leading indicator of potential credit problems.

The 2000 survey covered the 69 largest national banks with an aggregate loan portfolio of \$1.9 trillion, or 89 percent of national bank loans. The Office of the Comptroller of the Currency's senior examiners complete the survey. They are in charge of supervising their respective banks and are intimately familiar with the loan portfolios in those institutions.

The 2000 OCC survey found that:

- Underwriting standards for both commercial and retail loans exhibited less change than in prior surveys.
- While 25 percent of banks tightened commercial loan standards in both 1999 and 2000, 16 percent loosened standards in 2000 compared to 13 percent in 1999.
- Overall tightening was most evident in agricultural, asset-based, and small business lending, while easing resurfaced in the syndicated national and structured finance (leveraged lending) products.
- Several types of loans that comprise a significant portion of total credit exposure have experienced little or no tightening during the past six years. These include middle market, commercial real estate, syndicated/national loans, residential real estate loans, and conventional home equity products.
- For the fifth consecutive year, examiners reported that the level of inherent portfolio credit risk continued to increase. This was true for almost every lending product. Further, examiners expect credit risk to continue to increase over the next year.
- Examiners reported that the surveyed banks used pricing as their primary method to modify -- either tighten or ease -- commercial underwriting standards. The use of loan covenants was the second most used method to tighten standards.
- Standards for retail bank products were relatively more stable than for commercial products, with 41 percent of the banks making no change to their retail standards this year, compared to 27 percent in 1999.
- While competition and market strategy were the most frequent reasons given for easing underwriting standards, risk appetite and economic outlook were the primary reasons given for tightening standards.
- As loan portfolios continue to exhibit increasing risk, examiners have expressed growing concerns about the adequacy of credit risk management practices and infrastructures.

For a copy of the *2000 Survey of Credit Underwriting Practices*, write to: Office of the Comptroller of the Currency, Communications Division, Washington, DC 20219. A copy is also available on the OCC's web site: www.occ.treas.gov.

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The OCC charters, regulates and examines approximately 2,400 national banks and 58 federal branches of foreign banks in the U.S., accounting for more than 57 percent of the nation's banking assets. Its mission is to ensure a safe and sound and competitive national banking system that supports the citizens, communities and economy of the United States.